ALLOCATING ACTIVE AND PASSIVE APPRECIATION OF A SEPARATE BUSINESS ASSET FOR EQUITABLE DISTRIBUTION[1]

by David M. Wildstein, Esq.[2]

INTRODUCTION

Under New Jersey Law, the typical approach to valuing an active separate[3] business is to value the asset twice: the date of marriage (or when acquired during the marriage) and the date of the filing of the Complaint. *Scherzer v. Scherzer*, 136 N.J. Super. 397 (App. Div. 1975). The difference or appreciated value is subject to equitable distribution. This simplistic method for valuing the enhanced value of a business assumes all businesses actively increased. Part of the growth of a business may be passive in nature, such as a return on capital, market factors, or the effort of third parties that caused the business to grow and flourish during the marriage. The other part is active, such as the effort of either party that caused the business to increase in value.

Although *Berrie v. Berrie*, 252 N.J. Super. 635 (App. Div. 1991) held that the enhanced value of an immune active asset may have passive and active components, there are no New Jersey opinions that have offered any guidance as to the method for calculating passive and active increases. This article will summarize New Jersey case law and explore how community property states and other equitable distribution states address this question.

NEW JERSEY LAW RELATED TO EQUITABLE DISTRIBUTION OF ACTIVE IMMUNE ASSETS

N.J.S.A. 2A:34-23(h) provides in part that:

> The court may …effectuate an equitable distribution of the property, both real and personal, which was legally and beneficially acquired by them or either of them during the marriage. However, all such property, real, personal or otherwise legally or beneficially acquired during the marriage by either party by way of gift, devise or intestate succession shall not be subject to equitable distribution . . . (emphasis added).

In the seminal case of *Painter v. Painter*, 65 N.J. 196 (1974), the Court interpreted the statute as saying that:

> Clearly any property owned by a husband or wife at the time of marriage will remain the separate property of such spouse and in the event of divorce will not qualify as an asset eligible for distribution . . . We also hold that if such property owned at the time of the marriage, later increases in value, such increment enjoys a like immunity. Furthermore, the income or other usufruct derived from such property, as well as any asset for which the original property may be exchanged or into which it, or the proceeds of its sale, may be traceable shall similarly be considered the separate property of the particular spouse.

> *Painter*, 65 N.J. at 214 (emphasis added).

Despite this bright line rule, which would have eliminated equitable distribution of the appreciated value of an active immune asset, the infamous footnote 4 of the decision added much confusion: "The immunity of incremental value to which we refer is not necessarily intended to include elements of value contributed by the other spouse, nor those for which the husband and wife are jointly responsible." *Id*. Although there are inconsistencies in our cases related to this footnote, it now means that direct contributions from a non-owning spouse serving as a homemaker, confidant and caretaker of children entitles a spouse to share in the appreciated value of the asset. A short summary of the evolution of this concept follows:

In *Scherzer v. Scherzer*, 136 N.J. Super. 397 (App. Div. 1975) the Court dealt with the equitable distribution of stocks of a premarital corporation owned by the husband. The Court noted that:

> The stock in question, unlike ordinary marketable securities, necessarily derived its value in large part from defendant's personal participation in the business. … The value of defendant's interest in the corporation which predated the marriage is, of course, immune from distribution. However, any increase in value occurring after the marriage should be considered eligible to the extent that it may be attributable to the expenditures of the effort of plaintiff wife. The theory is that a homemaker's contribution cannot be given a monetary worth and its value may be gleaned from the earnings of the employed spouse. *Id.* at 400-01 (emphasis added).

Two years later, in *Mol v. Mol*, 147 N.J. Super. 5 (App. Div. 1977) the Appellate Division held that while plaintiff wife was "not entitled to share in the portion of enhancement in the value of a home which was due solely to inflation or other economic factors and to which she did not contribute in any way," the trial judge must distinguish between "that portion of growth and value which was the result of independent economic factors alone such as inflation and that portion to which plaintiff contributed or for which husband and wife were jointly responsible." *Id.* at 9.

