

New Options at Divorce: Legislation Treats Stock
Options as Marital Property

by:

Celia G. Gamrath

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Practice Tips

This article describes the property distribution statute under the Illinois Marriage and Dissolution of Marriage Act and explains new legislation, effective last January 1, governing the classification and division of stock options upon divorce.

New Options at Divorce: Legislation Treats Stock Options as Marital Property

By Celia Guzaldo Gamrath

"The new law is consistent with the national trend to treat stock options granted during the marriage as marital property."

Salary alone is no longer enough. Over the last 10-15 years, stock options have become the fastest growing, most lucrative benefit of employment in corporate America. Start-up companies, particularly technology companies, have been generous; so they thought; in giving all levels of employees a stake in their companies (some now defunct) through stock-based incentive programs and thousands of stock options in lieu of additional compensation, a practice likely to continue even in the face of the dotcom bust and the Enron collapse.

But what does all this mean for clients in the context of divorce? Are the stock options divisible and considered "property" even if unexercised or unvested? And what is their value upon divorce?

This article outlines the provisions of the property distribution statute under the Illinois Marriage and Dissolution of Marriage Act ("IMDMA") (750 ILCS 5/101 et seq) and discusses Illinois case law involving stock options. The article also explains the recent amendment to section 503(b)(3) of the IMDMA (PA 92-0306, effective January 1, 2002), which amends the property provisions of the IMDMA by classifying stock options as marital property and providing for their allocation between spouses upon divorce.

Finally, it presents ways courts have devised to distribute and value stock options upon divorce and discusses the possibility of double-counting options as property and income for purposes of support.

Illinois property distribution statute

Section 503(a) of the IMDMA defines marital and nonmarital property for purposes

of divorce. Marital property is defined as all property acquired during the marriage by either spouse, regardless of how title is held, unless it is proven to be nonmarital by one of the ways enumerated in IMDMA section 503(a)(1)-(8). Section 503(b) creates a presumption in favor of marital property. The presumption is rebuttable, but courts will generally err on the side of finding property is marital rather than nonmarital. See *In re Marriage of Gattone*, 317 Ill App 3d 346, 352, 739 NE2d 998 (2d D 2000).

The theory advanced by section 503 and the rationale for favoring marital property is that marriage is a functional partnership. See *In re Marriage of Mahaffey*, 206 Ill App 3d 859, 866, 564 NE2d 1300, 1304 (1st D 1990). IMDMA section 5/503(d)(1) and Illinois case law specifically give credit for the homemaking services of a spouse, recognizing that his or her contribution to the actual acquisition of property may be less, but that his or her contribution to the home and the family is equally as important. This is known as the shared enterprise theory and is relied on heavily by corporate spouses, who insist it takes the joint efforts of both parties to acquire property. See, e.g., *Mahaffey*, 564 NE2d at 1305.

Upon dissolution of marriage, the court will distribute property between the parties by first classifying it as either marital or nonmarital, next assigning the nonmarital property of each spouse to its owner, and then equitably dividing the marital property after adjusting for reimbursements due for contributions between the estates of property. 750 ILCS 5/503(a)-(d). Equitable division does not mean equal division. The court, in its discretion, looks at a myriad of factors in determining what property and how much of it to award to each spouse. 750 ILCS 5/503(d).

Given the dramatic shift in employee compensation over the last 10-15 years, pensions and stock options have become two of the largest assets in many divorce cases. A pension is often started before the marriage, but during the marriage the marital estate makes contributions and is entitled to a just proportion upon divorce.

The legislature has previously recognized the right to divide pension benefits upon divorce, even when the value is not fully ascertained. 750 ILCS 5/503(b)(2). Now, pursuant to IMDMA section 503(b)(3), it has similarly recognized the right to allocate stock options as a form of marital property, regardless of whether the options are vested or unvested or whether their value can be ascertained. 750 ILCS 5/503(b)(3) (PA 92-0306 (effective January 1, 2002) (see sidebar for full text).

What is a stock option?

