Divorce – The Valuation and Division of Stock Options

by

Sanford K. Ain, Esquire
Darryl A. Feldman, Esquire
AIN & BANK
1900 M Street, NW, Suite 600
Washington, D.C. 20036-3565
202-530-3300

Prepared for the Virginia Trial Lawyers Association
Appears on the American Association of Matrimonial Lawyers Web site – aaml.org

The classification and valuation of employee stock options often present a difficult area to negotiate in marital dissolution settlements. The difficulty stems primarily from the underlying nature of employee stock options and the varying circumstances under which such options are granted by an employer to an employee. Consequently, it is imperative that certain factors are determined before any practitioner can begin to classify and value employee stock options for settlement purposes. The key factors to consider are the following: (1) whether the options were granted before the marriage, during the marriage pre-separation, after separation or after the date of divorce; (2) whether the options vested during the marriage, after separation or after the date of divorce; (3) whether the options become exercisable during the marriage pre-separation, after separation or after divorce; (4) whether the options contract established any specific limitations; and (5) whether the employer granted the options to the employee as compensation for past services, an inducement for future services, or as a payment for both past and future services.
The last factor bears special consideration, as oftentimes, the purpose for granting employee stock options can only be resolved following an intensive fact-based analysis of the specific terms of the option contract and the employer’s underlying motives for awarding the options. Once these factors are considered, the prevailing property distribution statutes and case law must be addressed to determine whether the options should be classified as marital or separate property; and if marital property, the manner in which the non-titled spouse should be compensated.

A. DEFINING EMPLOYEE STOCK OPTIONS

A stock option is the right to buy a designated stock, if the holder of the option chooses, at any time within a specified period, at a determinable price, or to sell a designated stock within an agreed period at a determinable price. An option to buy a stock is termed a "call", an option to sell is called a "put", and an option to do either is called a "straddle." Employee stock options are invariably call options because they provide a stake in the positive performance of the company. Put or straddle options would give rise to counterproductive incentives. Accordingly, when this article uses the term "option" or "employee option" it is referring to call options.

The determinable price at which the employee may buy the underlying stock pursuant to the option is deemed the “exercise” or “strike” price. Any sum paid to acquire the option in the first place is called the "premium." Typically, though, employers give employees options without requiring them to pay any premium whatsoever in consideration of their past, present or future work efforts.

---

1 See In re the Marriage of Hug, 201 Cal. Rptr. 676 (1984). Generally, options that are intended as a reward for services previously performed by an employee are treated as compensation for past services. Options that are granted to an employee as an incentive for the employee to remain with the company and work productively are treated as compensation for future services. Finally, options that are conferred as a means of providing additional compensation to an otherwise undercompensated employee are treated as deferred compensation for present services.

2 Richardson v. Richardson, 659 S.W.2d 510, 512-513 (Ark. 1983); see also 7 Stand. Fed. Tax Coordinator (CCH) ¶ 19,611.015
For employee stock options, at the time of exercise, the company will issue to the holder either treasury stock or authorized, but previously unissued, shares of stock. Publicly traded instruments with these characteristics are referred to as “warrants.” By contrast, in the publicly traded market, instruments called “options” are issued by third parties rather than the company itself and backed by already outstanding shares of stock. However, it is common convention to refer to instruments with the characteristics of warrants as “options” when issued to employees. Accordingly, this article will also use the terms “employee options” or “options” when referring to such instruments.

Options where the fair market value of the stock is above the strike price are considered to be “in the money.” A strike price that is equal to the price of the underlying stock price means that the option is “at the money.” Those options whose fair market value is less than the strike price are “out of the money.”

There are some key dates that must be considered in all stock options cases. The “grant” date is the date on which the company gives the employee the options. Upon the “vesting” date, the employee receives an irrevocable right to keep the options until expiration. When the options reach their “exercise” or “maturity” date, the employee gains the ability to purchase the underlying stock for the strike price. Finally, the “expiration” date is the last date on which the employee may exercise the options.

B. TYPES OF EMPLOYEE STOCK/EARNSINGS BASED COMPENSATION PLANS

Stock options are but one of the various types of employee stock/earnings compensation plans available to employers. Each one has its own unique features and potentially raises different issues upon marital dissolution. Practitioners should carefully consider the applicability or inapplicability of general stock options case law to each type of plan that they encounter.

3 Id. at 613.
1. **Statutory Stock Option Plans.**

Employee stock options are classified either as statutory or non-statutory stock options. Statutory stock options meet the requirements set forth under IRC (26 U.S.C.) § 422 or § 423 and are generally not taxed until the owner disposes of the stock acquired through the exercise of the options; any gains therefrom are taxed as capital gains rather than as ordinary income. There are two types of statutory stock option plans: 1) Incentive Stock Option (ISO) plans also referred to as § 422 plans and 2) Employee Stock Purchase plans also referred to as § 423 plans.

In order to qualify for favorable tax treatment, an Incentive Stock Option plan must meet the technical requirements of § 422 at all times from the commencement to the end of the plan. Significant features of an incentive stock option plan include the following: 1) the grantee of the option must be an employee; 2) the stock received must be that of the company; 3) there must be a written plan document; 4) there must be shareholder approval of the plan; 5) the options must expire no more than ten years from grant; 6) the exercise or strike price must be no less than the fair market value of the underlying stock at the time of grant, i.e., the options must be issued at the money; 7) the options cannot be transferred except in the event of the death of the employee; 8) options on underlying stock worth no more than $100,000 as measured by the fair market value at the time of grant may vest in any one year; and 9) the employee may not dispose of the stock received after exercise for a holding period which is the later of one year from the date of exercise or two years from the time of grant or else he or she will lose favorable tax treatment.

By contrast, § 423 Employee Stock Purchase Plans provide corporations with the flexibility to set an exercise price that puts the options in the money. The exercise price may be as low as 85% of the fair market value of the underlying stock at grant. However, the trade off is that the corporation must make

---

5 Stand. Fed. Tax Coordinator (CCH) ¶ 19,611.011.
6 Id.
the plan available to virtually all employees and confer them with the same rights and privileges under the plan. Unlike §423 plans, § 422 plans may be restricted at the company’s election to a limited number of key employees. For § 423 plans, the annual limit on the amount of underlying stock upon which options can vest is only $25,000 in stock as measured by the fair market value at the time of grant. As well, the duration of the grant is limited to five years rather than ten. Otherwise, § 423 plans share many of the same technical requirements as § 422 plans.8

2. Nonstatutory Stock Option Plans.

Non-statutory stock options are governed by IRC (26 U.S.C.) § 83 and are taxed as ordinary income at the time they are granted if they have a readily ascertainable value; or, if they do not, at the time the owner exercises, sells, or otherwise disposes of the options.9 These plans generally do not have to meet the technical requirements set forth in IRC (26 U.S.C.) §§ 422 and 423. Corporations have the ability to issue options in the money with a set strike price of even less than 85% of the fair market value of the underlying stock at the time of grant. Option plans with an exercise price which puts them in the money are termed discounted nonqualified (nonstatutory) stock option plans.