Thereafter, in *Gibbons v. Gibbons*, 174 N.J. Super. 107 (1980), *rev'd on other grounds*, 86 N.J. 515 (1981), the Court noted that:

> The non-remunerated efforts of raising children, making a home, performing a myriad of personal services and providing physical and emotional support are, among other non-economic ingredients of the marital relationship, at least as essential to its nature and maintenance as are the economic factors, and their worth is consequently entitled to substantial recognition.Thus, the extent to which each of the parties contributes to the marriage is not measurable only by the amount of money contributed to it during the period of its endurance, but rather by the whole complex financial and non-financial components contributed. *Id.* at 112-13 (emphasis added).

The confusion related to footnote 4 of *Painter* was finally settled in *Weiss v. Weiss*, 226 N.J. Super. 281 (App. Div. 1988) *cert. den'd.* 114 N.J. 287 (1989). The Court explicitly held that the wife's efforts as a homemaker and caretaker entitled her to equitable distribution of the premarital asset that had increased in value. *Id.* at 289-90. In essence, the decision reflected the Court's philosophy that marriage is a joint enterprise akin to a partnership. *Rothman v. Rothman*, 65 N.J. 219, 229 (1974). The same year that *Weiss* was decided, Judge Kraft rendered an opinion on *Scavone v. Scavone*, 230 N.J. Super. 482 (Ch. Div. 1988), *aff'd* 243 N.J. Super. 134 (App. Div. 1960). Although the case dealt with a passive asset that was acquired during the marriage and the issue related to the date of valuation, the Court used this as an opportunity to write a treatise on passive and active assets. The Court defined passive assets as "those assets whose value fluctuations are based exclusively on market conditions." *Id.* at 486. An active asset was defined as an asset that involves "contributions and efforts towards their growth and development which directly increased their value." *Id.* at 487. Surprisingly, the Court held, contrary to prior opinions, that when an immune active asset increases in value due solely to the efforts of the owner, that value is undistributable. *Id.* "Conversely, when such value is derived, in part or in whole, from the efforts of the non-owner, it is subject to distribution." *Id.* at 488. For example, where the non-owner spouse contributes by way of a mortgage paydown, a 100% immune asset is transformed to an asset subject to equitable distribution, for limited purposes. *Id.* at 488 (citing *Griffith v. Griffith*, 185 N.J. Super. 382, 385 (Ch. Div. 1982).

In *Berrie*, 252 N.J. Super. 635 (App. Div. 1991), the trial court granted the husband's motion *in limine* to bar the wife from seeking equitable distribution of 53.1% of husband's premarital publicly owned stock in Russ Berrie and Company. The husband argued that any increase in the stock was due to market conditions of publicly-traded stock and had nothing to do with his efforts. *Id.* at 642. At the time of the divorce, the husband was Chief Executive Officer of the company which employed 2,300 workers, 800 salespersons and 200 managers with 5 subsidiaries, 12 distribution centers and a worldwide market. *Id.* at 641. Despite the magnitude of the company and the market forces, the Court held that there was no question that a single person's efforts can influence the growth and success of a business that is public or private. *Id.* at 643. As the business grows, however, the question becomes more one of fact, depending on how closely the individual is identified with the business entity. *Id.* The Court remanded this matter for a plenary hearing to have expert testimony relating to Mr. Berrie's impact upon the value of the stock notwithstanding the fact that there may also be market forces that increase the value of the stock. *Id.* at 649. The Court further held that there may be passive and active components in the enhanced value of public stock. *Id.* at 644.

In *Valentino v. Valentino*, 309 N.J. Super. 334 (App. Div. 1998), the court distributed to the non-owning spouse 10% of a premarital mini strip mall which was used as a gas station after the dissolution of a twelve year marriage.

Although the Court quoted *Scavone* concerning an immune active asset not being distributed if it was solely increased through the owner's efforts, the Court nevertheless noted that the wife made contributions to the home and children which allowed the husband to work at his business. Hence, the Court ordered a distribution of 10% of the business. The decision did not explain the basis of the 10% award or whether the Court's award determined equitable distribution based on a percentage of the increase in the appreciation of the asset, or whether the Court was taking a percentage of the entire value of the property.

