Discovering Employee Benefits

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Moving "fringe" into the frying pan of marital property

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More than ever before, employers are providing their employees with benefits in addition to cash compensation. Less than ten years ago, unique forms of employee benefits were reserved for only the top people in very large companies. The latest craze is the granting of potentially very lucrative stock options in many new dot.com companies. Most of these stock options benefit all levels of employees. Given this trend, it is more important than ever for a family law practitioner to become familiar with the various employee benefits, the methods for discovering the nature and extent of these benefits, and the issues commonly raised in a divorce case with respect to such benefits.

Stock options

The most prevalent forms of employee benefits, other than pensions and profit-sharing plans, are vehicles that provide an employee with outright or conditional stock ownership of the employer company. The most common types of these programs are stock options, employee stock ownership plans (ESOPs), and restricted stock. Further information about ESOPs, stock options, and other forms of employee ownership, such as restricted stock, can be found on the Web at www.nceo.org., the Web site for the National Center of Employee Ownership (NCEO), a private not-for-profit membership and research organization that serves as the leading authority on these benefits.

Defining terms. A stock option is the right to purchase shares of stock in the employer company at a specified price (the exercise or strike price) at a certain future point. Although the strike price usually is set at the market value at the time of the grant, it is anticipated that the stock will be worth substantially more at the time the option becomes exercisable. Typically, employers grant a certain number of stock options that are not exercisable until certain conditions occur (i.e., additional years of continued employment). These are commonly referred to as unvested stock options. Once the option becomes exercisable, it is a vested stock option. It is important to immediately identify the grant date for each stock option, any conditions that must be met for vesting, the exercise price, and any provision for expiration. It is also important to identify whether the option is classified as qualified (a.k.a. incentive stock option) or nonqualified (a.k.a. non-statutory) because tax implications differ.

Stock options as marital or nonmarital property. Generally, vested stock options granted during marriage are treated as marital property. If an option has been granted prior to the parties' marriage but the right to exercise it does not vest until after the marriage or options granted during the marriage will not be vested until after the dissolution of marriage, difficulties arise in determining the existence of marital property and its

extent. Each jurisdiction has developed its own law for determining whether unvested stock options are property and to what extent there is a marital interest.

Courts generally classify unvested stock options in three ways. First, an unvested stock option is treated as a mere expectancy because the holder has no enforceable rights; the unvested stock options are not property and not subject to division by the divorce court. With this classification, however, some courts have devised a way to compensate nonemployee spouses by taking a reserved jurisdiction approach by which the court treats unvested options as a contingent property right and, as such, reserves jurisdiction over the question of dividing the options "if, as, and when" they become vested and are exercised. The court can then divide the stock or cash between the parties at a then-determined value or on a percentage basis.

The second approach treats the unvested stock option entirely as marital property as long as it was granted during the marriage, even if it is conditioned upon postdivorce continued service. The rationale is that the property right under the contract accrued during the marriage at the time of the initial grant.

The third approach treats unvested stock options as part marital and part nonmarital property. The theory recognizes that even if the option grant came before marriage, since it is only exercisable after service during marriage or a grant during marriage that will not vest until after dissolution of marriage, there are characteristics of both marital and nonmarital property. Typically employers grant employees stock options based on past, present, or future years of service. These are variables a practitioner must discover during the pendency of a divorce case to effectively analyze the character of the options.

Stock options as property or income. Another issue is whether the court should treat the options as property or income. The court's decision depends on the jurisdiction's treatment of stock options and whether the proceeding is pre- or postdivorce. Most jurisdictions treat the options as property; however, stock options are part of an employee's compensation package and when exercised are treated by the Internal Revenue Service as income. Therefore, it is not unreasonable to ask the court to treat options as income, especially in postjudgment litigation for modification of support when property division is not an issue.

Valuation and division. Employee stock options typically are not assignable, so an immediate in-kind division is not possible. Consequently, courts have developed alternate mechanisms to divide these assets. Valuing and providing a buyout of stock options is a common method when the options are vested and one can easily value the stock. When options are not yet vested and the stock's value is not easily determined at the time of dissolution, a formula for division with reserved jurisdiction is the most equitable means to division.