Nonstatutory options do not qualify for the favorable tax treatment given statutory plans. Provided that the option has a readily ascertainable value at the time of grant, the employee is taxed the difference between the strike price and the fair market value as ordinary income at the time of grant. If there is no readily ascertainable value at the time of grant, then taxation is deferred until the time of exercise.10 If there is still no readily ascertainable value in the option at exercise, then, ordinary income taxation may be deferred until the employee sells or disposes of it. The fair market value at the time of taxation

7 BNA, Tax Management Portfolios, # 381, Statutory Stock Options, pp. A1-8; IRC (26 U.S.C.) § 422 (set forth in full in the appendix to this article).
8 Id. at A-14(3)-17; I.R.C. (26 U.S.C.) § 423 (set forth in full in the appendix to this article).
9 7 Stand. Fed. Tax Coordinator (CCH) ¶ 19,611.011.
10 IRC (26 U.S.C.) § 83(e); see also BNA, Tax Management Portfolios, # 382, Nonstatutory Stock Options, pp. A1-22. If upon the time of exercise, the stock is still subject to substantial restrictions and/or forfeiture (i.e., it is unvested) taxation is deferred until vesting which may be even further into the future. However, with restricted or forfeitable options, the employee has the option to make a § 83(b) election at the time of grant. A § 83(b) election taxes the difference between the fair market value and the strike price as ordinary income at the time of grant rather than upon vesting. Any subsequent appreciation receives capital gains treatment. Of
establishes the employee's basis in the stock. Any further gain above the basis amount that the employee realizes upon sale or other subsequent disposition of the stock is taxed at capital gains rates.

3. Other Types of Plans.

There are many creative ways for companies to provide their employees with stock or incentive based compensation. Several types of plans that do not involve options bear mentioning.

Restricted stock grants give the employee actual shares of the company stock at the time of grant. The employee immediately receives dividend rights, voting power and other incidents of share ownership. However, the shares bear a substantial risk of forfeiture. Typically, like most stock option plans, restricted stock grants base their vesting schedule on a required term of employment with the company. The value of the stock grants less any amount the employee must pay to purchase them is deemed ordinary income. Again, due to the substantial risk of forfeiture, the employee has the flexibility to defer paying the tax until the time of vesting. In the alternative, the employee can elect § 83(b) treatment at grant and convert any subsequent appreciation into capital gains.

Phantom stock programs give the employee rights pegged to hypothetical shares of stock. These rights can be tied to the performance of the actual fair market value of the company stock, the book value of the company or some formula based upon earnings. During the life of the plan, they can provide the employee with payments based upon corporate dividends. However, they do not confer voting rights. Upon cashing-out, they oftentimes provide the employee the full value of the stock at grant plus any subsequent appreciation. Payment can be in the form of cash or actual stock. These plans are only taxed at the time the employee cashes-out or realizes the benefits. At that time, they receive ordinary income treatment. A §83(b) election, though, is not available.

Phantom stock plans that provide the employee with only the increase in value of the stock from the time course, the employee, bears the risk of having paid income tax, yet, still forfeiting the option later, for instance, by not remaining employed with the corporation for the requisite time period.
of grant are termed Stock Appreciation Rights (SAR) plans. Again, payment can be in the form of stock or cash. SAR plans receive the same tax treatment as other phantom stock plans.\(^{12}\)

Another variation of the phantom stock plan is the performance unit plan. Rather than tying the amount the employee receives under the plan to the stock price, these plans are pegged to particular accounting measures of company performance. Sometimes, these measures are incentives specifically aimed at the employee's company division or, in some cases, the employee's particular job. Like other phantom stock programs, the performance unit is taxed as ordinary income only upon exercise.

**C. THE CLASSIFICATION OF STOCK OPTIONS IN VIRGINIA**

In Virginia, all assets, including deferred compensation, acquired during the marriage by either spouse, and before the last separation of the spouses, are treated as marital property in the absence of satisfactory evidence showing that the assets are separate property.\(^{13}\) Virginia’s equitable distribution statute is “based on the notion that marriage is an economic partnership in which the parties, through varying contributions, monetary and nonmonetary, to the acquisition, maintenance, and care of property and to the well-being of the family, may accumulate marital wealth.”\(^{14}\) To this end, Virginia case law has thus far considered the issues of classifying employee stock options that are: (1) granted during the marriage, but not vested and not exercisable at the time of the spouses’ separation, (2) granted during the marriage, vested and exercisable at the time of the spouses’ separation, but not exercised, and (3) granted after the last separation of the parties.

1. **Employee Stock Options Granted During Marriage, But Not Exercisable At The Time of Separation.**

---

\(^{11}\) BNA, Tax Management Portfolios, # 382, Nonstatutory Stock Options, pp. A51.

\(^{12}\) *Id.* at A42-43.


In *Dietz v. Dietz*, 17 Va. App. 203, 436 S.E.2d 463 (1993), one of the few Virginia cases that discusses stock options, the Court of Appeals of Virginia determined that deferred compensation in the form of stock options should be treated like a pension, profit sharing, or deferred compensation plan and considered under the provisions of Virginia Code Ann. § 20-107.3(G)). Consequently, employee stock options granted during the marriage as deferred compensation are treated as marital property. This is the case even where the options have not been exercised during the marriage.

In *Dietz*, a spouse received employee stock options that vested and became exercisable at different times following a specified period during which the spouse had to remain an employee of his employer. Some options were exercisable before the parties separated, some were exercisable before the hearing on the divorce, and others were exercisable following the hearing date. The trial court treated the stock options in a manner similar to a pension and ruled that 53% of the marital share of the options should be paid to the wife whenever those options were exercised in the future.

