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Dealing with Distressed Businesses, Catastrophic Losses, and Divorce During COVID-19

Three experts discuss how they are valuing distressed businesses, real estate holdings, and financial portfolios – as well as provide creative solutions to help settle cases in these uncertain times.

By Tracy Farryl Katz, Forensic Accountant; Jason Naimi, Family Lawyer; and Briggs Stahl, Valuation Expert

The COVID-19 pandemic has negatively impacted most business values, depending on the valuation date and type of business, as revenues significantly decreased in 2020. The pandemic has also affected investment properties: in many states, unemployed tenants cannot pay rent and cannot be evicted due to COVID. These uncertainties impact all financial aspects of a divorce – from property division to support.

Tracy Farryl Katz, Jason Naimi, and Briggs Stahl shine a light on the challenges divorce and family law practitioners continue to face during this pandemic, and offer creative solutions to help settle cases.

Tracy Farryl Katz: When we talk about distressed businesses and catastrophic losses, there are essentially three large areas of asset classes that we deal with: business valuations, real estate holdings, and investment portfolios. Let's start with the meat and potatoes: business valuations.

Briggs Stahl: When valuing a business during COVID, you have three choices. One, if this a business that has been affected substantially by the pandemic or other distressing agent, you can value the business before the distress or catastrophic loss. Two, you can wait until the distressing agent has gone (six months to a year – hopefully no longer) and then look at the effect on the business for this period of time. Three, you can develop a value estimate now by trying to estimate the effect that COVID is going to have on the business. You have two choices when creating that estimate: using either a discounted cash flow approach and models for that first year, or using some kind of cap earnings method with a component added or subtracted for the change in the value of the business.

The next question is how are you going to settle this case once you have a value. Especially if you're deferring the valuation of the business, the non-business-owner spouse may have to become something of a business partner until the company recovers. Are you going to have to establish a compensation level for that spouse in lieu of equitable distribution and alimony?

Another creative way to settle this is to fix a formula based on company performance over the next two to five years, so there's some percentage payout. I have seen alimony payments structured as a base amount and a sliding scale: reducing alimony in a bad year and increasing it in a good one.

You may also want to consider requiring a minimum amount, or a down payment, with a longer-term payment plan.

Whatever we do to get a payout for our client is going to affect the cash flow from that business – and ultimately, that's going to affect the business owner's ability to pay alimony and/or child support. You may also have to look at some form of COVID discount, either a fixed or flat amount or a specific percentage off the top, as you're doing the payments.

I've also had cases where the business' income and value increased, not only during COVID but in other catastrophic situations as well. I'm based in Florida, and I was doing a business valuation for a roofing contractor when Hurricane Sally hit in May. Then three hurricanes hit in June. You can imagine the increase in business for a roofing contract supplier with four hurricanes! We basically did a hurricane premium: we looked at the extra money he made in that one year and developed a percentage to apply in the equitable distribution for the non-business spouse. The argument was that it was a passive issue: he did not do anything active to cause the hurricanes.

The same kind of application would apply to a COVID discount. You really have two choices: you can either make a one-time adjustment, or you're going to have to do some kind of discounted cash flow.

Tracy: When we talk about your ex-spouse becoming your business partner, let's not forget these people are not getting divorced because they want to spend more time together. Making a spouse your business partner isn't the easiest solution, but it's sometimes the only solution in a cash-strapped household.

Briggs: I agree. You also want to make sure the courts are going to be retaining jurisdiction in these areas. You don't want to file one of these agreements and not have some way to go back into court if issues develop. Include some contingent consideration provisions in the agreement to review financials and make adjustments at a future date.

The provisions need to protect the out-spouse – whether it's the right to review financials or maybe a seat on the board. I know that's not going to be popular. And where you've got longer term payouts, what kind of security are you going to have? Are you going to hold the stock in escrow? Are you going to do some kind of debt filings, or some kind of UCC filing? How is that going to affect loan commitments of the business? You must be aware of those issues while crafting the settlement agreement.

If the out-spouse is your client, you need to look at things like the capital expenditures, and how you are going to allow for those new debts and compensation, especially for the out-spouse. I've seen the business owner's new girlfriend or boyfriend suddenly become a very highly paid employee in the successor business.

Now over to Jason to talk about some of the real estate issues.

Jason Naimi: We're talking about how to deal with distressed businesses in a pandemic situation. The irony is that in most of this country, real estate is actually hot right now. It's a seller's market. I think that's for two reasons. First, because of the pandemic, borrowing money right now is cheap: we're seeing interest rates as low as 2.6%. Many people are thinking, "I can sell my home and get maximum value (or near-maximum value) right now. Then I can either buy something immediately, or hold off and rent for a year and buy when the prices come down at low interest rates."

That means they can upgrade their housing. Here in Las Vegas, we

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have a lot of California buyers right now. They are fleeing their state, particularly Southern California, and coming this way. There are certainly income tax incentives as a result of that. Tracy, isn't there about to be a tax hike in California?

Tracy: Yes. In the last month, I have had three separate clients who are working to establish residency outside California because of the upcoming proposed tax hikes, which would raise taxes about 17%.

