Stock Options and Child Support: The Price of Accuracy

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Stock Options and Child Support:
The Price of Accuracy
Susan Isard*

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* J.D., University of California, Hastings College of the Law, 2003. B.A., University of Chicago, 1996. I would like to thank Professor Lois Weithorn, the Honorable Donna J. Hitchens, and Claire Williams at the San Francisco Unified Family Court for their assistance and inspiration.
A. INTRODUCTION

The obstacles a court faces in valuing stock options in child support orders indeed may be one of those luxurious burdens facing mainly the very wealthy and their attorneys. Nonetheless, they do not fit neatly into our child support systems and, although the vast majority of Americans have no options to value, stock option contracts are increasingly available to rank-and-file employees. Furthermore, the very fact that options test the boundaries of child support systems makes them a useful tool for examining the system’s most paramount objective: The best interests of the child. In this context, children have multiple and sometimes conflicting interests.

The scenario might look like this: A divorced parent, Francis Father, earns $100,000 per year from his job at World Economic and Technology Solutions (WETS). In lieu of paying him a higher cash salary, WETS grants Francis stock options. Francis began working for WETS in 1991; he married Melinda Mother in 1994. They had one child, Harmony, but divorced soon after her birth. As part of the marital settlement, Melinda received a small sum of WETS options and $2,100 per month in child support. Francis never misses a payment. Melinda has custody of Harmony and earns $40,000 a year working at a bank.

The year is 2000. Melinda’s portion of the options vested some time ago and she exercised them and sold the underlying stock to help make ends meet. That money is gone. WETS’ position in the market remains strong. In the past, Francis refrained from selling any WETS stock because he thought it a good investment. Now, he doesn’t even exercise his options because his attorney told him that doing so might – the law is not clear – subject it to child support. So Francis waits. The difference between Francis’ base salary and his salary plus options is considerable. A few years ago, his options were doubling his worth. He held those options, and WETS stock rose. Now his options are valued at $6.5 million after tax.

The year is 2003. The market has slid considerably, especially the technology industry. WETS is still a solid company, but everyone is poorer. Were Francis to exercise his vested options, he would still make a profit, but he keeps holding, hoping that the economy will look up.

The question this paper examines is whether the child support payments Francis makes to help Melinda support Harmony should reflect only Francis’s base salary, the $100,000 he brings home each year, or should his payments also account for the other assets WETS pays him – the stock options. Are those options which Francis kept as part of the marital support agreement exempt from child support on the theory that Melinda’s household already benefited from them? Suppose Francis exercises a block

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of options worth, after tax, $1 million? If the family court considers the options, how should it account for this sudden chunk of income in an ongoing, monthly child support order? If Melinda still has options, should the court put hers in the formula as well? Should the court in effect force Francis to exercise the options and sell shares, even if he thinks doing so is a poor investment decision? What if WETS tanks? What if Francis exercises and sells the WETS stock solely in order to purchase stock in other companies, thereby diversifying his portfolio, but does not use the money to improve his standard of living? What if WETS were a closely held corporation that expected Francis to retain a personal investment in the company? What if Francis believes in living modestly and investing for slow growth? What if Francis thinks Melinda and Harmony don’t need more than $2,100 per month? Finally, suppose the court begins the process of modifying child support in 2000. After significant hearings and briefing, the court makes a decision a year and a half later, when the market has fallen considerably. Since the order no longer reflects the value of Francis’ assets, can he immediately request a modification because of market changes? When exactly will the problem be resolved? What effect will these protracted hearings have on Harmony? Some of these questions are more important than others. Most of them have not been fully answered.

Now is a good time to think realistically about the problems stock options pose in the child support context. We have indeed watched the stock market rise and fall considerably in the last couple of years. A smattering of cases have come down in various states, and the debate is starting to take shape. The Court of Appeals of Ohio drew attention in 1999 with its decision to impute income to vested but unexercised stock options in Murray v. Murray. In September of 2001 the California Court of Appeal handed down that state’s most recent proclamation on the subject. In re Marriage of Cheriton held that a child support order should account for the income generated from a one-time sale of stock derived from exercised stock options. Cheriton did not answer all outstanding questions about options in California. Indeed, the court did not face as challenging a question as did the Murray court, because in Cheriton the obligor-parent had already exercised the options and sold the underlying stock — a clearer case of income. Still, Cheriton went far to delineate the appellate court’s approach toward stock options in the child support context. Furthermore, the court, in dicta, practically overruled a

4. Id. at 794.
significant line of cases delineating what constitutes the “best interests of the child” when imputing income to a non-working parent. Although it remains to be seen if California will extend as far as Ohio to reach option assets for child support, the trend in child support law is headed in that direction. Cheriton and its progeny may prove to have a significant impact on high-income families in California.

Clearly stock options differ from stock, although they share some important properties. Stock options are somewhat complicated, and valuing them is very difficult in the child support context. Even the threshold question facing courts, should stock options even be considered in making a child support award, defies an easy yes or no answer. There are a wide range of factors affecting the financial picture of a parent with stock options, including the restrictions the issuing company places on the options, the strength of the company’s position in the marketplace, and the past practices of the parent owning the stock. 6

This note focuses on California’s child support laws, but always with an eye toward trends and important decisions in other states regarding treatment of stock options. My aim is to evaluate the case history and scholarship to date in order to assess where courts are and should be headed. Part B provides background on child support law, focusing on those aspects most relevant to stock options. Part C explains and defines stock options and outlines concepts important to understanding stock options in the child support context. Part D examines those inherent qualities in stock options that render them difficult to value in making child support awards. Part E outlines nation-wide court decisions which have come down thus far on the topic, dividing the cases into three categories based on the type of options in question. Part F reviews scholarly work to date. Part G looks at other relevant factors affecting a child support order, particularly in the high earner context. Given the timing difficulties and real possibilities of protracted litigation on this topic, Part H considers the child’s interests from a psychological rather than financial standpoint, observing that the best interests of the child standard should consider the negative impact of litigation as well as financial needs of the child. Finally, Part I concludes that given the valuation difficulties, adopting a fair, predictable, and rule-based methodology for valuing stock options affords families the best opportunities to meet their children’s best interests.

B. MODERN CHILD SUPPORT: FORMULAS AND POLICIES

Over the last fifty years, the federal government has played an

6. Diana Richmond, The Challenges of Stock Options, 35 Fam. L.Q. 251, 251 (2001). Other factors affecting valuation include when the options were earned, vesting and re-pricing, limitation of transferability, taxation, manipulability, and availability for support. ld. at 251.
increasingly large role in legislating family law generally and child support specifically. In the mid-1980s, congressional concern grew because child support obligations averaged an estimated eighty percent of the poverty level and twenty-five percent of estimated average expenditures on children. Furthermore, the case-by-case methodology then in place was widely perceived as treating similarly situated families differently.

Consequently, Congress passed the Family Support Act (FSA) in 1988 and created the U.S. Commission on Interstate Child Support. Prior to its enactment, states used a case-by-case method that was roundly criticized for treating similarly situated families differently. The FSA gave each state until October 1989 to adopt a child support law that used a mathematic formula to establish a guideline support award. Thus, there are certain consistencies in child support law from state to state: By FSA mandate, a guideline child support figure is rebuttably presumed correct, and any deviation from guideline must account for the best interests of the child. At a minimum, state guideline formulas must look to all the earnings and income of the non-custodial parent.

Today, child support law remains stable in that, since 1990, every state has had a rebuttably presumptive child support guideline system in place. However, because the FSA left it up to the states to create their own formulas, various models emerged for calculating child support. Some states factor shared parenting time into their formulae. Some base support on a percentage of the non-custodial spouse’s income while other states’ formulas prorate support based on both parents’ incomes.

9. Id. at 8; see also 42 U.S.C. § 651 (2001).
15. See *id.* at 10-18 for a thorough discussion of the four models states employ.
16. *Id.* at 18. California and twenty-three other states account for visitation in formulating an award. The result is that the more time a non-custodial parent spends with her child, the lower her resultant child support payment. Thus, joint-custody families are subject to the same calculation as single-custody families. The time share, rather than custody status, dictates the support award.
17. *Id.* at 11. California does the latter. CAL. FAM. CODE § 4055 (West 2002).
Although most states order a set monthly amount, some earmark a fixed percentage of the non-custodial's paycheck to go toward child support each month.\(^\text{18}\)

In examining stock options in the child support context, it is important to keep in mind the larger policy goals underlying child support law. Three additional aspects of child support law have particular relevance to stock options: First, the definition of income in child support statutes; second, the doctrine of imputed income; and third, the high-income earner exception to the guideline formula.