Virginia defines "marital share" as "that portion of the total interest, the right to which was earned during the marriage and before the last separation of the parties, if at such time or thereafter at least one of the parties intended that the separation be permanent."¹⁵ Essentially, in *Dietz*, although the issue was not in dispute in the appeal, the court approved the use of a "time rule" running from the date of grant. The court stated that the marital portion of the unvested options granted during the marriage, but maturing after the date of separation, is a fraction “the numerator of which shall be the number months the [husband] was covered by the identified plan prior to [the date of separation], and the denominator of

---

which shall be the total number of months the [husband] is covered by the plan.”\textsuperscript{16}

In finding that the stock options were deferred compensation that should be treated under Virginia Code Ann. § 20-107.3(G),\textsuperscript{17} the Court stated that the legislature expressly intended to treat uniformly all plans of compensation, whether payable upon retirement or not, if the payment is deferred to the future, but earned during the marriage.\textsuperscript{18} The Court of Appeals, however, reversed the trial court and remanded the case because it found that the trial court exceeded its authority under § 20-107.3(G) by awarding the wife more than 50% of the options.

2. Employee Stock Options Granted During Marriage And Exercisable At the Time of Separation But Not Exercised.

In \textit{Donohue v. Donohue}, No. 2675-96-2 (Va.Ct.App. July 8, 1997), 1997 WL 374817 (unpublished), the Virginia Court of Appeals held that the full value of employee stock options should be treated as marital property if, during the marriage, the spouse earned the options and became fully vested of the unconditional right to exercise the options. In this case, Mr. Donohue, during his marriage, received options from his employer that were not exercisable until one year after they were granted. At the time of the equitable distribution hearing, Mr. Donohue had not exercised any of the options, all of which were

\textsuperscript{16} Dietz, supra, 17 Va. App. at 213.
\textsuperscript{17} Va. Code Ann. § 20-107.3(G)(I) states that: The Court may direct payment of a percentage of the marital share of any pension, profit-sharing or deferred compensation plan or retirement benefits, whether vest or nonvested, which constitutes marital property and whether payable in a lump sum or over a period of time. The court may order direct payment of such percentage of the marital share by direct assignment to a party from the employer trustee, plan administrator or other holder of the benefits. however, the court shall only direct that payment be made as such benefits are payable. No such payment shall exceed fifty percent of the marital share of the cash benefits actually received by the party against whom such award is made. “Marital share means that portion of the total interest, the right to which was earned during the marriage and before the last separation of the parties, if at such time or thereafter at least one of the parties intended that the separation be permanent.

\textsuperscript{18} Dietz, supra, 17 Va. App. at 214.
vested in Mr. Donohue prior to the parties’ separation. Citing Dietz, Mr. Donohue argued that the marital share of the options was only a fraction of their total value and therefore the trial court’s award of 50% of their total value violated Virginia Code Ann. § 20-107.3(G)(1).

Disagreeing, the Court distinguished Dietz by stating that, under the facts in Dietz, the employee’s right to exercise the option grant was conditioned upon his continued employment; thus, a portion of the option grant was earned after the parties’ separation and was not marital property. In Dietz, a portion of the option grant had not vested before separation. By contrast, in Donohue, the entire grant had vested even though the husband had not yet elected to exercise his rights. Finding that Mr. Donohue’s reliance on Dietz was misplaced, the Court said that, at the time of Mr. Donohue’s separation, all of Mr. Donohue’s options were fully vested, and he could exercise any or all of them. Therefore, the Court found that the full value of the options was marital property, and Mr. Donohue’s wife was entitled to 50% of the proceeds earned upon the exercise of the stock options.

3. Employee Stock Options Granted After The Spouses’ Last Separation.

In Virginia, there is a presumption that property acquired by a spouse after the last separation of the parties is separate property.19 In Dietz, the court stated in dicta:

While Va. Code § 20-107.3(A)(2) does not expressly state that property acquired after the last separation shall be presumed to be separate property, it necessarily follows that if the marriage partnership is presumed to have ended as of the date of the last permanent separation, in order for property acquired after that date to be classified as marital, the party so claiming will have the burden of proving without the benefit of a presumption, that is was acquired while some vestige of the marital partnership continued or was acquired with marital assets. Thus, if the party with the burden of proving that the property is marital fails in his or her burden, then necessarily, the property acquired after the marital partnership ended is separate property.20

---

19 See Dietz, 17 Va. App. at 211-212, 436 S.E.2d at 469.
20 Id.
Applying the rationale in Dietz, one may reasonably conclude that stock options which are granted by an employer to a spouse after the last separation of the parties should be deemed to be separate property, particularly if the purpose of the grant was to compensate the employee for future services. Similarly, to the extent that unvested stock options are granted solely on the basis of work after the marriage, they should be considered separate property as well. Perhaps, this scenario may be best analogized to Luczkovich v. Luczkovich, 26 Va. App. 702, 496 S.E.2d 157 (1998), a case which held that severance pay received after a marital dissolution is separate property where the severance pay was not payment for work during the marriage.

This rationale was implemented in Gardner v. Gardner, 1994 WL 1031481, decided on December 21, 1994. In Gardner, the wife was granted options approximately one month after the last separation. At the trial, the wife testified that the options were granted to her as a “welcome” to the new company. The court concluded that the options were granted as an incentive for future services and held that the options were the wife’s separate property.

By contrast, in Ott v. Ott, 2001 WL 32675, decided January 16, 2001, the husband failed to prove to the court that the grant of stock options he received after the last separation was not for services performed prior to the separation. To the contrary, the husband testified that he thought the grant was a result of a very successful project that contributed to the award of a contract to his employer before the date of the last separation. The Court apportioned the options 2/3 marital and 1/3 separate property to reflect the periods of time in which the options were earned.

D. THE CLASSIFICATION OF STOCK OPTIONS IN THE DISTRICT OF COLUMBIA

21 This case is not for publication. See Va. Code 17.1-413.
There are no District of Columbia cases that deal with stock options in the context of marital dissolution. However, *Powell v. Powell*, 457 A.2d 391 (D.C. 1983) serves as a useful analogy. *Powell* concerned the division of shares of stock acquired through an employee stock purchase plan. The employee spouse had the right to purchase shares of stock in lieu of a percentage of her income. She purchased one block prior to separation. After the separation, but before the date of divorce, she also acquired another block of the company’s stock through the plan.

At the conclusion of the trial, the court equitably distributed the stock acquired before the separation between the employee spouse and the non-employee spouse equally. As for the post separation stock acquired by the employee in lieu of salary, the trial court awarded it all to the employee spouse.

The non-employee spouse appealed arguing that the trial court had applied the wrong date for the cutoff of the accumulation of marital assets: the date of separation rather than the date of divorce. In affirming the trial court, the District of Columbia Court of Appeals pointed out that the date of separation, while not acting as a cutoff for the marital estate, is a legitimate equitable factor. Here, after separation it could safely be assumed that the non-employee did little or nothing to contribute to the employee spouse’s success on the job. It should be noted, though, that the non-employee spouse apparently did not raise the argument that at least a portion of the post separation stock may have been in recognition of past job performance that occurred prior to separation.