In his article on the distributability of premarital assets, Frank Louis commented on *Valentino* as follows:

> *Valentino* clearly confirms that the non-economic contributions of a spouse can create a right to share in post-marital appreciation unless the appreciation was not created by <u>either</u> spouse, i.e., interest on a bank account, appreciation of real estate, or publicly traded stock. Marital effort, as *Valentino* confirms, includes non-economic contributions such as raising children, maintaining a home. Yet, how this value is to be distributed should logically be effected by the fact that the asset itself was not created during the marriage. For example, in *Valentino*, the percentage received by the non-titled spouse was probably <u>less</u> than what she would have received had the asset been the initial product of the parties' hopes, dreams and marital efforts from inception. Frank A. Louis, *Premarital Assets: Proving and Defending Against Claims of Distributability*, at 19, Family Law Symposium (1999).

In summary, the law is now clear: non-economic contributions by a non-owning spouse to an immune active marital asset are sufficient to afford the non-owning party a right to share in the appreciation of the asset. However, if all or part of the appreciation of a business is passive in nature, that portion of the business shall be exempt from equitable distribution.

<u>**Burden of Proof**</u>

In *Sculler v. Sculler*, 348 N.J. Super. 374 (Ch. Div. 2001), a case of first impression, the Court addressed the burden of proof when a non-owning spouse is seeking equitable distribution of an immune active asset.

The Court set forth the burdens as follows:

> If a spouse asserts that an asset is immune, he or she bears the burden of establishing such immunity. Once the immunity is proven, any increase in value will also be immune unless it is shown that the increase was due, in whole or in part, to the efforts of the spouse seeking equitable distribution of the increase . . . proof that an asset is immune from equitable distribution raises a rebuttable presumption that any subsequent increase in value will also be immune. The burden then shifts to the non-owner spouse to demonstrate that (1) there has been an increase in the value of the asset during the term of the marriage; (2) the asset was one in which had the capacity to increase in value as a result of the parties effort (an active immune asset); and (3) the increase in value can be linked in some fashion to the efforts of the non-owner spouse. *Id.* at 380-81.

This opinion mandates that the non-owning spouse has the burden of proving that the increase in value was "linked in some fashion to the efforts of the non-owning spouse." *Id.* at 381. This appears inconsistent with *N.J.S.A.* 2A:34-23.1 which provides, in pertinent part, that, "it shall be a rebuttable presumption that each party made a substantial financial or non-financial contribution to the acquisition of income and property while the party was married." *N.J.S.A.* 2A:34-23.1

This opinion also places the burden of proof on the non-owning spouse to prove that the business actively increased during the marriage. *Sculler,* 348 N.J. Super. at 381. This burden seems misplaced since the owning spouse has all the knowledge and information about the business and would be in a better position to prove whether it was active or passive. This argument would be analogous to *Ozolins v. Ozolins* , 308 N.J. Super. 243 (App. Div. 1998), where the Court placed the burden on the cohabiting spouse to prove that there was no economic benefit or detriment derived from the cohabitation. The court relied on *Frantz,* 256 N.J. Super. 90, 93 (App. Div. 1992), which held that it would be unreasonable to place the burden of proof on a party not having access to the evidence necessary to support that burden of proof.[4]

Its noteworthy that the Virginia Code §20-107.3 (a) (3) (a) provides in pertinent part:

> For the purpose of this subdivision, the non-owning spouse shall bear the burden of proving that (i) contributions of marital property or effort were made and (ii) the separate property increased in value. Once this burden of proof is met, the owning spouse shall bear the burden of proving that the increase in value of some portion thereof was not caused by contributions of marital property or personal effort. (emphasis added).

OTHER EQUITABLE DISTRIBUTION STATES

Since New Jersey case law offers no guidance or model to quantify passive and active appreciation of an immune active asset, an examination of other equitable distribution states was undertaken.

Despite an exhaustive search, no cases were located. Clearly, the cause of a business's appreciation is fact sensitive. There is no precise formula or consistent approach that will determine why a business increased in value. Following is a summary of various case law which will underscore relevant facts that may bear upon passive increases in the value of a business.