1. **POLICY GOALS OF CHILD SUPPORT**

Concepts of the best interests of the child developed in the later twentieth century were heavily influenced by scholarship, theory, and research in the fields of psychology, psychiatry, and child development.\(^\text{19}\) The Uniform Marriage and Divorce Act ("UMDA"), influenced by these concepts, enumerates factors for courts to consider in making custody determinations: The parents’ wishes; the child’s wishes; the child’s relationships with parents, siblings, and others who significantly affect his or her best interests; the child’s adjustment to home, school, and community; and the mental and physical health of all involved parties.\(^\text{20}\) California’s custody standard tracks the UMDA requirements.\(^\text{21}\) The best interest of the child standard has been criticized as being too vague, subjective, and open to judicial discretion where children would be better served by a standard designed to minimize litigation.\(^\text{22}\)

Similar to the custody context, the California Family Code clearly states the goals of the child support system. In both areas, the state seeks to place the best interests of the child as its top priority.\(^\text{23}\) The child support statutes go on to explain the assumptions and goals of the system. The law operates under the assumption that a parent’s “first and principal obligation is to support his or her minor children according to the parent’s circumstances and station in life.”\(^\text{24}\) Parents are expected to support their children commensurate with their ability; the system seeks to equalize the homes in which a child lives.\(^\text{25}\) Thus, the California guideline formula is an

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22. Maxwell, supra note 19, at 145.
23. CAL. FAM. CODE § 4053 (West 2002); see also CAL. FAM. CODE § 3011 (West 1994).
24. CAL. FAM. CODE § 4053 (West 2002).
25. Id.
implementation of these policies. To the extent that the legislature defines "income" broadly, it does so because children benefit when judges are able to secure a child support order that reaches children's financial needs. For its part, at least in the imputed income context (see section B(3) below), the Supreme Court of California has refused to limit the court's discretion where the best interests of the child is concerned.\(^{26}\)

Not surprisingly, the language of California child support law couches the child's interests in economic terms. The law rightfully seeks to ensure that a child's basic support needs are met through the contributions of both parents to the extent of their financial ability.

2. **INCOME DEFINED IN CHILD SUPPORT STATUTES**

Child support statutes define income broadly. For example, California's formula looks to income "from whatever source derived.\(^{27}\) Thus, gifts and bequests are specifically excluded from the "income" category, but the interest they generate is not so excluded.\(^{28}\) Many states have similar statutes, offering exhaustive yet non-exclusive lists of income sources.\(^{29}\) Once a court makes a child support order, it remains in place until one party moves for modification. Courts will reconsider the order if they find that the parties' circumstances have changed.\(^{30}\) In this paper, I assume that the parent paying child support is a non-custodial parent. However, Figure 1 on page 246 illustrates that in California, if the parents' incomes are disparate enough and visitation with the non-custodial parent extensive enough, it is possible for a custodial parent to owe child support to a non-custodial parent.

A difficult threshold question concerning stock options, as I discuss below, is whether they should be considered income for purposes of calculating child support even when the Internal Revenue Service has not defined them as income for tax purposes.

3. **IMPUTING INCOME**

In California, the court may, at its discretion, impute income to either party, thus basing child support on the parents' earning capacity rather than

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27. CAL. FAM. CODE § 4058 (West 1994). The statute goes on to state that income includes, but is not limited to, "commissions, salaries, royalties, wages, bonuses, rents, dividends, pensions, interest, trust income, annuities, workers' compensation benefits, unemployment insurance benefits, disability insurance benefits, social security benefits, and spousal support actually received from a person not a party to the proceeding to establish a child support order . . . ." Id.
28. See id. See Figure 1 at page 246 for examples of Guideline figures under the California system.
30. Watson, supra note 13, at 1532.
their actual earnings.\textsuperscript{31} Courts read "income" broadly because doing so is in concert with their highest priority: The best interests of the child.\textsuperscript{32} In the case of an obligor parent, the court may impute income even if the parent did not intentionally and deliberately seek to avoid family financial responsibilities.\textsuperscript{33} However, courts cannot impute income "from thin air."\textsuperscript{34}

There are two types of income courts impute. First, where a parent is unemployed or underemployed, they impute a salary the parent could be earning if s/he chose to work. Second, where a parent has an asset she or he is underutilizing as a source of income, the court may impute a reasonable rate of return to the asset. California courts have been willing to impute sizable incomes to such assets; as I discuss below, both types of imputed income may affect a stock options situation.

In the case of unemployment or underemployment, the court will impute income to either the obligor or obligee parent, even if the parent chooses not to work in order to devote his or her full time to caretaking for young children.\textsuperscript{35} In \textit{In re Marriage of Hinman}, a non-custodial mother of five moved away and bore three additional children, all under age three and in her direct care at the time of trial.\textsuperscript{36} Although she was not working in order to devote herself full time to the three children in her direct care, the court imputed her earning capacity at her old job, concurring with the lower court that, "She has brought . . . eight kids into the world, and wishes to be responsible for the support of only three."\textsuperscript{37} Additionally, just because a parent chooses to take a less lucrative job with equal or greater prospects in the future does not entitle that parent to a reduction of support payments in the interim.\textsuperscript{38} In \textit{In re Marriage of Padilla}, a father asked for a reduction in his support obligation after quitting his job in good faith to start up a business.\textsuperscript{39} Denying his request, and in effect imputing the income of the father's prior job, the court noted, "Once persons become parents, their desire for self-realization, self-fulfillment, personal job satisfaction, and other commendable goals must be considered in context of their"
responsibilities to provide for their children's reasonable needs.” In effect, Padilla says that parents lose some personal autonomy regarding decisionmaking about finances once the courts are overseeing the best interests of their children.

In the case of the obligee parent, it is easy to see how imputing income is in the child's best interests. Courts treat recipient parents similarly. Noting that both parents are equally responsible for supporting their children, California's Court of Appeal also imputes income to non-working recipient parents, even though doing so effectively reduces the resulting child support order.

California also imputes income to under-utilized assets; for example, the In re Marriage of Destein court imputed a reasonable rate of return to historically non-income producing real estate. In County of Kern v. Castle, the Court of Appeal reversed a trial court failure to impute a reasonable rate of return on a $1-million inheritance even though the obligor father had already spent the corpus by the time of trial. The court reasoned that the father's standard of living had improved when he used the money to pay off a mortgage, and it was not in the child’s best interests to preclude her from sharing in her father’s good fortune. Additionally the In re Marriage of Dacumos court imputed rental income to a father based on the fair market value of the real property even though the properties were losing money. Thus, courts are not willing to allow a parent to avoid child support by sheltering wealth in non-income producing assets.

Having said all this, Cheriton dicta may alter this analysis in the lower courts.

4. THE HIGH-INCOME CONTEXT: DEVIATING FROM THE FORMULA

Some parents have so much income that the guideline calculation yields a number far in excess of the reasonable needs of their child.

40. Id. at 560.
42. Id.
43. In re Marriage of Destein, 111 Cal. Rptr. 2d 487, 496 (Ct. App. 2001). Here, Father did not work but had substantial assets. The court imputed a hypothetical reasonable rate of return to his real estate investments, yielding $328,066 per year. Id. at 489.
44. County of Kern v. Castle, 89 Cal. Rptr. 2d 874, 885 (Ct. App. 1999). Here, Father quit work upon receiving an inheritance. He claimed stress prevented him from returning to work. Id. at 876
45. Id. at 884.
47. Destein, 111 Cal. Rptr. 2d at 495.
49. See, e.g., CAL. FAM. CODE § 4057(b)(3) (West 2002). The statute does not define “high income.” The legislature left that determination to the discretion of the trial court. Cheriton, 111 Cal. Rptr. 2d at 776. The appellate division has held that a $35,000 per month order “would be absurd.” In re Marriage of Kerr, 91 Cal. Rptr. 2d 374, 380 (Ct. App.
States have various mechanisms for addressing this situation – in effect reducing the guideline figure. Some state guidelines use tables that simply do not contemplate an obligor income above, say, $100,000 per year. However, most states use a case-by-case method to determine an appropriate order where a parent’s income is literally “off the charts.” Some states provide for a method of extending the guideline formulas to apply in high earner contexts. The issue of including stock options is more pressing in these states because the value of the options will directly affect a child support figure.

