RECENT DEVELOPMENTS IN STOCK OPTIONS (The once-popular compensation plan at a crossroads), Todd Brogowski and Charles F. Vuotto, Jr.

When the heady days of the technology boom slipped away, and the general public began to hear frequent references to men like Kenneth Lay and Bernard Ebbers (CEO's of Enron and WorldCom, respectively), it was clear to most pundits, legislators, and market analysts that stock options could come under fire as being responsible for a sizeable portion of the losses that had recently befallen investors. For example, in a recent article in the Wall Street Journal, Diya Gullapalli noted that the distribution of stock options in divorce now appears more akin to a game of "hot potato" than a battle over a coveted asset.[i]

Notwithstanding such comments it is clear that Employee Stock Options represent, for many parties, an important component of the marital estate. For every company, like Lucent, that is trading in the single digits,[ii] there is another, like Exxon-Mobil[iii], that remains a profitable. Furthermore, options on a depressed company's stock may have no or little value now, but may very well have great value before their expiration. As most companies continue to provide stock options as components of executive compensation and incentive compensation packages, these assets will continue to be issues that affect property distribution in divorce for the foreseeable future.

Because stock options will remain assets to be distributed in divorce, it is important to consider the recent developments that have changed the way options will be addressed by the legal system after the financial scandals that have recently rocked the nation. This article will address the current view on stock options by a number of key figures in the worlds of finance and law, the recent corporate fraud law, an IRS regulation addressing taxation issues related to transferred options, and recent case law addressing Employee Stock Options.

Options to be Expensed by Corporations

Most commentators regard the failure of major corporations, such as Enron and WorldCom, to be reflective of a widespread problem regarding the accounting of executive compensation and pension plans.[iv] One of the most well-respected and successful corporate officers, Warren Buffett, Chief Executive Officer of Berkshire Hathaway, Inc.[v], stated that corporations have erred in their treatment of stock options by virtue of their failure to list these options as compensation expenses in their financial statements.[vi] Mr. Buffett noted that the failure to report stock option grants on their financial statements as expenses has been, at best, a foolish accounting practice, and at worst, dishonest.

Chief executives frequently claim that options have no cost because their issuance is cashless. But when they do so, they ignore the fact that many C.E.O.'s regularly include pension income in their earnings, though this item doesn't deliver a dime to their companies. They also ignore another reality: When corporations grant restricted stock to their executives these grants are routinely, and properly, expensed, even though no cash changes hands.

When a company gives something of value to its employees in return for their services, it is clearly a compensation expense. And if earnings don't belong in the earnings statement, where in the world do they belong?[vii]

A similar critique – that a major flaw concerning corporate accounting relates to the expensing of executive compensation (options in particular) – was made by Jeffrey Garten, Dean of the Yale School of Management.[viii] As Garten puts it, "[the] magnitude of stock options – and the fact that they were not treated as a company expense – gave executives too much incentive to cut corners to pump up stock prices in the short term."[ix] In response to the public's demand for reform of corporate practices, primarily with relation to accounting and executive compensation (and therefore stock options), the present Administration has endorsed the reform platform. The Chairman of the Board of Governors of the Federal Reserve Bank ("FRB"), Alan Greenspan, has also urged that stock options be treated as expenses by corporations[x].[xi]

Perhaps as an attempt to provide some encouragement for those corporations who have resisted reform, the IRS has proposed a regulation that would require U.S. companies to treat stock options as an expense when involved in international ventures.[xii]

The end result of this groundswell of criticism of corporate accounting practices and the Enron/WorldCom scandals has created some changes in the Federal Government's treatment of corporate accounting practices and compensation programs. Two in particular stand out: The Sarbanes-Oxley Act of 2002 and IRS Revenue Ruling 2002-22. The first directly addresses many of the accounting practices now under fire. The second addresses the taxation of stock options incidental to divorce.

The Sarbanes-Oxley Act of 2002:

The Bush Administration and Congress responded to the problems created by the recent accounting scandals through the non-partisan passage of the Sarbanes-Oxley Act of 2002.[xiii] Much has been made of this act,[xiv] but it remains to be seen whether it has the teeth to combat corporate malfeasance. Sarbanes-Oxley was designed to address the questionable accounting practices undertaken by accounting firms, such as Arthur Anderson, and corporations, such as Enron, in the preparation of required SEC financial statements.[xv]

One of the biggest problems with regard to the accounting practices used in the preparation of these statements has been the issue of expenses, such as loans and non-salary executive compensation. Corporations, as part of a combined incentive and retention program, often offer executives stock options and enhanced performance pay. The key issue, with regard to accounting practices, has been how or if these incentives are shown on annual and quarterly financial statements.

