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## **EMPLOYEE STOCK OPTIONS AND DIVORCE**

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I. Overview

**A. Terms used in discussing employee stock options**

**B. Types of employee stock options**

1. Qualified employee stock options
2. Nonqualified stock options

II. Are employee stock options property?

III. Marital property, separate property, or partly marital and partly separate?

IV. Valuation of stock options

**A. Intrinsic value approach**

**B. Black/Scholes pricing model**

V. Tax issues

VI. Are options income for support purposes?

VII. Information the attorney needs to know

VIII. Discovery

**A. Informal discovery**

**B. Formal discovery**

IX. Role of the attorney

**A. When representing the employee spouse**

**B. When representing the nonemployee spouse**

X. Other common forms of equity compensation

**A. Restricted stock plans**

**B. ESOPs-qualified retirement plans**

**C. Phantom stock plans**

XI. Additional resources

## **I. Overview**

Employee stock options and other forms of equity compensation are no longer reserved for executives and “key” employees. They have become commonplace for employees of all levels. Large and small employers, start-ups and Fortune 500 companies find that this mode of compensation serves many purposes in addition to the traditional “golden handcuffs.”

The treatment of employee stock options in the context of divorce presents challenges. Stock options are not well understood by most family law practitioners or family law judges. Employee stock options are reminiscent of retirement benefits in the 1970’s. The idea that retirement benefits could be an asset of the marital estate was a novel concept. Courts struggled with how to value them, and what to do with them in the context of a divorce. A whole body of law developed and now retirement benefits are universally recognized as one of the largest assets of the typical marital estate. The treatment of employee stock options is in its infancy and the courts throughout the country are struggling to recognize the financial impact of this contingent property interest in a way that is rational and equitable to both parties, as well as their minor children. The development of the case law has not kept up with the economic reality. There are contradictory results and many different approaches. Because this is a developing area of the law, family law practitioners have the opportunity to exercise creativity in representing their clients, as well as the chance to make mistakes.

This presentation is intended to give the family law practitioner a basic working knowledge of employee stock options and the terms used in discussing them, a heads up on what to look for and what to look out for, and some strategies for representing your client.

### **A. Terms used in discussing employee stock options**

An employee stock option is the right of an employee (*option holder*) to buy a specified number of shares of stock in the employer-corporation at a specified price (*strike price, grant price, or exercise price*) at a specified future time not earlier than the *maturity date* or later than the *expiration date*.

The employer will usually place restrictions or conditions on the employee’s right to exercise the option, such as continuing employment with the employer for a required number of years

(typically 3-5) as a condition of vesting. The employer may allow portions of the options to vest in stages (*flights*).

When the conditions are met, the option is *vested*. Before the conditions are met the option is *unvested*. Sometimes an option is granted without conditions. In that case it is vested upon grant.

The earliest date at which an option may be *exercised* (the employee may buy the stock) is the *maturity date*. Usually the maturity date and vesting date are the same and therefore these terms are often used interchangeably, but sometimes the grant has a maturity date that is later than the vesting date.

Most options expire (*lapse*) within 10 years of the date the option was granted by the employer (*grant date*).

The employer usually sets the exercise price at market value (*at the money*) at the time the option is granted. Sometimes the exercise price is set below market value (*in the money*). The employee usually does not pay anything to acquire the option, but if there is a cost it is called a *premium*.

The result is that the employee is allowed to purchase stock in the employer-corporation at less than market value if the employee continues employment with the employer for the required time period.

## ***B. Types of employee stock options***

Employee stock options are classified as qualified<sup>1</sup> (*statutory*) or nonqualified (*non-statutory*). These terms relate to the tax treatment of the options to the option holder. Qualified plans, unlike nonqualified plans, have favorable tax treatment to the option holder.

### **1. Qualified employee stock options**

There are two main categories of qualified (statutory) employee stock options. They are similar but fall under different sections of the Internal Revenue Code.

#### **a) Incentive stock option (ISO)**

IRC 422 governs incentive stock option plans. ISO's are the most tax favorable form of equity compensation for employees. This is because no income tax is triggered until the option holder both exercises the option (buys the stock) and sells the stock that is acquired with the option. Then the option holder pays only capital gains tax (not ordinary income tax rates) on the market value of the stock on the date of sale or disposition minus the strike price. For the capital gains tax rate to apply, the option holder cannot dispose of the stock until more than one year after it was acquired (the option was exercised), and more than two years after the grant date. The option holder must also be an employee of the employer-corporation from the grant date until at least 3 months after the option was exercised. Note that the alternative minimum tax may be triggered in the year the option is exercised in the amount equal to the market value of the stock minus the strike price.

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<sup>1</sup> "Qualified" has no relationship to "qualified" retirement plans under IRC 401.

