ILLINOIS STATE BAR ASSOCIATION
FAMILY LAW TABLE CLINIC SERIES
MAY 18, 2017
STOCK OPTIONS

Presenters:

Susan W. Rogaliner	**Hon. Arnold Blockman (retired).**	**Tamika R. Walker**	**Lisa M. Nyuli, Esq.**
2445 Dean Street, Suite H St. Charles, Illinois 60175 (630) 513-1116	1218 Wilshire Ct Champaign, Illinois 61821 (217)649-3914	Sreenan & Cain PC 321 W. State Street Suite 700 Rockford, IL 61101 (815) 962-5490	Ariano, Hardy, Ritt, Nyuli, Richmond, Lytle & Goettel, P.C. 2000 McDonald Road Suite 200 South Elgin, IL 60177 847-695-2400
srogalinerlaw@att.net	arnoldblockman@ gmail.com	Walker_tamika@ hotmail.com	lmn@attorneys-illinois.com

STOCK OPTIONS

Stock options give an Employee a chance to profit in the growth of a company's value in addition to earning a salary. At the time of dissolution, stock options may be a substantial asset of the family. Dealing with stock options is complex, in part because each company makes its own terms concerning the awarding and exercise of options, and in part because the benefits may be vested, not yet vested, may not be able to be valued at the time of entry of judgment and may have tax considerations.

Following is an overview of important issues when a party has stock options.

IMDMA PROVIDES FOR THE DISTRIBUTION OF STOCK OPTIONS

750 ILCS 5/503(b)(3)

> For purposes of distribution of property under the Section, all stock options and restricted stock or similar form of benefit granted to either spouse after the marriage and before a judgment of dissolution of marriage, legal separation or declaration of invalidity of marriage, whether vested or non-vested or whether their value is ascertainable, are **presumed to be marital property**.
>
> This presumption is overcome by a showing that the stock options or restriction stock or similar form of benefit were acquired by a method listed in subsection a of this Section.
>
> The **court shall allocate** stock options and restricted stock or similar form of benefit between the parties **at the time of the judgment**, recognizing that the value of the stock options and restricted stock or similar form of benefit may not be then determinable and that **the actual division of the options may not occur until a future date.**
>
> Additional factors for allocation:
>
> Court shall consider all circumstances underlying the grant of the option, including
>
> - the vesting schedule
> - whether the grant was for past, present or future efforts,
> - whether the grant is designed to promote future performance or employment,
> - the length of time from the grant of the option to the time the option is exercisable.

TYPES:

RESTRICTED STOCK UNITS

- Restricted Stock Units are company shares that are granted to an employee at no cost, but are not transferable until certain conditions such as employment by the company for a specific period of time and/or vesting, have been met.

- No company stock is issued at the time of the grant. Restricted Stock Units are owned subject to divestment and are rights of the Grantee to receive the stock subject to the conditions of the Plan.

- Vesting may be time-based, performance-based or both. There may be special vesting rules based upon certain circumstances such as disability, death, retirement, or change of control of the company.

- Upon vesting, the company distributes the shares, or the cash equivalent of the shares, to the Grantee. The Grantee is typically taxed at ordinary income rates. Depending on the terms of the Plan, the Grantee may be allowed to choose cash or stock.

- The Plan may or may not allow Restricted Stock Units to be transferred upon divorce. If the Restricted Stock Units are non-transferable, the Grantee may need to hold the spouse's designated Restricted Stock Units as a constructive Trustee for the benefit of the former spouse.

- The granting of Restricted Stock Units is often seen as a form of compensation by tech companies. They are usually granted at the signing of the new employee, but may also be granted periodically based on performance of the employee. Typically, the Grantee must pay income tax based on the market value of the shares at the time of vesting.

- Restricted Stock Units at the time of divorce can be tricky to divide because:

    1. The grant date, the vesting date, and the potential sale dates are different from each other.
    2. The value of Restricted Stock Units, a non-cash equity compensation, varies with the stock value of the company and therefore fair market value at a later date is hard to predict.
    3. Restricted Stock Units are usually non-transferable.
    4. Restricted Stock Units do not vest unless an employee stays at the company.
    5. An employee may be granted Restricted Stock Units after the divorce based on performance from prior the divorce.

