CCH® BUSINESS VALUATION ALERT

VOL. 5, ISSUE NO. 3
APRIL 2004

Valuing Businesses in Divorce: Emphasis on Passive and Active Appreciation

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Divorce attorneys are encountering business valuations more frequently as the proportion of households owning and operating closely held businesses steadily increases each year. Rights of non-owner/manager divorcing spouses to share in the wealth created during a marriage have also been steadily expanding as shown by the number of recent rulings handed down all over the country. These rulings generally state that increased value resulting from spousal efforts (active appreciation) becomes the property of the marital partnership, while increased value attributable to other sources (passive appreciation) remains separate property.

Divorce attorneys representing a business owner are, therefore, particularly interested in clearly separating the growth in business value during the marriage between growth attributed to efforts of a spouse (active) and to external factors and market forces (passive). How to clearly identify that portion of the business value attributed to the marriage, and prior to a marriage, is of particular interest for those attorneys representing a business owner and is the essence of this article.

Method for Apportioning Change in Value

One of the most troubling issues involving this active and passive appreciation doctrine is finding a viable "method" or "formula" for determining the portion of appreciation attributable to spousal efforts and the portion that results from third-party or market forces.[1]

A fundamental distinction between the concept of marriage as economic union (marital property) or economic partnership (separate property) underlies the treatment of marital estate in divorce. Both the concept of a "natural increase" occurring without exerting any human effort, e.g., as a result of inflation, and the concept of marriage as an economic partnership, with the spouses sharing in the gains accruing from marital efforts, have been well established for some time. The interaction of these two doctrines creates an interesting situation, where the emphasis has shifted from a simple split down the middle towards identifying the extent of efforts made by one or both spouses during the marriage, and the contribution of such efforts to the increase in value of the estate. The courts have recognized that the value of a business may change as a result of external factors, but in practice this distinction has been difficult to make.

Determining the share of value subject to distribution in a divorce involving an owner of a closely held business pre-existing at the time of the marriage is a two-step process. The first step is to determine the value of the business in question at the two points in time: first at the time of the commencement of the marriage and second at the time of the divorce. Once the value of the business interest at these two points in time has been determined, the next step is to calculate, and apportion, the change in value of this marital asset to active and passive appreciation.

The following five steps are commonly involved in determining the active and passive components of appreciation in a business value during the marriage:

1. State whether the business is separate or marital property.
2. Assess the value of the non-marital property before it became subject to the active and passive appreciation analysis (date of marriage value).
3. Assess the value of the property at the time of divorce action (date of separation, filing for divorce, or another specific valuation date mutually agreed to or decided by the court).
4. Calculate the change in value during the period of marriage as the difference in the valuation at these two dates.
5. Determine the proportion of the increase in value of the non-marital property as active or passive.

Court Rulings

Divorce laws and their interpretations differ substantially across the states with varying degrees of emphasis on the separation of marital and non-marital portions of the value of business interests. Several cases around the country have addressed the issue of separating non-marital and marital portions of the value of a business.

For example, for the son of Joe Robbie (Miami Dolphins), in *Robbie v. Robbie*[2] (*Robbie I*), the courts found that although the husband, Michael Robbie, may not have been active in the decision making, the business increased in value during the marriage partly as of a result of his efforts. Michael Robbie was given a 9.5% share of the Miami Sports Corporation by his father prior to the marriage in question. The Miami Sports Corporation owned a number of entities, including the Miami Dolphins, of which the husband in this case was a General Manager. Although the General Manager of the Miami Dolphins, Michael Robbie argued that he did not make decisions, or day-to-day decisions, of the business (Miami Sports Corporation), and therefore any increase in value was substantially non-marital. The Court did not agree.

The Court's decision was understandable given the circumstances of the case; however, the extent of the appreciation that was marital versus non-marital (passive) was not quantified. Many subsequent cases[3] relied on the *Robbie I* decision, and the *Robbie* decisions that followed (*Robbie II* and *III*), yet a clear and concise approach to determining the passive and active appreciation had not been defined with regard to the business owner spouse and the role he or she plays in the increase in value.

In another example, thousands of dollars that otherwise could have been attributed to passive growth was ignored. In *Innerbichler v. Innerbichler*,[4] the expert subtracted the value at the time of marriage from the value at the time of divorce—in effect, not quantifying that portion attributed to the passive growth of the company, but rather indicating that the husband's work effort during the marriage contributed entirely to the growth of the company for the period of the marriage.

In a number of cases, where it could be shown that the efforts of a spouse could materially impact the value of the business, analysis has stopped at step 4 (calculate the change in value during the period of marriage as the difference in the valuation at these two dates), effectively treating the entire increase in value of the business as active appreciation, determining the change in value from one point in time to another. For example, in *Reich v. Reich*,[5] based on the trial court's findings that the wife's efforts contributed to the appreciation of the husband's business, the trial court considered the enhancement in value of the business during the marriage as a marital asset subject to equitable distribution pursuant to subsection 61.075(5), Florida Statutes (1993).[5]

External Factors Affecting Value

It is very important to recognize that businesses do not function in a vacuum. Economic conditions outside the control of owners have significant impact on the well-being, even survival, of the business being valued. The last step in this process (determine the proportion of the increase in value of the non-marital property as active or passive), therefore, requires that two questions be answered:

- Which factors outside the control of the owner manager(s) of the business, if any, significantly impacted the (passive) changes in value of the business?
- What proportion of the change in business value can be explained by these external factors outside the control of the managers?

