

Stock Option Distribution via Constructive Trusts in Divorce Settlements

by

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Introduction

This article examines the legal and financial theories behind the use of constructive trusts in the body of a Matrimonial Settlement Agreement (“MSA”) for purposes of effectuating equitable distribution of stock options in divorce. *Part 1* introduces the more common financial options the matrimonial practitioner will encounter. We will briefly describe these options and touch on the complex valuation issues associated with them (the taxation of options is outside the scope of this article). *Part 2* contains a practical discussion of how to implement and structure the equitable distribution of options with the use of a constructive trust within the Matrimonial Settlement Agreement.

Part 1

Options are financial derivatives, i.e., they derive their value from other assets, in our case the price of the stock to which the option is related. The stock options matrimonial practitioners will commonly see are as follows¹:

Incentive Stock Options (ISOs)

- Granted to employees only.
- Cannot exceed 10 years from grant to expiration.
- Generally taxed on date of exercise for AMT purposes.

Nonqualified Stock Options (NQSOs)

- May be granted to non-employees.
- Generally causes ordinary compensation income when exercised.

- Subject to all withholdings.

When dividing stock options in a divorce, the practitioner faces three choices: value the options and determine the equivalent offsets when distributing the remaining marital property; transfer actual ownership of the options (rarely available); or use a Callahan Trust as discussed in Part 2.

Until 2002 when the IRS issued Revenue Ruling 2002-22, ISOs and NQSOs could not be divided between spouses (assuming a company plan would allow it) without triggering tax under the assignment of income doctrine. Revenue Ruling 2002-22 followed by Revenue Ruling 2004-60 (clarifying the withholding obligations of employers) has made this possible. Revenue Ruling 2002-22 exempts the transfer of options pursuant to a divorce decree from the assignment of income doctrine. Revenue Ruling 2004-60 clarified the withholding and other requirements for employers and employees.

As a practical matter, however, we have not yet seen any publicly held company change its stock option plan to accommodate the change in tax treatment; thus valuation/offset or using a trust are still often the only available solutions.

Why are we so concerned? After all, if an option can be exercised at say \$25 and the stock is trading for \$100 isn't there an *intrinsic* value of \$75? Or, if the stock is trading below \$25 the option is "underwater" or worthless and we don't need to worry about it? Not so, says financial theory.

The value of options is influenced by a variety of factors including, but not limited to: time to expiration ("expiry"), dividend payout, risk free rate of return based on zero coupon U.S. Treasuries of the same duration as the option, and perhaps the most important factor, the volatility² of the security.

Today most everyone has heard of the Black-Scholes ("B-S") formula to value options. It was developed in the 1970's and led to a Nobel Prize.³ Over the years it has been tweaked, changed, and otherwise modified to account for how American options are traded versus the European options used in the original model.⁴

For those with a masochistic bent, the formula⁵ is as follows;

$$C = SN(d_1) - Xe^{-rT}N(d_2)$$

Where:

$$d_1 = \frac{\ln(S/X) + (r + \sigma^2/2)T}{\sigma\sqrt{T}}$$

$$d_2 = \frac{\ln(S/X) + (r - \sigma^2/2)T}{\sigma\sqrt{T}} = d_1 - \sigma\sqrt{T}$$

Where:

S = Stock Price; X = Strike Price; r = Risk-free interest rate; T = Time to expiry in years; σ = Volatility of stock price; and $N(x)$ = Cumulative normal distribution function.

Modern option theory tells us that even an “underwater”⁶ option may have value. In fact, the longer the time to expiry and the greater the volatility of the stock, all other factors held constant, the greater the value of any option whether “under water” or “in the money.” Accordingly, in theory at least, an option should be held to expiry, although most employees engage in “suboptimal exercise behavior,” i.e., exercising before expiry.

Let’s look at the effect of volatility on the price of an option using two examples holding all the facts the same except the volatility:

Figure 1 – Value of “in the money” option with 30% volatility

OPTIONS XL Black-Scholes

Input:	<u>Mod. B-S Euro</u>
Model	1
Type of Option	1
Function	1
Underlying Price	100
Exercise Price	65
Time to Expiration	365
Volatility	30.00%
Interest Rate	5.00%
Yield Rate	0.00%
Output:	
OptionsBS	38.7105

Figure 2 – Value of “in the money” option with 50% volatility

OPTIONS XL Black-Scholes	
Input:	<u>Mod. B-S Euro</u>
Model	1
Type of Option	1
Function	1
Underlying Price	100
Exercise Price	65
Time to Expiration	365
Volatility	50.00%
Interest Rate	5.00%
Yield Rate	0.00%
Output:	
OptionsBS	41.6243

You can see there is almost a \$3.00 price differential by changing volatility on this “in the money” option.