For the option holder to receive this advantageous tax treatment the employer must meet a number of restrictions described in IRC 422. Among the restrictions, options can only be granted to employees, the strike price cannot be less than the market value of the stock on the grant date, the option must lapse within 10 years after the grant date, the option cannot be transferable except upon death, and no more than \$100,000 of stock ((based on the stock's value on the grant date) can become exercisable to the employee in any one calendar year. It is the non-transferability requirement that creates special problems for divorce practitioners.

If these requirements are not met, the option loses its tax-favored treatment.

### **b) Employee Stock Purchase Plan**

An employee stock purchase plan is similar to an ISO, but is governed by IRC 423. As with an ISO, no tax is triggered when the option is exercised. The main differences are that the employer may set the exercise price below the market value of the stock on the grant date, the option must expire within 5 years of the grant (instead of 10), and only \$25,000 of stock ((based on the stock's value on the grant date) can become exercisable to the employee in any one calendar year.

## **2. Nonqualified stock options**

Nonqualified stock options do not meet the requirements of IRC 422 or IRC 423. Instead they are governed by IRC 83. Nonqualified options are typically less restrictive than qualified options. For example, nonqualified options can be granted to independent contractors and directors, in addition to employees. They are not as favorable to the option holder from a tax standpoint. Part of the gain is taxed at ordinary income tax rates, and only part is taxed at the lower capital gains rates.

The taxation of nonqualified stock options is not as straightforward. If the option has a readily ascertainable value and is transferable when granted, then the option holder is taxed at that time at the marginal rate on the difference between the market value and the strike price for the stock. Otherwise, the tax is generally deferred until the option is exercised. However, if the option still does not have a readily ascertainable value when the option is exercised, the tax is deferred until the stock is sold. The taxes can be substantial because not only is the option holder taxed at the marginal rate, but the income is also subject to FICA and Medicare. Note that sometimes the employer will pay the taxes on the exercise of the option, as an additional perk, so there is no tax cost to the employee.

The basis in the stock is the market value of the stock at the time the ordinary income tax is triggered. The option holder pays capital gains tax when the stock is sold.

## **II. Are employee stock options property?**

An employee stock option is a contingent property right, but does it have the attributes of *property* that allow a court to divide it upon divorce? The answer varies with the jurisdiction. Some courts have held that if an option is not vested it is nothing more than an expectancy and therefore cannot be divided upon divorce. The majority of courts do not have conceptual difficulty determining that employee stock options are property, but instead focus their energies on whether to characterize them as separate or marital property. In post

judgment support proceedings the issue is whether the options constitute property, or income from which support can be paid.

### **III. Marital property, separate property, or partly marital and partly separate?**

The issue that receives the most attention by the courts is the characterization of employee stock options as marital or separate property. Some courts have adopted a bright line test: if the options were granted during the marriage, regardless of whether they are vested, they are marital property since the right accrued during the marriage. Most courts do not see the issue in such simplistic terms.

The option holder's rights are driven by dates: grant date, vesting date, maturity date, exercise date, and expiration date. The court has the task of determining how the employee spouse's rights interface with the jurisdiction's property determination date. Depending on the state, the critical date is the date of separation, the date of filing, the date of judgment, or another date chosen in the court's discretion.

Generally courts have held that the options are marital if they were granted and vested during the marriage, regardless of whether they were exercised during the marriage. However there are many possible scenarios. What if the options were granted before the marriage but vest during marriage? On the other end of the spectrum, what if the options were granted after separation, but were awarded for services rendered by the employee spouse during the marriage?

These difficult fact situations have lead certain courts to consider the purposes for which the options were granted as an aid to characterizing them as marital or separate.

*In re Marriage of Hug*, 154 Cal. App. 3d 780, 201 Cal. Rptr. 676 (1984) is recognized as the seminal case on this issue. The court explored not only when the options were granted, but also when they were earned. When they were earned depends on the purpose for which they were granted. If they were granted in connection with a purpose that overlaps the marriage, then a prorata portion should be deemed marital. In effect, the court adopted the use of a coverture fraction (*time rule*) to apportion the option between marital and separate property of the employee spouse. The court derived a coverture fraction in which the numerator was the length of time from the beginning of the option holder's employment to the end of the marriage and the denominator was the length of time from the beginning of employment until the option become exercisable.

A more recent case, *Wendt v Wendt*, 757 A.2d 1225 (Conn. Ct. App. 2000), contains an exhaustive exposition about coverture fractions as applied to employee stock options with references to the holdings in many states. Recognizing that no one formula works in all cases, the court discussed the factors to consider in determining how to structure the coverture fraction. The complete text of the decision is available on the Internet at <http://www.ct-divorce.com/wendt1.htm>.

Following are some example fact scenarios that demonstrate how conceptually difficult this issue can be.