Jason: Now that many people are working remotely – and can essentially live anywhere without changing jobs – we're seeing people flee from places like that. With high property values, and with essentially free money to borrow, it is definitely a seller's market. I think real estate as an asset is actually holding its value at a minimum if not appreciating in value.

However, if you live in an area where property prices are dropping, that is a concern in terms of distributing the assets in a divorce. One strategy is to hold on to the property until the market in your area recovers. Conceptually, both parties maintain their equity in the property. Perhaps they rent it out, or perhaps one of the spouses lives in it post-divorce, and pays to maintain it while they're there. Once the property sells, they can each take their equitable share of the equity.

There really aren't a lot of options when dealing with a distressed real estate holding.

One worrying situation is if your client and/or their spouse owns some kind of multi-tenant residential property. In Nevada, our governor has issued a stay on evictions during COVID. If the property owner is not receiving the rental income that they relied upon to pay the mortgage, that's problematic.

If they can afford to hold on to the property because they have other assets, I would suggest they do so and then wait to sell or perhaps buy out the other spouse when the rent starts to recover. Chances are, the property will hold its value because of the market and the low interest rates. You can agree to look at the situation in six months, and then again in a year, until both parties agree it's the right time to sell. I would advise you not to make the deal contingent on the last true value, however.

Tracy: What about the rental situation in California?

Jason: Although real estate is doing well right now in this part of the country, we must expect that it is going to crash. When you're looking at a divorce scenario, maybe now is the best time for the parties to maximize the equity in their home by selling it.

Tracy: Real estate is cyclical; it's on a seven-to-10-year boom-bust cycle in most places. We all remember what happened to real estate in 2008, when we had our last big market crash. The real estate investors I listen to think that there is a downturn coming, so they are much more cautious about taking on debt.

Jason: This is really a case-by-case scenario. Even though the interest rates are low, and people are eager to borrow or refinance so they can buy out their spouse, the banks are way more critical right now because of the uncertainty. You might have an ideal credit score and the home equity and value to accomplish a refinance, but maybe your income has plummeted because of the pandemic, so you may not qualify. What do you do then?

Briggs: You may be in a situation where you're going to have to wait for that to occur and figure out a way to stabilize this for some period of time. Where do you pull the money from for those stabilizations? Do you have to invade the retirement account?

Tracy: Last March, we were all riding the same rollercoaster with our portfolios. Things were very uncertain. They have obviously stabilized somewhat since then. Given the unemployment rates and what is happening globally, it's interesting that the markets are doing this well.

We have to make sure we are protecting both spouses when dividing up the investment portfolios. Depending on what type of investor you're dealing with, there are margin calls happening in a volatile market. I have clients who have really significant margin: some investment houses will allow you to borrow up to 60% or 70% on margin. But whatever was an acceptable margin limit in a volatile market might not be an acceptable limit tomorrow, so people have to be really careful about that.

In the pending period, which could last months or even years, these margin issues are real issues, because they will last until the assets are divided.

On the investment side of things, this distressed market is not all bad news. If you own Apple or Chipotle stock, for example, you've been a very happy investor over the past few months.

I've had clients who have owned Apple stock since the early 1990s who have made millions in the last couple of months. At the same time, if you have appreciating assets sitting in your investment account, and you have the ability to borrow on margin, that's a creative way for us to get through the next few months. We can figure this stuff out on the other side, so that nobody's lifestyle really has to suffer. Is it ideal? No – but it's a really good Band-Aid for plugging a sinking ship.

Briggs: When dividing that stock, be careful that you're not just dividing the number of shares but the actual lots. If you're doing a valuation, and you're not dividing the specific shares, at least make sure you're using the same valuation dates. When you've got these big swings in the market, you must be very careful about the valuation dates in these accounts.

Tracy: Let's talk about distressed assets and their impact on support. Lawyers are now fielding calls from clients saying, "Hey, wait a second, I settled my divorce a couple of years ago, but the world has changed and now I can't afford to pay the support order."

We're seeing a lot of post-judgment modifications and more support orders with percentage kickers. You start with a low base, and then as money gets made over and above that base, the increase is self-executing. It doesn't require expensive lawyers and attorneys to come in. You're paying support on a base of X dollars, and when you make more than X, you pay the agreed upon percentage. It requires the two ex-spouses to work together – or their personal accountants to work together – but it takes lawyers out of the middle.

You may have to be creative in the sources of funds to pay living expenses other than traditional support: for example, margin borrowing, or cash surrender proceeds from life insurance. Reduced cash flow from any and all assets impacts the ability to pay support; the supported spouse will not be living at marital standard until we recover from the financial effects of the pandemic. ■


Tracy Farryl Katz, Esq., CPA/CFF, is a partner in Gursey Schneider's litigation support department, specializing in forensic accounting in family law and civil litigation matters. She is a charter member of the AAML Foundation's Forensic & Business Valuation Division.


Jason Naimi, Esq., the managing partner of Naimi & Cerceo Family Law Group, specializes in litigation for contested divorce. Board certified by the State Bar of Nevada as a family law specialist, he is also a Fellow of the AAML and IAML.


Briggs Stahl, CPA, ABV, CFF, is a partner at Baker Tilly and a charter member of the AAML Foundation's Forensic & Business Valuation Division. With over 30 years of court experience, he has over 600 testimony and deposition appearances in both state and federal courts.

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