

Valuation and Division of Employee Stock Options in Divorce

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An employee stock option is a contractual right to purchase stock during a specified period at a predetermined price.⁽²⁾

Increasingly, corporations are granting stock options to employees as compensation for services that have been, or will, be performed. The increasing use of employee stock options has translated into expanding litigation concerning whether stock options are marital property, and if so, how they should be valued and divided.⁽³⁾

As retirement benefits provided fertile controversy in the 90's, stock options are destined to become a primary focus in the new millennium.

I. ARE STOCK OPTIONS MARITAL PROPERTY?

Marital property generally includes all property acquired by either spouse during the marriage.⁽⁴⁾

In evaluating whether an employee stock option constitutes a "property" interest, as opposed to a mere expectancy, the first determination is whether the stock option is "vested."⁽⁵⁾ A non-vested stock option is treated as a mere expectancy because the holder has no enforceable rights. Therefore, non-vested stock options are not "property" and are not subject to division.⁽⁶⁾

The definition of "vesting," for purposes of determining whether the options are "property" under dissolution of marriage laws, is not the same as the concept of "vesting" for the purpose of the tax code or under the option itself.⁽⁷⁾ Under Colorado dissolution of marriage law, stock options can be "vested," and therefore "property," even though the ability to exercise the option is contingent on passage of time or continued employment.⁽⁸⁾ So long as the employer cannot unilaterally repudiate the option, it should be deemed "vested" and therefore "property" in divorce law.⁽⁹⁾ When the option-holder has the absolute right to exercise the option at any time by payment of the option price, the option is said to be both "vested" and "matured."

Once an option is determined to be "vested," and therefore a "property" interest, the next step is to classify that interest as either marital or separate property. The test for making this classification was determined by the Colorado Supreme Court: "[T]o the extent an employee stock option is granted in consideration of past services, the option may constitute marital property when granted [footnote and citations omitted]. On the other hand, an employee stock option granted in consideration of future services does not constitute marital property until the employee has performed those future services [citation omitted]."⁽¹⁰⁾

Whether an employee stock option is characterized as being granted in consideration of past or future services depends upon the circumstances surrounding the grant and the effect of the option agreement. The determination may depend upon such factors as the flexibility and variety of option plans as well as the size of the company and its need to offer incentives to employees to remain as employees of the company.

⁽¹¹⁾ Options may be awarded as an inducement to lure an executive to a company. Options are also an effective tool to provide incentives to an employee to stay with a company, especially in the competitive high technology industry. Options granted during a term of employment may be a reward or bonus for work well-done (*i.e.*, for past services) or as "golden handcuffs" to keep an employee from accepting a lucrative offer elsewhere (*i.e.*, for future services).

At a minimum, the following factors should be considered in determining whether options are granted for past or future services:

- a. Were the options granted at inception of employment or during a continuing term of employment?
- b. Were the options a reward for a specific past service?
- c. Are the options a substitute for salary?
- d. Are the options a bonus or profit sharing reward?
- e. Were the options an inducement to accept employment?
- f. Were the options spread uniformly over time or front end?
- g. Is there any testimony from the employer explaining the purpose of granting the option?⁽¹²⁾

Even if initially granted for future services, a stock option may become marital if the future services have already been performed by the employee at the time of dissolution.⁽¹³⁾

II. HOW CAN A COURT DIVIDE AND VALUE STOCK OPTIONS?

Once vested stock options have been classified as "marital" property, the court has discretion to determine the appropriate method for valuation and distribution.⁽¹⁴⁾ There are basically three approaches to valuation and division: (1) net present value, (2) deferred distribution, and (3) reserve jurisdiction.⁽¹⁵⁾

Each method will be discussed in turn.

a. Net Present Value :

The "net present value" approach results in immediate distribution to the non-employee spouse. A lump sum that represents the net present value of the future benefit is determined and may be offset by the value of other property in the marital estate.⁽¹⁶⁾ If using this method, the trial court, guided by actuarial data, values the future benefit, considers a number of different factors, including certain risks, and accords a present value to the future benefit.⁽¹⁷⁾ The benefits associated with immediate distribution are compelling in those instances where the value of the stock options are minimal relative to the overall marital estate. The non-employee spouse exchanges future contingent post-dissolution enhancements for the benefits of immediate distribution, while the employee spouse reaps the benefit of potential enhancements that may occur post-dissolution.⁽¹⁸⁾ If the employee spouse foresees that the options may dramatically increase after the divorce, that spouse will want to "cash out" the non-employee spouse.⁽¹⁹⁾