The first approach ascribes a current value for the options, then allocates the options to the employee spouse. The nonemployee spouse receives other assets from the estate as a setoff for his or her share. This completely disentangles the parties financially upon dissolution of marriage. Various other methods may be used to value stock options, but they are beyond the scope of this article.

In its most basic form, valuation works as follows. An employee's vested stock option of a publicly traded company is valued at fair market value of the shares at the time of dissolution less the option's exercise price. Experts also use economic models to value stock options, such as the Black-Scholes method. Valuing stock options is complex and must be carefully considered. Private companies with stock option plans routinely do annual valuations of their stock, which are applied in ascribing a value to options.

Tax implications. When determining the current value or future distribution strategy of an employee stock option, consider the tax treatment of the options. With qualified incentive stock options, no income tax is triggered until after the option is exercised and the stock acquired is sold. The difference between the cost of the option and the ultimate sales price is taxed at the capital gains rates. Nonqualified stock options that have no readily ascertainable fair market value when granted are taxed when exercised at ordinary income tax rates. The employee then recognizes as ordinary income the value of the stock purchased minus what was paid for the stock and option.

When the stock received through the exercise of a nonqualified stock option is sold, the difference between the exercise price and the selling price is taxed at capital gains rates. Sometimes nonqualified stock options are taxed to the employee at grant, but only if they are vested and have readily ascertainable fair market values at the time. It is important for a divorce practitioner to identify the point in time at which the option is taxed, as it will clearly affect the option's value. It is also wise to consult an accountant when analyzing the taxability of qualified as well as nonqualified stock options.

Defining an ESOP. A qualified retirement plan commonly known as an employee stock ownership plan (ESOP) is used to provide stock ownership to employees. An ESOP is a type of qualified retirement plan governed by the Employee Retirement Income Security Act of 1974 and is similar to a profit-sharing plan. ESOPs relate only to corporations. An ESOP borrows on the credit of the company for purposes of investing in company securities. Alternatively, a company sets up a

trust fund into which it contributes new shares of its own stock or cash to buy existing shares. As plan contributions are made to repay the loan, a number of shares are released and allocated to the individual accounts of the employee plan participants. Generally, participants receive their account balances in cash or company stock when they terminate employment.

A plan provides retirement benefits for employees in the form of company stock and/or cash in exchange for the stock. Regardless of how the plan acquires stock, the shares in the trust are allocated to individual employee accounts. Many ESOPs have vesting schedules that require an employee to stay with the company for a period of years before realizing 100 percent of their account interest value. As with stock options, similar issues arise regarding property classification of ESOP interests as marital or nonmarital.

Valuation, division, and tax implications. ESOPs are qualified retirement plans and, thus, are subject to qualified domestic relations orders (QDROs) when dividing the benefits incident to a divorce. This allows for a direct assignment of the employee's benefits to the nonemployee spouse. With publicly traded corporations, an employee's vested ownership interest in an ESOP is readily valued, based on the fair market value of the company stock and is treated as a defined contribution profit-sharing plan. With respect to privately held companies, valuing an employee's interest in an ESOP becomes much more difficult. When employees leave the company, they receive their stock, which the company must buy back at fair market value. As there is no public market for the shares, private companies have regular outside valuations done to help price the stock. These valuations are used to value the employee's interest in the ESOP, which is held on a pretax basis.

Defining restricted stock. Typically, employers offer employees grants of rights to their stock at a certain future point based on certain conditions. When grant conditions are satisfied, the employee receives stock, which may or may not have additional restrictions that must be satisfied before the stock becomes marketable. A grant condition may require the employee to complete future years of service or achieve certain goals before restricted stock is issued. Once all conditions are met, the restricted stock becomes marketable. Plans generally are taxed to the employee at ordinary income rates at the fair market value of the restricted stock when it becomes marketable. The tax implications of restricted stock grants differ depending on the restrictions and, therefore, it is wise to consult an accountant. If the stock is held and later sold, the transaction would result in a capital gain or loss above or below the value at which the stock became marketable. If the grant of the unvested restricted stock occurs before marriage but vests during marriage, or the grant is given during marriage and the actual vesting occurs following a divorce, classifying and dividing the asset raises other issues. The implications discussed relative to characterization and valuation of stock options apply here as well.

