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The New Marital Property of Employee Stock Options

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I. Introduction

One of the most valuable assets in a dissolution case today is an employee stock option (ESO). An ESO is a contractual right granted to an employee to purchase the stock of her corporate employer during a designated period of time at a predetermined price.[1] The law, however, has failed to keep up with this modern form of employee compensation and indeed has struggled to understand this new form of property in the context of dividing and distributing marital property. Only fourteen state supreme courts to date have spoken on any aspect of this complex issue, and of these, only a handful have analyzed the relevant issues in any meaningful way.[2] This article thus delineates the

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1. I.R.C. § 1234(a); Treas. Reg. § 1.421-7(a)(1) (a stock option grants the right but not the obligation to purchase corporate shares at a fixed price on a fixed date or range of dates); BLACK'S LAW DICTIONARY 986–87 (5th ed. 1979) (in general, a stock option is the right to buy a designated stock at a particular price for a specified period of time).

2. Baccanti v. Morton, 752 N.E.2d 718 (Mass. 2001) (addressing all issues of characterization, valuation and division of unvested ESOs); Payson v. Payson, 2001 WL 1083117 *1 n.1 & *2 (Ga. Sept. 7, 2001) (an ESO granted to wife prior to marriage but exercised during marriage was not marital property because it was not generated by the marriage nor accumulated during the marriage); *In re* Balanson, 25 P.3d 28 (Colo. 2001) (a stock option granted for future services that had not yet been completed by employee spouse was not property but only a mere expectancy); Fisher v. Fisher, 769 A.2d 1165 (Pa. 2001) (addressing relevant issues of characterization and valuation of options); Bornemann v. Bornemann, 752 A.2d 978 (Conn. 1998) (addressing all issues of characterization, valuation, and division of an ESO as property); Broadribb v. Broadribb, 956 P.2d 1222 (Alaska 1998) (holding without discussion that options granted but not yet exercisable at time of divorce were marital assets); Davidson v. Davidson, 578 N.W.2d 848 (Neb. 1998) (addressing all relevant issues); DeJesus v. DeJesus, 687 N.E.2d 1319 (N.Y. 1997) (adopting time rule to apportion marital share of an ESO); *In re* Marriage of Miller, 915 P.2d 1314 (Colo. 1996) (granted and exercisable ESOs at the time of divorce were marital property akin to other securities or

emerging lines of reasoning in an attempt to direct the legal analysis as consideration of the ESO in dissolution percolates through the courts.

In the seminal case addressing ESOs as marital property in 1984, the California Court of Appeals in *In re Marriage of Hug* noted, "Considering the frequency with which employee stock options are provided as part of key employee compensation packages, it is surprising that the allocation of community and separate property interests therein has not previously been addressed."[3] The frequency of granting ESOs has exploded in the ensuing years since the time of *Hug*.[4] Today, it is estimated that between ten and twelve million private sector employees have ESOs, up from just one million employees in 1992.[5] Ninety-eight percent of the S&P 500 companies grant ESOs to their management employees.[6] Moreover, the expanded use of granting ESOs in new and risky enterprises like high-technology, e-commerce, and dot-com companies have moved this property form out of the corporate executive office into the lives of many married employees.[7]

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common stock); Klingenberg v. Klingenberg, 675 A.2d 551 (Md. 1996) (an ESO was deferred compensation that could be divided and transferred as marital property); *In re* Marriage of Short, 890 P.2d 12 (Wash. 1995) (an ESO constituted both marital and separate property); Pascale v. Pascale, 660 A.2d 485 (N.J. 1995) (an option granted after separation for past services was marital property); Kapfer v. Kapfer, 419 S.E.2d 464 (W.Va. 1992) (stock options should have been considered in equitable distribution); Richardson v. Richardson, 659 S.W.2d 510 (Ark. 1983) (ESOs constituted marital property the same as traded options or common stock and were valued as of the market price on the date of divorce); Ettinger v. Ettinger, 637 P.2d 63 (Okla. 1981) (an ESO granted after divorce was not property).

3. *In re* Marriage of Hug, 201 Cal. Rptr. 676, 685 (Ct. App. 1984).

4. *See* Tracy Seipel, *Silicon Valley Divorce Settlements Become More Intricate*, KNIGHT-RIDDER TRIB. BUS. NEWS, Sept. 11, 2000, *available at* 2000 WL 26270112 (modern divorces complicated by many new issues including division of ESOs). A new Web site has even emerged to help the increasing numbers of employees figure out the tax consequences of the options and to maximize their use. *See* www.myStockOptions.com.

5. Diane Stafford, *Buy? Sell? Hold? Availability of Company Stock Options Often Comes with Lack of Knowledge*, KAN. CITY STAR, Sept 3, 2000, at F16; (12 million working Americans, or about one in ten private-sector employees, have stock options); Erika Stutzman, *Former Qualcomm Workers in Boulder, CO, Area Sue Over Stock Options*, KNIGHT-RIDDER TRIB. BUS. NEWS, Dec. 21, 2000, *available at* 2000 WL 310198543 (estimates from the National Center for Employee Ownership are that 10 million employees hold options); *Divorce Courts Grapple with Division of Stock Options*, HOUS. CHRON. at 2, Aug. 28, 2000, *available at* 2000 WL 24507789 (number of Americans holding stock options soared from one million in 1992 to an estimated ten million today).

6. *Share Option Beauty Is in the Eye of the Holder*, SUN. BUS. POST (Ireland), Jan. 21, 2001, *available at* 2001 WL 8742013.

7. *Stafford, supra* note 5 (company stock options once the province of executives are now part of the compensation for whiz kid programmers in high-tech startups and rank-and-file workers in established corporations); Clark Mason, *Stock Options Can Make Divorce Even Messier: Millions at Stake in North Bay*, PRESS DEM. (Santa Rosa,

An ESO provides an opportunity for companies to align the interests and performance of their employees with that of the company and allows companies to encourage investment of human capital and effort during times when they are unable to pay large salaries.[8] These options represent potentially huge payoffs for employees.[9] In one example, a wife entered a separation agreement under which she received one million dollars for her share of her husband's ESOs; four months after the agreement was reached, a sale of the company increased the value of the options to sixty million.[10] Nonetheless, an ESO is also potentially worthless as in the case of a dot-com company that goes out of business or a company that is bought out in a hostile situation.[11] The question for family law courts is how to treat such contingent yet potentially valuable interests in the context of divorce.[12]

The law has been slow to address the new property of the ESO and instead has tried to conform the option to the existing legal parameters

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CA), July 31, 2000, at A1 (stock options prevalent in technology community of Santa Rosa for employees from upper management to the secretaries and janitors).

8. *Called to Account: Stock Options and Pooling Can Damage Shareholders' Wallets*, ECONOMIST (Jan. 27, 2001), *available at* 2001 WL 7317392 (the goal of aligning corporate and employee performance has not been realized according to a study by the Harvard Business School which found that companies which grant options do not perform any better than companies that do not); Jerry Knight, *Options Are Usually Best Left to the Pros, but LEAPS Might Help the Common Folk*, WASH. POST, Jan. 29, 2001 at E1 (high-tech companies give ESOs instead of paying big salaries or cash bonuses); Saul Levmore, *Puzzling Stock Options and Compensation Norms*, 149 U. PA. L. REV. 1901, 1901–02 (2001) (describing that ESO compensation practice has grown in popularity to include a majority of traded firms and many firm employees who individually would seem to have only a remote influence on firm profits).

9. Some, like outgoing Securities and Exchange Commission Chief Arthur Levitt, argue that this payoff is at the expense of the corporate shareholders because granting the options at below-market rates dilutes the value of the existing public shares. Kathy Kristof, *Outgoing SEC Chief Urges Shareholder Say on Stock Grants*, CHIC. TRIB., Jan. 28, 2001 at 3, *available at* 2001 WL 4035053; *Called to Account*, *supra* note 8.

10. Mason, *supra* note 7; *see, e.g.*, Davidson v. Davidson, 578 N.W.2d 848, 853 (Neb. 1998) (Union Pacific executive's stock options worth $4 million in one year, $1 million the next); *In re* Marriage of Short, 890 P.2d 12, 14 (Wash. 1995) (exercise of one option share realized profit $500,000).

11. Matthew Boyle, *Keep Your (Stock) Options Open*, FORTUNE MAG., Jan. 22, 2001, at 155, *available at* 2001 WL 2172236 (detailing stories of dot-com employees losing hundreds of thousands of dollars in stock options when the company folds and public company employees losing money when the price of the stock is under water, that is, below the option exercise price). Indeed, stock options today are frequently the basis of so-called disappointment litigation in which the employees sue for the worthless value of the options. L.M. Sixel, *Unhappy Workers Check out Options*, HOUS. CHRON. 1 (Jan. 19, 2001), *available at* 2001 WL 2993761.

12. *See Flying Solo: Stock Options Difficult to Assess in a Divorce*, FLA. TIMES UNION (Jacksonville), Dec. 11, 2000 at C2; Hon. Douglas P. Cohn, *Stock Options and the Dissolution of Marriage*, VT. BAR J., Mar. 2000 at 7 (Vermont family courts have not yet considered the question of dividing stock options at divorce).

of pensions,[13] deferred compensation,[14] fringe benefits,[15] or publicly traded stocks.[16] However, these analogies all fail to adequately address the relevant legal questions simply because ESOs do not fit the characteristics of these other forms of property.[17] The resulting law is thus contradictory and disjointed as it tries to fit the square peg of an ESO into existing round holes.

This article will circumscribe the legal debate by identifying the existing conceptual parameters utilized by the courts in developing the framework for this emerging body of the law. It will synthesize the cases in order to discern the key lines of reasoning utilized by the courts to characterize ESOs as marital or separate property; to value or measure the option, and then to distribute or divide the option between the parties. This synthesis will reveal the commonalties among the various decisions as well as the inconsistencies and gaps in analysis. This article

13. Fisher v. Fisher, 769 A. 2d 1165, 1168 (Pa. 2001) ("unvested stock options are analytically identical to unvested pensions and both should be considered marital property"); Bornemann v. Bornemann, 752 A.2d 978 (Conn. 1998) ("stock options are analogous to pension benefits in that they bestow a right upon the holder to receive a promised benefit under prescribed conditions"); Kapfer v. Kapfer, 419 S.E.2d 464 (W.Va. 1992) (on remand use guidelines for evaluating and dividing pensions to evaluate ESO as marital property). *See* Hann v. Hann, 655 N.E.2d 566, 570 (Ind. Ct. App. 1995) ("we find pension law in the context of marital dissolutions to be closely analogous to the issue before us. Similar to the unvested nature of [husband's] stock options, a pension is unvested where the right to be paid is subject to forfeiture if the employment relationship terminates. . . . Aside from this useful analogy, *stock options are not like pensions in any significant sense*") (emphasis added); *Id.* at 571 (Chezem, J., dissenting) (majority inappropriately treated ESOs as identical to pension benefits, but there was a significant difference as pensions were not deferred compensation in lieu of salary and options remain subject to forfeiture); *In re* Marriage of Miller, 915 P.2d 1314 (Colo.1996) (ESOs not like pension because option granted for past services).

