The ALI Proposals and the Distribution of Stock Options and Restricted Stock on Divorce: The Risks of Theory Meet the Theory of Risk

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I. INTRODUCTION

The traditional marriage vow's "for better for worse, for richer for poorer, in sickness and in health, . . . till death us do part" represents the most comprehensive expression possible of the risks assumed by a marrying couple. The covered risks include those intrinsic to the marriage as well as those risks arising from forces external to the marriage. Moreover, the vows effectively deal with the passage of time, the one omnipresent variable in the process of risk evaluation and risk adjustment. Would that the premises of domestic life had remained constant!

The American Law Institute (ALI) is in the last stages of the process of evaluating the laws applicable to the dissolution of a marriage. The ALI is proposing that states amend their laws so as to embody certain principles governing the financial remedies available on divorce. In many instances, these proposals would amount to a significant overhaul of these remedies. One interesting aspect of the draft proposals is the way they reflect presumptions regarding the risks people assume in domestic relationships. This article will examine how these risk assumptions play out upon divorce with respect to the treatment of certain employment compensation packages. Incentive based packages are playing a rapidly increasing role in employee compensation, and, at least

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1. THE AMERICAN BOOK OF COMMON PRAYER 301 (1928).
3. A recent survey suggests that in 1999 nineteen percent of employees were eligible to participate in stock option plans, an increase from the twelve percent who were able to participate in 1998. Frederic M. Biddle, A Special News Report About Life on the Job and Trends Taking Place There, WALL ST. J., Jan. 18, 2000, at A1. The number of people holding options is estimated to have reached the ten million mark. See Amy Zipkin, Stock Option Splitsville, N.Y. TIMES, Aug. 9, 2000, at Cl. A survey of fifty large U.S. companies in 1999 found that nearly fifty percent of them granted options to all of their employees. See Michael J. Powe et al., America's Best Company Benefits, MONEY, Oct. 1999, at 103. In May 2000, Congress amended the Fair Labor Standards Act to exclude the value of stock options received by hourly paid workers from the amount used to calculate the employee's overtime.
among certain classes of employees, may be starting to overwhelm conventional compensation packages. This article will focus on stock options and restricted stock offered by the employer. These compensatory devices carry with them substantial elements of risk that generally are independent of the risks directly associated with the marriage of the spouse-employee. Some of the carried risks

compensation. Worker Economic Opportunity Act, Pub. L. No. 106-202, § 2(a)(3), 114 Stat. 308 (2000). Nor are we just concerned with pocket change. A survey of sixty “new economy” companies found that their chief executives held options where the median holding was nearly $15,000,000 and the average holding was a staggering $121,000,000. Even among “old economy” stocks, of 100 corporations surveyed, the median option holding was about $5,500,000 and the average holding was worth nearly $23,000,000. See David Leonhardt, Report on Executive Pay, In Options Age, Rising Pay (and Risk), N.Y. TIMES, Apr. 2, 2000, § 3, at 1. One estimate puts the value of stock options exercised by employees of U.S. corporations during 1999 at $35,000,000,000. Martin A. Sullivan, Let the Good Times Roll: Options and Tax-Free Profits, TAX ANALYSTS NOTES TODAY, May 26, 2000, at 1185. Responding to changes in compensation trends, in 2000 the U.S. Department of Labor’s Bureau of Labor Statistics began surveying the incidence of stock option plans and the impact on compensation costs across all industries and all occupations in the country. BUREAU OF LABOR STATISTICS, U.S. DEPT OF LABOR, EMPLOYMENT COST INDEX, NOTES (Dec. 1999), available at http://stats.bls.gov/ect/sp/ecnr0022.txt (last visited Nov. 14, 2001). See generally Jan Harden Webster & Margaret de Lisser, Divorcing the Executive: QDRO (DRO) Issues, 14 AM. J. FAM. L. 146 (2000) (discussing that executive compensation is increasingly dominated by options and similar compensation devices).

4. See generally Joan S. Lublin, Net Envy, WALL ST. J., Apr. 6, 2000, at R1 (discussing study by William M. Mercer, Inc., in 1999 and the increasing role of options packages in recruitment and retention of Chief Executive Officers of major industrial and service concerns). Compensation packages typically included options with a face value of more than three times the individual's salary, and average restricted stock awards equaled the recipient's cash pay. Id.

5. The paper makes no effort to tackle the even loftier heights of nonqualified deferred compensation arrangements such as Supplemental Executive Retirement Plans (SERPs) and Supplemental Savings Plans that present other interesting divorce issues. The former looks like a defined benefit pension, the latter like a defined contribution plan. These schemes operate beyond the reaches of a conventional ERISA treatment and defer the employee’s tax liability by avoiding conferring on the employee any immediate economic benefit or liability for constructive receipt of income. The essence of such schemes is a promise of the employer to pay at some point in the future. For our purposes, the schemes expose the employee to the risk that the employer's promise becomes valueless, through bankruptcy or insolvency. Direct transfer of the benefits of such schemes pursuant to a divorce decree ordinarily will not be possible, although the use of a trust-type approach to convey a beneficial interest (discussed in other contexts below) might be effective. The beneficiary then becomes subject to the employee spouse's risks. See Webster & de Lisser, supra note 3, at 150-52.

The paper also does not deal directly with Stock Appreciation Rights (SAR) which have limited use today for compensating U.S. employees. SARs obligated the employer to pay the difference between the SAR exercise price and the market value of the underlying stock. SARs replicated the function of options, but freed the grant from the expansive Securities and Exchange Commission restrictions that existed on a broadly defined group of “insiders,” preventing these individuals from exercising and then immediately selling options. Revision of SEC regulations in 1991 made the use of SARs of limited appeal. Victoria M. Trumbower, Optimizing Stock Option Strategies for Corporate Executives, 25 TAX MGMT EST., GIFTS & TR. J. 163 (2000). Again, any risk analysis would start with the value of the employer's undertaking.
relate to the employment relationship, but some relate to factors that are essentially external to the relationship. The risks associated with options and restricted stock are ordinarily different from the risks associated with other compensatory devices.

This article will begin with a brief description of the ALI's proposals regarding property distribution and income maintenance awards upon divorce. Then, the article will analyze both the risk premises of the awards and the risks associated with the remedial devices the ALI is proposing. These analyses will be followed by a short description of stock option and restricted stock compensation packages. The article will then look at the possible bases for a claimant's access to such schemes under the ALI proposals. The article will consider the problems of risk allocation that arise with respect to awards made under each basis, and with respect to the difficulties flowing from the risk structures inherent in incentive based schemes. The article will conclude by looking at whether the ALI proposals are compatible with reliance on incentive based schemes as sources of property and income.

II. THE ALI'S PROPOSALS

A. Property Division

Following its analysis, the ALI concluded that most jurisdictions believe in the principle of equitable distribution of assets on divorce.6 Beyond that, however, there are significant differences among the states regarding what assets might be included in the distribution. In particular, there are differences regarding whether a presumptive equal distribution ought to be employed, whether this presumption should apply to all assets or only to those acquired by a spouse's labor, and the extent to which access, as a matter of property division, should be available to a spouse's post-divorce earnings.7

Every state must determine whether a given "asset" is indeed distributable as "property" under its laws. Then, there is the question of whether a spouse may lay claim to a particular item of acknowledged property, and, if so, what share of the item the claimant should receive. Finally, there is the issue of what value should be assigned to each party's share of the asset. Jurisdictions take widely differing approaches to these questions. These topics

6. PFD, supra note 2, at 1-2.
7. Id. at 2-3.
have particular significance when it comes to the distribution of incentive based compensation packages.

At the outset of its analysis, the ALI accepts certain generalizations pertaining to property division. The ALI proposes property be distributed according to principles that “respect both spousal ownership rights in their property and the equitable claims that each spouse has on the property in consequence of their marital relationship.” Additionally, the ALI’s aim is to facilitate the satisfaction by the spouses of their obligations to support their children, and to ensure that the spouses “share equitably in the financial losses arising from the dissolution of their marriage.”

Finally, the goal is to have principles “that are consistent and predictable in application.”

The ALI declines to define property, and thus refuses to get involved in the debate of whether a particular “asset” should be viewed as distributable “property.” The ALI’s position is that the identification of distributable “property” is a policy question, informing, for example, the debate whether earning capacity and goodwill are distributable items of property. Thus, the ALI espouses the position that a definition of property that differs from its meaning in other areas of law is neither necessary nor desirable.

The ALI takes the view that property acquired during the marriage, rather than by gift or inheritance, is “marital property” such that a spouse may lay claim to it. The ALI adopts the approach taken by the majority of states that if property is earned by spousal labor during the marriage, a claim of shared ownership upon divorce may be made.

Regarding the specifics of property division, the ALI proposes that when property is divided on divorce, the spouses should receive “net shares equal in value, although not necessarily identical in kind.” This proposal stems from the notion that property division on divorce reflects the tension between the goal of reflecting a spouse’s relative contribution to the acquisition of marital property, on the one hand, and the desire to allocate resources based on the
spouse’s relative need on the other. “These principles conflict because [they are] usually inversely related [...giving the judge] no idea how to divide the property....” The ALI proposal attempts to steer a middle course between these two concerns by permitting departure from a presumption of equal division only in specific instances where the aim is to address a spouse’s claim for a compensable loss.

The ALI acknowledges that the proposed equal division presumption is a rough compromise between the competing claims of contribution and need. Furthermore, the rule follows logically from the premise of sharing that identifies assets acquired during the marriage as marital property. The ALI rejects the notion that a spouse’s claim is grounded on the premise that he or she made an equal financial contribution to the marriage. Rather, the ALI view is that the equal division claim should be grounded on the premise that each spouse contributes equally to the marriage, “not just to the accumulation of financial assets.” The presumption is admittedly an “ideological norm” in which marriage is regarded as more than a sum of its financial parts.

Important for our purposes is that the ALI acknowledges in certain cases spousal labor during the marriage produces benefits which accrue only after the marriage is dissolved. The ALI’s position is that property earned by labor performed during the marriage is distributable marital property, even if the property is received after the marriage has ended. Where the “property” represents a contingent return on labor performed during the marriage and, in particular, where it reflects compensation that is contingent on post-marital events, the ALI’s view is the “property” is marital property to the extent it was earned during the marriage. In essence, the asset is characterized according to when the spouse earns it, rather than according to when the spouse receives it.

17. Id. § 4.15(1), cmt. a, at 194-95.
18. PFD, supra note 2, § 4.15, cmt. a, at 195; § 5.01, cmt. a, at 257.
19. Id. § 4.15, cmt. a, at 195-96.
20. Id. § 4.15, cmt. b, at 196.
21. Id. at 196-98.
22. Id. § 4.15, cmt. c, at 198.
23. Id. Reporter’s Notes, cmt. c, at 210 (citing JOHN EEKELAAR & MAVIS MACLEAN, MAINTENANCE AFTER DIVORCE 45 (1986)).
24. PFD, supra note 2, § 4.03, cmt. b, at 89.
25. Id. § 4.08(1) & (3), at 168-69.
26. Id. § 4.08(1)(b), at 168.
Where an asset's receipt is contingent on future events, the contingency may produce two discrete domains of uncertainty. First, of course, there may be an issue of whether the asset will accrue at all. Second, there may be a further uncertainty regarding the value the asset may have when and if it becomes due. As a technical matter, the ALI takes the view that a court should use the most recent valuation date practical when dividing assets, even if the spouse ceased acquiring the property at an earlier date. The argument is that "[t]he parties will thus be affected equally by market fluctuations during the pendency of their divorce proceedings." There is one notable exception to this position, however, which is particularly relevant to our concerns. The ALI accepts that a "different rule is appropriate..., where the value of marital property is altered by the activities of either spouse after the cut-off date for marital acquisitions." Any increase in value of the asset flowing from the post-marriage labor of the spouse should be treated as that spouse's separate property.

To take the edge off some of the uncertainties associated with the valuation of a contingent future receipt, the ALI suggests that if the value of a spouse's future share can be determined on dissolution, that value can be included in determining the value of the pool of assets available for distribution between the spouses. If the value is uncertain at the time of divorce, however, the court either should be free to assign a share of the asset's value when and if it materializes, or should be able to reserve jurisdiction to make a distribution at a future date when the value becomes known. While, at first blush, these proposals appear to be eminently reasonable, the entire ALI goal is to distribute value equally. It is difficult to imagine how this can be done effectively if only a portion of the distribution is deferred to a later date, or, even then, if a contingent asset is distributed on any basis other than equally. We shall return to these themes in due course.

The ALI’s principles covering property distribution relate to the distribution of value, not specific assets, and therefore, at one level the principles readily handle the traditional overlap found in American law between the concepts of property division and of alimony. Conceptually, enhanced property division awards can be

27. Id. § 4.03, cmt. f, at 95.
28. Id.
29. Id.
30. PFD, supra note 2, § 4.08(3), at 169.
31. Id. § 4.08(3)(a) & (b), at 169.
32. Id. § 4.15, cmt. d, at 199.
the financial analog of periodic alimony payments.33 The ALI proposal recognizes a thorny problem, however, which has significance for our concerns. If property division is to be relied upon to provide spousal support, one must have confidence in the valuation of the resources available to satisfy the claim.34 This, as we will see, presents some difficulties where a substantial component of the marital estate may be reflected by a contingent asset of uncertain value.

In contrast, under the ALI analysis, periodic payments for spousal maintenance may be modifiable,35 and thus may better lend themselves to addressing the uncertainties associated with assets such as stock options. Accordingly, we now turn to the ALI proposals for modifiable awards.

B. Compensatory and Restitutionary Awards, Not Alimony

The ALI analysis concludes that while current awards of alimony reflect an unease with traditional rationales for such awards, no clear-cut justification for an alimony award has emerged, except to the extent that there is some recognition of the necessity to meet a claimant’s “need.”36 Even then, no consensus exists as to how “need” is to be determined.37 The ALI review acknowledges that there is a substantial overlap between property division and alimony awards.38 The ALI report points out that while no-fault promoters hoped that adequate equitable distribution of property would displace alimony awards, this has proved to be an illusory goal in most instances because few couples have capital resources that are sufficiently large to provide an adequate replacement for income flow awards.39

The ALI study suggests that it is necessary to develop a coherent justification for alimony, and to integrate this into the principles for allocating property.40 Accordingly, the ALI proposes that the law should cease to focus on a claimant’s “needs,” and instead focus on any “loss” suffered by the claimant as a result of

33. Id.
34. Id.
35. Id. § 5.09, at 357. It should be noted, however, that the ALI proposals only envision modification under limited circumstances, not including changing value options. See infra text accompanying notes 127-30.
36. PFD, supra note 2, § 5.09, at 4-6.
37. Id. § 5.02 cmt. a, at 261.
38. Id. at 6.
39. Id. at 6-7.
40. Id. at 6, 8.
the termination of the marriage which might entitle the claimant to "compensatory payments."\textsuperscript{41} The proposal allows compensatory awards only where a marriage of significant duration dissolves and a spouse with less wealth or earning capacity will suffer a loss in living standard;\textsuperscript{42} or where one spouse has suffered a loss of earning capacity because of a disproportionate assumption of responsibilities for care of children or for care of sick or disabled third parties.\textsuperscript{43} Additionally, the ALI proposal recognizes a restitutionary claim where the marriage is dissolved before the claimant has been able to recoup an investment in the other spouse's earning capacity\textsuperscript{44} and where, in limited circumstances, after a short marriage there will be a disparity between the spouses' abilities to recover their premarital standards of living.\textsuperscript{45}

Not all of these theories are directly relevant to this paper although, in appropriate circumstances, each may lay a foundation for a claim against resources that may include an incentive based compensation package. Thus, in the circumstances specified above, the proposals seek to protect a former spouse against a potential loss in living standard flowing from the dissolution of the marriage. For marriages of short duration, the reference standard of living is that which existed prior to the marriage.\textsuperscript{46} In longer marriages, the reference baseline is the marital living standard.\textsuperscript{47} One of the justifications the ALI makes for advancing its "new" awards is that because alimony payments were traditionally justified on the basis of "need" rather than on a foundation of equitable entitlement, it often became necessary to expand the scope of recognizable property claims, even though property division remedies were not particularly suited to responding to the premise for the claim.\textsuperscript{48}

The ALI proposed awards fall into two groups. First, there would be those claims on behalf of a spouse who, after a marriage of significant duration, experiences a loss in living standard by virtue of having less wealth or earning capacity. This group also recognizes claims by individuals who have suffered a loss in earning capacity during marriage which endures beyond dissolution where the loss arises by virtue of having borne a disproportionate share of

\begin{itemize}
\item \textsuperscript{41} Id. at 8-10.
\item \textsuperscript{42} PFD, supra note 2, § 5.03(2)(a), at 271. See id. § 5.05 for details.
\item \textsuperscript{43} Id. § 5.03(2)(b) & (c), at 271. See id. § 5.06 and § 5.12 for details. The spouse's lost earning capacity must be of a sort that continues after dissolution.
\item \textsuperscript{44} Id. § 5.03(3)(a), at 272. See id. § 5.15 for details.
\item \textsuperscript{45} Id. § 5.03(3)(b), at 272. See id. § 5.16 for details.
\item \textsuperscript{46} Id.
\item \textsuperscript{47} Id. § 5.02, cmt. a, at 260.
\item \textsuperscript{48} PFD, supra note 2, § 5.02, cmt. a, at 262.
\end{itemize}
caring for children, a sick or disabled spouse, or a third party in fulfillment of a moral obligation.\textsuperscript{49} Where the recovery is based on the duration of the marriage alone it recognizes the claimant’s expectation to continue to share in the other spouse’s income.\textsuperscript{50} The extent of the claim will be premised on the marriage having exceeded a minimum duration and will be a function of the duration, subject to a maximum recovery expressed as a percentage of the post-marriage income differential of the divorcing spouses.\textsuperscript{51} Under this approach, the spouses’ post-divorce incomes are not automatically equalized, but rather the proposal envisages that the post-divorce gap will lessen the longer the marriage endured, until ultimately a marriage of sufficient length will produce post-divorce equality of income.\textsuperscript{52}

For the purposes of the present paper, the idea that compensatory awards may be linked to a spouse’s post-divorce income is not without difficulty when dealing with the possibility that “income” may be reflected in the realization of deferred contingent interests. The ALI proposal accepts that the source of income may well be income from invested capital as well as income from labor.\textsuperscript{53} The ALI proposal does permit compensatory awards to be adjusted to reflect income from an enhanced share of marital assets.\textsuperscript{54} This may produce a highly complex analysis when dealing with contingent assets which in due course may produce income. In such scenarios, compensatory awards may require one to deal with a concept of what is essentially contingent income. If this is true, the associated

\textsuperscript{49} Id. § 5.03, cmt. b, at 274.

\textsuperscript{50} Id.

\textsuperscript{51} Id. While these principles are relatively easy to apply in instances when neither former spouse has sufficient income after divorce to support himself or herself at the marital standard, the formula can become very complex when this is not true and the ALI suggests judges should retain discretion to deal with such cases. Id. § 5.05, cmt. g, at 298.

\textsuperscript{52} Id. § 5.05, cmt. g, at 296-99.

\textsuperscript{53} Id. § 5.05, cmt. f, at 292. The ALI suggests that reference may be had to the principles it is proposing for determining income for the purposes of fixing child support. PRINCIPLES OF THE LAW OF FAMILY DISSOLUTION: ANALYSIS AND RECOMMENDATIONS, AMERICAN LAW INSTITUTE (Tentative Draft No. 3 Part II, Apr. 8, 1998) [hereinafter TD3]. This child support proposal provides little for our assistance beyond noting that an ordinary rate of return should be imputed to an asset that yields less than an ordinary rate of return, that is the rate of return for secure investments. TD3, § 3.12(4)(b), at 90. One of the open questions that this analysis triggers when dealing with the situation where the employee rejects current payments in favor of contingent future benefits is whether it is correct to view the employment skill of the contingent interest holder, or the contingent interest itself as the under-yielding asset. Arguably, neither of these interests is under-performing. Rather, the benefit is delayed so that the income should be determined on the basis of some discounted present value of that future performance. This then must raise concerns about the risks associated with that future performance.