E. CLASSIFICATION OF STOCK OPTIONS IN MARYLAND

1. Employee Stock Options Granted During Marriage, But Not Exercisable At The Time of Divorce.

In *Green v. Green*, 494 A.2d 721 (Md. App. 1985), the Maryland Court of Special Appeals held that

---

22 *Powell*, supra, 457 A.2d at 393; see also *Wendt v. Wendt*, 757 A.2d 1225 (Conn. App. 2000) (holding that although Connecticut uses the date of dissolution of the marriage as the cutoff for the marital estate, the date of separation was a significant equitable factor and the trial court properly awarded all post separation employee stock options to the employee spouse where the non-employee spouse contributed little to the post separation work effort).
employee stock options granted during the marriage constitute marital property. This is the case irrespective of whether the options will become vested as of the date of divorce, the cutoff date for the accumulation of the marital estate in Maryland. The Court reasoned that the contingent benefit that attaches to unvested, unexercisable stock options is akin to that of an unvested pension benefit which it also considers to be marital property.

In examining the methods available to the Court in awarding the benefits of options to the non-titled spouse, the Court of Special Appeals commented that a Court may not adopt an approach to the equitable adjustment of property which would operate to compel the option holder to exercise options, since to do so would in effect deprive him of the essence of his property interest; that is, the right to make a choice regarding the exercise of the options. Accordingly, if the Court were to grant a monetary award based upon the intrinsic value of the options, which award could only be satisfied by compelling the titled spouse to liquidate options, such an award would likely be held invalid by the Maryland Court of Special Appeals.

Rather, the Court of Special Appeals held that the trial court “may in its discretion, however, adopt an ‘if, as and when’ approach to the valuation and equitable distribution of the unexercised options...” Under the “if, as and when” approach, the non-employee receives his or her awarded percentage of options or their value upon the employee spouse’s exercise or sale of the options. The main advantage of this method, particularly if it applies after sale, is that it takes all of the guess work out of the valuation process. Presumably, a true fair market value is established by a motivated and willing buyer and seller. It avoids a battle of experts. On the downside, it works against finality and entangles the parties further.

---

23 Green, supra, 494 A.2d at 728-729.
24 Id. at 729.
25 Id.
into the future. It also presents potentially significant enforcement problems. In order to protect his or her interests, the non-employee spouse would have the burden of insisting upon regular financial disclosure.

2. Preemptive Stock Options.

A pre-emptive option to purchase stock, however, is not considered to be marital property in Maryland. In Ross v. Ross, 600 A.2d 891 (Md. App. 1992), the employee spouse was a principal in a closely held corporation. As is a common feature of closely held businesses, the employee spouse, like other principles in the company, held a pre-emptive right to buy the shares of a departing principal in the event of a triggering event: death, retirement, termination of employment or the desire of the departing principal to sell or otherwise dispose of his or her shares of stock in the company.\(^{26}\)

The Court of Special Appeals held that such a pre-emptive right is simply too speculative to qualify as marital property.\(^ {27}\) It constitutes a mere possibility. Although the unvested options involved in Green were contingent upon continued employment, they were considered reasonably likely to be realized. Whether a terminating event would occur before the employee sold his own shares in the company, though, was deemed far too uncertain.

3. The Direct Transferability of Employee Stock Options.

Generally, Maryland law does not allow the direct transfer of property titled in one spouse’s name to the other spouse upon marital dissolution. The only mechanism available to account for the value of such

\(^{26}\) Ross, supra, at 893.

\(^{27}\) Id.
property to the extent that it is part of the marital estate is to make an offsetting monetary award to the non-titled spouse. An exception to this rule is Md. FL § 8-205(a) which like its Virginia counterpart, Va. Code Ann. § 20-107.3(G), allows for the direct award to the non-titled spouse of the marital share of a pension or other deferred compensation plan.

It is still an open issue in Maryland whether unvested options qualify as a deferred compensation plan subject to direct transfer. However, *Klingenberg v. Klingenberg*, 675 A.2d 551 (Md. 1996) indicates that they probably are deferred compensation.

In *Klingenberg*, the employee spouse had received actual shares of stock pursuant to a restrictive stock grant. If the employee failed to satisfy the conditions of the grant including sufficient tenure of employment with the company, he would be required to sell to the stock back to the company on unfavorable terms. On the other hand, if he satisfied all the terms of the restriction, he would have the right to sell the stock to the company at a very favorable price. The Court held that this ability to realize significant income on the sale of stock to the company in the future made it deferred compensation within the ambit of Md. FL § 8-205.28

The rationale in *Klingenberg* appears to make stock options deferred compensation under the Maryland statute as well. Practically speaking, though, most employee stock options grants contain substantial restrictions on the transferability of the options themselves. Therefore, courts would be reluctant to order direct transfer of options because it would likely result in forfeiture of the options.29

---

28 *Klingenberg*, supra, 675 at 555.
29 *Monitor Technology, Inc. v. Hetrick*, 141 Cal. Rptr. 711 (1987) (where transfer of options is restricted, non-employee spouse not entitled to transfer of options themselves; transfer of a share of the marital value of the options as a monetary award was sufficient).
F. CLASSIFICATION OF STOCK OPTIONS IN OTHER JURISDICTIONS

Because there is not a substantial body of case law in Virginia, the law as it has developed in other jurisdictions should be considered where different facts and circumstances are presented or where an allocation of the marital and separate property must be determined.

1. Employee Stock Options Granted Before Marriage And Exercised To Acquire Stock During the Marriage.

At times, a spouse will enter into a marriage having already been granted stock options which will vest during the marriage. The court is faced with the issues of whether the options granted before the marriage are for services performed prior to or after the marriage, and if the options were granted for services performed prior to the marriage, whether the funds used to exercise the options were separate or marital funds.

In In re Marriage of Reiner, 854 P.2d 1382 (Colo. Ct. App. 1993) the court found that stock acquired during marriage through options granted to a spouse prior to marriage was marital property in the absence of evidence that separate funds were used to purchase the stock. The Court concluded that even if the options were the separate property of a spouse, the stock acquired by exercising the options during marriage would not be characterized as separate property if marital funds were used to exercise the options.