14. *Davidson*, 578 N.W.2d at 854; Klingenberg v. Klingenberg, 756 A.2d 551 (Md. 1996) (ESO is deferred compensation within the ordinary and popularly understood meaning of the term); *Hann*, 655 N.E.2d at 571 (Chezem, J., dissenting) (ESO was "pure deferred compensation" akin to "money in the bank"). Deferred compensation has been defined as "money, which by prior arrangement, is paid to the employee in tax years subsequent to that in which it is earned." MICHAEL J. CANAN, QUALIFIED RETIREMENT AND OTHER EMPLOYEE BENEFIT PLANS 1.6 (1994); *see also* BLACK'S LAW DICTIONARY (6th ed. 1990) (deferred compensation is "compensation that will be taxed when received and not when earned").

15. *See e.g., In re* Marriage of Harrison, 225 Cal. Rptr. 234 (Ct. App. 1986) ("fringe benefits are not a gift from the employer but are earned by the employee as part of the compensation for services. Thus, fringe benefits such as employee stock options are community property to the extent they are earned by the time, skill, and effort of a spouse during marriage. Fringe benefits consisting of contractual rights to future benefits after separation, though unvested and unmatured, are property subject to allocation between community and separate interests at the time of dissolution").

16. *Miller*, 915 P.2d at 1314; Richardson v. Richardson, 659 S.W.2d 510 (Ark. 1983).

17. Callahan v. Callahan, 361 A.2d 561, 563 (N.J. Super. Ct. 1976). ("Certainly this court does not intimate that the pension cases and stock option are identical. The myriad forms of property ownership in the modern world dictate that virtually no universal principle can be devised to fit every case.")

does not attempt to answer all of the key legal questions raised by the exploration of the issue; rather, it seeks to be a first step toward synthesizing the common strains of analysis and identifying the inconsistencies in order to promote a clearer resolution of the issues.[18]

II. Characterizing the Employee Stock Option as Property

Courts have initially struggled with the question of whether the contingent interest represented by the ESO constitutes property that can be distributed in the context of a dissolution. The contingent nature of the option, meaning that the employee may never acquire any actual interest through the option, and the ability of the employee to actually use the option to purchase stocks have been two key factors that have guided the courts in their decisions characterizing ESOs as property or non-property.

A. Characteristics of an Employee Stock Option

In order to characterize the ESO as property for purposes of division upon separation or divorce, a court must first understand the descriptive components that comprise the option. An ESO is a contractual right granted to an employee for past, present, or future services that gives her the right to choose to exercise the option to purchase company stock at a designated time.[19] The option typically is nontransferable and non-

18. *See also* Andrew C. Littman, *Valuation and Division of Employee Stock Options in Divorce*, COLO. LAW., May 2000 at 61; Cohn, *supra* note 12; Michael J. Mard & Jorge M. Cestero, *Stock Options in Divorce: Assets or Income?* 74 FLA. B.J. 62 (2000); Lynn Curtis, *Valuation of Stock Options in Dividing Marital Property Upon Dissolution*, 15 J. AM. ACAD. MATRIM. LAW. 411 (1998); Laurence J. Cutler & Samuel V. Schoonmaker, IV, *Division and Valuation of Speculative Assets: Reasoned Adjudication or Courthouse Confusion*, 15 J. AM. ACAD. MATRIM. LAW. 257 (1998); Michael A. Ealy, Note & Comment, *The Characterization of a Contingent Interest in an Employee Stock Option upon Dissolution of the Marital Community: In re* Marriage of Short, 32 IDAHO L. REV. 691 (1996); Thomas P. Malone, *Employee Stock Options and Restricted Shares: Determining and Dividing the Marital Pot*, 25 COLO. LAW. 87 (1996); *Characterizing Stock Options*, 14 FAIR 26 (1994); Sandra G. Musser, *A Discussion of In-Kind Division of Vested and Contingent Stock Options in California*, COMM. PROP. J. 19 (1989). For an exhaustive opinion collecting many of the relevant cases pertaining to the issue of ESO as marital property, *see* Wendt v. Wendt, 1998 WL 161165 (Conn. Super. Ct. Mar. 31, 1998). *See also* Eric Hollowell, Annotation, *Divorce and Separation: Treatment of Stock Options For Purposes of Dividing Marital Property*, 46 A.L.R. 4th 640.

19. Another form of employee equity compensation is restricted stock. Restricted stock is a grant of a share of company stock—rather than an option to buy stock—that vests if the employee remains with the company for a specified period of time. *Equity-Oriented Arrangements*, COMPENSATION TAX GUIDE (CCH) 634–35. Stock retention shares have generally been treated the same as ESOs. *See* Davidson v. Davidson,

assignable and thus can only be utilized by the employee herself.[20] The option generally requires continued employment with the firm in order to take advantage of the option at the designated exercise date. At the time the option is granted, it usually has no value until such time as the employee exercises the option to purchase company stock at a below-market price, which may result in profits upon a subsequent sale of that stock.[21] Courts sometimes discuss employee options in terms of qualified and nonqualified,[22] but these are simply designations used by the Internal Revenue Service (IRS) to determine the point in time at which the option will be taxed as income.[23] Of course, as a contractual creature, an ESO can be defined in an individual stock plan in a variety of different forms, and the contract can alter any of these usual characteristics of the option.[24]

There are several important operational characteristics of an ESO. First, the option is *granted* when the employer gives or awards the option to the employee, that is, usually by contract or upon employment.[25] The

578 N.W.2d 848, 856 (Neb. 1998); DeJesus v. DeJesus, 687 N.E.2d 1319 (N.Y. 1997); *In re* Marriage of Harrison, 225 Cal. Rptr. 234, 238 (Ct. App. 1986) (trial court failed to recognize distinction between options and restricted stock); *but see In re* Marriage of Miller, 915 P.2d 1314 (Colo. 1996) (stock retention shares acquired as property when granted whereas ESOs acquired when vested).

20. *See, e.g.,* Green v. Green, 494 A.2d 721, 726 (N.D. Ct. App. 1985); *Callahan,* 361 A.2d at 562.

21. For this reason, the IRS does not tax the option at the time of the grant. I.R.C. § 83(a); Treas. Reg. §§ 1.83-1, 1.83-7.

22. *See* Smith v. Smith, 682 S.W.2d 834, 836 (Mo. App. 1984); *Callahan,* 361 A.2d at 562.

23. The two main categories of ESOs for tax purposes are nonqualified stock options (NQSOs) and incentive stock options (ISOs). NQSOs are the most popular method of employee stock plan that grant an employee the right to purchase the employer's stock at a fixed price for a stated period of time without any statutory restrictions on transferability, exercise prices, exercise periods, or holding periods. For NQSOs, an employee is not taxed on the grant date; instead, she is taxed at the date of exercise of the option on the difference between the market value of the stock on the exercise date and the exercise price of the option, and this difference is taxed as ordinary income. An employee is also taxed when she sells the stock, and this income is taxed as capital gains. *Equity Oriented Arrangements, supra* note 19, at 626–27; Treas. Reg. S.1.83-4(b).

An ISO, or qualified or statutory stock option, is defined in I.R.C. § 422(b)(1) and has specific requirements for exercise prices, dates, and holding periods. I.R.C. § 422. ISOs were created to provide a tax-advantaged form of stock options. Unlike an NQSO, an ISO does not trigger any ordinary income recognition at either the grant date or the exercise date. Instead, all of the potential income is treated as capital gain upon the ultimate disposition of stock by the employee. *Equity Oriented Arrangements, supra* note 19 at 628–31. *See, e.g., DeJesus,* 687 N.E.2d at 1320.

24. *E.g.,* Bornemann v. Bornemann, 752 A.2d 978 (Conn. 1998) (agreement provided that ESO was preserved after termination of employment).

25. *In re* Marriage of Short, 890 P.2d 12, 13 (Wash. 1995); *cf.* Ettinger v. Ettinger, 637 P.2d 63 (Okla. 1981) (trial court could not award wife share of all options that could accrue in future as option must have been granted and in existence at time of divorce to be divided).

option then becomes exercisable at the point in time when the employee can use the option to purchase shares of stock.[26] Typically, the date on which the option becomes exercisable is designated in periodic increments following the initial grant date: for example, a grant of options upon employment might become exercisable beginning eighteen months later and continuing in six-month periods.[27] In addition, some courts also use the pension terminology *mature* to characterize the time period at which the employee has the right to access the stock option.[28] In the ESO context, however, the label *mature* connotes the same operative period as exercisable; both are when the employee can access the option to buy corporate stock.[29] The question for the courts is what relevance, if any, these characteristics of the ESO have to the determination of the option as property.

B. The Option as a Contingent Future Interest

In the case of an ESO that has been granted and exercised at the time of divorce, the answer is relatively straightforward that the option constitutes property for purposes of division by a domestic relations court.[30] A dispute arises over the characterization of an unexercised ESO, which represents simply the right to some undetermined future interest contingent on continued employment.[31]

A key determination for the courts that draw analogies to other future interests, such as pensions, is whether the interest is vested or just a mere expectancy. A mere expectancy, such as the expectation that a spouse will inherit from her parents, is not divisible marital property.[32]

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26. *In re* Marriage of Walker, 265 Cal. Rptr. 32, n.1 (Ct. App. 1989).

27. *E.g., In re Short,* 890 P.2d at 14.

28. *E.g.,* Hann v. Hann, 655 N.E.2d 566, 569 n.1 (Ind. Ct. App. 1995); Davidson v. Davidson, 578 N.W.2d 848, 853 (Neb. 1998); David S. Rosettenstein, *Exploring the Use of the Time Rule in the Distribution of Stock Options on Divorce,* 35 FAM. L.Q. 263, 270 (2001).

29. Rosettenstein, *supra* note 28; Everett v. Everett, 489 N.W.2d 111, 113 (Mich. Ct. App. 1992).

30. *E.g.,* Green v. Green, 494 A.2d 721, 726 (N.D. Ct. App. 1985); *In re* Marriage of Stachofsky, 951 P.2d 346, 351 (Wash. Ct. App. 1998); *cf.* Payson v. Payson, 2001 WL 1083117 (Ga. 2001) (ESOs granted prior to marriage but exercised during marriage were separate property).

31. *Contingent* means possible but not assured and conditioned on the occurrence of some future event that is itself uncertain. BLACK'S, *supra* note 1, at 290 ; HOMER H. CLARK JR., THE LAW OF DOMESTIC RELATIONS IN THE UNITED STATES 614–15 (2d ed. 1988) (discussing the treatment of various contingent interests in the division of marital property).