California is such a state. However, under its “high-income earner” exception, the court may deviate downward from guideline and base the child support order on the reasonable needs of the child. California determines reasonable needs based on the standard of living an obligor parent’s available resources can attain rather than the historical spending habits of the parent. “It matters not whether the non-custodial parent miserly hoarded his $1 million per year income and lived the life of a pauper or whether he lived the life of a prince spending every cent of the available income.” Not all states are so generous. In Washington, the law does not consider that a child’s lifestyle might become more lavish than the obligor parent’s by means of child support.

Additionally, the California courts recently determined that, in some situations, it may be appropriate to deviate upward from the child support formula. In re Marriage of de Guigne considered the child support order of a couple who, during their marriage, lived entirely off the securities and family trusts of the father. Their annual expenses averaged $450,000, although the father’s holdings only generated $240,000 per annum. The father regularly dipped into the principle to make up the difference, withdrawing about $4 million from his securities accounts between 1986 and 1997. At trial, the father argued that the trial court erred in deviating upward from the guideline formula, which factored in only the income


50. Venohn & Williams, supra note 8, at 34. This is true of eleven states. Id. Presumably the legislature cannot fathom that a child’s needs would exceed the resulting support award, although this allows high income parents to contribute a smaller percentage of their income to their children than do their low income counterparts. In Arizona, for example, the child support tables go up to only $20,000 per year gross income. Beyond that, the burden falls on the custodial parent to prove that a higher amount would be in the best interests of the child(ren). ARIZ. REV. STAT. ANN. § 25-320 (West 2002).

51. Venohn & Williams, supra note 8, at 34.

52. Id. These states include Indiana, New Mexico, Virginia, and West Virginia.

53. CAL. FAM. CODE § 4057(b)(3) (West 2002).


55. Id. at 626.


58. Id. at 434.
generated from his trusts and securities. The appellate division found that, during his marriage, the father chose to raise and support his children using the principle on his investments, and he should not now be permitted to deny them that source of wealth because of the divorce. Furthermore, minimizing the children's lifestyle changes as a result of the divorce served the de Guigne children's best interests. Thus, the best interests of a wealthy child in California may result in upward or downward deviation from the presumptive guideline formula.

Of course, not every holder of stock options will qualify as a high-earner. Before courts reach the question of what constitutes the best interests of the child, they need a mechanism for valuing stock options in order to fit them in their mandated formulas.

C. DEFINING AND UNDERSTANDING STOCK OPTIONS

A stock option is a contractual right to purchase stock during a specified period at a predetermined price. Although they used to be the exclusive purview of upper-echelon executives, option plans are more common today. Generally, options are an alternative to fixed salaries and are valuable because they secure favorable tax treatment; their benefits can be substantial. Companies use stock options to compensate employees for past, present, and/or future services. They are frequently misunderstood and their value underestimated. Although every company writes its own deferred compensation plans, stock options have certain common characteristics, and for our purposes it is most important to understand some basic qualities about options that make them difficult to account for in a child support order.

Stock options can be either call options or put options. Call options give the employee the option to buy the underlying stock at a specific price until a specific date. This paper focuses on call options. A put option gives the employee the right to sell the underlying stock at a specific price. When an employee receives a stock option, it has a strike price, which is the dollar amount per share an employee must pay in order to

59. Id.
60. Id. at 440.
61. Id.
63. Jones, supra note 1, at 6.
64. Eric Hollowell, Valuation of Stock Options for Purposes of Divorce Court's Property Distribution, 46 A.L.R. 4th 689, 691 (1986).
66. Jones, supra note 1, at 6-7.
67. Watson, supra note 13, at 1534.
68. Id.
69. Id.
exercise the option. She may only exercise the option once it has *vested*. The *vesting period* is the time when options are exercisable; before that the option is *unvested or restricted*. Options often have an expiration date, usually ten years after the *grant date*. Furthermore, option plans usually cease along with termination of employment. In order to exercise an option, the employee pays the strike price and then owns the company’s stock outright with no further restrictions. Stock options can be incentive stock options (ISOs) or non-qualified stock options (non-quals). ISOs are more common. A high-level executive would typically receive a combination of both types. The difference is their tax treatment.

Consider the following example: On January 1, 1996, Corporate Company (“Company”) offers Ellie Employee (“Ellie”) the option to purchase 100 shares at a strike price of $2.00 per share. The company’s shares are currently worth only $0.10 per share on the market, meaning that Ellie’s shares are *under water* – the strike price ($200.00 for 100 shares) is lower than the current market value of Company’s stock ($10.00 for 100 shares). However, Ellie values her stock options because she anticipates Company’s stock value will rise over time. When Ellie receives her options they are unvested. Under the contract, they will vest on January 1, 2000. Typically, an option remains unvested for three to five years.

Once the options vest, Ellie may exercise the options whenever she wishes. To exercise her options, Ellie pays the strike price and in exchange she owns the underlying 100 shares of Company stock outright. Thus, if Company stock is trading for $5.00 per share on February 1, 2000, Ellie can pay the strike price ($200.00) in exchange for 100 shares of stock worth $500.00. At this point, Ellie owns the stock (valued at $500.00) outright; Company can no longer restrict her ownership interests. Ellie can hold onto the stock or sell immediately and realize a gain of $300.00. Clearly, stock options are valuable to the employee because they reduce the risk of investing in the stock market. Often, an employee will regularly receive options. Thus, although this hypothetical contemplates the “life” of a single block grant, Ellie might, at any given time, have multiple grants with different vesting dates.

71. Id. ISO’s must vest within ten years. See Lance W. Rook, TAX PLANNING FOR THE ALTERNATIVE MINIMUM TAX § 6.04 (Matthew Bender 2002); see also 26 U.S.C. § 422 (2002).
72. Hollowell, supra note 64, at 691.
73. Sweeney-Vecchio, supra note 70.
74. Id.
75. Id.
76. For a good example of real block grants, see Davidson v. Davidson, 578 N.W.2d 848, 861-65 (Neb. 1998). The case concerns division of stock options as marital property. In an appendix, the decision includes charts detailing the father’s block grants and their values.
In addition, options have important tax benefits. The significant
difference between ISOS and non-quals is their tax treatment.\textsuperscript{77} Recall the
example above with the added event that on September 1, 2001, when
Company’s stock is selling at $6.00 per share on the market, Ellie decides
to sell the underlying stock she now owns outright:

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If Company is offering Ellie ISOS, she pays no tax at all until
September 2001 when she sells the stock. At that time, she pays tax on the
difference between the strike price and the sale price of the stock ($600.00 - $200.00 = $400.00 taxable income). Under the IRS tax code, if she has held the stock for more than one year, she pays only the capital gains tax rate (which is the case here).

By contrast, if Company offers Ellie non-quals, the same transaction
will involve two taxable events. First, at time of exercise Ellie pays tax – at
the ordinary income rate – on the difference between the strike price and the market price on date of exercise ($500.00 - $200.00 = $300.00). Notice this may create a liquidity pinch for Ellie, since she doesn’t yet have any
cash on hand from the sale of the stock itself. This pinch could be quite
significant if Ellie exercised thousands or millions of dollars of stock.
Second, when Ellie sells the stock, she pays tax on the difference between
the exercise price and the sale price ($600 - $500 = $100). Again, Ellie
will be eligible for capital gains treatment at this time only if she holds the
options for one year.