What if the option was granted to the employee spouse before the marriage, vests during marriage, and is exercised during the marriage, but the employee spouse did not use

marital funds to purchase the stock? Instead the employee spouse either used separate funds to exercise (pay the strike price) or used the cashless exercise method to buy the stock (where some of the shares are sold to pay the strike price for the remaining shares purchased in a same day transaction).

What if the option was granted during marriage but vests after the marriage ends? In most cases at least a portion of the option would be deemed marital. What if the same option was granted to the employee spouse in respect to employment services rendered prior to the grant date, but during the marriage? Most courts would find this to be marital. But, if the option was granted for future services to be performed by the employee spouse after the marriage ends, most courts will determine the option to be separate property, although some may elect to treat part of it as marital and part as separate.

What if the option is granted after the marriage has ended (for example in those states that set an early property determination date, such as the date of separation), but for service performed during the marriage? The court may deem the option to be marital property.

Unless the option is exercisable at the time of the divorce, there will always be a component of future service involved because the option holder must remain an employee to exercise the option. The key is to determine if the option was granted in respect to past, present, or future service with the employer. Sometimes the option will expressly state its purpose, but often the court will need to look behind the express language of the grant to make a factual determination of the purpose.

Examples of options granted in respect to past performance of the employee:

- 1) As a bonus or reward for a specific project performed
- 2) As a reward for long term employment with the company
- 3) In recognition of past achievements

Examples of options granted in respect to present performance of the employee:

- 1) A signing bonus for a new employee (although it could also be argued that a signing bonus is a recognition of past achievements)
- 2) Options in lieu of current compensation (deferred compensation) or in addition to salary, especially when options are granted regularly and the employer is a cash poor start-up company
- 3) To give favorable tax treatment to income

Examples of options granted in respect to future performance of the employee:

- 1) As an incentive to retain the employee, such as during a change in control of the company (merger, sale, etc.)
- 2) As an incentive for future efforts
- 3) Golden handcuffs

If the option is granted during the marriage and is vested when granted, the employer would typically be granting the option for past service to the employer. Generally such options

would be deemed marital, if the employee's tenure with the employer fell within the term of the marriage.

Options do not always fit neatly into one category and are often granted for more than one purpose. When an option is granted during the marriage for both past and present services, a coverture fraction can be used to determine the marital share of the option. The fraction varies depending on the jurisdiction and the facts of the case. The factors used directly affect the resulting marital portion. If the numerator and the denominator are the same, the coverture fraction is 1 and the entire option will be treated as marital. The larger the numerator in relationship to the denominator, the larger the marital share, and vice versa. The choice of factors to use in the coverture fraction can be a significant issue because of the impact on the outcome.

Following are some examples of coverture fractions:

- 1) The numerator is the time from grant to the end of the marriage. The denominator is the time from grant until the option is exercisable (maturity). This coverture fraction presupposes that the option was granted for future performance and removes from the marital estate the portion attributable to the employee's service to the employer after the marriage.
- 2) As in the prior example, the numerator is the time from grant to the end of the marriage. However, the denominator is the time from grant until the option is actually exercised. By lengthening the denominator, the marital portion is reduced.
- 3) Where numerous grants have been awarded over the period of the employee's employment, the court may elect a broader approach and use the entire period of employment during the marriage as the numerator, and the period of employment until vesting as the denominator. Starting both time periods with a date that precedes the current option grant has the effect of increasing the marital portion.
- 4) Where the grant was awarded before the marriage for prospective employment, but matured during the marriage, the court may use the time period from the marriage to the maturity date for the numerator, and the period from the date of the grant to the maturity date for the denominator. This fraction excludes from the marital estate the portion of the option earned before the marriage.

#### **IV. Valuation of stock options**

Determining how the options factor into the property division is a two-step process. First, what portion of the option is marital property? Second, what is the value to which that percentage is applied? A simple analogy to a defined benefit plan will illustrate. If the employee spouse accrues a pension over a twenty year period, but is only married for the last ten years of employment, the court might determine a coverture fraction of 10/20 is appropriate, or 50% of the accrued benefit.<sup>2</sup> If the employee spouse retains the pension, then the nonemployee spouse is entitled to offsetting property equal to 50% of the entire value of the pension, or a buyout of his or her interest. While the assumptions used in present valuing a pension may differ among experts, there is general consensus about the valuation approach. In the case of employee stock

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<sup>2</sup> Other coverture fractions might also be determined.

options, as with the issue of marital versus nonmarital, there is no consensus on the valuation approach. There are two major schools of thought on valuation.

### ***A. Intrinsic value approach***

The simplest approach is to use the intrinsic value of the options. This is the difference between the market value of stock at valuation date and the strike price. If the market value is equal to or less than the strike price, the options have no value. This method has the advantage of simplicity. There are some detriments. The employee spouse may object that this approach does not take into account the risk that the options will never mature (the employee may die or terminate employment before they mature); there is no discount for the lack of marketability (employee stock options are generally not assignable); there is no discount for the time value of money (there may be several years before the options become exercisable); the value of the stock could drop before they become exercisable. The nonemployee spouse may object to the unfairness of not sharing in the expected post marital appreciation in the stock value.