In Demo v. Demo, 101 Ohio App.3d 383, 655 N.E.2d 791 (1995), the Court of Appeals of Ohio ruled that a stock option given in recognition of employment prior to marriage, and which was not exercised through the use of marital funds, is separate property. There, the husband was awarded stock options shortly
following his marriage based on his job performance prior to marriage. The Court determined that the stock option was not earned during marriage. In support of this conclusion, the Court noted that the stock option plan agreement indicated that it was intended to provide special recognition and potential long-term value to key employees.

In *Dunavant v. Dunavant*, 986 S.W.2d 880 (Ark.App. 1999), the husband was granted four sets of options prior to the marriage all of which he exercised after the marriage. While the court ruled that options exercised after the marriage with separate property maintained their character as separate property, the court did not transmute all the options that were exercised after the marriage with marital funds into marital property. It granted the wife an interest in such stock to the extent that marital funds were expended to purchase the stock, but did not extend to the wife the benefits the husband acquired before the marriage from ownership of such stock. Prior to the marriage, the husband was granted 1,200 shares of stock with a strike price of $8.47 per share. The market value on the exercise date, after the marriage, was $30.56 per share, an increase of $22.09 per share. In exercising the options, the husband paid $10,164 (1200 x $8.47). The court ruled that the husband is entitled to receive as premarital property the difference between the strike price (the purchase price granted in the option) and the market price the parties would have paid for stock without the option. Thus, the court reasoned that had the parties spent $10,164 for stock at the market price of $30.56, they would have only been able to purchase 332.5 shares of stock. Therefore, the difference between the 1,200 shares of stock and 332.5 shares of stock, or 867.5 shares of stock, was husband’s premarital property.

2. **Stock Options Both Granted and Vesting During the Marriage.**

Options granted during the marriage which both vest and mature before the cutoff date qualify as another
form of compensation for marital work effort. Therefore, regardless of whether they are actually exercised or not before the cutoff date, they are entirely marital property. This view has received virtually universal acceptance in every jurisdiction which has considered the issue.\(^\text{30}\)

Once stock options reach their vesting date, they become irrevocable. Because they can no longer be taken back by the company, they do not provide a substantial incentive for future work efforts. Therefore, courts usually deem vested options to be in consideration for work efforts that predated the vesting date.\(^\text{31}\)

3. **Stock Options Granted During The Marriage But Vesting After Divorce.**

Even if stock options vest after the cutoff date for the accumulation of marital property, it is rarely the case that a grant made during the marriage is not at least in part a reward for work done during the marriage from the time of grant to the end of the marriage. A small minority of jurisdictions have held that such options are not marital property.\(^\text{32}\) They reason that since the options are not an irrevocable right and have no value in the marketplace, they do not constitute property. They are merely contingent expectancies that are personal to the holder. Accordingly, they are not part of the marital estate.

Most jurisdictions which have considered this issue appear to follow the philosophy established by the Virginia Court of Appeals in *Dietz*. They consider the portion of the options that are attributable to work effort before the cutoff date to be marital property.\(^\text{33}\)

In *Garcia v. Mayer*, 920 P.2d 522 (N.M. Ct. App. 1996), the Court of Appeals for New Mexico stated that the community had an interest in Husband’s unvested options to the extent that the ultimate vested rights were earned by Husband’s labor during the marriage. The court noted that an inquiry must be made

---


regarding whether the options granted during the marriage represented work performed prior to the grant of the options or whether the stock option rights granted during marriage were granted solely as an incentive for future employment and effort. If the latter is true, then the marital property share of the options should reflect only the length of time from the date of option agreement until the cutoff date for the accumulation of marital property. Interestingly, the court in this case, in computing the amount of post divorce labor necessary to acquire the vested options, used the period of time representing the date of divorce to the option vest date per the stock option agreement, even though the options vested prematurely one day after the date of divorce.

In *In re Marriage of Short*, 890 P.2d 12 (Wash. 1995), the Washington Supreme Court considered how to divide stock options which were granted to the employee spouse during the marriage, but vested after the cutoff date for acquiring marital property. The Court held that a vested stock option is acquired when granted. An unvested option must be analyzed to ascertain whether the option was granted to compensate the employee for past, present or future employment services. A specific fact finding inquiry was mandated in every case to evaluate the circumstances surrounding the grant of the option. The Court found that a “time rule” is to be applied to stock options vesting after the parties separated, where the option award was based at least in part on future efforts. The Court further found that stock options awarded for future services, which vest after the cutoff date for acquiring marital property, are deemed to be separate property.

4. Stock Options Granted After the Cutoff Date for Past Services During the Marriage.

In *Pascale v. Pascale*, 660 A.2d 485 (N.J. 1995), the Supreme Court of New Jersey declared that vested stock options awarded shortly after the filing of the divorce complaint, but obtained as a result of efforts

---

expended during the marriage, should be subject to equitable distribution. The Court reasoned that stock options, like pension benefits, are a form of deferred compensation for efforts expended during the marriage, and therefore, should be recognized as marital assets. Because the options were vested immediately and provided an irrevocable right of ownership, it would be difficult to argue that they represented compensation for future services. Accordingly, they had a substantial marital component.

In *Goodwyne v. Goodwyne*, 639 So.2d 1210 (La.App. 4 Cir. 1994), the parties entered into a separation agreement and were subsequently divorced in 1985. In 1992, the former wife discovered that her former husband had been granted stock options after the dissolution of the marriage and filed a petition with the court asking that such options be equitably distributed. After making a finding that the options were related to employment services during the marriage, notwithstanding that they were granted after the dissolution of the marriage, the court equitably distributed such options.

**G. THE DETERMINATION OF THE MARITAL PORTION OF EMPLOYEE STOCK OPTIONS**

To determine the marital portion of employee options most jurisdictions apply a “time rule” or “coverture” formula. Courts also frequently use this concept to divide pensions. The coverture formulas generate the marital share through the use of a fraction. A typical coverture fraction makes the numerator the amount of time from the grant (provided it was during the marriage) to the cutoff date for the accumulation of marital property. The denominator is usually the amount of time from grant to the time that the option becomes exercisable.

---

34 *Id.* at 489.
35 See also, *Goodwyne v. Goodwyne*, 639 So.2d 1210 cert. denied 645 So.2d 211 (La. 1994) (same).
Virginia utilizes the definition set forth in Dietz, supra, which defines "marital share" as "that portion of the total interest, the right to which was earned during the marriage and before the last separation of the parties, if at such time or thereafter at least one of the parties intended that the separation be permanent."38

A recent Maryland stock options appeal, Chimes v. Michael, 748 A.2d 1065 (Md. App. 2000) touches on the subject of the time rule. Unfortunately, the case was dismissed on other procedural grounds.39 The Court of Special Appeals never reached the merits of the coverture issue.

