Unsettled Issue in a Divorce Suit: Should Granted, Unvested Stock Options Constitute a Marital Asset or a Separate Asset?

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For domestic cases in Utah, the general rule is that courts equitably divide marital property, and return premarital property, gifted property, and/or inherited property to the acquiring spouse. Property that is earned after entry of the decree of divorce is generally earmarked as the acquiring spouse's separate property.

With stock options granted during the marriage but that do not vest until after the entry of the decree of divorce, various state court rulings have lacked consensus. In Utah, there is no reported case law that directly addresses the question of whether granted but unvested stock options are deemed an employee spouse's separate asset or a marital asset.

This article explores that question by 1) discussing when to divide such stock options and two common methods of division; 2) examining how other state courts have addressed the issue of granted, unvested stock options; 3) analyzing Utah cases that provide analogous reasoning that could be applicable to the issue of granted, unvested stock options in Utah courts.

Before getting into the analysis, by way of background, a stock option is defined as "the right to buy a designated stock at any time within a specified period at a determinable price, if the holder of the option chooses." *See Divorce and Separation: Treatment of Stock Options for Purposes of Dividing Marital Property*, 46 A.L.R.4th 640, § 1[a] (2016). The grant date is defined as the date the option "becomes the employee's property." *See* Tiffany A. McFarland, *Dividing Stock Options in Divorce*, NATIONAL BUSINESS INSTITUTE, at 1. In contrast, if a stock vests, it means it is "exercisable" or "matured," and the employee may use the option to buy the stock. *See Divorce and Separation: Treatment of Stock Options for Purposes of Dividing Marital Property*, 46 A.L.R.4th 640, § 2[a] (2016).

I. Classifying and Dividing Granted, Unvested Stock Options

The first step in deciding whether a granted, unvested stock option should be divided in a divorce suit is to focus on classification of the stock option. One should ask:

- When did the grant of options occur: before the marriage, during the marriage, after separation, or after the date of divorce?
- When did/does the vesting occur?
- When did/does the options become exercisable?
- If the grant occurred during the marriage, was it towards the beginning of the marriage or at the end?
- Were the stock options granted to reward past work or to incentivize future work?

The last point is key. Employers offer stock options to reward past work and/or to incentivize future work. *See* Tiffany A. McFarland, *Dividing Stock Options in Divorce*, NATIONAL BUSINESS INSTITUTE, at 3. If the grant of stock options is to reward past work—presumably during the marriage—the argument that the asset is a marital asset is strengthened. If the reward of the stock

options is to incentivize future work—presumably after the date of the divorce—that could suggest it is one's separate asset.

To determine whether the award was for past work or to incentivize future work, one must look to the circumstances surrounding the grant, including, but not limited to:

- Was there a letter or documentation surrounding the grant explaining the reasoning for the grant?
- When did the grant occur, and under what circumstances? Was it right after a big project was completed or does the company have a regular policy of offering the grants after x years of work with the company?
    - The former could suggest it was a reward/bonus for past work (marital asset) and the latter could suggest it is an incentive to remain with the company (separate asset).
- Was it voluntarily given to the employee or did the employee have to negotiate for it?
    - Negotiation suggests the grant could be a substitute for salary, and compensation earned during the marriage is generally considered a marital asset.
- Were the options spread out over time or front-end loaded?
    - The former could suggest an incentive to remain with the company, and the latter could suggest it is more a form of compensation.
- Did other co-workers in similar positions or tenure receive the same granting of options?
    - If it is the employer's policy to grant stock options after any employee has been with the company for x amount of time, this could suggest the grant is the company's way of compensating for loyalty to the company for past work (marital asset).

Id.

If after conducting the above analysis, one determines the options are entirely or partially marital assets, the focus shifts to division of the asset. There are generally two ways stock options can be divided in a divorce suit: (1) net present value and (2) deferred distribution. *See* Tiffany A. McFarland, *Dividing Stock Options in Divorce*, NATIONAL BUSINESS INSTITUTE, at 9–11, (noting a third valuation method is to "reserve jurisdiction," where the division occurs once benefits are actually paid, but the analysis is similar to deferred distribution). The pros and cons of each division method are discussed below.

A. Net Present Value

First, with net present value, there is an immediate distribution to the non-employee spouse based on the net present value of the future benefit after reduction for the payment of taxes. To determine the present value, one looks to current value of the stock; projected values when the stock option vests and can be exercisable; actuarial data; and other factors.