- If the RSU's are granted and vest during the marriage, the division of the RSU's is more straightforward. If an employee wishes to keep his or her RSU's, he or she can cash-out the spouse based on the fair market value at the time of the divorce, but the tax implications must be taken into account. In the alternative, the spouse's share may be sold to cash him or her out but, again, the income tax and capital gains tax implications must be addressed.

- If the RSU's are granted during the marriage but vest after the marriage, the division is more complicated. The employee spouse must stay with the company through the vesting date. If he or she leaves or is dismissed prior to vesting, the RSU's typically have no value.

- Major considerations.
  The RSU's are difficult to value until vested because the RSU Grantee cannot sell the RSU's until they are vested.
  If dealing with RSU's granted after divorce for past performance during the marriage, it can be argued by the Grantee spouse that the refresher grants were meant to continue compensation at the employee's current level and for compensation for future work. It can be argued by the recipient spouse that the company has awarded the RSU's for past work/performance.

STOCK OPTIONS:

Grant of a future right to buy a share of stock at a price equal to at least the FMV of a share of stock on the date of grant

Exercise of that right to purchase the stock at the exercise price

The compensatory portion is the spread, the difference between the stock's FMV at the time of exercise and the option's grant date.

Vesting – amount of time an option must be held before being exercised

Incentive Stock Options – ISOs

- Must meet criteria in Internal Revenue Code
- Available only to employees
- Available only if issuer is a corporation
- Only $100,000 of stock options can become exercisable for an employee for the first time within a calendar year
  - Limit is measured as of the grant price value on the grant date]

    - In multiple grans, overlapping vesting must be tracked
- Options must be granted pursuant to a plan approved by the shareholders

    - Exercise price must be at least FMV of the underlying stock on the grant date
    - Must be exercised within 10 years of the grant date
    - If option expires, it's worthless
    - Special rule for 10% shareholders –
        - Exercise price must be at least 110% of the FMV of the stock on the grant date
        - Must be exercised within 5 years of grant

Nonqualified (non-statutory) Stock Options – NSOs

- All related income is taxed at ordinary income rates
- The spread is taxable as ordinary income at the time of exercise (Option may be characterized as income vs. property right)
- Subject to both income tax and FICA
- Company must withhold taxes.

    - Revenue Ruling 2002-22 – transfers of vested, nonqualified stock option to a non-employee incident to divorce – Distinguishes between vested and unvested stock options
        - Non-employee spouse recognizes income resulting from exercise of non-qualified stock option
        - Employee spouse does not recognize income
        - IRS considers transfers of stock option as a transfer of property under IRC Section 1041
        - Two major limitations: First, it applies only to the transfer of stock options in divorce. Married spouses who want to transfer stock options must look elsewhere for guidance. Second, Revenue Ruling 2002-22 does not apply to the transfer of unvested stock options

DIVISION CONCERNS/QUESTIONS?

- Can the options be distributed "in kind"
- What is the value at the time the options are granted
- If not, how should you value them for a cash buy-out at divorce
- Is it best to hang on to them to see if they are exercised
- When do options vest

- Retirement impact on vesting
- Termination impact on vesting
- Conditions of vesting

CASES/OTHER STATUTES:

In re Marriage of Moody, 119 Ill.App.3d 1043, 457 N.E.2d 1023, 1026,1027 (1st Dist., 1983).

In re Marriage of Frederick, 218 Ill.App.3d 533, 578 N.E.2d 612, (2d Dist., 1991)

HOW DO WE FIND THEM? DO DISCOVERY!

- Based on terms of a plan or a contract – should be in employment file
- Can be subject to shareholder agreements – need a copy of the agreements
- Right to receive dividends?
- Right to vote?
- Request a stock option history from the corporation and evaluate each grant and the price at which each option may be exercised.
- Evaluate the tax consequences of each grant of stock options, just as you would evaluate the basis of stocks that were purchased over a period of years.

MSA SAMPLE LANGUAGE (Courtesy of Attorney Margaret A. Bennett)

- Allows the non-employee spouse the right to be notified when the options are exercisable and to serve notice on the employee spouse of the right to exercise options awarded by the Court pursuant to the terms of the MSA.