32. An "expectancy" as applied to property is contingent as to possession and is a mere hope or expectation of possession imposing no obligation upon the holder of the property nor any right upon the expectant person. BLACK'S LAW DICTIONARY 517 (5th ed. 1979); *In re* Marriage of Miller, 915 P.2d 1314 (Colo. 1996) ("a nonvested interest is an expectancy and not a property because the holder has no enforceable rights"); *see* Fisher v. Fisher, 769 A.2d 1165, 1167 (Pa. 2001) (employee spouse argued that unvested ESOs should have been treated the same way as an expectancy under a will).

Conversely, a vested interest, in which a spouse holds an absolute, guaranteed right to an interest at some time in the future, is held to be marital property.[33] However, few ESOs, if any, are absolute guarantees because the employee must usually satisfy the conditions of continued employment up to the time of exercising the option. Thus, the question for the domestic relations courts is whether such unvested options constitute property.

The emerging majority rule is that an unvested ESO that is granted at the time of divorce is property even if that option is not yet exercisable.[34] The courts have reasoned that the ESO represents a property interest rather than a mere expectancy for several reasons. First, the grant of the stock option creates a presently existing enforceable contract right against the employer as long as the employee satisfies the contingency of remaining employed by that employer.[35] In contrast, the defining characteristic of an expectancy is that the holder has no enforceable right to that expectation.[36] Second, there is a modern trend in domestic relations law to recognize all forms of property, including intangible and contingent interests. Such interests are based on the economic partnership theory of marriage, under which each spouse contributes directly and indirectly to the marital economy by a variety of

33. A "vested" right is a right that is fixed or absolute. BLACK'S LAW DICTIONARY 1401 (5th ed. 1979). For example, vested pension benefits are those pension rights that survive the discharge or voluntary termination of the employee's employment. CLARK, *supra* note 31, at 614–15.

34. *Fisher*, 769 A.2d at 1168–69 (the court's research of the decisions of sister states revealed that they were nearly unanimous in treating unvested stock options identically as unvested pensions to characterize both as property); e.g., Baccanti v. Morton, 752 N.E.2d 718 (Mass. 2001); Davidson v. Davidson, 578 N.W.2d 848, 856 (Neb. 1998); Bornemann v. Bornemann, 752 A.2d 978 (Conn. 1998); Klingenberg v. Klingenberg, 756 A.2d 551 (Md. 1996); *In re* Marriage of Hug, 201 Cal. Rptr. 676 (Ct. App. 1984); Keff v. Keff, 757 So. 2d 450, 452 (Ala. Ct. App. 2000); Salstrom v. Salstrom, 404 N.W.2d 848 (Minn. Ct. App. 1987); Chen v. Chen, 416 N.W.2d 661, 663 (Wis. Ct. App. 1987); Callahan v. Callahan, 361 A.2d 561 (N.J. Super. Ct. 1976); *Green*, 494 A.2d at 721; Smith v. Smith, 682 S.W.2d 834 (Mo. Ct. App. 1984); Bodin v. Bodin, 955 S.W.2d 380 (Tex. Ct. App. 1997); *see also In re Short*, 890 P.2d 12 (Wash. 1995) (implicitly assuming granted and not exercisable option was property by determining whether option was marital or separate property).

35. *Bornemann*, 752 A.2d at 984; *See also Chen*, 416 N.W.2d at 662 (an ESO was an economic resource, an enforceable right, not a mere gratuity). The option is a contract right that is generally irrevocable and that creates a choice of action in contract if the option is breached. *Bornemann*, 752 A.2d at 984; *accord Green*, 494 A.2d at 728. For example, in the Qualcomm litigation, employees claimed the company had unfairly terminated lucrative unvested stock options when the company sold its infrastructure division. *Suit Against Qualcomm Split into Two*, SAN DIEGO UNION-TRIB., Jan. 20, 2001 at C2, *available at* 2001 WL 6438296; Stutzman, *supra* note 5; *see also* Sixel, *supra* note 11 (discussing other breach of contract actions for loss of value of stock options).

36. *See Bornemann*, 752 A.2d at 984.

in-kind, financial, and intangible means.[37] Third, failure to recognize an ESO as property would create substantial inequality among the varied forms of employment compensation by subjecting immediate compensation or income (but not deferred or alternative forms of compensation) to inclusion in the marital estate.[38] Finally, courts have discerned that the fact of the contingency, that the employee-spouse must remain employed to retain the interest, simply effects the valuation of the interest, not its nature as a property interest.[39]

A few courts, however, have held that ESOs do not constitute property unless they are vested. The appellate courts in Indiana and North Carolina have reached this conclusion based on their particular statutory laws that exclude unvested rights from consideration as marital property.[40] The appellate courts in Illinois have held that the inability to value accurately the option until such time as it vests precludes recognition of the unvested option as property.[41] Thus, for these courts as well as for other courts struggling with these new issues of ESO, one important question has been at what point does the ESO vest.

C. Vested Employee Stock Options

Despite the importance of this issue, courts have failed to provide a consistent definition of the term *vest* in the context of ESOs at divorce.[42] The term *vest* derives in part from the analogy to pension law in which the courts look for the point at which the employee has performed the requisite years of service so as to entitle her to some retire-

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37. *Id. See also* DeJesus v. DeJesus, 687 N.E.2d 1319 (N.Y. 1997) (statute defining marital property recognized that spouses had claim to "things of value" arising out of the marriage, including a wide range of intangible interests); *Green*, 494 A.2d at 727 (property included obligations, rights, and other intangibles as well as physical things).

38. *See Bornemann*, 752 A.2d at 986.

39. *See Chen*, 416 N.W.2d at 663; *See also Keff*, 757 A.2d at 452.

40. Hann v. Hann, 655 N.E.2d 566, 568–69 (Ind. Ct. App. 1995) (only vested options as of time of dissolution were property subject to division under IND. CODE § 31-1-11.5-2); Hall v. Hall, 363 S.E.2d 189 (N.C. Ct. App. 1987) (N.C. GEN. STAT. § 50-20(b)(2) provides that the expectation of unvested rights shall be considered separate property).

41. *In re* Marriage of Issacs, 632 N.E.2d 228 (Ill. App. Ct. 1994); *In re* Marriage of Frederick, 578 N.E.2d 612 (Ill. App. Ct. 1991); *In re* Marriage of Moody, 457 N.E.2d 1023 (Ill. App. Ct. 1983).

42. Wendt v. Wendt, 1998 WL 161165, at 131 (Conn. Super. Ct. Mar. 31, 1998) ("the term 'vesting' in a marital property division setting has acquired a special meaning, different from the contractual conditions of the asset itself"; "[t]hus the continued use of 'vesting' and 'nonvesting' may be misleading in a marital distribution context"); *In re* Marriage of Miller, 915 P.2d 1314 (Colo. 1996) (noting that other courts have recognized the varied used of the term *vested*). *Cf.* CLARK, *supra* note 31, at 612 (the terms *vesting* and *matured* with respect to pensions are just beginning to achieve acceptance and uniform treatment in the cases).

ment benefit even if employment is terminated.[43] That concept of vesting, however, can rarely be replicated in the ESO context absent some specific contractual provisions because continued employment is required in order to exercise the option. Thus, courts evaluating ESOs in a divorce have developed three different definitions of when the option vests: (1) when it is actually exercised, (2) when it becomes exercisable, or (3) when it is earned through completed service.

Some courts use the first definition, that the option vests when it is actually exercised, because it is not until that point in time that the employee has an irrevocable right to the option.[44] This follows the generally accepted definition of vesting as the time at which a person gains an absolute right to the property interest that is not subject to forfeiture.[45] The IRS utilizes this definition of vesting with respect to an ESO and assesses taxes on the option only when the option is actually exercised as provided by law.[46] The Indiana Court of Appeals has also adopted this definition of vesting, holding in *Hann v. Hann* that an ESO was property only when vested, and that such vesting occurred only when the option was actually exercised.[47] The *Hann* court reasoned that an ESO was not vested prior to the time of actual exercise because the employee could forfeit the option by failing to remain employed by the issuing company.[48] The Illinois courts have similarly held that unvested ESOs are not property until such time as those options are actually exercised and become vested interests.[49] These courts have reasoned that the inability to value accurately the ESO until such time as it is actually exercised precludes recognition of

43. *See* text accompanying *supra* note 33; CLARK, *supra* note 31, at 612; *In re* Marriage of Harrison, 225 Cal. Rptr.. 234, 238 (Ct. App. 1986).

44. *In re Frederick*, 578 N.E.2d at 619 (options did not constitute property until exercised); *Hann*, 655 N.E.2d at 571 (only those options which were exercisable and which could not be forfeited upon termination of employment were property).

45. *See* text accompanying *supra* note 33.

46. I.R.C. § 422 (ISO); I.R.C. § 83 (NQSO); Treas. Reg. § 1.83-4(b); *Equity-Oriented Compensation*, *supra* note 19, at 627, 630–31. A nonqualified stock option is taxed when it is exercised. However, a qualified stock option vests and therefore is taxed only upon sale of the stock acquired through the exercise of the option because an ISO requires a mandatory holding period between the time of the option exercise and the sale of the stock. Thus, an employee can potentially forfeit the option rights if her employment is terminated during that holding period.

47. *See* 655 N.E.2d 566, 570–71 (Ind. Ct. App. 1995).

48. 655 N.E.2d at 571.

49. *In re* Marriage of Moody, 457 N.E.2d 1023, 1027 (Ill. App. Ct. 1983); *In re* Marriage of Frederick, 578 N.E.2d 612, 619 (Ill. App. Ct. 1991); *In re* Marriage of Isaacs, 632 N.E.2d 228 (Ill. App. Ct. 1994); *see also In re* Marriage of Evans, 426 N.E.2d 854 (Ill. App. Ct. 1981) (employee's share of unvested corporate stock in his employing company was not property).

the option as property.[50] Several courts have openly criticized this approach of utilizing tax law concepts to determine whether ESOs are marital property and have instead adopted alternative definitions of vesting.[51]

The second and most common working definition of vesting is that the option vests when it becomes exercisable.[52] The Pennsylvania Supreme Court has expressly defined vesting to refer to the time when all conditions attached to the stock options have been satisfied and the options can be exercised—that is, the time of exercisability.[53] The legal significance of adopting this second definition of vesting, however, varies by court. For most courts, the determination is irrelevant because they include unvested options as property. Yet for North Carolina courts, ESOs are not property until vested, and the options will thus be considered property only if they are exercisable as of the time of dissolution.[54] For some courts, the vesting determination is relevant to characterizing the property as marital or separate as in the case of *In re Marriage of Short*, in which the Washington Supreme Court held that options not exercisable at the time of dissolution were separate rather than community property.[55]

50. *Moody*, 457 N.E.2d at 1025–26; *Frederick*, 578 N.E.2d at 618–19. Although Illinois courts do not recognize unvested ESOs as distributable property, they do authorize a court to retain jurisdiction over the dissolution case in order to allocate the proceeds between the spouses if and when the options become property through actual exercise.

