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Inside this issue:

Drafting Marital Settlement Agreements: The Term "Brown Formula" Is Not Always Equivalent to the Term "Time Rule" When Dividing Retirement Benefits

A judgment or marital settlement agreement should be as clear as possible to avoid subsequent disagreements between divorced spouses. The case of *In re Marriage of Gray*[1] shows that a judgment or marital settlement agreement that merely refers to the "Brown Formula" to divide community property retirement benefits is insufficient to require the court to apply the time rule formula to the division of community property retirement benefits. To be more exact, we advise that judgments and marital settlement agreements use the term "time rule" if the parties have agreed to divide the community property based "upon the number of years of service during marriage, on the one hand, and the number of years of service before marriage and after separation, on the other hand."[2]

In re Marriage of Gray involved two ex-spouses who entered an interlocutory judgment of dissolution of marriage in 1980 which provided that the "Court reserves jurisdiction over that certain IBEW Retirement Plan through [Husband's] employment until such time as benefits are due and payable, and at such time, the *Brown* Formula shall be applied."[3] The IBEW Retirement Plan was a defined benefit pension plan which provided for a monthly benefit beginning at Husband's attainment of retirement age.

In 2005, 25 years after entry of the judgment, Husband reached retirement age and filed a motion with the trial court requesting that his pension not be divided by application of the strict time rule, but "rather, by a modified time rule since years of service was not a substantial component in the calculation of his monthly benefit, that benefit having largely been derived as a percentage of yearly contributions based on hours worked." The trial court denied Husband's motion and ruled that the time rule should apply to the division of benefits because the previous judgment provided for application of the "Brown Formula" which the court found to be "synonymous with the 'time rule.'" *Id.* at 513.

Husband appealed, and the Court of Appeal for the Sixth District of California held that the trial court had abused its discretion by concluding that the previous judgment's reference to the "Brown Formula" required strict application of the time rule. The Court of Appeal specifically held that the trial court should have exercised its discretion to divide the pension benefit equitably because a reference to "Brown" only signified that "[Husband] and [Wife] agreed that the

Drafting Marital Settlement Agreements (cont'd)

pension rights which derived during their marriage, whether or not vested, were community property and that these rights were subject to later in-kind division, with the court retaining jurisdiction over the pension to later implement that division." In other words, the judgment's reference to the "Brown Formula" was not dispositive on the issue, and the case was remanded back to the trial court with direction that the trial court was to exercise its discretion to divide the retirement benefits equitably.

Wife ultimately learned the hard way that "Brown Formula" is not enough to connote division of defined benefit pension plan benefits pursuant to the "time rule."

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When Should Parties Apply a Formula Other Than the Time Rule When Dividing Defined Benefit Pension Plans?

In addition to providing a guideline for drafting marital settlement agreements, *In re Marriage of Gray* reminds divorcing spouses that the time rule is not always the most appropriate method of division for a defined benefit pension plan. The Court of Appeal remanded the case back to the trial court to determine whether the time rule or some other formula should divide a defined benefit pension plan. The Court of Appeal did admit, however, that "today, although the court has discretion to choose among apportionment methods, the time rule is the most frequently employed method of dividing pension benefits. According to our Supreme Court, its use 'is not unreasonable when the "amount of retirement benefits is substantially related to the number of years of service""" *Lehman*, 955 P.2d 451.

Although the time rule formula is the most common formula for dividing defined benefit pension plans, an understanding of the benefit formula for each particular defined benefit pension plan is necessary in order to determine whether a different formula should be applied. In *Poppe*, 97 Cal.App.3d at 8-9, the court stated that application of a strict time rule is inappropriate where service points rather than years of service determine the benefit amount. The Supreme Court in *Lehman* further acknowledged that the time rule's result was "unreasonable when the 'relative contributions of the community and separate estates' are accounted for." *Lehman*.

