

Divorce Economics in the Time of COVID-19

July 17, 2023

By Bettina Hindin

Originally posted on 04/01/2020, content updated on 07/17/2023

“Nothing is more dangerous to [men or women] than a sudden change of fortune.”

– Quintilian ^[i]

Nostradamus could not have foreseen a darker economy and—we are told—the worst is yet to come. In the first week of April 2020, an excess of 3.3 million people have filed for unemployment benefits—a precipitous rise compared to the 832,000 filings of the week before.^[ii] A national survey showed one in five households in the United States had their income cut or stopped altogether.^[iii] At that point, more than 1,000 deaths in the United States had been attributed to the coronavirus, also known as COVID-19, and the numbers grew in the hundreds each day. Another economic crash was upon us. The economy was going down; but divorce rates were exploding.

As the economy faltered, divorce rates rose as self-imposed “sheltering-in-place” put additional stress on marriages already wavering on the edge of the divorce abyss. Couples who already could not bear another day together were confined in the same space 24/7. In New York City, that space can be inordinately small, yet extraordinarily expensive. In short, it is a “pressure cooker” about to explode. This author has already seen a rise in inquiries from couples who cannot bear to be together another moment.

But what of those couples who have already jumped into the quagmire of divorce, and now after months—even years—find themselves in their next and last stage—the financial battle?

What is to be done where barely one month ago there was a sizeable marital pot to carve up—and now all that exists are bare bones?

The financial hardship and instability that were caused by the pandemic and continued as a result thereof bore witness to incomes, assets and property values that had fallen and undoubtedly continued to drop dangerously.

Those previously enjoying high levels of income suffered drastic pay reductions, and the prospects of new employment for those unemployed or about to be unemployed vanished. Retirement expectations once buoyed by investment and retirement accounts in the seven figures have dropped in some cases by fifty percent or more.^[iv] Support expectations that could not reach the heights of pre-pandemic earnings and spending patterns were not only depressing but difficult for many to comprehend. Splitting debt rather than assets became the reality in many divorces. Trying economic times demand innovative

solutions for the unique problems confronting divorcing couples. Two houses demand more to maintain than one. Incurring considerable credit card debt or dipping into retirement funds early leads to inevitable havoc in both parties' current and long-term financial situations. The matrimonial practitioner is no longer merely the butcher responsible for carving up the fiscal carcass of the marriage; but now he/she must also be a new age philosopher enabling the client's adjustment from what is expected to what is achievable at least in the foreseeable future.

Once the Courts re-opened, they undoubtedly and inevitably found themselves in a myriad of "cases of first impression" when it came to the determination of what was an equitable distribution of marital assets that less than one month prior were flying high, but had reached an all-time low.

REAL PROPERTY

Divorce almost always means valuing, selling and buying houses or apartments. Historically, divorcing couples wrangled over the post-divorce ownership of the marital residence, the weekend home, or the Pied-a-Terre. Now they battle over who gets stuck with the current expenses of the asset as well as the future debt.^[vi]

The strong U.S. housing market plummeted from the pandemic, financing was questionable and selling and buying a house became much more difficult. ^[vi] Even if able to sell the family home, the value will likely be below expectations, or what was originally paid and put into the property. For spouses who have been unemployed for a significant period of time, getting financing for a new home will be more challenging than ever.

In the past, the most common solution with respect to the marital home was for one spouse to buy the other out. Typically, there were more than the necessary amounts of other assets so as to offset the purchase of the residence by one spouse with an allotting credit to the other vis-a-vie the reallocation of distributive awards or like/kind transfers. Often, where there was lacking in marital offset funds, or liquidity, it was not unheard of for a wealthy relative (a mother or father of one of the parties) to step forward and provide a low interest loan, or provide additional credit by co-signing or offering funds not obtainable from a bank or other lending institution. Those days are gone.

Now, the most common solution for the divorcing couple is to retain the house, permitting one or the other to remain in the residence until the market improves, fixing the financial responsibilities of one to the other in retaining the residence, agreeing to postpone final division of the asset until a time in the fixed future, tied often to a child's attainment of a certain age or emancipation status, or making the sale subject to a triggering event, exercisable by either party (with notice), with a guaranteed base return for the departing resident. Often, and especially at the present time, refinancing the current mortgage, without incurring additional debt, so as to reduce the monthly financial "nut," is strongly advised, i.e., is a "no-brainer." In situations where the residence is preserved for a future sale, there is often a two-level structure of support in place — one amount before and another amount after the house is sold.