The position of the IRS has been that corporations should list these plans (options in particular) as expenses on their financial reports.[xvi] While this would certainly reduce the profit shown by some corporations on their statements, it is the position of many, including the aforementioned CEO of Berkshire Hathaway, that this is the more accurate profit figure for corporations.[xvii]

Sarbanes-Oxley only indirectly addresses the problem of the inclusion of executive compensation in financial statements. Title I, Section 108 of the Act requires audits to follow generally accepted accounting practices in the preparation of corporate financial statements.[xviii] In order to enforce this requirement, the Act creates an oversight body (the Public Company Accounting Oversight Board, or PCAOB, referred to herein as "the board")[xix] that will determine which principles of accounting are "generally accepted."[xx] While creating this new board to determine the appropriate methodology for accountancy in the preparation of financial reports, the Act makes no judgment as to the treatment of options by corporate auditors. Thus, the newly created oversight board will be forced to determine what standards are acceptable in the treatment of stock options.

The oversight board's treatment of these options will be determined based on whether the board approves of the accounting methods used by corporate auditors.[xxi] Given the fact that there are opposing views on the treatment of options,[xxii] it is conceivable that the board will not require corporate auditors to expense options. This leaves open the same loopholes that existed prior to Sarbanes-Oxley.[xxiii] Past shareholder derivative cases have demonstrated that this may be problematic, especially when addressing executive compensation, as shareholders will still lack accurate information upon which they can act to ensure accountability in their Boards of Directors.[xxiv]

Sarbanes-Oxley also imposes much stiffer penalties for accounting malfeasance than has been imposed in the past.[xxv] The Act imposes longer terms of incarceration, fines, and fee awards against those who violate the Act or other sections of the Securities Exchange Act of 1934 (the underlying Act for all Federal securities law).[xxvi] While the penalties are more severe, it is unclear whether the increased penalties enable greater discovery and apprehension of those engaged in accounting fraud.

While the same standards problem exists with regard to accounting practices, it is clear that the board will be able to enforce whatever standards it does impose. However, the Act's relationship to equitable distribution may be limited to the impact it has on corporations' willingness to grant options if they are required to expense them and thereby reduce their bottom line.

Revenue Ruling 2002-22

On May 13, 2002, the IRS released Revenue Ruling 2002-22, in order to address confusion concerning stock options and taxation.[xxvii] When stock options are transferred incident to divorce, two particular tax regulations apply to that transfer: 26 C.F.R. 1.1041-1T and 26 C.F.R. 1.83-7. The first specifically deals with the transfer of property between spouses during divorce.[xxviii] Under this regulation,

A taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce is not required to include an amount in gross income upon the transfer. Rather, the former spouse [receiving the options] is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse.[xxix]

The Ruling only applies to the transfer of stock options or nonqualified deferred compensation transferred in the context of a divorce.[xxx]

Prior to Revenue Ruling 2002-22, it was possible for the transferor spouse to be taxed upon the transfer of stock options to the transferee spouse. [xxxi] Now, the transferor spouse has non-recognition of the transfer of the options as a taxable event, and the transferee spouse bears the tax burden for the options.[xxxii]

The impact of this recent ruling concerning stock options is the resolution of confusion concerning the taxability of transferred non-qualifying options after parties have distributed them during divorce. Admittedly, this does not happen often, since most plans do not permit transfers of such assets. However, where transfers are permitted, the taxation has now been clarified. The IRS has ensured that the parties garnering the benefits of property after equitable distribution will also bear the taxation burdens associated with that property.[xxxiii]

Hanson v. Hanson **and the treatment of Stock Options**

Other than *Callahan*[xxxiv] and *Pascale*[xxxv], there are no reported cases addressing Employee Stock Options in the context of a New Jersey Divorce. Until recently, there were only two unreported decisions, which addressed the intricacies of option/restricted stock distribution incident to divorce, of which the authors are aware[xxxvi]. The first, *Allex v. Allex*,[xxxvii] addressed the award of restricted stock and options. In Allex the employed spouse received the restricted stock and options during the marriage but was not able to exercise them until after the date of complaint.[xxxviii] However, the inability to exercise the options was not the crux of the ruling to exclude them from equitable distribution. The Appellate Division affirmed the trial court's finding that the restricted stock and options in question were not subject to equitable distribution, because the Merrill Lynch compensation plan was "designed to reward continuous employment."[xxxix] Therefore, the Court concluded that the restricted stock and options were not earned during the marriage and marital effort had not been expended in their acquisition.