### ***B. Black/Scholes pricing model***

The other valuation approach is far from simple. This approach uses a recognized financial model for valuing publicly traded stock options called the Black/Scholes model. The Black/Scholes model uses a highly sophisticated and complicated formula that factors in various features of the option itself (such as strike price and time to maturity) as well as various features of the underlying stock (such as its current price and historical price volatility) and is then adjusted by a risk free market rate of return. This method can be used even for privately held companies, which typically obtain an annual valuation of their stock. This approach may yield a positive value for the option when there is no intrinsic value. Even if the option has an intrinsic value, the Black/Scholes method may yield a dramatically different value.

This approach does not directly factor in the lack of marketability presented by the nontransferability of employee stock options, or the risk of forfeiture. This method is not intuitive and requires the use of an expert to make the calculation as well as explain it to the judge.

## **V. Tax issues**

If the options have a value, regardless of the method used, that value cannot be realized without incurring income taxes. As with any asset subject to unrealized gain, the extent of tax to be recognized in the future is uncertain. Tax law is a moving target.<sup>3</sup> The difficulty is that the tax burden is on the option holder and cannot be transferred to the nonemployee spouse. Unless the option holder's employer is paying the tax on the exercise of the option, taxes should be taken into account or the nonemployee spouse will receive a windfall at the expense of the employee spouse. Testimony from a CPA will help the court understand the issues, but whether a court will adjust for contingent tax liabilities is a matter of state law.

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<sup>3</sup> Refer to the section on Types of Employee Stock Options for further information about the tax rules currently applicable to employee stock options.

One of the challenges presented by employee stock options, which destroys the analogy to retirement benefits, is that they are not assignable. Typically retirement benefits are divided equally and the taxation issue becomes moot; each party pays tax when the retirement funds are paid out. Under present law, this cannot be accomplished with stock options.

A 1999 Internal Revenue Ruling on the subject of taxability of stock options in divorce is worth noting. IRS Ltr. Rul. 200005006 (11-01-99). The husband-employee had both qualified and nonqualified employee stock options. The judgment of divorce awarded half the options to the wife. The IRS ruled that the transfer of options to the former wife under the decree disqualified the assigned options from tax treatment as qualified options and triggered a taxable event resulting in the husband owing ordinary income tax in the amount of the market value of the shares on the date of the decree. The IRS applied IRC 83, the assignment of income doctrine. IRC 1041 did not shield the husband from tax on *ordinary income* because 1041(a) only applies to *gain* or *loss* from the transfer of property between spouses and former spouses incident to divorce. The wife received a carry over basis in the options under 1041(b) and was taxed under IRC 1001 when she sold the stock.

The parties made the mistake of awarding the actual options to the nonemployee spouse. Instead provide for the employee spouse to exercise the options on behalf of the nonemployee spouse and to pay the nonemployee spouse the net (after transaction costs and income taxes owed by the employee spouse) proceeds. Unfortunately this may result in more tax than if the taxes could be paid at the nonemployee spouse's tax rate (which would often be lower), but that is not a choice.

In addition to tax, transaction costs should be considered.

### Deferred distribution or reserved jurisdiction

Since employee stock options are generally not assignable, an in-kind division is not possible. The nonemployee spouse could receive an offset of other equivalent assets (if available), or the employee spouse could buyout the nonemployee spouse's equitable interest. The offset/buyout approach affords finality, but has many shortcomings as explained above.

One way to circumvent many of these problems is to adopt a deferred distribution approach, also called reserved jurisdiction. This is the method preferred by this writer. The idea is to "wait and see" and divide the marital portion of the options in the future "if, as and when" they are exercised. There is no present payment to the nonemployee spouse. The goal is to share the after tax value of the options (proceeds) when realized or allow the nonemployee spouse to direct (through the option holder) the disposition of the portion of the optioned shares determined to be held for his or her benefit. This method minimizes unfairness to either party. It is similar to an in-kind distribution of a defined benefit plan using a Qualified Domestic Relations Order, but without the QDRO mechanism to tie up all the loose ends. As when a pension is divided by a QDRO, there is no need to determine the present value of the employee spouse's interest, but the court would typically make a present determination of the nonemployee spouse's share (marital versus nonmarital). Only the payout is deferred until the options are exercised.

There are many advantages to deferred distribution: both parties benefit from the post marital appreciation in stock price; non-transferability, uncertainty of value, uncertainty of

taxes, and the risk of forfeiture all become moot. There are some disadvantages: the court will need to retain jurisdiction to effect provisions perhaps years after the decree; there is no clean break between the parties; the provisions to be included in a deferred distribution order are complex.

