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DOWN & OUT IN BEVERLY HILLS How Current Economic Issues Impact Divorce

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Stimulate the economy. Bailout. Ease the credit crunch. All hot topics and subject of daily conversation and nightly news bites. Unemployment. Foreclosure. Bankruptcy. Diminished retirement funds. Plummeting stock portfolios. These are topics having a direct, personal impact on your clients, and therefore, on your cases, right now.

In order to navigate the current tides of this economy, it is important to understand where we are, how we got here, and what we're trying to do about it. Without a basic understanding of the current economic issues, how can you expect to weigh their impact on your clients' individual circumstances?

While the New Deal of the 1930's is used in many comparisons today, and while the Resolution Trust Corporation of the 1980's should not be forgotten, for this presentation we are generally focusing on the past 10 years.

How we got here

In 1999, the Clinton administration moved to "expand homeownership opportunities". Whether they "pressured" Government Sponsored Enterprises (GSEs) to expand or they "provided" for GSE's to expand depends on your "spin cycle" but that debate is not a part of this discussion. Since then, in any case, a series of events have occurred.

Interest rates fell thanks to the Federal Reserve, and loan originations soared as Wall Street supplanted the GSEs, Fannie May and Freddie Mac, and expanded their market share of Mortgage Backed Securities.

At the same time, an already over-heated housing market was further fueled by Sub-prime loans, Adjustable Rate Mortgages (ARMs) and other exotic loan products. Home prices appreciated unsustainably, loan fraud became rampant (can anyone say liar's loans?) Many eyes opened wide when home prices dropped more than 20% from the 2006 peak and we saw a record increase in the supply of homes for sale.

Suddenly, interest rates increased and the declining home values made it difficult to impossible to refinancing out of these sub-prime, hybrid and ARMs. These exotic loan products failed at alarming rates. Not surprisingly, investors no longer wanted to purchase Mortgage Backed Securities, some of which are now labeled “Toxic”.

Finally, foreclosures occurred at record levels and investors experienced dramatic losses and retreated from both the real estate and stock markets.

Where does that put us now?

Global credit is seized up; Wall Street firms are failing or being bought by commercial banks; US Bank failures are accelerating; US Stock Market and global markets are eroding causing dramatically reduced IRA and 401k retirement funds, foreclosures are at record highs and the housing market is flooded.

What is being done about it?

The Feds and Congress are attempting to implement numerous steps to “unfreeze the markets”, “ease the credit crunch” “stimulate lending and the economy” and assist struggling homeowners.

Mortgage Forgiveness Debt Relief Act 2007

EESA (Emergency Economic Stabilization Act) and TARP (Trouble Asset Relief Program) provided \$700 Billion in September/October 2008.

Bailouts of institutions posing “systematic risk” to the economy.

\$250 Billion Equity share purchases

\$125 Billion to BofA, Merrill Lynch, Bank of New York, CitiGroup, etc.

Federal Reserve announced its decision to buy \$600 Billion of Fannie/Freddie MBS and debt.

30 year fixed rates drop to mid 5% range

Investors more willing to buy mortgage backed securities from GSEs.

Fannie/Freddie put a moratorium on foreclosures

Fed announces plan to further reduce rates to spur growth

So, what does all this mean?

Well, without a crystal ball, it helps to compare this recession to an “average” recession (if there is such a thing):

AVERAGE RECESSION	THIS RECESSION
S & P starts to lose ground about 7 months before recession began	S & P 500 peaked October 2007 at 1557
Lasted about 10 months	Started December 2007
Stock market starts to recover 6 months into the recession – or four months before it ended	Recession is 17 months old (as of April 2009)
Takes approximately 13 months for the stock market to decline from its peak to its bottom	Market bottom (so far) of S & P was Nov 2008 at 752

More recession comparisons:

	Prior Recessions	This Recession (as of Sept 2008)
GDP	-1.9%	+1.1%
Income	-2.2%	-1.0%
Consumer Spending	+0.3%	-0.6%
Unemployment	7.6%	6.7%
Residential Spending	-12.3%	-20.7%

Seeing what history shows as a “pattern” of a recession, economists are hypothesizing that our current housing supply and demand will stabilize in late 2009 or early 2010 and unemployment may go as high as 9% by the 2nd quarter of 2009. They believe the modifications and refinances should reduce foreclosures and keep more homeowners in their homes; and, since new purchase mortgage rates are as low as mid 4% range, housing affordability will improve.