\textsuperscript{54} PFD, supra note 2, § 5.05, cmt. f, at 293.
risks may be the risks of the uncertain realization of the underlying asset, the risks associated with the uncertain value of that asset, and finally the risks of uncertain income flowing from that value. In such instances, the ALI idea that compensatory awards represent a transfer of value,\(^{55}\) rather than specific assets or income, comes sharply into focus. We will return to these themes in due course.

The first set of income-related claim theories also recognizes that a claimant may be entitled to compensation for an earning capacity loss resulting from her disproportionate share of child-care responsibilities during the marriage.\(^{56}\) Under the ALI scheme, the claimant’s recovery is a percentage of the difference between the spouses’ post-divorce incomes, where the percentage is a function of the period of time for which child-care was provided.\(^{57}\) For pragmatic reasons, a primary child-care provider who emerges from a marriage with an earning capacity which is equal to or greater than that of the other spouse is precluded from recovering under these principles, even though the theory suggests that the care-giver may have lost earning capacity. Recovery is denied on the notion that it appears to be inequitable to require the less affluent spouse to support the more affluent care-giver, even though allowing recovery would tend to drive the spouse with the lower earning capacity into performing the child-care function, and thus produce economic efficiencies in the allocation of household duties.\(^{58}\) Arguably, the fact that the spouse with the greater earning capacity assumes the child-care function reflects a risk and loss allocation assumption made by the parties. Of course, pushed to extremes, this analysis might be applied to the underlying decision of the couple to have a child. This would eliminate the need for any compensatory device at all.

Ultimately, the ALI proposal seeks to synthesize a claim for compensation based on the marriage’s duration with a claim for compensation based on child care responsibilities, by arguing the foundation for the claim is the claimant’s disproportionate vulnerability to the financial consequences of divorce.\(^{59}\) The ALI proposal recognizes this fact by proposing a maximum recovery when compensation claims are made on both premises. The effect is that if a child-care function is performed, as the marriage endures, a potential claimant moves toward a maximum recovery more quickly

55. Id. § 5.05, cmt. g, at 295.
56. Id. § 5.06(1), at 317.
57. Id. § 5.06(4), at 318.
58. Id. § 5.06, illus., at 325.
59. Id. at 328.
than if no child-care function is performed. Essentially, to the extent that the two rationales for compensatory awards have embedded in them different risk assumption structures, with the passage of time these two sets of structures become synthesized.

The ALI advances one further rationale justifying a compensatory award for performing a child-care function. The argument is that by performing the child-care function the claimant enabled the other spouse to develop his or her earning capacity. The ALI assumes the contribution was made on the basis that the contributor would retain access to the other spouse's enhanced earnings, and argues that this justifies direct post-divorce access to those earnings. The ALI characterizes the goal of such a claim as compensation, although arguably it is restitutional in character, albeit the enrichment component may be difficult to measure. This distinction is relevant to distribution of stock options and restricted stock upon divorce where much may hinge on the question of whether a claim exists to a finite amount or a revenue stream (not to mention a specific asset).

The ALI proposal envisions that both types of compensatory awards just discussed preferably should be for fixed terms rather than for indefinite duration on the premise that spousal disentanglement is good for both the individuals and the legal system. The hope is that within the specified time frame the claimant will have recovered all lost earning capacity or have achieved the ability to sustain an acceptable living standard. In a choice between an accurate determination of the period necessary to recover from the loss and the desirability of imposing a limit on the term of the award so as to limit the obligor's responsibility, the ALI opts for the latter. The difficulty is to determine an appropriate period that adequately protects the reliance or other premise for the award. The ALI does, however, accept in certain instances that age and marital duration will raise a presumption any loss is indefinite. In those circumstances, an indefinite award will be appropriate although the ALI is not willing to suggest any particular age or marital duration, or combination thereof, that necessarily is to trigger an indefinite award. The suggestion is indefinite awards may not be justified even if the obligee does not achieve the marital

60. PFD, supra note 2, § 5.06, at 328. For examples of how the ALI envisions the system working, see id., illus. 5, 6, 7, at 329-31.
61. Id. § 5.06, at 328.
62. Id. § 5.07, cmt. a, at 339.
63. Id. § 5.07, cmt. b, at 340.
64. Id. § 5.07, cmt. c, at 342.
standard of living if the standard of living achieved is, at least, acceptable. In principle, the analysis recognizes that the goal of the process is loss sharing, not shifting of the entire loss. It follows that if the extent of the potential loss is a function of the risks associated with a potential income stream, the award should be subject to those risks.

The second set of claims to be recognized are those which flow either from a claimant’s inability during the marriage to realize a fair return on an investment in the other spouse’s earning capacity, or where after a short marriage there is an unfair disparity between the former spouses’ ability to recover their pre-marital living standard. These claims are restitutional in character. They are not limited by the ceilings imposed on the first group of claims, but generally a claimant who makes a substantial recovery under one of the themes permitted in the first group will be precluded from recovering under the second group as well. The risks assumed have been rewarded.

Where the recovery is premised on an investment in the other spouse’s earning capacity, the ALI position turns out to be somewhat confused. On the one hand, the recovery is only permitted if the claimant’s efforts have provided a substantial enhancement to the earning capacity of the other spouse. On the other hand, the recovery is linked and limited, in a formulaic way, to the extent of the claimant’s contributions to the cost of educational and living expenses. The argument made is that, in general, divorce should not provide an opportunity for a general accounting as to the allocation of benefits received on marriage. The ALI’s position, however, is the benefit of an education partially funded by the other spouse should be an exception where a residual financial advantage remains after divorce. The premises for the disconnect between contribution and recovery will be explored when we turn to consider the implied risk allocations within the relationship.

The final significant basis on which the ALI suggests a recovery can be made applies to short childless marriages which otherwise do not permit a recovery under ALI principles. Recovery is allowed if, after the divorce, a disparity exists between the spouses’ abilities to recover their premarital living standards where the disparity is
inequitable because the claimant made expenditures or gave up educational or occupational opportunities in order to serve some purpose the spouses considered important to their marital life. When the marriage ends, the expended assets must be essentially unrecoverable, or the lost opportunities must leave the claimant with an earning capacity significantly less than it was before the marriage. Generally, the recovery is quantified as either half the amount necessary for the claimant to recover the premarital standard of living, or the amount necessary to enable the claimant a reasonable chance to recover the lost opportunity.

The ALI position is that, if after a short childless marriage the parties financial circumstances are as disparate as they were prior to the marriage, the financial consequences do not arise from the marriage. Accordingly, no remedy is justified. Ordinarily, it is only child-care or the passage of time which merges the financial fortunes of the parties. It therefore will be in only a limited number of exceptional circumstances, such as where a spouse gave up employment to his or her significant disadvantage in order to move with the other spouse, that a remedy aimed at restoring the claimant to a premarital standard will be triggered. Indeed, in such marriages, if one spouse suffers a loss in premarital living standard and the other does not, the remedy generally will call for no more than that the loss be shared, not that the claimant be fully restored to his or her original situation. We now turn to a risk analysis of this award as well as of the other awards just outlined.

C. Risk Assignment Under the ALI Proposals

1. The Risk Premises of Entitlement Claims

As far as property division is concerned, the ALI's proposals accept that, in principle, spouses are free to regulate the allocation of their assets by agreement, including a premarital agreement, to the extent that individual states will enforce them. These premarital agreements reflect the spouses' efforts to assign the risks of marriage failure between them. States are increasingly willing to recognize such efforts, subject to certain reservations. In particular, there is a concern that in the event of a divorce a spouse should not

71. PFD, supra note 2, § 5.16, at 394-95.
72. Id. § 5.16, cmt. a, at 396.
73. Id. § 5.16, cmt. c, at 401. The ALI proposal contains an "escape" provision from these principles where equity requires it. Id. § 5.16(3), at 394; cmt. d, at 405.
74. Id. § 4.01, at 81-82.
be left without adequate resources – at least to the level of becoming a public charge – and that otherwise the contractual allocation of risks should not, on analysis, prove to be procedurally or substantively unconscionable. Additionally, there are on-going concerns about relative power in the bargaining process and the appropriateness of reducing the marriage to an economic bargain. But the reality of the current situation is that in the absence of the parties’ agreement the law and the courts essentially are driven on an ex post facto basis to determine the “bargain” anyway.

In the absence of express risk assumption or assignment by the parties, the ALI proposals bring a number of principles into play. Regarding property division, the lynchpin theme is one of a presumption of equal division of marital property. The premise is one of sharing the rewards of both financial and non-financial marital contributions. This principle is readily applicable to those instances where the “rewards” are defined and can be realized on the dissolution of the marriage. The analysis becomes problematic, however, when the existence of the “reward,” the asset, is uncertain or its valuation difficult. Moreover, the ALI analysis specifically rejects the idea that an asset should be allocated to a spouse simply based on that spouse’s financial contribution to the asset’s acquisition. Accordingly, would it be appropriate to place at either spouse’s door all the risks associated with the asset’s realization? More plausible would be a model that allocates the risk of realization equally between the claimants. Given that an ALI assumption is both parties acquire an interest in marital property by virtue of a contribution to the marriage itself rather than a financial contribution to the acquisition of any specific asset, and both parties derive benefits from the marriage while it continues, that certainly

75. “[A] conventional contract rationale would require describing the spousal relation in exchange terms that seem inapt because the parties define their relation by its nonfinancial aspects even though financial sharing is an important part of it.” Id. § 5.05, cmt. b, at 285. For a collection of references relating to a contract based analysis, see PFD, supra note 2, Reporter’s Notes, cmt. b, at 302-04.

76. Id. § 4.15, cmt. b, at 196.

77. Thus, in Chammah v. Chammah, the court stated: “The wife is entitled to know at the present time the assets she will have and not wait for some time in the future. In order to receive such an equitable share due to the large amount of ‘contingent resources,’ she must share in some of the risk of forfeiture.” FA 95145944S, 1997 Conn. Super. LEXIS 1896, at *16 (Conn. Super. Ct. July 11, 1997) (citing Krafick v. Krafick, 234 Conn. 783, 803-04, 663 A.2d 365 (1996)). The court then allocated the wife a percentage of the stock option and restricted stock schemes, but not an equal share of them. Id. at *31. In the absence of reliable risk discounting devices, the only way a risk prone asset can be distributed equitably is by equal division.

78. PFD, supra note 2, § 4.15, cmt. c, at 197-98.
would be the way the ALI would assume the parties allocated the risks during the marriage, at least in the absence of evidence to the contrary. Presumably, too, this point can be made more forcibly once the use of incentive based compensation packages becomes more widespread. Notably, under the ALI proposals, the parties' risk sharing becomes disengaged if one of the spouse's efforts after the date for identifying marital property affects the value of some of that property. The ALI specifically indicates that this is the case where these efforts enhance the value of the property. Fairness would suggest where the value of the property declines as a result of these endeavors the other spouse should be locked into the higher antecedent value. After all, the risk sharing partnership came to an end at the relevant date. Whether it is possible to convert the employee spouse to an underwriter of the value of an incentive based compensation package, however, appears to be highly problematic.

The ALI's proposals for compensatory payments to distribute income losses flowing from the failure of the marriage rely on a somewhat more complex model of risk allocation. The ALI analysis suggests that spouses have a financial stake in their marriage and a dependent spouse — one whose income earning capacity is less than the other's — faces the possibility the passage of time will gradually increase her risk to the point where she will be unable to replace her financial stake if the marriage breaks down. Thus, it has been suggested that the divorce process should, in a formulaic way, move in the direction of eliminating, at least for a period of time, any post-divorce income disparity between the former spouses. The argument is that a no-fault analysis suggests that the marriage breakdown, like its creation, is a matter of joint responsibility. The underlying rationale is the sustained income disparity which endures over time is a matter the risks of which both parties, expressly or implicitly, assumed. Accordingly, as time passes the risks of failure are ultimately to be borne equally. Conversely, in the earlier years of the marriage, the burden of failure, at least as

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79. This tends to be borne out by the fact that the ALI advises that distribution should occur on the basis of the latest available valuation data so that the parties equally are subjected to market fluctuations. Id. § 4.03, cmt. f, at 95.
80. Id.
81. Id. This is because the ALI's position is the claimant should not share in any increase in value of an asset where that increase is attributable to one spouse's post-divorce labor.
82. Id. § 5.05, cmt. c, at 288.
83. Id. § 5.05(3), at 281.
84. PFD, supra note 2, § 5.05, cmt. c, at 287.
85. Id. § 6.05, Reporter's Notes, cmt. g, at 315.
far as income disparity is concerned, may be borne disproportionately by one spouse alone.

Work in a related area suggests that the root of the risk assumption may be viewed as fairly deep-seated. Thus, evidence suggests that individuals select mates of similar socio-economic status. Accordingly, the argument is made that, to the extent that child rearing produces an economic disparity between the two, the higher earning spouse’s income is an appropriate benchmark of the lower earning spouse’s detriment from the relationship. In a society where mate selection is voluntary, this analysis seems to hold up in all contexts where one of the spouses assumed a particular socio-economic role in the marriage and suffered economic detriment as a result. This analysis suggests that not only did the parties assume the risks as to who would bear any post-divorce obligation, but also that they effectively assumed the extent of the risk. This analysis would tend to be reinforced by the ALI view that as the marriage lengthens, the marital standard of living replaces the premarital standard as the reference baseline. While, in principle, the parties might avoid these results by prenuptial agreement, at least under existing law, it is likely that their actual risk assumption might be overridden in favor of a socially imposed model of risk assumption where the result is construed as unconscionable, or perhaps even simply inequitable.

In contrast, the ALI proposes to impose the obligation of making compensatory income payments to a spouse who assumed the role of primary caretaker of a child. The basis for this award is the assumption that the parent who takes on the role of primary caretaker does so in the expectation that the marriage will endure and that she will continue to share in the income of the other parent. The presumption of entitlement arises from the fact that minor children resided in the household for a minimum period of time and that on dissolution the claimant’s earning capacity is substantially less than that of the other spouse. While the presumption that the claimant provided a disproportionate share of the child care is rebuttable, the assumption that child care

87. PFD, supra note 2, § 5.06, Reporter’s Notes, cmt. e, at 337.
88. Id. § 5.06, at 317-19.
89. Id. § 5.06, cmt. a, at 319.
90. Id. § 5.06(2), at 317-18.
91. Id. § 5.06, cmt. c, at 321.
responsibilities adversely affected the claimant's earning capacity is not rebuttable.\(^9\) This assumption is made because of the difficulty of identifying what a claimant's earning capacity would have been had different lifestyle choices been made.\(^9\) Not only does the assumption bridge the potential causal gap, but the assumption's rationale provides a justification for disconnecting the character of the loss from the quantum of recovery which is now primarily driven by the non-care-provider's income. Moreover, and this is significant for our purposes, the link is established to the earnings of the latter spouse together with the risks associated with the source of those earnings. In short, by caring for the couple's child, the caregiver loses risk autonomy in return for income replacement.

The rationale for the payments to the parent providing childcare is not really one of risks assumed. Rather, the imposition of the obligation occurs as a matter of law, and is independent of any agreement between the spouses.\(^9\) It reflects both parents' underlying obligation to the child. The couple may identify the parent who is to discharge the obligation, but because the underlying obligation belongs to both parents, the ALI assigns the risk of the consequences that may materialize in the event of a failed marriage. Again, the actual amount of the award is to be formulaic, reflecting, as described above, the post-divorce income disparity between the spouses and the duration of the child-care. Here, as to the amount of the compensation, the analysis does merge with the risk-assumption model described above.

The ALI recognizes that relating the child-care compensatory claim to the earning capacity divergence of the spouses is but a proxy for the claimant's loss of earning capacity through performing the child-care function.\(^9\) This proxy link is justified on the basis that people choose mates of similar socio-economic status so that the spouse's earning capacity is a better measure of the claimant's loss capacity than most. Moreover, the claimant presumably undertook the primary caretaker role on the assumption and expectation that the marriage would continue and, accordingly, that the spouses would continue to share income.\(^9\) The ALI formulation, however,

\(^{92}\) Id. § 5.06, cmt. d, at 322.

\(^{93}\) Group data establishes the fact of earning capacity loss through performing the child-care function as a general matter. Proving the fact or the quantum of the loss in an individual case is much more difficult. PFD, supra note 2, § 5.06, cmt. d, at 322; § 5.06, Reporter's Notes, cmt. d, at 335-37.

\(^{94}\) Id. § 5.06, Reporter's Notes, cmt. a, at 335.

\(^{95}\) Id. § 5.06, at 326.

\(^{96}\) Id. § 5.06, at 326-27.
does not permit unbridled expectations. The claim is limited in amount to the difference in income the spouses are expected to have after dissolution, and is connected to the duration of child care. If one accepts the premises of the ALI analysis, the cap on the quantum of recovery is one that was assumed from the outset.

The ALI acknowledges that a loss of earning capacity as a benchmark for compensation is inappropriate for some. For many women, motherhood is considered more important than professional development. Thus, the ALI formulates her expectation as having children in the context of an enduring relationship with someone. The technically accurate measure of compensation would involve comparing her situation on divorce to what it would have been if she had married another man. Because that is impractical, the ALI argues that their proposed measure is at least reasonably equitable.

Arguably, the underlying risks of the burden allocation just described are assumed to the extent that the couple selects each other as mates, and to the extent that the decision to have a child is a matter of choice. But, it could be argued, for example, that the acceptance of the role of primary caretaker carries with it a risk which can be characterized as being assumed voluntarily. Might this justify not imposing on the dominant breadwinner an obligation to pay compensation? The response would seem to be that the realities of the market place, which place a premium — albeit in recent years a diminishing one — on a father's participation, suggest that responsibility for the roles played in a child-producing marriage should be placed at the door of economic realities external to the relationship. For this reason, an assumption of risk model can justifiably be discarded in favor of the ALI's gender free assignment of risk approach that seems to be more reliably equitable.

A risk assumption model would have difficulties in other regards as well. One view is, at least historically, women underinvested in their own education and training in the expectation that they would have child care responsibilities. To the extent that this practice continues today, should it be viewed as laying the foundation for an assumed risk? Or, given the social concern for recognizing and reinforcing the child-care function, do we identify the person assuming the risk as the person selecting the underinvested spouse? Which behavior pattern is it appropriate to

97. Id. § 5.06, at 327.
98. Id. § 5.07, at 338.
99. PFD, supra note 2, § 5.06, at 327.
100. Id. § 5.06, Reporter's Notes, cmt. a, at 337.
reinforce? There is a practical problem involved here as well. If we could identify the detriment the claimant suffered by virtue of pre-marital choices such as under-investing in education, as distinct from losses arising from post-marital choices, we might assign the risk of losses associated with the former to the claimant and the latter to both spouses.\(^{101}\) In general, though, the calculation cannot be performed reliably. Accordingly, the ALI takes a pragmatic view. The totality of the risk of loss is assigned to the couple on an *ex post facto* basis to deal with results, namely a child-care function was performed by someone who emerged from the marriage with a disadvantaged position. The matter is not really looked at as one of risk assumption. On the other hand, the ALI proposal does draw the line. A spouse who withdraws from the labor market for reasons other than child-care will not be allowed compensatory recovery. The risks of such a withdrawal are assigned to that spouse subject, as we saw, to the limitation that as time passes the withdrawing spouse becomes entitled under the ALI proposal to a compensatory award premised on the duration of the marriage alone. Time causes these risks, whatever their source, to be shared.\(^{102}\)

One aspect of the ALI compensatory payments analysis is potentially troubling. The measure of recovery is linked to the claimant's loss in standard of living or earning capacity at the time of divorce relative to that enjoyed while the marriage continued.\(^{103}\) The ALI analysis recognizes that, at least in a traditional marriage, a wife's investment of reproductive capacity, domestic labor, and support of her husband's career produces benefits for both spouses in later years. The ALI accepts, however, that these benefits are largely realized by the time the marriage is twenty to twenty-five years old. In contrast, it accepts that the husband's investment in his own earning capacity is potentially able to yield returns beyond divorce.\(^{104}\) This analytical model suggests it may be appropriate to limit the claimant's recovery to a measure linked to income and living standards at the time of divorce, notwithstanding the fact that the obligor's resources and income may continue to increase after the divorce.\(^{105}\) Claimants, however, may not see why the

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101. *Id.* § 5.06, cmt. d, at 324.
102. *See supra* text accompanying note 85.
103. *PFD, supra* note 2, § 5.05(1), at 280; § 5.06(1), at 317.
104. *Id.* § 5.05, Reporter's Notes, cmt. c, at 304-05.
105. The ALI's goal is not income equalization, although this may result in those cases where the parties have similar incomes during the marriage. *See id.* § 5.05 cmt. g, at 314-16. If the parties' aggregate income after divorce is greater than their combined income during the marriage a goal of income equalization becomes highly suspect. Such a situation may arise where a party returns to full-time employment after the divorce. *Id.* at 314. It is also
divorce should generate a discontinuity between the claimant's contributions and the obligor's potential rewards.\textsuperscript{106} Apparently, in this regard, the ALI model places the risk of lost expectations on the shoulders of the claimant.\textsuperscript{107}

Even where the basis of the claim is restricted to a post-divorce divergence in income notionally flowing from a child-care function performed by the claimant, the ALI is driven to use the financial disparity between the spouses' incomes as the proxy for the claimant's loss. The claimant does not recover lost earning capacity.\textsuperscript{108} Ordinarily, the claimant's recovery will, at most, amount to half the difference between the two spouses' post-divorce incomes — given that the magnitude of the recovery will also result from the amount of time spent on child care. With the passage of time, the risk of frustrated expectations will ultimately be shared equally. The claimant's presumed expectations are restricted, however. In principle, the recovery is limited to a sum that relates to the incomes the spouses are expected to have immediately after the dissolution, not at some point in the distant future.\textsuperscript{109} Accordingly, the claimant cannot look to the enhanced income of the now ex-spouse as a way of ameliorating what her actual losses from a diminished earning capacity are, assuming those losses can be quantified.