Enforcement of the nonemployee spouse's rights can be difficult. For example, what if the employee spouse refuses out of spite to exercise the option before it expires? Some courts will not force the employee spouse to exercise the option. Although not a perfect solution, the nonemployee spouse can be awarded a liquidated sum from the option holder at a specified point in time if the option holder fails to exercise the option. Another technique is to impose a constructive trust on the employee spouse for the benefit of the nonemployee spouse.

Deferred distribution works best in a negotiated settlement where there is cooperation between the parties. The settlement agreement should provide that the nonemployee spouse is designating the option holder to act as fiduciary to exercise his/her options upon request, and requiring the option holder to notify the nonemployee spouse of any post judgment events that affect the options, such as termination of employment, expedited vesting, re-pricing of options, etc. Careful negotiation on the part of counsel for both parties is needed to achieve a balanced result and avoid unwelcome surprises. Each party should have the agreement reviewed by a CPA before it is finalized.

Whether the deferred distribution is achieved by settlement or imposed by the court, certain issues should be addressed:

- 1) Carefully describe the affected options: number of shares, grant date, strike price, vesting date, exercise date and expiration date
- 2) Carefully articulate the nonemployee spouse's right to direct the employee spouse to exercise certain options on his/her behalf when they mature and provide for responsibility to pay the exercise price; or, alternatively reserving all such rights to the option holder
- 3) Include notice provisions:
  - a) For the nonemployee spouse to notify the option holder to exercise the options designated for the nonemployee spouse
  - b) For the option holder to notify the nonemployee spouse if his/her employment with the grantor terminates (which typically results in forfeiture if the option is not exercised within a short specified period, such as 60 days)
  - c) For the option holder to notify the nonemployee spouse when he/she exercises any options
  - d) For the option holder to notify the nonemployee spouse if the employer re-prices the options or grants replacement options
  - e) For the option holder to notify the nonemployee spouse if the employer accelerates the maturity date for the options
- 4) Provisions that address the possibility that the employee spouse may leave employment with the grantor employer before the options are exercised
- 5) Addressing reload options, if applicable

- 6) How taxes will be calculated (employee spouse's average tax rate or marginal rate)
- 7) Provisions for documenting the actual tax after the fact
- 8) How to adjust between the parties for the difference between the tax estimated at the time of payment to the nonemployee spouse and the employee spouse's actual tax
- 9) Provisions for dispute resolution in carrying out the agreement

## **VI. Are options income for support purposes?**

There is no doubt that employee stock options are a component of an employee's compensation package, and in some instances are a very significant part of that package. Each state has its own rules on what constitutes income for support purposes. Stock options may or may not fit the definition, but most states seem willing to recognize stock options as income for child support purposes. Qualified options often result in capital gain income. States that don't recognize capital gains as income for purposes of support may have difficulty with this concept. States that exclude single event income may have similar difficulty. The economic reality is that for some employees stock options are a standard form of deferred income, which replace or supplement cash bonuses.

While many states will not force an option holder to exercise an option, the Ohio courts took an interesting stance. In *Murray v Murray*, No. CA98-08-097 (Ohio Ct. App. Feb 8, 1999) the court held that an unexercised stock option was income for purposes of establishing child support in the year in which the restrictions lapse. The court theorized that a parent should not deprive children of a source of income otherwise available. The court valued the unexercised stock option at the difference between the market value of the stock on the date the option became exercisable and the market value on the grant date.

At the time of the divorce, the parties must decide whether to treat options as part of the property division or as income for support. The issue frequently resurfaces in post judgment support modification proceedings when the recipient of support argues that the options are income and the option holder argues that they were already counted as property during the divorce, the "double dipping" argument. While the double dipping argument may afford some relief as to alimony, the same argument is not compelling as to child support. By analogy to retirement, the parties' benefits may have been allocated as part of the property settlement, but retirement is still an appropriate source of income for child support, and depending on the court, for alimony as well.

## **VII. Information the attorney needs to know**

Following is a checklist of basic information the attorney needs with respect to each stock option:

- 1) Number of shares for which the option was granted
- 2) Grant date (were they granted before the marriage, during the marriage, or after the marital termination date)
- 3) Conditions for vesting, if any, and the vesting schedule (before, during, or after the marriage)
- 4) When they become exercisable (before, during, or after the marriage)

- 5) Number of shares already exercised and number still outstanding
- 6) Any reload feature (automatic grant of additional options when original options are exercised)
- 7) Expiration date
- 8) Strike price (any price reset provisions)
- 9) Whether classified as qualified or nonqualified (when the employee spouse will be taxed, the type of tax - ordinary vs. capital gain - and the estimated amount of tax)
- 10) Whether the employer is paying the tax on the exercise of the option as an additional perk so there is no out of pocket tax cost to the employee spouse
- 11) Whether transferable (some plans allow transfer, but may not allow prorata transfer of options with staggered vesting and exercise dates)
- 12) Employer's basis for the award (for past service, to induce future service, for present compensation, or a combination)
- 13) If the options will be valued using the Black/Scholes model, additional information will be required by the expert

## **VIII. Discovery**

Although there is little uniformity across the county in the way the courts handle employee stock options, one thing that is consistent is that decisions are very fact dependent. The more information available, the better prepared the attorney will be to present the most cogent argument for the client's position.