To complicate matters further, if a block of options has vested, Ellie
may partially exercise at one time and exercise the remainder at a later
time.\textsuperscript{78} Furthermore, exercising ISOS may trigger Alternative Minimum

\textsuperscript{77} See generally I.R.C. § 421 (2002).
Tax (AMT).\textsuperscript{79} This means that ISOs will not receive special tax treatment, and instead the tax due will be computed as though they were non-quals.\textsuperscript{80}

**D. UNIQUE PROBLEMS STOCK OPTIONS PRESENT IN THE CHILD SUPPORT CONTEXT**

1. **INCOME OR ASSET?**

The threshold question facing courts is whether availability of stock options constitutes income, thus making them available for child support. Before it was a child support issue, courts examined stock options in the context of marital settlements. State decisions have almost unanimously concluded that stock options earned during the marriage, even if unvested, constitute marital property.\textsuperscript{81} A fair amount of ink has been devoted to evaluating this problem.\textsuperscript{82} Observers often note the “dual nature” of stock options:

They have characteristics of an asset in that they represent a right to purchase an ownership share in the underlying corporation’s stock . . . . On the other hand, they have characteristics of income in that the whole purpose behind options is to allow the owner to capture the appreciation in value of the stock prior to its actual purchase. They are usually exercisable over time. Options are often designed to be exercised immediately, not held over the long term. Also, they are often given as a form of compensation. Complicating their nature even further, if an option is given as compensation, it can be deferred compensation for past services, compensation for present services, or compensation for future services.\textsuperscript{83}

\textsuperscript{79} Littman, \textit{supra} note 62, at 63; see also Rook, \textit{supra} note 71, § 1.04.

\textsuperscript{80} The AMT system runs parallel to and separate from the regular tax system. Rook, \textit{supra} note 71, § 1.01. After determining AMT liability, a taxpayer pays the greater of the AMT or the regular income tax due. Boris I. Bittker & Lawrence Lokken, \textit{Fed. Taxation Income, Estates and Gifts} § 111.4.5 (1989). ISOs trigger AMT because, under the AMT system, they do not receive special tax treatment and are treated identically to non-quals. Rook, \textit{supra} note 71, § 6.04(2)(b). Thus, a taxpayer does not necessarily enjoy the benefits of the preferred ISO tax treatment.

\textsuperscript{81} Fisher v. Fisher, 769 A.2d 1165, 1168-69 (Pa. 2001). By 1998, 17 states had held options not yet exercisable at date of dissolution to be marital property, while only 3 had found to the contrary. See Bornemann v. Bornemann, 752 A.2d 978, 986 n.4 (Conn. 1998). The seventeen states are: Arkansas, California, Colorado, Connecticut, Illinois, Louisiana, Maryland, Minnesota, Missouri, New Jersey, New Mexico, New York, Oregon, Virginia, Washington, West Virginia, and Wisconsin. The three finding otherwise are Indiana, North Carolina, and Oklahoma.


Arkansas finds that once the parties have divided the options as marital property, any later income those options generate are not available for child support. By contrast, when making a child support order, California will continue to look to income generated from property that is part of a property division.

Since there is no obvious, simple answer, the policy question emerges: Should stock options be considered income? For commentators who look at the issue from the standpoint of the child – the best interests of the child – the answer must be yes. Options are generally given as an (often significant) portion of employment compensation, which clearly fits within states’ broad definitions of income in child support statutes. Options are often extremely valuable, especially for high-level employees. For example, one Arizona AOL employee earned $42,600 per year as base salary, but by exercising options brought in twice that salary: Between $88,297 and $1,817,059 per year. Another California father worked as a professor and consultant and held $45 million in stock options from Cisco Systems. A Washington Microsoft employee earned $7,408.79 per month ($88,905.48 per year) in 1999, but reported $1,758,272 in taxable income to the IRS because he exercised options and sold the underlying stock.

As a matter of family law policy, it stands to reason that a parent should not be able to avoid paying child support because she or he is compensated with stock options rather than cash. Some courts examining the problem have noted that the best interests of the child are certainly not served by providing wealthy parents with a method of sheltering significant resources from child support, in effect leaving the employee with “unfettered discretion” to determine the amount of income available for support. Parents wishing to avoid child support could simply wait until their children reach the age of majority before exercising their options (at least those not in danger of expiring). This was the basic concern of the Murray court when it handed down a landmark decision holding that a father’s vested, but unexercised options, were available to support his children. I discuss Murray in greater detail in section F below. For now, suffice it to say some observers have lauded the Ohio Court of Appeal. Others have seriously criticized the Murray decision as being dangerous.

86. See generally Watson, supra note 13, at 1558.
91. See Murray, 716 N.E.2d at 299.
92. See Robinson, 35 P.3d at 95.
from a tax policy standpoint.\textsuperscript{93}

2. \textbf{Valuation}

If a court decides that stock options constitute income available for child support – and many courts have not yet made this decision – then the next question is how their value is, or ought to be, calculated.\textsuperscript{94} If parents exercise their options and sell the underlying stock, then value is easy enough to ascertain: It is the difference between the strike price and the market price at which the employee sold the stock, which is also the amount realized by the employee. Indeed, AMT notwithstanding, this is the position the IRS takes regarding ISOs; the option holder pays no taxes until he or she sells the underlying stock. Non-quals are trickier because the employee pays some tax before realizing any cash; however, it would be an inequitable and inconsistent policy to count non-quals as income but not ISOs, especially since the AMT system treats ISOs the same way the regular system treats non-quals. Although their tax implications differ, courts have not distinguished ISOs and non-quals for support purposes.

The valuation question grows even more difficult if the court is looking at an obligor with either vested, but unexercised options, or exercised options where the stock has not been sold. Because the employee has realized no cash, the court must adopt some method for imputing income to the employee parent, even though the underlying stock price is constantly fluctuating with the market. Furthermore, imputing income will raise the obligor’s support payment and may have the effect of forcing that parent to exercise and sell to meet his or her child support obligation.

There are several methods courts use to value stock options for purposes of marital property division. These methods provide a useful tool for examining some of the difficulties in valuing options. However, the problem in the marital property context is simpler because the property division is a one-time event, whereas a child support order represents an ongoing payment commitment. The simplest method courts use is the intrinsic value method. The intrinsic value is the current market price minus the strike price.\textsuperscript{95} The problem with this method is that the market value of a stock on any given day bears no relation to how financial markets value stock options.\textsuperscript{96} Furthermore, the intrinsic value method does not account for the fact that, although stocks are volatile in the short term, historical fact dictates that most Fortune 1000 company stock

\textsuperscript{93} See Karns & Hunt, \textit{supra} note 78, at 238-39; Sweeney-Vecchio, \textit{supra} note 70.

\textsuperscript{94} A court may be constrained by the record. Recently the \textit{Seither} court bemoaned the constraints of making a decision amid a barren record. \textit{Seither v. Seither}, 779 So. 2d 331, 334 (Fla. Dist. Ct. App. 1999). In \textit{Seither}, Father, a pilot, represented himself.


\textsuperscript{96} \textit{Id.}
increases in value over time. The true value of the stock option is the "potential for appreciation in stock price without investment risk." Thus, a child support order based on the value of a stock option on a specific future date has a speculative quality some courts are unwilling to abide even in a marital property context.

The Murray court used a modified version of the intrinsic value method when it assessed Mr. Murray's income. Finding it necessary to choose some date for valuation, the court chose the date each block of options vested, that is, the date each became exercisable to Mr. Murray. The court reasoned that the date of exercise was the day Mr. Murray began making an investment choice not to exercise the options, sell the stock and use the proceeds to support his children.

The second method of valuation is the Black-Scholes method, a theoretical model accounting for "option price, option term, market value of the underlying security, risk-free rate of return, and underlying volatility" to reach a present value. Although some courts use the Black-Scholes method to divide marital property, no court has yet employed it to value options in the child support context. Arguably, this stands to reason. With a vested option, the court essentially tells the obligor parent to exercise now on behalf of the children; the Black-Scholes method bases option value on criteria derived from the notion of holding onto the asset.

