Value in the Details: The Equitable Distribution of Partially Vested Interests in Divorce

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In divorce litigation, big changes in value can depend on small distinctions. That is particularly true when it comes to employees' deferred compensation. This article explores how subtle differences in the wording or circumstances of an award of deferred compensation (think: equity in a startup, subject to a vesting schedule) can lead to big swings in potential equitable distribution awards under the equitable distribution laws of Virginia, Maryland, and D.C.

Many employees are awarded interests in their company (for example, stock, options, carried interest, etc.), both as compensation for past service to the company and to incentivize future service to the company. Those awards often are subject to a vesting schedule.

It is well established that when an employee gets divorced, partially vested interests are subject to equitable distribution to the extent they are earned or acquired during the marriage—even if they have not actually vested.

That often comes as a surprise to the uninitiated. Employees going through a divorce often point out that the interests may never vest. Companies may tank. Employees could get fired or quit. On this point, however, the law is clear. The *equitable* nature of equitable distribution means that partially vested interests are considered marital property subject to equitable distribution to the extent such interests are earned or acquired during the marriage.[1]

That seemingly simple rule leads to a seemingly simple mathematical analysis. The "marital" portion of the deferred compensation is determined using a coverture fraction. The numerator is the amount of time the employee was subject to the vesting schedule *and* married (often times, for example, the amount of time between the date of the award and the end of the marriage).[2] The denominator is the total amount of time it takes for the award to vest.

For example, suppose a married employee is awarded stock in his company, but it vests in 60 months. Suppose further the employee's marriage ends after 12 months. For purposes of equitable distribution, a court would calculate the "marital" share of the stock as:

$$\frac{12\ months\ married}{60\ months\ total\ vesting} = 20\%\ marital$$

That analysis gets more complicated as vesting schedules get more complicated. Suppose an employee is awarded 100 shares of stock. But instead of those 100 shares vesting *entirely* after 60 months, the shares of stock vest in four separate tranches, as follows:

Anniversary	Total Shares Vested
24 months after award	40 shares
36 months after award	60 shares
48 months after award	80 shares
60 months after award	100 shares

The question under these circumstances is whether the marital share is calculated using a

single coverture fraction or *four* coverture fractions *i.e*., a coverture fraction for each tranche.

The answer to that question makes a big difference in how much of the stock is classified as marital. If a single fraction using a single denominator is used, then the marital share is:

$$\frac{12\ months\ married}{60\ months\ total\ vesting} \times 100\ shares = 20\ shares\ marital$$

But if different fractions are used, then the marital share might be:

Tranche	Coverture Fraction	Marital Shares
Tranche 1	$\frac{12\ months\ married}{24\ months\ total\ vesting} \times 40\ shares$	20 shares
Tranche 2	$\frac{12\ months\ married}{36\ months\ total\ vesting} \times 20\ shares$	6.67 shares
Tranche 3	$\frac{12\ months\ married}{48\ months\ total\ vesting} \times 20\ shares$	5 shares
Tranche 4	$\frac{12\ months\ married}{60\ months\ total\ vesting} \times 20\ shares$	4 shares
TOTAL		**35.67 shares**

An employee's spouse, for obvious reasons, is highly motivated to argue that the tranche-by-tranche analysis should apply.

At a superficial level, different courts in the D.C. metropolitan area seem to reach different conclusions as to which result is correct. Consider two influential cases:

- *Shiembob v. Shiembob*, 55 Va. App. 234, 238 (2009) concerned a stock award that vested in tranches each year over five years. The court ruled that the tranches that vested after the date of separation were not marital property at all. *Id*. at 242. Curiously, the court did not cite Va. Code § 20-107.3(G), which governs the equitable distribution of "vested or unvested" deferred compensation. *See id*. The Supreme Court of Virginia notably narrowed *Shiembob's* applicability in a subsequent case, stating that "the husband earned the shares in yearly increments *and did not begin to earn the shares at issue* until *after* the date of separation," and that "the holding in *Shiembob* is limited to the facts of that case." *Schuman v. Schuman*, 282 Va. 443, 447 n.5 (2011) (emphasis added).
- *Otley v. Otley*, 147 Md. App. 540, 554-55 (2002), concerned options that vested in tranches each year over four years. The Maryland Court of Special Appeals in that case calculated different coverture fractions on a tranche-by-tranche basis, such that a greater portion of the fastest-vesting tranche was marital property, as compared to the slowest-vesting tranche.

