

## **STOCK OPTIONS AND SUPPORT A NEW AND CHALLENGING ISSUE**

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As our local colleague, Gregory S. Cabot, opined in the April 2000 issue of the Contra Costa Lawyer, stock options are equity-based compensation that is increasingly the "currency of choice" for technology companies.<sup>1</sup> In addition to technology companies, even large traditional retailers and service companies, such as Wal-Mart, Starbucks and Home Depot, are increasingly utilizing stock options to compensate their employees.

Stock options are an employee benefit that give an employee the right to purchase stock in the employer corporation at a strike (i.e., purchase) price, which company management believes will be less than fair market value at the time the options vest (i.e., when the option may be redeemed in stock shares, or exercised). Typically, options are restricted so they cannot be exercised immediately upon receipt from the employer corporation. Rather, the employee must remain with the company for a minimum period of time before the options vest and can be exercised. The purpose of the restriction is to motivate the employee to continue working for the employer and presumably share in the value of the corporation, which will appreciate, in part, due to the employee's efforts.

While family lawyers have frequently treated stock options received by one spouse during the marriage as an asset within the community estate that must be equitably divided, the tremendous and unprecedented capital appreciation experienced by many public corporations during the past five years has greatly enhanced the wealth of their employees. In many cases, employees have utilized income realized from their exercise and sale of stock options to support or enhance their standards of living. In light of this trend, the family bar and bench in California and other jurisdictions have recently begun to evaluate stock options as income available for child and spousal support.

In December of 1999, the Fourth District Court of Appeal addressed this issue in *In re Marriage of Kerr*.<sup>2</sup> The court held that it is proper to award additional support, both child and spousal, based on husband's future income derived from the exercise of stock options; however, it reversed the trial court's decision to award a set percentage of husband's stock options awarded to husband in the future. Instead, the court of appeal held that an award of husband's future stock options must be limited, for purposes of child support, by the needs of the children, and for purposes of spousal support, to the needs of the supported spouse, after an analysis of the factors set forth in Family Code §4320 and the marital standard of living.<sup>3</sup>

Kerr presented the appellate court with the following facts: The parties were married for 20 years. During the last six years of the marriage, husband was a vice president of engineering at a high-tech company, Qualcomm, in San Diego. Between 1987 and 1995, husband was granted options to purchase 125,000 shares of Qualcomm stock. In addition to his base salary, the parties used additional income generated by husband's stock option income to enhance their standard of living. At the date of separation in 1993,

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<sup>1</sup> George Cabot, "Equity Based Compensation, the Currency of Choice for Technology Companies," *Contra Costa Lawyer* (April 2000) p. 8.

<sup>2</sup> 77 Cal.App.4th 87 (1999).

<sup>3</sup> While there are many cases that discuss "marital standard of living" as it pertains to spousal support, two cases that are often cited by appellate courts, including the Kerr court, are *Marriage of Smith* (1990) 225 Cal.App.3d 469, and *Marriage of Ostler & Smith* (1990) 223 Cal.App.3d 33.

husband's base salary was \$110,427. After separation, husband agreed to pay wife \$1,143 and \$2166 per month as spousal and child support, respectively.<sup>4</sup> In addition, the parties entered into a stipulated judgment wherein husband agreed to transfer his interest in the family residence to wife and pay her \$1.1 million to equalize the division of the community estate, which included all stock options existing at the time of separation.

Subsequent to the parties entering into the stipulated judgment dividing the community estate, wife filed an order to show cause for modification of spousal and child support.

In addition to both parties submitting further information about Qualcomm's stock option plan, husband stipulated that his base salary has increased to \$159,735 annually. Wife submitted that she was a homemaker and had a 12th grade education. She received passive interest income of \$1,883 per month and had monthly expenses of approximately \$6,500. However, wife claimed that the monthly expenses submitted on her income and expense declaration did not reflect the marital standard of living.