A third method for dividing options as marital property is the deferred distribution or "if, as, and when" method. In the marital property context, the nonemployee spouse receives his or her share at such time as the employee spouse chooses to exercise the options. The nonemployee spouse is guaranteed his or her share of the marital property at a future date without hampering the employee spouse's decision about when is best to exercise. Pennsylvania has accepted this model in the marital property context, rejecting the notion that the employee parent's power over the options should prove fatal. A few states have tacitly accepted the

97. Karns & Hunt, supra note 78, at 256.
100. Murray, 716 N.E.2d at 298.
101. See id. at 299.
102. Littman, supra note 62, at 62; see also Mard & Cestaro, supra note 82, at 63. According to Sweeney-Vecchio, the Black-Scholes valuation method is the only acceptable scientific methodology for valuing options. Sweeney-Vecchio, supra note 70.
103. See, e.g., Davidson v. Davidson, 578 N.W.2d 848 (Neb. 1998).
104. Id. at 858.
105. Id.
106. Fisher v. Fisher, 769 A.2d 1165, 1169-70 (Pa. 2001). The Fisher court chose deferred distribution as the lesser of evils even though the deferred distribution lacks finality. Id. It rejected an immediate offset of the market value of the options as being too speculative and found that distribution by proportions (assigning a percentage to the nonemployee spouse) precluded by the nontransferable nature of the options. Id.
deferred distribution method for child support in that they have held that exercised options do constitute income for child support.\textsuperscript{107} Most of these states have not addressed the issue of unexercised or unvested options, so it remains to be seen whether they will extend their analysis to encompass those as well. Colorado alone has explicitly excluded this possibility in that \textit{In re Marriage of Campbell} remanded to the trial court for a determination of “the income father actually has realized from the exercise of his stock options” since the court did not “perceive any basis for the trial court’s consideration of potential income to be received by father for exercise of future stock options until exercise of those options actually occurs.”\textsuperscript{108} The \textit{Campbell} decision is confusing to read. The court often refers to “exercised” options when the context suggests the court in fact meant exercised options where the underlying stock is sold. Thus, it appears that obligor parents in Colorado enjoy the exact scenario the \textit{Murray} court found unacceptable, in which obligors control the size of their support payments by their decisions about exercising stock options. \textit{Campbell}, which predates \textit{Murray}, does not address this concern.

In light of all these options, the Arizona Court of Appeal recently declined to adopt a universal valuation method, preferring to evaluate each family situation on a case-by-case basis.\textsuperscript{109} Arizona’s \textit{Robinson} case is the latest word on the subject and, although the holding doesn’t answer valuation questions with finality, it at least establishes that children in Arizona have a right to their parents’ options as a source for support.

\textbf{E. EXAMINING THE CASE LAW TO DATE}

Decisions tackling stock options as child support can be divided into three categories: Those examining (1) vested and exercised options where the underlying stock has been sold; (2) vested and exercised options where the employee holds the underlying stock without selling; and (3) vested but unexercised options. There is a theoretical fourth category: Unvested options. However, an employee’s right to an unvested option is merely an expectancy interest too tenuous for a court to consider income since the employee has no ability to access cash from a restricted option. The first category is arguably the simplest because the parent here has actually realized the cash benefit of the option. At this point, the parent has paid all tax associated with exercising the stock option and selling the underlying stock. Not surprisingly, the greatest number of cases on the subject address this question, probably because custodial parents learn about options when


\textsuperscript{108} \textit{Campbell}, 905 P.2d at 20.

they appear as taxable income on the obligor's tax return.

1. **VESTED, EXERCISED OPTIONS: UNDERLYING STOCK IS SOLD**

In 1995, the Colorado Court of Appeals became the first court to examine vested and exercised options where the underlying stock was sold in *Campbell*. The *Campbell* court was interested in "income actually realized" and "actual proceeds received by father," concluding that once the father realizes actual proceeds from the sale of underlying stock, the initial value of the stock option is a moot question. The court expressly limited child support income to the difference between the strike price of the optioned stock and the price at which it was sold. Again, *Campbell* suggests that Colorado will go no further to reach an obligor parent's income, leaving it up to the obligor parent to decide whether to sell the stock and expose it to the child support formula or hold it until after the children reach the age of majority.

Four states have also held that selling underlying stock constitutes income for child support: California (1999 and 2001), West Virginia (2001), New Hampshire (2001), and Washington (2002) have looked at the same basic fact pattern and reached a decision similar to Colorado's. The critical difference from Colorado is that these four opinions do not contain language precluding lower courts from going further to reach options where the underlying stock has not yet been sold. Rather, these four cases establish a floor below which trial courts cannot go in considering income for a child support order. In these states, obligor parents know selling underlying stock may raise their child support order, but custodial parents can hold out hope that a court might still reach the options of an obligor refusing (or choosing not) to sell underlying stock.

Since the 1995 *Campbell* decision, the only outlier case is a 2001 Arkansas decision, *Southerland v. Southerland*. In *Southerland*, both parents worked for the same employer, United Medical. When United Medical was bought out, it granted both employee-parents a one-time lump sum payout based on what amounted to an accelerated option agreement. The obligor father, who worked for United Medical longer, received $118,775 while the mother received only $43,905. The parties considered their options in their marital settlement agreement but did not divide them because both considered the options worthless at the time. The court limited its holding to the facts of the case and found that the option

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111. *Id.* at 21.
114. *Id.* at 868.
115. *Id.*
agreement was "more akin to a marital property that increased in value after the divorce." Consequently, *Southerland* may be distinguished from a more normal stock options fact pattern in the future. However, a court might also read *Southerland* to shield significant income from child support if the options in question were divided – or even considered – in a marital property division. Such a holding would be unfortunate for West Virginia children, especially where the parents are married only a short time and the custodial parent receives few options in the marriage dissolution. Indeed, were this to become West Virginia's law, those children would prove better off had their parents never married, in which case all the obligor's options might be available for child support.

2. VESTED, EXERCISED OPTIONS: UNDERLYING STOCK NOT SOLD

Interestingly, the Delaware Supreme Court examined this question back in 1990 – even before *Campbell* – but it received no critical attention and scant legal attention. In *Kenton v. Kenton*, an obligor father exercised stock options but had not sold the stock.\(^{117}\) From the stated facts, it appears his options were probably non-quals, because upon exercise he paid tax on the difference between the strike price and market price on date of exercise.\(^{118}\) It was that taxed "paper" profit the court considered. The father, of course, argued that he acquired only stock, a non-cash asset, and so the exercise should not trigger an increase in his support payment.\(^{119}\) The court held that, despite the fact that the profit was merely a paper-profit, the state's guideline formula should properly account for it.\(^{120}\) It directed the trial court, on remand, to consider whether the father had successfully rebutted the formula's presumption.\(^{121}\) Thus, Delaware became the first state to hold that exercised options where the stock was not sold should be considered income.

An interesting question remains: Since the Delaware court presumably examined non-quals, would its holding extend to ISOs (where no tax is paid until the stock is sold)? To the extent that the holding was based on Delaware's broad definition of income, it appears to extend to ISOs. Furthermore, the IRS treats ISOs exactly like non-quals in the AMT context. However, to the extent that the court looked to "profits realized from the exercise of the employee stock option"\(^{122}\) as exhibited on tax returns, it may not. Nonetheless, the stronger argument suggests, especially in light of AMT treatment of ISOs, it is illogical and unjust to treat similar resources differently only because the IRS sees fit to tax them

\(^{116}\) Id. at 870.
\(^{118}\) Id.
\(^{119}\) Id. at 783.
\(^{120}\) Id. at 782.
\(^{121}\) Id. at 784.
\(^{122}\) Id. at 783.
at different times. The result would be that two children with similar resources may have different amounts of child support available depending on nothing but tax preferences. Ironically, the parent with less income available because of the tax liability would have a higher child support order than the parent with no tax due at the time of exercise.

The California Court of Appeal reached a conclusion similar to Delaware's in 1999. *In re Marriage of Kerr* concerned a marital dissolution.\(^{123}\) During the marriage, the parties regularly used the father's options to enhance their lifestyle.\(^{124}\) The trial court awarded the mother a percentage of the father's exercised options.\(^{125}\) The appellate court remanded because the trial court failed to put a reasonable needs cap on the award.\(^{126}\) However, it held that "a percentage award based on the realized income from the exercise of stock options" would be permissible when accompanied by such a cap.\(^{127}\) The holding stresses "option income" and "realized income."\(^{128}\) It is unclear whether the court envisioned a scenario where the father exercised but did not sell his options, and if so, whether non-quals would be considered income where ISOs would not because income is realized for tax purposes.

