

Valuation & Litigation Briefing

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Differentiating active vs. passive appreciation in divorce

The laws in most states make a distinction between marital and separate property for purposes of marital dissolution. Marital property is subject to division, while separate property — such as property a spouse owned prior to marriage or received by gift or inheritance — isn't divisible. But what happens if separate property appreciates significantly in value during the marriage? Should that increase in value be considered marital property? In many jurisdictions, the answer is yes.

Not all appreciation in the value of separate property is treated as marital property, however. Typically, the courts make a distinction between "active" and "passive" appreciation, particularly when the property is a business or business interest. When this distinction is made, the courts classify only active appreciation directly attributable to a spouse as marital property.

What's the difference?

Active appreciation is an increase in value that's attributable to the efforts of one spouse (or both spouses) during the marriage. For example, a

spouse might invest capital, management expertise or labor hours to help the investment grow.

Passive appreciation generally results from external factors, such as market forces, inflation, legal or regulatory changes, and the efforts of others. The last factor, the efforts of others, isn't technically passive, but it's included in this category to distinguish it from the active efforts of the spouses.

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How to divvy up appreciated value

For certain types of property, distinguishing between active and passive appreciation is relatively straightforward. Suppose that a spouse owned undeveloped real estate on the wedding date, and then built a rental office building on the property

during the term of the marriage. The active portion of the property's appreciation in value typically equals the property's overall appreciation in value at the time of divorce minus the amount of appreciation a comparable undeveloped property would have experienced over the same period.

Dividing up active vs. passive appreciation for a business interest is more complicated and often calls for the use of



Bair v. Bair: Court rejects active-passive appreciation analysis

In *Bair v. Bair*, the husband had acquired a 47.5% interest in a boat dealership prior to marriage. The parties disagreed about the value of the marital portion of the husband's interest, which increased during the marriage, in large part due to the husband's efforts.

The trial court accepted the analysis of the wife's expert, which excluded the value of real property owned by the business. The property's value had decreased significantly due to the construction of a major overpass in front of the business's sales location. Her expert concluded that this decrease in value was passive, and, therefore, excludable from marital property.

The Second District Court of Appeal of Florida rejected the trial court's appreciation analysis. It found this approach to be improper, noting that the value of a business comprises all of its assets and liabilities, and that the husband had contributed to the change in value of the company as a whole. The trial court had no discretion to pick *specific* assets to include or exclude.

By excluding the real property, the trial court had overstated the business's value by almost \$1 million. The appeals court determined that the proper approach was to include all of the business's assets and liabilities in the valuation and then decide on the marital portion of any appreciation in the entity's overall value.

a valuation expert. The first step is to determine the value of the business on the wedding date (or when it was acquired by inheritance or gift). This can be challenging, particularly if the business is closely held and wasn't valued regularly in the past.

Next, the business valuation professional determines the value on the date of divorce. Assuming the business has appreciated in value, the valuator must then identify passive factors that influenced the business's value and quantify the impact of the factors, often by applying econometric analysis or other statistical methods.

Once passive appreciation has been quantified, any remaining appreciation is considered active. But other owners and key employees might be responsible for a portion of the active appreciation, too, unless one or both spouses were the dominant force behind the operation of the business. The business valuation expert may exclude from the marital estate any portion of active appreciation that's attributable to third parties.

It's important to note that distinguishing between active and passive appreciation for a business requires a *holistic* view. That is, a valuator can't cherry-pick business assets to include or exclude from the marital estate based on whether changes in their standalone values result from active or passive forces. (See "*Bair v. Bair*: Court rejects active-passive appreciation analysis" above.)

Appreciating the difference

The classification of appreciation as active or passive can significantly affect the division of property in marital dissolution cases in states that recognize this distinction. Divvying up value can be especially challenging when one or both spouses are private business owners. A business or business interest is often a spouse's most valuable asset; so, it's critical to determine whether that asset is marital property. Sophisticated valuation analyses may be needed, depending on the facts and circumstances of the case. ■

Dissenting shareholders: What's the fair value of the interest?