After a hearing, the trial court ordered husband to pay \$2,000 per month in spousal support and \$2,806 in child support, based upon his base salary. The trial court found that "[a]bsent the award of child support and spousal support from future options, the ongoing monthly amount set herein does not adequately meet the parties' former standard of living."<sup>5</sup> Thus, in addition to its base support award, the trial court ordered husband to transfer to wife a beneficial interest in 40 percent of his future stock options he exercised until April 1, 2003, and 25 percent thereafter.<sup>6</sup>

While the appellate court recognized the trial court's decision to award a percentage of future stock option income as correct and beneficial because it would "remove the need for further litigation with its attendant costs, and oftentimes, emotional upheaval,"<sup>7</sup> the appellate panel held that in this particular case, such an award was improper because husband's stock options had increased in value more than 2000 percent between the date the parties entered into the stipulated judgment and date of the appellate court's decision. In effect, the tremendous appreciation of Qualcomm stock could have amounted to a multi-million dollar windfall of spousal and child support to wife.<sup>8</sup> The appellate court remanded the issue back to the trial court to determine an additional award of spousal support that would not exceed the parties' marital standard of living, as determined under Family Code §4320,<sup>9</sup> and an award of child support that would not exceed the children's needs.<sup>10</sup>

1. Unfortunately, the Kerr court left many issues unresolved for family law practitioners and judges who will be left to interpret and apply the decision. For example: When does the capital appreciation of an underlying stock option warrant a deviation from the generally permissible rule allowing use of percentages to determine additional support?

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<sup>4</sup> It is unclear whether this initial support award was a temporary or permanent support award.

<sup>5</sup> Kerr, 77 Cal.App.4th 87 at 91.

<sup>6</sup> The youngest child turned 19 on March 12, 2003. Before April 1, 2003, 25% of the options was to be characterized as spousal support and 15% was to be characterized as child support.

<sup>7</sup> Id. at 95.

<sup>8</sup> Although the court did not provide information concerning the strike price of husband's stock options, one could estimate that the 125,000 options owned by husband had a gross value before tax of at least \$80 million and the trial court's decision at a minimum provided wife with a support award of at least \$20 million.

<sup>9</sup> Id. at 95.

<sup>10</sup> Id. at 97.

2. What happens if the stock appreciation does not occur until after a court has made its decision?<sup>11</sup> In *Kerr*, the court of appeal was very conscious of the tremendous capital appreciation enjoyed by Qualcomm stock between the date of the hearing and the date of the appellate court's decision. Presumably, if this decision had been issued two years earlier, the appellate court not have had the benefit of seeing Qualcomm stock appreciate 2000 percent prior to rendering its decision.

3. The court of appeal stated that a percentage support award based on husband's "exercised" option income would be "generally" permissible,<sup>12</sup> but what if husband intentionally decided to not exercise stock options?

While the above questions are difficult to answer since attorneys and courts are not clairvoyant, the issue of support based on unexercised stock options was recently addressed by the Ohio court of appeal in *Murray v. Murray*.<sup>13</sup> In a case of first impression, the court was presented with the issue of whether unexercised stock options should be included in "gross income" for purposes of determining child support, and if so, how to value the stock options.

Husband was an executive employee at Proctor & Gamble (hereafter referred to as "P&G"). Subsequent to the final decree of dissolution filed in 1994,<sup>14</sup> wife filed a motion to modify husband's child support obligation in 1997. During the interim three years between 1994 and 1997, husband stipulated that his income (based on his average base salary, average annual bonuses, dividends and interest, and taxable employee benefits) had increased. But husband would not stipulate that the stock options he had received after the initial support decree was entered should be included as income available for support.

In January of 1998, a hearing on wife's motion was held in which the primary issue was whether appellant's unexercised P&G stock options should be included in his gross income for purposes of determining child support, and if so, how to value the stock options. After receiving testimony from P&G's Director of Global Compensation that executive stock options were given every year and at Mr. Murray's sole discretion could be exercised between one year and ten years after their grant, the trial court held and the Ohio court of appeal affirmed that the appreciation in the value of the unexercised options should be included in husband's gross income for purposes of support.