Let’s take a look at those “worthless,” “out of the money” or “underwater” options.

Again, holding everything constant except volatility, observe the following:

Figure 3 – Value of “underwater” option with 30% volatility

OPTIONS XL Black-Scholes	
Input:	<u>Mod. B-S Euro</u>
Model	1
Type of Option	1
Function	1
Underlying Price	60
Exercise Price	65
Time to Expiration	365
Volatility	30.00%
Interest Rate	5.00%
Yield Rate	0.00%
Output:	
OptionsBS	6.3844

Figure 4 – Value of “underwater” option with 50% volatility

OPTIONS XL Black-Scholes

Input:	<u>Mod. B-S Euro</u>
Model	1
Type of Option	1
Function	1
Underlying Price	60
Exercise Price	65
Time to Expiration	365
Volatility	50.00%
Interest Rate	5.00%
Yield Rate	0.00%
Output:	
OptionsBS	11.1317

The reader can see that this ostensibly worthless option not only has value, but, if it's a more volatile stock, there could be almost a \$5.00 per share difference!

Real people often earmark options for exercise to pay for children's education or other large ticket items. Others have their own investment agendas. Thus we might find that in any given company there is an average holding period before exercise, often less than ten years when all employees are considered. When valuing specific options in a divorce matter, the practitioner should look at the exercise history of the spouse(s). Does he/she hold until the last minute or have a pattern of, say, exercising every few years? Are there any plans to earmark the funds for education expenditures?

Needless to say, today there are software programs available for purchase which calculate these values.⁷ It is important to remember, however, that the input of data requires a great degree of subjective judgment and is not as black and white as an Excel spreadsheet might imply.

Experts may have legitimate reasons to disagree on any one of the variables. Finally, Black-Scholes, while the best known and most frequently used formula, is not the last word and

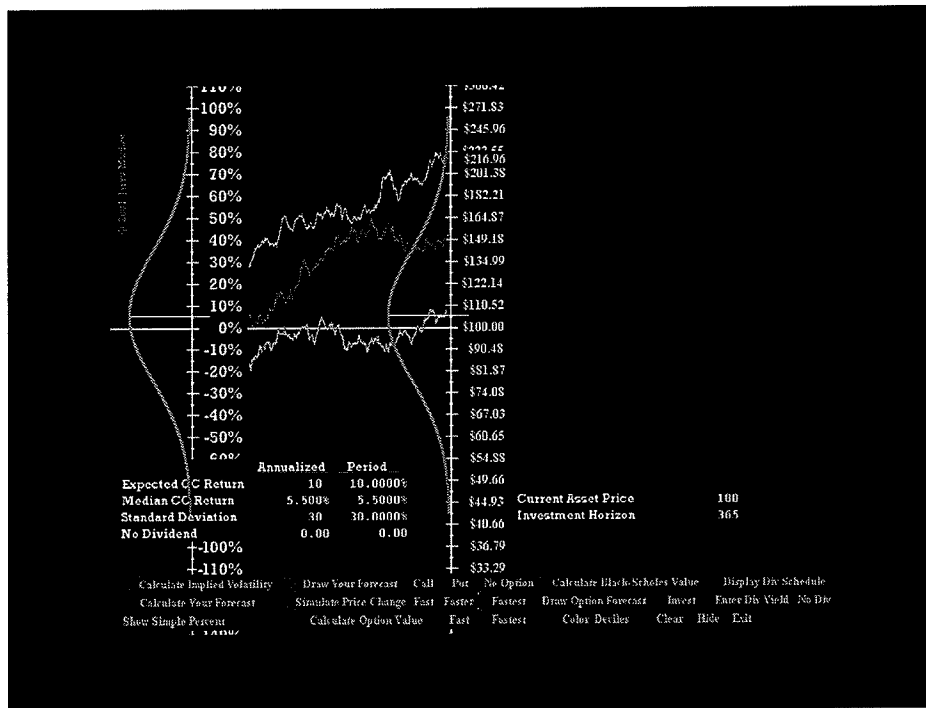
has many known shortcomings when used for employee options. Other models such as the Cox-Ross-Rubenstein binomial model and binomial lattice models⁸ have emerged to challenge Black-Scholes and have been gaining recognition and acceptance.