51. Salstrom v. Salstrom, 404 N.W.2d 848, 850 (Minn. Ct. App. 1987) ("federal tax laws have little relevance to the characterization of property as marital or nonmarital under Minnesota law"); *In re* Marriage of Short, 890 P.2d 12, 14 (Wash. 1995) (in determining whether unvested stock options were community property for marital distribution, the tax laws were "not the tail that wags the dog"), *reversed on other grounds*, 890 P.2d 12 (Wash. 1995); Hann v. Hann, 655 N.E.2d 566, 573 (Ind. Ct. App. 1996) (Chezem, J., dissenting) (the fact that tax laws allowed for future recognition of current earnings did not mean that ESOs were not marital property for purposes of division at dissolution).

52. Chammah v. Chammah, 1997 WL 414404 at n.5 (Conn. Super. Ct. July 11, 1997) ("upon the exercise date the stock options will vest"); Bornemann v. Bornemann, 752 A.2d 978 (Conn. 1998) (definition of vesting as of date of exercisability relevant to determining marital share of property); *In re* Marriage of Short, 890 P.2d 12–14 (Wash. 1995) (exercise date of option was when option vested pursuant to contract terms of an employee stock plan); Keff v. Keff, 757 So. 2d 450, 451 at n.2 (Ala. Ct. App. 2000) (the only manner in which stock options were unvested was that they could not be exercised until time had passed).

53. Fisher v. Fisher, 769 A.2d 1165, 1166 n.1 (Pa. 2001).

54. Hall v. Hall, 363 S.E.2d 189 (N.C. Ct. App. 1987) (statute provides that unvested property is separate property, but court found that option vested at the time of exercisability rather than actual exercise).

55. *In re Short*, 890 P.2d at 14, 16; Wikel v. Wikel, 483 N.W.2d 292 (Wis. Ct. App. 1992) (only options that were exerciseable on the first day of trial were part of the marital estate)

The Colorado Supreme Court, however, has expressly rejected the first two definitions of vesting, which have been applied by lower and sister courts.[56] The court agreed that "[c]haracterizing the options as nonvested, though perhaps accurate for purpose of employee benefits and tax law, may be misleading for purposes of ascertaining what interests are marital property."[57] However, the court held that an option vested only when the employee had an enforceable right to the option, which it defined as the time when the option was earned through completed service.[58] Thus, an ESO granted for past services has been earned and is thus property.[59] Conversely, where an ESO is granted for future services that have not yet been completed, the option is not property but rather a mere expectancy.[60] This Colorado rule seems to parallel pension law, which bases vesting upon completion of the required years of service before the right is available.[61] However, the Colorado Supreme Court disavowed any attempt to rely upon a vesting concept in characterizing property—despite its holding that the determinative issue was when the employee had an enforceable right to the option, which is in fact the very definition of vesting.[62] Instead, the Colorado court relied upon concepts of accrual or earning through service to determine whether the option constituted property.[63] Other courts have relied upon similar requirements of service but have held those determinations to be relevant to characterizing the property as marital or separate rather than as relevant to the threshold issue of whether the option is a property interest.[64]

D. Post-Separation Grants

One final question relating to the characterization issue arises with respect to those employee options granted *after* a couple's separation. One line of reasoning holds that such options cannot be considered property within the court's purview because they do not exist at the time of the divorce proceeding and will thus be beyond the court's

56. *In re* Balanson, 25 P.3d 28, 39 (Colo. 2001) (expressly rejecting holding of Colorado appellate court in the case, 996 P.2d 213, 218 (Colo. Ct. App. 1999), and in *In re* Huston, 967 P.2d 181 (Colo. Ct. App. 1998), defining vesting as the time of exercise).
57. *In re* Marriage of Miller, 915 P.2d 1314 (Colo. 1996).
58. *In re Balanson*, 25 P.3d at 39–40.
59. *In re Miller*, 915 P.2d at 1318.
60. *In re Balanson*, 25 P.3d at 39.
61. CLARK, *supra* note 31, at 612.
62. *In re Balanson*, 25 P.3d at 39.
63. *Id.* at 40.
64. *See* discussion *infra* part III(A).

jurisdiction.[65] A second line of argument holds that if the options granted after the separation date are for past services or employment rendered during the marriage, then they will be considered as property and apportioned into marital and separate shares.[66] Either reasoning, however, tends to mesh the determination of whether the option is property with the question of whether or not the option is marital property because it tends to focus on the purpose for which the option is granted, which (as is discussed in the next section) is usually a factor for determining the marital share of the property.

III. Determining the Share of Marital Property

Once it is decided that an ESO is property to be considered in the marital division, the next question is what share of that property can be allotted to the marital or community unit and what share is a separate interest. Marital or community property commonly is defined as property that is acquired during the marriage.[67] However, when is an ESO "acquired": when it is granted, when it is earned through service, when it becomes exercisable, or when it vests as an absolute right?

Early on in the resolution of this question, several courts summarily concluded that an ESO was acquired when it was granted.[68] These courts reasoned that at the time of the grant, an employee acquired a present, enforceable right or privilege that if granted during the marriage, was solely marital property. However, more recent appellate decisions employing similar reasoning have been resoundingly over-

65. Ettinger v. Ettinger, 637 P.2d 63 (Okla. 1981); *In re* Marriage of Hug, 201 Cal. Rptr. 676, 685 (Ct. App. 1984) ("claims of a community interest in employee stock options granted to the employee spouse after the dissolution of the marriage would appear to [sic] speculative and would lack the immediacy and specificity necessary for the exercise of jurisdiction over them").

66. Pascale v. Pascale, 660 A.2d 485 (N.J. 1995) (wife's stock options granted after the date of filing were marital property because they had been awarded as additional compensation for past services); Goodwyne v. Goodwyne, 639 So. 2d 1210 (La. Ct. App. 1994) (options granted after dissolution were part marital property because they had been granted based on services performed prior to dissolution during the marriage); *Cf. In re* Marriage of Nelson, 222 Cal. Rptr. 790, 796–97 (Ct. App. 1986) (options granted after separation for future service after promotion were separate property).

67. *E.g.*, WASH. REV. CODE § 26.16.03; N.Y. DOM. REL. L. § 236(B)(1)(c).

68. Smith v. Smith, 682 S.W.2d 834, 837 (Mo. Ct. App. 1984) (a stock option was earned when the contract for the stock option was signed, and thus, even though continued employment was required by the husband after the divorce trial to exercise many of the options, all the options were characterized as marital property); Green v. Green, 494 A.2d 721, 728 (Md. Ct. App. 1985); Chen v. Chen, 416 N.W.2d 661 (Wis. Ct. App. 1987).

turned and criticized as adopting a simplistic and inaccurate analysis of when an option is acquired.[69]

Instead, most subsequent courts have recognized that the acquisition issue with respect to an ESO cannot be so easily resolved because, in fact, when the option is acquired depends on an employee's service and the purpose for which the option is granted.[70] Thus, courts—beginning with the seminal case of *In re Marriage of Hug*[71]—have developed a more sophisticated two-part test for determining the marital share of the option property. Under this test, a court must first determine the purpose for which the option was granted to discern whether it was awarded as compensation for past service or as an incentive for future service.[72] The time period of this service either in the past or the future must overlap with the period of marriage. Accordingly, the court must then apply a coverture or time rule formula in order to compute a ratio of what exact portion of the option property belongs in the marital estate.[73]

A. Characterizing Marital Property According to the Purpose of the Grant

Since ESOs are contractual creations, their parameters vary so widely that they preclude a general description of why such benefits are awarded by companies to employees.[74] At one level, stock options are simply employment benefits offered in deferred amounts in order to obtain preferential tax treatment.[75] Thus, like other forms of deferred

69. *In re* Marriage of Short, 859 P.2d 636 (Wash. Ct. App. 1993), *overruled*, 890 P.2d 12 (Wash. 1995); DeJesus v. DeJesus, 163 Misc. 2d 267, 270 (N.Y. Ct. App.), *overruled*, 687 N.E.2d 1319 (N.Y. 1997).

70. Baccanti v. Morton, 752 N.E.2d 718, 728 (Mass. 2001); *Hug*, 201 Cal. Rptr. at 682 ("benefits may be a function of longevity or time, or of the nature or frequency of services rendered"; "the receipt of benefits may be perceived entirely apart from any period of service and turn instead on the purpose for which they are created"); *In re Short*, 890 P.2d at 15–16; Davidson v. Davidson, 578 N.W.2d 848, 856 (Neb. 1998); Bornemann v. Bornemann, 752 A.2d 978 (Conn. 1998).

71. *Hug*, 201 Cal. Rptr. at 676.

72. *Baccanti*, 752 N.E.2d at 728; *Davidson*, 578 N.W.2d at 855; *In re Short*, 890 P.2d at 16; *Bornemann*, 752 A.2d at 987; *DeJesus*, 687 N.E.2d at 1324.

73. *Davidson*, 578 N.W.2d at 856; *In re Short*, 890 P.2d at 17; *Bornemann*, 752 A.2d at 989; *DeJesus*, 687 N.E.2d at 1322, 1324 (recognizing that many courts had applied various time rules to determine the marital share of the stock plans).

74. *Hug*, 201 Cal. Rptr. at 679 (treatises describing ESOs suggested that the contractual rights vary in benefits thereby preventing a general characterization of the options); Batra v. Batra, 17 P.3d 889 (Idaho Ct. App. 2001) (ESOs were awarded for a variety of options and thus "it [made] little sense to invite the trial court to divine the intent behind the options' grant," and instead the court would adopt a single time rule to characterize the options).

75. *Id.* at 785 n.3 (discussing the substantial tax benefits); *see* text accompanying *supra* notes 23 & 44 (discussing preferential tax treatment of stock options).

compensation, an employee option can be granted as deferred compensation for *present* services.[76] Options can also be awarded as bonuses in order to reward *past* services or performance,[77] or they can be granted for the purpose of *future* services, including those that serve as golden handcuffs to force employees to remain with companies in order to receive large payoffs.[78] Additionally, ESOs may serve as golden handshakes, which are incentives to attract employees and executives to businesses or new ventures.[79] No one purpose describes all ESOs, and one option can be granted for multiple purposes. However, the purpose of an individual option grant is critical to evaluating when the option was acquired. If the grant is earned through employee service falling outside the time period of the marriage, it is acquired outside of the marriage and is thus not marital property. Courts have therefore developed a list of factors to distinguish the various purposes of options to determine when an option was acquired. Relevant factors have included

—whether an option is granted as an addition or an alternative to a fixed salary;[80]
—whether an option is intended to secure optimal tax treatment;[81]
—whether an option's value or quantity is tied to future or past performance;[82]

76. *In re* Marriage of Miller, 915 P.2d 1314 (Colo. 1996); *Hug*, 201 Cal. Rptr. at 682–83 (employee spouse anticipated the options from the outset, and the company granted options in lieu of present compensation during its infant stages when the company's success was limited).

