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April 17, 2005

Ms. V (Wife's Attorney)

RE: Marriage of L (Husband) and G (Wife)

Dear Ms. V:

Since your mediation is Tuesday, there really isn't enough time to formulate a step-by-step rebuttal of the sequential method valuation, but the following points leap out at me.

- *Marriage of Short* has been around since 1993. That is eleven years ago. Ms M (Husband's Attorney) concedes that no California court has yet adopted the method. California courts decide at least dozens and probably hundreds of stock option allocations every year. I conclude that there is nothing blatantly and inherently unfair with *Nelson* that forces the parties to find or devise a more equitable method to allocate community value. In this case, Husband's attempt to use the sequential method adopted in *Marriage of Short* is a thinly veiled attempt to deny Wife her fair share of a significant community asset.
- One of the attractive features of *Nelson* is that it does NOT require the court to determine the "intent" of the employer in granting options. In criminal cases, intent may be relevant in determining culpability. California is a no-fault divorce state, and intent between the parties is not a permitted litigation issue (as I understand it – I'm not an attorney). Attempting to discern the "intent" of a corporation is even more specious. Furthermore, such a determination is clearly subject to manipulation, depending on the relationship between the employee and the company. I would cite Mr. M's (Corporate Personnel Manager) statement as an example.
- I do note that Mr. M didn't even join T (Corporate employer of Husband) until June 1999. Before that time, he was at O (Other company). I would contend that he is not qualified to interpret the "intent" represented by the actions of T's management two years before he was hired. I think his statement should be interpreted merely as a generic statement of why companies offer stock options rather than some circumstance unique to T. But those reasons haven't really changed in the past eleven years, so why do we need a new method for valuing stock options?
- I think the argument that the efforts of the optionee and the efforts of the community have no influence over the stock price and the success of the company is ridiculous. It is precisely this effect and effort that companies are attempting to elicit and reward when they grant options. If that were not so, there would be no reason to grant the options in the first place. "Here, I'll give you something we both know is worthless and I expect great loyalty and effort from you in return"? I don't think so.
- I would argue that after courting Husband for a year and inducing him to move to California from New York, T probably would have been sued if they had cut Husband loose barely four years after they got him out here. Allowing him to continue as a consultant was a nice gesture. No one has mentioned how Husband's workload or income has changed since he was laid off. I do know that in order to meet the requirements of being a contractor, rather than an employee (see the *Vizcaino vs Microsoft* decision) there needed to be a significant change in his responsibilities. It is quite likely that he was part time for T, and had other clients as well.
- There is nothing in the option grant language that specifically implies that the options are intended only for future efforts. It is very clear that options are intended to reward past service (generally indicated by the number of shares awarded) and to inspire future effort (as indicated by the vesting schedule).
- Consider what the structure of an option would have to be in order to justify being valued by the sequential method. Suppose any portion of an option could be exercised only in the month that it vests. The following

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month that portion of the option is cancelled, and the next increment of the option vests. Obviously if there is only one month when it is possible to exercise an option, it looks much more like compensation or bonus. The option has value only if the stock price exceeds the option price at some time during the month. In that case, since the option vests in accordance with the sequential method, it would make sense to value it that way. On the date of separation, there is some previously exercised stock which is community property, there are unvested options which vest in the months following separation which are separate property and only the aliquot maturing in the month of separation needs to be divided by the time rule. I have never seen an option structured this way.

I hope this helps in your mediation. Let me know if something is not clear.

Sincerely,

Patricia P. Watt
Fellow of the Society of Actuaries