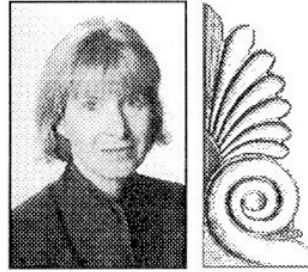


Stock Options In A Community Property State

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California Community Property: Determining The Division Of Stock Options

I. Introduction

Employee compensation increasingly includes the opportunity to acquire stock and thereby invest in the employer. Of 600 companies selected by the American Institute of Certified Public Accountants and surveyed in their Accounting Trends and Techniques 1999, 590 companies offered stock options to their employees. The purpose of this article is to provide a brief overview of the manner in which California courts address characterization of stock options in a divorce — and to mention concomitant issues which both employee and the employer face.

WHAT IF: Employer X in December 1995 granted Employee Y 5,000 options when employee and spouse were married, exercisable in blocks of 1,000 yearly, commencing in December 1998 — and employee and spouse separated in January 2000? Are all 5,000 stock options community property? What if employer granted the options to induce employee to either join or to remain with the company. What if employer is a publicly traded company with an uncertain future, a *nemo* exist, giving this as a reason for issuing options?

II. Stock options are "community property" if granted and "vested" during the marriage — unless...

California led the way, in 1984, in declaring stock options awarded during a marriage to be "community property." In *re* Marriage of Hug (1984) 154 Cal.App.3d 780; see also: In *re* Marriage of Nelson (1986) 179 Cal. App.3d 1216. At least 22 courts in the United States have followed California's lead, and held that exercisable stock options constitute a marital asset, to be divided during the dissolution proceeding using the "time" rule set out in *Hug* or *Nelson*, or a variant.

In *Hug*, Paul Hug left IBM to begin employment in Amdahl in November 1972; the first option grant to him was two weeks after he began employment. The first set of disputed options were granted in August 1974, "to replace" the 1972 options. Options granted during the marriage were in issue, includ-

ing 800 shares exercisable only after the parties' separation. Each option was exercisable over four years in increments of 30 percent, 25 percent, 25 percent and 20 percent. Paul argued that the options were not granted as an incentive to become employed by Amdahl because after he began employment and that each option was compensation for services during that year — thus those exercisable after separation were his separate property.

The appellate court in *Hug*, noting that the issue before it was one of "first impression," held that the options were both community and separate. The court adopted the term "time rule" — a term utilized in prior court rulings to describe a formula for determining the community interest in retirement benefits, and set forth the following formula to determine what was "community":

Time (months/years) between beginning of spouse's employment and date of parties separation.

Time (months/years) between beginning of spouse's employment and date option can be exercised.

The court considered at length the various reasons why employers grant options — which it mentioned "could be classified as an alternative to fixed salaries to secure optional tax treatment." In concluding, the court stated: "Thus, no single characterization can be given to employee stock options. Whether they can be characterized as compensation for future service, for past services, or for both, depends upon the circumstances involved in the grant of employee stock options... since the purposes underlying stock options differ, reference to each particular case must be made to reveal the features and implications of a particular employee stock option..." With these words, the court in its attempt to explain its decision, provided ample ammunition for spouses to argue that options are "community property" because "earned" during the marriage, or are "separate property" because the employer and/or the employee intend them to be for future services, after date of separation.

III. Factors considered by the California courts in determining how to characterize and divide stock options

1. Inducement to begin employment:

One factor mentioned in most court opinions, including *Hug*, is whether or not the grant was to induce the employee to join the company. In *Hug*, husband had been working for another company for seven years prior to his switch and his retirement benefits were almost vested. The court wrote: "Amdahl's option plan was designed to attract as well as to retain key employees."

2. In lieu of present compensation

Again in *Hug*, the court noted that husband was granted the options at the start of his employment, which would support a finding that the grant of stock options "was in lieu of present compensation during the initial period of employment, a time when Amdahl's success was limited."

In *Nelson*, stock options were granted by employer at a price equal to the equal market value of the stock. The court found the options "were intended as compensation after their issuance."

3. Options to induce an employee to remain with a company — or contingent upon employee's continued employment

Employee husband in *In re: Marriage of Harrison* (1986) was given different types of options by *Loral*, including options which were "restricted" — stock issued upon exercise of the option was to be forfeited to the corporation if the employee were terminated for cause or left without corporate consent; the forfeiture provisions lapsed in 20 percent increments. The trial court found that the option represented a "golden handcuff" to ensure continued employment. The *Hug* rule was modified.

IV. Is the California "time rule" appropriate?

Other courts apply the *Hug* rule, or a variant. In *re: Marriage of Short* (1995) 890 P.2d.12, the Supreme Court of Washington applied a variant of the *Hug* rule. Husband had been induced to join *Microsoft* (instead of starting a new company) by receiving one grant of options to purchase 25,000 shares of *Microsoft*; the options were to "vest" over time intervals. *Microsoft's* plan stated that the purpose for granting options "is to encourage ownership... enabling the company to attract and retain personnel." The "vesting" of the options was contingent upon employee's continued employment. The trial court decided to treat the various grants differently, and

awarded wife 50 percent of one grant, 25 percent of two grants, and none in the post-separation grants. The appellate court ruled that since all of the options were "acquired" during the marriage, they were all community property.

The Supreme Court of Washington reversed the appellate court, and reinstated the trial court's decision. The court said certain options were "unvested" — that is, *Microsoft* "provided no absolute right of ownership." The court then found that evidence supported the trial court's finding that certain options were granted for present services. But, since there also was evidence that the options were granted for future employment, including the language of *Microsoft* option plan, a time rule was required.

V. Issues for Employers and Employees

Trial courts, faced with differing arguments by the spouses when options are not both granted and exercised during the marriage, look at "the facts." Attorneys representing either party are unlikely to have all of "the facts" — sufficient information to adequately prepare his/her case without discovery. Accordingly, subpoenas to the employer for relevant documents might include: (1) Employee compensation plans; (2) Stock option plans; (3) Documents written to the Employee involved — offers of employment or contracts for continued employment. (4) Memorandum explaining why employer authorized the grant.

A foray into corporate records and internal memorandums may ensue. Employers and employees need to be prepared to respond, especially to privacy and trade secret concerns.

VI. Conclusion

The characterization and disposition of marital property is within the trial court's discretion. The method to be applied is that which will "achieve substantial justice between the parties." *Tassi vs. Tassi* (1958) 160 CalApp.2d 680. Because the California courts have not adopted one formula, such as the "Brown formula" (which is used when retirement determination of community property component benefits are at issue), the characterization of stock options is not a simple one. Employers, employees, and spouses each have an interest in insuring that the court selects the appropriate criteria and formula in each particular situation.

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