The "Net Present Value" method serves the goal of finality and allows the parties to disentangle financially, providing some measure of closure. By immediately offsetting

the value of the options with other marital property, the policy of judicial efficiency is served because the parties do not have to return to court at a later date. In circumstances where the marital estate is large enough to permit an offset with other marital property, the "net present value" method should be preferred.⁽²⁰⁾

One approach to assigning a value on stock options is to determine its "intrinsic value," which is simply the market value of the stock, less the exercise cost of the option and any applicable financing costs. Courts and experts have also used more complicated mathematical formulae to determine a stock option's present value. Two main types of models exist: econometric and theoretical. Econometric models, or empirical models, use "regression analysis of historical relationships among economic variables to estimate statistically the expected value of an economic variable," in this case, the expected value of stock options.⁽²¹⁾ The two most widely used econometric models to value stock options are the Shelton Model⁽²²⁾ and the Kassouf Model.⁽²³⁾ The Shelton model is especially useful for valuing stock options of closely held companies. Most models use a variable known as the volatility factor, which quantifies the historical fluctuations of the stock's price. The Shelton model does not use this variable. The information needed to determine the volatility factor is often not available when dealing with options issued by closely-held companies. Use of the Shelton model in this situation eliminates the need for the costly analysis, or outright speculation, which would be necessary to compute a volatility factor for the stock of closely-held companies.

Theoretical models, or statistical models, rather than being based on historical observation, "are forward looking and attempt to determine what the option *should* sell for in the market given the option terms and the underlying stock's salient characteristics."⁽²⁴⁾ These models are based on a number of assumptions, one essential assumption being "that the price of the underlying stock behaves in such a way that possible future prices can be accurately modeled by some probability distribution."⁽²⁵⁾ The other assumptions vary from model to model. The best known, and most widely used, of the theoretical models is the Black-Scholes Model.⁽²⁶⁾ Computer programs using the Black-Scholes Model are readily available. The Black-Scholes Model accounts for the option price, the term of the option, the market value of the underlying security, a risk-free rate of return, and the underlying volatility of the stock option, in order to come up with a present value for the option.⁽²⁷⁾

When using any of these approaches to value employee stock options, it is important to note that these models were generally designed to value marketable options. Usually, employee stock options are non-marketable, and a discount for lack of marketability should be utilized.⁽²⁸⁾ Furthermore, valuation should not rely on use of only one model. Using at least two models will help to ensure that the valuation is relatively accurate. The practitioner should bear in mind that, if the circumstances do not warrant an immediate distribution because there are either insufficient assets to permit an offset *or the present value is too difficult to ascertain*, the trial court may use either the deferred distribution or reserve jurisdiction method.⁽²⁹⁾

b. Deferred Distribution Method

Unlike the "net present value" method, the deferred distribution and reserve jurisdiction methods do not result in an immediate offset with other marital property. Under these approaches, the non-employee spouse will not receive any benefits until the benefits are actually paid to the employee spouse or the employee spouse

becomes eligible to receive benefits.⁽³⁰⁾ Under the deferred distribution method, the court pre-determines the percentage the non-employee spouse will be eligible to receive once the benefits are paid or the employee spouse is eligible to receive them. The percentage used is commonly based upon the "time rule" formula.

The "time rule" formula was explicitly made applicable to the division of stock options in *In re Marriage of Balanson*.⁽³¹⁾ While the Court of Appeals did not specify how the time rule formula is computed for stock options, caution requires not following the methodology rejected by the Supreme Court in *Miller*. In *Miller*, the Supreme Court refused to use a formula based on the ratio of the period the parties were married during the respective options in proportion to the entire length of options or grant.⁽³²⁾

One commentator has suggested that the time rule fraction should be as follows:

Period of Employment
During Marriage (numerator)
Period of Employment
From Hiring Until Vesting
(denominator)⁽³³⁾

No Colorado case has expressly determined whether the employee-spouse is required to exercise the options as soon as possible. Most stock options preclude the employee-spouse from transferring or assigning the option so that the trial court would not be able to simply order a division in kind.⁽³⁴⁾ One solution under the deferred distribution method is to have the court require the employee spouse to make a payment in cash to the non-employee spouse, based upon the pre-determined "time rule" formula, as soon as the options are exercisable, whether or not the employee chooses to retain the options. Another alternative is to order the employee spouse to exercise the options and then transfer the underlying stock or sale proceeds to the non-employee spouse. Each of these possible solutions involves potential future court involvement and issues of employer cooperation.

c. Reserve Jurisdiction Method .