The same sort of result follows in those situations where the claimant establishes a cognizable claim for contributions made to the other spouse's education. Even though the residual benefit to the spouse receiving the education triggers the claim, the recovery still is not linked to the benefit. The argument is made it is not appropriate to consider the claimant as entitled to a "return" on his or her "investment" in the other spouse's education. Rather, the

\begin{footnotesize}
\textsuperscript{106} The claimant's view may be justified. After all, the ALI does acknowledge that one rationale for a compensatory award where the claimant has fulfilled a child care function is that the claimant's efforts enabled the other spouse to have both a family and advance his career, the benefits of which revert to him alone after the divorce. The ALI view is at least its approach produces a more balanced allocation of the benefits of the marriage. See \textit{id.} § 5.06, cmt. e, at 328.

\textsuperscript{107} The ALI proposal hedges its bets somewhat by allowing a departure from a presumptive award where "substantial injustice" would result. \textit{id.} § 5.05(4), at 281; § 5.05(4), cmt. h, at 299. The examples cited by the ALI suggest that expectations may be relevant, even though the underlying model does not envision meeting those expectations. \textit{id.} cmt. h, illus. 11, at 299-300; Reporter's Notes, cmt. h, at 317.

\textsuperscript{108} \textit{id.} § 5.06, cmt. d, at 327; Reporter's Notes, cmt. a, at 335.

\textsuperscript{109} PFD, supra note 2, § 5.06, cmt. e, at 327. The ALI proposal, however, does allow for limited modification of awards in a limited number of situations. \textit{id.} § 5.09, at 357.
\end{footnotesize}
financial consequences arise from the marriage. Even if there was an expectation that the support provider would share in the enhanced future income stream, it is argued that expectation must have been paired with an expectation that the couple would still be married. On this basis, any income sharing would be premised on the relationship, not the prior financial support. The provider essentially assumed the risk of the consequences of the failure of the relationship, beyond the value of the financial contributions. Accordingly, the obligation to repay becomes decoupled from the risks associated with the “performance” of the recipient spouse’s benefit. This, in turn, frees a court from the necessity of making an anticipatory estimate of the value of the future benefit, as well as of determining what component of that benefit is a function of the claimant’s contribution and what is due to the recipient’s efforts after the marriage. These issues become particularly relevant when one attempts to model a basis for participation in incentive based compensation schemes.

Where the marriage is of short duration, we saw in limited circumstances, such as if the claimant had suffered a detriment which enured to the benefit of the other spouse or was to achieve a purpose that the spouses agreed was important to their marriage, the claimant might receive an award. But the value of the recovery is limited to half the amount necessary to recover the premarital standard of living. The goal here is to assign the risk equally for a loss which was suffered from the undertaking of a specific activity, where, by necessary implication, the spouses assumed the risk of any loss which might result if the marriage failed, and the causal link between the loss and the activity undertaken is clear. The remedy is for a specific amount, not a particular asset, and, thus, ordinarily should be freed from the risks associated with the obligor’s assets or financial future. The ALI, however, does envision that the award might take the form of an enhanced share of the marital assets, which might then subject the award to an assessment of the risks associated with the asset’s availability or uncertain value. Where a specific activity recognized by the ALI proposals does not occur, any relatively disadvantaged position of the claimant after the marriage is perceived to be a function of the claimant’s disadvantaged financial position prior to

110. Id. § 5.15, Reporter’s Notes, cmt. b., at 392-93.
111. See id. at 392.
112. See supra text accompanying note 72.
113. PFD, supra note 2, § 5.16(3), at 394.
114. Id. § 5.17, at 406.
the marriage, the risks of which remain allocated to the claimant until such time as the claimant qualifies for one of the compensatory awards proposed by the ALI. The ALI clearly articulates the view that "[n]ot every risk an individual takes in entering a marriage can be shifted or shared with the other spouse."\(^\text{115}\)

2. The Risks Associated with Remedial Devices

Under the ALI proposal, marital property is to be divided equally. In principle, this does not require that the parties be allocated equal shares of the same asset, only that each receives equal value. Initially, this proposal seems reasonable; but, in application, substantial difficulties arise where the parties own assets that embody a significant risk factor. Basically, this risk may exist in two forms. First, there is the risk that the asset's existence may be subject to contingencies that are not under the parties' control. If this is true, the only fair way to allocate these assets is to assign the assets themselves equally between the parties; in this way, each of the individuals is subject to the same substantive risk. Moreover, this process eliminates difficulties associated with a second class of risk, namely the risk associated with uncertain valuation. Whatever the true value is, the parties will share in it equally.

The ALI proposal tolerates the allocation of value. To this end, the ALI points out their plan does not require the parties to receive property "identical in kind." It does note that if an asset is so large a portion of the marital estate that it "cannot be offset by other assets," it may be divided. Whether this is even technically possible with respect to some of the classes of assets we will be considering later is open to question. In this regard, the ALI proposes that if the asset is better left undivided, that asset can be offset by requiring the recipient to exercise a promissory note in the other spouse's favor.\(^\text{116}\) It is not clear, however, how this might be done in contexts where the contingency of the claim or the uncertainty of the value would in turn make the face value of the note uncertain. Ominously, allocating value in a way that results in one class of asset in its entirety being allocated to a particular individual may result in that party being subjected to all the risks inherent in the asset not materializing, or materializing at a lesser value than was antici-

\(^{115}\text{Id. § 5.16, cmt. b, at 402.}\)
\(^{116}\text{Id. § 4.15, cmt. f, at 200.}\)
pated at the time of distribution. Conceptually, this is not a totally insurmountable problem if there is a reliable mechanism for discounting the value to take into account the risks of the party never owning the asset. This solution, however, is only conceptually satisfactory. Getting more than a half share of a high-risk asset may be of little solace to an individual if that asset never materializes. Of course, again conceptually, if the asset is marketable, notwithstanding the associated contingencies, the recipient should theoretically be able to pass on whatever component of the risk with which he or she feels uncomfortable. Indeed, any share awarded the party should include an amount to cover the transaction costs associated with hedging the risk. This might be achieved by simply reducing the value assigned to the asset for distribution purposes. Notable, for our concerns, is the condition that the asset be marketable.

There is another problem that potentially flows from the disproportionate allocation of a high-risk asset to one party alone: such an allocation may cause that party's portfolio of assets to contain too high a proportion of high-risk assets. Looking at it from a slightly different perspective, during the marriage a couple might have been perfectly comfortable having a certain proportion of their "capital at risk" in a particular asset which itself had particular risks associated with it. Their risk concerns might be allayed by the relative stability of the rest of their asset portfolio. But, after the divorce, an asset distribution based on anticipated value, not content, might unbalance each of the resulting portfolios, unless an appropriate risk adjustment of the entire portfolio was made.

117. See Roberta Rosenthal Kwall, Retained Jurisdiction in Damage Actions Based on Anticipatory Breach: A Missing Link in Landlord Tenant Law, 37 CASE W. RES. L. REV. 273, 303-04 (1987) (arguing that the discounted value of the future benefit of a stock option may produce an excessive award if the anticipated benefit does not materialize); see also In re Marriage of Evans, 426 N.E.2d 854, 857 (Ill. 1981). For an example of how an incentive/handcuff plan can go wrong, see Vanderbeek v. Vanderbeek, 177 Cal. App. 3d 224 (1986). Here, a restricted stock purchase scheme, enabling the employee to purchase certain stock using a loan from the employer, turned into a crushing liability when the stock price declined while the loan obligation remained. Id.

118. This is an underlying difficulty in attempting to protect the scope of an option holder's exposure using a so-called "basket hedge," involving the use of notionally similar performing instruments, rather than the options themselves being hedged. The individual option value may decline for reasons not affecting the supposedly similarly performing instruments. See Schizer, infra note 145, at 451-53.

119. The process of diversifying a portfolio containing options is itself much more complex than diversifying a portfolio composed of stock alone because of the characteristics of the process of realizing the value of options and the different tax treatments that apply to the funds produced in the process. See Elizabeth P. Anderson, Reducing Concentrated Exposure to Employer Stock, 70 CPA J. 58 (2000).
taking into account the relative certainty of realization of value or the underlying risks of distributed assets.\textsuperscript{120} Such a process is essential if the recipient of the assets in question will face difficulties in realizing the allocated assets and these difficulties are not otherwise reliably reflected in the value assigned to these assets.\textsuperscript{121}

Clearly, the ALI proposal is critically dependent on the ability to reliably assign a value to an asset. In principle, this process can involve discounting the value to take account of the risk, perhaps to the extent of the costs of hedging the risk, if such hedging is technically possible. If this can be done, in essence the recipient of the asset/value receives it free of risk. The ALI proposal attempts to take into account the underlying problem by suggesting if the value of the marital property portion of future payments cannot be determined at the time of dissolution, the court should fix a share in the future payments if and when they are received.\textsuperscript{122} But, as was just suggested, any allocation other than on an equal basis would represent an unbalanced allocation of the risk. The ALI proposal does envision that if fixing a share is not possible at the time of dissolution, allocation may be deferred until the uncertainties are resolved.\textsuperscript{123} The difficulty here is that if some portion of the assets is distributed on divorce and some later as events emerge, it may never be possible to achieve a balanced distribution of the assets. This would be a particular problem in those situations where the contingent interests represent a substantial component of the assets available for distribution.

\textsuperscript{120} Even without the prospect of a divorce, option holders like to spread their risks. Fifty one percent of executives holding options cashed in some of them in 1998, with an average gain of four million dollars. See \textit{Pay Survey}, \textsc{The Economist}, May 8, 1999, at 16.

\textsuperscript{121} Thus, as market volatility (a critical component in the valuation of options) increases beyond originally anticipated levels, the holder of a risky asset, must increase other asset holdings to offset the risk. See \textit{Living Dangerously}, \textit{International Banking Survey}, \textsc{The Economist}, Apr. 17, 1999, at 24-25. This may be particularly relevant where large option grants were made to attract employees to work for an employer where the employer’s risks of failure are high. Indeed, an adjustment in technology stock prices in the first third of 2000 led to an estimated reduction in the value of options held by the chief executives of some corporations to be as much as between sixty-eight and one hundred percent. See David Leonhardt, \textit{Technology Share Plunge Hurting Stock Options}, \textsc{The New York Times}, Apr. 19, 2000, at C1. Moreover, there is the possibility of a death spiral. If those in charge hold options, there is an incentive to drive up stock prices. While this may be achieved through increased profitability, it can also be achieved by reducing the number of shares outstanding. To achieve this, companies tend to borrow funds to buy back shares, making the company more vulnerable to failure. See \textit{The Trouble With Stock Options}, \textsc{The Economist}, Aug. 7, 1999, at 13.

\textsuperscript{122} PFD, \textit{supra} note 2, § 4.07(3)(a), at 169.

\textsuperscript{123} \textit{Id.}, § 4.07(3)(b), at 169; cmt. g, at 180.
Both of the ALI suggestions for dealing with uncertainty raise the specter of an obligor spouse interfering with the asset value or income realization after the divorce. This might dictate in favor of awarding the obligor a relatively larger share of the contingent asset to create a disincentive against such disruptive behavior. If the asset also is subject to contingencies which are not under the obligor's control, a strategic award designed to control the obligor's future behavior may work an injustice on the obligor by virtue of third party behavior. This risk is of particular significance to our present concerns with incentive based compensation schemes. If the effect of a court order on divorce is to direct, say, half the benefits of an employer incentive scheme away from the obligor, the employer may see the necessity to restructure or replace the scheme in order to restore the original incentive package. This may occur totally independently of any efforts on the part of the employee/obligor to disrupt the court award. Additionally, there clearly exist opportunities for the employer and the obligor to combine their talents in this endeavor. We shall return to these themes in the context of discussing the incentive schemes themselves.

Where the ALI proposal calls for a compensatory award by virtue of the duration of the marriage, or the child-care function performed, the risk issues become even more complex. The award is one of value and the reference measure is the difference in incomes the spouses are expected to have after the marriage. The most extreme manifestation of the problem arises when a significant portion of one spouse's income involves a substantial element of risk. Two methods are available to respond to this problem. First, it might be possible to adjust the value of the anticipated income to accommodate the risk. Whether it is possible to adequately do so both as to the fact of the income and the amount is questionable. In principle, however, a high negative risk source would lead to a discount and thus a reduction in the marginal difference in the incomes of the claimant and the obligor, and accordingly a lower award. In short, if the theory works, the parties share the risk. Of course, even this scenario is of small comfort to the obligor in cases where the income does not materialize at all, but the obligation to pay, albeit at a reduced level, still exists. Accordingly, this option is truly viable only if the obligor is in a position to hedge the risk of an income shortfall in the general market.

124. Id. § 5.05(3); § 5.06(4).
125. Whether such an alternative is viable given contractual, regulatory, and tax constraints is discussed infra note 145 and accompanying text.
theory this could be done using the income instrumentality itself, or other assets of the obligor. The transaction costs of the hedging process should further reduce the income gap between the claimant and the obligor. The claimant too may have some hedging needs, if the income does not materialize at all or in a sufficient amount, and the obligor has no alternative resources. Note, however, that the claimant's risks are fundamentally different. In principle, the claimant gets an entitlement, the award, which is not source-specific, but the obligor must meet the obligation from finite resources.

A second solution to the problem is to allow the award to be modified after discovering what income was actually produced. The ALI proposal contains such a possibility of modifying a compensatory award. The risk allocation it envisages is somewhat unbalanced, however. The award may be modified if the financial capacity of either party is far less than the level upon which the award was based and the living standards of the obligor or the claimant therefore are substantially more or less than was contemplated at the time of the order. Accordingly, if the income does not materialize at all, or to the extent anticipated, the obligor could seek a downward modification of the order, unless notwithstanding the income failure—his standard of living does not change. This principle requires the claimant to share some of the risks associated with the income flow. The ALI proposal, however, does not permit the claimant to seek an increase in the award should the financial capacity of the obligor increase as the result of a higher than anticipated income yield. In many situations, the ALI justification of this is defensible because, given the nature of the ALI's proposed compensatory awards, the parties' situations subsequent to the divorce are essentially irrelevant. Nevertheless, where the

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126. Another way of looking at this is that the transaction costs associated with hedging, which are not insubstantial, reduce the obligor's true pay. See Schizer, infra note 145, at 454.
127. PFD, supra note 2, § 5.09.
128. The ALI notes that a modification should occur only if the parties' financial capacities, and not simply incomes, change. Financial capacity reflects both earning capacity as well as actual earnings. Additionally, a party's financial capacity may be affected by a change in assets even though the party's income does not change. See id. § 5.09, cmt. c, at 361. This article uses the example of income disruption on its own for the sake of simplicity. In fact, the concept of financial capacity is irrelevant to this paper's concerns because it oftentimes may be difficult to know with certainty whether the incentive-based compensation package should be viewed as income or asset or some form of fiscal hybrid.
129. This is clear from the substantive principle that the ALI is proposing. See id. § 5.09, at 357. The ALI allows an exception if the obligor's financial capacity at the time of the divorce was less than it had been earlier in the marriage but has increased substantially since the divorce. Id. § 5.09(1)(c).
essence of the award concerns the allocation of known high-risk returns, two alternatives should be considered: (1) no modification should be allowed on the basis that the award was adjusted at the outset to accommodate the uncertainties (and other awards simultaneously may have been made as part of the risk adjustment); or (2) we should accept that initial risk adjustment was not possible and therefore, in order to share the risks appropriately, adjustment should be allowed for both over and under yields from the income sources. The first approach is preferable if the goal is to achieve certainty, and to avoid the transaction costs associated with modification. The downside of the approach is that it is unable to "accommodate compelling changes in the equities." Moreover, we should not lose sight of the possibility that the risk assumption model associated with the couple's original relationship implicitly involved exposure to long-term risks, for better or worse.

The ALI proposal permits the substitution of an enhanced share of marital property in place of periodic compensatory awards. In principle, if the assets replacing the compensatory payments carry the same risks as the risks associated with the anticipated income sources justifying the compensatory payments then this option seems unobjectionable. If the risks are disparate, however, the court has to be extremely confident of the relative value attribution and income generation potential that are attributed to the assets assigned to the claimant and those left in the hands of the obligor. In particular, it must be comfortable with any value adjustment made to reflect the risk differentials of the two sets of assets.

Finally, the ALI permits restitutionary claims in two circumstances. These flow from an investment in the other spouse's earning capacity or in a short marriage where there is an unfair disparity in the ability to recover a premarital living standard. In the first instance the claimant is allowed to recover her contributions to the obligor's living and education expenses, while in the latter case the claimant recovers half the amount necessary to restore his or her premarital standard of living. For our purposes, the feature to note is that in both cases the award is for a specific sum which is not linked either in terms of amount or in terms of payment to contingencies associated with resources in the hands of the obligor. Even in the case of the educational benefits conferred, the recovery is a function of costs to the claimant, not potential

130. Id. § 5.09, cmt. a, at 358.
131. Id. § 5.11(2), at 376.
132. See supra notes 82-85 and accompanying text.
133. PFD, supra note 2, § 5.15(4), at 384; § 5.16(3), at 394.
benefits to the obligor. In principle, no adjustment for risk is necessary, because the nature of the award is such that, the obligor's bankruptcy apart, the claimant ought to receive the amount risk-free. Even so, risk adjustment is called for in one regard. The ALI proposal envisions that the payments preferably be made from an enhanced share of the marital property, or a lump-sum payment from the obligor's separate property. If either of these sets of assets have risks associated with them, the value of the relevant assets should be appropriately discounted to reflect the risk. If neither of these sources is available, the payment may be affected through a series of monthly payments of equivalent value. These monthly payments are not modifiable and therefore the amount is superficially unaffected by the risks of contingencies. The ALI does not address whether there should be an adjustment in the basic amount to reflect possible variations in the risk that the obligor may not be able to pay as time passes. This may be a sensible approach. True, the divorce provides the claimant with an absolute entitlement. If the marriage had endured, the recovery of the benefits through the marriage ordinarily would have been subject to the same risks. In short, the claimant takes the obligor and his or her long term risks as the claimant found them.