This valuation method could be beneficial to the non-employee spouse because it reduces interaction and potential conflict with the former spouse; the non-employee spouse could start investing the proceeds so the funds begin working for him/her; and it lowers the non-employee

spouse's risk in the event the stock does not perform well in the future or the employee leaves the company before the options are exercisable.

Along those same lines, if the non-employee spouse is fearful the employee spouse would sabotage the non-employee's claim to the granted, unvested options, it can be advantageous to obtain an immediate payment for his/her share of the options, even if that means accepting a discount on the funds. The authors of this article are aware of a situation where the divorcing couple agreed the stock options would be paid out equally once the options vested, which was years away. Shortly after the decree of divorce was entered, the employee spouse began negotiating with a new employer for a more remunerative salary based on the fact the employee spouse would leave unvested stock options from his prior employer. The new company agreed, and the employee spouse quit his job. While the employee spouse received the benefit of the unvested options through his new income package, the non-employee spouse was left empty-handed.

Dividing the net present value may be less desirable for the employee spouse because it is contingent upon ongoing employment. If the non-employee spouse was paid out the net present value of the stock option that fails to become exercisable, the non-employee spouse received a windfall at the employee spouse's expense. The net present value paid to the non-employee spouse may also end up being higher than the benefit actually received by the employee spouse, again resulting in a windfall to the non-employee spouse.

On the other hand, the employee spouse may be confident that the stock options will be more valuable in the future based on company projections and one's knowledge of that company and upcoming projects. By doing a lumpsum payout to the non-employee spouse at the time of the divorce, the future windfall belongs to the employee spouse. Further, an attorney could negotiate a discount on the net present value as a way to factor in the risk that the employee spouse's employment may be terminated, the stock options could be worth less by the time of vesting. The lack of contact with the non-employee spouse may also be desirable.

According to this division method, which aims to make a clean break and limit contact in a divorce suit, the most effective way to divide the asset is to have a marital estate sizeable enough to afford the pay-out. Set payments for a certain period will work, but it is not preferred.

B. Deferred Distribution

Under the deferred distribution method, the parties divide the marital options when the options become exercisable. This method eliminates the need to agree on a current value of the stock options when the options remain unvested. This division method is also known as a wait-and-see approach. *See* Tiffany A. McFarland, *Dividing Stock Options in Divorce*, NATIONAL BUSINESS INSTITUTE, at 10. The main benefit to this distribution method is that the parties share in the risk and upside. *Id.* If the business outperforms projections that were held as of the date of the divorce decree, the non-employee spouse also benefits. If the business underperforms, both parties share in the diminished returns. If the employee spouse's employment is terminated, the parties are on equal footing with the loss. Another benefit is that the figures used for the division are based on reality, not speculation. With the net value method, it is almost certain one of the parties will end up with the shorter end of the stick, but that is generally not so with the deferred distribution

method. The exception is if a party has malevolent intentions to manipulate the stock options to his or her own benefit at the expense of the non-employee spouse (such as by leaving the stock options on the table but receiving a higher salary in exchange), though courts can order constructive trusts to prevent this. *See Jensen v. Jensen*, 824 So. 2d 315 (Fla. Dist. Ct. App. 2002); *Callahan v. Callahan*, 361 A.2d 561, 563 (N.J. Super. Ct. Ch. Div. 1976)

This distribution method is not without complications. First, employer plans differ on whether a separate account can be set up for a non-employee spouse, and the plan's restrictions control even if a decree of divorce provides otherwise. Most plans do not allow for the transfer of options to a third party, as most grants involve at least a partial incentive for the employee to remain with the company. *Id.* If the employer plan does not allow for the non-employee spouse to have a separate account, the employee spouse must exercise the option for the non-employee spouses. This involves more contact between the parties. The employee spouse would need to notify the non-employee spouse about the stock options so the non-employee spouse could make an educated decision about when to exercise the stock options.

The decree of divorce should have provisions mandating that the employee spouse inform the other spouse about the stock options, so that a contempt mechanism exists. Notice provisions to put in a decree of divorce include:

- Notice must be given if the employment status of the employee spouse changes;
- Notice must be given if the employee spouse exercises any options;
- Notice must be given if the employer changes terms with the options, including repricing or grants replacement options;
- Notice must be given if the employer accelerates the maturity date, expiration date, or other terms surrounding the options.