- Provides a formula for the withholding of Federal, State, FICA and Medicare taxes

[This language presumes that the Petitioner is the Wife/Non-Employee and Respondent is the Husband/Employee receiving the stock options from the Corporation]

"The parties agree that they shall divide the right to exercise stock options issues to Respondent as follows:

From Plan/Grant _____, the Petitioner will receive the right to exercise ___ options and the Respondent will receive the right to exercise ___ options. All of these options must be exercised by (insert expiration date).

From Plan/Grant _____, Petitioner will receive the right to exercise ___ options, and Respondent will receive the right to exercise ___ options. All options from this grant must be exercised by (insert expiration date).

From Plan/Grant _____, Petitioner will receive the right to exercise ___ options, and Respondent will receive the right to exercise ___ options. There are currently no options that are exercisable from this Plan/Grant. On (date exercisable), the options will become exercisable, of which Petitioner will receive the right to exercise ___ options, and Respondent will receive the right to exercise ___ options. On (date exercisable), an additional _____ options will become exercisable, of which Petitioner will receive the right to exercise ___ options, and Respondent will receive the right to exercise ___ options. All options from this grant must be exercised by (insert expiration date).

All options not exercised by the prescribed date, as shown in the last sentence of each paragraph for each grant listed above, will be terminated. Additionally, if Respondent leaves the employment of the Corporation, all stock options will be terminated after a prescribed period of time as determined by the Corporation, and the parties shall have no further right to the options.

Respondent shall notify Petitioner each time of the year of the periods during which he can legally sell stock options **. He will forward to Petitioner copies of all notices, correspondence, etc. relating to the options in which the Petitioner has an interest pursuant to the terms of this Marital Settlement Agreement (or Judgment). Petitioner shall have the right to request that Respondent exercise her share of the exercisable options any time (but sale of stock may occur only during periods permitted by SEC regulations and insider trading regulations **). If Petitioner wishes to exercise the above options awarded to her, Petitioner will receive the net proceeds after payment of all taxes and

fees incurred as a result of the said exercise. The parties further agree that any personal Federal, State, FICA and Medicare taxes incurred by Respondent in connection with the exercise of the aforesaid stock options on behalf of Petitioner will be deducted at Respondent's then current tax rate and Petitioner will receive no reimbursement from Respondent for said deductions. The above includes all exercisable and non-exercisable stock options not exercised prior to the date of the Judgment for Dissolution of Marriage."

** only use if insider trading regulations apply to the Respondent.

Stock Options

By Arnold F. Blockman
Lisa M. Nyuli
Susan W. Rogaliner
Tamika R. Walker

The Statute

750 ILCS 5/503(b)(3) (as amended by Public Act 99-90 on January 1, 2016) now reads as follows:

> (3) For purposes of distribution of property under this section, all stock options and restricted stock or similar form of benefit granted to either spouse after the marriage and before a judgment of dissolution of marriage or legal separation or declaration of invalidity of marriage, whether vested or non-vested or whether their value is ascertainable, are presumed to be marital property. The presumption of marital property is overcome by a showing that the stock options or restricted stock or similar form of benefit were acquired by a method listed in subsection (a) of this section [definition of non-martial property under 750 ILCS 5/503(a)]. The Court shall allocate stock options and restricted stock or similar form of benefit between the parties at the time of the judgment of dissolution of marriage or declaration of invalidity of marriage recognizing that the value of the stock options and restricted stock or similar form of benefit may not be then determinable and that the actual division of the options may not occur until a future date. In making the allocation between the parties, the court shall consider, in addition to the factors set forth in subsection (a) of this section [the equitable division of marital property factors under 750 ILCS 5/503(d)], the following:
>
> (i) All circumstances underlying the grant of the stock option and restricted stock option or similar form of benefits including but not limited to the vesting schedule, whether the grant was for past, present or future efforts, whether the grant is designed to promote future performance or employment, or any combination thereof.
>
> (ii) The length of time from the grant of the option to the time the option is exercisable.

The Caselaw

There is not a lot of Illinois caselaw on the subject of the equitable distribution of stock options and similar property.

