In the Details: Valuing Restricted Stock and Options in Litigation

By William Carrington and Karl Snow

Employee stock options (ESOs) and restricted stock grants are increasingly important parts of the compensation packages of executives of publicly traded firms. It is no surprise, then, that claims involving options and stock grants are becoming part of the landscape of employment litigation. The valuation of restricted stock and ESOs, however, presents special challenges that are often ignored in the litigation context.

Many methods for valuing standard stock or options do not recognize that the restricted assets' value is affected by contractual features and employee job decisions. As a result, these methods typically misstate the value of these assets to employees. Further, valuation methods for unrestricted stock or options assume that security holders have well-diversified portfolios or can hedge financial risks, whereas employee owners of restricted stock and ESOs typically have a large proportion of their assets tied to their employer and are explicitly barred from engaging in many financial transactions that would minimize or eliminate the firm-specific risk associated with these securities.

This article reviews the mechanics of how restricted stock and ESOs work, illustrates why standard methods overstate their value, and outlines the factors that should be taken into account in a proper valuation of these forms of compensation.

"Restricted stock" is employer stock granted to an employee with the restriction that the employee cannot sell the stock for a fixed period—typically five years. Restricted stock is less valuable than unrestricted stock because the employees (1) forfeit the stock if they separate from the company during this period and (2) usually can neither liquidate the restricted shares for cash nor diversify away from the stock of the company where they work. Aligning the employees' incentives with those of the employer is, of course, the goal of restricted stock grants, but as employees of Enron learned, having wealth tied up in their employer's stock means that employees' careers and financial wealth both are vulnerable to the employer's misfortunes.

Measuring the extent to which restricted stock is less valuable than unrestricted stock depends upon factors such as the employee's expected tenure with the employer, the length of the restriction, constraints on the employee's ability to hedge or borrow against the restricted shares, and the volatility of the stock price. Properly accounting for these factors is an involved economic calculation, but proper accounting is important because the true value of restricted stock to the employee is often much less than a similar block of unrestricted stock.

ESOs confer upon employees the right but not the obligation to purchase the employer's stock at a fixed price—typically the stock price on the option issuance date. This right can be exercised after a vesting period and at any time before a fixed termination date—typically seven to ten years from the issuance date. Options are valuable because the holder gains if the stock's value increases but does not lose anything out of pocket if the stock's value decreases. There are commonly accepted approaches for valuing standard stock options, including the famous Black-Scholes formula for which Myron Scholes recently won a Nobel Prize.

These methods are also sometimes used without alteration to estimate the value of ESOs in employment litigation, but their application in this situation is typically inappropriate. The problem is that standard methods overvalue ESOs because of the ways they differ from standard options. Some of these differences are described below:

Vesting period. ESOs typically have a vesting period of up to four years during which the options cannot be exercised. Option valuation methods that fail to account for this restriction may overvalue the ESO.

Employee exits. An employee who leaves the company during the vesting period, either voluntarily or involuntarily, loses unvested options. An employee who separates from the employer after the vesting period but before the option termination date loses all options whose value is below the exercise price (out-of-the-money options). The employee is also then forced immediately to exercise all options whose value is above the exercise price (in-the-money options). Any of these events makes the option worth less than a standard option that is not tied to employment status. Because employees can and do leave firms, ESOs are less valuable than standard options.

Nonmarketability. Employees are explicitly prevented from selling vested ESOs. This means that to convert these securities into cash, employees must exercise the option and then sell the underlying shares. This nonmarketability feature of ESOs causes holders, on average, to exercise their options before the termination or maturity date. Some of the standard option pricing methods, such as the Black-Scholes model, assume that the option will not be exercised until its terminal or maturity date. This feature of the standard models leads them to overstate the value of an ESO, sometimes by a substantial amount.

In sum, the widely used methods for valuing *un*restricted stock and standard stock options may be inappropriate for valuing restricted stock and employee stock options, when the value of the financial instrument is tied to employment and the financial decisions of individual employees. The appropriate modeling of the intricacies of restricted stock and ESOs leads to valuations of these assets that are typically less than their unencumbered analogs. In some cases, failing to take account of this fact may lead to highly inaccurate measures of total compensation or damages to employees claiming the loss of these assets. ■

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