COMPENSATION

Stock Options: Extending Employee Ownership Rights

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Although stock options are a well-established form of executive incentive compensation, their legal treatment continues to be the subject of controversy.

In dealing with a wrongfully dismissed employee's right to exercise stock options and damages for the lost opportunity to purchase shares under a stock option plan, courts have consistently viewed stock options as contracts and have determined that an employee's entitlement following termination of employment depends on the interpretation of the terms and conditions of the specific stock option plan and agreements involved.[1]

A recent decision of the Court of Appeal for Ontario, *Ross v. Ross*,[2] addresses the ownership and division of stock options and other elements of employment compensation in the context of a marital breakdown and does so independent of the underlying contractual terms and conditions. *Ross* holds that, at least in some circumstances, an employee may own stock options even before they have been granted depending on an employer's past practice. In doing so, the Court of Appeal has expanded an employee's entitlement to stock options in a significant way.

The Facts

Mr. and Mrs. Ross were husband and wife for 13 years before separating on August 31, 2001.

Mr. Ross was a senior executive of IAMGOLD Corporation, a publicly traded corporation, employed since 1996 and appointed as its chief financial officer in January 2000.

At the date of separation, Mr. Ross had 175,000 stock options of IAMGOLD; of these, 125,000 stock options were vested and could be exercised. However, none of the stock options had been exercised. The stock options were "under water;" that is, the shares of IAMGOLD were trading at a price below the strike price of the stock options.

IAMGOLD's practice was not to issue stock options every year. Grants were discretionary and based on the prior year's performance. Each year, its compensation committee would review whether stock options should be granted and, generally, senior executives would be considered as a group. During Mr. Ross' employment at IAMGOLD prior to the date of separation, stock options were issued to him in 1996, 1997 and 2000, but not in 1998, 1999, or yet in 2001.

On December 12, 2001, some three-and-a-half months after separating from his wife, Mr. Ross was granted an additional 245,000 stock options. IAMGOLD's letter advising Mr. Ross of his December 12, 2001 grant of stock options referred to the significant progress made in the preceding year towards increased value for shareholders and IAMGOLD's appreciation of his efforts. The grant also reflected Mr. Ross' promotion in the previous year.

Subsequently, Mr. Ross negotiated a new employment agreement with his employer providing that, in the event of a change in control of IAMGOLD, any unvested stock options would immediately vest and could be exercised for a period of 60 days following his severance period.

In October 2002, IAMGOLD merged with another company, triggering the change in control provisions in Mr. Ross' employment agreement. Then, in January 2003, Mr. Ross was advised that his employment would be terminated effective the following month and that he would receive severance payments for two years thereafter. As a result of the corporate merger and his dismissal, all of Mr. Ross' non-vested stock options became vested and could be exercised until April 2005.

[1] See, e.g., *Kieran v. Ingram Micro Inc.* (2004), 33 C.C.E.L. (3d) 157 (Ont. C.A.); *Gryba v. Moneta Porcupine Mines Ltd.* (2000), 5 C.C.E.L. (3d) 43 (C.A.).
[2] (2006), 83 O.R. (3d) 1 (C.A.).

IAMGOLD's share price increased substantially after the date of separation. Accordingly, Mr. Ross exercised all of his stock options by April 2005. Mr. Ross profited substantially on the transaction: his net after-tax capital gain on the 175,000 stock options issued prior to the date of separation was $423,313; on the 245,000 stock options issued on December 12, 2001, his gain was $652,313.

The Dispute

The husband and wife disputed the division of their assets.

Mrs. Ross took the position that all of the share options, whether granted to Mr. Ross before or after the date of separation, should be considered as part of the overall family property and that she should receive one-half of the actual proceeds resulting from their exercise and sale of shares in 2005.

On the other hand, while Mr. Ross conceded that the share options granted to him prior to the date of separation should be considered family property arising during the marriage, he objected to the inclusion of any subsequent grant of share options. Further, Mr. Ross sought to have the share options valued as at the date of separation – when they were under water – as opposed to sharing the proceeds once they had increased in value after the merger almost four years later and after the share options had been exercised.

Family Law Primer

In order to understand the issues in *Ross*, a brief overview of certain family law principles is necessary.

Similar in type to legislation enacted in other provinces, the property provisions of Ontario's *Family Law Act*[3] recognize that marriage is a partnership and that, upon breakdown of the partnership, the affairs of the spouses should be settled equitably. With some exceptions, the value of all property accumulated during the marriage partnership is to be calculated and shared equally by the spouses on a marriage breakdown through a transfer payment; the property itself is not divided or transferred.

[3] R.S.O. 1990, c. F.3.

The first step in this equalization process is to determine each spouse's "net family property" on the "valuation date," here, the August 31, 2001 date of separation. The second step is to determine the value or worth of the net family property as of the valuation date. The third step is to equalize the value of the net family property to the extent necessary, that is, to compel a payment from the spouse with a higher level of net family property to the other.