Deferred compensation

The second class of employee benefits are employee deferred compensation plans and supplemental executive retirement plans. Generally, deferred compensation plans provide an employee with pretax cash compensation in the future for past, present, or future services. Payouts may be in a lump sum at the end of a term or more often over a period of years in the future. Most supplemental executive retirement plans are similar to defined benefit retirement plans, which begin paying benefits at a certain retirement age and continue for life.

Marital, nonmarital, or contingent property rights. Several issues surface in a dissolution of marriage action when an employee spouse is the beneficiary of one of these plans. The first is whether the employee spouse's rights under the plan are marital, nonmarital, or a contingent property right. The characterization of an employee's interest in these plans depends on the same principles as for stock options. The timing of the marriage, when the deferred compensation was earned, and when the option will be paid are all required for a meaningful analysis.

Valuation and division of benefits. The property rights of an employee spouse are difficult to value in some circumstances. Many deferred compensation plans provide for an amount to be paid in certain future years. If these amounts are readily definable, the stream of future payments may be discounted to a present value. Value arguments also must consider the tax implications of when payments are received.

Supplemental executive retirement plans generally are not qualified plans. As such, they are not divisible via a QDRO. Clearly, the court may compensate the nonemployee spouse with an offset of other marital property or provide a payment based on a formula when received. The drawback to this approach is continued financial entanglement.

If the supplemental executive retirement plan is in pay status during the pendency of the case, most jurisdictions treat plan benefits as property not income. The employer, although not obligated to recognize a QDRO and divide the pretax benefits between the employee spouse and nonemployee spouse, may, nevertheless, agree to do so and provide a separate check to each party on an ongoing basis. As long as the employee treats both payments as 100 percent taxable to him or her, the employer should have little reservation in providing this service. This in some way disentangles the parties. The employer may require a court order similar to a QDRO before voluntarily committing to such terms. Any such order should clearly reflect the employee spouse's tax liability so as not to confuse it with a division under a QDRO.

Phantom stock plans

A company can provide an employee with certain forms of additional cash compensation, such as phantom stock plans and cash bonus plans. A phantom stock plan ultimately provides an employee with cash in lieu of stock but the amount is linked to growth in company stock. If a company's stock has risen during the period, the executive receives a cash bonus in the amount phantom stock has appreciated. The benefit is taxed to the executive at ordinary income tax rates. Other more traditional bonus plans provide an employee with a cash bonus in addition to the recurring income based on company performance, the individual's performance, and/or other identified factors.

If phantom stock bonus or cash bonus is not paid to an employee during a divorce case but earned by personal efforts expended during the pendency of the divorce, it may be argued that the bonus should be treated as property subject to a percentage division much like stock options or deferred compensation. Phantom stock plans usually are offered only to certain high-level executives and are linked to an increased value of company stock.

Only if the cash bonus is in the form of a guaranteed level of payment can one argue justifiably for a division of the bonus as property. Generally, however, the bonus will be considered a component of the employee spouse's income, which is relevant to his or her ability to pay child support and/or alimony because the bonus is so speculative.

Often cash bonus plans are linked to the employee's performance during a certain period with a component of the company's overall performance. With cash bonus plans, first quantify the factors upon which the level of bonus is calculated. How the cash bonus is calculated and when it is paid will depend on whether the benefit should be treated as additional income to the employee or a current asset subject to division. For high-level executives in publicly traded companies, specific written instruments may set out the anticipated level of the bonus in a separate employment agreement.

Lower-level employees may be entitled to a bonus at their superiors' discretion. In such situations, depose the employee in charge of setting the bonus and gather discoverable information on past bonuses, such as tax returns and the like, which may provide a basis for predicting future bonuses. An employee's pay stubs will show bonuses earned during the year as well as in prior years.