A stock option is defined as the right to buy a stock within a specified period at a determinable price (strike price) if the option holder chooses. A vested stock option is one that the employee may keep even if he or she leaves the company before it is exercised. An unvested stock option is one that the employee loses if he or she leaves the company before it is exercised or before it becomes exercisable.

Through the use of stock option plans, corporate America has found a successful way to increase employee productivity and satisfy shareholders

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without raising salaries or dipping into capital the company may not have. This article focuses on the grant of "risk-free" stock options to an employee as a component of compensation, rather than stock options purchased freely in the open market by an individual who takes a risk that the future market value will exceed the price at which he or she can buy the stock under the option. This distinction is critical in ascertaining the value, if any, of the option upon divorce.

Typically, employers will grant "risk-free" stock options to employees based on past, present, or future years of service or the level of performance. "The fundamental premise of these stock plans is that when an employer 'gives' an employee stock, or the right to purchase stock, the employer receives a harder working employee and the employee receives a part of the company in return; a definite *quid pro quo*." *Grandon v Amcore Trust Co.*, 225 Ill App 3d 630, 634, 588 NE2d 311, 315 (3d D 1992). In addition, stock options may offer some tax benefits that ordinary salary does not, and options may also be used upon retirement to generate a future stream of income.

Stock benefits generally increase over time, which encourages employees to remain with the company. However, there is no universal rule as to whether stock options will be considered in exchange for past, present, or future services upon divorce.

Some corporate agreements specify whether options are linked to past, present, or future services, and divorce practitioners should look at the stock option agreement, as well as the employment agreement, to see if it defines the reason for the granting of stock options. The employee's personnel file and annual reviews may also indicate whether the options were granted to reward past performance or to encourage the employee to remain with the company.

Cases on the subject vary widely, although courts are skeptical that vested and matured stock options; ones that are absolutely exercisable; are in exchange for future services, since the owner of the option has the immediate irrevocable right to exercise the option; there is no contingency on future employment.

Early Illinois case law dealing with stock options

Regardless of whether options are granted for past, present, or future service, existing Illinois case law, prior to the enactment of section 503(b)(3), held that options do not constitute property under section 503 of the IMDMA unless and until they are exercised. Until that time, they have no measurable value and the courts would not view them as marital property. *In re Marriage of Moody*, 119 Ill App 3d 1043, 1048, 457 NE2d 1023, 1027 (1st D 1983).

However, section 503(b)(3) clarifies that all stock options granted to a spouse during the marriage, whether vested or nonvested or whether their value is ascertainable, are presumed to be marital property, even if the actual division of the options does not occur until a future date.

The amendment to section 503 does not require that the options be valued at the time of judgment for dissolution of marriage, but it does mandate the court to allocate them upon dissolution to avoid a second trial. This approach not only avoids the cost and expense of a second trial on how to divide the asset post-dissolution, but allows both parties to bear the same risk that the options may become worthless or result in a windfall in the future.

In re Marriage of Evans. The Illinois Supreme Court in *In re Marriage of Evans*, 85 Ill 2d 523, 426 NE2d 854 (1981), first dealt with stock options in a dissolution of marriage case. In *Evans*, stock options were granted to the husband as compensation for services performed during the marriage. The trial court awarded the wife one-half of 527 vested shares of stock, but refused to treat the unvested shares as marital property because their receipt was contingent upon the husband's continued employment.

The appellate court reversed, holding that the unvested shares of stock were susceptible to valuation and should have been classified as marital property subject to division. Justice Barry dissented on the grounds that the unvested shares were contingent and too speculative to be considered marital property.

The Illinois Supreme Court reversed the appellate court, commenting on the problems associated with allocation of contractual rights to future income as "property" subject to division under section 503 of the IMDMA. The court stated that the personal right of an employee to receive future payments from his employer is not susceptible to being divided in the same sense that real estate or personal property may be. If the payment of benefits is contingent upon future events, such as the continuation of employment, a present award based on the discounted value of future payments to the employed spouse will prove excessive if the amount of benefits he actually receives is less than the amount assumed.