77. *Hug*, 201 Cal. Rptr. at 680–81; *Bornemann*, 752 A.2d at 991 n.9 (agreement extending right to exercise ESOs after termination was evidence that the options had been granted for past services rendered; employee did not argue that the agreement allowing him to retain his ability to exercise stock options was in lieu of a severance package intended to replace lost future income).

78. *Davidson*, 578 N.W.2d at 854; *cf. Bornemann*, 752 A.2d at 991 n.9 (employee might have argued that agreement extending his options after termination of employment showed purpose of options intended to serve as a severance package to replace lost future income).

79. *Hug*, 201 Cal. Rptr. at 680; *In re* Marriage of Short, 859 P.2d 636 (Wash. Ct. App. 1993) (Microsoft option is a valuable fringe benefit or a golden opportunity that was offered as an inducement to forgo other employment or attract key employees).

80. DeJesus v. DeJesus, 687 N.E.2d 1319 (N.Y. 1997); *Davidson*, 578 N.W.2d at 856 (whether options were granted on a regular or irregular basis).

81. *Davidson*, 578 N.W.2d at 856.

82. *DeJesus*, 687 N.E.2d 1324; *In re Short*, 890 P.2d at 17 (vesting schedule providing that options became exercisable after termination of marriage indicated that options granted for the purpose of future service); *see* Ealy, *supra* note 18, at 710–11 (criticizing *Short* on its over reliance on this characteristic of the option to conclude it was all separate property and ignoring the community contribution that led to the grant of the option during the marriage); *See also Hug*, 201 Cal. Rptr. at 681 (husband relied too heavily on the single feature of the fact that the option agreement set periods of time as a prerequisite to exercising the options).

—whether an option is granted as an incentive to attract key personnel;[83] and,

—the specific language of the stock option grant.[84]

Courts repeatedly caution that these factors are illustrative, not determinative, and that each court must simply examine the specific facts of each case.[85] Moreover, courts do not agree on the import of each factor. For example, finding that an option has been granted as an incentive to attract employees has led some courts to find that the option was for past services,[86] other courts to find the grant was for present services,[87] and still other courts to find the grant was for future services.[88] Thus, the variety of relevant factors and their meaning within a case seem driven by the unique facts of any given situation.

If a court determines that the purpose of an option grant falls within a time frame that is all marital or all separate, then that determination ends the analysis of calculating the marital share. For example, if an option is granted during a marriage for past employment service and for service occurring during the marriage, then a court can easily char-

83. *DeJesus*, 687 N.E.2d 1324; *Hug*, 201 Cal. Rptr. at 683 (company's inducement to employee to leave prior employment and forgo opportunity for retirement benefits implied that the options were for past service and were earned from the commencement of employment); *In re* Marriage of Miller, 915 P.2d 1314 (Colo. 1996) (relevant factor was the size of the company and its need to offer incentives to employees to remain as employees of the company); *Davidson*, 578 N.W.2d at 856 (whether option was intended to induce the employee to accept employment, remain with the employer, or leave former employment).

84. Wendt v. Wendt, 757 A.2d. 1225, 1235 n.6 (Conn. Ct. App. 2000); *Miller*, 915 P.2d at 1319 n.9 (determination of whether option granted for past or future services could turn on factors such as the flexibility and variety of option plans offered); *Davidson*, 578 N.W.2d at 856 (stating that neither the language of the ESO agreement nor the testimony of the employer was dispositive in determining what percentage of the option represented compensation for past, present, and future services, but nonetheless deciding that the options were granted for past and future services based on the evidence of the company option proxy statement and the testimony of the employer).

85. *In re Miller*, 915 P.2d at 1314 n.9 ("whether an employee stock option is characterized as granted in consideration of past or future services depends on the circumstances surrounding the grant and the effect of the option agreement"); *DeJesus*, 687 N.E.2d at 1324; *Davidson*, 578 N.W.2d at 856 (relevant, non-exhaustive factors, plus any other relevant consideration should have been applied by the trial court according to the unique circumstances presented).

86. *Hug*, 201 Cal. Rptr. at 682 (grant of option at new company to some extent replaced retirement benefits at prior employment that would have vested if husband had remained at prior job rather than accepting the inducement to make a career move).

87. *In re Short*, 890 P.2d at 16 (option granted during marriage to induce employee to forgo establishing company and accept employment with Microsoft was granted in consideration of present services); Warner v. Warner, 46 S.W.3d 591, 602 (Mo. App. 2001) (husband's AOL stock options granted near end of marriage at time of initial employment offer were offered for past expertise developed by husband during marriage and to induce change of employment and therefore were marital property); Stachofsky v. Stachofsky, 951 P.2d at 346, 351 (Wash. Ct. App. 1998).

88. *Wendt*, 757 A.2d at 1235; *Stachofsky*, 951 P.2d at 351.

acterize the option as entirely marital without doing a coverture computation.[89] Conversely, if a stock option is granted during the marriage for past services wholly performed prior to the marriage, then the option is characterized as separate property without the use of an apportionment or time rule formula.[90] Similarly, at least one court has held that if an option is granted for future services and those future services will all occur after the end of the marriage, then the time rule formula should not be applied to those options because they are separate property.[91] Such future separate interests, however, may be subject to treatment as actual or imputed income as a basis for awarding spousal or child support.[92] In all other cases where the evaluation of the purpose of the grant reveals that an option was earned during both marital and separate time periods, then a court must apportion the stock to determine the actual marital share.

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89. *DeJesus*, 687 N.E.2d at 1323; *e.g.*, Bornemann v. Bornemann, 752 A.2d 978 (Conn. 1998); Kline v. Kline, 17 S.W.3d 445 (Tex. Ct. App. 2000); *cf.* Pascale v. Pascale, 660 A.2d 485 (N.J. 1995) (wife's stock option granted shortly after marriage as compensation for past services occurring during the marriage was entirely marital property).

90. Demo v. Demo, 655 N.E.2d 791, 793 (Ohio Ct. App. 1995); *cf.* Payson v. Payson, 2001 WL 1083117 *1–2 (Ga. Sept. 17, 2001) (stock option granted prior to marriage but exercised during marriage was not marital property because it was not generated by the marriage nor accumulated during the marriage). Unless, the state is an equitable division state that authorizes the court to divide all property regardless of when or how it was acquired; then, stock options given for past services performed prior to marriage are still considered part of the divisible marital estate. Baccanti v. Morton, 752 N.E.2d 718, 728 (Mass. 2001).

91. *In re Short*, 890 P.2d at 17. This holding of the Washington Supreme Court has been criticized for unduly focusing on the separate nature of the option interest resulting from the future service and ignoring the marital contribution to the grant, which resulted in the grant of the option during the marriage, and contributing to the employee spouse's excellent job performance, which triggered the company's incentive to retain that employee in the future. Ealy, *supra* note 18, at 710–11. Accordingly, the Massachusetts Supreme Court in *Baccanti v. Morton* stated in dicta that stock options given to an employee for future services to be performed after dissolution of the marriage could still be marital property if the value of the employee to the employer that resulted in the grant of the stock option had come about as a result of the efforts of the marital partnership. 752 N.E.2d 718, 729 n.6 & 730 n.7 (Mass. 2001); *accord* Batra v. Batra, 17 P.3d 899 (Idaho Ct. App. 2001) (husband's labor preceding the divorce contributed to the vesting or exercisability of the options in the months after the divorce).

92. Murray v. Murray, 716 N.E.2d 288 (Ohio Ct. App. 1999) (affirming trial court's division of unexercised stock options as marital property and then proceeding to hold that the appreciation in the stock options since the time of divorce constituted imputed income for purposes of determining child support); *In re* Marriage of Kerr, 91 Cal. Rptr. 374 (Ct. App. 1999); *In re* Marriage of Moore, 2000 WL 564165 (Iowa Ct. App. May 10, 2000) (post-separation stock option grants were properly included as income for child support). *See also* Jack E. Karns & Jerry G. Hunt, *Should Unexercised Stock Options Be Considered "Gross Income" under State Law for Purposes of Calculating Monthly Child Support Payments?* 33 CREIGHTON L. REV. 235 (2000); Kristy Watson, Note, *Acting in the Best Interest of the Child: A Solution to the Problem of Characterizing Stock Options as Income*, 69 FORDHAM L. REV. 1523 (2001).

B. Apportioning the Marital Share

After a court has made a qualitative decision on the reason why the ESO was granted (that is, for past, present, or future service), then the court must take that information and plug it into a quantitative formula to compute the precise share or ratio of the option that will be designated marital or community property. This formula—the coverture factor or time rule formula—is simply a calculation to determine the portion of an entire option property that covers the period of the marriage.[93] Time rule formulas are used for options, as in pension cases, when a property is acquired in exchange for an employee's service that includes service both during and before or after the marriage.[94] Thus, the court must compute the period during which an employee's service covers the marital period and segregate the separately acquired interest.[95]

The first time rule formula in the ESO arena was adopted by the *Hug* court. The *Hug* formula computed the share of community property by multiplying the relevant coverture time period by the number of option shares (time x shares = community property). It computed the appropriate coverture period by a fraction in which the numerator was the period of months from the start of employment to the end of the marriage, and the denominator was the period of months from the start of employment to the option's date of exercisability.[96] Courts following the *Hug* formulation have explained that the formula is simply a means to compute the relevant time period during which the marriage earned

93. *Wendt*, 757 A.2d at 1234 (tracing the history of the term *coverture factor*, which the court identified as a "new term in our judicial lexicon"); Braderman v. Braderman, 488 A.2d 613, 619 (Pa. Super. Ct. 1985) (coverture fraction represented that portion of the value of the retirement benefits attributable to the marriage); Rosettenstein, *supra* note 28, at 263 (discussing in depth the complexities of applying a time share rule to ESOs).

94. *In re* Marriage of Hug, 201 Cal. Rptr. 676, 685 (Cal. Ct. App. 1984) (time rule primarily used to describe the formula for determining the community interest in retirement benefits according to the ratio of the length of employment between the date of marriage or date of commencement of employment, if later, and the date of separation to the total length of employment); *Wendt*, 757 A.2d at 1234–35; Braderman v. Braderman, 488 A.2d 613, 619 (Pa. Super. Ct. 1985) (coverture formula for dividing pension was fraction in which the numerator reflected the total period of time the employee spouse participated in the plan during the marriage and the denominator was the total period the employee participated in the benefits program); Rosettenstein, *supra* note 28, at 264–69 (discussing time rule as applied in pension cases).