Life and disability insurance

Employers routinely offer life, disability, and health insurance to all employees. Generally, life insurance is term and thus has no cash value. The nonemployee spouse may attempt to claim insurance proceeds as security for child support, alimony, and other obligations of the employee spouse. Another frequently overlooked benefit is disability insurance, which pays a sum to the employee spouse when he or she is disabled and unable to work. Health insurance may reimburse the employee for some medical, dental, and other expenses and extend similar coverage to his or her dependents.

The employee spouse should be obligated to name the nonemployee spouse and/or children as beneficiaries of any life insurance policy to secure various support obligations. In addition, the employee spouse should be obligated to provide a portion of his or her disability payments in the event that he or she is unable to provide adequately for their support. Disability payments would be paid directly to the employee spouse with the court's judgment or marital settlement agreement providing benefits to the nonemployee spouse and/or children.

The terms and conditions of the employees' health insurance plan will help to identify issues of importance to the nonemployee spouse and children. Because a nonemployee spouse is no longer considered a dependent after the divorce, COBRA provisions of the employees' health insurance policy should be reviewed. Confirm that the nonemployee spouse and children are covered during the pen-

dency of the divorce case. If both spouses are employed and covered by a company health insurance plan, analyze both policies to determine how the children should be covered. The nature and extent of health insurance coverage will affect each spouse's obligation to maintain coverage for the children and pay unreimbursed and uninsured medical, dental, psychological, orthodontic and other expenses.

Following a dissolution of marriage, if a nonemployee spouse has difficulties securing benefits, such as reimbursement for medical expenses for the parties' children, ask the court to enter a qualified medical support order, which will require the employee's plan to honor and process the nonemployee spouse's claims for reimbursement.

Cafeteria plans

A cafeteria plan or flexible benefits plan is a fringe benefit that allows a participant employee spouse to choose among employer-provided taxable and nontaxable benefits. This flexible compensation allows an employee to divert salary to employee benefits on a pretax basis. An employee may then use pretax dollars to pay his or her share of insurance premiums, deductibles, coinsurance payments, or uncovered medical bills. In addition, the employee can set aside money to pay for dependent care expenses, including day care, which would otherwise be paid with aftertax dollars. Employees generally may choose between one or more benefits on an annual basis. Amounts allocated on a pretax basis for unreimbursed medical expenses, day-care expenses, and the like are forfeited if not used during the plan year.

Before discovering the nature and extent of an employee spouse's cafeteria plan and evaluating it's availability, it is important to understand how such benefits will affect the pending divorce, especially if you represent the primary custodial parent. The employee spouse's participation in such a plan will affect his or her income available for alimony or child support. The more pretax income is diverted for these plans, the lower the employee spouse's income. In addition, the employee spouse's benefit elections will depend on each spouse's obligations to maintain health insurance and pay other expenses for the children, such as unreimbursed medical or dental expenses, orthodontia, psychological expenses, day care, and the like. Usually in the context of settlement or trial, it is important for the parties and/or the court to understand these benefits so that issues relating to the children and their expenses can be resolved in the most efficient manner.

Miscellaneous perks

Other perquisites include expense accounts that create a personal benefit to the employee, such as reimbursement for use of a cellular phone, company car or airplane, club memberships, relocation reimbursements, and cash compensation for unused vacation days.

Expense account reimbursements. An employee spouse's use of an expense account impacts a divorce case on many levels. Many employees use personal funds while traveling for business. The employer later reimburses the employee in full or in part. Review an employee's bank account records for these deposits to confirm that reimbursements are not simply accumulated over time, which could result in a considerable amount of undocumented marital money that is not reflected on account statements.