Nevertheless, the trial court’s allocation of the unvested stock options bears mentioning. It awarded the options on an if, as and when basis. Here, though, in a departure from the general rule, to determine the denominator of the coverture fraction, the court applied the “Bangs formula.”40 Accordingly, instead of making the denominator the total number of years from grant to maturity, the trial court made it the total number of years from grant to actual exercise.

This formulation gives the non-employee spouse the potential to dilute the marital share of the options by

39 The non-employee spouse sought to challenge the trial court’s allocation of the employee spouse’s unvested stock options. Prior to the filing of briefs, though, the non-employee spouse accepted full payment of the trial court’s monetary award. The Court of Special Appeals dismissed his appeal of the stock options allocation because his acceptance of payment of the monetary award meant that he was deemed to have acquiesced to the trial court’s judgment.
40 So named after the leading case of Bangs v. Bangs, 475 A.2d 1214 (Md. App. 1984). Bangs concerned the division of pensions. In formulating its coverture fraction to determine the marital share of a pension for an “if, as and when” distribution, it made the numerator the number of years of marriage while covered under the pension plan. The denominator, however, would be the total number of years that the employee spouse worked while covered by the plan. Thus, the denominator would be subject to change. By working longer, the employee could dilute the non-employee’s share.
holding them longer before exercise. Although the Maryland Court of Special Appeals never got to address this issue, at least one trial court has accepted this formulation.

All of the above formulations of the coverture formula assume that unvested employee options are in consideration only for services performed from the grant date forward. They are particularly appropriate where the employee received the grant upon beginning employment. In those instances, there is no past performance to consider.

Where the options were granted a significant time after the commencement of employment, some courts have held that unvested options may also be considered, at least in part, a bonus for past performance that predated the grant date. *Davidson v. Davidson*, 578 N.W.2d 848 (Neb. 1998) is an example of this approach. In *Davidson*, the Court reasoned that the past work effort must be reflected in the coverture fraction. The Court found that the past work effort reflected in the current grant began on the date of the last prior stock option grant. It reasoned that it could not go back any further because presumably, if the company wished to compensate the employee for work that predated the prior grant, it would have given more options at that time.\(^{41}\)

Accordingly, *Davidson* made the numerator of the coverture fraction the time from the date of the last prior stock grant to the maturity of the current grant. The denominator would be the time from the later of the date of marriage or the date of the last prior grant to the marital property cutoff date.\(^{42}\) Variations of this approach include running the fraction from the date of the last bonus (if there were no prior option

\(^{41}\) *Davidson*, supra, 578 N.W.2d at 857.
\(^{42}\) Id.
grants) or even the date of the commencement of employment.\textsuperscript{43}

Determining whether there is a past performance component to the options grant is a factual issue that often revolves around the wording of the grants. A key factor that the Davidson court pointed out that goes towards establishing past performance was that the grants were to reward the employee for the completion of a specific project or attaining a specific goal.\textsuperscript{44} A key factor that helps prove a future performance component is that the options are an inducement to stay with the company (i.e., “golden handcuffs”).\textsuperscript{45}

Employee spouses who married after the grant date will typically want to argue that there is a past performance component to the options. Also, non-employee spouses who married before the grant will generally want to maintain that the options are a reward for past marital work efforts.

**H. THE VALUATION OF STOCK OPTIONS**

Among those courts that attempt to give options a present value, some have adopted the intrinsic value approach approved in *Richardson v. Richardson*, 659 S.W.2d 510, 513 (Ark. 1983). Under the intrinsic value approach, a present value of the option is obtained by simply subtracting the strike price from the current price of the underlying stock.\textsuperscript{46} The court then makes a monetary award to the non-employee spouse of the appropriate percentage of the marital share of the options based upon this value.

\textsuperscript{43} See *In re Marriage of Hug*, 201 Cal. Rptr. 676 (Cal. Ct. App. 1984). This approach would be particularly appropriate where there have been no prior option grants or bonuses.

\textsuperscript{44} *Davidson*, supra, 578 N.W.2d at 856. Language concerning a reward in recognition of years of service would also go towards a past performance component.

\textsuperscript{45} Id.

\textsuperscript{46} Id. See also Pratt, supra, at 447 (discussing the intrinsic value of options).
When the trial court applies this method, the non-employee spouse gets the certainty of an up front payoff, but gives up the potential upside of any appreciation on the options. Conversely, the employee spouse gets to keep any upside appreciation. However, he or she risks paying out money up front on account of assets that may lose a substantial amount of their value before exercise or may even be subject to forfeiture if vesting conditions such as employment tenure are not satisfied.

The primary benefit of this approach is finality. It also removes control over the timing of the payment from the employee spouse. Among the major disadvantages of basing an award on the intrinsic value is that it does not apply discounts for the lack of marketability and the potential forfeitability of the options. Also, it does not account for the “time value” of the options. There is certainly a value in being able to realize any future appreciation in the stock price until expiration without the requirement to invest any resources, unless and until the holder wishes to take advantage of that appreciation and exercise the option.47

Other courts have adopted a more complex approach in attempting to ascertain the value of unexercised options. These courts recognize that for unexercisable options that the current stock price may not accurately reflect the stock price at the point in the future when the employee gains the ability to actually exercise his or her rights. Also, for already exercisable options, there is potential value in being able to realize any stock price gains over a certain period of time without any commitment of resources to actually purchase the stock unless and until the employee wants to take advantage of those increases. This is commonly referred to as the “option privilege.”48

---

47 See Pratt, supra, at 448–449 (discussing the time value of options).
48 “The option privilege in the case of an option to buy is the opportunity to benefit during the option’s exercise period from any increase in the value of property subject to the option during such period without risking capital.” Treas. Reg. § 1.83-7(b)(3).
Essentially, the intrinsic value method ignores the time value of the options. The total value of the option is the intrinsic value plus the time value. The time value of the option is the discounted present value of the difference between the underlying stock price at expiration (or any other point where it reaches its peak value) and the strike price. The problem is that the stock price peak will not be known until some point into the future. Accordingly, several mathematical models have been developed in an attempt to predict this value. Some of the more prominent models are the Shelton model, the Kassouf model, the Black/Scholes formula and the Noreen-Wolfson variant of the Black/Scholes formula.