In *Athlon Sports Communications v. Duggan*, the Tennessee Supreme Court addressed whether the Delaware Block method was mandated when valuing shares in appraisal rights actions. To determine the appropriate method for determining “fair value,” the state court looked outside of its jurisdiction to *Weinberger v. UOP, Inc.*

This 35-year-old case from Delaware expands the relevant valuation evidence that may be used in dissenters’ rights cases to “any technique or method that’s generally acceptable in the financial community and admissible in court.” Under *Weinberger*, experts may apply not only the Delaware Block method, but also the discounted cash flow (DCF) and the guideline company methods.

Case background

Athlon publishes sports magazines, websites and other branded sports products. The company struggled during the financial crisis of 2008. In 2012, its board of directors decided to initiate a merger transaction that effectively squeezed out minority shareholders who were former employees of the company.

The Tennessee Supreme Court turned to Weinberger v. UOP, ruling that the statutes don't prescribe a specific valuation method for determining fair value.

The merger was completed in August 2012, and the board offered to buy the minority shareholders’ stock for \$0.10 per share. The dissenting shareholders rejected the board’s offer and, instead, demanded \$6.18 per share.



Trial court favors Delaware Block method

Athlon petitioned the trial court to determine the fair value of the minority shareholders’ stock under Tennessee law. The state’s dissenters’ rights statutes — like the laws in many states — give a dissenting shareholder the right to obtain payment equal to the fair value of a shareholder’s interest in the event of a merger.

Both sides hired business valuation experts to value the dissenters’ stock, and the experts assumed that the Delaware Block method was required based on previous case law in Tennessee. This method averages the following three indicators of value:

- 1. Market value.** Typically, the price of the company’s stock is used to represent market value. For private companies, experts might consider prior transactions involving the company’s stock.
- 2. Asset value.** This equals the difference between the fair values of the company’s assets and liabilities, and
- 3. Earnings value.** This metric is represented by a multiple of the last five years’ average earnings.

These indicators are based on the company's *historical* performance. They specifically exclude forward-looking financial projections and comparable transaction data. Using the Delaware Block method, the company's expert said the stock had no value; the defendants' expert estimated that the stock was worth \$6.48 per share.

The business valuation experts also valued the dissenting shareholders' stock under forward-looking valuation approaches. However, Athlon's expert testified that the DCF method wasn't "practical, useful, or reliable when projections of future results cannot be made without resorting to undue speculation."

The trial court ultimately valued the stock at "no more than \$0.10 per share," based on the Delaware Block method. That ruling was upheld by the Court of Appeals.

Supreme Court weighs in

In matters of corporate law, Tennessee courts often look to Delaware law. In this case, the Tennessee Supreme Court turned to *Weinberger v. UOP*, ruling

that the statutes don't prescribe a specific valuation method for determining fair value. Rather, trial courts have flexibility to choose the valuation method that best fits the circumstances of the case at hand.

The Delaware Supreme Court overturned the *exclusive* reliance on the Delaware Block method. The court opinion calls the Delaware Block method "outmoded" and "mechanistic" to the extent that it "excludes other generally accepted techniques used in the financial community and the courts." As a result, the court remanded the case to the trial court to determine the fair value of the shares, using a broader range of financial evidence.

Lessons learned

When calculating fair value in dissenters' rights cases, think outside of the Delaware Block. Forward-looking metrics — such as financial projections and comparable market data — can also provide meaningful indicators of value. But they shouldn't be speculative or based on synergies that would come from the corporate action that the shareholders dissent to. ■

Market approach

How to pick a relevant pricing multiple

Courts tend to prefer the market approach in business valuation over the income or cost approach, because it's based on real-world transactions. Under the market approach, the value of a private business interest is determined using comparisons to "similar businesses, business ownership interests, securities, or intangible assets that have been sold."

Comparable transactions — which may involve publicly traded stocks or privately held businesses — are analyzed to determine pricing multiples that find a mathematical relationship between a financial

variable and selling price (market value). But which pricing multiple provides the most reliable indication of value?

Multiple choices

Business valuation experts select from a varied menu of pricing multiples. Common choices compare deal price to such financial variables as:

- ◆ Net sales,
- ◆ Earnings before interest, taxes, depreciation and amortization (EBITDA),

- ◆ Earnings before interest and taxes (EBIT),
- ◆ Discretionary income (with varying definitions),
- ◆ Net income, and
- ◆ Book value.

