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The Treatment of Stock Options Under Part 5 of the *Family Relations Act*

I. Introduction

In the past decade, the stock markets have accounted for vast increases in the net worth of many individuals. As a result, the nature and value of various types of securities have increasingly become the subject of family law litigation. Profits earned in the stock market are relevant both to a division of assets and a determination of income for the purposes of the Child Support Guidelines and the payment of spousal support. This paper will deal exclusively with the characterization of stock options as family assets under Part 5 of the *Family Relations Act*.

The stock options which are generally in issue in *Family Relations Act* cases are contracts between a spouse and a company of whom the spouse is an employee and/or a director or officer. They take the form of a contract which entitles the spouse to purchase a limited number of shares of the company at a fixed price. The contract is valid for a fixed period of time which can be several years. The price at which the stock can be purchased by the employee under the option (the exercise price) is set at the market value prevailing at the time the option is granted. Generally, stock options are provided as an incentive to the employee, director or officer to enhance the performance of the company. They are usually granted as a form of compensation and as part of a compensation package.

If, during the term of the option, the market value of the stock exceeds the exercise price, the spouse may exercise the option by purchasing the stock at the exercise price and then selling it at the higher market value. This assumes that the market has sufficient liquidity to allow these transactions to occur. The “profit” may be taxable in the hands of the spouse as either capital gains or employment income, depending upon a number of *Income Tax Act* considerations which will not be canvassed in this paper. Nor will this paper address stock options which are purchased on the open market without any connection to employment benefits.

The main issue which arises in *Family Relations Act* litigation with respect to stock options is whether or not stock options held by a spouse are family assets and subject to division.

II Legal issues relating to the division of stock options

A. Are they assets or income?

Options do not become income until such time as they are exercised. Until then, they are only potential income. By their nature, they are somewhat similar to a deferred profit sharing plan ("DPP"). Both of these vehicles hold the promise of additional compensation based on future corporate performance, although they are designed to operate over different periods of time and be realized at different times. In *Norton v. Norton (1989), 19 R.F.L. (3d) 181 (B.C.C.A.)*, the Court of Appeal held that a DPP may come under the definition of a "pension" under s. 58(3d) of the *Family Relations Act.*

B. Are they "ventures" under s. 58(3)(e)?

A "venture" has been described as "...any investment in which there is an element of risk, and which has the potential for profit, even though its primary function may be to serve some other purpose...": *Joki-Hollanti v. Joki-Hollanti, [1990] B.C.W.L.D. 862 (S.C.)*.

Stock options bought on the market for cash (or on margin) clearly carry risk, namely that the funds invested may be lost. Employment options do not generally require any direct financial investment by the employee or director. This does not mean that the holder of the options has not taken on any risk. Since they are usually included as part of a compensation package, it can be said that the option holder is taking the risk of accepting part of his or her compensation not in cash, but in the more speculative form of a stock option. In accepting this term of the compensation package, he or she runs the risk of realizing nothing on part of his or her compensation package.

S. 58(3)(e) also requires the claiming spouse to have contributed money or money=s worth, directly on indirectly, to the venture in order to establish that it is a family asset. Given the liberal interpretation accorded those terms, this is unlikely to be an impediment in cases involving marriages of any length. Stock options have received very little consideration under this section (See *Roberts* infra).

III. The Authorities

There are very few cases dealing specifically with the characterization and division of true stock options.

The earlier cases involving options provide little or no analysis of the nature of these particular assets and their characterization. The focus of the analysis was on whether or not the options in question were "ordinarily used for a family purpose": *Ripley v. Ripley* (June 29, 1988), Vancouver Registry, D62279 (B.C.S.C.); *Roberts v. Roberts* [1989] 20 R.F.L. (3d) 141;

In *Ripley,* the Husband exercised stock options after the date of separation. The judgment does not indicate if the options were granted before or after the separation. Relying in part on *Schmidt-Ramelow* (which held that a deferred profit sharing plan was not a "pension" and hence not a family asset), the Court in *Ripley* concluded that, in the absence of evidence of the intended use of the proceeds of "...this particular option.." for a family purpose, or the use of family assets in the exercise of the stock options, the proceeds of that stock option were not family assets. *Schmidt-Ramelow* was subsequently considered and overruled by the Court of Appeal in *Norton.* Although it is unclear from the facts, it may be that the option in *Ripley* was acquired after the separation and this was viewed as eliminating any suggestion of use, or intended use, for a family purpose.

In *Roberts*, the Court rejected the notion that money accumulated from the wife=s employment stock options were the proceeds of a "venture" pursuant to what is now section 58(3)(e) of the *Family Relations Act* because the holder of the options was a "salaried employee" and not "..engaged in a venture...". There is very little discussion of this topic in the judgment and it appears that the asset in question was not of significant value.

In *M.R. v. S.R.R.* (May 28, 1998), Vancouver Registry, D100220 (B.C.S.C.), the wife regularly exercised her options after the separation and spent the proceeds on vacations with the children. The judgment does not indicate whether the options in question were granted before or after the separation. Since the parties had been separated for over four years at the date of trial, it may be that the options in question were granted after the separation. The Court found that there was "...no evidence that she..invested in (the) plan for the purpose of savings for the family but rather for her own future security.". That would certainly be the case if the "investment" (there is no indication what form the investment took) was made after the separation.