MARKET FORCES

a.**Inflation[5]**

Inflation is changes in the value of money over time which would be deemed passive appreciation. There is a paucity of cases on this subject. In general, inflation and fluctuations in the nationwide economy are not considered relevant in valuing passive increases in an asset. The reason is simple: "Like a flower, a business must be tended to if it is to flourish." Brett R. Turner, *Distinguishing between Active and Passive Appreciation as Separate Property, A Suggested Approach*, 13 No. 5 Div. Lit. 73 (May 2001). If inflation is used for any calculation that will isolate a passive asset, it should not be based on a national rate of inflation but rather be focused on the specific industry that is being evaluated. *Id.*

In *Anthony v. Anthony*, 355 Pa. Super. 589 (1986), the Court rejected the owner spouse's request to reduce the active immune asset's value by inflation. The Court held that where the parties' economic partnership has existed in the marketplace influenced by inflation, it is appropriate to have the property reflect inflation's affect upon the partnership's assets. It should be noted, however, that under the Pennsylvania Divorce Codes, 23 P.S. §401e, the increase in the value of an active immune asset during the marriage is defined as marital property subject to distribution.

b.**The Increase is Due to Efforts of Third Parties**

If the owner spouse does not actually work in a business, he has no ability to influence or impact upon the value of that business. Therefore, all appreciation would be deemed passive. A prime example would be an absentee owner who leaves the management of the business to hired employees. See *Oxley v. Oxley*, 695 S. 2d. 364 (Fla. Dist. Ct. App. 1997) (Appreciation of the value of the business was entirely non-marital. Even though the husband was the Chief Executive Officer, most of the real management work was done by third parties, and the husband had medical problems which apparently limited his ability to manage the company.)

In most cases where the owning spouse played a pivotal role in the business, appreciation in the value of the business is active (e.g. when the owner is among the top managers of the company). However, persons who occupy lower positions in companies, even as high middle management, have generally been treated as having no affect upon the increase in the value of the business. *Porter v. Porter*, 67 Ariz. 273, 195 P. 2d. 132 (1948). But, perhaps, one could argue that an outstanding individual may have a dramatic affect upon the performance of a company. For example, someone who develops software that saves the company significant money or someone who creates an invention that becomes very profitable to the company. In *Berenberg v. Berenberg*, 474 N.W. 2d. 843 (Minn. Ct. App. 1991), the husband owned 49% of the business for which he worked as a Vice President and Director of Operations. The husband's father was the CEO and main shareholder of the business. The husband argued that he did not actively cause the increase in business. The Court held that the appreciation in his stock was active. See also, *Smith v. Smith*, 197 W.Va. 505, 475 S.E. 2d. 881 (1996). These cases demonstrate that notwithstanding a large number of third parties involved in a business, the appreciation may still be active. It should be noted that the recent surge in shareholder actions to dismiss top executives of unsuccessful large companies demonstrates that successful individual management can make a difference in large entities.

In many instances, the efforts of third parties may be relevant to the appreciation value that is equitably distributed. In *Decker v. Decker*, 17 Va. App. 12, 435 S.E. 2d. 407 (1993), the husband was a high level executive of a large public company. Although he was one of five key executives, he was considered “first among equals.” The company provided more life insurance for him than any other executive. Ultimately, he became president of the company. Despite these facts, the court held that he was one of five other managers and only 20% of the appreciation was attributable to the husband’s efforts. In *Ellis v. Ellis*, 235 A.D. 2d. 1002, 653 N.Y.S. 2d. 180 (1997), the court held that the husband who worked with five of his siblings in the business contributed to 20% of the appreciation, which was equivalent to 20% of the sales figures for which he was responsible. In other words, his effort was directly attributable to the percentage of gross revenues that he created. In a large company, this would be totally impractical since no one individual produces more than a small fraction of the company’s overall revenues. In *Innerbichler v. Innerbichler*, 132 Md. App. 207, 752 Ap.2d. 291 (2000), despite the fact that husband owned only 51% of a company which employed many people, the court held that the husband’s extraordinary expertise caused the appreciation to be active. In *Robbie v. Robbie*, 654 So. 2d. 616 (Fla. Dist. Ct. App. 1995), the husband was the general manager of the Miami Dolphins football team. The evidence is uncontroverted that he mainly carried out decisions made by the team’s owner and head coach. Nevertheless, the Court held that all the appreciation in husband’s stock was marital property. In *Mayhaw v. Mayhaw*, 197 W.Va. 290, 475 S.E. 2d. 382 (1996), the Court held that although a business may reap substantial benefits from the labor of others, some of whom may have been selected, trained or directed by the owner, the Court must consider the degree to which they acted under the overall supervision of the spouse.

