LITIGATION CONSULTING

COVID-19 and Divorce—Dealing with Financial Uncertainty in Marital "Portfolios" (Part I of II)

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COVID-19 is having a profound impact on our daily lives, provoking previously unimaginable changes in the way we work, conduct business, and interact. These changes have a direct impact on people's mental health, and many experts predict an increase in marital dissolutions in the coming months and years. Indeed, as of this writing, many family law professionals have already reported an uptick in divorce-related work.

At the same time, we believe that market and asset volatility, and the resulting economic uncertainty, has deterred many couples from initiating divorce proceedings. Investment and retirement account values sometimes change by several percentage points in a matter of hours, creating significant challenges for professionals assisting their clients in determining equitable distribution and spousal support. In part I of this two-part series, we suggest an alternative approach to equitable distribution calculations as well as an approach to asset management throughout a divorce proceeding that promotes value retention in the marital estate rather than immediate liquidation upon the division of property. Part II will provide examples, checklists, and other resources to assist practitioners who are dealing with these issues.

Three Guiding Concepts

Based on our experience assisting clients during this time, we have identified the following three concepts family law professionals should embrace:

1. **Update information frequently.** To understand assets, liabilities, and cash flow, credible financial information is imperative. Relying on outdated or inaccurate information is just as dangerous as not analyzing an asset's historical performance.
2. **Understand the volatility of asset classes.** Certain asset classes have been more volatile than others, but their relative volatility may change in the future. Assets in the equity markets have generally followed a V-shaped recovery, although the future of the equity markets is never certain. In contrast, commercial and residential real estate professionals, especially in certain locations, are concerned that the end of government stimulus programs and changes in consumer attitudes will have a negative impact on property and lease values.
3. **Research industry and economic implications.** The pandemic has impacted certain industries more severely than others, leading economists and other analysts to scrutinize industry and economic performance more closely than ever. As a result, a great deal of information is available to better inform users. The restaurant and hospitality industries have felt the greatest impact of the pandemic, forcing travel and dining operators to be as innovative as possible or face layoffs and closures. The full impact on the economy and other industries has not yet been fully realized.

Building on these concepts, we have developed the following list of issues and strategies for practitioners to consider when assisting marital dissolution clients with equitable distribution and support payments. This list is not exhaustive and is under continuing development. However, we believe that these and other considerations can help practitioners advise clients going through a divorce and relieve some anxiety regarding their finances.

- Relying on financial information that is more than 30 days old may lead to disadvantageous positions—unless an asset is being divided equally. Analyzing the impact of post-filing asset value changes as well as investment and business decisions on the marital estate is as important as a historical analysis leading up to the date of filing.

- Equity markets and consumer reactions may have created assets not easily identifiable by the layperson. These include, but are not limited to, passive and active losses and increased limits on interest deductions that can generate allowable write-offs and lessen potential tax liabilities.
- Assess business assets in comparison to competitors to determine if changes are due to uncontrollable market forces or self-interest. Some debt-laden businesses have suffered while others have been able to seek relief from government programs. Understanding the decisions made and their impact on certain assets will help you determine whether assets are being devalued to benefit one party or because of market forces.
- It is imperative, when assessing assets, to understand the client's current financial condition and future financial needs and goals. There may be opportunities to acquire assets at less than fair market value, which may align with longer term strategies.
- Real estate holdings have varying values and outlooks driven by the property's location, which may affect decisions by current and future tenants (residential or commercial). Depending on the business's location and the business climate, owners may need to project future values and their impact on the estate's value. Jacksonville, Florida, for example, has seen an increase in migration of greater than 10 percent, while New York City saw a greater-than-24-percent decrease in arrivals.[1]
- Individuals and businesses may have opportunities to refinance and obtain more favorable credit terms, which, in turn, increase the estate's net worth and improve cash flow available for support.
- Understand the short- and long-term effects of Economic Injury Disaster Loans (EIDL) and Paycheck Protection Program (PPP) loans on small businesses. These may include increased free cash flow and reduction in the weighted average cost of capital (WACC) due to low interest rates and potential forgiveness.
- Certain industries—such as hospitality, travel, and restaurants—are struggling more than others. Couples whose livelihoods are associated with these industries may need to consider layoffs, closures, and changes in lifestyle. According to a McKinsey & Company industry report, the manufacturing industry will take the longest time to recover from COVID-19, while the healthcare industry is projected to rebound in early 2021.[2]
- For many industries, the pandemic's financial impact has been minimal, and in some instances, performance has exceeded expectations. Determining whether the impact is attributable to market forces or owner involvement will affect equitable distribution in some cases.