3. **VESTED BUT UNEXERCISED OPTIONS**

The difference between the previous category and this one is that here the obligor parent does not own the underlying stock. In many ways, this category is analytically identical to the previous one, since in both situations the obligor has no actual cash, but rather the right to receive cash at any chosen time. The critical difference between the two situations is their tax consequences. If the obligor carries non-quals or pays AMT on ISOs, exercising the options is itself a taxable event, potentially creating a liquidity pinch because the obligor owes tax but does not yet have any cash from the sale of stock. In addition, whether the obligor has non-quals or ISOs, if the obligor sells them immediately after exercise, she or he will be taxed at the ordinary tax rate, whereas obligors who hold on to the option for a year are taxed at the lower capital gains rate. This is not an inconsequential difference where the tax on thousands or millions of dollars is at stake.\(^{129}\) Tax consequences affect support differently in different states, depending on the income model each uses. For example, some states calculate child support using gross income and others use net

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123. *In re Marriage of Kerr*, 91 Cal. Rptr. 2d 374, 376 (Ct. App. 1999);
124. *Id.*
125. *Id.* at 377.
126. *Id.* at 381.
127. *Id.*
128. *Id.*
None of the three courts examining vested, unexercised options discuss tax considerations, but obligors have a policy argument that they should be able to hold their underlying stock one year in order to obtain the favorable tax treatment. Surely it is in the best interests of children for parents to keep the asset one year (assuming no financial need to sell sooner), as doing so will open up greater funds for child support.

The first case to examine vested, unexercised stock options was Murray. The Ohio Court of Appeals began by noting that the law’s overriding concern is the best interests of the child and that gross income in Ohio’s child support statute is broad, flexible, and expansive. The court went on to find that it would be “grossly inequitable” for an obligor to “hide behind the shield of corporate business decisions, and prevent his children from enjoying the standard of living they would have enjoyed had the marriage continued.” Again, the Murray court rejected the deferred distribution “if, as and when,” instead valuing the options by using the market price on the date of vesting, since that’s the date the options became available for the father to utilize. Murray generated both criticism and support, which I discuss in Section F below.

A few months after Murray, the Court of Appeal of Florida decided Seither. Seither concerned a Southwest Airlines pilot’s stock options. It appears from the scant facts that the obligor father held both vested and unvested options from his employer, and he exercised none of them. On such a weak record, the court declined to question the trial court’s discretion and chose not to preclude options from ever being income. Thus, the court accepted the trial court’s method of valuing the options based on expert testimony about the market price a few days before the trial. The appellate court noted that no single formula or set of factors can effectively settle the valuation question for all cases.

The most recent case to follow Murray is In re Marriage of Robinson. The Court of Appeals of Arizona agreed with Ohio that stock options, even unexercised ones, should be included as income. Like Murray, Robinson explicitly rejects the deferred distribution valuation.

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130. Venohn & Williams, supra note 8, at 15.
132. See id. at 292 (citing McQuinn v. McQuinn, 673 N.E.2d 1384, 1387 (Ohio Ct. App. 1996) and Williams v. Williams, 600 N.E.2d 739, 742-43 (Ohio Ct. App. 1991)).
133. Id. at 293 (quoting Williams, 600 N.E.2d at 742).
134. Id. at 298-99.
136. Id. at 332.
137. See id.
138. See id. at 333.
139. Id. at 332.
140. Id. at 334.
142. Id. at 94.
method as leaving too much power in the obligor’s hands.¹⁴³ Unlike Murray, the Robinson court declined to select a single method for valuation.¹⁴⁴ Seither and Robinson are important in following Murray and Kenton. California’s Cheriton, which came out one month before Robinson, also addresses the question of vested but unexercised options, but does so in the framework of assets rather than income. I discuss Cheriton in detail in Section G.

F. CRITICAL RESPONSE TO MURRAY


Karns is a professor of business law and Hunt a professor of finance. Their central criticism of Murray is that the court violated public policy in finding that the options constituted income.¹⁴⁷ Their article suggests that Murray should not be adopted in other jurisdictions,¹⁴⁸ pointing out that Murray is a gross simplification of complex issues.¹⁴⁹ Instead, the authors observe that options are not taxed because they are non-transferable and subject to forfeiture, essentially endorsing the IRS and economists’ view of what constitutes income.¹⁵⁰ Furthermore, they point out that options – especially those of top companies – increase in value over time because of market volatility principles, and an employee is better off holding onto his or her options rather than cashing them out the minute they become free of restraints.¹⁵¹ Their bottom line is that parents with stock options should not have income imputed to them. Notably, they observe that the Murray reasoning forces a parent to sell even if doing so yields a loss.¹⁵²

The Karns and Hunt article is a well-written, thorough analysis of the tax principles underlying the Murray decision. However, unlike the Court of Appeals of Ohio, Karns and Hunt are more interested in economic

¹⁴³. Id
¹⁴⁴. Id. at 95.
¹⁴⁵. Karns & Hunt, supra note 78.
¹⁴⁶. Watson, supra note 13.
¹⁴⁷. Karns & Hunt, supra note 78, at 236.
¹⁴⁸. Id. at 264.
¹⁴⁹. Id. at 240-41.
¹⁵⁰. See id. at 246.
¹⁵¹. Id. at 256.
¹⁵². Id. at 241. It is debatable whether such a forced sale is in the best interests of children. On one hand, the idea that more child support is better than less supports imputing income despite the loss. On the other hand, forcing a parent to take such a loss may prove to be a cost not worth the benefit in the child’s overall financial picture.
principles – and the property interests of the obligor parent – than in the best interests of the child. Indeed, they criticize the “vast amount of Ohio case law that clearly places the interest of the child of divorce ahead of even sound application of financial and economic principles.” Well, they are right. States do – under the congressional mandate of the FSA – place the interests of children before the personal economic wishes of parents. Unfortunately, Karns and Hunt do not suggest a better system except for implying that not imputing income is the only equitable solution to this conundrum. Still, as scholars well aware of market forces, they end with a prediction well worth noting:

Unless a more reasoned approach is taken, corporate employer attorneys will develop deferred compensation packages which will not be assailable by the disenfranchised spouse. Deferred compensation may take the form of annuity payments that do not begin for a considerable number of years, or at least until the children reach the age of twenty-five, or it is possible that the deferred compensation planners may become even more creative with regard to defeating the concept that unexercised stock options are “gross income from any source” as concluded by [the Court of Appeals of Ohio].

One possible solution to the Karns and Hunt quandary comes from Kristy Watson’s well-reasoned note. She suggests that both the child’s best interests and sound financial management are served by putting the options in a constructive trust. Constructive trusts avoid the issue of the stock being non-transferable, problems of valuation, and offer flexibility to a court wishing to impose special requirements on the parties. Watson’s suggestion seems to solve all the court’s problems, but it’s not clear how a constructive trust will play out in reality. At least in California, creating a constructive trust is easier said than done, as I discuss in the next section.

F. CHANGES IN CALIFORNIA UNDER CHERITON AND OTHER FACTORS AFFECTING AN ORDER

Stock options do not exist in a child support void. There are other aspects of child support law that come into play, further confusing an already complex subject. This section focuses on California’s body of case law in the context of the cases I discussed in Section E.

1. TRUSTS AND THE HIGH-INCOME EARNER EXCEPTION

One important complication here is the high-income earner exception

154. Id. at 264.
155. Watson, supra note 13, at 1558-59.
156. Id. at 1564-65.
to the guideline order presumption, relevant to many stock options proceedings. In California, once the court decides to deviate below the guideline order, it examines the reasonable needs of the child.\textsuperscript{157} As I noted in Section B(3), states differ in ascertaining the reasonable needs of a child. For example, while California looks to the standard of living obtainable by the wealth, Washington uses the parent’s own living standard as the bar. Thus, if a court is inclined to award options using a percentage of the options rather than assigning an actual dollar amount, the court will have to cap the dollar amount a custodial parent may actually receive.\textsuperscript{158} Again, in \textit{Kerr}, California held the trial court erred in awarding a percentage of exercised and sold options as child support unless it be accompanied by a reasonable needs cap.\textsuperscript{159} Thus, child support will consist of the percentage of options or their dollar value, whichever is lower.

This would certainly complicate a constructive trust, which requires valuing options and allocating an appropriate quantity (or percentage) for support. Although Watson envisions both parties sharing the benefits of a strong market as well as the risks of a weak one, it is difficult to imagine how a California trial court could confidently order such a trust in light of \textit{Kerr}, unless the trust contained explicit language addressing the situation wherein the option yield exceeds the reasonable needs cap. Thus, a trust would have to provide for a reimbursement to the obligor or arrange for the excess to remain in the trust in case the options fell short of the reasonable needs cap in a future month.