Renting the house to a third party, though often more of a headache than it is worth, may be a viable option for some in the hopes that the near future will bode well for the real estate market. An income can be derived from such a step that will, at a minimum, help offset monthly housing payments. Turning over the costs of utilities to the renter will also relieve some of the financial pressure on the parties. Those who determine to take such a step would be wise to engage a property manager or an accountant to oversee the day to day dealings incumbent upon a landlord.

Where minor children are still living at home, some couples may prefer what has become referred to as "nesting." The parties retain ownership of the home, and either rent or purchase another nearby (smaller than the marital home). Each parent alternates living in the marital residence with the children and in the other residence alone. This not only preserves the residence for sale in an upturned market, but provides an added degree of stability for children thrown into the divorce maelstrom.

Short sale, Foreclosure, or Bankruptcy

Short sale, foreclosure or bankruptcy are more drastic solutions – and should be considered sparingly as such steps often negatively affect both parties' financial futures. However, in the long run beggars cannot be choosers.

A short sale is the sale of real estate in which the proceeds fall short of the debt owed on the property. It occurs when a borrower cannot or chooses not to pay the mortgage obligation, and the lender decides that a sale at a modest loss is the best option. Both debtor and creditor must agree to the short sale procedure inasmuch as it allows foreclosure to be avoided (foreclosure will involve hefty fees for the bank/lender and poor credit report results for the debtors.) The lender's agreement to the short sale, however, does not automatically release the borrower from the obligation to pay the remaining balance of the debt, known as the "deficiency."^[vii]

In the short sale scenario neither side is "doing the other a favor;" it is simply the most cost-effective resolution of the debt. The lender reduces its exposure to a greater financial loss than would result from foreclosure or continued default. The debtors are able to lessen damage to their credit histories, and to a limited degree control the debt. The short sale is often faster and less expensive than a foreclosure. The lender's acceptance of the short sale does not extinguish the remaining balance unless settlement is clearly indicated on the acceptance of the offer.^[viii] The short sale typically remains on a credit report for seven years.

A few last comments concerning short sales: (i) always negotiate the waiver of the deficiency; (ii) leave plenty of time, as the approval process can be long and arduous; (iii) if approved and the deficiency waived, the forgiven debt may have tax consequences.^[ix]

Foreclosure is the process by which the lender obtains a court ordered termination of the borrower's right of redemption. The lender traditionally obtains a security interest in the property in issue from the borrower who pledges the asset to secure the debt. Upon default the lender is typically desirous of repossessing the property. Courts of equity however, can grant the borrower the right of redemption if the debt is then repaid. While this right exists, the lender cannot be sure that it can successfully repossess the property, thus the lender seeks to "foreclose" the equitable right of redemption.^[x] Other lien holders can also foreclose the owner's right of redemption for other debts, such as for overdue taxes, unpaid contractors' bills or overdue homeowners' association dues or assessments."^[xi] A foreclosure generally appears on a credit report for seven to ten years, usually as a settlement, settlement for less than owed or pre-foreclosed redemption.^[xii] A foreclosure will have a greater negative impact on a party's credit than a short sale.

Bankruptcy

For those with significant liabilities and little or no foreseeable means out of the debt incurred, bankruptcy may be the only option. The parties may choose to declare bankruptcy and file for Chapter 7 or Chapter 13, depending on their financial predicament.^[xiii]

Where the problem is late mortgage payments, and the parties are desirous of keeping the marital residence out of foreclosure, then a Chapter 13 bankruptcy is the best choice. In a Chapter 13 bankruptcy case, the Court will supervise and restructure the debt, and schedule a payment plan which will typically involve a three to five-year repayment period.^[xiv] Once repayments of the debts have been made in accordance with the Court's repayment plan, then any debt still remaining will be forgiven. A bankruptcy will typically remain on a parties' credit report for ten years.^[xv]

A Chapter 7 bankruptcy filing, known as a straight bankruptcy, involves liquidation of all assets that are not exempt. It is the best selection where the parties do not have the income to commit to a repayment plan. In a Chapter 7 bankruptcy filing the Court assigns a Trustee to collect the debtor's assets in order to satisfy some or all of the debt. Fortunately, most debtors have only what is considered "exempt property" which is defined to include, the family home, family car, household items and clothing. After the non-exempt assets have been sold to pay off as many of the debts as possible the debts remaining are forgiven. The discharge of debts through Chapter 7 may be done only once every six years.