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It is important for family law professionals to analyze credible information, assess the volatility of specific assets, understand clients' individual goals, and

1 George Anders, "So long big city! Handling a pandemic often means calling the movers," LinkedIn, September 23, 2020, https://www.linkedin.com/pulse/so-long-big-city-handling-pandemic-often-means-calling-george-anders/?published=t.

2 André Dua, Deepa Mahajan, Lucienne Oyer, and Sree Ramaswamy, "U.S. small-business recovery after the COVID-19 crisis," McKinsey & Company, July 7, 2020, https://www.mckinsey.com/industries/public-and-social-sector/our-insights/us-small-business-recovery-after-the-covid-19-crisis.

identify whether assets, liabilities, or cash flows are valued or presented in a manner that is detrimental to their clients' goals. Professionals should rely on credible market data, from multiple sources, to reconcile their conclusions and advise clients.

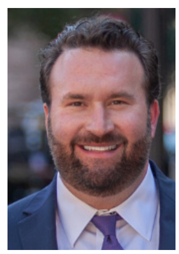
Alternative Approaches to Consider

Given the volatility and uncertainty of asset valuations, professionals and divorcing couples should consider alternatives to classic equitable distribution approaches. If a couple's goal is to preserve the value of the marital estate rather than subject it to immediate liquidation or division, there are techniques to consider. Equitable distribution pre-COVID-19 focused on values at a specific date with no or very little emphasis on asset values and the standards of value applied to them. In the current environment, practitioners should consider focusing on volatility and standards of value.

It is a common practice for financial professionals analyzing businesses to develop an understanding of asset types not for purposes of valuation on a specific date but rather to assess the business's ability to convert assets to capital or the potential impact of asset volatility on operations. This approach can also be used by marital litigants in negotiating a settlement (keeping in mind that in court the standard of value is dictated by state law). The first step is to evaluate and rank the volatility of various assets. Not only does this make the parties aware of the potential exposure of certain assets to market fluctuations (both positive and negative), but it also helps the professionals assisting them in understanding how specific assets align with their post-divorce financial plan. Armed with these volatility rankings, the next step is to value assets under different standards of value (e.g., fair market value, investment value, intrinsic value). This allows the professional to perform a risk assessment and to provide the couple with various scenarios to assist them in their future planning. After completing these exercises, many couples are surprised to learn which assets they truly "value" and the impact that certain asset selections can have on their longer term goals.

One idea that has recently received attention is allocating assets on the basis of percentages as opposed to values at a specific date. This allows the parties to share equally in the marital estate while being equally exposed to external market forces. For example, rather than distribute "fixed" assets (e.g., the marital home) to one spouse and "liquid" assets (e.g., investment accounts) to the other in roughly equal values, one might assign each spouse a specified percentage of each asset. This approach is not right for everyone and does not work for all assets. But for assets such as businesses or lease contracts, which face an uncertain future, it can protect both parties financially while alleviating many of the pressures of the litigation process (i.e., dueling experts).

No one could have predicted the impact of COVID-19 on so many facets of our lives. As a result, family law professionals—e.g., attorneys, accountants, valuation practitioners—need to consider alternatives to deal with and mitigate client concerns regarding asset values and uncertainty. This article provides some food for thought, but it is critical for professionals to be innovative in crafting solutions to address the current risks faced by marital litigants. VE



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