95. *See, e.g.*, Salstrom v. Salstrom, 404 N.W.2d 848, 851 (Minn. Ct. App. 1987) (ESOs granted to spouse during marriage but scheduled to vest after separation should have been apportioned to reflect their marital and non-marital aspects).

96. *Hug*, 201 Cal. Rptr. at 678; *In re Short*, 890 P.2d at 15.

$$\frac{\text{Employment Start—End Marriage}}{\text{Employment Start—Exercisability}} = \text{Coverture Period}$$

the option by considering the time of the marriage in proportion to the total time over which benefits were earned.[97]

Yet, in developing this time rule formula, the court in *Hug* cautioned that there was no one right formula for each case, and that courts could be flexible in adopting formulas to fit the particular facts of a case.[98] The *Hug* court therefore adopted a flexible time rule, emphasizing that while it could adopt an easy, inflexible rule to allow spouses definitively to settle disputes, such a rule would too often achieve inequitable results.[99] Indeed, the courts since *Hug* have taken this caution to heart and have developed innumerable formulas and variations on the formula to fit precise case facts.[100]

Despite this case-by-case approach, there are some specific time rule formulas that seem to be gaining uniform acceptance within sister courts. The choice of formula often depends on whether the court is attempting to apportion property acquired prior to the marriage or segregate property that will be separately acquired after the marriage. For apportionment for past service, courts have utilized a formula in which the numerator is the difference between the marriage start date and the grant date, and the denominator is the difference between the employ-

97. *Salstrom*, 404 N.W.2d at 851; Dietz v. Dietz, 436 S.E.2d 463, 470 (Va. Ct. App. 1993).

98. *Hug*, 201 Cal. Rptr. at 685 ("[W]e stress that no single rule or formula is applicable to every dissolution case involving employee stock options. Trial courts should be vested with broad discretion to fashion approaches which will achieve the most equitable results under the facts of each case."); *In re Short*, 890 P.2d at 16 ("the characterization of stock options according to the 'time rule' is not inflexible and may be modified depending upon the particular facts of a case, including the different purposes served by granting employee options").

99. *See Hug*, 201 Cal. Rptr. at 685–86. The *Hug* court emphasized its duty to achieve equity: "A special benefit of a system which allows for equitable considerations, especially in the family law field, is to afford the judge before whom the litigants appear, subject to applicable legal principles, the opportunity to fashion a remedy which achieves a just result. While critics may claim this results in inconsistency, we believe the strength of the judicial systems is enhanced when the judiciary possesses the ability in family law cases to tailor a remedy to fit the circumstances of the individual litigants before the court."

100. *See, e.g.*, *Davidson*, 578 N.W.2d at 857–859 (identifying four different time rule formulas depending on the combination of the date of grant and the purpose of the grant and describing additional adjustments to these typical formulas based on varying facts); *In re* Marriage of Walker, 265 Cal. Rptr. 32, 34–36 (Ct. App. 1989) (identifying three different time rule formulas developed by the California appellate courts); Garcia v. Mayer, 920 P.2d 522, 527 (N.M. Ct. App. 1996) (evaluating time from start of employment to intended vesting date); Baccanti v. Morton, 752 N.E.2d 718, 730 (Mass. 2001) (adapting time rule to hotch pot equitable division state that includes in marital division separate property acquired prior to marriage); Batra v. Batra, 17 P.3d 889, 843 (Idaho Ct. App. 2001) (rejecting *Hug* and *Short* time rules and adopting one bright line time rule for all cases consisting of number of days of the marriage during the year of vesting of the flight of stock option over the number of days in a year).

ment start date and the grant date.[101] When a court needs to apportion separate interests in an option property that will be acquired through future service of an employee, two different formulas have been used. One formula uses a fraction in which the numerator is the difference between the grant date and the marriage end, and the denominator is the time from the grant date to the date of exercisability.[102] The second formula substitutes the date of vesting for the date of exercisability in the denominator of the fraction.[103]

Once the coverture time period is computed under either of the formulas, it is multiplied by the asset in order to apportion the property into the marital share. The asset may be the number of option shares, the number of stock shares, or the gain realized depending on whether the option has been exercised in a particular case and, if so, whether it has been used to purchase shares or sell those shares for income.[104]

In an exhaustive opinion on this subject, a Connecticut trial court in *Wendt v. Wendt* examined dozens of cases in an attempt to draw out the key variables that might be relevant in a coverture computation rather than adopting one specific formula.[105] It concluded that the key factors were the purpose of the grant for past, present, or future services; the employment start date; the grant date; the separation date or end of

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101. DeJesus v. DeJesus, 687 N.E.2d 1319 (N.Y. 1997); *Davidson*, 578 N.W.2d at 857.

$$\frac{\text{Marriage Start—Grant}}{\text{Employment Start—Grant}} = \text{Coverture Period}$$

102. *DeJesus*, 687 N.E.2d at 1324; *In re* Marriage of Nelson, 222 Cal. Rptr. 790, 792 (Cal. Ct. App. 1986).

$$\frac{\text{Grant—Marriage End}}{\text{Grant—Exercisability}} = \text{Coverture Period}$$

103. *In re* Marriage of Harrison, 225 Cal. Rptr. 234, 237 note 1 (Cal. Ct. App. 1986); *In re* Marriage of Walker, 265 Cal. Rptr. 32, 35 (Cal. Ct. App. 1989); *Davidson*, 578 N.W.2d at 857; *In re* Marriage of Powell, 934 P.2d 612, 613–14 (Or. Ct. App. 1997), *review denied*, 944 P.2d 949 (Or. 1997).

$$\frac{\text{Grant—Separation Date}}{\text{Grant—Vesting}} = \text{Coverture Period}$$

The problem with this formula is again, as discussed in section I, the definition of vesting. In two of the cases advocating this formula, the stock options at issue had in fact vested pursuant to the option contract so that the relevant time for the court was the actual vesting of the options. *See Harrison*, 225 Cal. Rptr. at 237; *Walker*, 265 Cal. Rptr. at 35. However, as a general formula, the use of a vesting criteria may be nonsensical in that an option does not truly vest and become an absolute right until it is actually exercised (absent a special contractual designation in the plan). Therefore, the use of the vesting time would make it impossible to compute the period of coverture if applied to cases in which the option had not in fact vested pursuant to the contract terms.

104. *Walker*, 265 Cal. Rptr. at 36; Wendt v. Wendt, 757 A.2d. 1225 (Conn. Ct. App. 2000).

105. *See* 1998 WL 16165 at nn.182, 185–86.

marriage date; and the date of exercisability or the date of vesting.[106] Each of these factors may be relevant in determining the coverture period depending on the facts of a particular case.[107] These factors can be mixed and matched in order to achieve a result that seems equitable under the facts and circumstances of the case.[108] Accordingly, the *Wendt* opinion provided advocates and courts with the analytical tools necessary to determine the marital share of an ESO in individual cases without requiring blind adherence to any one particular formula or test.

IV. Valuing and Distributing the Marital Share of the Option

The final issue in considering the impact of an ESO property in a dissolution proceeding is valuing and distributing the marital share of the property between the two former spouses.[109] As with some other intangible property interests such as unvested pensions, the problem with valuing an ESO is that it does not have an ascertainable market value because it is unassignable and because its value is dependent upon certain future contingencies.[110]

Thus, courts valuing and distributing property shares associated with ESOs have different approaches to the appropriate way to value the option. Some courts have applied one of a variety of accounting methods in an attempt to estimate the present value of the option. However, other courts have rejected any valuation method as inappropriate to a non-marketable, contingent stock option interest and instead have

106. *Wendt*, 1998 WL 161165 at n.185.

107. *Id. In re* Marriage of Short, 859 P.2d 636 (Wash. Ct. App. 1993) (time rule had to be flexible and modified according to the particular facts of the case including the different purposes served by granting an ESO).

108. *See, e.g., In re* Marriage of Stachofsky, 951 P.2d 346, 352 (Wash. Ct. App. 1998) (trial court's award of 50% share of spouse's ESOs was not error even where time rule of *In re Short* calculated only a 10/48 interest because the court had to dispose of property as was just and equitable); Rosettenstein, *supra* note 28, at 303 (in applying the time rule to ESO, court had to carefully analyze the context of the parties' marriage and the terms of the option grant itself in order to effect a distribution that achieved a measure of fairness).

109. *See generally* Littman, *supra* note 18; Curtis, *supra* note 18; Cutler & Schoonmaker, *supra* note 18, at 284–96.

110. Fisher v. Fisher, 769 A.2d 1165, 1169 (Pa. 2001) (it was impossible to ascribe a meaningful value to the unvested stock option primarily because it was absolutely impossible to predict with reliability what any stock would be worth on any future date); Baccanti v. Morton, 752 N.E.2d 718, 726 (Mass. 2001) ("what distinguishes employee stock options from most other assets is the uncertainty of their value. . . . That, however, is simply the nature of the asset and a risk inherent in accepting stock options"); Green v. Green, 494 A.2d 721, 728 (Md. Ct. Spec. App. 1985); 1998 WL 161165 at note 16; 1997 U.S. MASTER TAX CODE (CCH) § 1923.

deferred the valuation and distribution decisions until the option is in fact exercised.

A. The Present Value of an Employee Stock Option

Some courts simply value an ESO at the time of dissolution by computing an intrinsic value for the option.[111] Intrinsic value is the market price of an option as of the date of dissolution or separation minus the option price.[112] The intrinsic value method, however, fails to discount for any of an option's contingencies such as required future employment and stock price volatility.[113] Therefore, some courts have utilized more sophisticated accounting formulas that compute a present value of the option by taking into account all relevant variables.[114]

The most common alternative valuation method seen in marital division cases is the Black-Scholes method.[115] The Black-Scholes for-

111. *E.g.,* Richardson v. Richardson, 659 S.W.2d 510, 512 (Ark. 1983); Smith v. Smith, 682 S.W.2d 834, 836–37 (Mo. Ct. App. 1984); Warren v. Warren, 407 P.2d 395 (Ariz. App. 1965); *see generally* Eric Hollowell, *Annotation, Valuation of Stock Options for Purposes of Divorce Court's Property Distribution*, 46 ALR 4th 689 § 6.

112. Curtis, *supra* note 18, at 439; Littman, *supra* note 18, at 62; Chammah v. Chammah, 1997 WL 414404 at n.5 (Conn. Super. Ct. 1997); *cf. In re* Marriage of Moody, 457 N.E.2d 1023, 1027 (Ill. App. Ct. 1983) (trial court improperly took judicial notice of market price of stock rather than relying on any evidence of market price submitted by parties).