Key concepts are property and ownership. Two definitions from section 4(1) in the *Family Law Act* are relevant:

> "net family property" means the value of all the property ... that a spouse owns on the valuation date ...
>
> "property" means any interest, present or future, vested or contingent, in real or personal property ....

The Trial Judgment

The trial judge rejected the wife's claim to one-half of all the proceeds of all of the stock options granted to the husband; she was not effectively a co-owner of those share options. Rather, the trial judge determined that Mrs. Ross was entitled to have included in the net family property calculation all stock options that had been "received or earned" by Mr. Ross as at the date of separation.

Given the husband's concession, the trial judge included all 175,000 stock options actually granted to Mr. Ross prior to the date of separation in the net family property calculation. Further, based on the evidence at trial, the trial judge determined that the 245,000 stock options granted to Mr. Ross after the date of separation were intended by his employer, at least in part, to compensate him for work done during the 2001 year prior to the date of separation. The trial judge, therefore, included 8/12 of the stock options – the percentage of the year during which the spouses were still living together as spouses – in the net family property calculation.

The trial judge determined that the fairest way to value the stock options, including those granted both before and after the date of separation, was to use an "if and when" approach. Under this approach, Mr. Ross would be considered the legal owner of the stock options, but holding one-half of the asset in trust for

his wife. "If and when" the stock options were exercised and the shares sold by Mr. Ross, he would be required to pay his former spouse one-half of the proceeds. The effect of this approach was to quantify the worth of the stock options in 2005 when they were actually exercised – and having taken into account IAMGOLD's merger transaction – as opposed to on the date of separation.

The Court of Appeal Decision

Mr. Ross appealed the determination that the post-separation date stock options should be included in the net family property calculation. He also appealed the trial judge's use of the "if and when" valuation approach.

On the issue of the inclusion of the stock options granted after the separation date, the Court of Appeal, in a two to one decision, agreed with the trial judge. According to the Court of Appeal, stock options should be considered and treated the same as any "employment related benefit" such that "stock options awarded to a spouse by his or her employer after the valuation date ought to be included in the spouse's net family property if, on the valuation date, the spouse had earned the right to the options."[4] Put another way, an employee's ownership of stock options or other items of employment compensation flows from the employee having earned the right to be granted stock options or other compensation even if there has not yet been an express grant.

Moreover, even discretionary compensation could be considered to be "earned" even if not yet paid to the employee if it has become an integral part of an employee's overall compensation. In this regard, the Court of Appeal reiterated that an employer's past conduct can convert a discretionary benefit into an integral part of an employee's compensation package and create an employee entitlement.[5]

The Court of Appeal analogized stock options to a wrongfully dismissed employee's claim to a bonus, profit sharing, stock option or similar form of remuneration which would have been earned but for the termination of employment:[6]

> [A] benefit beyond salary should be included as part of the employee's remuneration package if the employee has established an entitlement to the benefit. Discretionary benefits are not always to be excluded. The substance of the arrangement between employer and employee must be determined. The form of arrangement is often helpful in that determination. It is not always conclusive of the substance of a particular arrangement. It is necessary to consider whether the bonus or claimed profit-sharing entitlement is an integral part of the plaintiff's salary or remuneration package. Were bonus and performance so closely related so as to lead to the conclusion that the defendant has received performance in circumstances that would have attracted payment of bonus or perhaps profit-sharing, had the plaintiff not been fired? All of the circumstances of the profit-sharing and bonus arrangements have to be considered.

According to the Court of Appeal, the test was whether it was more likely than not that Mr. Ross would be granted stock options from his employer. If the answer is yes and the grant is to compensate for services during the period prior to the marital breakdown, then the employee had "earned" them. Although the granting of stock options at IAMGOLD was discretionary, the Court of Appeal concluded that there was "a relatively consistent history" of issuing stock options to Mr. Ross.[7] Based on the evidence, therefore, the Court of Appeal approved the trial judge's determination that, "as at the date of separation, [Mr. Ross] had *earned* 8/12 of the as yet unissued stock options and that, on a balance of probabilities, Mr. Ross was *entitled as of right* to that benefit on the date of separation. In other words he was, within the meaning of subsection 4(1) of the *Family Law Act*, the owner of property which consisted of a right to receive or an interest in these earned stock options"[8] (emphasis added). The Court of Appeal concluded that, in the particular circumstances, such an interpretation best

[4] *Ross v. Ross*, supra note 2 at 8.
[5] Ibid. at 9.
[6] Ibid. at 8, quoting *Thomson v. Bechtel Canada Ltd.* (1983), 3 C.C.E.L. 16 (H.C.J.), at 21, aff'd (1985), 6 CCEL xxv (C.A.).
[7] Ibid. at 9.
[8] Ibid.

achieved the primary goal of the *Family Law Act* of "a division of assets that is fair to both spouses."[9]

With respect to valuing the stock options, the Court of Appeal unanimously rejected the trial judge's use of the "if and when" approach on the basis that such an approach bypasses the mandatory requirement of the *Family Law Act* to calculate the value of net family property as at the separation date. Rather, the "if and when" approach inappropriately prefers hindsight results – here the corporate merger and other events occurring after the valuation/separation date – over information available at the time of separation.

