

THE PRACTITIONER

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Weighing Options

Courts Disagree About How to Divide Stock Options as a Marital Asset

Despite the potential value of employee stock options as an asset in the division of the community estate in a marital dissolution, only four California cases address the division issue squarely, and none of those provides authoritative guidance for the division of these assets. The most troublesome issue is division of options that are granted during marriage but only vest and become exercisable after separation.

A stock option is a right to purchase a specified number of shares at or within a certain time at a predetermined price. That purchase is known as an option exercise. The right to purchase shares of stock is distinct from ownership of the shares themselves.

The value of an option grant depends on several factors, including but not limited to the following: the company whose stock the optionee has the right to purchase; the performance of that company internally and in the stock market; the number of shares the optionee is entitled to purchase; and the difference between the exercise price and the market price at the time of the exercise.

Many purposes may exist for granting options to an employee. Under California law, these purposes may play an integral role in allocating options between community and separate interests. Unfortunately, these purposes are often conflicting and inconclusive.

The leading case addressing division of stock options granted during marriage but vesting and becoming exercisable after separation is *In re Marriage of Hug*, 201 Cal.Rptr. 676 (Cal.App. 1984). In that case, husband and wife were married for 20 years. About four years before separation, husband left his job at IBM to join the Amdahl Corp. Amdahl granted husband 1,000 options in 1974 (which replaced the higher-priced grant he received two weeks after his employment began in 1972), 1,300 more options in 1974 and 800 more options in 1975, for a total of 3,100 options. The options vested incrementally over four years.

As the Court of Appeal summarized the situation, "Since portions of the options were exercisable only after the parties' separation,

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the [trial] court sought to allocate the options to reflect the relationship between periods of [husband's] community contribution in comparison to his overall contribution to earning the option rights." Id. at 679.

Husband conceded a time-rule allocation was appropriate but claimed the trial court's formula unfairly credited wife with the time since husband began working at Amdahl, rather than merely the time since the options were granted. The court engaged in a functional analysis to determine the purpose of the option grant. The court noted: "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."

The court tried to ascertain the purpose of Amdahl's grant of options to husband. The trial court had found Amdahl adopted its stock option plan "for the purpose of attracting and retaining the services of selected directors, executives and other key employees and for the purpose of providing an incentive to encourage and stimulate efforts by them." Id. at 678.

The Court of Appeal noted that husband had worked at IBM for almost seven years, at which point his retirement benefits would have vested, leading to an inference that the benefits Amdahl offered replaced benefits left behind at IBM (that were earned during marriage). It also noted that Amdahl's plan intended to attract and to retain key employees. Also, the offer of stock seemed to have been a "key inducement" in making the move to Amdahl. "These facts support an implied finding that the options were earned from the commencement of [husband's] employment at Amdahl." Id. at 682.

The court further found the evidence supported a finding that husband "anticipated the options from the outset" and that Amdahl "likely granted them in lieu of present compensation." Thus, the options constituted

compensation earned during the marriage. Id. at 682-83. The court also found the replacement of the initial options to be further proof that the options constituted "a vital part of [husband's] compensation package from the very outset of employment." Id. at 683.

The time rule the *Hug* court approved was expressed as follows: Community options equals months between time employment begins and date of separation, divided by months between time employment begins and date of exercisability.

The *Hug* court urged several times that its decision not be the final word on the issue: "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." Id. at 678.

Marriage of Nelson involved three separate option grants to husband by his employer, the Ampex Corp. The first options were granted and became exercisable during marriage, and were determined to be entirely community. The second set was granted during marriage but was exercisable after separation, and was characterized as part community, part separate property. The third group, granted after separation, was characterized as husband's separate property.

On a scant recitation of the facts, the Court of Appeal rejected husband's argument that the second group of options had no community aspect. Noting that the stock's value had to increase after the date of the exercise for the grantee to realize any benefit from the grant, the *Nelson* court found it "appropriate to place more emphasis on the period following each grant to the date of separation [rather] than on the employee's entire tenure with the company up to the time of separation as the *Hug* Court did," *Nelson* at 793 n.3.