A brief explanation of a quantitative method for apportioning the change in value between these active and passive components is provided in the following part of this discussion. Use of an econometric technique known as regression analysis can readily identify the variables affecting the value and measure each variable's influence on the value of the business. Such regression analysis for determining the marital and non-marital value can be performed subsequent to an already existing business valuation, or made part of the initial valuation.

Multiple and linear regression analysis has been used in other industries to determine, predict, or quantify the effects of one

Table 1 Influence of External Economic Factors on Selected Industries

			Variables Affecting Total Retail Sales and Their Respective Influence on Growth			
	Passive Factors (effect on value)	Total Retail Sales	Unemployment	Housing Starts	Prime Rate	Mortgage Rates
Automobiles (new)	78.65%	+	-	-	-	-
Automobiles (used)	83.61%	+	-	-	-	-
Building Materials	76.91%	+	-	-	-	-
Food & Beverage	95.32%	+	+	-	-	-
Restaurant (full service)	90.68%	+	-	-	-	-
Pharmacy	92.98%	+	-	+	-	-
Gas Stations	79.85%	+	-	-	-	+
Disc. Dept. Stores	71.99%	+	+	-	+	-
Taverns/Drinking est.	79.20%	+	+	+	-	-

or more variables on another unrelated variable. Because the value of a business is influenced by several variables, regression analysis is well suited for identifying and isolating, for instance, those variables that influence the marital and nonmarital values. More specifically, quantitative analysis, including multivariable regression, provides a valuable tool for identifying economic factors that can explain the changes in value of the business interest.

Quantitative analysis including multivariate ordinary least squares (OLS) regression provides a valuable tool for identifying external economic factors that can explain the changes in value of the business interest. OLS has been used extensively for almost a century and is a well-established statistical tool for hypothesis testing. Briefly, the OLS regression procedure consists of specifying a model equation with the dependent variable as the factor to be explained and the independent variables being the factors providing an explanation. These independent factors may include the level of economic activity, interest rates, customer demographics, regulatory changes, and other similar data. The sum of regression squares (R-square) statistic for the specified regression equation (model) measures the percentage of change in value of the dependent variable that can be explained by these external factors and therefore considered passive appreciation not subject to distribution.

Businesses offering consumer goods and services, for instance, are very sensitive to the impact of economic conditions. For example, one can use OLS regression methodology to identify the external factors explaining the changes in sales for the category of business and the extent to which the variation in these sales can be attributed to the changes in these external variables (passive appreciation).

Illustration of the Impact of Economic Factors

Table 1 indicates the percentage of variation in sales for subject industries explained by external economic factors such as the level of retail sales, interest rates, unemployment, and housing starts during 1992-2001 at the national level. In layman's terms, the following table identifies the influence of some external factors for performance of certain businesses over a period of nearly ten years. Specifically, it illustrates the impact of four economic factors outside the control of individual managers (passive) on the total sales.

The results in Table 1 indicate that it may be justifiable to exclude a substantial proportion of the growth in business value during the period of marriage from the marital estate based on industry, period of analysis, and initial investment from nonmarital resources. In case of individual businesses serving limited markets, the R-squares (percentage of explained change in value) are likely to be smaller, but still large enough to allow substantial exclusion of appreciated value as passive appreciation not subject to distribution.

Aside from the factors identified here (i.e., retail sales, unemployment, housing starts, prime rate, and the mortgage interest rate), additional factors may include customer demographics or regulatory changes. This article is not intended to be a substitute for Statistics 101, but rather to explain that an additional approach is available to extract the marital and nonmarital values of the total value of the business interest.[4]

Conclusion

With the number of individuals creating home-based businesses, family limited partnerships, or simply going into practice for themselves, attorneys are often faced with the dilemma of how to determine the value of a business in divorce. It is very likely that the need to properly identify and measure the active and passive components of the increase in value of the closely held business during the marriage will become more urgent in the future. Econometric modeling techniques can provide valuable guidance in these cases, in addition to, or as part of, any business valuation. Business valuation practitioners and parties involved in these issues will need to understand and apply these methods as this analysis gains importance. ◆

End Notes

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1 Deborah H. Bell, *Equitable Distribution: Implementing the Marital Partnership Theory Through the Dual Classification System*, 67 Miss. L.J. 115, 147-149 (1997).

2 *Robbie v. Robbie*, 654 So. 2d 616 (Fla. 4th DCA 1995).

3 *Pagano v. Pagano*, 665 So. 2d 370; 21 Fla. Law W. D 90 (1996), *Minton v. Minton* (1997), *Dunagan v. Dunagan*, 664 So. 2d 68; 20 Fla. Law W. D 2706 (1995), *Turner v. Turner*, 529 So. 2nd 1138 (Fla 1st DCA 1991), and *Stefanowitz v. Stefanowitz*, 586 So. 2d 460 (Fla 1st DCA 1991).

4 *Innerbichler v. Innerbichler*, No. 0149 September Term, 1999 (Md.Sp.App. 06/16/2000).

5 *Reich v. Reich*, 652 So. 2d 1200 (Fla. 4th DCA 1995).

6 *See also Hanks v. Hanks*, 553 So.2d 340, 341 (Fla. 4th DCA 1989); *Buttner v. Buttner*, 484 So.2d 1265, 1267 (Fla. 4th DCA 1986).

7 OLS is an acceptable research methodology under the *Daubert* standard of analysis having been peer reviewed and accepted, see *Daubert v. Merrell Dow Pharmaceuticals*, (92-102), 509 US 579 (1993).