113. Chammah v. Chammah, 1997 WL 414404 at n.5 (Conn. Super. Ct. 1997) (intrinsic value method failed to account for substantial contingencies affecting the ability of the court to accurately value stock options, including the contingencies that the employee had to survive to the exercise date, she had to remain employed, the employee had a choice of when and whether to exercise the option after the exercise date, and the employer could not terminate the employee or the stock program); *Fisher,* 769 A.2d at 1171 (Newman, J., concurring) (intrinsic value method was too speculative); *Wendt,* 1998 WL 161165 at n.191 (intrinsic value did not take account of risk of investment or volatility of stock price); Musser, *supra* note 18, at 22 ("A common misperception is that a stock option is worth the difference between the strike price [option price] and the market price. This is not always so.").

114. Littman, *supra* note 18, at 62; *Chammah,* 1997 WL 414404 at n.5 (discussing Black-Scholes valuation method referenced by expert); Davidson v. Davidson, 578 N.W.2d 848, 856 (Neb. 1998) (valuing the stock options by the Black-Scholes method); *Fisher,* 769 A.2d at 1171–72 (Newman, J., concurring) (suggesting alternatives to the unacceptably speculative intrinsic value method, including the discount-to-present-value-method, which applied three discounts to the intrinsic value for tax due upon sale, lack of marketability, and risk of forfeiture and the Black-Scholes valuation method); Hansel v. Holyfield, 779 So.2d 939 (La. Ct. App. 2000) (valuation of stock options based on expert testimony of an actuary who applied the present value discount method), *writ denied,* 789 So.2d 591 (2001).

115. *Davidson,* 578 N.W.2d at 858 (trial court did not abuse its discretion by using the Black-Scholes method to value ESO); *Wendt,* 1998 WL 161165 at nn.194–95; *Fisher,* 769 A.2d at 1172 (Newman, J., concurring) (suggesting use of Black-Scholes method in valuing options).

mula is a complex method that reflects the interrelationship between market value and exercisability by taking into account eleven different variables.[116] The method is well known and generally accepted and is commercially accessible through user-friendly computer software programs. While this revised method recently won the Nobel Prize for economics in 1997,[117] some courts have rejected its use in valuing ESOs as marital property.[118] The primary objection is that the Black-Scholes model evaluates value for publicly traded options; by definition, ESOs are not publicly traded, and the Black-Scholes measures based on marketability are therefore skewed as applied to an ESO.[119] Thus, the Black-Scholes method's formula for market value may be misplaced in an ESO context.

In any case, when a present value of an option is calculated, the option is then immediately distributed by awarding the non-employee spouse a lump-sum cash value.[120] The cash value is generally offset

116. F. Black & M. Scholes, *The Pricing of Options and Corporate Liabilities,* 81 J. POL. ECON. 673 (1973). The Black-Scholes model accounts for the five factors affecting the market value of an option, including an option's intrinsic value, an option's time to execution, the value of the underlying security, market interest rates, and dividends. The model also integrates six variables affecting the exercise of an option, including the exercise price of the option, the market price of the underlying security, the expiration date of the option, the underlying security's volatility, current interest rates, and the dividends of the underlying security. Curtis, *supra* note 18, at 440; *Wendt,* 1998 WL 161165 at n.195 (discussing the history and complexity of the Black-Scholes method).

There are other accounting models as well that may be used to ascertain an option's present value, including the Shelton and Kassouf models that are econometric or empirical models that use regression analysis of historical relationships among economic variables to estimate statistically the expected value of the option. Shelton, *The Relationship of the Price of a Warrant to the Price of Its Associated Stock,* FIN. ANALYSTS J. (May–June, July–Aug. 1967); Kassouf, *A Theory and an Econometric Model for Common Stock Purchase Warrants* (Analytical Publishers 1965); *See also* Littman, *supra* note 18, at 62 (discussing the Shelton, Kassouf, and Black-Scholes models of option valuation); *Wendt,* 1998 WL 161165 at n.191 (discussing Shelton and other variations of Black-Scholes method).

117. Eric Brazil, *Stanford Economist Wins Nobel, Shares Award With Harvard Colleague for Pioneering Formula to Value Stock Options,* S.F. EXAMINER, Oct. 14, 1997 at A1.

118. *Chammah,* 1997 WL 414404 at n.6 (the "Black-Scholes method does not appear to be an accurate method for evaluating employment issued stock options in a marital context"); *Wendt,* 1998 WL 161165 at n.197.

119. *Chammah,* 1997 WL 414404 at nn.5–6; *Wendt,* 1998 WL 161165 at nn.196–97; Littman, *supra* note 18, at 62 ("when using any of these approaches to value employee stock options, it is important to note that these models generally were designed to value marketable options. . . and a discount for lack of marketability should be used").

120. Littman, *supra* note 18, at 61. The court could also determine the present value of the option to understand the extent of the wealth available to determine the proper share of the option to award the non-employee spouse, which would then be distributed upon actual exercise of the option. *See also* Green v. Green, 494 A.2d 721, 728 (Md. Ct. Spec. App. 1985).

against other property since the option has not yet been exercised. The advantages of this method, as in the arena of distributing pensions, is that the parties are financially disentangled and that there is finality to the dissolution without the need for future court involvement.[121] The non-employee spouse receives an immediate benefit to what otherwise might be a contingent or nonexistent benefit, and the employee spouse reaps the benefit of potential increases in value that may occur post-dissolution.[122]

B. Deferred Valuation and Distribution

The appealing simplicity of valuation and distribution with the use of a present value method has alerted some courts to the conclusion that the simplicity masks the fact that the methods are inappropriate for use in the case of an ESO.[123] The court in *Chammah* explained that no present value could be accurately determined because the intrinsic value method ignored the options' contingencies and the Black-Scholes method was applicable only for publicly traded options.[124] The court in *Moody* went further, explaining that the existence of the contingencies and non-market factors "make it impossible to value the options" prior to their exercise.[125] *Moody* noted with concern,

> The personal right of an employee to receive future payments from his employer is not susceptible to being divided in the same sense that real estate or personal property may be. Again, if the payment of benefits is

121. Fisher v. Fisher, 769 A.2d 1165, 1169 (Pa. 2001) (immediate offset method had the commendable quality of finality because it made a final disposition at the time of distribution and did not need to take account of future fluctuations in stock prices or other contingencies which could affect the value); Littman, *supra* note 18, at 61; *cf. Chammah*, 1997 WL 414404 at n.6 (rejecting offset distribution because even though there were substantial other assets to offset the value of the options, no present value could be accurately valued and no clean break established between the parties due to alimony and child support awards).

122. Littman, *supra* note 18, at 61.

123. Batra v. Batra, 17 P.3d 889, 895 (Idaho Ct. App. 2001) (trial court did not err in refusing to value stock option shares as of date of divorce because "given the nature of stock options, a lump sum payment for yet to be vested [exercised] stock options at the date of divorce would not reflect the value and risk inherent in stock options"); *Chammah*, 1997 WL 414404 at n.6; Murray v. Murray, 716 N.E.2d 288 (Ohio Ct. App. 1999) (financial models that existed for calculating a value for stock options although regularly used in the market place could not be reliable for litigation over child support); Chen v. Chen, 416 N.W.2d 661 (Wis. Ct. App. 1987).

124. *Chammah*, 1997 WL 414404 at n.5.

125. *In re* Marriage of Moody, 457 N.E.2d 1023, 1027 (Ill. Ct. App. 1983). The *Moody* court identified the following factors as precluding an accurate valuation of an ESO in that case: the options are nontransferable; the employee must exercise the option to realize any profit; if an option is never exercised, it has no value; the employee was not yet able to exercise the options; and the employee's poor health and lack of liquid capital made it improbable that he would be able to actually exercise the options. *Accord* Fisher v. Fisher, 769 A.2d 1165, 1170 (Pa. 2001).

> contingent upon future events, such as the continuation of employment, a present award based on the discounted value of future payments to the employed spouse will prove excessive if the amount of benefits which he actually receives is less than the amount which was assumed.[126]

Accordingly, these courts have rejected any present value method for valuing stock options and instead have deferred the valuation and distribution decisions either through the *retained jurisdiction* approach or the *deferred distribution* approach.[127] Under the retained or reserved jurisdiction approach to valuation and distribution, a court retains jurisdiction to award the non-employee spouse a portion of the marital share of the option "if, as, and when" the employee actually exercises the option.[128] Just as in the pension context, this allows the non-employee to share in the future risk and contingency of the option.[129] This option does not result in an immediate payment to the non-employee spouse and increases judicial oversight, but it provides equal shares of the accrued value risk between marital partners.[130] A similar approach to valuation and distribution is the deferred distribution approach, under which the court retains jurisdiction to distribute and value the award yet proceeds to determine the percentage share that the non-employee spouse will be entitled to at the time an option is exercised.[131]

Under these deferred approaches, courts have derived a variety of means to ensure that an employee spouse actually shares the marital portion of the option at a future date. As the Pennsylvania Supreme Court aptly stated in *Fisher v. Fisher*, "unreasonable or spiteful spouses are not altogether unknown to trial courts" in domestic cases, and there

126. *Moody*, 457 N.E.2d at 1026 (quoting *In re* Marriage of Evans, 426 N.E.2d 854, 857 (Ill. Ct. App. 1981).

127. *E.g.*, *Fisher*, 769 A.2d at 1170 (deferred distribution approach excludes options from the present distribution and holds the case open as long as necessary to ascertain the values of options on the future dates when they may be exercised); *Chammah*, 1997 WL 414404 at n.6 (present division and reserved jurisdiction methods could be used when the evidence was inadequate to establish a present value of an ESO); *In re* Marriage of Frederick, 578 N.E.2d 612, 617 (Ill. Ct. App. 1991) (method of distribution of either deferred distribution or reserved jurisdiction was appropriate for distributing ESOs that had no present value until they were actually exercised).

128. Baccanti v. Morton, 752 N.E.2d 718, 726–27, 802 (Mass. 2001); Green v. Green, 494 A.2d 721, 728 (Md. Ct. App. 1985); *Moody*, 457 N.E.2d at 1027 (court had to retain jurisdiction to value and divide property because option was not property until it had been exercised).

129. *Chammah*; 1997 WL 414404 at n.6.

130. *Cf. id.* (rejecting reserved jurisdiction approach in favor of present division because of the need to minimize uncertainties to the non-employee spouse and to lessen the need for future court appearances); *Baccanti*, 752 N.E.2d at 727 (dividing ESO "if and when they vest and are exercised" allowed the husband and wife to share in the rise or fall of the asset).