Where does this leave the practitioner? The risk of valuing options and calculating other asset offsets means that one spouse will more than likely benefit from an increase or decrease in value at actual exercise. Remember, the value calculated using mathematical formulas is based on a probability and rarely, if ever, does it predict value with great certainty. Indeed, it will be wrong 1/3 of the time, and below or above the predicted high 2/3 of the time.⁹ An angry husband or wife may come knocking on your door about the windfall the other person had, or the spouse now holding “underwater” options will lament about what was given up as an offset at settlement for now worthless.

Figure 5 below shows graphically the normal distribution of expected stock prices assuming 30% volatility, a one year horizon, and several other assumptions. Two-thirds of the time, with a one year horizon, the price of a \$100 stock today is predicted to be between \$55 and \$182.

The following graphic does not go far in assuaging the feelings of an angry ex-spouse:

Figure 5 - Stock Forecasts are Probability Curves:



Trial and expert testimony is much more complex than a typical business or real estate valuation controversy. Imagine examining a witness on the formulas presented above. Who amongst us is even qualified to be the expert or trial attorney dealing with such complex financial theory? How about the sitting judge with a busy calendar who is asked to make a call? Dueling experts are bad enough. Dueling Ph.D.'s in financial theory and statistics can make for a very bad day with little or no clarity added in the end.

Risk is allocated equally between the spouses if the options are placed in trust. Both parties rise or fall with the same tide. Language should be used which clearly reflects when the options are exercised. Is it a unilateral decision by the holder? Do both parties need to agree on exercise? How do you break a deadlock? Are they exercised at a specific date certain? Careful wording of the trust, as discussed below, will insure equity between the parties and perhaps keep

the peace between practitioners and clients when things don't turn out like the models say they should.

A final practice tip - soon to be ex-spouses need to understand, preferably in writing, from the attorney or expert, that placing options in a constructive trust is no guarantee of value. As we explained above, the litigants may indeed hit a home run, but can also very well strike out.¹⁰

Part 2

The Deferred Distribution Method is the most commonly implemented method for distributing options and restricted stock in divorce settlements. Moreover, this method was utilized in one of the earliest New Jersey cases dealing with stock options incident to divorce. See Callahan v. Callahan,¹¹ 142 N.J. Super. 325, 328 (Ch. Div. 1976). The Callahan court ruled that options acquired during a marriage were subject to equitable distribution even though (1) the options were potentially terminable; (2) the husband had to make an expenditure to exercise the options; and (3) the options were subject to various SEC regulations.¹² See id. at 327-29. In so holding, the court impressed a constructive trust on the husband, in favor of the wife, for a portion of the options. See id. at 329. The court reasoned that imposition of a constructive trust would result in the most equitable outcome to the parties without creating undue financial and business liabilities. See id. It should be noted that all of the options were granted during the course of the marriage. See id. at 327. Although not specifically stated, however, it appears that some or all of the options were not fully vested because they were subject to divestiture under certain circumstances. See id. at 330. This may be why the wife was awarded only 25% of the options at their maturation.

Many provisions must be considered when devising "trust" like language to be included in a MSA. Examples of some of these clauses follow. Other provisions may be needed depending upon the exact nature and content of the Stock Option or Restricted Stock Plan involved. What follows is sample language based on a particular fact pattern.

CALLAHAN TRUST CLAUSES

The parties acknowledge that the Husband has received various awards of stock options, restricted stock and portfolio grants through his employment with ABC Corp. The following is a summary of the outstanding stock options, restricted stock and portfolio grants awarded to Husband as of July 2001, which are subject to Equitable Distribution:

	Date of Grant	Type	Number of Options Awarded	Option Price	Vesting Date	Expiration Date
Vested Options						
1	2/24/97	NQSO	1,167	22.15	2/24/98	2/23/07
2	2/24/97	NQSO	1,167	22.15	2/24/99	2/23/07
3	2/24/97	NQSO	1,167	22.15	2/24/00	2/23/07
4	2/23/98	NQSO	2,534	29.30	2/23/99	2/22/08
5	2/23/98	NQSO	2,534	29.30	2/23/00	2/22/08
6	2/23/98	NQSO	2,534	29.30	2/23/01	2/22/08
7	2/22/99	NQSO	<u>4,000</u>	35.29	2/23/01	2/21/09
Total Vested Options			15,103			
Nonvested Options						
1	2/23/98	SRNQSO	9,900	29.30	2/23/02	2/22/08
2	2/23/98	SRNQSO	9,900	29.30	2/23/03	2/22/08
3	2/25/98	SRNQSO	9,900	29.30	2/23/04	2/22/08
4	2/23/99	NQSO	4,000	35.29	2/23/02	2/21/09
5	2/24/99	NQSO	4,000	35.29	2/23/03	2/21/09
6	2/28/00	NQSO	4,450	43.67	2/28/02	2/27/10
7	2/28/00	NQSO	4,450	43.67	2/28/03	2/27/10
8	2/28/00	NQSO	4,450	43.67	2/28/04	2/27/10
9	2/26/01	NQSO	4,667	44.47	2/26/03	2/26/11
10	2/26/01	NQSO	4,667	44.47	2/26/04	2/26/11
11	2/26/01	NQSO	<u>4,667</u>	44.47	2/26/05	2/26/11
Total Nonvested Options			<u>65,050</u>			
Total			<u><u>80,153</u></u>			