c.**Marital Contributions Made to Separate Assets**

If marital funds are contributed to a separate asset, that contribution is deemed active. Otherwise, a devious spouse may divert marital funds for the improvement and contributions to a separate property. *Tibbetts v. Tibbetts*, 2000 M.E. 210, 762 A.2d. 937 (Me. 2000), *Hall v. Hall*, 462 A.2d. 1179, 1182 (Me. 1983).

d.**Negotiating Skills is Active Effort**

In *Dujack v. Dujack*, 221 A.D. 2d. 712, 632 N.Y.S. 2d. 895 (1995), the Court held that the talents of the husband in the negotiating of the sale of the business was a significant effort that caused the appreciation and the value of the asset.

e.**Other Economic Forces**

In *Hoffman v. Hoffman*, 676 S.W. 2d. 817 (Mo. 1984), the husband manufactured water cooling towers. In light of the fact that legislation increased the demand for cooling towers, business increased. The Court held that the appreciation was passive and separate property. An argument could be made, however, that Mr. Hoffman was wise enough to anticipate legislative changes and that his skill and acumen to develop and remain in this business was an active effort. Similarly, in another government action, the public road constructed across husband's separate property, increased the value of the farm dramatically. Again, the Court held that it was a passive asset. *Harrison v. Harrison*, 912 S.W. 2d. 124 (Tenn. 1995). In *Nordberg v. Nordberg*, 658 A.2d. 217 (M.E. 1995), appreciation was caused by fluctuations in the international currency market and was deemed passive. In *Myers v. Myers*, 70 Haw. 143, 764 P. 2d. 1237 (1988), appreciation caused by favorable change in the dollar/yen exchange ratio was deemed passive.

Similarly, in *Jolis v. Jolis*, 98 A.D. 2d. 692, 470 N.Y.S. 2d. 584 (1st Dep't. 1983) the Court held that a wife is not entitled to equitable distribution in the increase of the value of her husband's business where the increase in value was the result of, among other items, an explosion in the demand for diamonds.

COMMUNITY PROPERTY APPROACH

For over 75 years, many community property states, particularly California, have addressed the allocation of passive and active appreciation of a separate business.[6] Similar to New Jersey, the underlying philosophy of community property law is to view marriage as an economic partnership akin to a joint enterprise. Under community property law, the partnership encompasses all property generated during marriage by the effort of each spouse and both spouses are awarded an equal interest. J. Thomas Oldham, *Symposium: The Continuing Evolution of American Community Property Law: Article: Separate Property Businesses That Increase in Value During Marriage,* 1990 Wis. L. Rev. 585 (May/June 1990). If the increase in a separate asset is passive, it is not a part of the community estate as long as no community resources were used for the asset. If the asset increases due to the effort of either party, it is part of the community. The time, toil and talent of each spouse is perceived to be a community asset. To reach a fair result, community property law created the doctrine of reimbursement: "The fundamental purpose of the doctrine is to bring back into the community estate value which was created by community contributions, but which took the form of appreciation in the value of a separate asset." *Id.*

Two approaches used by most community property states to allocate active from passive increases are enunciated in the California cases of *Pereira v. Pereira*, 156 Cal. 1 (Cal. 1909) and *Van Camp v. Van Camp,* 53 Cal. App. 17 (1921)

***Pereira* approach**

The *Pereira* approach provides a reasonable annual rate of return for the separate capital invested in the business. The value of this capital, plus the annual rate of return on the capital, is the separate property claim. The community property claim is the amount, if any, by which the value of the business at dissolution exceeds the separate property claim. Oldham, *supra* at 587 (internal citations omitted).[7] For example, if the business, prior to marriage, had capital invested into it totaling $100,000, the reasonable rate of return was 6% per annum, the marriage lasted ten years and the business is now worth $500,000, the appreciated value of the business subject to community property would be $340,000 ($500,000 (value of business) minus $100,000 (capital) minus $60,000 (10 years of reasonable return on $100,000 at 6%).