FAMILY BUSINESSES

When a couple owns a business together, decisions must be carefully made to insure an equitable outcome. It goes without saying that every business and business segment is unique. One universally convenient truth, however, is that the implosion of the U.S. and world financial markets has affected and will continue to affect for the foreseeable future most U.S. businesses. This has caused a whole new series of problems for valuing business for the purpose of divorce quantification

and division.

Revenue Ruling 59-60, issued in 1959, has long been the golden rule for business valuations, and has stood the test of time when it comes to the fundamental principles of valuing a family business, for divorce or any other purpose. Traditionally, business valuations have used methods based on the then realistic presumption that the historical performance of the business was a legitimate gauge of its future course. Implicit in the mathematical models was the tacit understanding of incremental improvement over a period of time. Most often, the evaluators view the last five years of the endeavor to ascertain its current value. Even if the present year evidenced a lower profit than years before, it is factored in with the prior four. However, this result may be a valuation that is nowhere near the realities of what the recession has done to future revenue forecasts.

In the daily changing fiscal environment it was necessary to find ways to fashion an equitable distribution of the business taking into account the uncertainty of the business environment. On the one hand care must be taken so as not to value the business too high thus forcing the person running the business to pay out to the other a large amount that is inconsistent with the current economic conditions, and possible future of the business. Alternatively, the business could be in seriously negative territory at the time of the divorce, yet rebound considerably in years to come. The future, as always, remains a mystery.

Thus more complex solutions must be approached than those traditionally utilized when there is a simple buy out of one of the owners at the then determined fair market value of the business – these solutions include: earn-out options; corporate co-existence, and estate planning opportunities.

Buy Out, With Earn Out Options

Optimally planned, a buy out with earn out options, i.e., where part of the total payment for a business is deferred, may be the best route. In this way, the “seller spouse” receives partial payment of an agreed base value of the business at the time of divorce and a further payment or payments after an agreed period or periods based on future business performance. The buy out/earn out therefore represents a results-based value of the company and may be considered by both parties as the fairest means of valuation and subsequent distribution. The amount of the future payments is based on agreed performance criteria and typically calculated as a multiplier with reference to historical profits although it may be based on turnover or other financial criteria^[xvi]. The earn-out period may run from months to years and may include payments at different stages during the period. Typically, the “buyer spouse” will receive a cash sum, or an initial issue of securities, plus the earn-out.

Corporate Co-Existence

Often the only thing the parties can agree on is that the family business should not be sold or divided at the time of the divorce. This often occurs where the spouses desire to retain their positions in the company, where neither party is willing or able to buy the other out, or where the parties’ children are actively engaged in the business. Of course, each of these reasons requires the parties to be emotionally and mentally capable of co-existing in the business.

In order to continue the ongoing business relationship, it is imperative that certain rules be established between the parties, and enforced going forward. These “rules,” would include: (i) the entering into of management agreements to set out specific duties of each spouse in the business, and classify those specific issues that would require the vote or agreement of both spouses, such as any future sale of the business, salary increases, personnel decisions, borrowing, and the like^[xvii]; (ii) preparation of employment agreements to address benefits, termination, resignation, and covenants not to compete; (iii) preparation of buy-sell agreements to particularly address the future transferability of stock, and purchase of rights upon the death of one of the spouses, among other items; and (iv) the manner in which to address any shareholder disagreements.^[xviii]

Estate Planning Prospects

Where the parties own all or the majority of their business, they may have available to them a unique estate planning opportunity, especially where the parties’ children participate in the business. The parties, with the help of knowledgeable corporate, and estate planning counsel, create a succession plan for the benefit of their children, that may reduce or eliminate

the uncertainty of the manner in which the company will be distributed upon one party's death, and also take advantage of valuation discounts by putting each of the spouses in a minority position.^[ix] This may all be undertaken by the parties while they still maintain joint control over the business. This will also ensure that the parties' children will have an opportunity to acquire an interest in the business upon the death of either or both parents.

RETIREMENT AND DEFERRED COMPENSATION

The pandemic has also wreaked havoc on most retirement or deferred compensation benefits, in particular plans such as a 401(k), SEP, or IRA.