Furthermore, the trust option – and it is debatable whether this is relevant to the best interests of children – denies obligor parents the opportunity to satisfy the child support obligation from other funding sources if they so choose. Nonetheless, where the California Court of Appeal imputed income to historically non-income producing real estate, it pointed out that the order did not force the obligor father to liquidate the asset since he was “free to use whatever resources he chooses to meet his support obligations.”\textsuperscript{160} A constructive trust undermines this justification.

These are not the only complication a trust faces in California. First, the California Supreme Court held that child support can only provide for present, not future, support.\textsuperscript{161} Therefore, any trust language must be sure to provide for current support. Therefore, as the child’s needs change over time, the trust will become subject to amendment. Second, the California Court of Appeal has criticized trusts in the child support context. Largely,

\begin{enumerate}
\item \textit{In re Marriage of Cheriton}, 111 Cal. Rptr. 2d 755, 765 (Ct. App. 2001).
\item \textit{In re Marriage of Kerr}, 91 Cal. Rptr. 2d 374, 380-81 (Ct. App. 1999). \textit{But see Venofoh \& Williams, supra} note 8, at 11 (noting that some states award child support strictly on a percentage basis).
\item \textit{Kerr}, 91 Cal. Rptr. 2d at 380-81.
\item \textit{In re Marriage of Destein}, 111 Cal. Rptr. 2d 487, 494 (Ct. App. 2001).
\item Primm v. Primm, 299 P.2d 231 (Cal. 1956).
\end{enumerate}
the concern is in limiting a custodial parent’s access to the funds. The Chandler court stated, “We doubt it is ever appropriate to employ a trust when ordering a parent to pay child support, particularly one which, in part, places the custodial parent under the fiscal control of the supporting parent.” It is possible a judge could distinguish Chandler by ordering a no-strings trust. However, the Court of Appeal may view Chandler’s central statement casting doubt on the appropriateness of trusts in the child support context as near absolute. Indeed, the Cheriton parents had stipulated to, though they never actually established, a support trust to provide for housing and educational expenses. Quoting Chandler, the Cheriton court held it was error to include the benefits of an inchoate trust in making an award. Furthermore, Cheriton found the trust would be unenforceable because it capped the children’s housing needs even though the parties had yet to purchase a house for the custodial parent and children. Therefore, in California, a high earner award must cap the children’s reasonable needs under Kerr, but errors in doing so before those needs are actually ascertained under Cheriton.

2. Cheriton’s Valuation Method

In addition, Cheriton may alter the debate about valuation. Cheriton concerned the wealth of David Cheriton (David), a Stanford computer science professor, who owned vested stock options associated with work as a Cisco Systems, Inc. consultant. David and his wife, Iris Cheriton (Iris), separated in 1988, reconciled, and separated again in 1994. In 1994, David agreed to pay temporary child support of $2,171 per month. In 1997 the parties stipulated to a dissolution judgment. Also in 1997, David exercised 300,000 Cisco shares. He then sold half the shares at $65 per share, grossing $9.75 million, in order to pay taxes and attorneys fees. According to David’s attorney, the rest paid off back taxes. In 1998, the trial court held a hearing on the issue of child and spousal support. At time of trial, David’s options were valued at more than $45 million based on the stock market. The trial court held that, until the options were exercised, they did not constitute income available for support. The Court of Appeals divided its discussion of stock options into two parts, examining them as a source of income and as an asset. In the income

163. Id. at 112.
164. In re Marriage of Cheriton, 111 Cal. Rptr. 2d 755, 763 (Ct. App. 2001). Furthermore, the court found the trust would be unenforceable because it capped the children’s housing needs. Id. at 773-74.
165. Id. at 773.
166. Id.
167. Id. at 762 n.2.
168. Id. at 762.
169. Id. at 769.
analysis, the court cited Kerr and federal tax law in observing that an “employee-parent may realize income at the time an option is exercised.”

The court went on to hold that the actual sale of underlying stock ($9.75 million) after permissible deductions constituted income for child support. Although acknowledging Kerr, the holding does not address the issue of exercised options where the underlying stock is not sold as income.

The Cheriton court next analyzed David’s options as an asset. As Section B(2) makes clear, California is willing to impute a reasonable rate of return to an obligor’s assets. Observing that a parent cannot underutilize income-producing assets to avoid child support, the appellate division held that “at the very least” the trial court should have imputed a reasonable rate of return to those vested options David held. Therefore, Cheriton laid out a new floor for child support from vested options: A reasonable rate of return. However, the case does not go as far as Murray. The Murray children will benefit from the full value of Graeme Murray’s options, while the Cheriton children might only benefit from a small percentage of their worth. Although Cheriton opens some doors for child support, it may allow obligor employees to shelter wealth from child support.

Cheriton’s holding that a vested stock option may be considered an asset (with income imputed) until it is sold, at which time its full value may be assessed could have peculiar results. For example, suppose Francis (from the introductory hypothetical) owes a child support award based on imputing income to his vested, unexercised options. When he exercises options, he may have income under Kerr. If Francis sells the underlying stock to help make his child support payments, he definitely has income at that time of sale, which may in itself raise his income level enough to constitute a change of circumstances leading to a higher support award. Francis now has another incentive not to sell his underlying stock. Ironically, if he has no choice financially, Francis may end up with the same child support payment he would have had if the court had considered the full value of his vested options initially.

The Cheriton court also addressed a new issue: Treating stock options a custodial parent receives in a dissolution proceeding. The court observed that, although the value of the entire sale of David’s stock constitutes income for him, when Iris does likewise with stock options she received, she is “liquidating a principal asset that she received in the property

170. Cheriton, 111 Cal. Rptr. 2d at 768.
171. Id. at 769 n.9. Permissible deductions included tax liabilities but the court questioned deducting attorney’s fees.
172. Perhaps this is because David never exercised options without selling. In any event, the court preferred to examine the remainder of David’s options as assets rather than a source of income.
173. Cheriton, 111 Cal. Rptr. 2d at 772.
This different treatment may render Karns and Hunt apoplectic.

In any event, where Arkansas appears to put stock options divided in a marital settlement on the same footing, California puts them on different footing. The Cheriton court did not spell out the full ramifications of this distinction, leaving it instead to the trial court to account for on remand. As much as I am convinced that stock options ought to be reached by the courts, I am not certain of the equity in considering similar assets differently for the two parties across the board.

3. IMPUTING INCOME UNDER CHERITON

Courts have generally imputed income where doing so is in the best interests of the child. Noting that both parents have a statutory obligation to provide for their children, courts in the past have been willing to impute income to either the obligor or the custodial parent. Of course, imputing income to a custodial parent effectively reduces the child support award. Cheriton takes issue with this point. Since the record contained ample evidence of Iris’s earning capacity, the court observed there was legal authority to impute income to her. However, the court went on to observe that,

[N]o authority permits a court to impute earning capacity to a parent unless doing so is in the best interest of the children . . . .

We find it difficult to imagine how the children’s interests are served by doing so, since the imputation of earning capacity to Iris effectively reduces overall monetary support for the children.

Thus, Cheriton questions the whole line of cases imputing income to custodial parents, pointing out that appellate decisions provide no explanation for why decreasing a child support payment is in that child’s interests. Clearly, Cheriton is altering the perspective from which we view a child’s best interests. Where prior courts said, in effect, “children’s best interests are served when both parents work to support them,” Cheriton said “children’s best interests are served when their support award is higher rather than lower.” Both views dictate opposite decisions regarding whether to impute income to a non-working custodial parent. It remains to be seen how trial courts will apply Cheriton. It may take another appellate decision to sort out this new discrepancy in the law.

174. Id. at 769 n.10.
175. See supra Part B(2).
176. Cheriton, 111 Cal. Rptr. 2d at 779.
177. Id. at 779-80.
178. Id. at 780 n.19.
4. **TIMING REALITIES**

Realistically, timing may play a large part in stock option valuation. What if some options are vested and unexercised while others are vested, exercised, and sold? Does the actual income received by an employee parent who sells underlying stock trump the more fictional value a court assigns to the unexercised options? Courts have suggested that a change in the market may constitute a change of circumstances.\(^{179}\) What if, no sooner than an order is put in place, the obligor files a valid motion for a modification? The parties could spend the entire minority of their children litigating child support. The Court of Appeals of Ohio solves this problem by assigning a somewhat artificial value to the options based on stock price at date of vesting.\(^{180}\) At what point do we say that administrative efficiency is more important than the integrity of the child support? For the party on the raw end of the stock market, the answer may be never.