### ***A. Informal discovery***

It is always best to obtain as much information as possible informally before engaging in formal discovery. With some basic knowledge formal discovery will be more effective. A considerable amount of information is available through public sources. If the employee spouse is employed by a publicly traded company, the annual reports to shareholders include information about the highest paid executives as well as terms and conditions of certain employee benefit plans. Additional information about employee benefit plans is available in corporate filings with the Securities and Exchange Commission. These can be obtained on the Internet at [www.edgaronline.com](http://www.edgaronline.com), or <http://www.sec.gov>. Examine the 10-K, 10-Q, 11-K and 13D.

An informal interview of the employee spouse, in the presence of counsel, may be very helpful to gaining an understanding of the context in which any options were granted.

### ***B. Formal discovery***

Ask specifically about stock options (interrogatories). Remember that nonqualified options can be issued to independent contractors as well as employees; so do not assume there are no options just because the other spouse is not an "employee." Using request for production of documents to the employee spouse and/or using a records only subpoena directed to the employer, request the following documents:

- 1) Stock Option Plans and all amendments (sometimes the company resets the strike price lower than the original grant price)
- 2) Option grant agreements and amendments
- 3) Award letters, memos or other correspondence relating to the grant
- 4) Any documents that indicate the purpose of the grant
- 5) Summary plan descriptions
- 6) Annual statement of employee benefits
- 7) Any employee manual that describes the employee's rights to benefits
- 8) Employment contract/letter offering employment
- 9) Beneficiary designation forms
- 10) Employment records (newly granted options may have replaced prior existing options)

If the information obtained is unclear, identify and depose an actual employee at the company who is knowledgeable about the plans, especially on the issue of the purpose for which the award was made.

And, it may be appropriate to depose the employee spouse to further elucidate employment history, compensation background, prior options; future intentions with regard to exercise of options and potential employment changes, context in which the options were issued, source of funds used to acquire or exercise options; and related issues.

A CPA should be on board to assist in the discovery process by itemizing the information needed to value the options and determine the tax ramifications of the options involved.

## **IX. Role of the attorney**

### ***A. When representing the employee spouse***

The starting point is to argue that the option is too speculative to be considered property and is merely an "expectancy," like a future inheritance. This argument has worked in some jurisdictions when the facts support it; for example, where it is an unvested option in a private corporation.

To the extent the option is deemed property, consider whether a defensible argument can be made that the option, or a portion, is separate property. As discussed in the section on "Marital property, separate property, or partly marital and partly separate," this will require a careful analysis of many factors and how they interrelate, including: the timing of the award, vesting and maturity; the employee spouse's general employment history and record of prior stock options; the source of funds to purchase the options or resulting stocks; the employer's stated and inferable reasons for the award; and other circumstances relevant to the case at hand. For example, if the option was granted to the employee spouse just before divorce by a new employer as a signing bonus, the attorney could argue that the option can only be for future service, since the option holder has no past service with the employer and therefore the entire amount should be excluded as nonmarital. A careful history from the client is necessary.

If the court uses a coverage fraction, the analysis is directed toward maximizing the denominator and minimizing the numerator to derive a fraction that creates the smallest marital portion.

If the court is inclined to determine a value and order an offset, the attorney's attention must be directed to minimizing the valuation. Argue that the options have no value if there is no intrinsic value (if the market value is less than the strike price). Generally the intrinsic value method (which is more commonly accepted) will yield a lower value than the Black/Scholes model. Some attorneys have had success dissuading the court from using the Black/Scholes model on the basis that it is too speculative, is inapplicable because the underlying stock is not publicly traded, or it fails to account for the risk of forfeiture and the nonmarketability of the option itself.

Argue that any gross value must be adjusted for contingent taxes. Collaborating with a CPA is critical; both to understanding the contingent tax issues and convincingly explaining them to the court so that any valuation will be appropriately adjusted. Remember that in addition to income taxes there may be FICA and Medicare taxes. As to income taxes, there is the further issue whether the rate to be applied is the option holder's marginal rate or average (effective) tax rate. For the employee spouse, the marginal rate will result in a larger discount and therefore a lower adjusted value. Generally the employee spouse has the burden to prove the projected tax liability to the court.