The preferred approach was to use a broadly accepted probability-based mathematical formula for valuing stock options of publicly-traded corporations known as the "Black-Scholes" method. The valuation of stock options produced by this model would be subject to discount in order to account for vesting restrictions, performance contingencies and market variables, or to acknowledge that the stock options are not freely saleable or transferable.[10]

A Dissenting Opinion

Justice Borins provided a well-reasoned and persuasive dissent on the issue of ownership of stock options.

Reviewing and relying on the incidents that must accompany true "ownership," Justice Borins' conclusion was that, as at the date of separation, Mr. Ross did not and could not own the 245,000 stock options which were only granted to him several months afterwards. At best, Mr. Ross had an unenforceable expectation that his employer might grant him stock options. Chastizing his fellow Justices, the dissent states: "In implicitly finding that [the husband] owned these phantom options on the valuation date, the majority has reached the conclusion that a person is capable of owning something that does not exist."[11] That is, by effectively taking into account "hindsight" information namely the employer's post-separation date grant of share options, the majority made the same error as the trial judge did.

[9] Ibid. at 10.
[10] Ibid. at 17 and 34.
[11] Ibid. at 21.

The dissent emphasizes the importance of determining the ownership interests of the spouses as of the date of separation as the first step in the process. The fact that share options may constitute "property" as defined in the *Family Law Act* is beside the point if there is no ownership: "Ownership encompasses far more than a mere share in the value of property. It includes additional legal rights, elements of control and increased legal responsibilities."[12] The incidents of ownership are also evident from well-established legal definitions:[13]

> *Own.* vb. To have or possess as property, to have legal title to.
>
> *Owner.* One who has the right to possess, use, and convey something; a proprietor.
>
> *Ownership.* The collection of rights allowing one to use and enjoy property, including the right to convey it to others. Ownership implies the right to possess a thing, regardless of any actual or constructive control. Ownership rights are general, permanent, and inheritable.
>
> *Title.* 1. The union of all elements (as ownership, possession, and custody) constituting the legal right to control and dispose of property; the legal link between a person who owns property and the property itself < no one has title to that land >. 2. Legal evidence of a person's ownership rights and property; an instrument (such as a deed) that constitutes such evidence.

Notwithstanding that the trial judge determined that the stock options granted to Mr. Ross were "given for work done" by him and that he had "earned" the stock options prior to the date of separation, Justice Borins correctly pointed out that the trial judge never made a finding that Mr. Ross owned the stock options on the date of separation. Rather, Mr. Ross' argument was accepted as follows:

- The December 2001 stock options did not exist on the valuation/separation date.
- On the valuation/separation date, Mr. Ross did not own them and had no entitlement

[12] *Rawluk v. Rawluk*, [1990] 1 S.C.R. 70, at paragraph 44.
[13] *Ross v. Ross*, supra note 2 at paragraph 82, citing *Black's Law Dictionary* (1999, 7th Ed.), at 1130-1131 and 1493.

to them because their issuance and grant were always within the discretion of IAMGOLD's board of directors.

- There was no evidence that the December 2001 stock options were authorized or had even been discussed with Mr. Ross prior to the marriage break-up. The board of directors might not have granted Mr. Ross any options for 2001 – just as it did not in 1998 and 1999. At most, Mr. Ross might have had an expectation that, in December 2001, the board of directors would, in its discretion, vote to give him an unspecified number of stock options that, at least in part, would represent compensation for his efforts for IAMGOLD throughout 2001.

Quite simply, at the valuation/separation date, Mr. Ross had none of the usual incidents of ownership in the stock options at issue such as title, possession, use, control, risk or power to convey. As such, those share options should be ignored for the net family property calculation.

In contrast to the majority's approach and reliance on an employer's past conduct and treatment of stock options as a form of earned compensation, Justice Borins approached the issue of post-valuation/separation date stock options as akin to that receipt of severance package from an employer. If the severance package is received after the employee and his or her spouse separated, it is not included in net family property even though the quantum of the severance package based on years of service is partly determined by reference to a period occurring during the marriage.

