Retirement Accounts and Accidental Inheritance

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Americans currently hold more than $9 trillion in retirement savings accounts. Those accounts, together with the family home, are the principal source of wealth for most working and retired Americans. But when a retirement accountholder dies prior to exhausting retirement savings, what governs the distribution of the account? Most often, not the accountholder’s will or trust, but a one-page fill-in-the-blanks beneficiary designation form that the accountholder filled out, typically without advice of counsel, when she or he opened the account.

When accountholders fill out beneficiary designation forms, they are focused on starting a new job or beginning to save for retirement, not on estate planning. Accountholders generally open retirement accounts as tax-sheltered savings vehicles, not as substitute wills. Employees often establish 401(k) retirement accounts while doing the paperwork associated with accepting a first job, when succession is far from the employee’s mind. Similarly, people establish IRAs when starting a business or when arranging retirement. In each case, the participant is confronted with a “beneficiary designation form” as a matter of course, generally without counsel, and at a time when the employee is not focused on succession. Moreover, participants may not look again at those forms for decades; many will have no idea whom they designated as beneficiaries and no idea how to find out.

With surprising frequency, people neglect to change their beneficiary designations after experiencing major life changes. When a decedent neglects to change her will, the results need not be catastrophic; wills law provides a number of doctrinal rules that enable a court to distribute probate assets consistently with the decedent’s probable intent. For example, a court may be authorized to give spouses or children acquired or born after the will was executed a share of the testator’s estate. Most states have statutes automatically revoking will provisions in favor of an ex-spouse. These doctrines, however, do not uniformly apply to nonprobate assets such as retirement accounts, frustrating the likely intent of the accountholder.

Undoubtedly, many participants do not worry about these forms because they expect that they will subsequently prepare a will or revocable trust that disposes of all of their assets, including assets in any retirement plan. Others assume that they can change the beneficiary designation through other documents, such as prenuptial agreements or divorce decrees that incorporate property settlement agreements. But a number of states, by statute or case law, hold that a will, revocable trust, or other document purporting to dispose of retirement account proceeds—even if the instrument precisely identifies the account—is ineffective to dispose of

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1 For an in-depth exploration of the issues in this article, see Stewart E. Sterk and Melanie B. Leslie, Accidental Inheritance: Retirement Accounts and the Hidden Law of Succession, 89 N.Y.U L. Rev. 165 (2014).
those proceeds. Other states address the issue with vague standards that require resolution through costly litigation. The Employee Retirement Income Security Act (ERISA), which applies to 401(k) and other accounts established as part of employer-sponsored plans, prohibits accountholders from changing a beneficiary designation in any manner other than by executing a change of beneficiary form. Thus, even a clearly written divorce agreement stipulating that the ex-spouse relinquishes all rights to the employee spouse’s retirement funds is ineffective if the employee neglects to fill out a “change of beneficiary form.”

These rules are designed to protect the financial institution holding plan assets from liability for distributing the assets to the beneficiary designated by the participant. They are also designed, at least in theory, to make it easier for the designated beneficiaries to receive the assets as quickly as possible. But the result is that the assets often pass in accordance with a beneficiary designation that might have been executed decades earlier; neither the sponsor nor a court is entitled to consider explicit language in other documents, such as the accountholder’s will, revocable trust, or divorce agreement, that directs a different distribution of the account.

To make matters worse, the preprinted instructions on the beneficiary designation forms are not generally transparent. First, not a single one of the ten IRA forms we examined mentions or discusses the effect that a will, revocable trust, or other dispositive instrument might have on the designation made on the form; the same is true for nine of the ten 401(k) forms we studied. Second, five of the ten IRA forms are silent as to the consequences of failing to designate a beneficiary or making an ineffective designation, providing absolutely no notice to the accountholder about what that default distribution would be (nor do they signal the existence of a default distribution).

Third, the forms are woefully inadequate in explaining the potential consequences of divorce on a designation of the spouse as beneficiary. Fourth, all of the beneficiary designation forms require the accountholder to designate “primary” beneficiaries and either “contingent” or “secondary” beneficiaries. Most forms, but not all, explain that contingent or secondary beneficiaries will share in the account only “[i]f no primary beneficiary survives me.” Many of the forms, however, have room to designate only one, two, or three primary beneficiaries. These forms leave accountholders with three or four children in a quandary about how to fill in the forms, and may lead some to name children as “secondary” or “contingent” beneficiaries simply because the forms include additional spaces for such beneficiaries.

These problems might be tolerable if only the “one percent” established 401(k) and IRA accounts. They, at least, are likely to pay for the best legal advice available. But these retirement accounts, along with the family home, represent the principal asset of most working and retired Americans. In 2011, seventy-one percent of American households headed by a person born during the 1950s held assets in a defined-contribution plan, an IRA, or both. For many in this group, most of whom prepare beneficiary designation forms without the advice of counsel, the inadequacy of the current beneficiary designation system is a disaster waiting to happen.
Although the issues raised by inadequate beneficiary designations have already generated considerable litigation, that litigation represents only a taste of what is soon to come. Because these accounts have become staples of the legal landscape only recently, a relatively small percentage of current decedents have had the opportunity to accumulate account assets over the course of their entire working lives. This situation will change dramatically over the coming decade, however, leaving the families of deceased accountholders to bear the consequences of an inadequate beneficiary designation system.

Reform is critical. The financial intermediaries who currently draft beneficiary designation forms have little incentive to improve them because accountholders and employers are unlikely to choose providers based on the quality of their forms. Federal and state legislation is necessary to ensure that these assets are distributed consistently with accountholders’ intentions.