The above chart delineates each option grant based on the respective vesting dates. The above chart does not include the 13,825 stock options awarded to the Husband in February 2002. Since the awards received by the Husband in a certain year are for work performed both in the preceding years and work to be performed in all subsequent years up until the applicable vesting periods, the Complaint for Divorce in this matter was filed on May 23, 2001, it is hereby agreed that 17.5% of the 13,825 options awarded in January 2002 shall also be included in the group of unvested options to be distributed incident to this Agreement. This would add 2,419 stock options from the February 2002 award to the pool of unvested stock options which the Wife shall receive.

Husband also received restricted stock awards (RSA) as a result of his employment with ABC Corp. A summary of his outstanding RSA's as of July 10, 2001 (none were awarded in 2002) is as follows:

			Number of	
	Date of Grant	Type	Restricted Shares Awarded	Vesting Date
Restricted Shares				
1	2/28/00	RSA	2,000	2/28/04
2	2/28/00	RSA	2,000	2/28/05
3	2/28/00	RSA	2,000	2/28/06
Total Restricted Shares			6,000	

The RSA's held by Husband begin to vest in 2004 and are not fully vested until 2006. At the time of each vesting date, the then fair market value of the shares will be taxed to Husband as ordinary income. At that time, the Wife shall be entitled to receive 25% of the vested RSA's upon tendering to the Husband the total tax due on her share of the then vesting RSA's at the agreed upon rate of 44%. Thereafter, the Husband shall transfer title to the Wife's share of the RSA's within ten (10) days of his receipt of same.

Additionally, as part of his income, and as part an employment retention device, the Husband received Portfolio Grants.

A target incentive is awarded annually. The Husband represents that the value of the ultimate award increases or decreases based on the Husband's performance over a three or four year period. In addition, the ultimate payout is strictly conditioned upon ABC Corp.'s financial performance and total shareholder return as compared to the Standard and Poor's 500 Index over a three or four year performance period, depending on the year of grant. The target incentive listed below is the initial value of the award at the time of grant.

The payments have historically been made in cash and the ultimate award has been larger than the target incentive. Based on the payouts received by Husband including the 2002 grant that has been set and shall be paid in September, 2002, the average pay-out was 2.52 times the target incentive.

			Ratio of	Date of
			Amount	Payout
			Paid to	or
Grant	Target	Amount	Target	Expected
Date	Amount	Paid	Amount	Payout
05/24/1993	22,000	57,312	2.61	12/31/1995
02/28/1994	25,000	59,421	2.38	12/31/1996
02/27/1995	35,000	89,694	2.56	12/31/1997
02/26/1996	30,000	81,995	2.73	03/15/1999
02/24/1997	35,000	100,320	2.87	03/31/2000
02/23/1998	30,000	78,900	2.63	03/15/2001
02/22/1999	30,000	Not Yet Vested		09/30/2002
02/22/1999	30,000	Not Yet Vested		09/30/2003
02/28/2000	33,660	Not Yet Vested		09/30/2004
02/26/2001	35,500	Not Yet Vested		09/30/2005

The vesting period of the portfolio grant had historically been three years. The PG's awarded in 1999 will pay \$55,000. Beginning in 1999, the vesting period was increased to four years and a supplemental award was received in 1999 to compensate for the additional vesting year. This will effectively provide a bonus to Husband in 2003.

The above chart does not include a Portfolio Grant received by the Husband in February 2002 with a target value of \$30,786. Since the awards received by the Husband in a certain year are for work performed in the preceding year together with performance over the subsequent year vesting period and the Complaint for Divorce in this matter was filed on May 23, 2001, it is hereby agreed that 17.5% of the ultimate pay-out of the Portfolio Grant awarded in February 2002 shall also be included in the group of Portfolio Grants to be distributed incident to this Agreement. For example, the Wife's share of the PG to be paid in September 2002 (i.e., \$55,000) shall be paid as follows: \$55,000 times Wife's share (25%) equals \$13,750. This figure shall then be reduced by the agreed upon marginal tax rate of 44% (\$6,050), resulting in a net payment to the Wife of \$7,700.