In *Klein v. Klein*,[xl] the Appellate Division addressed the inclusion of options in equitable distribution by a trial court even though they vested after the date of complaint. The Appellate Division ruled that the inclusion of such options in equitable distribution was not an abuse of discretion, as the options were awarded for past labors by the employee-spouse.[xli]

Each of these decisions is consistent with the seminal case, i.e., *Pascale*, but does not address the thornier issue of how to properly, fairly and uniformly determine the marital and one-marital portions of unvested options or restricted stock.

No published New Jersey opinion has addressed the core issue of how to accurately distinguish between the marital and non-marital portions of unvested stock options. Although *Pascale* deals with the issue by imposing a general obligation to distribute all assets earned during the marriage, this gives little practical guidance. Throughout the nation, most states adopt a "Coverture Fraction" or "Time-Rule Formula" when determining which portion of unvested stock options (or restricted stock for that matter) is in the pool of asset subject to equitable distribution.[xlii]

A recent unpublished opinion by the New Jersey Appellate Division, issued in the matter of *Hanson v. Hanson*, A-4492-00T1 (App. Div. 2002), dealt with a trial court's inclusion of restricted stock (analogous to unvested stock options) in equitable distribution[xliii]. The trial court, in including the restricted stock in equitable distribution, applied the coverture fraction to the division of this stock.[xliv] The Appellate Court did not disturb this portion of the trial court's ruling, implicitly affirming the trial court's use of the majority rule (i.e., the coverture fraction) with restricted stock (as set forth in the groundbreaking California case of *In re Marriage of Hug*[xlv]*)*. This appears to mark the first occasion where the Appellate Division has sanctioned, at least implicitly, the use of the coverture fraction for an asset such as restricted stock.[xlvi] As for the actual formula used in this case, the trial court adopted a coverture fraction covering the date of the initial award of restricted stock (*In re Marriage of Hug* used the date of employment as the start date) to the date of trial as the numerator and the date of the initial award to the first date of allowable exercise as the denominator.[xlvii]

In *Hanson*, the Appellate Division adjusted the fraction's end date based upon the trial court's imposition of the principle of "momentum" to justify including a post-complaint period.[xlviii] By momentum, the Court meant "the impressive consistent upward trend in [the husband's] earnings over a period of several years."[xlix] Momentum is a principle that has been applied only to alimony in the past, in *Gugliotta v. Gugliotta*.

Where a family's expenditures and income had been consistently expanding, the dependent spouse should not be confined to the precise lifestyle enjoyed during the parties' last year together. Defendant's income picture should be viewed with an eye toward the future, since it was to this potential that both parties contributed during the marriage. The then existing earning potential of the working spouse may be shared by the spouse who kept the home, and that standard of living should be implemented through an adequate alimony award.[l]

It appears that the difference between the use of "momentum" in *Gugliotta* and in *Hanson* is that, in *Hanson*, momentum was being applied by the trial court as to equitable distribution, not alimony. For this reason, the Appellate Division remanded the case, holding that there was no basis for applying momentum to the fixing of assets for the purposes of equitable distribution.[li] However, what is critical, is the Appellate Court's adoption of the Coverture Fraction for determining the marital portion of restricted stock.

The adoption of the majority rule continues across the nation, as is evidenced by the a recent case from New Hampshire, *In re Valence*.[lii] In *Valence*, the New Hampshire Supreme Court reversed and remanded the decision of a trial court with instructions to distribute all vested and unvested stock options earned by one of the spouses, regardless of whether these assets were earned during the marriage.[liii] The New Hampshire Supreme Court stated that the trial court should determine whether the unvested stock options were granted as incentives for future services. If so, then, according to the Court, the trial court was instructed to apply the coverture fraction in order to determine which portion of the assets were earned prior to the dissolution of the marriage.[liv]

It appears that the utilization of a straightforward coverture fraction to distribute restricted stock and unvested options, as done by the majority of states, remains the most objective and fair formula, without sole reliance on the often unclear and contradictory evidence that may be presented with regard to why such assets were awarded.