Unfortunately, there are still a number of unanswerable questions:

How long and protracted will this recession be?

Will the new Economic Stimulus Bill help?

Will the stock market grow or continue to decline?

The effect of this recession is as profound in the Family Law arena as it is on any other segment of society, perhaps more so. Mortgage loans are undergoing significant changes. Underwriting Guidelines are more restrictive. Divorce clients rely on child support and alimony to qualify for mortgages and to sustain their ownership. Pricing of loans has changed, there are fewer loan product options, and of course, the diminished value of the home will have some bearing on the outcome of a family law matter.

Unemployment, underemployment, and career changes in support issues must be addressed. Does lower income always mean lower support? When is deferred income really deferred? How can deception be detected in an unqualified deferred plan? Can a bonus be used to determine support? What are the pitfalls? What are the tax implications? How do we now

determine the ability and opportunity to earn to establish support when jobs are so scarce? How does the volatile market affect the division of a retirement plan for seniors already retired?

Business Valuations. Because of the heavy reliance on historical and recent buy/sell information for the report preparation, business valuations tend to overvalue a company during a recession and undervalue a company during a recovery. Fraud and cooked books pay the biggest dividends during Recession. Even with perfect books, divorce is used as the opportunity to buy out cheap during Recovery. Business Goodwill has more precise valuation methods but declines faster than Personal Goodwill, which has little connection to traditional goodwill valuation methods. How do these facts play out during a recession or recovery?

Real Estate. Traditionally, one spouse would keep the house with an indemnification clause signed by each. Currently, we are faced more often with insufficient funds to buy the other out. Problems are compounded if one party wants to retain a home with a negative value. But, if party in the house does not pay mortgage because there is no money, they may lose an asset. There is also the valuation problem as values tend to be changing day to day.

Possible solutions may include trading the house for retirement (instead of a buy-out). Refinancing to pay off the debt and increase cash either while working on solutions or delay putting the home up for sale until the market improves. Living under one roof is another possible solution which could perhaps minimize a support obligation as well. This is not allowed in some jurisdictions; may have adverse tax consequences; and is not well advised in many divorce scenarios.

Dividing a negative marital estate. What creates a negative marital estate is not always a clear indication of how division should or will be made. Partial or complete business failure can be partially or completely attributed to one or both parties; refinancing to cover-over spending, the decline in residence values below mortgages, and/or judgments can all contribute to or be the sole cause of a negative marital estate. The issues present in this situation include, but may not be limited to, secured debt must follow the property; creditors may still have claims against both parties after a split; equitable division may be determined by which party is best able to pay; and there are unpaid tax and possible future tax benefits to consider.

Bankruptcy. Is bankruptcy still a last resort or is it a viable solution? Substantial judgments and garnishments, diminished home value below mortgage and/or foreclosure may all precipitate a move to bankruptcy. Certain obligations will not be discharged even with a bankruptcy, such as taxes, child support and student loans. A bankruptcy of a marital business under a restructure Chapter 11 may be more appealing or advantageous than a personal bankruptcy. Don't forget an Offer in Compromise with large unpaid taxes. And, consider the effect on credit in better days.

What should I do?

Regardless of what the ultimate outcome of the economy is, you will be required to address your family law issues in real-time context, even during the transitions that are sure (hopefully!!) to be taking place in the coming months. The economy does have an impact on divorce, be ready for it.