All of the aforementioned stock options, restricted stock and portfolio grants awarded to Husband as stated above shall be distributed in accordance with the "Callahan Trust" provisions that follow. The Parties acknowledge that neither party shall have rights with respect to the grants of stock options and restricted stock and portfolio grants that were paid out or inured to the benefit of either party subsequent to the date of the filing of the complaint for divorce as referred to above.

The parties agree that the Wife is hereby granted an equitable and constructive interest in the aforementioned stock options, restricted stock and portfolio grants granted to Husband by ABC Corp., as noted above. As part of this Agreement, subject to the ABC Corp. policy procedures and restrictions in place, Wife is entitled to fifty percent (50%) of the vested stock options. Further, the Wife is entitled to 25% of the unvested Stock Options, Restricted Stock ("RSA's") and Portfolio Grants awarded prior to the Complaint for Divorce. For the stock options and Portfolio Grant awarded in 2002, the Wife is entitled to 17.5%. As to the stock options, the Wife is entitled to direct Husband to exercise on her behalf a total of fifty percent (50%) of the vested stock options, and twenty-five percent (25%) of the unvested stock options (except for those awarded in 2002, in which the Wife's share is 17.5%), culminating in a total of 7,552 vested options and 18,681 unvested options from the total of 93,978 stock options and 1,500 RSA's which represents 25% of the 6,000 RSA's, as set forth above and subject to policies, procedures and limitations of ABC Corp. which are in full force and effect at the time of the request of the exercise by either party. These options, PG's and RSA's vest across various dates, as noted in the above chart. Husband shall hold the options, PG's and RSA's allocated for Wife as a fiduciary and in constructive trust for her, subject to the following provisions as well as the policies, procedures and limitations of ABC Corp. governing the stock option plan. As to the restricted stock and portfolio grants, the Wife shall receive her share of these benefits immediately upon Husband's receipt of his share subject to deduction of 44% for applicable Federal, State and local taxes.

For example, Husband shall hold in constructive trust 3,801 of the 7,602 options awarded on February 23, 1998, through and including their vesting date of February 23, 2001, until their expiration date of February 22, 2008. The Husband shall act as a fiduciary to the Wife with respect to these options and shall not act in any manner contrary to his duties therein. However, voluntary or involuntary termination of employment for any reason shall not be construed as a breach of his fiduciary obligations pursuant to the terms of this paragraph.

Husband shall hold in constructive trust for the Wife the following portions of the options, both vested and non-vested, until she so directs him to exercise these options. The Wife has sole and complete control over the exercise of the stock options allotted to her (as limited by the provisions of the stock option plan, and/or ABC Corp. policies, practices and procedures in effect at that time.

Date of Grant	Type	Number of Options Awarded	Percentage Allotted to Wife	Portion set aside for Wife
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<u>Vested Options</u>				
2/24/97	NQSO	1,167	50%	584
2/24/97	NQSO	1,167	50%	584
2/24/97	NQSO	1,167	50%	584
2/23/98	NQSO	2,534	50%	1,267
2/23/98	NQSO	2,534	50%	1,267
2/23/98	NQSO	2,534	50%	1,267
2/22/99	NQSO	4,000	50%	2,000
<u>Non-vested Options</u>				
2/23/98	SRNQSO	9,900	25%	2,475
2/23/98	SRNQSO	9,900	25%	2,475
2/25/98	SRNQSO	9,900	25%	2,475
2/23/99	NQSO	4,000	25%	1,000
2/24/99	NQSO	4,000	25%	1,000
2/28/00	NQSO	4,450	25%	1,112
2/28/00	NQSO	4,450	25%	1,113
2/28/00	NQSO	4,450	25%	1,112
2/26/01	NQSO	4,667	25%	1,167
2/26/01	NQSO	4,667	25%	1,166
2/26/01	NQSO	4,667	25%	1,167
2/26/02	NQSO	13,825	17.5%	2,419

The following provisions shall govern the exercise of the Wife's share of those options:

- i. Notice and Instructions: When the Wife wishes the Husband to exercise the stock options allocated to her herein, or any portion thereof, she shall send written instructions to the Husband at his then current E-Mail work address. The current E-Mail work address: higgins@xxx.com. In order to carry out the terms of this agreement, Husband agrees to keep Wife informed of any changes in his email address by notification in writing to Wife at her email address at doris.poppins@xxxxx.com with such a change. The written instructions from Wife to Husband shall include the exact number of stock options that she wishes Husband to exercise on her behalf and shall designate the particular grant (i.e., "flight") from which the shares are to be exercised. The parties may agree to alternative notice provisions if one or both emails become unavailable.
- ii. Taxes: The parties understand that the income tax withholding in conjunction with the exercise of stock options or receipt of RSA's or