Tiffany A. McFarland, *Dividing Stock Options in Divorce*, NATIONAL BUSINESS INSTITUTE, at 10. The decree of divorce should include a specific plan or formula that devises the method whereby the non-employee spouse will be paid once the employee spouse has exercised the option, including reimbursement for payment of taxes to the employee spouse. The employee spouse will pay taxes upon the exercise of the option, and the tax amount will depend on what type of stock option it is (non-qualified stock options and incentive stock options). It is advisable to consult a tax professional before creating the formula for the non-employee spouse's payment and reimbursement for any paid taxes upon the exercise.

II. Other States' Treatment of Granted, Unvested Stock Options

Other states have addressed the issue of allocating and dividing granted, unvested stock options. As seen from the survey below, the results vary wildly across the nation. Because of the myriad holdings on this issue, this article will conclude by citing to Utah case law on deferred compensation, which could be indicative of a Utah court's ruling on the issue of granted but unvested stock options.

In *Hann v. Hann*, 655 N.E.2d 566 (Ind. Ct. App. 1995), the Indiana court of appeals affirmed the trial court's grant of the husband/employee spouse's motion for summary judgment determining

the granted, unvested stock options were his separate property. *Id.* at 571. Specifically, the appellate court ruled that the only marital stock options are those "which are exercisable upon the date of dissolution or separation which cannot be forfeited upon termination of employment as marital property." *Id.* The court reasoned that unvested stock is "wholly contingent" on husband's continued employment with the employer, and he would have no right to exercise the options if his employment was terminated before the exercise date. *Id.*

While the *Hann v. Hann* case was decided back in 1995, even recently, the *Hann* holding was reaffirmed *Fischer v. Fischer*, 68 N.E.3d 603, 608–09 (Ind. Ct. App. 2017). In fact, the Fischer court took the *Hann* ruling one step further by concluding that stock options needed to vest before "final separation," which is the date the petition for dissolution was filed in order to qualify as marital property. Otherwise, "the date of final separation seals the property to be included in the marital pot." *Id.* at 609.

Similarly, in North Carolina, the appellate court in *Hall v. Hall*, 363 S.E.2d 189 (N.C. Ct. App. 1987) held that any stock options not vested "as of the date of separation and which may be lost as a result of events occurring thereafter . . . should be treated as the separate property of the spouse for whom they may, depending upon circumstances, vest at some time in the future." *Id.* at 196. In that case, the court ruled that only 1,400 shares of the 54,000 shares of stock granted during the marriage were deemed marital. *Id.* at 195–96.

In contrast, several states have held that the act of granting stock options during the marriage makes the options a marital asset subject to division. In *Garcia v. Mayer*, 920 P.2d 522 (N.M. Ct. App. 1996), the New Mexico court of appeals held the district court did not err in holding that unvested stock options granted to the husband by his employer were marital property when part of the labor necessary to earn the benefit of vested options was performed during the marriage. *Id.* at 524. The holding was affirmed even though the husband argued it was a contingent benefit and he had no right to exercise any of the unvested options. *Id.* Specifically, the court held that "[t]he fruit of a spouse's labor before divorce is community property." *Id.* The court also noted the divide between jurisdictions on the treatment of granted, unvested stock options but stated that the majority of jurisdictions that considered the issue have decided that stock options granted during the marriage are marital property even if the stock cannot vest until after the time of divorce. *Id.* at 525.

In Missouri, in *Beecher v. Beecher*, 417 S.W.3d 868 (Mo. Ct. App. 2014), the court ruled that it was the grant of stock options, not the vesting of the options, which was dispositive to the issue of whether options could be classified as a marital asset. There, the husband was granted stock options from his employer during the marriage, but the shares would not vest until two to three years after the entry of the decree of divorce. *Id.* at 871. In support of the claim it was his separate property, the husband testified the stock options "represented future compensation, they were offered as an incentive to stay employed, vesting was contingent on continuing employment, and the stock was subject to significant pre-vesting restrictions." *Id.* The court disagreed, holding that "[a]ny argument that options could not be treated as marital property due to contingencies was 'discredited' by Missouri dissolution cases dealing with pension plans," *id.* at 872 (quoting another source) and that the record did not show the options were "'entirely related to future performance.'" *Id.* (quoting another source).