The court of appeal reasoned that once husband's options vested and he had sole discretion whether to exercise the options, "the option then becomes an investment choice, and its value may be imputed as part of appellant's 'gross income'...[otherwise]...if we were to hold that executive stock options were not to be included in 'gross income' [citation omitted], an employee receiving such options would be able to shield a significant portion of his income from the courts, and deprive his children that standard of living they would otherwise enjoy. This would be in direct contradiction of the very purpose of the child support statute, the child's best interests."<sup>15</sup>

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<sup>11</sup> While it is difficult to speculate, arguably the trial court would have made a different award if it had known the stock options would appreciate so dramatically.

<sup>12</sup> *Id.* at 95.

<sup>13</sup> 716 N.E.2d 288 (1999).

<sup>14</sup> According to the Ohio court of appeal, "the divorce decree accounted for all of the stock options which appellant possessed at the time of the divorce by treating the options as marital property. Thus, when the support order was issued with the divorce decree, there were not any options to be included in the income calculation."

<sup>15</sup> 716 N.E.2d 288, 294. The court of appeal reiterated this reasoning on the final page of their decision when they stated: "Whenever [Mr. Murray] chooses not to exercise his options, he is making an investment choice, and he should not be allowed to benefit from such a choice by depriving his child of the substantial growth in the stock options' values." *Id.* at 299.

Therefore, the appellate court held that the trial court should "add together the total number of unexercised shares from all the options (on the anniversary date of the stock option grant), and multiply this number by the stock price increase for the income year at issue. In this manner, the court can account for the appreciation in the value of the stock underlying the options that accrued in one year, without inadvertently considering appreciation that was gained in earlier years."<sup>16</sup> The Ohio court opined that such a method "best captures the immediate appreciation in value the stock has gained due to husband's choice not to exercise the options and allow their potential value to increase."<sup>17</sup>

While the reasoning of the Ohio court is compelling because it is couched in terms of protecting the best interests of the children, it also raises a number of questions. For example, what happens to husband when a stock price fluctuates wildly? With respect to P&G, the value of the stock has decreased over 50% between January 17 and March 17, 2000, to a price lower than when wife filed her motion for modification in May of 1997. The recent decline in P&G's stock price may have resulted in husband losing all the benefits of stock appreciation, thereby requiring him to pay support from income which does not exist.

In order to avoid the inequities discussed above and excessive litigation in the form of support modification motions, family lawyers and courts need to craft careful resolutions to cases that present issues related to stock options and support. For example:

1. A marital standard of living should be established prior to an award of permanent spousal support. Similarly, a determination of the needs of the children should be established prior to an award of permanent child support. Without a determination or stipulation regarding the marital standard of living and the needs of the children, it would be difficult to establish a ceiling on support as required by the court of appeal in *Marriage of Kerr*.

2. Attorneys and courts should understand the tax implications of exercising stock options. As explained by my colleagues in other recent articles, there are significant tax issues involved with the exercise of stock options that will affect the income available to pay support.

3. If the community estate includes a significant number of stock options, it may be easier to divide the community stock options in kind between the parties. (It will generally be necessary to effectuate such a transfer by means of a beneficial interest only, as the issuing company will not allow a non-employee to hold the stock options.) For example, if the Kerr's had divided the options in kind instead of allowing Mr. Kerr to buy out Ms. Kerr's interests, then both parties would have enjoyed significant stock option appreciation and the necessity of evaluating stock options for support may have been obviated.

In summary, both the courts and family law practitioners should proceed cautiously when dealing with this issue, otherwise the risk of financial inequity is great.

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<sup>16</sup> *Id.* at 294.

<sup>17</sup> *Id.* at 299.