In Colorado, a court may also apply the "reserve jurisdiction" method of dividing stock options.⁽³⁵⁾ Unlike the deferred distribution method, whereby the court pre-determines the non-employee spouse's share, the reserve jurisdiction approach is effectively a "wait and see" method. If the court reserves jurisdiction, the marital portion of the options may be divided and distributed at a later date when they are exercised.⁽³⁶⁾

d. Examples of Distribution and Valuation Alternatives .

- In *In Re the Marriage of Chen* ,⁽³⁷⁾ the Wisconsin Court of Appeals upheld the use of the "if and when" method. The case concerned stock options that had been granted during the marriage but were not exercisable until dates after the divorce. The options were not transferable or assignable and expired if employment terminated. The trial court found that no reasonably accurate value could be assigned to these stock options, and therefore an award of a fixed sum would not be practical. The court then held that the employee spouse could exercise the options "if and when" he desired, subject only to employer and SEC regulations. Upon sale of the underlying stock acquired via

exercising the options, the employee-spouse was to pay the non-employee spouse one half of the net profit. If the stock thus acquired had not been sold within 18 months of the date of exercise, the non-employee spouse could elect to be paid using the stock price 18 months from the date of exercise, or she could choose to wait until the stock was finally sold. If no net profit was made, no additional monies were due either party.

- The Maryland Court of Special Appeals, in *Green v. Green*,⁽³⁸⁾ approved a similar method of division. Just as in *Chen, supra*, the employee spouse's stock options were not assignable and could not be sold. The court found that "[a]lthough it is true that an unassignable, unsalable option has no fair market value, it is nonetheless an economic resource, comparable to pension benefits, to which a value can be attributed."⁽³⁹⁾

The court approved an "if, as, and when" approach to the valuation and equitable allocation of the unexercised options, which applied to both matured and unmatured options. The trial court was to calculate a value of the options as of the date of the divorce decree.⁽⁴⁰⁾ The court could then determine a percentage by which the profits should be divided if, as, and when the options are exercised. The court felt this was equitable as the employee spouse is under no compulsion to exercise his options. At the same time, however, the non-employee spouse's equitable interest in the options, if exercised, is protected.⁽⁴¹⁾

- In contrast to the Colorado appellate courts, the Illinois Court of Appeals in *In Re Marriage of Moody*,⁽⁴²⁾ found that stock options do not constitute property until exercised. It directed the trial court to retain jurisdiction until such time as the options were exercised or expired. If and when the options were exercised, the trial court was permitted to use its discretion in allocating an appropriate share of any profit realized by the employee spouse. This "if and when" approach subsequently withstood an argument that the court should have retained jurisdiction to permit the non-employee spouse to compel the exercise of her share of the options.⁽⁴³⁾
- In *Smith v. Smith*,⁽⁴⁴⁾ the Missouri Court of appeals upheld a trial court decree finding that the employee spouse had the right to decide whether or not to exercise his stock options. However, if the employee-spouse elected to exercise any of the options, he was to give the non-employee spouse 30 days notice before acting. During those 30 days, the non-employee spouse could provide the employee spouse with the cash necessary to buy a one-half interest in that option on her behalf. If she did not provide him with the cash, she forfeited her right to the one-half of that option. Each party was to pay a share of the income taxes on the options. *See also, DeJesus v. DeJesus*⁽⁴⁵⁾ (New York Court used similar method and constructive trust to divide options); *Callahan v. Callahan*⁽⁴⁶⁾ (New Jersey court used constructive trust theory and with non-employee spouse prorated right to determine date to exercise options subject to SEC limitations).
- *Hug v. Hug*⁽⁴⁷⁾ approved a valuation formula using numerator equal to period between commencement of employment and date of dissolution and a denominator equal to the period between commencement of employment and date when each option is first exercised times the number of shares which can be purchased on date option is first exercised.

e. Incentive v. Non-qualified Stock Options .