Evans was ultimately decided on the ground that the spouse seeking the apportionment failed to present sufficient evidence as to the value of the unvested shares, thereby making it impossible for the trial court to enlarge the award to her. The court reasoned, "Where one spouse has acquired a right to potential future benefits through his employment there is no way in which the other spouse may be awarded some defined interest in those benefits as marital property without a determination of the value they have to the employed spouse." *Id.*, 426 NE2d at 857.

Illinois cases interpreting *Evans*. The Illinois Appellate Court has interpreted *Evans* as holding that an award of an interest in future benefits derived from one's employment is inappropriate under section 503 when the evidence presented does not establish the present value of the benefits. For instance, in *In re Marriage of Moody*, 119 Ill App 3d 1043, 457 NE2d 1023 (1st D 1983), the court held that the husband's stock options did not constitute property and had no value until such time as they were exercised. The court stated that under the terms of the stock option agreement

the options were nontransferable, and thus the only way the husband could realize any profit was to exercise the options. However, if they expired without ever being exercised, they would have no value whatsoever.

The *Moody* court noted that the husband's deteriorating health and lack of liquid capital made it nearly impossible for him to exercise the options. Consequently, the options were viewed as having no value whatsoever and could not constitute property within the meaning of section 503 of the IMDMA until they were exercised.

Following suit, the Illinois Appellate Court in *In re Marriage Frederick*, 218 Ill App 3d 533, 578 NE2d 612 (2d D 1991), and *In re Marriage of Isaacs*, 260 Ill App 3d 423, 632 NE2d 228 (1st D 1994), also held that where there is no evidence of present value of the stock options, the court cannot properly value them or consider them to be marital property subject to immediate equitable distribution.

Rather, the court should retain jurisdiction for the purpose of allocating the proceeds from the exercise of the options if and when they are exercised. Alternatively, the court could determine at the time of dissolution the percentage share that each party would receive if and when the options are exercised, allowing the employee spouse the sole discretion whether to exercise them at all. *Frederick*, 578 NE2d at 619.

The rationale in those cases is that if the options are not transferable and the only way their value can be realized is through exercise, then options granted during the marriage should remain the "separate property" of the spouse holding the option unless and until they are exercised. "If and when the options are exercised, the trial court may at its discretion allocate an appropriate share of any profit realized from the transaction to each spouse." *Moody*, 457 NE2d at 1027.

The problem with this approach; where the court reserves jurisdiction over the options; is that it requires a second trial years down the road, which becomes costly and time-consuming for the divorced parties and raises issues about the finality of the dissolution judgment. *In re Marriage of Wisniewski*, 286 Ill App 3d 236, 242-43, 675 NE2d 1362, 1368 (4th D 1997).

Another problem is the court's unintentional use of the term "separate property." The IMDMA defines only two types of property in Illinois: marital and nonmarital. There is no "separate property" as defined by statute. The drafters wanted to make that point clear in amending section 503(b)(3) by providing that, like other property acquired during the marriage, stock options granted during the marriage are presumed to be marital property unless the option holder can prove the options are nonmarital property pursuant to section 503(a) of the IMDMA. See transcript of testimony from the Illinois House Judiciary Committee (April 19, 2001) regarding SB 433 (PA 92-0306 (effective Jan 1, 2002)); see also ISBA position statement in support of SB 433 (June 13, 2001).

Effect of the new legislation, 750 ILCS 5/503(b)(3)

Section 503(b)(3) was written to be consistent with sections 503(a) and 503(b) by providing that all stock options granted during the marriage are presumed to be marital property, not so-called separate property. It was also written to be consistent

with section 503(d) by providing that the court shall allocate the options at the time of dissolution of marriage in just proportions, considering the specific criteria set forth in sections 503(b)(3) and 503(d). And it was drafted to avoid the problems associated with a second trial, where the court is called upon to allocate the profits of the exercised stock options several years after the divorce.

It was not written, however, to require the court to engage in a complicated exercise of valuation where the task would be futile because of uncertainties as to vesting or maturation of the options. All options granted during the marriage, whether vested or not, are presumed to be "marital property" even if their value is not readily ascertainable.