In In re Marriage Moody, 119 Ill. App. 3d 104 (1st Dist. 1983), in a case decided before the 2002 amendment to 503(b)(3) making stock options marital property, vested or non-vested, the Court held that employee stock options were not marital property until the options were vested and exercised. Accordingly, the Court found that the trial court erred in awarding the stock options to the husband at the time of the ancillary hearing and placing a present value on the options in dividing the marital property. In reversing the equitable division of the trial court the Appellate Court stated as follows regarding the stock options:

> …We also direct the trial court to retain jurisdiction until such time as the options are exercised or expire. If and when the options are exercised, the trial court may at its discretion allocate an appropriate share of any profit realized from the transaction to each spouse. 119 Ill. App. 3d at 1048.

In In re Marriage of Frederick, 218 Ill. App. 3d 533 (2nd Dist. 1991) the trial court simply retained jurisdiction over the equitable division of stock options with a potential of substantial value. The trial court also ordered that the husband would have the sole right to exercise the option and ordered an equal division of any profit realized should the options be exercised. The Appellate Court affirmed the reserved jurisdiction approach noting that "the value of the options cannot be properly valued until they are exercised." 218 Ill. App. 3d at 541.

In In re Marriage of Isaacs, 260 Ill. App. 3d 423 (1st Dist. 1994) the Appellate Court reversed the trial court's refusal to retain jurisdiction to value and distribute later the proceeds of the stock options, if exercised by the wife. The Appellate Court found that the stock options had no value until exercised and that the trial court should have retained jurisdiction regarding the value of and distribution of the stock options at a later time, if exercised, citing with favor the Frederick opinion, supra.

In In re Marriage of Micheli, 2014 IL App (2nd) 121245, the trial court in its amended ancillary judgment divided all assets equally, including vested stock

options. The trial court, however, set off to and awarded the husband all unvested stock options and restricted stock units (RSUs). The wife argued on appeal that the unvested stock options and RSUs should be equitably divided just like the vested assets. The estimated value of the unvested stock options and RSUs was $604,558.00. The Appellate Court reversed and remanded finding that the trial court abused its discretion in not dividing the unvested options and RSUs giving the husband potentially a windfall. The Court stated as follows at para. 37:

> The estimated values of the unvested stock options and RSUs are based on John's April 2011 financial statement, but they illustrate the disparate impact of the court's decision to deviate from its original ruling that divided the stock options and RSUs equally. The uncertainty of the values of the unvested stock options and RSUs is not an impediment to an equitable distribution when they become vested. We agree with Ellen that the court's decision to award John all of the unvested stock options and RSUs was an abuse of discretion.

As noted above, Public Act 99-90 amended section 503(b)(3), effective January 1, 2016, to include the equitable division of all restricted stock or similar form of benefit, vested or unvested.

In In re Marriage of Peters, 326 Ill. App. 3d 364, 321 (2nd Dist. 2001) the employment agreement of the husband provided that if he stayed with the company for 10 years and averaged a certain amount in annual collected gross profits, the company would transfer a percentage of its stock to him (the maximum gross would entitle him to 10% of the company stock). The husband had been with the company 5 years when the marriage dissolved. The trial court determined that the stock bonus option was not marital property subject to equitable division because it was future compensation for future efforts and that it was speculative whether the stock would have any value in the future. The Appellate Court reversed holding that contingent stock bonus/option plans, like non-vested pension plans, are marital property to the extent they were earned during the marriage citing the amendment to section 503(b)(3) that was to become effective on January 1, 2002. The Court also cited the Frederick, Issacs and Moody cases, supra. discussed above for the proposition that a reserved jurisdiction approach should be used. The Court noted as follows:

> Having concluded that part of the stock bonus could be marital property, we must now determine what to do on remand. When dealing with pension rights, courts generally follow a "total offset" approach or the "reserved jurisdiction" approach…
>
> Under a "reserved jurisdiction" approach which is also used with stock options, the court delays actually valuing the asset but orders how it will be divided if and when it is paid out…
>
> Under these facts, we believe that the court should use a reserved-jurisdiction approach. This method is better when an asset's present value is difficult to determine because of uncertainties as to vesting or maturation. Mantei, 222 Ill. App. 3d at 397. If it wishes, the court can determine how it will divide any marital portion of the bonus…

It is worth noting that 4 of the 5 Illinois cases dealing with the issue of equitable distribution of stock options as martial property, vested or unvested, clearly indicated a preference for the reserved jurisdiction approach and similar treatment as the marital portion of a pension plan.