Portfolio Grants for Wife will be reported on Husband's earnings statement at the end of each year. (Caveat: If, however, any of the stock options, RSA's or Portfolio Grants, in which the Wife shares, can be taxed at her tax rates, pursuant to present or future tax laws (e.g. Rev. Rule 2002-22), then her tax liability shall be limited to the amount computed on her own individual tax returns.) If, however, the Wife's share of the income associated with the Stock Options, RSA's and Portfolio Grants cannot be transferred to the Wife, the parties agree that the Wife is obligated for her share of the taxes owed on the "taxable amount" resulting therefrom. This shall be effectuated by the Husband, at the time of exercise or receipt of benefits due to the Wife, deducting 44% as the Wife's complete and full tax liability for the taxes related to the options exercised, or RSA's/Portfolio Grants received. The Husband shall be fully responsible for all other taxes owed with regard to said assets and indemnify the Wife fully for same. To the extent possible, the taxes attributable to any option exercise on Wife's behalf shall be deducted from the proceeds distributed to her from a same-day sale.

iii. Same-Day Sales Rights (Cashless Exercises): Husband shall make available to Wife any cashless or other exercise rights that are available to him for the exercise of stock options. The Wife shall be liable and responsible for any and all actual costs associated with the exercise of such rights as mandated by the Husband's employer, including but not limited to administration fees, documentation fees, and service fees.

iv. Exercise of Options and Sale of Stock: In the event Wife instructs Husband to exercise the options and sell the stock allocated for her (i.e., via a same-day sale, cashless exercise or otherwise), the Husband agrees to instruct the stock brokerage firm to remit the net proceeds of the sale of the stock on Wife's behalf, by a wire transfer to an account as directed by her. The Wife shall be responsible to provide any and all current account data including ABA and routing information at the time of each exercise request to insure the accuracy of such transfers. The "net proceeds of the sale" of stock options are defined as the proceeds available after deduction of the state and federal taxes at the agreed upon marginal rate of 44%.¹³ When possible, Husband will enable Wife to take advantage of all cashless transaction rights for the exercise of options. Thus, Wife shall have the right to exercise options less the net value of the strike price without putting forward cash for the exercise of the options, to the extent this right is granted to the Husband through ABC Corp. However, the Wife shall pay all applicable fees and out-of-pocket costs incurred by the Husband in connection with the exercise of such right.

- v. Limitations on Amount of Options Exercised: The Wife acknowledges that the exercise of stock options by the Husband, for his benefit as well as hers, is now subject to certain ABC Corp. policies that requires senior executive approval of such exercise, if said exercise exceeds 40% of all vested stock options. At this time, the senior executive in his or her sole discretion may expressly withhold approval for a period of 90 days subsequent to a scheduled meeting to review the exercise. For this reason, the Wife expressly agrees not to exercise more than 20% of the total vested options (calculated as all of the vested stock options in which the Husband has an interest as of the date of her request to exercise). However, should the Husband be granted the right to exercise more than 40% of all vested stock options, the Wife shall have the right to exercise 50% of the amount in excess of 40% of all vested stock options to which permission was granted.
- vi. Exercise of Options and Distribution of Stock to Wife in Kind: In the event Wife wishes Husband to exercise the stock options allocated for her and receive the stock in kind, the Wife shall deliver to Husband all funds necessary for the exercise of the specified stock options prior to the exercise, including the agreed upon 44% federal and state income taxes attributable to the exercise,¹⁴ if any, at the time of exercise of the specified stock options applied by the taxable amount together with any and all applicable fees and out-of-pocket expenses, required to be paid to the Husband's employer as a result of said exercise. This delivery shall be made in the form of a wire transfer to an account as outlined in accordance with the aforementioned procedures. In the event that the company will not authorize the issuance of stock in the name of the Wife, then the Husband shall cause the stock to be issued in his name, as the trustee and the fiduciary for the benefit of the Wife and shall immediately thereafter transfer the stock into the Wife's name. Any stock transfer or related cost associated with the exercise of the options for the wife's benefit or the transfer of the stock into the name of the Wife, shall be borne solely by the Wife.
- vii. Damages for Untimely Exercise of Options: The Husband shall be liable for any intentional delays in the exercise of options requested by Wife pursuant to the procedures set forth herein and subject to ABC Corp. processes and procedures.
- viii. Exercise of Husband's Options: In the event that Husband desires to exercise his share of the ABC Corp. stock options, he will provide written notice to the Wife at the aforementioned email or residential mailing addresses at least 24 hours prior to the exercise of the options.