III. INCENTIVE BASED COMPENSATION SCHEMES

A. The Nature of the Incentive Scheme

A simplistic analysis of the employment relationship would suggest the more the contract of employment represents a contract of adhesion, the greater is the likelihood that the compensation packages will embody rewards linked directly to results produced by employees. Some examples of this form of compensation are well-
known, including payment for piece work and payment on a commission-only basis. For our purposes, these modes of compensation have certain features of interest. First, it is known precisely when the work triggering a particular reward was performed. Second, we know what the employee's compensation will be if the employee's own efforts bear fruit. Developments in recent years in the American labor market have produced a new phenomenon. In certain industries, it is the employees themselves who are insisting on essentially incentive-based compensation schemes in the form of stock options. In other industries, employees are insisting on an alternative manifestation of what also is perceived to be an incentive driven scheme — namely, granting to the employees the stock itself.¹³⁷

A stock option gives the employee the right to purchase stock of the employer at a predetermined price.¹³⁸ The price is usually fixed at the then prevailing market price,¹³⁹ in circumstances where it is envisaged that the price will rise, so the ultimate benefit to the employee will be the difference between the price at which the

¹³⁹. Stock options fall into two general classes based primarily on their conceptualization for tax treatment purposes. If they receive “preferred” tax treatment they are Incentive Stock Options (ISO) under the Internal Revenue Code § 422. To avoid triggering a “taxable event” when the option is granted, the exercise price must be the “fair market value” of the stock at the time the option is granted, among a number of other stringent conditions. BARTLETT, supra note 138, at 227-28; I.R.C. § 422(b). If the qualifying conditions are not met, the options are classed as Non-Qualified Stock Options (NSO). Of significance is the fact the holder of an ISO can defer taxation of the shares, and then do so on a preferred capital gains basis when the shares acquired through exercising the option are actually sold, if the stock acquired is held for a qualifying period before sale. The holder of an ISO pays tax on the difference between the basis (essentially the option’s exercise price) and the value of the stock at the time the stock is sold. See BARTLETT, supra note 138, at 230; Webster & de Lisser, supra note 3, at 149. In principle, an NSO may be taxed at the time the option is granted. This is advantageous because any subsequent appreciation in the stock can be subjected to capital gains treatment. This treatment, however, requires that the option have a readily ascertainable fair market value at the time of the grant. It may be difficult to meet this requirement for many reasons, not the least of which is the option’s transfer and vesting restrictions. See Webster & de Lisser, supra note 3, at 147. In this event, when exercised, the option will trigger taxation as ordinary income on the difference between the exercise price of the option and the fair market value of the underlying stock. When the stock acquired through exercising the option is sold, appreciation after the option exercise date is taxed on a capital gains basis, possibly even a short-term capital gain basis if the holder sells the stock within a year of acquiring it. Id.; Rehfeldt v. Rehfeldt, Appeal No. C-850056, 1986 Ohio App. LEXIS 5603, at *6 (Ohio Ct. App. Feb. 12, 1986); see also Schizer, infra note 145, at 466-69. Because the option holder may be subject to the Alternative Minimum Tax (AMT) under I.R.C. § 56(b)(3), the tax benefits of an ISO may not be as great as the basic treatment first suggests. Schizer, infra note 145, at 467. For some strategies for dealing with the AMT, see Trumbower, supra note 5, at 174-77.
option is to be exercised and the market price at which the employee is able to sell the stock after exercising the option. The employee is freed from risk to the extent that if the stock price does not rise, the employee has not paid out anything, and does not have to do so. To the extent that the option represents compensation for labor performed or to be performed, a decline in the price of the stock will leave the holder of the option uncompensated. In this sense the option is not risk free.

Normally, the employee may not exercise the option before a specified period has elapsed, and then only if the employee remains in the employment of the employer. The option is commonly said to vest when both these conditions have been met. Technically, it may be necessary to recognize four situations. The option may be vested (sometimes described as accrued) and matured, that is the employee will have an absolute right to exercise the option immediately. Then, the option may be vested but not matured, that is the employee has an absolute right to exercise the option at some future date, but cannot currently do so. Third, the option is matured, or can be exercised but not vested; conventionally, the stock will be received unconditionally only if the option holder remains in employment at a date in the future. Finally, if the option can be exercised in the future only, and the privilege of exercising it may be lost in the interim, the option is described as unvested. Jurisdictions are not always careful in the use of the terminology, and generally, unless the context otherwise indicates, we will treat the option as unvested if it is subject to the risk of forfeiture.

Ordinarily, the employee is free to exercise the option only for a specified period. The concept of "vesting" may differ in the context of pensions and tax law. See In re Marriage of Miller, 915 P.2d 1314, 1318 n.3 (Colo. 1996); Thomas P. Malone, Employee Stock Options and Restricted Shares: Determining and Dividing the Marital Pot, 25 COLO. LAW. 87, 88 (Oct. 1996).

This type of arrangement really involves a hybrid scheme, part option, part restricted stock.


See Hall v. Hall, 363 S.E.2d 189, 195-96 (N.C. App. 1987). Even when the case is settled, confusion may remain. See Taylor v. Taylor, 752 A.2d 1113 (Conn. App. 2000) (holding that the term "vested" in a settlement agreement applied to options that were exercisable as well as those not yet exercisable).

In the case of an ISO, this period is no longer than ten years. I.R.C. § 422. The plan may impose a shorter period.
A rudimentary analysis suggests that the option is intended to do two things. First, because the recipient must remain an employee for a minimum period in order to exercise the option, the option is a device aimed at ensuring the employee remains in the service of the employer for at least a minimum period. Second, the device creates an incentive for the employee to do whatever he or she can to enhance the price of the stock, so as to increase the spread between the price at which the employee is free to exercise the option and the price that the employee is able to get for the resulting stock on the open market. In concept, the device creates a unity of interest between employees and the employer's stockholders. This is known as "incentive compatibility." 4

Despite the forward-looking elements associated with options, the option itself may be awarded for prior services. This may be a significant feature when it comes to determining the portion of the

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145. Thus, in one case the stock plan provided: "the purpose of the Plan is to give the Company a significant advantage in attracting, retaining, and motivating key employees and to provide the Company with the ability to provide incentives more directly linked to the profitability of the Company's businesses and increases in stockholder value." Peterson v. Peterson, No. CA99-01-007, 1999 Ohio App. LEXIS 5121, at *4 (Ohio Ct. App. Nov. 1, 1999). The unity between stockholders and employee option holders may be transitory. The effect of exercising the option is to increase the number of shares in circulation, which dilutes the existing stockholders' interest. See David Leonhardt, In the Options Age, Rising Pay (and Risk): Will Today's Huge Rewards Devour Tomorrow's Earnings?, N.Y. TIMES, Apr. 2, 2000, § 3, at 1. Indeed, the unity of interest may be only illusory, even before the option holder exercises the option. It may be possible for the option holder to simulate the sale of the option using the derivatives market. In addition, the option holders' and stockholders' risk exposures are not symmetrical because at one level of analysis, an option holder has no downside risk. See David M. Schizer, Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility, 100 COLUM. L. REV. 440, 443-44, 453 (2000). Some senior executive option holders may be precluded by law from hedging in some circumstances, and tax laws create a disincentive to do so for many option holders. Id. at 444. Schizer concludes that except where a broad contractual prohibition is in place, regulatory constraints on hedging may be limited if the holder does not qualify as an "insider," and even in this case, the controls may be bypassed by using broad-based hedges rather than a hedge closely tied to the employer's operations. Id. at 460-66. Nevertheless, the tax constraints on hedging may be substantial, and it is not just "insiders" who will be impacted. Where the underlying income source is an option, the prevailing tax treatment makes effective hedging prohibitively expensive in many instances. Id. at 474-91. One of the major sources of difficulty is that the beneficiary of the incentive-based scheme receives the benefit as compensation, which for tax policy reasons is treated differently than benefits and losses on investments. Ordinarily, hedging strategies will be viewed as implicating an investment treatment. Id. Generally, stock owned by an individual and purchased with his or her own funds will not be subject to hedging penalties by the tax system. Id. at 491-92. Unfortunately, however, where restricted stock is received as compensation, efforts to hedge the value of the grant may be subjected to essentially the same adverse tax treatment as is encountered with options. Id. at 492-94. In certain instances, it may be possible to engineer a hedge arrangement that does not trigger such unfavorable tax treatment. Id. at 484-91, 493-94.
option’s value that is distributable as marital property, a topic to which we will return.

A stock option is not without limiting considerations. First, as noted, the employee has to remain in the employer’s employment. The option instrument may effectively leave the employer free to terminate the employment relationship, and thus deprive the employee of any potential benefits of the option, or the employer may have a limited right to do so. Not infrequently, the employer also is free to cancel the scheme at any time before the employee exercises the option. Even if the employee is in a position to exercise the option, however, there may be constraints on the employee’s doing so. If the underlying stock is publicly traded, the employee may be precluded from publicly disposing of the stock acquired by exercising the option for a minimum period of time after acquisition under rules primarily targeted at regulating the behavior of “insiders.” Tax laws may impose similar constraints. Additionally, the grantor of the options may limit the ability to trade the stock for a period after acquisition for the purposes of controlling market liquidity and, hence, the price of the stock in general. Finally, depending on whether the stock option scheme is one meeting standards established under the Internal Revenue Code, transactions may be subjected to various tax treatments which may be advantageous or treacherous.

On its face a stock option is prospective in character. Nevertheless, it is quite possible for an employee to be awarded stock options for work that has already been performed. In such a context, the link between value of the compensation received and the employee’s historic performance is conceptually tenuous although a link to the employee’s current performance still exists because the recipient has to retain the status of employee for the necessary period to

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146. 17 C.F.R. § 230.144 (2001). Certain instruments offered to employees may be subject to shorter restriction periods than those required under Rule 144. See BARTLETT, supra note 138, § 7.11, at 28-30 (cumul. supp. 1990).

147. In the case of an ISO, the option holder may not dispose of stock received under the option scheme earlier than two years from the date the option was granted and one year after the option was exercised. See I.R.C. § 422(a)(1) (2001); Webster & de Lisser, supra note 3, at 149. This rule means that an ISO package cannot be hedged. See also Schizer, supra note 145, at 484 n.171.

148. See Lomen v. Lomen, 433 N.W.2d 142 (Minn. Ct. App. 1988) (stating that employee agreed all shares purchased under the option agreement would be acquired for investment and not for resale).

exercise the option. Where the option is awarded as compensation for future endeavors, as we saw, notionally the concept is it is the employee's endeavors that will contribute to the option's value. In reality, however, the value may well be a function of market forces and/or the employer's unrelated activities.\textsuperscript{150} Again, as in the instance where the option is awarded for historical efforts, the ultimate value of the compensation will be a function of time and circumstance.

Ordinarily, a stock option only has appeal in contexts where the stock value is likely to appreciate significantly because the benefit to the recipient is the marginal difference between the market price of the stock and the exercise price of the option. Where the stock price is relatively stable or even declining slightly, employers have another weapon in their compensation arsenal, namely, the ability to issue restricted stock.\textsuperscript{151} The employer in this case issues stock to the employee at a discount price and subject to certain limitations. First, the stock is issued to the employee subject to the condition that the company has the right to buy back the stock at the employee's nominal cost should the employee leave prematurely. This restriction is often lifted with the passage of time, that is, the stock is said to "vest." The employee is absolutely precluded from alienating the stock until it vests.\textsuperscript{152} From the employer's point of view, the scheme's structure serves two purposes. First, the

\textsuperscript{150} See \textit{In re Marriage of Short}, 859 P.2d 636, 644-45 (Wash. Ct. App. 1993). The source of the enhancement of value may be of significance in some jurisdictions. Thus, if the asset in dispute came into the marriage as non-marital property, where any appreciation is "passive" — not due to the active contribution of the title holder — the appreciation remains separate property, but the appreciation will be considered for distribution purposes where the non-titled spouse can be said to have made a contribution. Conversely, if the asset is marital property, then "passive" appreciation can be attributed to both spouses. See, e.g., \textit{Bepler v. Bepler}, FA 960154815S, 1998 Conn. Super. LEXIS 2627 (Conn. Super. Ct. Sept. 17, 1998) (holding the appreciation of nine million dollars in restricted stock owned by the employee spouse had occurred in the two years between the inception of the divorce proceedings and the date of the decree was "passive," due to the overall increase in the stock market, and therefore was distributable marital property).

\textsuperscript{151} David Leonhardt, \textit{In the Options Age, Rising Pay (and Risk): Order of Compensation Universe Reflects Pull of New Economy}, \textit{N.Y. Times}, Apr. 2, 2000, § 3, at 12 (indicating that "old economy" stocks were issuing restricted stock as compensation because these companies were unable to issue options with the same appreciation potential as the stock of companies in the "new economy").

\textsuperscript{152} \textit{Bartlett}, supra note 138, at 78. For our purposes, a question arises as to whether an attempt to transfer an interest pursuant to divorce proceedings is a violation of, or may be thwarted by, such a prohibition against alienation. For an example of this problem in a context where the employer held a right of first refusal to purchase shares which the employee proposed to transfer to his wife as part of divorce settlement, see \textit{Monitor Technology v. Hetrick}, 76 Cal. App. 3d 912 (1978). The matter here was further complicated because the shares were not publicly traded.
employee is motivated to enhance the market value of the stock. Second, the employee is required to remain an employee in order to reap the benefit. From the employee's point of view, the compensation is reflected in the value of the stock above the discount price, plus any further appreciation. Unlike a stock option, once the qualifying conditions are satisfied the employee receives a benefit even if the stock price has not climbed. Basically, the associated negative risks are those of not meeting the qualifying conditions for the stock to vest or the risk of a market downturn. On the plus side, there is the possibility of an appreciation in value. With restricted stock the employee is at greater risk than with an option scheme. Unlike options, the employee has an investment in the stock, albeit at a discounted price. This is significant for our purposes because the investment of the couple, independent of the employee spouse's labor, is more readily apparent. This might be significant when "value" contributed during the marriage is sought to be recaptured at the time of divorce. In this context, the marital contribution might also be reflected in investments in other assets designed to hedge against the consequences of any market downturn. Because compensation in the form of stock options, unlike restricted stock, does not involve a direct investment by the employee other than in the form of his or her labor, the need for such a hedging strategy would not be as compelling where the employee receives options rather than restricted stock.

153. Under I.R.C. § 83(b), the employee recipient of the restricted stock is given the ability to pay tax on the difference between the discounted price and the fair value of the stock at the time the stock is issued to the employee, that is, assuming the stock will appreciate with time, when the taxable spread is at the lowest possible. Subsequent appreciation is taxed on a capital gains basis. This is potentially a significant benefit to the employee and one which is not available to the recipient of stock options, even ISOs. See Bartlett, supra note 138, at 79; Schizer, supra note 145, at 494.

154. It should be mentioned we are not presently concerned with what are known as Employee Stock Ownership Plans ("ESOPS"). These plans permit an employee and an employer to make contributions to a trust which holds stock in the employer for the benefit of the employee. In what is probably the most common manifestation, the trust forms the corpus of an employee pension. See generally 4 William M. Lieber, Lieber on Pensions ch. 14 (1996). There is clearly an incentive for the employee to add value to the employer's stock. To the extent that an ESOP is an intrinsic part of an employee pension scheme, it is regulated by the laws governing pensions and the associated tax treatment. One element of these regulations frees the employee, aged at least fifty-five and after ten years of employment, to diversify the portfolio, thus distributing the risk beyond the boundary of the employer's gates. Id. at 14-136-14-155. For a variety of materials dealing with ESOPS, see Bartlett, supra note 138, at 131 n.96.

155. In the simplest manifestation of restricted stock offerings the employee actually pays for the stock at the outset, or agrees to pay for the stock in the future. In the more complex schemes, the obligation to pay progressively may be forgiven by the employer in return for future endeavors. Either way, the contribution of the "marriage" is readily identifiable.
While it might appear that an employee holding stock options or restricted stock in the employer may have limited opportunity to hedge the risks associated with those instruments, risk distribution may be available to a sophisticated employee. First, an employee absolutely entitled to exercise an option may be allowed to sell the option without exercising it, unless the condition of the grant precludes such a sale. Even if the option or stock instrument which the employee holds, or the tax or securities laws, preclude dealing with the instrument, the employee may be able to trade in "surrogates," that is instruments, be they stock or options, which track the performance of the employee's own instruments in a more or less predictable manner. In short, it might be possible for an employee to preserve the "value" in the instrument he or she is holding even without the ability to control the instrument. Such a process, however, certainly is not without transaction costs or risk. These concerns become particularly relevant to the issues we are considering in those circumstances where an employee, as part of a divorce process, is forced to relinquish known "value" at the time of divorce in return for a share of potential, and arguably more or less hypothetical, value to be realized in the future. This article will return to this theme.

B. The Claimant's Access to the Incentive Scheme

As was seen earlier, using the ALI analysis, a claimant has three routes that might lay the foundation for a claim to an incentive based compensation scheme or its proceeds. First, the assertion might be the scheme represents marital property. Second, the claimant may assert the compensation scheme constitutes a portion or all of the other spouse's income and, as such, should be

156. See Share and Share Unalike, THE ECONOMIST, Aug. 7, 1999, at 20 (describing survey finding increasing use of derivatives to escape constraints on dealing in their employer's options). Basically, the employee looking for a surrogate can use a so-called "synthetic," a stock that mimics his or her own, whose earnings are related to factors affecting the held stock's performance or, use may be made of market indices or something similar that tracks the employer's operations. This strategy is sometimes called "basket hedging." See Schizer, supra note 145, at 451-52. As alluded to earlier, tax law or administrative or remedial constraints may prevent the option holder from adopting these strategies. See id.

157. Apart from the risk intrinsic to the hedging itself, an employer might take a dim view of the option holder seeking to decouple himself or herself from the employer's interests, and the market itself might become apprehensive about investing in a concern where presumably informed sources found the need to hedge their interests. See Schizer, supra note 145, at 458. Of course, the option holder may try to keep the hedging secret, because the technical duty to disclose, absent contractual obligations, may be restricted to "insiders" as defined by the Securities and Exchange Act of 1934, § 16(a). See id. at 460-62.
considered in calculating the parties' income differential for the purpose of a compensatory award. Third, the argument would be the scheme represents an item of value which could be used to satisfy claims based on contributions to the other spouse's education, or for the restoration of a premarital standard of living after a short marriage. A discussion of the first route will address the issues relevant to the second and third routes as well.

1. Property Distribution

a. Does the Incentive Based Scheme Constitute Property?

Where the claimant seeks a recovery on the basis that the item constitutes marital property, the first hurdle that needs to be overcome is to establish that the incentive based scheme constitutes "property." This question arises in two respects.

Initially, there is the question of whether the contingencies associated with the scheme render it a mere "expectancy," and thus not distributable as property.\(^{158}\) At the outset, notice the contingencies associated with incentive based compensation schemes essentially fall into two groups. One group of conditions will affect the employee's entitlement to the benefits of the scheme. These conditions include potential loss through resigning from employment prior to becoming absolutely entitled to the benefit, being dismissed for cause, or the employer's cancellation of the scheme for whatever reason. The other set of conditions will affect the value of the benefit. These concerns might cover the ultimate market price of the stock, restrictions on alienation imposed by the grantor or securities regulators, or the tax treatment required or able to be employed by the beneficiary of the scheme. Our present concerns are primarily with the former set of conditions,\(^ {159}\) although some

\(^{158}\) The fact that an item is apparently valueless does not in itself mean that it is not distributable property. See Banning v. Banning, No. 95 CA 79, 1996 Ohio App. LEXIS 2693 at *14, *20 (Ohio Ct. App. June 28, 1996) (holding the trial court erred in refusing to distribute stock option because the exercise price was above the market price of the underlying stock).