If the court adopts deferred distribution, the focus is on reserving as much discretion to the option holder as possible, such as when to exercise the option. Another key issue is to insure that the option holder's tax liability is fully accounted for in the distribution to the nonemployee spouse.

The attorney should address the income aspects of the options for child support and or alimony purposes. At least as to those options determined to be marital property, the attorney will argue that any eventual proceeds should not be included in the option holder's income for alimony purposes. Depending on the jurisdiction, a further argument may be made that options should not be included as income for alimony or child support because of their nonrecurring nature. Alternatively the option holder may propose provisions to direct a portion of any post judgment option proceeds for the benefit of the minor children (such as funding a college account) rather than for additional basic support.

### ***B. When representing the nonemployee spouse***

For the most part the arguments of the attorney for the nonemployee spouse are the reverse of those for the employee spouse as described above.

Remember that stock options can also be awarded to nonemployees, such as independent contractors. This is not an unusual compensation mechanism for independent contractors.

The attorney for the nonemployee spouse will have a more difficult discovery task and should engage a CPA to assist with the process early on. Consider deposing a company representative to elucidate the option grant and the context of the grant.

A CPA or other expert experienced with the Black/Scholes model may be needed to establish the value of the options. Explaining this method to the court in a comprehensible way will be

key, as the model is extremely complex, and this should be taken into consideration in choosing the expert.

If a present valuation is conducted and the court will adjust for the option holder's contingent tax liability, argue that the tax liability should be based on the option holder's projected effective (not marginal) tax rate and further should be discounted to present value since the taxes are not being incurred presently.

If deferred distribution is used, include as much control as possible for the nonemployee spouse over the exercise of the options. Include provisions for the option holder to notify the nonemployee spouse of any events or changes in the option that may affect the value of the options or the decision when to exercise them. Examples are: termination of employment by the option holder; re-pricing by the employer; and expediting vesting offered by the employer. As for the deduction for the option holder's taxes, argue that the average tax rate (as opposed to the marginal tax rate) is a fairer measure of the actual tax burden.

One of the areas in which the attorney can exercise most creativity is in arguing the marital share of the option. The fact that an option may have been granted before or after (in states that recognize an end to the marriage before actual divorce) the marriage does not mean it is nonmarital. With an option granted before the marriage, show that the options were *earned* during the marriage. And with an option granted after termination of the marriage or that is not yet vested before the end of the marriage, show that it was received in respect to career development and achievements that occurred during the marriage. In states that use the coverture fraction analysis, these arguments can have a significant impact on the factors used in the fraction, and thus the ultimate marital share. Present the facts in a way that supports an argument that shortens the denominator and enlarges the numerator.

## **X. Other common forms of equity compensation**

Corporate employers use other mechanisms for equity compensation besides stock options, which may be as valuable or more so than stock options. The most common of these are described below.

### ***A. Restricted stock plans***

An award of restricted stock is very similar to a stock option. The primary difference is that with restricted stock, the stock ownership is awarded subject to a condition subsequent, whereas with a stock option the stock is awarded subject to a condition precedent. With restricted stock, the employer grants the employee legal title to company stock when the grant is made, but there is a substantial risk of forfeiture back to the employer until certain conditions are met. Usually the restrictions or requirements entail the employee continuing employment with the employer for a specified number of years similar to a vesting schedule. The employee has the right to vote the stock and receive dividends in the interim. The employee does not incur any tax when the stocks are granted, but does incur ordinary income tax under IRC 83 when there is no longer a substantial risk of forfeiture. The tax is based on the difference between the market value of the stock when the restrictions lapse, and the amount paid by the employee, if any, for the stock. When the employee later sells the stock, the employee incurs capital gains tax on the difference between the market value of the stock at the time of sale, and the market value at the time the restrictions lapse. The capital gains

tax is long term if the employee holds the stock for more than 1 year from the date of grant, or short term if one year or less. Note that the employee may elect under IRC 83(b) to pay tax when the grant is received, rather than later when the restrictions lapse. This election must be made within 30 days of receipt of the restricted stock, and once made is irrevocable and the tax paid is nonrefundable. An employee may find this election advantageous if the market value of the stock is low when granted and the employee projects the market value to rise before the restrictions lapse. In this way the employee lowers the tax burden from ordinary income tax to capital gains tax rates on the subsequent stock appreciation. In order to correctly tax affect this asset, it is important to know whether an IRC 83(b) election has been made.

If the stock is held and later sold, then the stockowner incurs a capital gain (or loss) depending on the difference between the market value of the stock when it is sold and the market value of the stock when the restrictions are removed.

The same marital vs. nonmarital issues apply (for example, if the restricted stock grant occurred before the marriage, but the restrictions lapse during the marriage; or the restricted stock is awarded during marriage and the restrictions do not lapse until after the divorce). However, since the stock is actually owned by the employee spouse, subject to forfeiture, some courts ignore the restrictions and treat the employee spouse as the owner of the stock. Other courts recognize the economic reality and treat restricted stock like unvested stock options.