H. **THE PRICE OF ACCURACY**

Without actually granting a custodial parent a portion of a non-custodial parent’s stock options, any valuation method courts use to fix an income number under a child support formula is necessarily inaccurate, since option values fluctuate. In California, the court is “limited to the conditions and circumstances existing at the time [child support orders] are made, and the court cannot then anticipate what may possibly thereafter happen and provide for future contingencies.”\(^{181}\) In *Cheriton*, the Court of Appeal reversed the trial court’s attempt to create a formula the parties could use for calculating future child support modifications based on the father’s income from stock options.\(^{182}\) Noting the laudability of the trial court’s motives in avoiding further litigation, it nonetheless held the procedure exceeded the trial court’s jurisdiction and hampered effective judicial review.\(^{183}\)

One wonders if the Cheritons are destined to spend the whole of their children’s minority in litigation. Once an order is in place, either party can seek modification at any time based on a change in circumstances.\(^{184}\) In California, a change of circumstances may be *anything* affecting the financial status of either party.\(^{185}\) This suggests a change in the market, and hence the financial picture of an option holder, is grounds for modification. Florida has suggested as much.\(^{186}\) Ironically, the significant costs of

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182. *Cheriton*, 111 Cal. Rptr. 2d at 777.
183. Id.
184. CAL. FAM. CODE § 4620 (West 2002).
protracted litigation drain the very resources at issue before the judge. Even as parties debate the needs and interests of their children, the available funds flow not to their children but to the attorneys who debate the children’s interests. If that is the case, only private ordering – the parties’ personal agreement to cease litigation – will spare them this ongoing ordeal.

Nonetheless, the theoretical benefits of the child support system are clear. The law seeks to ensure that the parties’ child support order both accurately reflects their true financial picture and accounts for the children’s best interests and needs. Again, the possibility for protracted litigation emerges. When we consider best interests in the child support context, we think most readily of financial rather than emotional needs. This may be an error. Notably, in the context of custody disputes, the psychological harm to children of ongoing family conflict is well documented. In fact, studies indicate that children in high-conflict, non-divorced families have greater self-esteem and psychological adjustment difficulties than those in divorced families. Conflict between divorced couples tends to diminish over time, but remains high where parents continue navigating co-parenting relationships and economic responsibilities. Furthermore, the conflicts most harmful to children are those in which the children are caught in the middle. These studies do not directly examine child support conflict; nonetheless, it seems reasonable to suggest that ongoing interparental conflict in the form of protracted litigation about the money moving between the parties for the purposes of raising children may be a source of stress. To that extent, the Cheriton trial court may have exceeded its jurisdiction in fashioning a formula for considering future option income for modification of its child support order, but it was doing so in the best interests of the Cheriton children. It is not my aim to minimize the financial needs of children or their custodial parents; indeed, there is no need for financial need and psychological well-being to be mutually exclusive.

This issue highlights a significant strength of the Murray decision. By choosing the date the father’s options vested as the valuation date, the Murray court announced a rule that all Ohio families can readily ascertain and apply to their child support calculations. By contrast, since Arizona’s Robinson court declined to adopt a formula, instead favoring accuracy and

187. See supra Part B(1).
189. Id. at 175.
190. Id.
fairness on a case-by-case basis, Arizona parents with options may find themselves more likely to have trials and evidentiary hearings on the subject of their option package values. This seems particularly regrettable for rank-and-file corporate employees who aren’t extraordinarily high earners and may not otherwise require evidentiary hearings for calculating child support. Ironically, this case-by-case methodology is exactly the situation Congress hoped to move away from when it enacted the Family Support Act back in 1988.192

Therefore, courts should considering fashioning a methodology for valuing stock options that is fair given the parties’ financial picture, but also predictable. Child support is an area wherein the advantages of rule-based lawmaking outweigh the costs of increased judicial discretion associated with standard-based guiding principles. Rules are meted out equitably; because they are clear, they are easily understood and discourage shirking responsibility and testing authority.193 When Congress laid out the guideline formula in 1984, they enacted a rule-based child support law. States deviate from that rule only in special circumstances. Stock options are increasingly common; there is no need to subject so many families to litigation over their valuation. If a family qualifies as high earner, the court will already be holding hearings to ascertain the reasonable needs of the children. A clear valuation method would minimize the litigated issues for high-earner families and potentially eliminate the need for litigation at all for the rest of families.

I. CONCLUSION

The trend of courts examining stock options as a resource available for child support is to find that it is indeed available to support children. Although valuation is difficult, courts are right to take on the challenge consistent with children’s best interests. Valuation continues to trouble courts, and, with the exception of Ohio, jurisdictions examining the problem have been reluctant to mandate across-the-board solutions. This requires courts to examine each family situation on a case-by-case basis. In this context, high income, high conflict families, or families where the parents cannot reach an amicable agreement on the subject, are destined for trials on a range of issues: Valuation of options, living standards, historical exercise patterns, market prices, children’s needs, and imputed income. Again, litigation incurs costs that drain the resources available for children and potentially creates psychologically damaging conflict in the lives of children. Creating a rule-based formula or methodology for valuing stock options addresses the difficulties associated with litigation. Such a formula might compromise the exactness and fairness of the valuation for a

192. See supra Part B.
particular family, but as the law stands now, we lack both predictability and a valuation method that can truly account for stock option value.

The picture of our current market is far darker than it was when I first began looking at these issues in the summer of 2001. With less money at stake, appellate courts may be spared some decision-making in this area, at least for now. Nonetheless, the challenge of incorporating stock option value in our child support systems remains pertinent. To the extent courts are committed to the best interests of children, they would do well when formulating solutions to consider all the best interests of children – both their financial needs and their emotional health.

**Figure 1:** Sample child support guideline calculations using SupportTax, a computer program that calculates child support under California Law. There are numerous variables that may affect the child support order including number of children, visitation schedule, mortgage tax payments, and other tax considerations. Consequently, these figures are approximations for illustration purposes only. Here, I am presuming a typical scenario: One child residing primarily with Mother. 28% visitation would be a situation where the child spends every Friday and Saturday night with Father. 36% visitation would be Friday and Saturday nights plus one weeknight every other week with father.

<table>
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<tr>
<th>Father's Income</th>
<th>Mother's Income</th>
<th>Visitation with Father (non-custodial parent)</th>
<th>Child Support Per Month</th>
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<tr>
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<td>$1,787</td>
</tr>
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<tr>
<td>$250,000</td>
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<td>$1,016*</td>
</tr>
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</table>

*Indicates Mother owes Father child support

California's child support formula has been criticized for being too
complex. As Presiding Justice Sills famously observed in *In re Marriage of Schulze*, 70 Cal. Rptr. 2d 488, 492 n.2 (Ct. App. 1997),

> [T]he algebraically based computation method has been likened to something out of Alice in Wonderland. Actually, it's worse than that. The system is a kind of hybrid of quantum physics and Zen philosophy. Support is calculated on after-tax income, but after-tax income may be *itself* affected by the support order! Thus, in a manner reminiscent of an attempt to pin down an electron or the image of a snake eating its own tail, the nooks and crannies of the computer program involved in this case contain sophisticated feedback loops which seek, in essence to continually adjust for the tax effects of a given order, but at the same time formulate an order in light of those same tax effects. The complexity is compounded because not only does every child support calculation in California now require the parties to do their tax returns (a fiendishly complicated process by itself), but on top of the tax computations an algebraic formula must be applied to the result. For a judge trying to manually apply the law, it would be like taking an algebra exam after doing somebody else's tax returns.

*Id.*
Figure 2: To aid the reader in keeping the various phases of stock options ownership clear, what follows is a chronology of stock option ownership. The note considers the case law on stock options phase by phase:

- **Time Frame:** Employee receives options.
  - **Employee holds:** Unvested, unexercisable options.

- **Time Frame:** Employee exercises the options.
  - **Employee holds:** Exercised options, a.k.a. stock.

- **Time Frame:** Employee sells stock.
  - **Employee holds:** Cash received from sale of stock.