Some states take a middle ground, which results in divergent rulings on this issue. Often the distinguisher between the two holdings is whether the grant was to reward past work or incentivize future work. *Compare Gilbert v. Gilbert*, 808 A.2d 688 (Conn. App. Ct. 2002) (holding that unvested stock options created an enforceable right in the non-employee spouse and were deemed marital assets) *with Hopfer v. Hopfer*, 757 A.2d 673 (Conn. App. Ct. 2000) (holding that the granted, unvested stock options were entirely an incentive for future services, and therefore, not a marital asset). *Compare also Ruberg v. Ruberg*, 858 So. 2d 1147 (Fla. Dist. Ct. App. 2003) *with Jensen v. Jensen*, 824 So. 2d 315 (Fla. Dist. Ct. App. 2002) (same). For example, in *In re Marriage of Miller*, 915 P.2d 1314 (Colo. 1996), the Colorado court determined that when dealing with stock options granted during the marriage that have yet to vest, the main inquiry was whether the employee stock option is granted in consideration of past services (marital property) or in consideration of future services (separate property). *Id*. at 1319.

Other states have created formulas to address this issue. In *In re Marriage of Hug*, 201 Cal. Rptr. 676 (Cal. Ct. App. 1984), the California court recognized the broad discretion given to courts to select an equitable method to allocate marital and separate property interests with granted, unvested stock options. *Id.* at 678. In exercising its discretion, the California court of appeals adopted a formula known as the time-rule to determine the marital portion of granted, unvested stock options. *Id.* at 685. In that case, the parties had been married 16 years when the husband began employment with a new company. After being with that company two to three years, the husband was granted a total of 3,100 shares of company stock at below-market price. *Id*. at 678. Four years after joining the company and after 20 years of marriage, the parties separated. *Id.* At issue before the court was the classification of stock options that were not exercisable until after separation. The trial court applied a time-rule formula that determined approximately two-thirds of the stock options were marital property, as follows:

> the numerator is the period in months between the commencement of the spouse's employment by the employer and the date of separation of the parties, and the denominator is the period in months between commencement of employment and the date when each option is first exercisable, multiplied by the number of shares which can be purchased on the date the option is first exercisable. The remaining options are the separate property of the employee.

Id. at 678. This formula recognizes the marital effort in earning the contractual right to receive the stock benefits, and that the years of employment during the marriage carried as much weight as the last few years after separation. *Id.* at 684.

Reasonable minds differ, however. In *Batra v. Batra*, 17 P.3d 889 (Idaho App. 2001), the Idaho Court of Appeals rejected the California time-rule laid out in *Marriage of Hug*, and reasoned as follows:

> [T]he *Hug* approach may result in the parties' respective property interests being tied together for a potentially long period after divorce. In particularly acrimonious divorce cases, as the one at hand, this approach increases the opportunities for mischief, misunderstanding, and subsequent litigation. The *Hug* time-rule also runs

> counter to Idaho's policy of separating the parties' interests in the property as quickly as possible, giving each immediate control over their share of the community property as that interest vests, while avoiding the inequitable distribution of the assets.

Id. at 893. Instead, the Idaho court adopted the time-rule similar in *Marriage of Short*, 890 P.2d 12 (Wash. 1995), which provided a spouse would only be entitled to a share of those flight of options in which the year of vesting coincides with a period of the marriage. More specifically: "The community's interest in vesting flights of stock options is limited to those vesting in whole or in part during the years of marriage, eliminating whole years of vesting outside of the marriage and thereby hastening separation of the parties' interests consistent with Idaho law." *Batra*, 17 P.3d at 893–94. To determine the marital portion of stock that vested in whole or part during a given year of marriage, the Idaho Court used the following formula: "the number of days of the marriage during the year of vesting of the flight of the stock option in question over the number of days in a year. The fraction is then converted into a percentage—the community's interest in the stock options in that particular flight." *Id.* at 893.

From the above analysis, it is clear there is no uniform formula across jurisdictions.

III. Utah Case Law on Deferred Compensation and Related Topics

The authors of this article could not find a reported Utah case where a trial court adjudicated the issue of classification and division of granted, unvested stock options—though a few cases dealt with setting aside stipulations awarding granted, unvested stock options. While there is not a clear ruling on this issue, Utah case law offers insight into how courts treated deferred compensation, vested or otherwise, that offers helpful analysis on this issue. Applying the law on deferred compensation to granted, unvested stock options has its support: Several other state courts have compared employment-related stock options with pensions, retirement accounts, and other forms of deferred compensation, and have used similar formulas to divide stock options. *See Divorce and Separation: Treatment of Stock Options for Purposes of Dividing Marital Property*, 46 A.L.R.4th 640, § 2[b] (2016); *see also Green v. Green*, 494 A.2d 721, 726–29 (Md. Ct. Spec. App. 1985) (holding that unvested stock options were comparable to pensions and other employee benefits).