With the exception of *M.R.*, the recent authorities have taken a broader approach to the characterization of options as family assets. This is in keeping with the generally expanding approach taken by the Courts in characterizing assets owned by the parties at the conclusion of a marriage as being family assets, even in the absence of evidence of actual ordinary use. Such findings are usually based on intended use or preservation of assets for future security or current family purposes: *Hefti*. Such findings can be made by inference based on the circumstances of the family and its financial arrangements: *Ogilvie v. Ogilvie (1995), 14 BCLR (3rd) 296 (C.A.).*

In *Swann v. Swann*, October 25, 1993, Vancouver Registry, D080753 (B.C.S.C.), the options were treated as "financial benefits" acquired by the husband as a result of a very lengthy period of employment with the same employer, much of which period occurred prior to the separation. Some of those options may have been granted after the date of separation. Nevertheless, the Court held, on the foregoing analysis, that all of these options were family assets.

In *Hartwick v. Hartwick*, June 1, 1993, Vancouver Registry, D084646 (B.C.S.C.), the Court held that options which had been granted prior to the date of the triggering event (though never exercised before then) were family assets. Rather than making a finding as to ordinary use or intended use, the Court held that the options were family assets "...in that the right to obtain them had been designated prior to the separation and substantially earned prior to that and the date of the triggering event". However, the end result was determined not by the characterization of the asset but by its value. The Court determined that, since the options were not "in the money" as of the trial date, they had no value and the spouse who held the options was entitled to retain them without compensation. The Court considered and rejected the suggestion that the options be held in trust until such time as they might be exercised in future. No reason was given for rejecting this alternative except that it was not "appropriate in the circumstances".

It is respectfully submitted that the valuation of options at the date of trial (or other arbitrary date) can lead to great unfairness because of the speculative nature of this type of asset.

The trust option was considered and adopted in *Kennedy v. Stoughton*, (August 14, 1996), Vancouver Registry, D097211 (B.C.S.C.). In that case, the husband held stock options in a publicly traded mining company of which he was president and a shareholder. Such options had been issued to him regularly over the years and had either been exercised or lapsed. In his reasons, Holmes, J. considered the nature and

purpose of options and whether their acquisition before or after the triggering event could determine their characterization:

> Stock options are a method of rewarding and compensating persons important to a company. They may be viewed as a form of compensation, or employment benefit, given to encourage and reward persons for loyal and valuable service to the company. Stock options that existed during the course of the marriage are family assets being a financial benefit accruing to the petitioner that was available for a family purpose. In that context options issued after the triggering event and arising afresh and unconnected to a previously rescinded and reissued option are likely to be treated as an incidental source of employment income to the petitioner.

Notwithstanding the foregoing analysis, options granted to the husband after the triggering event were declared family assets because they were issued by the company specifically as replacement options for options granted to him prior to the triggering event.

The next issue in *Kennedy* was the valuation and appropriate method of division of the options. Holmes, J. considered the issues and concluded as follows:

> The future value of an option often defies practical valuation. The option's value fluctuates with the value of the base stock. The exercise of the option attracts capital gains tax at personal tax rates. The option purchase price must be paid in full which likely would require some form of interim financing to accomplish.
>
> There may also be valid commercial and corporate reasons that officers of a company, such as the petitioner, might chose not to exercise an option at particular times. An unexpired option may be rescinded, or expire, and be without value.
>
> In my view, the respondent's entitlement to a portion of the stock option will require she compensate the petitioner as to adverse tax consequences for him caused by the exercise of any option by her instruction.

Holmes, J. went on to pronounce specific terms to address the foregoing interests and concerns:

> The respondent is entitled to a declaration that the petitioner holds in trust for her benefit one-half of each category of his existing share option for X-Cal shares. The respondent must give 48 hours written notice to the petitioner instructing any exercise of the option. That notice must be accompanied by a certified cheque for the full exercise price and an amount representing a reasonable estimate of the increased personal tax impact the transaction will have upon the petitioner. Any difference between the reasonable pre-estimate and actual tax impact will be determined upon filing of the petitioner's income tax for the year in question and either a refund made to the respondent, or if the difference is in favor of the petitioner be paid to him by the respondent, within seven days of notice of deficiency.

In *Berikoff v. Berikoff*, the options were apparently purchased by the husband through payroll deductions. The Court had little difficulty concluding that they were family assets, but did not indicate which section of the Act applied:

> The particular stock option in issue was bought through payroll deductions. If those deductions had not been made, the money would have been available in Mr. Berikoff's account for family use.

IV Conclusion

The characterization and division of employment stock options has not received enough thorough judicial consideration to establish any clear principles. They present a unique challenge because of their hybrid asset/income character and because they are difficult, and sometimes impossible, to value before they are exercised. It is likely that these issues will be increasingly litigated as the opportunities for enormous profit through employment stock option programs continue to be available and sought.