Benefits Bounty

Following is a list of employee benefits to search for:

- Stock options
- Restricted stock grants
- Stock appreciation rights
- Phantom stock plans and options
- Stock-based bonus or incentive programs
- Profit-based bonus or incentive programs
- Performance-based bonus or incentive programs
- Life insurance
- Disability insurance
- Disability income programs
- Holiday/vacation programs, (including payments for unused time off)
- Child-care benefits and/or subsidized or on-site day care
- Transportation and/or parking subsidies
- Company vehicle
- Auto lease or purchase programs
- Health club benefits, on-site and/ or subsidized programs
- Employer-subsidized wellness programs, including weight loss, stop smoking, exercise, stress relief.
- Country club/golf/tennis club memberships
- Frequent flier miles
- Sports tickets (baseball, football, etc)
- Subsidized cafeteria or meal programs
- Employer-provided or subsidized CPA, tax and/or financial planning services
- Employer-provided or subsidized legal services
- Employer-provided products or services (e.g., appliances, electronics, security systems, telephone service etc.)

Next, expenses incurred in selling a home, such as brokerage commissions, capital gains taxes, and moving expenses, may be reimbursed by the employer if the move is business related. If an employee spouse contemplates selling a residence during the pendency of a divorce or soon thereafter, identify whether and to what extent costs will be reimbursed. Reimbursements will affect the equity in the home, which ordinarily may be reduced by closing costs. These types of reimbursements generally are taxed to the employee as ordinary income, and some employers provide additional funds to cover anticipated income taxes on them.

Unused vacation days. Additional compensation for unused vacation, sick, and personal days is becoming a popular way to reward employees. This compensation should be added back to the employee spouse's gross income when calculating his or her ability to pay child support or alimony. Unused days that have accrued on or before the date of the parties' dissolution of marriage provide justification for dividing these benefits between the spouses if, as, and when received as property.

Discovery strategies

Your discovery strategy may vary slightly for each specific type of employee benefit, but generally the steps are the same. The first step will be to gather as many relevant documents as possible. Explore informal discovery methods by gathering as much relevant public information as possible. Public companies' annual reports give helpful information about the highest executives as well as general information about employee plans.

Depending on the size of the company, one can anonymously procure annual reports to shareholders, a principal document used by public companies to disclose corporate information, such as the terms and conditions of certain employee benefit plans. A proxy statement, usually created by the company, is intended to provide stockholders with information to enable them to vote in an informed manner.

The Securities and Exchange Commission (SEC) retains filings made by companies and certain shareholders, which may provide terms and conditions of employee benefit plans. These filings are available upon request from the SEC branch offices or on the Internet at www.edgaronline.com. The 10-K is an important SEC filing, which requires an annual report within 90 days after the close of the company's fiscal year. The 10-K provides a comprehensive overview of the company for the past year, including such information as company history, organization, nature of business, equity holdings, earnings per share, subsidiaries, and other pertinent financial information.

Companies also are required to file a 10-Q or quarterly report, which provides a continuing view of the company's financial position throughout the year. The filing is due 45 days after each of the first three fiscal quarters. Companies also are required to submit a Form 11-KT, which is an annual report of employee stock purchase, savings, and similar plans. Form 13-D, known as a statement of ownership, must be filed with the SEC by any person or persons reporting beneficially owned shares of common stock in a public company. When requesting these documents, be sure to ask for any amendments to these filings.

It is important to note that these filings are generally required only for publicly traded companies. Publicly traded small businesses are required to file similar reports.

Informal discovery allows a divorce practitioner to gain an immediate advantage in litigation by gathering information without the notice requirements of formal discovery. Obtaining public information early on educates the attorney, allowing him or her to streamline formal discovery. In addition, informal discovery helps to test the trustworthiness of the employee spouse's subsequent disclosures of assets, liabilities, and income.

Formal discovery

Generally, a practitioner begins formal discovery with a request for documents from the employee spouse and perhaps interrogatories. To the extent that the employee spouse's responses are incomplete, request documents from the employer or other third parties. Most jurisdictions allow for a records-only subpoena to be issued, requesting that documents be produced in lieu of a deposition whereby actual sworn testimony is taken. This allows the practitioner to analyze the full extent of relevant documents before deciding what, if any, testimony is required.