Where the option's present value is difficult to ascertain, the court may simply divide the options in-kind if possible, or, if the options are not assignable, on a percentage basis, letting the parties bear equal risk associated with the speculative nature of the options.

When to allocate options. Section 503(b)(3) of the IMDMA now requires the court to allocate stock options at the time of dissolution, recognizing that the value of the stock options may not be determinable at the time of dissolution and the actual division of the options may not occur until a later date.

This method of allocating options is similar to that employed by the trial court in *In re Marriage of Frederick*, 578 NE2d at 619, where the trial court properly determined in advance that the allocation of options would be "50% of any profit from the exercise of vested stock options and 50% of the marital fraction of any profit from the exercise of nonvested options to each party."

"Marital fraction" likely refers to a variation of the *Hunt* formula, whereby the number of shares of stock that is marital property is determined by dividing the length of time from the date of commencement of employment to the date of judgment for dissolution, by the length of time from the date of commencement of employment to the date the option is exercisable, and then multiplying that by the number of shares that could be purchased on the date the option is first exercised.

Neither spouse in *Frederick* was awarded an entire interest in the options as a specific apportionment of marital property, but each would share equally in any profit realized from the exercise of the options. *Id.*

Particularly when the options are nontransferable and uncertainties exist as to vesting, maturation, and value, the method used in *Frederick* of allocating a known percentage of profits "if and when" received is preferable because it avoids a second trial on apportionment of the options. It also avoids the taking of expert evidence at the original hearing

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as to the value of the options, which may be too speculative and complicated to value.

By allocating the options according to percentage or in-kind, both parties bear the same risk that unvested stock options may never vest and that neither party will benefit from them, or that they will vest and will generate substantial profits.

Very recently, in a case of first impression, the Illinois Appellate Court in *In re Marriage of Peters*, 2001 WL 1647100 (Ill App 2d D), used the reserved-jurisdiction approach with respect to a stock bonus earned partially during the marriage. *Peters* analogized the unvested stock bonus to an unvested pension or stock option, observing that where ascription of a present value to unvested employee benefits is speculative and difficult to determine, the better approach is for the court to retain jurisdiction to allocate the proceeds if and when they are received.

Peters held, "If it wishes, the court can determine now how it will divide any marital portion of the bonus. However, the court must reserve jurisdiction and, if petitioner receives the bonus, determine then how much of the bonus is attributable to petitioner's efforts during the marriage. That portion of the bonus is marital property subject to division." *Id* (emphasis added). Section 503(b)(3) now gives the court no choice; it must determine at the time of judgment for dissolution of marriage how to divide the marital portion of stock options. *Peters* was decided before the effective date of section 503(b)(3). It also involved a stock bonus, not options.

How To Allocate Options. Under section 503(b)(3) the court has discretion to decide how the allocation of options should occur and which spouse should be awarded a greater share, if any. In allocating stock options, the court must consider all the factors of section 503(d) in addition to all circumstances underlying the grant of the stock option, including but not limited to whether the grant was for past, present, or future efforts, or any combination thereof, as well as the length of time between the grant of the option and when it becomes exercisable.

If your client is the option holder, you will likely want to take the position that not all the stock options granted during the marriage were issued for services performed during the marriage; rather, they were for premarital or post-divorce services. The longer and harder the employee has to work to reap the benefit of the options after divorce, the greater his or her individual contribution is to the acquisition of such property and the greater his or her share should be. Also, where the option holder does not have a contractually enforceable right to the options or fails to complete the years of service required to enforce the right, the options constitute mere expectancies, not property subject to equitable distribution. See *In re Marriage of Balanson*, 25 P3d 28 (Colo 2001).

On the other hand, if the option holder has had to work a long time during the marriage to acquire the options, the nonemployee spouse should share equally in the benefits, and the options should be treated the same as any other property acquired during the marriage; as marital property; regardless of the date of maturity. (The date of maturity is the date on which the employee can in fact exercise the option. It is usually the same as the vesting date, though the actual maturity date may be later than