\(^{159}\) Courts have combined both sets of considerations in determining that a particular scheme amounts to an expectancy. See Ross v. Ross, 600 A.2d 891, 894-95 (Md. Ct. Spec. App. 1992) (finding a preemptive right to buy stock was a mere expectancy and thus not marital property, because the owner could not be compelled to sell and because the purchase price could not be determined in advance of the purchase). Other courts make it clear that uncertainties as to value are irrelevant to the determination that an option is distributable property. See, e.g., Charriere v. Charriere, No. 05-97-00434-CV, 1999 Tex. App. LEXIS 7475, at *10-12 (Tex. App. Oct. 7, 1999). Interestingly, because under the ALI proposals compensatory awards are premised on the realization of value without requiring an
courts find themselves overwhelmed by the cumulative effects of both sets.\textsuperscript{160}

Most jurisdictions have taken the position that mere expectancies, such as an anticipated inheritance, are not distributable on divorce. Normally, the testator is free to change his or her mind and this risk renders distribution on divorce inappropriate. This is well spaded soil in the area of pension schemes where the concern is whether an "unvested" pension, where the employee will receive nothing if the employee fails to satisfy some initial conditions — usually involving remaining in employment for a minimum period of time — is distributable. The vast majority of jurisdictions in the United States today take the position that non-vested pensions are distributable, on the theory that, unlike expected inheritances, the grantor of the employment benefit is not free to change his mind and eliminate the inchoate benefit.\textsuperscript{161} Of course, the employer and the employee are free to terminate the employment relationship that indirectly will result in the loss of any pension benefit. But, in the context of pensions, jurisdictions have developed a variety of techniques for dealing with this class of problem. Some simply defer the divorce related distribution until the uncertainties are resolved. Others assign a share to the non-employee spouse on a "when and if" basis. The effect of such an order is to make the non-employee spouse shoulder a proportional share of future risks, which, as has been pointed out, should not be unappealing if the alternative is non-participation in the benefit at all.\textsuperscript{162} Finally, others attempt to estimate the risk of the pension never vesting, and take this into account as part of the process of assigning a value to the pension. Given the pension experience, the trend among jurisdictions in the United States is to treat unvested stock options as property on the basis that the employee has a contractual right that has value as intangible property.\textsuperscript{163}

underlying characterization of the option grant as property, the ALI proposal may provide a device for a claimant to gain access to the benefits of the options even if the scheme is characterized as a mere "expectancy." In such a context the claimant becomes linked to the risks associated with the value realization rather than asset realization, which, depending on the jurisdictions treatment, may be a significant distinction.

\textsuperscript{160} See Brandon v. Brandon, No. 01-A-01-9805-CV-00235, 1999 Tenn. App. LEXIS 271, at *12-13 (Tenn. Ct. App. Apr. 29, 1999) (holding option subject to contingencies of serial vesting after marriage ended with the resulting uncertain value and uncertainties relating to the decision to exercise the option rendered the benefit too contingent and speculative to be considered marital property).

\textsuperscript{161} See, e.g., Krafick v. Krafick, 663 A.2d 365, 372 (Conn. 1995).


\textsuperscript{163} See Bornemann v. Bornemann, 752 A.2d 978, 986 (Conn. 1998). This case lists a
In the context of incentive based compensation schemes, the use of the various techniques with respect to pensions is, by and large, acceptable as long as the techniques are applied in a disciplined manner. Deferring resolution of the issue, or assigning a portion of the asset, tends to lead the court to allocate the underlying risk in isolation. For example, if the portion allocated to a claimant involves a share that is not equal to the other spouse's share because the other spouse is to receive some other class of asset, then there is a substantial risk of resulting inequity because the risks associated with the different classes of asset may be different. If we try to avoid these concerns by employing an appropriate distribution in-kind, the result may be the need for the now ex-spouses to maintain an on-going financial relationship which some jurisdictions, for good reason, find objectionable, even to the point

number of other jurisdictions coming to the same conclusion, as well as some states which have decided to the contrary. Id. at 986 n.4. For example, Colorado treats an option as a non-vested expectancy where the employee has not completed the minimum employment term to be entitled to receive the benefit, but as vested property an option where the minimum term is completed, even if the if the option does not have a readily ascertainable value and even if the option is subject to a substantial risk of forfeiture. See In re Marriage of Huston, 967 P.2d 181, 183 (Colo. Ct. App. 1998) (stating that only vested stock options are property).


166. This problem was briefly alluded to earlier in this article. See supra note 47 and accompanying text. A few courts are aware of the problem. See In re Marriage of Frederick, 578 N.E.2d at 619 ("There is no indication in the record... that the apportionment of marital property was affected in any manner by the determination to allocate the profits [from the options] equally between the parties."). Some courts adopt an incredibly simplistic approach: "Employee stock options are normally exercisable on the condition that the employee remain with the employer and, as between the spouses, that is obviously within the control of the employee spouse." In re Marriage of Hug, 154 Cal. App. 3d 780, 794 (1984). 'Even if the non-employee spouse cannot control the employment relationship, that does not mean that the employee spouse necessarily can. The issue is how to assign the risks associated with that missing element of control. In Wendt v. Wendt, FA 960149562S, 1997 Conn. Super. LEXIS 3104 (Conn. Super. Ct. 1997), the husband was employed by General Electric Corp. (GE). The court identified the following risks associated with some 420,000 unvested options and appreciation rights held by the husband: 1) the husband would not be employed by GE at the date of vesting and the options would thus have no value, 2) the husband would not be employed by GE at the date of vesting and would not have been offered a "separation package" which included the vesting of some portion of the options and thus the options would have no value, 3) the husband was offered a "separation package" under which the options which were allowed to vest did not include any which constituted marital property (as the court put it, they had a coverture factor of zero), 4) the husband was not offered a "separation package," but his new employer offered a signing bonus such that while the options became valueless, the husband received the equivalent sum from his new employer, 5) GE amended, suspended or terminated the option plans either individually or company wide, 6) the price of the underlying GE stock fell below the value it had on the date the parties separated which was the value the court proposed to use, in distribution based on the "intrinsic value" of the option. Id. at *22-23, *25-26. See infra note 258 and accompanying text.

of overriding an offer by the claimant to run the risks associated with the options.\footnote{168} In theory, this problem may be circumvented if it is possible to adjust the value of the various classes of asset to reflect the different risks associated with the ability to realize the value of each class, and then assign each spouse appropriately valued but different and discrete assets. The realities may be different. Generally, an employer is not free to unilaterally revoke a pension benefit, albeit one that has not vested. The same cannot be said for many of the incentive based schemes with which we are presently concerned.\footnote{169} In principle, one simply cannot give one spouse a portion of a pension and the other a portion of a stock option without acknowledging that the risks associated with the realization of these assets are different. Notice at this point we are concerned with the contingencies which impact the ability to get access to the value, not with the contingencies which affect the value itself, even though the former set of contingencies ultimately may affect the value to the claimant. As far as the value itself is concerned, if the value assigned to the asset is accurate, it will adequately reflect risks associated with the realization of the

\footnotesize{\begin{itemize}
  \item \footnote{168} See, e.g., Wendt v. Wendt, FA 960149562S, 1997 Conn. Super. LEXIS 3104, at *26 (Conn. Super. Ct. Dec. 3, 1997) ("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.").
  \item \footnote{169} Not only may the option not survive termination, but its benefits may be lost to company restructuring, or even by way of a "claw-back" provision under which an employee is liable to the employer for the profits realized through an option scheme if the employee joins a competitor. See IBM Corp. v. Bajorek, 191 F.3d 1033 (9th Cir. 1999) (options are contract rights and not covered by state law barring an employer from recovering wages); Ellen L. Rosen, \textit{Stock Options; Ex-Employees are Suing Over Promises Made}, 91 N.Y. L.J. 5 (2000). Apparently, employers are becoming increasingly aggressive in inserting and enforcing forfeiture provisions. See Carolyn T. Geer, \textit{Beware the "Clawback"...}, FORTUNE, Apr. 17, 2000, at 514.
\end{itemize}}
value.\textsuperscript{170} We shall return to matters associated with assigning value in due course.

Given the possibly substantial uncertainties associated with realizing the benefits of an incentive-based scheme, a court may be tempted to decline to recognize the benefits of such schemes as being distributable property.\textsuperscript{171} The cases\textsuperscript{172} suggest, however, that this is not occurring, possibly because the pension scheme analog appears deceptively similar.\textsuperscript{173}

\textbf{b. Does the Scheme Constitute Property or Income?}

The second sense in which it is necessary to consider whether these incentive based compensation schemes constitute property available for marital distribution relates to whether a better, or more appropriate, characterization of the benefit is as “income” to be used in fixing and meeting the obligations reflected in compensatory awards.\textsuperscript{174} Certainly, if the stock option has been exercised and

\begin{itemize}
  \item[\textsuperscript{170}] Technically, this assigned value might reflect a discount arising from the transaction costs associated with the hedging necessary to ensure the assigned value is achieved.
  \item[\textsuperscript{171}] Hutto v. Hutto, No. CA 92-51, 1992 Ark. App. LEXIS 523, at *5 (Ark. Ct. App. July 8, 1992). The company could revoke the option if the employee failed to exercise the option within three months of leaving the company’s employ, if the employee was terminated for acts “inimical” to the best interests of the company, or if the employee’s responsibilities were altered to a level that would not have initially warranted the grant of the option. \textit{Id.} at *2. The court held the employee’s rights to exercise the option were uncertain and accordingly that the option could only be classified as a “contingent expectancy”. \textit{Id.} at *5. Indiana takes essentially the same view if the option is not vested, that is if the right to exercise the option would be forfeited if the employment is terminated. Hann v. Hann, 655 N.E.2d 566, 571 (Ind. Ct. App. 1995).
  \item[\textsuperscript{172}] For an incomplete compilation of cases covering matters related to stock options, see Eric Hollowell, Annotation, \textit{Divorce and Separation: Treatment of Stock Options for Purposes of Dividing Marital Property}, 46 A.L.R. 4th 840 (2000).
  \item[\textsuperscript{173}] \textit{In re Marriage of Nelson}, 222 Cal. Rptr. 790, 792-93 (Cal. Ct. App. 1986). In \textit{Hann v. Hann}, Indiana used a pension analogy to go in the other direction. Under Indiana law a pension which is subject to forfeiture if employment is terminated is not distributable marital property. \textit{Hann}, 655 N.E.2d at 570.
    
      The difficulty with stock options... is that they have a dual nature. They have characteristics of an asset in that they represent a right to purchase an ownership share in the underlying corporation’s stock.... [T]hey have characteristics of income in that the whole purpose behind options is to allow the owner to capture the appreciation in value of the stock prior to its actual purchase....
      
    Also, they are often given as a form of compensation. The same analysis must be made when determining the employee’s income for the purpose of calculating child support. \textit{See} Murray v. Murray, 716 N.E.2d 288, 292-95 (Ohio Ct. App. 1999) (deciding that options given every year and exercisable after twelve months for up to ten years were income). This characterization problem has already caught the attention of the general media. \textit{See} Amy Zipkin, \textit{Stock Option Splitsville}, N.Y. TIMES, Aug. 9, 2000, at C1.
\end{itemize}
the shares are received and freely marketable by the employee, or if the employee is now holding restricted stock free from the risks of forfeiture. If the benefits received were not otherwise consumed during the marriage, there does not seem to be an objection to treating the results of these schemes as property available for distribution if the benefits otherwise qualify as marital property. But, if the situation is not as just described, compelling arguments can be made that these benefits could, query should, be viewed as income. After all, the employee is granted the option or the restricted stock as compensation. Or, put another way, the employee and presumably his or her spouse – agrees to forego salary in order to be paid in options. Indeed, in a noticeable number of instances, such schemes may constitute a significant portion of the employee’s compensation.

There are three possible scenarios to be considered. First, the grant may be made for services totally rendered during the marriage. In this event the benefit should be treated as marital property. But care must be taken. Because the receipt of the value may occur after the marriage, the claimant should not be allowed to recover a share of the scheme as marital property while at the same time the receipt of the value by the employee is treated

175. Indeed, it has been held where a grant of restricted stock during the marriage carried with it the ability to exercise rights of ownership such as to vote and receive dividends, and where the employer could not unilaterally repudiate the employee’s right to retain the stock, even if the stock was subject to the risk of forfeiture by reason of leaving employment within five years after the grant, the stock could be treated as marital property. In re Marriage of Miller, 915 P.2d 1314, 1319 (Colo. 1996). The risk of forfeiture was seen as affecting the value of the restricted stock, not their nature as marital property. Id. at 1320. Depending on the conditions triggering forfeiture, this may not be a universal truth. See Charriere v. Charriere, 7 S.W.3d 217, 221 (Tex. App. 1999).

176. For a case where the employee spouse claimed that stock were routinely cashed out to generate income, see In re Marriage of Huston, 967 P.2d 181, 185 (Colo. App. 1998).


180. The question for our purposes of when the marriage ended is not one to be taken lightly. The question is beyond the scope of the present paper save for noting that courts are aware of the need to take care lest the traditional date for valuing assets might lead to a claimant getting an unjustified benefit, especially where a lengthy period elapses between the breakdown of the marriage and the finalization of the divorce and the asset appreciates due to the effort of the employee spouse. See Soule v. Soule, 676 N.Y.S.2d 701, 704 (N.Y. App. Div. 1998). The appreciated value, however, may still be relevant if the appreciated option is being looked to as a source of income for making a compensatory award.

181. Some states may preclude this where the options are not exercisable during the marriage. See Hann, 655 N.E.2d at 571.
as income for the purposes of assessing a compensatory award.\textsuperscript{182} Of course, once the asset has been received, the asset itself may produce income that can be counted for compensatory purposes. This would apply equally to the employee and the claimant spouse. It is extremely important to note that even in the simple scenario just described, because the value will be received perhaps both after the marriage and considerably later than when it was "earned," and because each incentive based compensation package potentially carries with it its own "risk environment," regarding both realization and value,\textsuperscript{183} each package needs to be independently dealt with in this way. That is, one should not assign to one spouse a given incentive package in its entirety with a view to satisfying that spouse's property and income claims, and correspondingly assign the other spouse the total benefit of another package. Ideally, distributable shares of an incentive package only should be assigned in the same proportions, rather than giving one claimant a disproportionate share of one package, and enhancing the other spouse's share of another incentive scheme. The same concerns apply when marital property includes both incentive-based compensation packages and other property.\textsuperscript{184} True, it might be possible to adjust

\textsuperscript{182} In the context of pensions, see \textit{Majauskas v. Majauskas}, 61 N.Y.2d 481, 492-93 (1984). See also \textit{Chen v. Chen}, 415 N.W.2d 661, 664-65 (Wisc. Ct. App. 1987) (holding that the value of stock options were correctly treated as non-income for the purposes of fixing maintenance).

\textsuperscript{183} For example, grants of options and grants of shares may end up being subjected to different tax treatments, with a significant impact on the realizable value. \textit{Davidson v. Davidson}, 578 N.W.2d 846, 861-64 (Neb. 1998) (finding stock options triggered a forty-three percent tax rate, retention shares a thirty-two percent rate). Indeed, even a grant of just one type may cause problems if the grant involves a series of acquisitions with different exercise prices as with options or purchase prices in the case of restricted stock. In this event, each component of the grant may have a different "basis" for tax purposes and thus a different realizable value. \textit{Kapfer v. Kapfer}, 419 S.E.2d 464, 469 (W. Va. 1992).

\textsuperscript{184} See \textit{Banning v. Banning}, No. 95 CA 79, 1996 Ohio App. LEXIS 2693, at *22 (Ohio Ct. App. June 28, 1996). For a particularly bad example of a potentially unbalanced distribution of this type, see \textit{Kinsey-Geujen v. Geujen}, 984 S.W.2d 577, 581 (Mo. App. 1999) (awarding one party entire stock option package that might not survive employer's acquisition by another entity and awarding other party future farm subsidy payments of unknown value). Nor can it be said the courts necessarily are acting without thinking. In \textit{In re Marriage of Hug}, the court stated it would "be most equitable to fix the value of the community interests [in the stock options] at the date of separation and distribute the community interests to the employee spouse, awarding other community property of equivalent value to the nonemployee spouse." 201 Cal. Rptr. 676, 686-87 (Cal. Ct. App. 1984). The court specifically acknowledged exercising the option was conditioned on continuing employment, and the underlying stock might increase in value due to the employee's performance, or decrease in value due to the company's poor performance or due to the economy. These risks, the court reasoned, were best borne by the employee spouse. \textit{Id.} Unless the options were exercisable, and marketable, or could be valued using other marketable surrogates, it is hard to imagine how a realistic value could be attached to the options in order to assign an "equivalent value" in community interests to the other spouse.
the values and, hence, proportions to reflect the relative risks, but given the uncertainties of the asset's realizable value, such a procedure does not seem to be desirable. Indeed, even if the spouses receive equal shares in all marital property, the fact that the realizable value is uncertain may destabilize the entire award to a degree the court feels compelled to retain jurisdiction to the point the actual value is known. This theme, too, will be returned to later in this article.

In the other scenarios, the grant is made during the marriage for services to be rendered partly within the period the marriage endures or totally outside of that time frame. Some courts appear to take the position that the mere fact an option is granted during the marriage makes the option in its entirety marital property.

185. In Warren v. Warren, 407 P.2d 395, 397-98 (Ariz. Ct. App. 1965), the appellate court specifically directed the trial court not to adjust the value to reflect the fact the employee might voluntarily terminate his employment. Clearly this risk was under the control of the employee. What role other contingencies might play in the adjustment of value was not made clear.

186. Also, it may not be technically possible. Virginia courts have held under an applicable statute neither spouse may receive more than a fifty percent share of unvested stock options granted as deferred compensation. Dietz v. Dietz, 436 S.E.2d 463, 470-71 (Va. Ct. App. 1993).

187. In re Marriage of Miller, 915 P.2d 1314, 1316 (Colo. 1996). An appellate court in Illinois has taken the position that contingencies associated with a stock option make the option impossible to value. This meant the option could not constitute property available for distribution under the Illinois statute. Accordingly, the court directed the trial court to retain jurisdiction until the options were exercised, if that ever occurred, and to allocate an appropriate share of any resulting profit. In re Marriage of Moody, 457 N.E.2d 1023, 1026-27 (Ill. App. Ct. 1983). This apparently also was the result in In re Marriage of Huston, 967 P.2d 181, 183-84 (Colo. App. 1998), where the trial court was allowed to retain jurisdiction over the "distribution and valuation" of the options so the parties would "share in the risk of the fate of each of the options." Why the retention of jurisdiction was necessary is not clear given the trial court had already allocated twenty-five percent of the options to the husband and seventy-five percent to the employee wife. Id. at 183. Even more surprising is the appellate court let the distribution ratio stand given that other assets and liabilities were distributed equally. The court seems to have lost sight of the fact that mere common exposure to a risk is not necessarily fair if the adverse impact of that risk will fall disproportionately on one of the parties.

188. This may be true even if the grant itself is made after the point when the parties interests are severed. See Goodwyne v. Goodwyne, 639 So. 2d 1210, 1212-13 (La. Ct. App. 1994).

189. It may not be a simple matter to determine the period for which the grant is intended to provide compensation. Factors which impact this determination may include whether the form of the compensation reflects an effort to secure optimal tax treatment, was offered to induce the employee to accept employment, remain with employer, leave other employment, or is linked to the achievement of a particular goal; and whether the award is made on a regular or irregular basis. Davidson v. Davidson, 578 N.W.2d 848, 855 (Neb. 1998).

But, other courts reject this approach. The ALI proposal seeks to exclude from consideration as marital property certain assets because their value is “inextricably intertwined with spousal skills or earning capacity or post-marital labor.” In this regard the distribution of occupational licenses and educational degrees are not divisible property, and business and professional goodwill earned during the marriage will be divisible only to the extent that they have value apart from the value of spousal earning capacity, spousal skills, or post-dissolution labor. The conceptual problem we may face is that the employee spouse generally may not have an indefeasible entitlement to benefit from the incentive based scheme except by virtue of satisfactorily exercising skills and labor for the full qualifying period that may extend well beyond the marriage.

Is there a way to allocate some, but not all, of the resulting value to the marital portion of the claim in a manner that adequately finesse the risks of the assets non-realization and at the same time recognizes the employee spouse’s post-marital contribution? Conceptually, this process seems to be manageable provided that the court does not attempt to “mix and match” classes of claims; a distinction must be maintained between claims to property and efforts to minimize income divergence. Each spouse can be allocated as a property distribution an appropriate share of that portion of whatever value finally materializes, where the distributable portion is determined by the time-span within the marriage during which the benefit was “earned” relative to the overall time.