As with stock options, both attorneys need to consult a CPA.

## ***B. ESOPs-qualified retirement plans***

An employee stock ownership plan is a type of defined contribution plan and is governed by ERISA. These plans are used to provide company stock ownership to employees. The plan buys company stock by borrowing on the credit of the company and repays the loan as plan contributions are made. When the loan is repaid, shares are released and allocated to the individual accounts of the employees (plan participants). Or, the company creates a trust fund and contributes new shares of its own stock, or cash to buy existing shares. There is usually a vesting schedule. When the participant terminates employment, the plan distributes company stock or the cash equivalent. If the company buys back the stock, the purchase is at market value. Since there is no public market for a privately owned company, privately owned companies with such plans regularly obtain outside valuations to determine the stock price. The participant's interest is pre-tax.

As with stock options, there may be an issue of marital vs. nonmarital interests. Unlike options, the participant's interest may be divided with a QDRO. If the participant's interest is not fully vested, the QDRO can be structured to make an immediate distribution to the alternate payee of the awarded share of the vested interest, with a deferred distribution of such awarded share as the participant's interest fully vests. If offset is preferred, the participant's interest can be valued with reference to the stock value as of the property determination date. When the stock is publicly traded this is straightforward. If the stock is not publicly traded, it should be possible to obtain a valuation from the company. The value should be adjusted for contingent taxes if allowed in the jurisdiction, otherwise a QDRO is fairer.

### **C. Phantom stock plans**

Under a phantom stock plan, the employee spouse receives cash compensation in lieu of stock, but the amount of compensation is linked to growth in the underlying company stock value. If the stock value rises, the employee receives a bonus in the amount of the phantom stock appreciation. The bonus is usually paid in cash, but may be paid in stock. The bonus is taxed at ordinary income tax rates. These plans are typically reserved for executives.

If the stock bonus is not paid during marriage, but is earned by personal efforts during marriage, the attorney for the nonemployee spouse may argue that the bonus should be treated as property subject to property division, like stock options. The attorney for the employee spouse will typically argue that it is not property, but rather income, and is therefore only relevant as to support.

## **XI. Additional resources**

- 1) [www.nceo.org](http://www.nceo.org) web site for the National Center of Employee ownership (NCEO), a private nonprofit membership and research organization with information on employee stock options and other kinds of employee benefits.
- 2) The American Bar Association's Family Advocate, Vol. 23, No. 3, Winter 2001, at 8 has an article by Bruce L. Richman entitled, *Transferring Nonqualified /Compensatory Stock Options in a Divorce*.
- 3) The American Bar Association's Family Advocate, Vol. 23, No. 3, Winter 2001, at 18 has an article by Donald C. Schiller and Daniel R. Stefani entitled, *Discovering Employee Benefits*.
- 4) The American Bar Association's Family Advocate, Vol. 23, No. 3, Winter 2001, at 33 has an article by Brett R. Turner entitled, *Classifying Restricted Stock Plans*.
- 5) Michigan Bar Journal, Vol. 80, No. 6, June 2001, at 31, has an article by Anthony J. Caputo and Julia Caputo Stift entitled, *Stocking Up*.
- 6) Laura W. Morgan's web page at <http://www.supportguidelines.com/resources.html> has articles on *Stock Options as "income" for Support* and *Update: Stock Options as Income for Purposes of Child Support* (click on link for Articles). These two articles reference a number of cases from different jurisdictions.
- 7) Article by Sanford K. Ain and Darryl A. Feldman, *Divorce-The Valuation and Division of Stock Options* which can be found at the website for the American Academy of Matrimonial Lawyers [http://www.aaml.org/Articles/2001-01/classifying\\_and\\_valuing.htm](http://www.aaml.org/Articles/2001-01/classifying_and_valuing.htm)
- 8) Article by G. Daniel Jones and Melvyn Frumkes, *Dividing Stock Options, "Protecting the non-employee spouse, Protecting the employee spouse, Tax traps & More"* which can be found at the website for the American Academy of Matrimonial Lawyers <http://www.aaml.org/Articles/2001-03/Jones-StockOptions.htm>
- 9) Article by Tracy A. Thomas, *The New Marital Property of Employee Stock Options*, ABA, Family Law Quarterly, Vo. 35, No. 3, Fall 2001.
- 10) Article by Diana Richmond, *The Challenges of Stock Options*, ABA, Family Law Quarterly, Vo. 35, No. 2, Summer 2001.

11) Article by David S. Rosettenstein, *Exploring the Use of the Time Rule in the Distribution of Stock Options on Divorce*, ABA, Family Law Quarterly, Vo. 35, No. 2, Summer 2001.