In *Woodward v. Woodward*, 656 P.2d 431 (Utah 1982), the Utah Supreme Court held that deferred compensation—whether vested or not—should at least be considered when dividing marital assets. *Id.* at 432. ("In the context of Utah law, we find it unnecessary to consider whether or not the pension rights are 'vested or non-vested.'") (quoting another source)). In that case, the husband argued that because his pension benefit was contingent upon employment for another 15 years, the trial court "erred in considering, as a marital asset, that portion of his pension which would be contributed by the government at some future date." *Id.* at 431. The Utah Supreme Court disagreed, ruling that the 15 years that husband worked for the company while married were just as important to his pension payments as any future work while not married, and the wife should be entitled to a financial benefit for those early years of work. *Id.* More specifically, the Court ruled, "Whether that resource is subject to distribution does not turn on whether the spouse can presently use or

control it, or on whether the resource can be given a present dollar value. The essential criterion is whether a right to the benefit or asset has accrued in whole or in part during the marriage. To the extent that the right has so accrued it is subject to equitable distribution." *Id.* at 432–33. *See Dunn v. Dunn*, 802 P.2d 1314, 1318 (Utah Ct. App. 1990) (holding "the right to future income is a marital asset where that right is derived from efforts or products produced during the marriage, even in cases where that right cannot be easily valued") (citations omitted)).

Limiting the sharing of financial interests between divorced parties was a key part in the *Woodward* ruling:

> Long-term and deferred sharing of financial interests are obviously too susceptible to continued strife and hostility, circumstances which our courts traditionally strive to avoid to the greatest extent possible . . . .
>
> . . . [W]here other assets for equitable distribution are inadequate or lacking altogether, or where no present value can be established and the parties are unable to reach agreement, resort must be had to a form of deferred distribution based upon fixed percentages.

Id. at 433.

On the other hand, arguments can be made that suggest if stock has not matured and is contingent on future employment, the financial benefit is too speculative and uncertain. For example, in *Chambers v. Chambers*, 840 P.2d 841 (Utah Ct. App. 1992), the Utah Court of Appeals held that a basketball player's future contract payments were post-marital income and not subject to marital division, though the husband signed the contract during the marriage, and was two years into a five-year contract. *Id.* at 844–45. The court reasoned:

> [Mr. Chamber's] future income will be derived from his playing basketball during the term of his contract, rather than from some past effort or a product produced during the marriage. Furthermore, his right to the benefit of that salary will accrue at that time, and did not accrue during the course of the marriage. This is especially true in light of the fact that the contract payments will only be made provided that Mr. Chambers does not suffer injury, illness, disability or death as a result of participation or involvement in any one of a number of off-court activities.

Id. While one's salary is dependent on substantial future performance, the same can be said about certain unvested stock options. The *Chambers* ruling suggests the key distinction is whether the future income is a reward for past work or contingent upon future work—similar to other states' holdings on the issue of granted, unvested stock options.

Another argument to bolster the claim that unvested stock options should remain with the employee spouse is that Utah courts desire a clean break for the parties when possible: "The purpose of divorce is to end marriage and allow the parties to make as much of a clean break from each other as is reasonably possible. An award of deferred compensation which ties a couple together long after divorce can frustrate that objective." *Gardner v. Gardner*, 748 P.2d 1076, 1079

(Utah 1988) (holding it was error for the trial court to not place a present value on a portion of the husband's medical assets on the ground that the assets were "futuristic" and that the wife was entitled to a finding on that issue). The Utah Supreme Court recognized that clean breaks are not always possible, and it discussed a couple methods for dividing deferred compensation that resemble the methods of distribution discussed herein. *See id.* at 1079.

In conclusion, there are many considerations to weigh when negotiating for the treatment of granted, unvested stock options. If negotiation is unsuccessful, one has a plethora of cases and arguments to rely upon to justify the argument that granted, unvested stock options should be either a marital asset or a separate asset.