There's no universally optimal pricing multiple. Business valuation experts often perform statistical analyses on the sample of comparable transactions to determine which financial variables have the strongest correlation.

Experts also may decide to eliminate "outlier" transactions that might not meet the definition of fair market value. For example, a seller might have been under duress to sell quickly due to bankruptcy or the death of a key person. Or a buyer might have paid a premium price because it overestimated cost-saving or revenue-building synergies from the transaction. Related parties also may pay above- or below-market prices.

These factors can skew the results, so it's important to investigate the details of each comparable in the sample. Some private transaction databases provide more details than others.

Pros and cons

Once all relevant pricing multiples have been computed and analyzed, business valuation professionals evaluate the pros and cons of each multiple based on the nature of the business, its industry and case facts. For instance, the price-to-net-sales multiple may be preferred, because profit metrics are inconsistently defined and subject to manipulation. This is especially relevant in divorce or shareholder disputes when a controlling shareholder might have an incentive to downplay (or exaggerate) financial results to help understate (or inflate) the value of a business interest.

On the other hand, EBITDA multiples may be preferred when the subject company is subject to different tax rates or has a different capital structure than the comparables do. Price-to-book-value may make more sense when valuing an asset-holding company



or an asset-intensive business in which book values reasonably approximate current market values.

When valuing small businesses (under \$5 million in annual revenues), price-to-discretionary-income may be more meaningful. This multiple is often used in small company mergers and acquisitions, resulting in familiar industry rules of thumb. It also addresses the general desire of small businesses to reduce income tax expenses.

Detailed reports

Though the market approach seems objective and straightforward, selecting a pricing multiple adds an element of professional judgment into the valuation equation. So, business valuation professionals should be ready to explain and defend the pricing multiple (or multiples) selected based on quantitative and qualitative factors. In addition, their reports should explain why other pricing multiples and outliers were eliminated from the expert's analyses.

If your business valuation expert's written report doesn't fully explain the analyses, don't be afraid to ask for more details to be added before the report is finalized. Or you may want additional questions to be asked during deposition or trial to add credibility to his or her conclusion. ■

A picture's worth a thousand words

Why valuation experts use visual aids

Business valuation experts often use visual aids, such as graphs and charts, to capture the attention of a judge or jury and drive home key points. These exhibits may be presented orally during trial or deposition. They also may be provided in appendices to an expert's written report.

Keep it simple

Many people are visual, rather than auditory, learners. So visual aids are particularly effective in a courtroom setting, where the trier of fact may be expected to learn about a complex subject in a relatively short time. Verbal explanations may not be enough to explain complex issues or illustrate trends.

In addition to supplementing an expert's oral testimony or written explanation, visual aids can:

- ◆ Enhance jurors' attention and recall,
- ◆ Be more persuasive than nonvisual evidence, and
- ◆ Build the expert's credibility.

Effective visual aids focus on one or two key points. Exhibits that present too much information — as well as the use of too many exhibits — can be overwhelming.

Graph relationships and trends

Graphs can be an effective way to convey financial information to a judge or jury. Examples of analyses that may benefit from the use of graphs include demonstrating 1) the change in revenue during a finite period of economic damages due to patent infringement, or 2) the relationship between sales prices and economic variables (such as revenue, earnings and book value) to determine the most relevant pricing multiple to use in the market approach.

For instance, suppose an expert is engaged to value a private company. She finds 13 comparable transactions over the last year. Then she creates three graphs that plot each comparable's selling price against the following "independent" variables: earnings before interest, taxes, depreciation and amortization (EBITDA), annual revenue and operating cash flows. On each graph, the expert also plots a trendline that best fits the data points, using regression analysis. In statistical terms, her trendline minimizes the aggregate deviation from the data points to the trendline. Without getting caught up in statistical jargon — like standard deviations or correlation coefficients — her visual aids vividly demonstrate that the data points on the EBITDA graph have the closest "fit" and, therefore, the strongest correlation to value.

Show and tell

Many business disputes require complex financial concepts and analysis. Rather than relying on written and spoken words to convey key points, consider preparing some visual aids that grab the judge's or jury's attention, clarify the issues and bolster the expert's conclusions. ■