ix. Termination of Husband's Employment (Claw-back Provisions):

The parties expressly acknowledge the existence of portions of the ABC Corp. policies and procedures, which are called "Claw-back" provisions. These Claw-back provisions may require a disgorgement of the total gain realized on the exercise of stock options within a certain stipulated period of time before an employee's termination. It is acknowledged that these terms may change from time to time. The Husband shall provide Wife with a copy of the current applicable "Claw-back" provisions and any changes to such "Claw-back" provisions. Therefore, it is the parties' intention as to the distribution of the specific stock options, restricted stock and portfolio grants listed above, that they each be bound by the actual claw-back provisions that may be in effect at the time of the triggering event (i.e., the Husband's termination of employment with ABC Corp.¹⁵). Further, it is the intention of the parties that should the husband involuntarily or voluntarily terminate his employment with ABC Corp., that the claw-back provisions shall equally apply to the Wife should said company make a final, internally non-appealable decision to require the return of gain received (i.e., profits on the exercise of stock options), exercised within the "claw-back period" and the Husband actually returns his total gains. In that event, the Wife shall be obligated to do the same within 15 days of the Husband's return of the total gain.¹⁶ She shall return promptly her total gains to the Husband so that such total gains may be returned to the company. The amount to be returned shall be calculated in accordance with the policies and procedures of ABC Corp. in place at that time. (Example: Presently, the funds to be returned are the gross profit (i.e., fair market value of stock on date of exercise less strike price, exercise fees and other allowable fees), not the net amount received from the exercised stock options.) The Husband shall return these total gains to ABC Corp. in accordance with ABC Corp.'s stated policies, procedures and limitations in effect at that time. The Husband shall be obligated to provide the Wife with any documentation that he receives from ABC Corp. with respect to compliance with this policy. To the extent that the Husband loses any stock options, portfolio grants or restricted shares or rights for stock options, portfolio grants or restricted shares due to a change in employment, but receives stock options, portfolio grants, restricted shares or other form of compensation directly or indirectly attributable to the loss of such stock options, portfolio grants or restricted shares, the Wife shall be fully compensated for her lost rights and shall share in said recompensed stock options, portfolio grants or restricted shares or other form of compensation in the same proportions as with the original ABC Corp. stock options, portfolio grants or restricted shares subject to forfeiture due to the Husband's termination of employment. Housing allowances and moving expenses shall not be construed as compensation for lost stock options.

- x. **Notice of Termination of Employment:** In the event Husband's employment at ABC Corp. is terminated, Husband shall notify Wife within 24 hours of said termination of employment, by telephone and/or email, followed by immediate written notice (within 48 hours of termination), mailed to Wife's residential mailing address.
- xi. **Failure to Comply with Notice Provisions:** In the event Wife loses the right to have Husband exercise any stock options on her behalf as a result of Husband's intentional failure to comply with the notice provisions herein, the Court shall have reserved jurisdiction to determine the amount of the monetary loss, if any, resulting to Wife as a consequence of said failure and shall order reimbursement to her by Husband of that monetary loss, plus counsel fees and associated costs.
- xii. **Re-Pricing:** In the event ABC Corp. declares a re-pricing of the exercise price of the stock options, or makes any other adjustments to the options allocated to Wife in this agreement, Husband shall notify Wife of the adjustments or re-pricing within 15 days of his knowledge of such event by telephone and/or email. Husband shall not exercise any right to re-price any of the stock options allocated for Wife unless and until Wife has given Husband written instructions to do so. As soon as ABC Corp. notifies Husband of the opportunity to re-price such stock options, Husband shall notify Wife of the opportunity and provide her with copies of all documents from ABC Corp. pertaining thereto.
- xiii. **Reload Options:** To the extent that the Husband is granted or has any reload rights in the existing options listed in paragraph 45 above, the Wife shall also share in those rights up to her proportionate share allocated to her herein. However, provided that the Wife has and presents to the Husband ABC Corp. stock in the amount required for reload at the time of the requested stock option exercise, it is expressly agreed and understood that the Wife shall have no reload options granted for any post complaint period.
- xiv. **Reservation of Jurisdiction:** The Court shall have reserve jurisdiction to enforce the terms of this section subject to the then existing stock option plan terms and conditions regarding the exercise of said options and all applicable retention agreements of ABC Corp. in place at the time of the exercise. The Court shall also be able to make any further Orders as necessary to carry out the intent of the parties with respect to this section in the event of changes in the stock option plan for loss of options due to the voluntary termination of employment with ABC, Corp. or any other unforeseeable event that the parties have not contemplated as part of this Agreement, relating to

the designation of the parties' option rights subject to distribution under this Agreement.

