Over 14 million American workers now receive employee stock options, an increase from one million in 1990. Further, 79% of stock option holders earn less than $75,000 annually. Now that stock options have become a dominant component of compensation for both senior executives and middle management in public companies, the treatment of employee stock options has become of even greater importance for matrimonial attorneys.

Employee stock options generally are not transferable and thus represent nontraded assets. Consequently, their “value” is difficult to ascertain and, in many cases, is not realizable at the valuation date used for property. Furthermore, in many situations, employee stock options may have been granted prior to the date of the divorce complaint, but the employee will not receive full title (or vest) unless the employee continues employment with the firm beyond the complaint date. Thus, determining what component of executive stock options, if any, represents marital property for distribution is a difficult issue to resolve. How child support is impacted by the granting and subsequent exercise of employee stock options also is a topic that presents many questions requiring careful analysis. For example, how does the timing of the exercise of employee stock options impact the level of child support?

This manual provides guidance in answering these and other important questions. What follows is a brief overview of each of the five chapters comprising this guide to employee stock options. We hope that you find the material useful, timely, and clear.

Chapter 1: When Are Employee Stock Options Marital Property? Chapter 1 is divided into three sections. The first section discusses why employee stock options generally are considered property. The second section addresses the complex issue of whether unvested employee stock options should be considered marital property and is discussed through a review of major court decisions around the coun-
try. Unvested stock options generally are viewed as a contingent asset because the employee-spouse does not have the right to exercise the stock option until vesting. The third section examines the various “time rules” typically used to allocate employee stock options between marital and separate property. Appendix 1-A contains a summary of major court cases addressing whether employee stock options represent marital property. Appendix 1-B provides a discovery checklist of items to request when assessing whether employee stock options represent marital property. Both appendices are available on the accompanying CD-ROM for easy customization. Chapter highlights include:

- Factors that help determine whether employee stock options were granted for past or future service;
- Examples of the various time-rule formulas to allocate unvested employee stock options into marital and separate property; and
- Language found in stock option plans that indicate why employee stock options have been granted.

**Chapter 2: Employee Stock Option Valuation.** Traded stock options have value by providing investors greater upside potential with limited downside risk relative to purchasing shares of the underlying security outright. Employee stock options also have these characteristics with two major differences. First, employee stock options generally are nontransferable. A major issue for family law attorneys is how this lack of marketability impacts both the value of employee stock options and their effective division in a property settlement.

Second, the term of employee stock options is significantly greater than that of traded stock options. As discussed in this chapter, this difference materially increases the value of employee stock options.

Chapter 2 is divided into three main sections. The first section provides an overview of stock option terminology and valuation using examples of traded stock options. The second section discusses how stock options are valued. The critical assumptions needed to value employee stock options are identified as well as how these assumptions can be validated. The chapter ends with an in-depth look at how employee stock option valuation differs from that of traded stock options. Key points pertaining to the valuation of employee stock as they relate to equitable distribution are listed below:
• Out-of-the-money traded and employee stock options often have significant value. For example, traded Apple Computer stock options with an exercise price $8.70 greater than the market price that expire in two years were trading at $19.00.

• Employee stock option value can be determined with reasonable accuracy. Generally accepted accounting principles now require firms to recognize the cost of options granted to employees determined through option pricing models such as the Black-Scholes Option Pricing Model directly on their income statement. The IRS mandates the use of the Black-Scholes Option Pricing Model for valuation of employee stock options in a gift and estate tax settings.

• The value of an employee stock option should be based upon the expected life of the option. The use of the contractual life of the option rather than the expected time to exercise will result in the option being overvalued.

• The reduction in the value of an employee stock option due to its lack of marketability is captured through reducing the expected life of the option. Using a shorter life and a marketability discount will understate the value of the option to the employee.

• A marketability discount may be appropriate if, after exercise, the employee has restrictions on sale of the underlying security. Discounts in the range of 5% to 15% are warranted.

Chapter 3: Taxation of Employee Stock Options, Restricted Stock, and Stock Appreciation Rights. Employee tax liability resulting from the exercise of employee stock options is an important factor that family law practitioners must address as part of any property settlement. Chapter 3 discusses how employee stock options are taxed with an emphasis on the differences between incentive stock options (qualified) and nonqualified employee stock options. New tax rulings dealing with employee stock options are discussed along with several examples of how they impact the net proceeds from the exercise of employee stock options.

Chapter 4: Deferred Distribution vs. Immediate Offset Approaches to Dividing Employee Stock Options. Once employee stock options
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are determined to be marital property and to have value, they must be distributed or divided. One of two methods of distribution typically is employed. The immediate offset approach to dividing employee stock options often is preferred by the titled spouse who believes his or her employee stock options may substantially grow in value. In addition, this approach creates a clean break between parties, unlike the deferred distribution approach, which requires the parties to maintain a working relationship. The facts and circumstances in any given situation will, of course, determine whether this method makes sense. The deferred distribution method, often referred to as the “if, as, and when approach” of dividing marital vested and unvested stock options, has been the court’s preferred method. The advantage of this approach is that it eliminates the need to estimate the current value of unvested stock options. The advantages and disadvantages of this method are discussed. Because the vast majority of divorce cases settle out of court, stock options usually are distributed pursuant to the terms of a written agreement. A sample property settlement agreement is included as Appendix 4-A, and is also available on the accompanying CD-ROM.

Chapter 5: Stock Options as Income for Child Support and Alimony. How child support is impacted by the granting and subsequent exercise of employee stock options is a topic with many twists and turns. Vested employee stock options represent value to the option holder but may have no realizable value at the date of vesting. A deferral of the exercise date of employee stock options may provide the titled spouse the ability to reduce child support. Courts generally have considered vested options income upon exercise when they are converted into gross cash income or upon vesting when the ability to convert the option into income becomes possible. After an overview of the issues of when employee stock option income should be counted as part of gross income, a review of major court cases dealing with this issue is included. The chapter then moves on to a review of the use of a constructive trust to manage the use of employee stock options as part of child support. The listing of cases in Appendices 5-A and 5-B (also available on the accompanying CD-ROM) will assist attorneys in developing strategies in determining how employee stock options impact child support and alimony. Important issues discussed in the chapter include:
• Child support agreements should explicitly address how stock options will be handled in the determination of child support and alimony.

• When employee stock options convert to income and how that income should be measured is an area where there is little agreement. Should income only occur at time of exercise? Allowing the titled spouse to defer exercise may deprive the child of support.

• Whether employee stock options can be categorized as property for equitable distribution and utilized for child support varies across states. The classification is made more difficult when coverture ratios are used to allocate employee stock options as marital and separate property.

Note