An important consideration when determining the current value or the future distribution strategy of employee stock options or restricted stock is the income tax treatment of these options. Employee stock options can take two forms, Qualified Stock Options (typically called "Incentive Stock Options") and Nonqualified Stock Options.

Qualified stock options conform with certain guidelines in the Internal Revenue Code and are provided preferential tax treatment. Upon exercise of the option, there is no current income taxation of the options, and upon a qualifying sale of the stock received via exercise of the option, the increase in value is taxed at capital gains rates. The difference between the current price and the exercise price upon exercise is an Alternative Minimum Tax ("AMT") preference item and may trigger AMT in certain circumstances. If the Qualified Stock Options are disposed of in a disqualifying disposition, they lose their preferential tax treatment and are taxed as ordinary income.

Nonqualified Stock Options generally are taxed at ordinary rates upon exercise on the amount of the difference between the exercise price and the stock price at exercise. The amount of ordinary income is subject to both income taxes and employment (FICA and Medicare) taxes. Upon the ultimate sale of the stock received through exercise of a nonqualified stock option, the difference between the stock price at exercise and the selling price is taxed as short or long-term capital gain or loss. Proceeds received by exercising stock options are ordinary income for purposes of determining child support.⁽⁴⁸⁾

III. CONCLUSION

The "property" right at issue with regard to stock options is the *right to choose* whether or not to purchase stock shares which are offered at certain dates at specified prices. To divide this marital asset properly requires giving each spouse the *right to choose* whether or not to exercise the right to purchase the underlying stock. Because employee stock options are typically not assignable, and because division in kind is therefore not permissible, courts have developed alternative mechanisms to accomplish division.

The "net present value" method of dividing stock options is the preferable method where the stock and the options are readily capable of valuation. In situations where the options are not capable of valuation, the deferred distribution or reserve jurisdiction methods more equitably serve to divide the options. Reserving jurisdiction to divide the options should be the last resort, since the goal of finality is contravened when parties will inevitably need to return to court to value and divide the options. Under most circumstances, the time-rule formula can pre-determine the non-employee spouse's share when options become exercisable and therefore is preferable to reserving jurisdiction.

1. Thanks to Craig A. Weinberg (Esq.), David Werber (Esq.), Bill Vincent (CPA), John Connell (CPA) and Miriam Mason (Esq.), for research and drafting assistance.

2. *In re Marriage of Miller*, 915 P.2d 1314, 1317 (Colo. 1996).

3. An excellent article on employee stock options was published in the Colorado Lawyer in October of 1996. Malone, *Employee Stock Options and Restricted Shares: Determining and Dividing the Marital Pot*, 25 Colo. Lawyer 87 (1996).
4. 14-10-113(2), 5 C.R.S. (1999).
5. *In re Marriage of Huston*, 967 P.2d 181, 183 (Colo. App. 1998).
6. *Id.*
7. *In re Marriage of Miller*, 915 P.2d at 1317.
8. *In re Marriage of Miller*, 915 P.2d at 1318.
9. *Id.*
10. *In re Marriage of Miller*, 915 P.2d at 1319.
11. *In re Marriage of Miller*, 915 P.2d at 1319, n. 9.
12. This list is not exhaustive, and no single factor is dispositive. See *In re Marriage of Miller*, 915 P.2d at 1319, n. 9.
13. *In re Marriage of Balanson*, ___ P.2d ___ (Colo. App. No. 98 CA 982, July 22, 1999). The author acted as counsel for the Husband (employee-spouse) in this case. Cross-petitions for a Writ of Certiorari are currently pending before the Colorado Supreme Court.
14. *In re Marriage of Balanson*, ___ P.2d ___ (Colo. App. No. 98 CA 982, July 22, 1999).
15. *In re Marriage of Hunt*, 909 P.2d 525 (Colo. 1995).
16. *In re Marriage of Hunt*, 909 P.2d 525, 531 (Colo. 1995).
17. *In re Marriage of Hunt*, 909 P.2d at 531.
18. *In re Marriage of Hunt*, 909 P.2d at 539.
19. *In re Marriage of Hunt*, 909 P.2d at 539, n. 14.
20. *In re Marriage of Hunt*, 909 P.2d at 540.
21. Pratt, Reilly, Schweihs, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies* (2d ed.1989) (hereafter referred to as "Pratt") at p. 452.
22. J.P. Shelton, *The Relationship of the Price of a Warrant to the Price of Its Associated Stock*, Financial Analysts J., May-June, July-August, 1967.