Closing Thoughts

In the past two years, executive compensation plans, including those dealing with stock options, as well as corporations in general, have taken a great hit in public approval. Because of the crash of the stock market and the reported conduct engaged in by Enron, WorldCom, and Arthur Anderson, corporations have become a hot item for regulators and legislators alike.

The Congress has responded to the scandals by passing the Sarbanes-Oxley Act, designed to reform the enforcement wing of the Securities and Exchange Commission and the practices used for corporate statements by creating an oversight body (the PCAOB). This board will ensure that the reporting of corporate profits adheres to widely accepted accounting practices. The Act will also introduce tougher penalties for fraudulent reporting regarding the financial state of corporations. For corporations, this may mean that they will have to be more conservative in their executive compensation plans. In turn, this may indicate a reduction in the number of stock option-related issues arising during divorce.

[i] *See* Diya Gullapalli, *Divorcing Couples Spar Over Worthless Options: 'No, You Take 'Em'*, Wall St. J., Aug. 7, 2002, at D1.

[ii] As of the time of writing, Lucent Technologies, Inc., is worth $1.52 per share.

[iii] Exxon-Mobil traded at $37.16 per share as of the time of writing.

[iv] *See* Warren Buffett, *Who Really Cooks the Books?*, N.Y. Times, July 24, 2002, at A19.

[v] A remarkably successful company, Berkshire Hathaway reported net earnings of $795 Million for 2001. *See* Berkshire Hathaway, Inc., 2001 Annual Report, Selected Financial Data for the Past Five Years, *at* <http://www.berkshirehathaway.com/2001ar/fiveyear.html> (last viewed Aug. 15, 2002). Presently, a single share in Berkshire Hathaway Class A stock trades for $74,800.

[vi] *Supra.*

[vii] *Supra*.

[viii] *See* Jeffrey E. Garten, *Five Steps to Make Wall Street Safer for Investors*, Bus. Week, Jul. 15, 2002, at 28.

[ix] *Supra*.

[x] *See* Laura Smitherman, *SEC Denies Shareholders a Vote on Treating Options as Expenses*, Bloomberg Newswire, Jul. 25, 2002. Despite Chairman Greenspan's hopes for treatment of options as expenses, the Securities and Exchange Commission refused to require corporations, such as National Semiconductor Corporation and ConAgra Foods, Inc., to submit to a vote a referendum by shareholders demanding that options be expensed.

[xi] *See* Maxine Clayton and Courtney Schlisserman, *Anheuser-Busch 2nd-QTR Net Rises 12% on Higher Prices*, Bloomberg Newswire, Jul. 24, 2002. Anheuser-Busch stated that it would not expense stock options, unlike Coca-Cola Co. and Washington Post Co.

[xii] *See* Simon Kennedy and Brendan Murray, *IRS Proposes Stock Options for Some U.S. Affiliates*, Bloomberg Newswire, Jul. 26, 2002. This regulation may also be a perfect avenue for the Federal Government's imposition of business practices beyond the borders of the United States, as it imposes burdens on overseas corporations that may not normally expense these compensation plans.

[xiii] *See* H.R. 3763, 107th Cong. (2002) (hereinafter "Sarbanes-Oxley").

[xiv] *See* Sandra Sobieraj, *Bush Enacts Corporate Fraud Law*, Yahoo News/AP Newswire, *at* <http://www.story.news.yahoo.com/news?tmpl=story&u=/ap/20020730/ap_on_go_pr_wh/bush_business_scandals_18> (last viewed Jul. 30, 2002).

[xv] *Supra.*

[xvi] *See* Kennedy and Murray, *supra*.

[xvii] *See* Buffett, *supra*.

[xviii] *See* Sarbanes-Oxley, H.R. 3763, T. I, § 108(b)(1).

[xix] *See* Sarbanes-Oxley, H.R. 3763, T.I, § 101(a).