191. Demo v. Demo, 655 N.E.2d 791, 793 (Ohio Ct. App. 1995) (holding that the option granted during the marriage based on job performance prior to marriage was not distributable).
192. PFD, supra note 2, § 4.07, cmt. b, at 151.
193. Id. § 4.07(2)-(3), at 146.
194. The converse situation can be encountered also. The qualifying labor primarily may have been contributed prior to the marriage, with the option vesting during the marriage. The employee asserts the options are non-marital property. The claimant asserts the vesting during the marriage characterizes the option in its entirety as marital property. See In re Marriage of Fatora and Sullivan, No. CN95-10406, 1998 Del. Fam. Ct. LEXIS 195, at *16-17 (Del. Fam. Ct. July 10, 1998).
195. See Kapfer v. Kapfer, 419 S.E.2d 464, 467 (W. Va. 1992); Chen v. Chen, 416 N.W.2d 661, 664 (Wis. Ct. App. 1987). For an example of a situation where the court allowed the property division award to be considered for the purposes of determining income, see Hokin v. Hokin, 605 N.W.2d 219, 230 (Wis. Ct. App. 1999) (holding a share of pension plan funds distributed to claimant could be used to impute an income to her because considerably older husband at age seventy-four could be anticipated to retire relatively soon, so the court was doing what would likely have happened in the ordinary course of events, absent the divorce).
196. Even this concept is not without problem. If the employee spouse was working for the employer before the incentive scheme was granted, the decision has to be made whether the appropriate time should commence from some point prior to the grant. In essence, the
it took to "earn" the benefit.197 The relevant fraction is called the "coverture fraction or factor" and its use is well established in the context of distributing defined-benefit pensions.198 The underlying basis for determining the distributable portion of the option is commonly called the "time rule,"199 for the obvious reason that the marital "input" is reflected by the time spent during the marriage engaged in the activity, rather than the value of labor contributed during the marriage to the activity. Thus, a stock option whose value could be realized200 after five years and was granted one year

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197. While this concept may be simple, the application may not be. For example, what if during the marriage the spouse is granted an unconditional option (which is not exercised during the marriage) to buy restricted stock — stock subject to risk of forfeiture? Essentially, the option would be vested, but any stock purchased might not be vested until the restrictions were lifted. See Harrison v. Harrison, 225 Cal. Rptr. 234, 238-39 (Cal. Ct. App. 1986). For the purposes of the analysis in this case, the court assumes the benefit has been "earned" after the restrictions are finally lifted on the stock. This process is then used to determine the coverture factor, discussed infra. Id. at 237-40. In contrast, in a Texas decision the employee spouse was granted an option to purchase restricted stock. The options were "exercisable at any time." See Charriere v. Charriere, 7 S.W.3d 217, 220 (Tex. App. 1999). The options were held to be community property in their entirety, notwithstanding the fact the restrictions on any stock acquired by exercising the options only would lift progressively over ten years during which the employee spouse had to remain in employment. Id. The entire ten-year period would be post-divorce, and if the option holder left employment any unexercised options would be forfeited. Id. Louisiana also has taken the position that restricted stock acquired during the marriage will be a community asset notwithstanding that future services by the employee were envisaged by the scheme. Mestayer v. Williams, 569 So. 2d 1102, 1105-07 (La. Ct. App. 1990). The court distinguished between ownership that vested in the marital community and the ability of the "owners" to deal with the stock regulated by the restrictions. Id. This approach has been criticized as too simplistic. Lee Hargrave, Matrimonial Regimes, 52 LA. L. REV. 655, 669 (1992) (suggesting if the employee can demonstrate the asset is in part attributable to separate effort after the community ends, the court should adopt a mixed classification, rather than a single classification that only produces "rough equity"). Another criticism emerges if one postulates that the stock was purchased with separate funds, but the period spent working to free the stock from restrictions occurred during the marriage. See J. THOMAS OLDHAM, DIVORCE, SEPARATION AND THE DISTRIBUTION OF PROPERTY § 7.11[4] (1999). A few jurisdictions have attempted a pro rata approach. Id.

198. PFD, supra note 2, § 4.08 cmt. f, at 179. See also Macaleer v. Macaleer, 725 A.2d 829, 835 (Pa. Super. Ct. 1999). For a general discussion of the use of coverture fractions in the context of divorce cases, see Lawrence D. Dodds & Robert D. Feder, Stock Options in Divorce — A National Trend, 13 AM. J. FAM. L. 105, 105-09 (1999). The Colorado Supreme Court has noted a potential difference between pensions and stock options. See Malone, supra note 140, at 88. Unlike a pension, an option may be granted for future services, past services, or both. Id. For our purposes the significance of this is that particular care needs to be taken when structuring the coverture fraction.


200. Ordinarily, the period covered by the denominator should come to an end when the option could be exercised, rather than when it is exercised. Using the latter point generally would leave the option holder free to dilute the claimant's share by effectively reducing the distributable fraction of the grant. See Chimes v. Michael, 748 A.2d 1065, 1067-69 (Md. Ct.
before the dissolution of the marriage could be treated, to the extent of twenty percent of its value, as distributable property.\textsuperscript{201} The remaining eighty percent should only be considered in the context of calculating income disparities for the purposes of compensatory awards.\textsuperscript{202} Of course, this approach only works if the option is awarded entirely for future endeavors or primarily is intended to operate as "golden handcuffs."\textsuperscript{203} If the award is partly to reflect labor prior to the award, and that labor also occurred during the marriage, the numerator in the fraction reflecting the distributable share must be increased.\textsuperscript{204} This result also seems to follow if the court adopts the position that general contributions by the non-employee spouse to the marriage puts the employee spouse in a position to be awarded the benefit.\textsuperscript{205} In such a situation the numerator might be extended back to cover the entire period from the start of the marriage, or perhaps only to the commencement of

\textsuperscript{201} Realizing the value may require thought on a case-by-case basis. If the option vests after three years, so that the employee could demand the conveyance at that point, but the parties are divorced a year after the grant, arguably the non-employee spouse could lay claim to one-third of the stock. But if the incentive scheme's rules preclude that employee from alienating the stock for a further year, during which the employee has to remain an employee or the stock will be repurchased at the option exercise price, so that the scheme also has the hallmarks of a restricted stock scheme, the period to "realization" will depend on what in fact happens. In a scenario such as this, even the portion that is to be viewed as marital property — never mind its value — may be indeterminate at the time of divorce. Also, the possibility exists that the prospective labor for which the grant is awarded is to be completed inside the vesting period. See Malone, supra note 140, at 88. In such an event the denominator in the coverture fraction should be reduced if it is considered appropriate to do so. The better view, however, would seem to be if the option grant is at risk unless the employee remains in employment for the requisite period of time, that time also should be included in the denominator. The employee is not imposing the delay until the option can be exercised freely.

\textsuperscript{202} This approach seems to have been adopted by a majority of jurisdictions that have considered the matter. See Bornemann v. Bornemann, 752 A.2d 978, 988-89 (Conn. 1998). The idea that a stock option can be viewed as both an asset and a source of income has been criticized for a variety of reasons, not the least of which is that this treatment might result in an inefficient use of resources, and involves an unfair distribution of risk and tax consequences. See Jack E. Karns & Jerry G. Hunt, Annual Eighth Circuit Survey Article: Should Unexercised Stock Options be Considered "Gross Income" Under State Law for Purposes of Calculating Monthly Child Support Payments?, 33 Creighton L. Rev. 235, 255-60 (2000).


\textsuperscript{205} On the question of contribution, see infra text accompanying note 215.
employment with the relevant employer. Further complications ensue when the marriage materializes after the grant of the option and ends before it is exercisable, and the grant is both a reward for prior activities and contingent on future performance. The position may also be complicated because the option scheme itself may have mixed goals, leading to varying portions of the scheme requiring differing treatments. Sometimes the grant itself may be complex, involving, for example, a series of options. One approach to dealing with such a situation allows the court to adopt the position that unvested options granted during the marriage are marital property, but are acquired only over time as the options vest. Where the grant involves serially vesting options, the options may be considered to vest consecutively, not concurrently. This analysis enables the court to apply a time rule to some of the grant and entirely exclude other portions of the grant from consideration as marital property. A few jurisdictions have opted for simplicity. If the option is granted during the marriage it is distributable property regardless of when the services are to be performed. Other jurisdictions take the view that even if the option is granted during the marriage, it is not distributable property if it is not exercisable and may be forfeited in the future. Finally, least any


207. For formulae that may be used to cover these various combinations, see *Davidson v. Davidson*, 578 N.W.2d 848, 856-58 (Neb. 1998).

208. See *In re Marriage of Short*, 890 P.2d 12, 16-17 (Wash. 1995). In this case, a portion of the options was granted for present services to induce the husband to accept employment, and was completely community property because the employment commenced during the marriage. Other portions were for future services, some of which fell beyond the date of separation, and were therefore subject to the time rule. Finally, a portion of the options was found granted for a period entirely beyond the period of the marriage. For a discussion of some of the difficulties in deciding whether the award was for future services, see Michael A. Ealy, Note, *The Characterization of a Contingent Interest in an Employer Stock Option Upon Dissolution of the Marital Community: In re the Marriage of Short*, 32 IDAHO L. REV. 691, 703-11 (1996); *Malone, supra* note 140, at 90-91.

209. Employers are driven to use a system of progressive vesting of options and serial grants of such benefits in order to ensure the incentive component of the compensation package remains adequate as the option holder cashes out specific options. *Schizer, supra* note 145, at 448-49.

210. See *In re Marriage of Short*, 890 P.2d 12, 16-17 (Wash. 1995). This approach has been criticized because it ignores the contribution during the marriage to the acquisition of the stock option right. See Ealy, *supra* note 208, at 716. The Washington Supreme Court adopted the rule under the impetus of the state's community property statute. *Id.* at 715. California, in contrast, recognizes the contribution made during the marriage and applies a time rule to all of the options made under the grant. *Id.* at 716.

211. See cases cited in *Bornemann v. Bornemann*, 752 A.2d 978, 989 (Conn. 1998).

court get too complacent, all the calculations may in reality turn out
to be flawed, because option vesting dates may accelerate in the
course of corporate mergers, restructuring, or by virtue of perfor-
mance benchmarks being exceeded.213

At this stage, our concern is with the portion of the asset that
is distributable, not with assigning a value to that portion. Of
course, this premise is that each year of labor contributes equally to
the resulting benefit. It is open to question whether the premise can
be justified in the case of an employee who, after the divorce but
while the benefit is still “maturing,” is promoted to a position which
significantly impacts the value of the relevant stock.214 If the
claimant is able to argue that her contributions during the marriage
made it possible for the employee spouse to achieve the promotion,
her case for a strictly time-related share would be stronger.215
Under the ALI proposals, however, the concept of a contribution
other than to the marriage itself is rejected216 in favor of what seems

213. See OLDHAM, supra note 197, at § 7.11(3)[a]. Moreover, there is no standard rule that
in the event of a “change in control” all option holders will become fully vested. The
acceleration may apply only to some option holders, and it may do no more than shorten the
period to vesting by a specified time, say twelve months, so that a person who had acquired
options with a three-year vesting period, and who had held the options for twelve months
when the merger occurred would be deemed to have held the options for twenty-four months
following the acceleration, but the options would still not be vested. Ultimately, it depends
on the terms of the grant and the structure of the merger whether the option survives.

214. The impact need not be significant. In New Jersey, the court reduced the claimant’s
share in options awarded during the marriage to reflect the fact that the employee spouse’s
efforts might contribute “in some small way” to the appreciation in value of the underlying

215. In any event, at some point the link between the purported contribution and the
resulting benefit might be too attenuated. A contribution-based analysis seems to have been
Similarly, the husband in Pascale v. Pascale was able to assert stock options granted after the
divorce to the wife in recognition of her promotion were marital property in part because of
“his role as husband and father contributed in some way to [her] success, which increased her
worth for that promotion.” 660 A.2d 485, 498-99 (N.J. 1995). The converse problem also can
arise. What if the promotion occurs during the marriage and the claimant suggests the
enhanced benefits were a function of her contributions, but the marriage has been relatively
brief and the employee is a long-term employee? Is it appropriate to treat the incentive-based
compensation package as marital property? See Davidson v. Davidson, 578 N.W.2d 848, 858-
59 (Neb. 1998) (discussing a couple married thirty-eight months, but separated after two
years, while career spanned thirty-three years). A similar sort of problem arose in Vick v.
Vick, 675 So. 2d 714, 716-7 (Fla. Dist. Ct. App. 1996). Here, the husband’s employer gave a
gift of stock during the marriage. The court held it was marital property only to the extent
that his efforts during the marriage had contributed to an increase in the stock’s value. See
also OLDHAM, supra note 197, at § 7.11[3][a].

216. PFD, supra note 2, § 4.15, cmt. c, at 197. The concept of “contribution” is not rejected
in the context of distributing a defined contribution pension plan. The ALI accepts that the
claimant should have a share of the contributions made to the plan during the marriage
together with the appreciation of those contributions after the marriage. Id. at § 4.08, cmt.
f, at 178.
the easier concept of simply determining whether the asset was acquired through spousal labor during the marriage.

Underlying all of the above concerns is the question of when, if ever, is it appropriate to "decouple" the non-employee spouse from the upside, or indeed downside, potential of the incentive package that was earned during the marriage? "Cashing out" the non-employee's participation through assigning a value to that interest could accomplish this. Alternatively, in some schemes, it might be possible to actually cash out some measure of the actual value. What value should be employed for these purposes is an issue to which we now turn.

c. What Value Should Be Assigned to the Incentive Based Scheme?

Unless the court can delay dealing with an incentive based compensation scheme until the day any value actually materializes, or grants the parties an equal share of whatever value does eventually materialize, the determination of value is both critical and problematic. At the conceptual root of the problem is that the case may concern a situation where "it is true that an unassignable, unsalable option has no fair market value, [but] it is nonetheless an economic resource,... to which a value can be attributed."

When it comes to property division the court can determine a spouse's share of the asset. Unless there is no need to determine equivalencies, for example where each spouse obtains the same relative share of every asset that is marital property, it becomes necessary to determine the value of the incentive scheme in order to determine the relative value of each spouse's overall share of

218. In Rehfeldt v. Rehfeldt, No. C-850056, 1986 Ohio App. LEXIS 5603, at *7 (Ohio Ct. App. Feb. 12, 1986), the options carried with them Alternative Appreciation Rights. These rights permitted the holder to relinquish the options and receive the difference between the option exercise price and the market value of the stock, taxed at ordinary income rates. Id. The court went along with the referee's view that allowing the husband to exercise the rights with respect to the wife's share would be wasteful because it would involve sacrificing the favorable tax treatment that would be available if the options were exercised as such. Id. at *9, *16.
219. See, e.g., Chen v. Chen, 416 N.W.2d 661, 662-64 (Wis. Ct. App. 1987) (holding that present value of option not determinable at time of trial and award of half share of whatever benefit accrues after option exercised and the resulting stock ultimately sold).
marital property. Indeed, this may be true even if it is possible to allocate equal portions of each asset to the spouses. For example, a recipient of an interest in stock or options may not wish to be vulnerable to the risks associated with having a now former – and possibly hostile – spouse potentially in control of the underlying value of the stock or option. Valuation also is critical in the context of considering the incentive based scheme as a source of income, and thus relevant for determining the compensation awards the ALI proposes.

The difficulty with valuing the benefits of schemes such as stock options and restricted stocks is that they tend to have two sets of risk factors associated with them. One set of risks are those associated with the marketplace generally. The other involves "personal" risks associated with the employee beneficiary and his or her employment relationship as well as the relevant tax strictures. A New Jersey court used an interesting technique in order to circumvent some of these problems. It impressed a constructive trust on the options in the hands of the employee. Notionally,

222. One commentator suggests that a distribution in kind form of property division will provide the court with a greater opportunity to accept "approximate" valuations. However, unless the court distributes equal shares with balanced degrees of "approximation" across all classes of assets, the risks in individual divorce cases of pockets of injustice are not insubstantial. See Sharp, supra note 162, at 2142-43.

223. See, for example, the scheme alleged in *Richmond v. American Systems Corp.*, 792 F. Supp. 449, 451 (E.D. Va. 1992), where a spouse receiving stock in a divorce settlement alleges unlawful dilution of equity interest.

224. For a detailed discussion of risk factors associated with derivatives in general and options in particular, see Kimberly D. Kraviec, *More Than Just "New Financial Bingo": A Risk-Based Approach to Understanding Derivatives*, 23 J. CORP. L. 1 (1997). The author defines "market" risks more narrowly than the term is used in the present article. *Id.* at 18. Additionally, she identifies credit, legal, operational, liquidity, and systemic risks. *Id.* at 31, 35, 39, 45, 47. These various classes of risk may have subsets of risk associated with them. Thus, the market risk of an option may be a function of the delta (the relationship between the rate of change of price of the option and the price of the underlying stock), elasticity (the percentage change in the option price flowing from a one percent change in the price of the stock), convexity (the rate of change of the delta relative to a change in price of the stock), volatility (the price movement of the underlying stock), time decay (the loss in value of the option simply by virtue of the fact that it is approaching the time for exercise), and discount rate (the impact on the value of the instrument due to changes in the discount rate used to discount future returns to present value). *Id.* at 17-20. Most of these subtleties need not be considered for our present purposes. For our concerns market risks will be those arising from all of these forces that are applicable to market in general. Personal risks will be those pertaining particularly to the option holder and his or her ability to realize the value of the option, as the market risks determine that value to be.

225. The court directed the option holder to exercise the options when instructed to do so by the claimant on condition that she provide him with the necessary funds, and ordered the employee to hold in trust any stock resulting from the exercise of the option, or to sell the stock as directed by claimant, turning over the proceeds to her. The court, however, forbade a sale that would violate the Securities and Exchange Commission's "insider trading" rules.
marketplace risks are separate from the risks that an individual employee faces, but as we shall see that is not always true.

Superficially, market risks would have a discounting effect on the value to an investor of a contingent asset that would vary with the risk preferences of the individual investor. If that is true, it would be nigh on impossible to assign a value to incentive based compensation packages on divorce which would reflect a "fair" allocation of assets unless the spouses' risk preferences were identical. The relevant risks are those intrinsic to the asset itself, and those associated with the sensitivity of the asset to the movement of the market as a whole.

The above concerns can be dealt with in one of two ways. First, both spouses might be left in a position where they are able to generate a portfolio of assets sufficiently diversified to offset the parties' senses of the risks associated with any given asset. The obvious shortcoming of this approach is it requires that the risks be

Moreover, the claimant had to indemnify the employee for any tax liability that attached to him. See Callahan v. Callahan, 361 A.2d 561, 564 (N.J. Super. Ct. Ch. Div. 1976). This procedure does not deal with the issue of how the uncertain outcome is to be reflected by the parties relative shares of other assets. In this regard, the court technically seems to have erred in awarding the claimant only a twenty-five percent share of the options. Id. This unbalanced allocation of an interest of uncertain size potentially unbalances the entire distribution scheme. Arguably, this unfortunate outcome resulted from the fact that the court had to distribute options that were only discovered after the rest of the divorce distribution was finalized. Id. at 352. In a case in a different state, the court impressed a constructive trust on the options, but left control over whether and when to exercise the options in the hands of the option holder. See Smith v. Smith, 682 S.W.2d 834, 837 (Mo. Ct. App. 1984). This would seem to impose on the claimant risks associated with the option holder's conduct that would be in addition to those arising from market forces and the employment relationship. Perhaps the constructive trust requires fiduciary behavior that would eliminate these risks. Conventionally, however, imposition of a constructive trust does not generate a "constructive trustee." A totally different argument for employing a constructive trust technique is it provides a mechanism for bypassing restrictions on alienation contained in the grant or imposed by tax law. See Webster & de Lisser, supra note 3, at 147, 148, 150. These authors argue if the option is held in the context of a community property regime, any transfer pursuant to a divorce is not a violation of the restrictions on transfer. Id. at 148. For tax purposes, however, they suggest that an ISO's preferred status will be lost, community property jurisdiction or not, unless a constructive trust type transfer of the beneficial interest alone occurs. Id. at 150. The authors conclude that a constructive trust device may be the only means of bypassing restrictions on transfer in non-community property jurisdictions. Id. at 148. Arguably, tax concerns aside, an employer could seek to limit the transfer of the beneficial interest by the express terms of the grant, and, indeed, given the employer's incentive concerns, may have done so by implication from the other express restrictions on transfer.