23. Sheen T. Kassouf, *A Theory and an Econometric Model for Common Stock Purchase Warrants* (Analytical Publishers 1965).
24. Pratt at 452.
25. *Id.*
26. Fisher Black and Myron Scholes, *The Pricing of Options and Corporate Liabilities*, *Journal of Political Economy*, June 1973. The Black-Scholes model does not allow for dividends in the valuation. A variation of this model, the Noreen-Wolfson Model, does. Eric Wolfson and Mark Wolfson, *Equilibrium Warrant Pricing Models and Accounting for Executive Stock Options*, *J. Acct. Res.*, Autumn 1981.
27. *Davidson v. Davidson*, 254 Neb. 656, 578 N.W.2d 848 (1998). Other decisions have criticized using the Black/Scholes Method in a marital context. *Murray v. Murray*, 128 Ohio.App.3d 662, 716 N.E.2d 288 (1999), *citing, Chammah v. Chammah*, 1997 WL 414404 (Conn. Sup. Ct. 1997); *see also, Wendt v. Wendt*, 1998 WL 161165 (Conn. Sup. Ct. 1997).
28. Pratt at 451.
29. *In re Marriage of Hunt*, 909 P.2d at 540.
30. *In re Marriage of Hunt*, 909 P.2d at 531.
31. ____ P.2d ____ (Colo. App. No. 98 CA 982, July 22, 1999).
32. The *Hunt* Court approved a "Coverture Fraction" using a numerator (length of employment toward acquisition of pension during marriage) and denominator (total length of employment from eligibility for pension plan until receipt of benefits).
33. Malone, *Employee Stock Options and Restricted Shares: Determining and Dividing the Marital Pot*, 25 *Colo.Lawyer* 87 (October 1996). "Consider an employee who is hired in 1980 and marries in 1982. Her employer grants her stock options in 1987 that may be exercised after three years. However, in 1988 her marriage is dissolved. The employee-spouse would need ten years of employment before the stock option grant could be exercised, and six years of her employment were during the marriage. Applying the time rule formula, six becomes the numerator and ten becomes the denominator. The marital fraction of the options is 6/10. Thus 60 percent of the stock options would be marital property to be divided in the dissolution action." *cf. In re Marriage of Short*, 125 Wash.2d 865, 872, 890 P.2d 12, 15 (1995)(The "time rule" formula is nothing more than a fraction whose numerator is the period of time between the commencement of the spouse's employment by the employer granting the stock options and the date the parties were found to be "living separate and apart", and the denominator is the period of time between commencement of employment and the date when each option is first exercisable, multiplied by the number of shares which can be purchased on the date the option is first exercisable.).
34. *In re Marriage of Balanson*, ____ P.2d ____ (Colo. App. No. 98 CA 982, July 22, 1999).

35. *In re Marriage of Huston*, 967 P.2d at 183-184.
36. *In re Marriage of Balanson*, ____ P.2d ____ (Colo. App. No. 98 CA 982, July 22, 1999).
37. 142 Wis.2d 7, 416 N.W.2d 661 (1987).
38. 64 Md.App. 122, 494 A.2d 721 (1985).
39. 64 Md.App. at 138, 494 A.2d at 728.
40. The court permitted use of an "intrinsic value" approach to calculating the present value of the options.
41. 64 Md.App. at 138, 494 A.2d at 729.
42. 119 Ill.App.3d 1043, 75 Ill.Dec. 581, 457 N.E.2d 1023 (1983).
43. *In re Marriage of Frederick*, 218 Ill.App.3d 533, 161 Ill.Dec. 254, 578 N.E.2d 612 (1991).
44. 682 S.W.2d 834 (Mo. App. 1984).
45. 163 Misc.2d 267, 620 N.Y.S. 2d 704 (1994).
46. 142 N.J.Super. 325, 361 A.2d 561, 563 (1976).
47. 201 Cal. Rptr. 676, 154 Cal.App.3d 780 (1984).
48. *In re Marriage of Campbell*, 905 P.2d 19 (Colo. App. 1995).