131. Chen v. Chen, 416 N.W.2d 661 (Wis. Ct. App. 1987); *Green*, 494 A.2d at 729; *Frederick*, 578 N.E.2d at 617.

is a possibility that a vindictive option-holder might decline to exercise options to spite the former spouse and avoid sharing any profit.[132] However, most ESOs preclude the transfer or assignment of options to a non-employee, so the court cannot transfer a share of those options to a spouse.[133] Courts must therefore generally retain an employee's sole discretion on whether or not to exercise an option in the future.[134] Still, courts want to ensure that an employee spouse will turn over the appropriate share to his or her spouse when the option is exercised. This could be achieved through a qualified domestic relations order (QDRO), although a QDRO rarely appears in the existing cases.[135] Other courts have crafted protective relief in the form of a constructive trust upon the employee spouse to prevent that spouse from unjustly benefiting from options by retaining profits derived from the non-employee spouse's share of the property.[136]

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132. *Fisher*, 769 A.2d at 1170. Nevertheless, the court refused to place any specific limitations upon the option-holder's rights with respect to the exercise of the stock options, holding instead that if the holder had failed to exercise options that could have realized a profit, the court would retain power under principles of equity to rectify the situation. *Id.* Justice Nigro, concurring and dissenting in the *Fisher* opinion, elaborated that in such a case, fairness required that the option-holding spouse pay the non-holding spouse her marital share of the options' value on the date of expiration. *Id.* at 1173 n.2.

133. *In re* Marriage of Balanson, 996 P.2d 213 (Colo. Ct. App. 1999) (stock options could not be divided in kind upon dissolution because options by their terms were not subject to transfer); *but see* Batra v. Batra, 17 P.3d 889, 894–95 (Idaho Ct. App. 2001) (dividing husband's stock options by granting wife the right to exercise her share of the options as they became exercisable); Musser, *supra* note 18, at 23–25 (arguing that an ESO could be divided in kind just as pensions could be despite anti-alienation clauses similar to those found for options).

134. *E.g.*, *Green*, 494 A.2d at 728 (employee spouse could not be compelled to exercise his stock options by court distribution order); *Frederick*, 578 N.E.2d at 619; *but see, e.g.*, Broadribb v. Broadribb, 956 P.2d 1222, 1227 (Alaska 1998) (affirming trial court order that employee spouse had to exercise options during six-month exercise period if market price exceeded option price, and had to equally divide any proceeds); *In re* Marriage of Harrison, 225 Cal. Rptr. 234, 237 (Cal. Ct. App. 1986) (trial court ordered employee to pay wife her share of the option upon the exercise of stocks, or if he "does not choose to or cannot sell shares obtained through stock option rights," he was required to pay a portion of the gain he would have had on the first date the option was exercisable).

135. Carol Ann Wilson, *5 Errors Financial Planners Commonly Make When Working with Divorcing Clients*, J. FIN. PLAN., Oct. 2000 at 102, *available at* 2000 WL 14546198.

136. *E.g.*, DeJesus v. DeJesus, 687 N.E.2d 1319 (N.Y. 1997); Callahan v. Callahan, 361 A.2d 561 (N.J. Super. 1976); Musser, *supra* note 18, at 25–27 (advocating express trust or constructive trust); Sarah S. Oldham, *Distributing Executive Compensation Benefits*, 23 FAM. ADVOC. 30 (2001) (when ESO is not transferable and employee spouse is subject to limitations on disposition of funds, constructive trust may be best way to allocate share to non-employee spouse); *cf.* Diana Richmond, *The Challenges of Stock Options*, 35 FAM. L. Q. 251, 256–58 (2001) (in California, courts divide the options in kind through a trust mechanism in which the employee spouse holds the options for the benefit of the non-employee spouse). A constructive trust is a remedy, that is, a restitutionary device that is imposed on defendants who have unjustly benefited from a legal wrong done to plaintiffs. DOUGLAS LAYCOCK, MODERN AMERICAN

Other courts have crafted their own unique remedies. In *Chen v. Chen*, a court awarded the non-employee wife a fifty-percent interest and deferred distribution until such time as the employee-husband exercised the option.[137] However, if after eighteen months the employee had not sold the option, the wife could elect a cash payment akin to a present value amount as of that date.[138] In *Chammah v. Chammah*, a court assigned a percentage to each party (fifty percent) and then ordered annual payments to the non-employee spouse at the time each option became exercisable even if it was not in fact exercised.[139] In *Keff v. Keff*, an Alabama court granted the non-employee wife a fifty-percent share of the exercisable options and then provided distribution options under which the wife could elect to pay the option price and the employee husband was required to exercise the option, or the husband could instead pay the wife the intrinsic value of the options.[140] These cases demonstrate that courts have derived a variety of distribution mechanisms and remedies to ensure that deferred distribution decisions result in actual payment to the non-employee spouse.

C. Set Offs: Taxes and Costs

Finally, courts must account for the tax and transactional costs associated with the exercising of options.[141] The exercising of options and the selling of acquired stock may result in brokerage fees. In addition, an option transaction will be taxed under Internal Revenue Ser-

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REMEDIES 548–51 (1994); DAN B. DOBBS, REMEDIES 392–94 (1993). The constructive trust theory is that a wrongdoer or defendant holds the money or property in trust for the plaintiff and then like a trustee must return the full value of the property plus any appreciation or depreciation to the plaintiff-beneficiary. Laycock, *supra*, at 550.

137. *Chen*, 416 N.W.2d 661.

138. *Id.* at 664.

139. *See also* Fisher v. Fisher, 769 A.2d 1165, 1173 (Pa. 2001) (Nigro, J., concurring and dissenting) (to protect the non-holding spouse, court should have given non-employee spouse the choice of receiving her marital share of the options' value on the date the option matured and was exercisable even if the option-holding spouse had not elected to exercise the option).

140. Keff v. Keff, 757 So. 2d 450, 451 (Ala. Ct. App. 2000); *see also* Baccanti v. Morton, 752 N.E.2d 718, 727 n.4 & 802 (Mass. 2001) (providing that trial judge could divide shares of ESO by giving the non-employee spouse the power to exercise his or her shares of options through the employee spouse, regardless of whether the employee spouse ever exercised his or her shares after they had vested).

141. *E.g.*, Wendt v. Wendt, 757 A.2d. 1225 (Conn. Ct. App. 2000) (tax considerations regarding stock options were relevant in dividing assets); Hansel v. Holyfield, 779 So.2d 939, 944 (La. Ct. App. 2001) (finding it was inequitable for trial court to fail to take into account tax liability when valuing ESOs), *writ denied*, 789 So.2d 591 (2001); *In re* Marriage of Harrison, 225 Cal. Rptr. 234, 237 (Ct. App. 1986); Everett v. Everett, 489 N.W.2d 111 (Mich. Ct. App. 1992) (trial court erroneously failed to consider tax consequences of exercising options); *In re* Marriage of Nelson, 222 Cal. Rptr. 790, 792 (Ct. App. 1986) (reducing community property portion of ESO by 20% to reflect an assumed tax rate).

vice rules.[142] If an option is a qualified option, it will be taxed as capital gains when the option stock is sold.[143] If an option is a nonqualified option, the exercise of the option will be taxed as ordinary income to the employee, and then the sale of that stock will be subsequently taxed as capital gains tax.[144]

In many cases, however, courts do not consider the taxes and costs associated with options. The reasoning is that a trial court only needs to account for the immediate and specific tax consequences of the ordered division itself and that it is speculative to decide future tax liabilities because the tax code or an individual's tax bracket might change.[145] For example, in *Broadribb v. Broadribb,* the Alaska Supreme Court held that the tax consequences of exercising the option did not need to be considered in ordering a distribution of the option because the taxes were "speculative."[146] The court found that the taxes were not "immediate and specific" because it was unclear whether the exercise of the option would be taxed under U.S. or British law since the employee spouse was an British citizen working in Alaska.[147]

Ultimately, the failure of courts to consider the tax implications and the imprecision in valuing taxes and costs penalizes employee spouses, who will be assessed these taxes upon exercising their options and who will have to share the gains but not the costs. Perhaps the simplest way of addressing the tax and cost issue is to order a division of the profits realized from the stock option.[148] Dividing the net value after taxes and costs avoids speculation on the precise amount of tax liability but accounts for those costs and shares them equitably between the partners in the same manner as the option profit is being shared.

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142. The IRS recently ruled that the transfer of shares from an employee to a spouse pursuant to a divorce decree triggered taxation but that the subsequent exercise of those options by the non-employee spouse did not incur further tax. Natalie L. Bell, *Divorce-Related Transfer of Compensatory Stock Options Is Taxable,* TAX. ADV., Aug. 1, 2000, *available at* 2000 WL 10124927 (discussing Field Serv. Advice 200005006); *see also* Richmond, *supra* note 137 at 259–60 (suggesting ways to avoid the FSA tax trap).

143. I.R.C. § 422.

144. I.R.C. § 83; Treas. Reg. § 1.83-4(b).

145. Musser, *supra* note 18, at 23 (suggesting that court should have taken into account the tax consequences of exercising and selling the options rather than relying on the old "immediate and specific" tax rule).

146. Broadribb v. Broadribb, 956 P.2d 1222, 1227 (Alaska 1998); *but see Hansel,* 779 So.2d at 944 (tax consequences were no more speculative than determining the value of stock and husband submitted evidence of applicable federal and state tax rates).

147. *Id.* at 1228.

148. *E.g.*, Dietz v. Dietz, 436 S.E.2d 463, 470 (Va. Ct. App. 1993) (ordering employee to pay 53% of net proceeds from sale of any stock acquired from the exercise of the stock option); *In re* Marriage of Harrison, 225 Cal. Rptr. 234, 237 (Cal. Ct. App. 1986) (awarding non-employee a share of gain on stock after taxes and costs); Batra v. Batra, 17 P.3d 889, 895 (Idaho Ct. App. 2001) (requiring each party to bear the tax consequences of their own exercise of the stock options).

V. Conclusion

The intangible and contingent property interest in an ESO potentially is a valuable asset within a marital estate subject to division and distribution by the court at dissolution. Yet the parameters for characterizing, valuing, and dividing this new property interest have not yet become uniform in courts' approaches to these issues. The synthesis of the case law in this article attempts to define those parameters to enable advocates to address these new and complex legal issues as they are raised by the circumstances of each individual case. Indeed, a Nebraska court held a lawyer liable for malpractice for his failure to advise his client of this evolving area of the law and of favorable precedent in other jurisdictions.[149] Thus, it is imperative that lawyers stay abreast of the developments in this evolving area of the law and that they utilize the existing cases in a way to zealously advocate for new approaches benefiting their clients' positions.

149. Wood v. McGrath, North, Mullin & Kratz, 589 N.W.2d 103 (Neb. 1999) (court found malpractice where an attorney failed to advise his client prior to accepting a divorce settlement that the law was unsettled regarding whether ESOs were marital property and how to value such options, and that although the home state court of Nebraska had not decided these issues as of the time of the separation, other state courts had resolved the issues in her favor); *cf. In re* Balanson, 25 P.3d 28, 35 (Colo. 2001) (in case of first impression, state supreme court considered case law from other jurisdictions and scholarly commentary found in academic sources).