All of these formulas are somewhat complex and require expert computation. In fact, Nobel laureate economics Professor Paul Samuelson describes the Black/Scholes model as a "modern option pricing technique with roots in stochastic calculus and is often considered among the most mathematically complex of all applied areas of finance." Of all these methods, the Black/Scholes formula and its many variants receives the most attention from courts. It primarily relies on the five following variables: (1) time to expiration; (2) strike price; (3) the current value of the underlying stock; (4) the underlying stocks level of price volatility; and (5) the risk free rate of return (i.e., the rate of return for a risk free investment such as treasury bills). Recent refinements in the formula account for other factors such as fluctuating interest rates. Black/Scholes is considered reliable enough to have gained widespread usage among professionals dealing in publicly

49 Pratt, supra, at 449.
52 Id. at 196.
traded options.\textsuperscript{53}

In *Davidson, supra*, the Nebraska Supreme Court approved the usage of the Black/Scholes method to value the options. It used the Black/Scholes formula to arrive at the present value of the number of shares at issue, and then multiplied the product thereof by the marital percentage. The Court then made an adjustment to reflect the post-tax value.

Black/Scholes, however, works best where, as in *Davidson*, the underlying stock is widely and publicly traded. The method has been criticized in the context of closely held companies because there is no trading history to establish historic volatility or even a readily ascertainable market price for the underlying stock.\textsuperscript{54} The formula also presents particular difficulty in valuing employee options because it does not take into consideration the lack of marketability of the options due to transfer restrictions and the potential forfeitability of the options.\textsuperscript{55} At a minimum, an expert would have to make appropriate discounts to account for these factors.

Given all of the practical difficulties with the Black/Scholes method, a number of courts have opted for the "if, as and when" approach to unexercisable options.\textsuperscript{56} One court has even imposed a constructive trust on the holder of the stock options with such options to be sold at the discretion and at the direction of his former wife.\textsuperscript{57} Those courts reason that any other approach would be unnecessarily speculative.

\textsuperscript{53} Id.
\textsuperscript{54} Pratt, supra, at 458.
\textsuperscript{55} Wendt, supra, 1998 WL 161165 at 198 citing Rice v. City of Montgomery, 663 N.E.2d 389, 392 (1995); see also Pratt, supra, at 458.
\textsuperscript{56} See, e.g., Smith v. Smith, 682 S.W.2d 834 (Mo. App. 1984) (awarding a percentage of the marital share to the non-employee spouse if, as and when exercised.); In re Marriage of Moody, 457 N.E.2d 1023 (Ill. 1983) (reserving jurisdiction to award a share to the non-employee spouse if, as, and when the options are actually exercised). See, also, In re Marriage of Isaacs, 632 N.E.2d 228 (Ill.App.3d 1994); Green v. Green, 494 A.2d 721 (Md. App. 1985); Salstrom v. Salstrom, 404 N.W.2d 848 (Minn.App. 1987); In re Marriage of Frederick, 578 N.E.2d 612 (Ill.App. 1991).
\textsuperscript{57} Callahan v. Callahan, 361 A.2d 561 (N.J.Super. 1976).

In that case, the husband requested the trial court to assume that he would exercise all of his options. The Michigan Court of Appeals found that the present value of the husband’s options should be calculated by subtracting the option cost from the market price of the stock on a date to be determined by the trial court in its discretion. Selection of triggering day eliminated the need to wait for the actual exercise of the options.

**I. CONCLUSION**

In classifying and valuing employee stock options in a divorce context, a Virginia practitioner should be aware of the Dietz and Donohue decisions but still realize that there are still uncharted areas concerning valuation and characterization of employee stock options and that the classification of stock options as either marital, separate, or partly marital and partly separate are often decided after an intensive fact based investigation to determine the reason and purpose of the grant of the options.
APPENDIX

1. IRC (26 U.S.C.) § 422 provides as follows:

(a) In general.--Section 421(a) shall apply with respect to the transfer of a share of stock to an individual pursuant to his exercise of an incentive stock option if--

(1) no disposition of such share is made by him within 2 years from the date of the granting of the option nor within 1 year after the transfer of such share to him, and

(2) at all times during the period beginning on the date of the granting of the option and ending on the day 3 months before the date of such exercise, such individual was an employee of either the corporation granting such option, a parent or subsidiary corporation of such corporation, or a corporation or a parent or subsidiary corporation of such corporation issuing or assuming a stock option in a transaction to which section 424(a) applies.

(b) Incentive stock option.--For purposes of this part, the term "incentive stock option" means an option granted to an individual for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but only if--

(1) the option is granted pursuant to a plan which includes the aggregate number of shares which may be issued under options and the employees (or class of employees) eligible to receive options, and which is approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted;

(2) such option is granted within 10 years from the date such plan is adopted, or the date such plan is approved by the stockholders, whichever is earlier;

(3) such option by its terms is not exercisable after the expiration of 10 years from the date such option is granted;

(4) the option price is not less than the fair market value of the stock at the time such option is granted;

(5) such option by its terms is not transferable by such individual otherwise than by will or the laws of descent and distribution, and is exercisable, during his lifetime, only by him; and

(6) such individual, at the time the option is granted, does not own stock possessing more than 10 percent of the total combined voting power of all classes of stock of the employer corporation or of its parent or subsidiary corporation.

Such term shall not include any option if (as of the time the option is granted) the terms of such option provide that it will not be treated as an incentive stock option.

(c) Special rules.--

(1) Good faith efforts to value stock.--If a share of stock is transferred pursuant to the exercise by an individual of an option which would fail to qualify as an incentive stock option under subsection (b) because there was a failure in an attempt, made in good faith, to meet the requirement of subsection (b)(4), the requirement of subsection (b)(4) shall be considered to have been met. To the extent provided in regulations by the Secretary, a similar rule shall apply for purposes of subsection (d).

(2) Certain disqualifying dispositions where amount realized is less than value at exercise.--If--

(A) an individual who has acquired a share of stock by the exercise of an incentive stock option makes a disposition of such share within either of the periods described in subsection (a)(1), and

(B) such disposition is a sale or exchange with respect to which a loss (if sustained) would be recognized to such individual, then the amount which is includable in the gross income of such individual, and the amount which is deductible from the income of his employer corporation, as compensation attributable to the exercise of such option shall not exceed the excess (if any) of the amount realized on such sale or exchange over the adjusted basis of such share.

(3) Certain transfers by insolvent individuals.--If an insolvent individual holds a share of stock acquired pursuant to his exercise of an incentive stock option, and if such share is transferred to a trustee, receiver, or other similar fiduciary in any proceeding under title 11 or any other similar insolvency proceeding, neither such transfer, nor any other transfer of such share for the benefit of his creditors in such proceeding, shall constitute a disposition of such share for purposes of subsection (a)(1).