[xx] *Supra.*

[xxi] *Supra.*

[xxii] *See* Smitherman, *supra*, Note 11, where SEC Chairman Pitt refused to require a vote as to the treatment of options as expenses; Clayton and Schlisserman, *supra*, Note 12, where the Anheuser-Busch Corporation defended its refusal to treat options as expenses.

[xxiii] *See* Buffett, *supra*, Note 4.

[xxiv] *See In re Walt Disney Co. Derivative Litigation*, 731 *A.2d* 342, 350 (1998). In this case, shareholders unsuccessfully challenged the award of $140 Million in executive compensation to Michael Ovits for fourteen months of work.

[xxv] *See* Sarbanes-Oxley, H.R. 3763, T.VIII, §§ 802-805.

[xxvi] *Supra*.

[xxvii] *See* Rev.Rul. 2002-22, 2002-19 I.R.B. 849 (2002).

[xxviii] *See* 26 C.F.R. 1.1041-1T.

[xxix] *Supra*, at 1.

[xxx] *See* Rev.Rul. 2002-22, *supra*, at 5.

[xxxi] *Supra*, at 3; *citing Rubin v. Commissioner*, 429 F.2d 650 (2d Cir. 1970).

[xxxii] *Supra*, at 4.

[xxxiii] *See* Scott E. Vincent, *IRS Clarifies Treatment of Options Transferred Incident to Divorce*, 58 J. Mo. B. 162, 163 (2002). As noted in Mr. Vincent's article, the regulation is prospective, applying to stock option transfers occurring after November 9, 2002. Until that date, the old transfer tax liability rules will apply.

[xxxiv] *See Callahan v. Callahan*, 142 *N.J.Super.* 325, 328 (Ch. Div. 1976).

[xxxv] *See Pascale v. Pascale*, 140 *N.J.* 583, 612 (1995).

[xxxvi] *See Allex v. Allex,* A-5739-95T3 (App. Div. 1997) and *Klein v Klein*, A-5019-97T1 argued June 3, 1999 and decided on June 24, 1999. While *Mailman v. Mailman*, A-2321-97T3 (App. Div. 1999), also addressed stock options, it did so in a cursory

fashion, focusing more on situations where the time limitation on revisiting property settlement agreements under Rule 4:50-1 would be tolled.

[xxxvii] *Supra*.

[xxxviii] *Supra*, at 8.

[xxxix] *Supra*, at 8.

[xl] A-5019-97T1 (App. Div. 1999).

[xli] *Supra*, at 8. The inclusion at a post-judgment motion occurred because the trial judge forgot to so include the options as of the time of the initial trial.

[xlii] The most prevalent time rule fraction evolved from a formula implemented by the California Court of Appeals in In re Marriage of Hug, 154 Cal. App. 3d 780 (Cal. Ct. App. 1984). In Hug, the trial court expressed the options that were part of the marital estate in terms of a fraction. See id. at 782. For example, the court stated that the numerator represented the difference in months between the spouse's commencement of employment with the company and the date of the parties' separation. See id. The denominator was established by first determining the difference, in months, between commencement of employment and the date when the first option was exercisable. See id. This factor was then multiplied by the number of shares that could be purchased on the date that the option was first exercisable. The remaining options were determined to be the separate property of the husband, the employed spouse. See id. at 782-83. (See alsoBornemann v. Bornemann, 245 Conn. 508 (1998))

[xliii] *See Hanson v. Hanson*, A-4492-00T1 (App. Div. 2002), at 3.

[xliv] *See supra*, at 9-10.

[xlv] *See* 154 Cal.App.3d 780, 46 A.L.R.4th 623 (Cal.App. 1984).

[xlvi] *See Whitfield v. Whitfield*, 222 *N.J.Super.* 36 (App. Div. 1987) (as to pensions).

[xlvii] *See Hanson*, *supra*, at 10.

[xlviii] *See Hanson*, *supra,* at 9.

[xlix] *Supra*, at 10.

[l] *Gugliotta v. Gugliotta*, 160 *N.J.Super.* 160, 164, *aff'd* 164 *N.J.Super.* 139 (App. Div. 1978).

[li] *See Hanson*, *supra*, at 17.

[lii] 798 A.2d 35 (N.H. 2002).

[liii] *Supra*, at 39.

[liv] *Supra*.