Based on the above, we advise that before entering into a judgment or marital settlement agreement, divorcing spouses should consider the particular benefit formula used in each defined benefit pension plan in order to determine whether the retirement benefits are substantially related to the number of years of service with the employer.

[1] *In re the Marriage of Gray* (C.A. 6th, 2007) 155 Cal.App.4th 504.
[2] See *In re Marriage of Freiberg* (1976) 57 Cal.App.3d 304, 310.
3*In re Marriage of Gray*, *supra*, at 510.

Employee Stock Ownership Plans (ESOPs) Can Provide Liquidity to Facilitate Division of a Community Property Business

A community owned business can be one of the largest community property assets that spouses must divide upon divorce. Unfortunately, a community owned business can also be the most complicated asset to divide when other assets of the community are not sufficiently liquid to allow for a "cash out." Divorcing spouses should be aware that there are a variety of options available to help create liquidity in community owned businesses, especially during an economic slump.

One technique often overlooked by divorcing spouses is the use of an Employee Stock Ownership Plan (ESOP) to acquire the community interest in a business. An ESOP is a unique type of qualified retirement plan that can own stock of the corporation that sponsors the ESOP. In other words, the ESOP itself becomes part owner of the corporation. To accomplish this ownership structure, the ESOP is permitted to buy stock from a related party (such as the shareholders of the corporation). Most other types of qualified retirement plan transactions that involve company stock are deemed "prohibited transactions" under the Internal Revenue Code and the Employee Retirement Income Security Act (ERISA); therefore, an ESOP presents a distinct advantage.

Furthermore, an ESOP stock transaction can be accomplished by using a promissory note financed by the selling shareholder or by using a loan obtained from a bank. The benefit of a financed transaction is that the ESOP can pay for the stock with "pre-tax" dollars as opposed to the normal stock repurchase arrangement between spouses which would require one spouse to generally use "after-tax" dollars for the purpose of buying out the former spouse's interest in the stock. Essentially the U.S. government is subsidizing the cost of the buy-out through use of tax deductible payments.

Under certain circumstances, the spouse receiving the proceeds from the sale of his or her stock may be able to reinvest the sale proceeds and defer the payment of income tax which would normally be due on the sale. Thus, the use of an ESOP can provide significant tax-related benefits to both spouses:

- the spouse acquiring the former spouse's interest by use of an ESOP can redeem that interest with pre-tax dollars; and
- the spouse selling their interest may be able to defer the payment of the tax related to the sale of their community interest in the stock.

Although ESOPs do not fit every circumstance, ESOPs are a flexible mechanism which may work well in a number of family law related business division circumstances. Upon request, we can provide more information on the use of an ESOP in a dissolution situation.

The ESOP can use "pre-tax" dollars to cash out a community property interest in a family-owned corporation.

Ninth Circuit Rules Plan Did Not Abuse Discretion in Denying Former Spouse Survivor Benefits

On July 13, 2009, the Ninth Circuit ruled that a plan administrator did not abuse its discretion in denying survivor benefits to a former spouse in favor of the current spouse when the former spouse thought that her designation as the participant's surviving spouse on the beneficiary designation was irrevocable. *Sznewajs v. Bancorp*, No. 07-16489. The opinion of the Ninth Circuit confirms that a marital settlement agreement or divorce decree alone is insufficient to ensure survivor benefits are paid to a former spouse after the divorce is final. This case also illustrates that divorcing persons expose themselves to significant risk by failing to enter a qualified domestic relations order simultaneously with the divorce decree.

The Ninth Circuit opinion serves as a reminder that the only appropriate method of guaranteeing a former spouse's rights to survivor benefits under a Plan is to enter a qualified domestic relations order.

Robert Sznewajs was an executive of U.S. Bancorp and was covered by the corporation's top hat plan (the "Plan"). Robert resigned from Bancorp in December 1999 at age 53. At the time that Robert resigned, he was married to Franciene Sznewajs. In February 2001, Robert and Franciene were divorced. Pursuant to the divorce decree, Franciene was entitled to 50 percent of any annuity payments Robert received under the Plan.