In *Pereira,* at the time of the marriage, defendant husband had invested $15,500 in a successful saloon and cigar business. *Pereira,* 156 Cal. at 6. After the marriage, this fund remained in the business and contributed to its success. *Id.* at 7. The Supreme Court of California recognized the importance of this premarital investment in the success of the business and articulated the policy for crediting defendant for his capital investment as follows:

> It is true that it is …clearly shown that the principal part of the large income was due to the personal character, energy, ability, and capacity of the husband. This share of the earnings was, of course, community property. <u>But without capital he could not have carried on the business. In the absence of circumstances showing a different result, it is to be presumed that some of the profits were justly due to the capital invested.</u> There is nothing to show that all of it was due to defendant's efforts alone. The probable contribution of the capital to the income should have been determined from all of the circumstances of the case, and <u>as the business was profitable it would amount at least to the usual interest on a long investment well secured.</u> *Id.*

California courts have applied the legal rate of interest to the capital. *Id.[8]* In a New Mexico case, the Court applied the "rate of interest the community would have had to pay for a loan of such capital." *Id.* at 601, n.90 (citing *Gillespie v. Gillespie*, 84 N.M. 618 (1973)). New Mexico and California courts have also considered "the prevailing rate of a well-secured investment." *Id.* (citing *Jones v. Jones*, 67 N.M. 415 (1960); *Randolph v. Randolph,* 118 Cal. App. 2d 584 (1953); *In re Neilson's Estate*, 57 Cal. 2d 733 (1962)). Courts have also applied the "normal growth rate of businesses of the type owned by the spouse during the period involved in the geographical area where the business is located." *Id.* at 601, n.91 (citing *In re Marriage of Folb*, 53 Cal. App. 3d 862 (1975)). This "average rate of return" approach allows the Court to apply different rates of return to different types of separate property businesses. *Id.* at 601-02.

After the Court determines the reasonable rate of return, additional complex issues arise, such as whether the rate of return should be compounded and whether the business's goodwill at the time the asset is acquired should be included in calculating the value of the business at the time of dissolution. *Id.* at 603. In addition, courts have adopted different approaches to computing the "increase in value" during the marriage. *Id.* "Most courts have applied *Pereira* by comparing the value of a business at the time of marriage to the value at the time of dissolution by using a fixed rate of return." *Id.* However, Nevada courts have adopted a year-by-year accounting. *Cord v. Cord*, 94 Nev. 21, 27 (1978).

<u>***VAN CAMP*** **APPROACH**</u>

The other method for valuing the enhanced value of a separate business is called the *Van Camp* formula. This method gives the community estate the difference between the compensation received and reasonable compensation for the effort performed.

For example, if the business owner's compensation is $100,000 per year and reasonable compensation would be $150,000 a year, the difference of $50,000 would be multiplied by the number of years of the marriage and be subject to community property and the remainder of the business would be separate property.

In *Van Camp,* at the time of the marriage, the defendant husband was a successful businessman as President and manager of Van Camp Sea Food Company. *Van Camp,* 53 Cal. App. at 24. The California Court of Appeals articulated the following explanation in support of its new approach to distribution of property:

> While it may be true that the success of the corporation of which defendant was president and manager was to a large extent due to his capacity and ability, nevertheless without the investment of his capital in the corporation he could not have conducted the business, and while he devoted his energies and personal efforts to making it a success, he was by the corporation paid what the evidence shows was an adequate salary, and for which another than himself with equal capacity could have been secured. Had such course been pursued and defendant contented himself merely with the receipt of dividends from the business, the character of the dividends as separate property could not have been questioned. Instead, however, of doing this, he entered upon the duties as manager of the corporation, gave his exclusive time and efforts thereto, for which he received [a salary]. … It is impossible to say what part of the enormous dividends paid by the Van Camp Sea Food Company should be apportioned to the skill and management thereof and what part should be apportioned to the investment of the capital and the favorable conditions under which business was conducted. … <u>In view of the fact that [defendant] was adequately paid by the corporation for his services, such compensation… must be deemed the extent of his personal earnings, and the balance of the profits derived from the business accredited to the use of the capital invested therein, in the same manner as though he had not been employed by the corporation</u>. *Id.* at 28-29.