The "cut off" date for the classification and quantification (without considering the active or passive nature of the increases or decreases in account values) of marital property is the date on which the action is commenced^[x]. The valuation dates for such assets can however, range from the commencement date through the trial date. Over the years, certain standards have developed in determining which valuation date should be applied to particular classes of assets such as retirement and deferred compensation accounts.

Now, the existence of an increase in the value of such plans post-commencement will be a rarity. Despite this state of affairs, the Court will still look to such considerations as the active management of the account by one spouse; pre and post-commencement withdrawals and payback amounts and obligations; the selection of the assets in the account; and the risk of the assets decreasing during the action.^[xi]

It is important that neither party force the liquidation of retirement assets while values are low. Losses on paper can be tolerated; actual losses realized by sale or withdrawal from retirement accounts, plus the accompanying tax liabilities and penalties, should not be.

CONCLUSION

Difficult times produce new opportunities; new opportunities give rise to industrious solutions. Now more than ever, divorcing spouses (with knowledgeable counsel), need to exercise patience in the process, clarity in thinking and sound fiscal judgment.

[i] Marcus Fabius Quintilian, Roman educator, author of the Institutes of Oratory, published circa AD 95.[ii] "Unemployment Claims Soared to 3.3 million Last Week, Most in History," Tappe, Anneken, CNN Business, 3/26/20.

Cnn.com/2020/03/26/economy/unemployment-benefits-coronavirus.

[iii] "Exclusive: Goldman Injects \$1 Billion Into Own Money-Market Funds After Heavy Withdrawals," McLaughlin, Tim. 3/21/20. reuters.com/article/us-health-coronavirus-goldman-mny-mkt-ex.

[iv] "How to Protect Your 401(k) From the Coronavirus," Hartmen, Rachel. 3.12.20.

money.usnews.com/money/retirement/401ks/articles/how-to-protect-your-401-k-from-the-coronavirus.

[v] Negotiating for and receiving in the divorce an asset at a significantly reduced value can be a benefit for some. When the market recovers the asset could be a boon to the receiver.

[vi] The New York Times, "Is Now a Good or Terrible Time to Buy a Home?" nytimes.com/2020/03/21/realestate/coronavirus-pandemic.

[vii] Tedeschi, Bob, "Short Sales, A Long Process," The New York Times, Mortgages, 12/13/2009.

[viii] Olick, Diana, "Big Banks Accused of Short Sale Fraud," CNBC, 1/15/2010; "Mortgage Applications Drop 29% for Week Amid CoronaVirus Crisis." 3/25/20. www.cnbc.com>real-estate. Olick, Diana.

[ix] See IRS Publication 4681. The lender must send the borrower Form 1099-C, Cancellation of Debt, to indicate the amount of debt forgiven.

[x] Merriam-Webster's Dictionary of Law ©2020, Merriam-Webster, Incorporated

[xi] Rhodes, Trevor. American Foreclosure: Everything U Need to Know... about Preventing & Buying. McGraw-Hill, April, 2008.

[xii] Foreclosure Prevention Resource Center, MortgageBankers Association, 2008.

[xiii] "How to Divide the Family Business in a Divorce," Schnaubelt, Catherine. 3/15/19.

forbes.com/sites/catherineschnaubelt/2019/03/15; Cornell, Mark and Ovitt Puc, Kelly, "Debts, Divorce and Bankruptcy,

Representing Family Law Clients in a Down Economy," New Hampshire Bar Journal, Fall 2009.

[xiv] 11 U.S.C. Sections 1321 and 1322.

[xv] Building a Better Credit Report, Federal Trade Commission Bureau of Consumer Protection, Office of Consumer and Business Education, May 2005.

[xvi] "How to Divide the Family Business in a Divorce," Schnaubelt, Catherine. 3/15/19.

forbes.com/sites/catherineschnaubelt/2019/03/15; Sissel, Scott A., "Divorce and the Family Business – What Are the Options?", Business Entities, March/April 2007.

[xvii] Id.

[xviii] Id.

[xix] Id.

[xx] DRL Section 236(B)

[xxi] Michaellessi v. Michaellessi, 59 A.D.3d 688, 874 N.Y.S.2d 207 (2d Dept. 2009); Pickard v. Pickard, 33 A.D.3d 202, 820 N.Y.S.2d 547 (1st Dept. 2006).