Upon his termination of employment, Robert selected a joint and survivor annuity under which Robert would receive a monthly benefit during his lifetime and he designated his spouse (without naming her specifically by name) as survivor would to a monthly annuity for her remaining lifetime. The Plan further provided that after retirement, "[e]xcept for the death of the survivor the Participant shall have no power to name a new survivor." *Id*. at 2.

It appears from the facts of the case that Franciene assumed that she would be the designated survivor under the Plan because she was married to Robert when he left employment with Bancorp and because he was not permitted under the Plan to change his designated survivor. Therefore, Franciene did not enter a qualified domestic relations order.

Robert subsequently remarried, began receiving his benefits from the Plan, and then passed away.

Franciene filed a claim with the Plan for payment of the survivor benefits stating she was the spouse at the time of his "retirement"; however, the Plan interpreted the term "retirement" to mean when Robert began receiving benefits rather than when Robert terminated employment with Bancorp, and because Robert was remarried when he began receiving benefits, Franciene was not the designated survivor. Franciene sued in Arizona state court, the Plan removed the case to federal court, and the district court ruled in favor of Franciene.

The Ninth Circuit, in reversing the district court's decision, determined that the Plan did not abuse its discretion in interpreting the term "retirement" to mean the date the benefits commenced rather than the date of Robert's termination of employment. The Ninth Circuit ruled that because the Plan had no financial incentive to pay benefits to the current spouse versus the former spouse, the Plan did not have a conflict of interest and, therefore, any interpretation of the plan document by the Plan would only be reviewed for abuse of discretion. Thus, the Ninth Circuit concluded that the Plan did not abuse its

Plan Did Not Abuse Discretion (cont'd)

discretion because the Plan's decision was "based upon a reasonable interpretation of the plan's terms" and "the decision was made in good faith." *Id.* at 5, citing to *McDaniel v. Chevron Corp.*, 203 F.3d 1099, 1118 (9th Cir. 2000).

The Ninth Circuit opinion serves as a reminder that the only appropriate method of guaranteeing a former spouse's rights to survivor benefits under a Plan is to enter a qualified domestic relations order. In *Sznewajs*, Franciene assumed that she was the designated survivor because she was married to Robert when he terminated employment and the Plan provided that Robert could not change the survivor designation.

As we noted in our February 24, 2009, newsletter covering the Supreme Court decision *Kennedy v. Plan Administrator for DuPont Savings and Investment Plan,* the courts have not ruled out the possibility that a former spouse such as Franciene could pursue her award of community property against the current spouse in a state court action. It is clear however, that in an action against a Plan under federal law, a divorce decree alone without a qualified domestic relations order will not guarantee the former spouse's entitlement to collect survivor benefits from an ERISA plan.

Based on the above, we advise that a qualified domestic relations order should be filed simultaneously with the divorce decree to guarantee benefits to a former spouse when the participant passes away.

A divorce decree alone will not guarantee survivor benefits.

Can a Nonparticipant Same Sex Married Partner Get a QDRO Directed Distribution from a Qualified Retirement Plan Upon Dissolution?

The question of whether same sex married couples have the right to a distribution from a retirement plan upon dissolution is becoming more and more common. We have received a few calls this year about whether same sex partners can file a QDRO to receive a distribution from a qualified retirement plan upon dissolution of the partnership. The answer is we do not know yet. However, if the nonemployee partner meets the definition of a "dependent" for tax purposes, it is possible under the *Owens v. Automotive Machinists Pension Trust* case that a same sex partner could get a distribution.