Van Camp has since been interpreted to allocate to the community an *annual sum* equal to the salary which would have to be paid an employee rendering services equivalent to the husband's minus the salary or compensation received by that employee. *Cord v. Cord,* 94 Nev. 21 (1978).

In an Arizona case, *Rowe v. Rowe,* 154 Ariz. 616, 620 (1987), the Court of Appeals affirmed the trial court's application of *Van Camp.* Although the Court found that the predominant cause of growth was due to the owner's efforts, it did not award any of the appreciation in the business to the wife. The Court reasoned that other factors caused the growth in the business such as the marketing efforts of a manufacturer that the company represented, population growth, inflation, increased consumer buying power, demand for electronics and sales efforts by third parties. The Court concluded that 75% of the enhanced value was active effort. However, since the community had received 75% of the distributable earnings, including distributions, pension and profit sharing distributions, the community had been fairly compensated. In affirming the trial court, the appellate court stated, "our courts have previously recognized that a community may be fairly compensated by salaries and draws received prior to dissolution." *Id.* at 621. In essence, the Court held that the work effort of the husband was compensated by way of income and assets derived from the business during the marriage, which presumably both parties shared or will share as part of the community property.

Van Camp and *Pereira* are very early cases; yet, they are still followed in community property states today. In *Beam v. Bank of America,* the California Supreme Court discussed the importance of these cases at great length. *Beam v. Bank of America*, 6 Cal. 3d 12 (1971). However, the California Supreme Court noted that despite the adoption of these two approaches, "our courts have developed no precise criterion or fixed standard" for apportioning such property. *Id.* at 18. The court further instructed that courts can follow either approach:

> In applying this principle of apportionment the court is not bound either to adopt a predetermined percentage as a fair return on business capital which is separate property (the *Pereira* approach) nor need it limit the community interest only to a salary fixed as the reward for a spouse's service (the *Van Camp* method) but may select whichever formula will achieve substantial justice between the parties. *Id.*

When the appreciation is mostly active, *Pereira* is preferred; when the appreciation is mostly passive, *Van Camp* is preferred. Turner, *supra*.

In his article, J. Thomas Oldham proposes the following approach when selecting either the *Pereira* or *Van Camp* method:

> As a general rule, courts should determine whether the increase in value during marriage was primarily due to a spouse's efforts or due to separate property capital. If the former is true, the approach should be applied that yields the greatest community claim. If capital is the most significant factor, the approach that yields the largest separate property claim should be chosen. Oldham, *supra* at 588-89 (internal citations omitted).

Both approaches may be unfair. Under *Pereira*, the non-owning spouse could argue that the return on the capital was brought about as a result of his or her spouse's active effort. *Van Camp* is unfair because no matter how much the business appreciates or depreciates, the court only looks at the difference between reasonable compensation and actual compensation.

Conclusions

Under New Jersey law and other jurisdictions, appreciation of a separate or immune business is equitably distributed provided it is caused by direct or indirect marital contributions. Efforts of a non-owning spouse as a homemaker and caretaker of children is an indirect contribution that entitles that spouse to equitable distribution of the enhanced business asset.

New Jersey and other equitable distribution states have not developed a formula to allocate passive and active increases in a separate business that is subject to equitable distribution. Nevertheless, New Jersey law does immunize passive appreciation of a separate asset. The case law of other equitable distribution states underscores the need to critically examine the facts and circumstances that gave rise to the appreciation of the business. Some factors that have been upheld in equitable distribution states include: the impact of third parties, changes in government regulations, market fluctuations, inflation, consumer demand. Community property states have relied on the *Van Camp* or *Pereira* approach to develop a formula for calculating the active and passive portion of the increase in a separate asset. Although these methods may be popular in community property states, no equitable distribution states have adopted either method. The formula approach oversimplifies the evaluation without analyzing the myriad of facts that caused the increase.

The cause or reason for a separate asset's appreciation is relevant to both the valuation of the asset (to exclude passive increases) and the statutory factors relevant to the distribution of the asset. Pursuant to *N.J.S.A.* 2A:34-23.1(i), the Court is directed, when equitably distributing assets, to consider "the contributions of each party to the acquisition, dissipation, preservation, depreciation, or appreciation in the amount or value of the marital property, as well as the contribution if the party is a homemaker." (emphasis added).