The dissent is in accord with established precedent. In *Marquardt v. Marquardt*,[14] the husband was terminated and received a severance package from his employer some 16 months after the date of separation. The severance pay provided to the husband was based on his entire length of service at the employer, in this case, comprising most of the period represented by the severance. In rejecting the spouse's claim to a share of the severance, the trial judge in *Marquardt* stated:

> I think it is stretching the definition of "property" in section 4(1) of the *Family Law Act* to conclude that something that did not exist and to which the husband had no right at the time of separation should be considered his property, as of separation, merely because of the method of calculating his entitlement to severance some sixteen months later includes time during which the parties were married and living together.[15]

Marquardt was approved by the Court of Appeal in *Leckie v. Leckie*.[16] In that case, some time after separation, both the spouses were laid off from their employment. The trial judge included the severance packages received by each spouse in their respective net family property calculations, apportioning each severance package according to the years of marriage divided by the years of service. On appeal, the Court of Appeal rejected this approach, stating succinctly: "In that the severance packages did not exist at the date of separation, neither party had any entitlement to such a package as at the date of valuation. They are not property as of separation."[17]

It is germane to note that the majority decision in *Ross* agreed generally with this approach stating: "where the offer of a severance package and the termination of the employee do not occur until after the date of separation, the employee has no right or entitlement to the severance package at the date of separation."[18]

Implications

Ross is a significant decision in the family law context.

The scope of *Ross* is uncertain and it is unclear whether the Court of Appeal intended its decision to encompass executive compensation entitlements in the absence of a marital breakdown.

For example:

- Can an employee claim ownership rights in stock options that have not been granted to him or her and that are discretionary on the basis that he or she had been granted stock options on a regular basis in previous years or that they had been earned through prior job performance? Put another way, can an employee sue his or her employer for damages for the loss of

[14] [1996] O.J. No. 4139 (Gen. Div.).

[15] Ibid. at paragraph 13.
[16] (2004), 238 D.L.R. (4th) 571 (C.A.).
[17] Ibid. at paragraphs 4-5.
[18] *Ross v. Ross*, supra note 2 at 8.

opportunity to purchase shares or otherwise to enforce discretionary stock option entitlements even if there has not been an express grant of stock options? If so, *Ross* is inconsistent with established law to the effect that an employee is not entitled to damages where the employer retains a discretion as to whether or not to offer stock options or where the employer has never actually offered the employee the opportunity to purchase shares.[19]

- To what extent should consideration of an employee's stock option ownership rights be subject to the express terms and conditions of the specific stock option plan and agreements? Although options are to be interpreted as contracts, it is significant to note that neither the trial judge nor the majority decision of the Court of Appeal in *Ross* made reference to the underlying IAMGOLD stock option plan or any agreement in determining Mr. Ross' ownership rights or their valuation. As pointed out by the dissent in *Ross*, such contractual terms may restrict or remove an employee's vesting or exercise rights or other incidents of ownership.
- Can an employee properly transfer "ownership" in share options yet to be granted to his or her spouse even if there has not been a marital breakdown? It would seem anomalous if a former spouse is in a better position than a current spouse in terms of receiving the financial benefit accruing as a result of stock options.
- In drawing an analogy to a wrongfully dismissed employee's entitlement to claim stock options that would have been earned but for the dismissal, did the Court of Appeal intend to include stock options that had not yet been granted to the wrongfully dismissed employee? To date, awards to wrongfully dismissed employees had been limited to continued vesting and exercise rights of stock options that had actually been granted prior to the date of dismissal; courts have not awarded damages for stock option grants foregone following the date of dismissal.[20]
- Does the Black-Scholes valuation method apply to stock options of departing employees? If so, what is the proper valuation date – cessation of employment? the end of the reasonable notice/severance period (if any)? the date the stock options are issued? Previous case law has awarded damages only with respect to vested and exercisable stock options or those which would have become vested and exercisable during a reasonable notice/severance period, awarding damages based on the actual share price at the time rather than on an expert's financial model.[21]
- Does *Ross* apply to director or other non-employee compensation, or is its rationale dependent on earned employment compensation?
- Would *Ross* have been decided differently if the grants of stock options were expressly stated to be as an incentive to future performance and as part of a retention program (that is, as opposed to a reward for past performance)?
- Is a post-separation date severance package to be included as a part of net family property if it is pursuant to an employment agreement negotiated during the marriage?

As the foregoing issues are resolved in future litigation, the full implications of *Ross* on employment law and executive compensation, intended or not, will be learned.

[19] See, e.g., *PCL Construction Management Inc., v. Homes* (1994), 8 C.C.E.L. (2d) 192 (Alta. C.A.), at 197.

[20] *Gryba v. Moneta Porcupine Mines Ltd.*, supra note 1; *Veer v. Dover Corp. (Canada) Ltd.* (1999), 45 C.C.E.L. (2nd) 183 (Ont. C.A.).

[21] See, e.g., *Gryba v. Moneta Porcupine Mines Ltd.*, ibid.; *Veer v. Dover Corp.*, ibid.