Earlier this year, in the case of *Owens v. Automotive Machinists Pension Trust*, 551 F.3d 1138 (9th Cir. 2009), the Ninth Circuit Court of Appeals affirmed the lower court's ruling that a quasi-marital partner is entitled to pension benefits pursuant to a QDRO. Norma and Phillip Owens lived together for 30 years but never married. The couple separated in 2004, and Norma sought half of Phillip's pension. Because a person must meet the definition of an Alternate Payee in order to receive a portion of benefits from a qualified retirement plan pursuant to a QDRO, Norma was denied the benefit. Internal Revenue

Although not recognized as a spouse or former spouse, the Ninth Circuit agreed with the lower court that Norma was a "dependent" who lived in the household with the taxpayer and, therefore, met the definition of an Alternate Payee.

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Butterfield Schechter◆LLP is San Diego County's largest law firm focusing its practice primarily on employee benefit plan matters. As part of our overall Employee Benefits/ERISA practice, our firm has significantly enjoyed working with a large number of local family law attorneys and their clients on QDRO, employee benefits plan, and ERISA related issues. We have extensive experience in:

- Analyzing and valuing the community property in retirement plans, including, but not limited to:
  - 401(k) Plans, Profit Sharing Plans
  - IRAs
  - traditional pension plans
  - stock option plans and other executive compensation plans
  - disability pensions and severance benefits
- Drafting QDROs to divide these benefits

If you have any questions regarding any of the items addressed herein, or any employee benefits plan or QDRO issue, please do not hesitate to contact us. We appreciate the opportunity to be of service to your clients in these areas.

For more information about Butterfield Schechter◆LLP and our attorneys, please visit us at www.bsllp.com.

QDROs for Same Sex Partners (cont'd)

Code section 414(p) defines Alternate Payee as a spouse, former spouse, child, or other dependent of the participant. Although not recognized as a spouse or former spouse, the Ninth Circuit agreed with the lower court that Norma was a "dependent" who lived in the household with the taxpayer and, therefore, met the definition of an Alternate Payee.

We have yet to see a case where a same sex married partner was a "dependent" for purposes of testing whether they too would be entitled to a distribution pursuant to a QDRO, but based on this case, it is possible that a same sex married partner who meets the definition of "dependent" might also be considered an Alternate Payee for the purpose of a distribution from a retirement plan upon dissolution of the partnership. For the definition of "dependent," see Internal Revenue Code section 152.

Continuing Health Benefit After Divorce: Failure to Notify the Plan Within 60 Days of the Divorce Will Terminate Former Spouse's Right to Health Benefits

Whether a former spouse is entitled to continued health coverage after divorce is a common topic amongst divorcing couples. Typically a former spouse can get coverage so long as the costs are paid and, as held in a case heard by the United States District Court for the Eastern District of Pennsylvania, so long as the health plan is properly notified of the "final" divorce.

COBRA (Consolidated Omnibus Budget Reconciliation Act), which amended ERISA, requires welfare benefits plans to offer continuing coverage to qualified beneficiaries upon the occurrence of a "qualifying event" which includes a divorce. In *Ludwig v. Carpenters Health & Welfare Fund of Philadelphia & Vicinity*, 2009 WL 3014939 (E.D. Pa. 2009), Husband was a participant in the Carpenters Health & Welfare Fund of Philadelphia and Vicinity ("Plan"). COBRA required the Plan to offer continuing coverage to Wife after the divorce. However, COBRA requires that the employee or former spouse notify the administrator of the Plan within 60 days after the qualifying event [divorce], coverage under COBRA was denied to Wife because they had failed to notify the Plan within the required time period.

Wife argued that the Plan was on notice of the pending divorce because the Plan had responded to a request for information that was used to value Husband's assets during the divorce and, therefore, notification of the final divorce was unnecessary. The Court however found this argument unpersuasive and held that notification of a "pending divorce" was not a qualifying event under COBRA.

Lesson learned that notification of a "pending divorce" does not meet the definition of "divorce" under COBRA. Where continued coverage is an issue in a divorce, a practitioner should advise his or her client of the requirement to notify a plan within 60 days of the final divorce and perhaps even insert language into the MSA regarding who is required to notify the plan.