(4) Permissible provisions.--An option which meets the requirements of subsection (b) shall be treated as an incentive stock option even if--
(A) the employee may pay for the stock with stock of the corporation granting the option,
(B) the employee has a right to receive property at the time of exercise of the option, or
(C) the option is subject to any condition not inconsistent with the provisions of subsection (b).

Subparagraph (B) shall apply to a transfer of property (other than cash) only if section 83 applies to the property so transferred.

(5) 10-percent shareholder rule.--Subsection (b)(6) shall not apply if at the time such option is granted the option price is at least 110 percent of the fair market value of the stock subject to the option and such option by its terms is not exercisable after the expiration of 5 years from the date such option is granted.

(6) Special rule when disabled.--For purposes of subsection (a)(2), in the case of an employee who is disabled (within the meaning of section 22(e)(3)), the 3-month period of subsection (a)(2) shall be 1 year.

(7) Fair market value.--For purposes of this section, the fair market value of stock shall be determined without regard to any restriction other than a restriction which, by its terms, will never lapse.

[(8) Redesignated (7)]

(d) $100,000 per year limitation.--

(1) In general.--To the extent that the aggregate fair market value of stock with respect to which incentive stock options (determined without regard to this subsection) are exercisable for the 1st time by any individual during any calendar year (under all plans of the individual's employer corporation and its parent and subsidiary corporations) exceeds $100,000, such options shall be treated as options which are not incentive stock options.

(2) Ordering rule.--Paragraph (1) shall be applied by taking options into account in the order in which they were granted.

(3) Determination of fair market value.--For purposes of paragraph (1), the fair market value of any stock shall be determined as of the time the option with respect to such stock is granted.

2. I.R.C. (26 U.S.C.) § 423 provides as follows:

(a) General rule.--Section 421(a) shall apply with respect to the transfer of a share of stock to an individual pursuant to his exercise of an option granted after December 31, 1963, under an employee stock purchase plan (as defined in subsection (b)) if--

(1) no disposition of such share is made by him within 2 years after the date of the granting of the option nor within 1 year after the transfer of such share to him; and

(2) at all times during the period beginning with the date of the granting of the option and ending on the day 3 months before the date of such exercise, he is an employee of the corporation granting such option, a parent or subsidiary corporation of such corporation, or a corporation or a parent or subsidiary corporation of such corporation issuing or assuming a stock option in a transaction to which section 424(a) applies.

(b) Employee stock purchase plan.--For purposes of this part, the term "employee stock purchase plan" means a plan which meets the following requirements:

(1) the plan provides that options are to be granted only to employees of the employer corporation or of its parent or subsidiary corporation to purchase stock in any such corporation;

(2) such plan is approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted;

(3) under the terms of the plan, no employee can be granted an option if such employee, immediately after the option is granted, owns stock possessing 5 percent or more of the total combined voting power or value of all classes of stock of the employer corporation or of its parent or subsidiary corporation. For purposes of this paragraph, the rules of section 424(d) shall apply in determining the stock ownership of an individual, and stock which the employee may purchase under outstanding options shall be treated as stock owned by the employee;

(4) under the terms of the plan, options are to be granted to all employees of any corporation whose employees are granted any of such options by reason of their employment by such corporation, except that there may be excluded--

(A) employees who have been employed less than 2 years,
(B) employees whose customary employment is 20 hours or less per week,
(C) employees whose customary employment is for not more than 5 months in any calendar year, and
(D) highly compensated employees (within the meaning of section 414(q));
(5) under the terms of the plan, all employees granted such options shall have the same rights and
privileges, except that the amount of stock which may be purchased by any employee under such option
may bear a uniform relationship to the total compensation, or the basic or regular rate of compensation,
of employees, and the plan may provide that no employee may purchase more than a maximum amount
of stock fixed under the plan;
(6) under the terms of the plan, the option price is not less than the lesser of--
(A) an amount equal to 85 percent of the fair market value of the stock at the time such option is granted,
or
(B) an amount which under the terms of the option may not be less than 85 percent of the fair market
value of the stock at the time such option is exercised;
(7) under the terms of the plan, such option cannot be exercised after the expiration of--
(A) 5 years from the date such option is granted if, under the terms of such plan, the option price is to be
not less than 85 percent of the fair market value of such stock at the time of the exercise of the option, or
(B) 27 months from the date such option is granted, if the option price is not determinable in the manner
described in subparagraph (A);
(8) under the terms of the plan, no employee may be granted an option which permits his rights to
purchase stock under all such plans of his employer corporation and its parent and subsidiary corporations
to accrue at a rate which exceeds $25,000 of fair market value of such stock (determined at the time such
option is granted) for each calendar year in which such option is outstanding at any time. For purposes
of this paragraph--
(A) the right to purchase stock under an option accrues when the option (or any portion thereof) first
becomes exercisable during the calendar year;
(B) the right to purchase stock under an option accrues at the rate provided in the option, but in no case
may such rate exceed $25,000 of fair market value of such stock (determined at the time such option is
granted) for any one calendar year; and
(C) a right to purchase stock which has accrued under one option granted pursuant to the plan may not
be carried over to any other option; and
(9) under the terms of the plan, such option is not transferable by such individual otherwise than by will
or the laws of descent and distribution, and is exercisable, during his lifetime, only by him.

For purposes of paragraphs (3) to (9), inclusive, where additional terms are contained in an offering made
under a plan, such additional terms shall, with respect to options exercised under such offering, be treated
as a part of the terms of such plan.

c) Special rule where option price is between 85 percent and 100 percent of value of stock.--If the option
price of a share of stock acquired by an individual pursuant to a transfer to which subsection (a) applies
was less than 100 percent of the fair market value of such share at the time such option was granted,
then, in the event of any disposition of such share by him which meets the holding period requirements of
subsection (a), or in the event of his death (whenever occurring) while owning such share, there shall be
included as compensation (and not as gain upon the sale or exchange of a capital asset) in his gross
income, for the taxable year in which falls the date of such disposition or for the taxable year closing with
his death, whichever applies, an amount equal to the lesser of--
(1) the excess of the fair market value of the share at the time of such disposition or death over the
amount paid for the share under the option, or
(2) the excess of the fair market value of the share at the time the option was granted over the option
price.

If the option price is not fixed or determinable at the time the option is granted, then for purposes of this
subsection, the option price shall be determined as if the option were exercised at such time. In the case
of the disposition of such share by the individual, the basis of the share in his hands at the time of such
disposition shall be increased by an amount equal to the amount so includible in his gross income.