226. One might argue that the "acquisition" of the compensation package during the marriage justifies presuming the spouses have the same risk preferences, but such an analysis seems to be highly forced.

identifiable and that the former spouses are left with sufficient surplus assets to implement the necessary hedging.\textsuperscript{228}

If, however, we can come up with a valuation device which frees the value of an asset from the risk predispositions of the individual investor, we have eliminated one whole set of concerns which would impact the valuation of the asset on divorce. This is the particular appeal of the Black-Scholes\textsuperscript{229} type formula which is now widely mentioned in the cases,\textsuperscript{230} even though they may be less widely relied upon.\textsuperscript{231} Unfortunately, the basic Black-Scholes formula embodies assumptions as to some elements which are of particular relevance to our concerns. For example, the formula is critically dependent on information regarding market volatility.\textsuperscript{232} That volatility is in turn a function of the information that is

\textsuperscript{228} For some insight into the difficulties and expenses associated with the process, particularly if the instruments are not exchange traded, see Krawiec, supra note 224, at 21-22.

\textsuperscript{229} For a collection of material relating to the formula and its applications, see THE FINANCIAL DERIVATIVES READER (Robert W. Kolb ed., 1992). Basically, the Black-Scholes formula requires one to know the price of the underlying stock, the time before the option matures, the price to exercise the option, the market interest rate, and the volatility of the stock. See FISCHER BLACK, Fact and Fantasy in the Use of Options, in THE FINANCIAL DERIVATIVES READER 180 (Robert W. Kolb ed., 1992).

\textsuperscript{230} See, e.g., Davidson v. Davidson, 578 N.W.2d 848, 858 (Neb. 1998).


\textsuperscript{232} Technically, the valuation of options may be conducted using information relating to historical volatility. At least as far as exchange traded options are concerned, this information would be available to the market. Historical volatility, however, may be unreliable and valuation based on "implied volatility" is often preferred. If the option price is known, it is possible by doing calculations in "reverse" to determine what volatility factor must have been imputed to the instrument in fixing its price. See LAWRENCE G. MCMILLAN, OPTIONS AS A STRATEGIC INVESTMENT 411-12 (1986); Krawiec, supra note 224, at 19-20. If the market price is not known, however, the investor must determine an implied volatility factor to use based on views or information relating to future events available to him or her. Moreover, because the implied volatility may change without any change in value of the underlying stock, an option holder who has sought to protect the overall value of a portfolio by hedging may unexpectedly find himself or herself with an unbalanced portfolio. Krawiec, supra note 224, at 19. Efforts continue to project historical volatility into the future. See, e.g., Mark Britten-Jones & Anthony Neuberger, Option Prices, Implied Price Processes, and Stochastic Volatility, 55 J. FIN. 839 (2000). The formula term used to represent volatility is "vega." It represents a dollar value change in the option value for each percent change (positive or negative) in volatility. Perhaps a more appropriate term would be "vaguer." This suggestion seems to be borne out by a recent article cautioning option traders using a stochastic volatility model because the so-called volatility "smile" in options valued using a Black-Scholes pricing model could not be explained by correcting for "negative skewness" and "excessive kurtosis." See, e.g., Gary S. Moore & Rakesh Patel, Should Options Traders Rely on Stochastic Volatility Option Pricing Models?, 6 DERIVATIVES Q. 23 (2000).
available to the market. The information that is available to the employee spouse, however, may differ from that which is available to the market. For example, the volatility may be affected by a major development in product line, or by an unannounced merger with another more or less volatile corporation. The fact that the employee is privy to information which is not available to the market represents a transition point from market risk factors to personal risks. Parenthetically, this fact also raises the interest

233. Research seems to indicate that managers delay the release of good news until after options have been awarded. See Gretchen Morgenson, Hidden Costs of Stock Options May Come Back to Haunt, N.Y. TIMES, June 13, 2000, at A1. Of course, merely being an employee may not ensure that the option holder has access to the relevant information, much less the option holder’s ex-spouse. DeBriæ v. Attachmate Corp., Case No. 43561-2, 2000 Wash. App. LEXIS 127, at *2-3, *10-11 (Wash. Ct. App. Jan. 24, 2000) (noting former employee’s ex-spouse sued employer for fraud alleging the employer concealed from her ex-husband the value of options which it bought back from him and which the claimant alleged were partly community property).

234. See BLACK, supra note 229, at 184-85.

235. The fact that the employees generally may be aware of critical information has led at least some employers to impose an insider trading policy on all employees. See Geanne Rosenberg, Insiders Get a Sturdy Tool to Rake in Stock Gains, N.Y. TIMES, Sept. 27, 2000, at C1. Being privy to such information means it might be difficult for the employee to realize the benefits of an incentive scheme without being guilty of insider trading. To alleviate this problem, the Securities and Exchange Commission has recently amended its rules to enable the employee to dispose of his or her interest provided this occurs under a plan created prior to the employee becoming aware of “insider” information. 17 C.F.R. § 240.10b5-1(c)(i).

The claimant’s position is that of everyone else in the market. If we assume that when the option holder was offered the options he or she was in the same information neutral position as the rest of the market, the employee notionally might have insisted on a premium element to the option award to offset the risks of the existence of information of which he or she might be unaware. Theoretically, the claimant’s award on divorce might reflect a similar such premium, but it is difficult to see how realistically this might be quantified in the absence of the information itself. Another way to look at the problem is to assume the employee was fully informed at the time of the grant. In such a case, the size of the grant itself presumably reflects the anticipated impact of the information on the value of the option itself. If this is the case, does the structure of the risks assumed during the marriage entitle the claimant to anything other than an appropriate share of the options at whatever value happens to materialize? The beauty of such an analysis is that it justifies not engaging in anticipatory valuation. Moreover, it ducks any need to attempt to quantify risks in advance of the realization of the asset.

236. For a nice example of this situation, see Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 434-35 (7th Cir. 1987) (imposing duty to disclose to employee of a close corporation who held restricted stock that the corporation was in merger talks with a public corporation, even though the publicly traded corporation would not ordinarily owe the same duty to its employees). Purely personal risk assessment may merge with matters associated with issues not generally available to the market. Id. at 451-52 (Posner, J., dissenting) (arguing that any knowledge of the benefits of the impending merger would have to be weighed against potential domestic conflict if employee had not resigned and forgone the benefits of the merger).

A potential information gap between the parties renders questionable a device employed by a court in Alabama in effort to get the option holder to price the risks of future events. In Keff v. Keff, 757 So. 2d 450, 451 (Ala. Civ. App. 2000), the trial court gave the option holder the choice of paying the claimant only after the options had vested, using the
ing possibility of requiring the disclosure of confidential insider information in the course of the domestic dispute of an employee. Additionally, the Black-Scholes formula is less reliable when the underlying instrument pays dividends, which is common both in the case of stock options and restricted stock schemes. This concern may be particularly problematic as the not uncommon multi-year alienation restriction to which an employee is subject may result in the benefit holder being exposed to a protracted period of relatively unquantifiable volatility. In short, there may be real problem in translating a particular employee benefit scheme into an item of “universal” value. Finally, Black-Scholes modeling is premised on the existence of a market for the underlying instruments. Such a market may not truly exist in the case of closely held corporations, although it might be possible in some circumstances to identify an appropriate “surrogate” instrument.

The relationship between the employee spouse and the employer is also something that is worth evaluating in attempting to assign a “universal” value to a scheme. For example, a non-employee spouse may be willing to accept direct participation in a share of an incentive based compensation scheme based on a Black-Scholes attributed value. Unlike a freely tradable option, however, an incentive based scheme may be subject to defeasance by the employer. Given that the scheme is designed to operate as an incentive for the employee, in the employer’s eyes that incentive will be weakened to the extent that the beneficial interest is assigned to a non-employee’s soon-to-be-former spouse. Accordingly, the

238. There might be complications on top of complications. It was only in February 1999 that the Securities and Exchange Commission amended its rules pertaining to form S-8 to allow the offer and sale by a publicly traded company of stock received on the exercise of an option by an employee’s family member who had acquired the option pursuant to a court order flowing from domestic litigation. See Marla G. Franzese & Martha N. Steinman, Estate Planning Benefits of Transferable Stock Options, 32 NYSBA Tr. & Est. L. Sec. News. (Winter 1999), at http://www.nysba.org/sections/tande/newsletters/winter99/stockoptions.htm (last visited Nov. 30, 2001).
239. The model may be able to handle the contingencies inherent in the option scheme, even if they restrict the option’s marketability. See Chammah v. Chammah, No. FA 95145944S, 1997 Conn. Super. LEXIS 1896, at *13-14 (Conn. Super. July 11, 1997).
240. See, e.g., In re Marriage of Hoak, 364 N.W.2d 185, 193 (Iowa 1985).
241. The same result might follow if the distribution scheme adopted by the court required an employee to exercise an option and liquidate the benefit. Of course, the scheme’s structure must permit this to occur and so in a sense, the employer has assumed the risks of the loss of the incentive. At least one court has stated a court may not adopt a distribution scheme which compels an employee to exercise options, because the effect of so-doing is to deprive him
employer might see it as in its self-interest to cancel the relevant scheme and replace it with another in which the former spouse will not participate.\textsuperscript{242} The employer's motivation to act would exist even in the absence of a collusive\textsuperscript{243} enterprise between employer and employee,\textsuperscript{244} and if the employee is important enough to the employer, the motive for collusion on both sides will be substantial. In one sense, this represents a sub-case of unknown information impacting volatility. In another sense, it represents a manifestation of the risk atmosphere in which the employee alone operates.\textsuperscript{245} This suggests that a non-employee spouse should be circumspect about taking a direct share of the incentive scheme,\textsuperscript{246} even if that

of the essence of his property interest, namely the right to make a choice regarding the exercise of the options. \textit{See} Green v. Green, 494 A.2d 721, 728 (Md. Ct. Spec. App. 1985). This argument would seem to be misguided. Spouses have ownership interests in all sorts of property which interests should entitle them to dictate the future treatment of the property. Divorce courts, however, routinely compel liquidation or conveyance of such assets.

\textsuperscript{242} Of course, the non-employee spouse, through court order or agreement, could attempt to ensure access to any successor benefit package. The replacement scheme, however, may have a risk or benefit structure that differs from the original in a way that adversely impacts the non-employee former spouse. Replacement may occur in a deliberate effort to bolster the employee's incentive in the face of a divorce-based alienation, or it may arise from market considerations, as where the exercise price of an option is "repriced" following a stock price decline. \textit{See} Schitzer, \textit{supra} note 145, at 458 n.61.

\textsuperscript{243} An employer's interest in an option or restricted stock grant may extend beyond ensuring that the employee has an incentive to perform. The grant may turn the employee or a group of employees into "relational" investors with the power to entrench management. Management, in turn, would be in a position to enhance the employee's post-divorce interests. \textit{See generally} Edward B. Rock, \textit{Controlling the Dark Side of Relational Investing}, 15 CARDOZO L. REV. 987 (1994). Thus, for example, where restricted stock carries voting rights, the employer may not be a totally disinterested party when it comes to the distribution of the restricted stock on divorce. Accordingly, apart from a concern to maintain an incentive, an employer may wish to structure the incentive package in a way that ensures that the beneficial owner's interests and those of management do not diverge.

\textsuperscript{244} A conspiracy was alleged by the non-employee spouse in \textit{Mendenco, Inc. v. Myklebust}, 615 S.W.2d 187 (Tex. 1981), for failing to voluntarily disclose information about unemployment benefits. The Texas Supreme Court affirmed the trial court's summary judgment for the employer.

\textsuperscript{245} The claimant may have a risk atmosphere of his own. There is a report that a major accounting firm directed a senior audit manager to give up a claim in divorce proceedings to a share of his wife's multi-million dollar option package granted by the firm's client, or leave the firm, on the basis that a conflict of interest might result if he did not do so. He left the firm. Elizabeth MacDonald, \textit{Accountant Faces Salvo From SEC}, WALL ST. J., Feb. 28, 2000, at A3.

\textsuperscript{246} A claimant can get trapped between the proverbial rock and a hard place. In \textit{In re Marriage of Frederick}, 578 N.E.2d 612, 617-20 (Ill. App. Ct. 1991), the claimant felt that the employee spouse might not act in her best interests and might not exercise the options, leaving her with nothing. The trial court awarded her fifty percent of the profits from any exercise of the options, and retained jurisdiction to distribute any such profits. \textit{Id.} The claimant did not ask for the options to be transferred to her, or for the right to exercise the options directly. She asked only that the retained jurisdiction include the right to petition the court to compel the employee spouse to exercise the option at the petitioner's expense. The
is technically possible. Where an ALI proposed compensation order is predicated on the establishment of the "value" of an incentive based compensation scheme, as where the realization of a series of options or the sale of restricted stock is viewed as part of a process of generating income after the divorce, issues become more problematic. Obviously, if a technique like the Black-Scholes formula is employed to assign a value and it is not accurate in its predictions, either of the spouses may be overly burdened. Moreover, as we saw, the scope for

247. It may not be. For example, I.R.C. § 422(b)(5) deprives a stock option scheme of its recognition as an Incentive Stock Option scheme if it is transferable, except by will or the laws of descent, or it is exercisable by anyone other than the employee. See Webster & de Lisser, supra note 3, at 149. Similarly, in a recent field service memorandum, the IRS indicated that options transferred pursuant to a divorce decree would generate taxable income in the hands of the husband on the basis that he had received compensation, through the release of marital rights, equal to the fair market value of the options at the time of transfer. After exercising the options the wife held them with a basis of the exercise price and the carryover from the husband's taxable transfer. She would be liable for any capital gain realized when she sold the stock. The IRS position is that I.R.C. § 1041 only sheltered the inter-spousal transfer, not the husband's realization of income. Field Serv. Adv. 200005006 (Nov. 1, 1999). This position obviously opens up the possibility of a taxable event that intrinsically does not generate revenue to pay the taxes — presumably producing a strong disincentive to transfer the options and their associated risk. The suggestion has been made that these concerns should dictate either that assets of equal value should be transferred in lieu of the options, or that the net after tax proceeds should be transferred when the option is finally exercised. See Natalie L. Bell, Divorce-related Transfer of Compensatory Stock Options is Taxable, 31 TAXADVISER 537, 539 (2000). There is a existing body of tax law which suggests if a non-qualified stock option is transferred between spouses pursuant to a divorce and the option is community property by virtue of having been granted during the marriage, and there is an approximately equal division of community assets generally, though not necessarily equally of each asset, then the transfer of the option will not be a taxable event. Webster & de Lisser, supra note 3, at 148, 149; Bell, supra at 539.

Logically, an even more likely technical obstacle would be a termination provision in the scheme itself, given the foreseeable erosion of the incentive structure in the event of premature alienation, particularly an involuntary alienation under court order. Employers generally may not yet be aware of this problem, but it is only a matter of time. Authors have already noted that in order to maintain the incentive value of option packages, employers have imposed restrictions on transferability, such as limiting recipients to immediate family members. Franzese & Steinman, supra note 238, at 14, 16. Given our present concerns, such a restriction may not be adequate.

248. Thus, one court recognized that even though the underlying stock was worth less than the option exercise price, the option might have value, based on how likely it was that the market price might rise above the option price. What techniques like the Black-Scholes formula attempt to do is assign that value. Nevertheless, in this case the court said that an assigned measure of worth would be speculative and thus could not be used to value a stock option for distribution purposes. Banning v. Banning, No. 95 CA 79, 1996 Ohio App. LEXIS 2693, at *20 (Ohio Ct. App. June 28, 1996). Accordingly, the appellate court suggested the trial court might consider ordering a deferred distribution on a "when and if" basis in the same proportions as other property had been distributed. In another case, the option holder successfully argued that the option had no value because he was an "insider" and thus could not "trade" in the option, which extended to precluding him from exercising the options. The
modification of a compensation order under the ALI proposal is not balanced. Ordinarily, a higher than anticipated yield will short-change the non-employee spouse and is not correctable. More fundamentally, however, the Black-Scholes technique does not normally address the risks associated with the employee spouse's actual realization of the value. It does not take into account those risk factors that do not apply to the market in general but do apply to the employee. These range from risks of the scheme's termination as was just mentioned, an employee failing to satisfy qualifying conditions, to being held accountable for a value which the model suggests is intrinsic to the scheme but which cannot in fact be realized given the particular tax treatment of the scheme.

court held that in the circumstances it would be appropriate to award all the options to the holder. Waldron v. Waldron, C.A. No. 2729, 1992 Ohio App. LEXIS 5795, at *4 (Ohio Ct. App. Nov. 18, 1992).

249. PFD, supra note 2, § 5.09, at 357-58. One perspective is that the most common methods of valuing options often badly understate the value because they do not take into account the demand for the stock when it is offered on the open market. See David Leonhardt, In the Options Age, Rising Pay (and Risk): Order of Compensation Universe Reflects Pull of New Economy, N.Y. TIMES, Apr. 2, 2000, § 3, at 13. There is already some pressure from former spouses to share in "unexpected" increases in the value of retirement benefits, presumably the same problem is likely to arise where option schemes were valued improvidently. See Margaret A. Jacobs, As Workers' Pensions Swell in Value, Ex-Spouses Demand a Share, WALL ST. J., Mar. 17, 2000, at B1. In this regard, one apparently unresolved question arises from the fact an employer may be free to "reprice" the option grant in the face of a market downturn. At least two problems flow from this possibility. First, is this repriced option to be viewed as a totally new grant, so that a non-employee former spouse who was allocated a share of the earlier grant when and if it materializes loses out completely? Or, is the process to be viewed as simply "adjusting" the value of the initial grant, notwithstanding the fact that the employee, now former spouse, would have left the employer when the option went "out of the money" unless the employer repriced? Repricing now causes a "fixed" stock option to be reclassified as a "variable" option with significant accounting consequences. Under a "variable" scheme, the "costs" of the option compensation must be amortized, on a variable basis. Essentially, the cost is the difference between the strike price and the market value, as that value changes. As a result, as the stock price goes up, the "cost" of the option to the employer does as well, so that the employer's earnings will be reduced. See Anthony F. Cocco, FASB Interpretation No. 44, 70 CPA J. 22 (2000); Am. Inst. Cert. Pub. Accts., FASB Offers More Guidance on Stock Options, 190 J. ACCT. 22 (2000). This phenomenon may dissuade the employer from "repricing." Rather a new option grant may be preferable, perhaps with a shorter vesting period. Such a process, presumably, leaves the non-employee former spouse out in the cold unless the divorce carefully secures an interest in any "replacement" scheme.


251. For some examples of the impact of tax consequences on the value of options, see BLACK, supra note 229, at 187-89. Perhaps noteworthy too is the fact that an option is worth less to an investor in a higher marginal tax bracket. Id. at 187. Technically, this means that for the purposes of property division, simply giving each spouse an equal before tax share in the options will not produce an equal distribution of the assets if the spouses are not in the same tax bracket. This is particularly relevant because ordinarily during the marriage they will both be at the same marginal tax rate. As far as compensatory awards are concerned, this analysis means, in reality, with spouses in different tax brackets and income generated
Technically, these are problems outside the question of the fundamental value of the assets in the scheme. Nevertheless, they are real problems affecting the realization of the asset value. In some instances it may be possible to adjust the valuation model to deal with the underlying difficulty. For example, where the grant terms, market regulations, or tax rules delay the liquidation of the asset to beyond the point when the stock option first nominally is eligible to be exercised, it might be possible to deal with the problem simply by extending the notional period of the option for the purposes of applying the valuation formula. Sometimes, what appears to be a complication, in fact helps produce a simplifying analysis. Thus, the fact that an option may only be exercised by an employee, and then only after the divorce, means that the tax treatment resolves into his or hers alone, so that the distributable value should be the after tax benefit to that individual, not the aggregate consequences of two separate after tax treatments.

Not surprisingly, given the potential complexities of using a valuation technique like Black-Scholes, a number of courts have

252. See, e.g., In re Marriage of Frederick, 578 N.E.2d 612, 618-19 (Ill. App. Ct. 1991) (regarding options that could not be transferred except by will or laws of descent and distribution and only the employee could exercise the options).