Those results are not necessarily inconsistent with one another, however. A more sophisticated analysis of vesting schedules and the purposes they serve helps reconcile those results. That analysis starts with two modest propositions.

First, different vesting schedules imply different value propositions to an employee. Compare, for example, two employees with the same award of stock, but with two different vesting schedules. Employee Bert's stock vests all at once, five years following the award. Employee Ernie's stock vests in four tranches periodically over five years, as described above.

In that situation, Employee Ernie's stock award is more valuable than Employee Bert's stock award—even though the awards concern the exact same stock. Ernie receives his stock sooner and faster. As time goes on, he has less and less incentive to remain with the company. Employee Bert, by contrast, realizes no value from the stock award at all for five years. Thus, the opportunity cost of leaving the company after four years is much greater for Bert than for Ernie.

Second, an award that is more valuable to the employee should be more valuable to the *employee's spouse* in equitable distribution. Consider for example Bert and Ernie's spouses (assuming the court divides all marital property 50-50 in both cases). There is no obvious reason why Ernie's spouse should receive the same equitable distribution award as Bert's spouse in a divorce if Ernie's stock award is more valuable than Bert's.

When considering which approach to equitable distribution of the partially vested interests is correct in any particular case, it may help to consider what each interpretation of the vesting schedule would imply. For example:

- Are all tranches of stock meant to start vesting immediately; or are the "later" tranches meant to start vesting only after the previous tranche vests?
- In other words, do the tranches vest concurrently or consecutively?
- Are some shares of stock meant to vest faster than others?
- Do the company and its employees understand that the incentive to remain with the company is much greater in the short-term than in the long-term?
- Has the company made awards subject to differently structured vesting schedules? If so, why?

Counsel should seek testimony and evidence to answer such questions, which may support the client's preferred reading of the vesting schedule along these lines. For example, the lawyer for the employee's *spouse* (*i.e.*, the spouse favoring a tranche-by-tranche analysis of the vesting schedule) may want to exploit admissions that all shares of stock *start* vesting immediately, that the tranches vest concurrently, and that the opportunity cost to leaving the company declines as time goes on, *etc*.

With these considerations in mind, the apparent contradictions in the Virginia and Maryland case law are easily reconciled. As the Supreme Court of Virginia noted, the treatment in *Shiembob* turned on the fact that the husband "did not begin to earn the shares at issue until *after* the date of separation." *Schuman*, 282 Va. at 447 n.5 (emphasis in original). Speaking mathematically, the marital share of zero-percent-vested tranches is zero. If the court had found, however, that all tranches had started vesting on the date of the award, then the Virginia court's analysis in *Shiembob* may well have resembled the Maryland court's analysis in *Otley*.

Speaking more broadly, considerations like these illustrate why it pays to attend to the details. By thinking through subtle distinctions in vesting schedules and amplifying those distinctions through discovery, a good family law attorney can add or protect significant value for the client.

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Endnotes

1. The risks inherent in deferred compensation awards are typically accounted for in the *valuation* or *distribution* of those awards. Those issues are beyond the scope of this article.

2. For the sake of simplicity, this article refers only to the end of the *marriage*. This glosses over the rule that, in Virginia, marital property stops accruing as of the date of separation (not the date of divorce). This distinction between Virginia, on the one hand, and DC and Maryland, on the other hand, is irrelevant to the point of this article. ❖