Again noting the trial court's "broad discretion," the *Nelson* court approved a time formula as follows: Community proportion equals months between grant date (not employment date) and date of separation, divided by months between grant date and date of exercisability. This results in a lesser portion of shares to wife than in *Hug*.

The court apparently ignored any community effort resulting in husband's post-separation promotion and further option grant by holding that those options were entirely husband's separate property.

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Court Disagrees on How To Split Stock Options

Harrison also involved options granted to husband during marriage by his employer, the Loral Corp. The options at issue allowed husband to purchase shares immediately upon the grant, but the stock was subject to certain events of forfeiture (including voluntary termination without the company's consent, or termination for cause).

Wife challenged the trial court's use of a time formula to divide the stock option benefits. The Court of Appeal held that the trial court's formula incorrectly focused on the options rather than the stock, but still held a time rule was the correct method of division.

The trial court in *Harrison* found that these options, unlike the options in *Hug*, were "golden handcuffs" intended to assure husband would stay with Loral, a finding wife did not challenge on appeal. Nor did any evidence show that the options were a factor in attracting husband to Loral or that they were granted as deferred compensation for past services. Rather, the court found that the options reflected husband's time, skill and effort beginning on the date the options were granted.

Because of the emphasis (and lack of contrary evidence) on the future services aspect of the grant, the court approved the following time-rule division: Community portion of shares equals months between the grant date and the date of separation, divided by months an "inception of right" theory to determine that options granted during the marriage but vesting after separation do not lose their community character simply because of separation. Under the inception of right theory, the marital status at the time a right comes into being controls its characterization as community or separate.

The theory has support in California cases, generally in the area of real property, see, e.g., *Marriage of Joaquin*, 239 Cal.Rptr. 175 (Cal. App. 1987), but not yet in the area of stock options. Although much of the reasoning in *Short* tracks that in *Hug* and *Harrison* quite closely, the courts in the two states arrive at different results.

To the extent the courts continue to use *Hug's* functional analysis, the practitioner should be wary of conceding too much too quickly in either direction.

Review of the company's stock option plan is essential, but stock option plans' statements of purpose

are often vague and difficult to rely on.

If the asset is sufficiently valuable, the attorney representing the non-employee spouse may want to depose the party responsible for making the grant, but this is likely not to be conclusive. In many cases, however, the attorney will only have the statements of the spouses as to their understandings and expectations.

Issues of possible divestment of the options or the shares, the size of the grantor company and the importance of the grantee to the company are potential indicators of the emphasis on pre- or post-separation labor of the employee spouse and may be a factor in the division of the rights at stake.

The courts are entitled to exercise their discretion to make an award that is fair and equitable under the circumstances. between grant date and date stock vested. This ratio was to be divided into the gain as of the exercise date to determine the community property interest after reimbursement and taxes.

In *Marriage of Walker*, the court considered stock options granted during marriage with various dates of exercisability, but with stock that was subject to forfeiture and vested over time. Two years after husband began his employment, the parties separated. By time of trial husband still had several thousand options. Although the trial court used the *Nelson* time-rule formula, the Court of Appeal found it was error not to use the *Harrison* time-rule formula because of the distinction between the ability to exercise the option and the ability to purchase stock resulting from exercise of that option.

The cases leave several issues unresolved, apparently intentionally. Most troublesome is the question of why a contractual right that

is granted to the community does not remain a community right.

One answer is that the post-separation labor of the employee spouse renders some portion of the options vesting post-separation separate property if that spouse's labor is necessary for the options to vest. This logic, however correct for time-based pension plans, is not satisfying for stock options that have a value not necessarily related to longevity of service.

One case in Washington, a community property state, addressed this issue, specifically refuting the argument and time-rule division of *Marriage of Hug*, which it decried as simplistic.

The court in *In the Matter of the Marriage of Short*, 859 P.2d 636 (Wash. App. 1993), on facts somewhat similar to those in *Hug*, used