It is helpful to identify early on a proper deponent at the employer who is knowledgeable about all matters you plan to investigate. Most jurisdictions allow for a subpoena to the employer, requesting that a knowledgeable employee be designated to provide all pertinent information. There may be some level of discretion on the part of the employer in terms of information provided, such as payment of benefits. If a benefits agreement between employee and employer is silent as to certain terms and conditions, consider deposing a key officer or other employees of the company to clarify and expand on information contained in the documents.

To conserve valuable deposition time, informally interview key members of the company to obtain a general overview of benefits. An outstanding records-only subpoena may help motivate the employer to cooperate. The informal interview is not the preferred method of discovering information, but may give you at least a starting point in identifying

what additional documents exist and which key individuals to depose, especially when deposition time is limited.

Some documents are procured through formal discovery, either by requesting the documents from the employee, propounding interrogatories on the employee, or issuing a subpoena to the employer. Generally, each employee benefit is the subject of a particular formal document, copies of which are needed for a full understanding. Examples of employer-generated documents include summary plan descriptions, annual statements of employee benefits, an employee manual, or a schedule describing the employee's right to receive certain benefits.

Some benefits are reflected in a written employment contract. When dealing with privately held companies, periodic valuations may be done to help determine the value of benefits that are dependent on the price of the employer shares. Beneficiary designation forms provide helpful information not only about the beneficiary but benefit types and options.

When quantifying health insurance benefits, confirm coverage by procuring the insurance card and identifying the provider, plan type, policy, and group number. If a nonemployee spouse is covered under a spouse's health plan, the necessary information may already be available to the nonemployee spouse, obviating the need for formal discovery.

A cafeteria plan will require an employee to make an annual election of benefits; these forms are routinely discoverable and will explain the nature and extent of the employee spouse's elections. The employer's expense reimbursement forms, canceled reimbursement checks, financial statements, cash disbursement journals, and general ledgers reflect the expense reimbursements paid out to employees. The employee's personal bank account statements will reflect whether reimbursement checks were actually deposited.

If the spouse is an employee or co-owner of a closely held corporation, he or she is likely to incur expenses that are reimbursed by the company but beneficial to the individual. For example, some employees are reimbursed for expenses associated with a cellular phone, an automobile, club memberships, and/or a company airplane used for business and pleasure. Some jurisdictions recognize that a portion of these expenses should be added back to the employee spouse's net income for purposes of calculating child support and alimony. This add-back is necessary because the employee receives personal benefits that could otherwise be received in cash.

The Internet is a powerful tool in gathering SEC filings as well as other company information

To quantify expenses that are reimbursed by the company, analyze credit card statements (for both personal and corporate cards), expense reimbursement reports, detailed company financial statements (including profit-and-loss statements, cash disbursement journals, general ledgers), flight logs, and any employee manuals or other documents describing the perquisites provided to employees. These documents are discoverable from many sources, including the employee spouse, the employer, the employer's accountant, and the specific financial institution or club. This investigation is particularly important if the employee works for or is an owner of a closely-held corporation, because the employee has considerable discretion as to the range of perquisites provided. Usually a practitioner will need to depose the employee and a member of the employer company to help quantify personal components of reimbursements.

A thorough knowledge of common employee benefits is essential to comprehensive discovery. Practitioners should explore informal discovery by gathering as much publicly disseminated information as possible. The Internet is a powerful tool in gathering SEC filings as well as other company information. Informal discovery, however, is no substitute for formal discovery procedures, such as requests for production of documents, interrogatories, and subpoenas.

Before interviewing or deposing a third-party employer, serve him or her with a records-only subpoena to gather as many records as possible and conserve precious deposition time. Most jurisdictions allow for both a records-only subpoena and a subsequent subpoena for an actual deposition where an employer would give sworn testimony.

A full understanding of an employee's benefits allows the practitioner to more efficiently discover the information necessary to advance his or her client's interests. As the business world continues to evolve, companies will explore new ways to compensate their employees. Divorce practitioners must stay ahead of the learning curve to avoid having their clients' interests compromised.

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