

YOU HAVE OPTIONS WHEN DIVIDING STOCK OPTIONS

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As America progresses into the "information age," many companies are implementing employee stock option programs as a method of attracting and retaining the most valuable assets of the modern company: employee knowledge and/or human capital. Increasingly, family law practitioners are confronted with the task of dividing the potential value of employee stock options as an asset during the course of a marital dissolution.

A stock option is defined as a right to buy a specific number of shares at or within a designated time at a predetermined price. That purchase is described as an option exercise. The right to purchase shares of stock is different from ownership of the shares themselves. One of the more complex issues associated with the division of stock options occurs when an employee spouse is granted options during the marriage and the options vest and become exercisable after separation.

Companies offer employees stock options for many different purposes. Under California law, the employer's rationale for granting an employee stock options is very important with respect to allocating options between community and separate interests.

The leading case discussing the division of stock options received during the marriage but not exercisable as of the date of separation is *Marriage of Hug*.¹ In that case, husband was offered stock options which vested incrementally over four years. The Court of Appeals paraphrased the difficult issue as follows: "Since portions of the options were exercisable only after the parties separation, the [trial] court sought to allocate the options to reflect the relationship between periods of husband's community contribution to earning the option rights."² The court reasoned: "There is no compelling reason to require that employee stock options must always be classified as compensation exclusively for past, present, or future services. Rather, since the purposes underlying stock options differ, reference to the facts of each particular case must be made to reveal the features and implications of a particular employee stock option plan."³

After determining that husband's employer [Amdahl] adopted its stock option plan "for the purpose of attracting and retaining the services of selected...key employees,"⁴ the court determined that the offer of stock was a "key inducement" in attracting husband to change employers and that husband "anticipated the options from the outset" and that Amdahl "likely granted them in lieu of present compensation." Therefore, the options comprised "a vital part of husband's compensation package from the very outset of employment."⁵

¹ *Marriage of Hug*, (1984) 154 Cal.App.3d 780, 201 Cal.Rptr. 676.

² Id. at 783; 201 Cal.Rptr. at 679.

³ Id. at 784; 201 Cal.Rptr. at 679.

⁴ Id. at 783; 201 Cal.Rptr. at 678.

⁵ Id. at 789; 201 Cal.Rptr. at 683.

The time rule formula the court is Hug approved expressed as follows: (Community Property is "CP," Employment Begins is "EB", Date of Separation is "DS", Date of Option Exercisability is "OE")

$$CP = \frac{\text{Number of months between EB and DS}}{\text{Number of Months between EB and OE}}$$

Despite the Hug court's approval of the above time rule, the Hug court clearly stated that "The trial court has broad discretion to select an equitable method of allocating community and separate interests in stock options granted prior to the date of separation of the parties which became exercisable after the date of separation."⁶

In *Marriage of Nelson*,⁷ the Court of Appeals was presented with different facts. In *Nelson*, the grantee/husband received three separate option grants by his employer (Ampex). The first group of options were granted and became exercisable during the marriage; these options were determined to be community property. The second group of options were granted during marriage and exercisable after the date of separation. The third group of options were granted after separation and were held to be entirely separate property.

With respect to the second group of options, the company's stock value had to increase after the date of exercise in order for the grantee/husband to realize any economic benefit from the grant. Therefore, the *Nelson* Court held that it was more appropriate to value the options based upon the time period following the grant to the date of separation, instead of the grantee/husband's entire duration of employment with the grantor. After acknowledging the trial court's broad discretion the Appellate Court endorsed the following time-rule formula: (Community Property is "CP," Grant Date is "GD," Date of Separation is "DS," Date of Option Exercisability is "OE")

$$CP \text{ Interest} = \frac{\text{Number of months between GD and DS}}{\text{Number of Months between GD and OE}}$$

In *Marriage of Harrison*,⁸ the grantee/Husband's employer (Loral) granted options during marriage that allowed the grantee to purchase shares of stock immediately upon the grant. However, the stock was subject to forfeiture if certain events subsequently occurred, including, voluntary termination without the company's consent or termination for cause. While the Court of Appeals rule that the trial court's formula incorrectly focused on the options rather than the stock, the appellate bench upheld that the time rule was the correct method of division. The trial court labeled these options as "golden handcuffs" intended to assure grantee/Husband would stay under the employ of grantor. Furthermore, the trial court found that the options were intended to reward grantee/Husband for his time, skill and effort beginning on the date of options were granted. Because of the emphasis on the grantee/Husband's future services, the trial court approved the following time rule division: (Community Property is "CP," Grant Date is "GD," Date of Separation is "DS," Date of Stock Vesting is "SV")

$$CP = \frac{\text{Number of months between GD and DS}}{\text{Number of Months between GD and SV}}$$

⁶ Id. at 782, 201 Cal.Rptr. at 678.

⁷ *Marriage of Nelson*, (1986) 177 Cal.App.

⁸ *Marriage of Harrison*, (1986) 177 Cal.App.3d 150, 220 Cal.Rptr. 790.

then divide the above ratio into the gain as of the exercise date to determine the community property interest after reimbursement of the exercise cost and taxes.

In *Marriage of Walker*,⁹ the grantee/Husband was granted options during marriage which vested over time and had various exercise dates. Similar to the facts of *Harrison*, the stock was subject to forfeiture. At the time of trial, the grantee/husband still had several thousand options. The trial court used the Nelson formula, however the Court of Appeals overruled and held that the time-rule formula use in *Harrison* was correct because of the difference between the ability of exercising the option and the ability of buying stock arising from the vesting and exercising of the option.

As our economy develops into the information age, there has been and will be a proliferation of variations on the "stock rights as compensation" theme. These variations may tend to render the Hug, Nelson, and *Harrison* formulas obsolete. While overburdened family law judges may be reluctant to deviate from the Hug, Nelson and *Harrison* "mandate," it is the unique set of facts in each case that should determine how the court arrives at the "fair and equitable" division that is the true mandate of all these cases.

In conclusion, judges must exercise their discretion to make an award that is "fair and equitable" based upon the factual presentation at trial. Issues such as potential forfeiture (of the options or the shares), the internal characteristics of the grantor company, the position and importance of the grantee/spouse to the grantor company, the Board of Directors' past dealings with respect to stock option grants and the statement of purpose language within the grant option document/plan are all relevant facts that a court may use to determine an appropriate time-rule formula to divide the options at issue. Therefore, if the asset is sufficiently valuable, it may be important to not solely rely upon the understandings and expectations of your client or the opposing party. You may need to conduct other discovery such as taking the deposition of the grantor and reviewing the corporate minutes.

⁹ *Marriage of Walker*, (1989) 216 Cal.App.3d 644, 265 Cal.Rptr.32.