254. See Nelson v. Nelson, 222 Cal. Rptr. 790, 794 (Cal. Ct. App. 1986). The court took the position it was only if the employee was able to demonstrate what the tax situation would be when the options were exercised that the court would be required to take the tax ramifications into account. Nevertheless, the appellate court went along with a trial court scheme to attempt to allocate some of the possible tax burden to the non-employee spouse. The appellate court took the view that the “more equitable distribution” scheme would have been to divide the options in kind and leave each party to the mercy of his or her own tax circumstance. Id. at 794. Such an approach, while expedient, is hardly equitable, given that during the marriage both parties would have participated in the benefits after a tax imposed at a common marginal rate. Some states are totally indifferent to the tax consequences. Thus, in Indiana, the court may not consider the tax consequences of exercising the option unless the tax consequences necessarily arise from the plan of distribution itself, presumably, for example, if one of the spouses was forced by the divorce decree to exercise an option and then liquidate the cash value. See Hiser v. Hiser, 692 N.E.2d 925, 927 (Ind. App. 1998). The potential gross inequity of this would seem obvious if one considers one spouse receiving $100,000 in a bank account and another being awarded offsetting options valued at $100,000 before tax, but which might quite possibly trigger a tax liability of as much as $50,000 in liquidating the value embodied in the option. Some courts find the potential tax liability too uncertain to justify treatment. Rehfeldt v. Rehfeldt, No. C-850056, 1986 Ohio App. LEXIS 5603, at *15-16 (Ohio Ct. App. Feb. 12, 1986). In contrast, some courts have recognized the need to take into account the tax treatment that will result not only from possible gains, but also from possible losses. See Chen v. Chen, 416 N.W.2d 661, 664-66 (Wis. Ct. App. 1987).
reached for a "down and dirty" solution to the valuation question.\(^{255}\)

Where an option is exercisable, a court may be comfortable with
the idea that the value of the option is the difference between the
exercise or "striking" or "strike" price and the current market value
of the relevant stock itself.\(^{256}\) This tends to be called the "intrinsic
value" method of valuation.\(^{257}\) The use of this approach starts to
become remarkable when the court adopts it with respect to options
that are not immediately exercisable.\(^{258}\) Even if the option holder
accepts at the time of trial that all the options will be exercised,\(^{259}\)
this in and of itself does not justify using the difference between the
striking price and the market value of the underlying shares as the
method of valuation. All the option holder has done is waive the
impact of contingencies affecting the ability to exercise the option,
not necessarily the impact of other contingencies and risks that
might affect the option's value.\(^{260}\)

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\(^{255}\) There is no evidence in the cases of courts being willing to use approximations that
the "street" may be comfortable with. Thus, where the stock is traded publicly, one measure
of an options value that is used is that it is worth one-third of the exercise price. See David
Leonhardt, *Technology Share Plunge Hurting Stock Options*, N.Y. TIMES, April, 19, 2000, at
C1. In *Baumer v. United States*, 580 F.2d 863, 882 n.27 (5th Cir. 1978), the Fifth Circuit
Court of Appeals noted that a study showed that extended options to purchase quoted stock
which have at least two years to run are worth forty-one percent of the option price and the
value decreases by 1/24 for each month less than two years (citing D. Bret Carlson, *Taxation
of Taxable* Stock Rights: The Strange Persistence of Palmer v. Commissioner, 23 TAX L. REV.
129, 143 n.48 (1968)). It is not clear that these study numbers would hold up under current
market conditions.

\(^{256}\) See, e.g., Richardson v. Richardson, 659 S.W.2d 510 (Ark. 1983); Knotts v. Knotts, 693
N.E.2d 962, 968 (Ind. App. 1998). One author views this as a "less than optimal approach," but,
factually, it is not clear from whose perspective. OLDHAM, supra note 197, at
§ 7.11[3][b]. The reality is that even if the option is exercisable, if the option has time to run
before it expires, that time period endows the option with additional value beyond the
intrinsic value because it permits the option holder to participate in even further appreciation
in the value of the underlying instrument. See Les Barenbaum & Walt Schubert, *Measuring

\(^{257}\) See Davidson v. Davidson, 578 N.W.2d 848, 858 (Neb. 1998).

vested, but not matured — the holder cannot currently sell the option — although his or her
entitlement cannot be denied, the option, in the view of some, may be worth its intrinsic
value, but not its full value. Barenbaum & Schubert, supra note 256, at 5.

\(^{259}\) Everett v. Everett, 489 N.W.2d 111, 113 (Mich. Ct. App. 1992). In this case most of
the options had matured, that is, they could be exercised and thus the option holder's premise
they would be exercised is more acceptable. The appellate court, however, stressed the point
those options that were not currently exercisable should not have been given the same present
value as the options that were exercisable because of the contingencies associated with the
options that had not matured. Id. The court does not make it clear, however, whether the
contingent character of the latter group meant that the intrinsic valuation technique that had
been used in connection with the bulk of the options should not be used with the residual
group, or simply that some device should be found to protect the parties' interests in the
ultimate intrinsic value. Id. at 54-55.

\(^{260}\) See OLDHAM, supra note 197, at § 7.11[3][a].
between the option value and the underlying stock value is indeed fixed, the value of the option is not simply the difference between the striking price and the market value of the stock. Nevertheless, one tends to get the impression that given the choice in choosing a method of valuation that involves a process analogous to a graduate seminar in finance — which Black-Scholes' theory-based formula seem to require — and adopting a first cut approach based on the simple difference between the striking price and the stock's market value, the courts go for the latter, let the risks be damned.

Issues of valuation also arise when dealing with restricted stock. This is particularly a problem in closely held corporations. We certainly know the purchase price and, assuming this was paid during the marriage, this represents one way of measuring the value of marital property. Indeed, because restricted stock agreements, in the event of forfeiture through premature departure from the employment, often provide for the stock to be repurchased at the

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261. This is because embedded in the option's value is the concept of its "time value," based on the option holder's limited downside risk if the stock become valueless and the fact that the holder has not tied up capital, at least to the extent of the difference between the cost of the option and the price of the underlying stock. Schizer, supra note 145, at 448.

262. Even where the underlying stock lost about ten percent of its value during the trial, which the trial referee acknowledged, and over twenty percent more between the trial and the date the decree was entered — which the appellate court on pragmatic grounds considered did not require recognition. Rehfeldt v. Rehfeldt, No. C-860056, 1986 Ohio App. LEXIS 5603, at *8, *13-15 (Ohio Ct. App. Feb. 12, 1986). Of note is that all the options were exercisable at the time of trial. Apparently nobody thought that cashing out the options was appropriate. This suggests that everyone believed that the realizable market price did not adequately reflect the value, yet the husband was left with the options, and the risk that the stock would not recover. The wife received a cash adjustment and had to live with the risk that the stock would recover. Of course, she could take the cash and go into the market and hedge against that recovery. Hedging presumably was also open to the husband. The transaction costs would be a net loss to both parties, a not unexpected outcome in a divorce case.

In Francesco v. Francesco, No. FA990171592S, 2000 Conn. Super. LEXIS 1349, at *6-7 (Conn. Super. Ct. May 19, 2000), the defendants assets fluctuated twenty million dollars during a week of the trial and the option holder filed new financial affidavits daily. Although an acceleration clause caused all the options to vest prior to the court rendering an opinion, neither at this stage of the proceedings nor in the court's judgment was the option holder required to realize the value in the options, or even to transfer a portion of the options to the other spouse - a possibility under the specific scheme. Id. at *6. Instead, after a relatively short marriage, the court made a lump sum alimony award. The implication seems to be that the volatility of the options led the court to believe that an award of the options themselves would make it difficult to ensure that justice could be done to both parties. This seems to be borne out by the fact that the court ordered the option holder to continue to file post-trial financial affidavits right up until the court rendered the opinion. Scott Brede, Stocks Play Havoc In Divorce, 26 CONN. L. TRIB., June 19, 2000.

263. Closely held corporate stock may also have to be valued where we are concerned with the valuation of options using the intrinsic valuation method. In either circumstance, it has been pointed out that, given that the shares are not publicly traded, the process may be expensive. See OLDHAM, supra note 197, at ¶ 7.11[3][a].
issuing price, they tend to solidify the use of this measure. A better measure, however, might be one related to a rate of return on the investment, or to the fair market value of the underlying assets. A few state courts have taken the view that in the case of restrictive transfer agreements or buy-out agreements in closely held corporations, the price established in the agreement will be binding for valuation purposes, either absolutely or presumptively. The majority position is that agreements will not control the value in any divorce, at least if the other spouse did not consent or was not otherwise bound by the terms of the agreement although a growing number of jurisdictions hold the terms of the stock transfer agreement is a factor to be considered. This is not totally surprising because, at least by some measures, the restricted marketability of the stock does impact its value.264

By and large though, the techniques for valuing the stock itself are well established. The problem in divorce cases, more often than not, is one of liquidity, namely how to make the payments associated with the distribution of value when the stock itself cannot be readily sold.265

The problem of illiquidity surfaces in the context of options as well. The fact that an option may not be exercisable means not only there are still risks to be faced, but also in principle the option is not liquid. In this sort of context, valuations achieved by the Black-Scholes or intrinsic methods, or any other technique may be theoretically sound but produce difficulties in the real world. This may not be a problem when it comes to property division, as the process of distributing the property may be deferred until the necessary liquidity is achieved.266

Further, in some instances, the option holder may have other assets that could be transferred (always assuming that the right degree of comfort can be achieved with the underlying valuations). Also, there is always the possibility that some secondary market will recognize the value attributed to the option by the relevant valuation technique, and liquidity will be achieved in that market. It probably is a fact of the financial world, however, the more urgent the need for liquidity, the less likely it is to be available, and this proposition probably holds true for a cash-strapped-divorce-pressured household economy as much

265. See id. at 897-98 (requiring the one spouse to pay two lump sums and $30,000 a year towards paying off an overall award of $700,000).
as any other. In such a context, the illiquidity of the incentive based compensation scheme may also produce problems in areas other than property division.

As we saw, under the ALI proposals it may become necessary after the divorce to make compensatory payments that are designed to narrow the post-divorce income gap of the former spouses. The amount payable under any such award will be a function of the anticipated income disparity. Where the potential obligor receives compensation in the form of stock options, the question arises whether the Black-Scholes or intrinsic value techniques should be used to determine at least an element of the individual's income. Some aspects of this problem have already been alluded to earlier in the article.\textsuperscript{267}

Courts have some experience regarding the relationship between the exercise of options and the generation of income in the context of determining child support. The Ohio Court of Appeals took the view the Black-Scholes model was "designed to reflect market forces under certain conditions and may not be reliable for purposes of litigation."\textsuperscript{268} Instead, that court valued the option for income determination purposes by taking the increase in value of the underlying stock during a year referenced to the date of granting of the option, \textit{but only with respect to options that were exercisable}.\textsuperscript{269} The court took the position that this approach reflected the fact that the failure to exercise the options amounted to an investment choice, which the option holder could not use to shelter his obligations to others.\textsuperscript{270} By using the date of granting the option, the court intended to avoid gamesmanship by the parties seeking to use market fluctuations to enhance or minimize the obligation.\textsuperscript{271} The court rejected the lower court's valuation

\textsuperscript{267. See supra text accompanying note 249.}
\textsuperscript{268. Murray v. Murray, 716 N.E.2d 288, 297-98 (Ohio Ct. App. 1999).}
\textsuperscript{269. Id. at 298-99. An unintended consequence of the court's analysis is that if in computing child support, or indeed "income" for other purposes, one adheres rigorously to using the notional difference between the stock price and the option exercise price, when the exercise price is higher than the stock price, the option holder has a notional loss. See Karns & Hunt, supra note 202, at 263. Should this be deducted from other sources of income in order to calculate income disparity? Arguably, at least as far as options are concerned, there is no capital at risk, and accordingly, no loss has been experienced. The same cannot be said for restricted stock. If the court is willing to force realization of appreciated stock (after the restrictions are lifted) and treat the result as income, then when the sale of depreciated stock is required, the loss, represented by the difference between the acquisition costs and the sale price must be recognized before the "benefit" of the sale to the stockholder can be determined.}
\textsuperscript{270. This approach has been criticized because it may force a sub-optimal return on the option. See Karns & Hunt, supra note 202, at 255-58.}
\textsuperscript{271. Murray, 716 N.E.2d at 299.
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This technique that had taken the difference between the stock price on a date "deemed reasonable under the facts and circumstances of the case" and subtracted from the stock price the exercise price.\(^{272}\) This amount was then divided by the number of months the option had been in existence, and was then annualized to produce an "average annual deferred income."\(^{273}\) In rejecting this approach, the appellate court took the position that for the purposes of determining income, it was only the appreciation in value of the stock during a given year that was relevant.\(^{274}\) In terms of risk allocation, the appellate court, by limiting its analysis only to exercisable options, placed the risk of selecting between investment choices on the obligor, and as a result freed the obligee from all risks associated with the option scheme itself. As far as "income" in future years is concerned, the risks of returns on as yet unrealizable options would be shared equally. This is particularly true in the context of using notional option exercise to fund child support awards, since ordinarily child support orders are modifiable. This may be just as well because a court in Tennessee, as part of its process of crafting a child support order, adopted a technique of simply averaging the yields from two prior years of exercising stock options.\(^{276}\) Indeed, another Tennessee decision suggested it might be permissible to determine the obligor's annual income for child support purposes by averaging the benefits of a one time exercise of stock options over the time the obligor had taken to acquire the options.\(^{276}\)

The Ohio appellate court's technique just described worked well in the context of that case because the employee obligor consistently received options on an annual basis, and the obligee was only entitled to participate in whatever income stream actually materialized. Technically, compensatory awards under the ALI proposal do not entitle the recipient to participate in any income stream. The award only attempts to remedy a disparity in anticipated incomes. Accordingly, in such a situation, reliance only on income that is currently realizable seems less compelling, and correspondingly, the Ohio trial court's approach has a certain aesthetic appeal, particularly where the options are awarded on an irregular basis. The appellate court's approach is practical, however. After all, unlike

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\(^{272}\) Karns & Hunt, supra note 202, at 262.

\(^{273}\) Murray, 716 N.E.2d at 296.

\(^{274}\) Id. at 296-98.


child support orders, the ALI compensatory awards are only modifiable in a limited set of circumstances. Therefore, simply basing an award on historical average returns from exercising options is potentially problematic given that a critical element in determining the returns, the market price of the underlying stock, ordinarily will be beyond the control of the employee spouse. The employee could try to hedge the market price — if he had both the skill and the resources to do so. It is most likely, however, the effect of valuing by averaging will leave the obligor alone in shouldering the risks of finding the money to fund any compensatory order.

IV. ARE THE ALI PROPOSALS AND INCENTIVE BASED COMPENSATION PACKAGES RECONCILABLE?

When it comes to the division of property on divorce, the ALI proposals envision that the fruits of the spouses' labor during the marriage will be shared equally. In principle, this should pose few difficulties when applied to incentive based compensation schemes, but the realities are otherwise. To achieve an equal division, we ordinarily have to be certain the benefit will materialize and we know what its value will be.

Incentive based compensation schemes, however, are subject to two sets of risk factors that make obtaining the necessary information problematic. First, there are market related factors that generally impinge on the value of the benefit. Where the instruments underlying the scheme are publicly traded this value is probably identifiable within acceptable limits. Where the instruments relate to a closely held corporation, or where an established market does not otherwise exist, however, it may be difficult to know the relevant values at the time of divorce. In this context, the ALI proposals, which state that the court retain jurisdiction or make a distribution on a "when and if" basis, are viable provided that the court making the distribution understands what risks are being deferred. Ordinarily, unless a market acceptable value can be identified, it is difficult to imagine how division based on anything other than equality can be consistent with the ALI proposal of equal property division. Any other scheme of division would appear to allocate the risks of a sub-nominal return disproportionately to one party or the other. This is particularly true because of the other set of risks personal to the grant recipient that is associated with these schemes. As we saw, this body of risk includes meeting the contingencies that will enable the option to vest, the possibility of employer disruption of the scheme, the tax environment of the
individual option or stockholder, and so on. Under this set of risks, both the existence of the benefit and its value may be threatened.

While the spouses were engaged in a common endeavor, facing these risks together was an inherent part of the relationship. Although both the ALI proposals and the case law favor disengaging the couple as cleanly and quickly as possible, this does not appear to be achievable when it comes to these incentive schemes, at least if one hopes to be relatively fair. Essentially, fairness would seem to require that the couple continue to be exposed to the risk environment together. Unfortunately for the non-employee spouse, the divorce itself may modify the risk environment of the incentive scheme to the non-employee claimant's disadvantage. Unlike pension benefits where a comprehensive, highly regulated infrastructure exists to ensure that the diverging interests of the non-employee claimant are adequately protected, no such pre-structured mechanism currently exists in the case of incentive based compensation packages. Isolated courts have attempted to fashion such protective structures through the use of trust-like mechanisms, with ground rules that the courts developed on an ad hoc basis. Many more courts, however, have sought to surmount the uncertainties in dubious ways, for example by assigning questionable valuations to the benefits distributed at the time of divorce. Making the distribution on an unequal basis compounds these bad practices.

Even where the court accepts the realization of the asset or underlying value is fraught with uncertainty and defers the distribution, a number of courts seem to lose sight of the fact the distribution pattern of the spouses' other assets cannot be made at the time of divorce on the basis that the incentive scheme will produce particular returns. In this regard the ALI concept of equal shares is helpful. If the entire bundle of spouses' resources are to be distributed equally, this distribution pattern can be applied without unfairness as the assets become available. If the court employs an unbalanced distribution pattern, the distribution process will be held hostage until the true benefits of the incentive based scheme materialize, or the court will face the prospect that the carefully crafted distribution plan will be undermined when the incentive package materializes, or fails to materialize. This would be a significant problem given that generally under existing law and the ALI proposals, property distributions made at the time of divorce ordinarily are not modifiable.

277. See Webster & de Lisser, supra note 3, at 146 (citing a variety of Department of Labor opinions to the effect that stock option schemes are not subject to regulation by ERISA).
When it comes to the compensatory awards proposed by the ALI, the relevant benchmark is the anticipated income divergence of the parties following the divorce. Incentive based compensation schemes are relevant here in two contexts. First, the benefits may be distributed as property, but then in due course, generate income of their own. This expected income must be known in order to make a compensatory award in the correct amount. This is not a problem if we know the value of the underlying award. As we saw, however, that may be a problem! More problematic is the situation where the incentive based scheme is viewed as a source of income to the employee spouse. In these situations it is critical to assign a value to the expected benefit. As we saw, on this issue, courts are in some trouble. The prevailing favorite approach for valuing options seems to be to rely on the “intrinsic value” of the option, a method that is as inaccurate as it is simple. Even here, however, the technique, as well as the Black-Scholes approach, does not appear to have been used as a device for forecasting income. The limited experiences courts have at this point, from the context of child support cases, seem to involve a case-by-case approach. The accuracy and coherence of the result is doubtful, and none of the techniques adopted are fit for universal application. On the plus side, contemporary awards of spousal maintenance ordinarily are modifiable, and should certainly remain so if the income in issue is a function of the performance of an incentive compensation package. Even the ALI proposal, although it frowns on modification, will tolerate it if either the obligor's or the recipient's basic income is overestimated. If the incentive based compensation scheme exceeds expectations, however, the claimant has no redress. If the excess is more than the claimant and the obligor anticipated, the claimant is not considered to be short-changed.

Finally, to the extent that the ALI proposal envisages restitutionary awards, the amount recoverable is not a function of benefits receivable under an incentive based compensation scheme. The claim exists in its own right. With a bit of luck, the employee will be able to exercise an option, or sell some formerly restricted stock and meet his or her obligations. If this is not the case, the obligation persists, and in the ALI's view this is not an unfair or inequitable result.

V. CONCLUSION

The upshot of all of this is that the ALI proposals should not be applied to incentive based compensation packages in a cavalier
manner. It is imperative the courts thoroughly understand the risks actually or presumably assumed within the marriage and how these risks manifest themselves, either in their original form or as mutated by the ALI proposals, in the various remedial devices the ALI is advancing. The courts also need to understand the incentive based scheme that is under consideration and the risks associated with it, whether market in origin, or arising from the personal circumstances of the employee.

Finally, courts have to steer clear of simplistic solutions, such as exclusively relying on the intrinsic method of valuing options, however expedient this approach may be, if the court lacks an understanding of the relationship of the proposed solution to reality. The development of the relevant doctrine is occurring in the context of marriages where there is what might be described as an “elegant sufficiency” of assets, so courts might be inclined to gloss over the possible consequences of employing a defective valuation technique or making an unbalanced assignment of risk. In an era where Congress has found it necessary to legislate the compensation of hourly paid workers should not include the proceeds from stock options when it comes to calculating the employee’s overtime pay, defective doctrine may be applied in situations where the errors matter a great deal.