In either case, each party to an action must vigilantly marshal all relevant facts related to the passive or active appreciation of a separate business subject to equitable distribution.

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[2] David M. Wildstein is chair of the twelve member Family Law Department of Wilentz, Goldman & Spitzer, P.A., Woodbridge, New

Jersey.

[3] A separate asset is also known as an immune asset, *Scavone*, 230 N.J. Super. 482 (Ch. Div. 1988) and includes premarital, gifted or inherited assets. Hereinafter a separate asset shall also be called an immune asset.

[4] Brett R. Turner in his article *Distinguishing Between Active and Passive Appreciation in Separate Property: A Suggested Approach*, 13 No. 5 Div. Lit. 73, May 2001, notes at page 5 that:

> Nationwide, case law is divided on who bears the burden of proof in classifying appreciation in separate property. One group of states places the burden of proof upon the spouse who claims that the appreciation is active. See *Waring v. Waring*, 747 S.2d 252 (Miss. 1999); *Knapp v. Knapp*, 874 S.W. 2d 520 (MO. Ct. App. 1994) . . . Another group of states places the burden of proof upon the spouse who claims that the appreciation is passive. See . . . *Cockrall v. Cockrall*, 124 AZ 50, 601 P. 2d 1334 (1979); *Massis v. Massis*, 551 So. 587 (Fla. Dist. Ct. App. 1989) . . .

[5] In *Somers v. Somers*, 203 A.D. 2d. 975; 611 N.Y.S. 2d. 971 (1994), the Court held that government inflation statistics could be used as a basis for determining what portion of the appreciation of real estate was due to inflation or other market forces.

[6] The eight community property states are Arizona, California, Idaho, Louisiana, New Mexico, Nevada, Texas, and Washington. David W. Reinecke, *Community Property Issues for Non-community Property Practitioners*, SH0 92 ALI-ABA 1129, 1132 (June 2003). In addition, Wisconsin follows a marital property system that is a form of community property, and in 1998, Alaska adopted an “elective” community property system. *Id.* at 1132-33. It is important to note that Texas follows a different method of classification than other community property states. Bee Ann Smith, *Article: The Partnership Theory of Marriage: A Borrowed Solution Fails*, 68 Tex. L. Rev. 689, 710 (March 1990). This approach is called the inception-of-title rule which is described as follows:

> Under this doctrine, a separate asset brought into the marriage remains exclusively separate property, even if community funds or labor enhance its value or contribute to its purchase. This rule also applies to separate property acquired during marriage by gift or inheritance or from the proceeds of separate property. The rule advocates a snapshot test of ownership based on the marital property rights on the day that title or claim of title arose. This classification is fixed forever and may not be altered by subsequent contributions of time or funds. The inception-of-title rule permits only one adjustment: reimbursement, an equitable remedy based on unjust enrichment. Reimbursement is justified when the funds or energies of the marital estate benefit one spouse without the community’s receiving an equivalent benefit. *Id.* at 710.

[7] It is important to note that both Arizona and Nevada formerly adopted an “all or nothing” approach to computation which focused on the “primary cause of an increase in value of a business during marriage.” Oldham, *supra* at 592.

> If the primary cause was the separate property capital, the increase was separate property; if the primary cause was the effort of one or both spouses, the increase was community property. Pursuant to this approach, courts developed rules of thumb for different types of businesses. An increase in value of a hotel or a nursery was deemed separate property; in contrast, increases in the value of pool halls, restaurants, saloons or bakeries were considered community property. This all or nothing approach was not considered sufficiently precise in most community property states. Indeed, both Arizona and Nevada finally abandoned it. Most courts and writers agree that the all or nothing approach is not a good rule. *Id.* (internal citations omitted).

[8] *See Pereira*, *supra* (seven percent interest); *Price v. Price,* 217 Cal. App. 2d 1 (1963) (seven percent interest); *Weinberg v. Weinberg,* 67 Cal. 2d 557 (1967) (seven percent interest); *Elliott v. Elliott,* 162 Cal. App. 2d 350 (1958) (six percent interest); *Margolis v. Margolis,* 115 Cal. App. 2d 131 (1952) (six percent interest)).

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