- xv. **Death:** In the event of the death of the Husband, all rights of the Wife shall be preserved subject to the rules, policies, and procedures with respect to said options. The Husband's estate is hereby bound to honor the obligations imposed upon the Husband pursuant to this Agreement. The Estate shall, at the direction of the Wife, exercise the Options prior to any accelerated expiration, if any, resulting from the Husband's death.

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¹ Options on the shares of privately held securities are beyond the scope of this article. In such a case the underlying value of the privately held company must first be determined; comparable public stocks must be found as a proxy to determine volatility.

² What is Volatility? *FAS 123*: "...annualized standard deviation of the differences in the natural logarithms of the possible future stock prices." Simply put, it is a statement of the probability of where a stock price will be 2/3's of the time.

³ "In 1970, Myron S. Scholes found the formula for success. Nearly three decades later, it earned him the 1997 Nobel Memorial Prize in Economic Science. Along the way, it changed the way investors and others place a value on risk, giving rise to the field of risk management, the increased marketing of derivatives, and widespread changes in the valuation of corporate liabilities. Scholes, the Frank E. Buck Professor of Finance, Emeritus, at the Business School, shares the Nobel prize with Robert C. Merton of Harvard Business School. The prize was awarded by the Royal Swedish Academy of Sciences for "a new method to determine the value of derivatives" developed by the two, along with the late Fischer Black. Black and Scholes first published the formula as "The Pricing of Options and Corporate Liabilities" in the *Journal of Political Economy* in May 1973. The formula was further developed by Merton, who showed its broad applicability."

http://www.gsb.stanford.edu/community/bmag/sbsm1297/faculty_news.html

⁴ European options can be exercised at only date of expiry. The original B-S formula did not contemplate American options with a ten year life, able to be exercised at any point in time until expiry. Additionally it doesn't contemplate publicly held options which generally have a life of nine months.

⁵ From "The Complete Guide to Option Pricing Formulas" by Espen G. Haug.

⁶ An option with an exercise price above the market price of the stock.

⁷ We used *FinTools Software*®, Montgomery Investment Technology, Inc. for this article.

⁸ Binomial lattice models consider employee exercise behavior, employee demographics, blackout periods, and other factors not considered in B-S. According to Robert Dysan in an article in *The CPA Journal* (Sept. 2005), "no acceptable lattice computer model is available as of this writing." because of the computing power required to compute more accurate price predictions. Thus while in theory a more accurate result can be obtained, at this time it is not practical.

⁹ Standard distribution is a measure of how far the observations in a sample deviate from the mean. In a normal distribution of stock prices, prices will fall within one standard deviation approximately 2/3 of the time. Standard distribution is a measure of how far the observations in a sample deviate from the mean.

¹⁰ The following is a brief bibliography for those inclined to pursue this subject in greater depth:

- *Black-Scholes and Beyond*, Neil Chriss, PhD.
- *Option Pricing, Black-Scholes Made Easy*, Jerry Marlow

■ FAS 123(R) www.fasb.org/pdf/fas123r.pdf

■ FinTools Software®, Montgomery Investment Technology, Inc.

The Complete Guide to Option Pricing Formulas, Espen G. Haug

¹¹ In New Jersey, these constructive trusts have been known as Callahan trusts, after the name of the case.

¹² Certain SEC regulations required the employee option holder to forfeit "any profits [. . .] from the sale of stock within a specified period from the date of purchase." Id.

¹³ If the income becomes taxable to Wife on her individual tax returns pursuant to Paragraph XX (ii) and the Husband has no liability for her share of the asset, then the Husband shall remit the gross pre-tax amount of Wife's share without deduction for taxes.

¹⁴ See prior footnote.

¹⁵ If the Husband knows or intends that he is going to voluntarily terminate his employment with ABC Corp., or commences interviews with prospective employers, he shall advise the Wife in writing as soon as possible so that the Wife may be guided accordingly in terms of exercising her rights as to the stock options in a timely manner to avoid, to the extent possible, the effects of the claw back provisions. The Wife shall keep such disclosure confidential.

¹⁶ However, should the Husband receive from ABC Corp. some other money, stock, option, portfolio grant, restricted shares, compensation, benefit or other consideration which is attributed strictly to the return of the total gain, then the Wife shall share in said money, stock, option, portfolio grant, restricted shares, compensation, benefit or other consideration to the extent that she was entitled to share in the stock options, restricted stock and portfolio grants.