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Newsletter

CHAIR'S COLUMN

The Beauty of the Law

by Michael J. Stanton

One of the beautiful things about the law is that it's blind. It treats everyone the same. Another beautiful thing about the law is that it's rational. It's applied with logic and reason. The only way in which the law can remain at this metaphysical state of total resplendence is by complete adherence to the court rules.

I can unabashedly say that I love the law. Of course, I don't love everything about practicing law, but I love the law, itself, because of its beauty, its equanimity and its rationality.

This love of the law can turn to disillusionment and downright despair, however, when the law loses its adherence to the court rules. This is much like the marriages that end up in our offices and courtrooms after the love has been drained from the relationship by repeated abuses. In a similar fashion, the best characteristics of the law are destroyed by abuses of the court rules.

I am sure we all have our own list of rule violations which annoy us the most. The following are some of my least favorites.

At the bottom of the list is the affidavit or certification of the attorney concerning factual issues which is filed in support of a client's motion. I am not referring to a certification or affidavit of services. I am referring to a factual certification signed by the attorney, whereby the attorney is essentially being a witness on behalf of the client and wherein the attorney is alleging facts which could not possibly be within the attorney's personal knowledge.

Rule 1:6-6 requires that affidavits (or certifications) must set forth facts that are within the personal knowledge of the affiant, and only such facts which are admissible in evidence and to which the affiant would be competent to testify at trial. As stated in the comment to the rule, affidavits by attorneys alleging facts which are not part of the attorney's personal knowledge constitute objectionable hearsay; therefore, they are not properly part of an affidavit in support of a motion. An additional

problem arises by virtue of the fact that the affidavit of the attorney likely violates R.P.C. 3.7, which prohibits a lawyer from being a witness in a case in which the lawyer is also an advocate. An exception is the attorney's affidavit regarding the nature and value of legal services.

I always tell my clients that if we are going to complain about something to the court, that is, argue to the court that your spouse is guilty of some act of omission or commission, we must offer the court a solution. How do we solve the problem? In this context how do we cure this abuse of the rules? The answer in the case of the attorney's certification is that the attorney representing a client in a matrimonial matter should never offer his or her own certification or affidavit regarding any issue other than the nature and value of fees, or something purely procedural in nature which is within the personal knowledge of the attorney.

Another vexing abuse of the court rules, which lately has reached almost epidemic proportions, is the misuse of the subpoena. My client owns 100 percent or a majority of a closely held business. My adversary launches a fusillade of subpoenas to my client's customers as a preemptive strike in a blatant attempt to bring my client to his knees and capitulate to my adversary's settlement demands. My client's customers are threatening to terminate their business relationship with my client unless they can be extricated from my client's divorce hostilities.

Rule 5:5-1(c) permits the taking of depositions in family actions, and Rule 4:14-7 provides that the deposition subpoena may command a person to produce documents at the time of deposition. The abuses of the subpoena rules most frequently occur when the issuing attorney commands the production of the documents at his or her office without the scheduling of a deposition. Another abuse of the subpoena rules occurs when the issuing

New Jersey Family Lawyer

Table of Contents

Chair's Column

Continued from page 1

attorney fails to copy the adversary attorney with the subpoena, thereby denying the adversary attorney the opportunity to move to quash the subpoena. Further abuses occur when the issuing attorney actually states in the subpoena that the subpoenaed individual need not attend the deposition if the documentation is produced at the issuing attorney's office prior to the deposition date. These are all clear abuses of the subpoena rules. Furthermore, the applicable case law provides that such subpoena mechanism should not be used if there is a less burdensome means of obtaining the documentation.

Perhaps the most frequent abuses of the rules occur in motion practice. Attorneys violate the rules on page limits with impunity. Rule 5:5-4(b) provides that the moving certification not exceed 15 pages, the answering certification not exceed 25 pages and the reply certification not exceed 10 pages. This rule notwithstanding, we still see certifications exceeding the page limits, which means that the attorney is oblivious to the court rule or simply doesn't care as long as he or she can get away with it.

We also frequently see abuses of Rule 5:5-4(c), where attorneys file a post-judgment motion as a 16-day motion instead of a 29-day motion. They evade the rule by the misleading labeling of their prayers for relief as an enforcement of litigant's rights or by tenuously associating one of the prayers for relief with a child. Of course, the rule requires a 16-day post-judgment motion to either involve the status of a child or to actually involve a Rule 1:10-3 enforcement of litigant's rights. In reality, the abusive practice is simply an improper method to shorten the return date and put inordinate pressure on the answering litigant.

The examples of abuses of the court rules are far too numerous to address in this column. Perhaps this should be included in the subject matter of a continuing legal education program. In some fashion we must get the message across to practicing family law attorneys that abuses of the court rules are unprofessional, unfair and, perhaps most importantly, destroy the beauty of the legal system. The solution is easy. First, read the rules. Second, follow the rules. Third, insist that your adversaries follow the rules. Fourth, request in the strongest and most respectful terms that the court enforce the rules. Let's restore where necessary, and retain everywhere else, the beauty of the law. ■

FROM THE EDITOR-IN-CHIEF

The Goal of the Family Court System

by Mark Sobel

With all the discussion of recent endeavors under the umbrella of best practices, I began to wonder about the goal of these *best practices*. I was taught by my firm's managing partner that it is imperative at the outset of a matter to determine the client's goals. It is only with an understanding of the client's perception and perspective of what is sought to be accomplished that appropriate practices and procedures can be implemented to effectuate that goal. In looking at what has transpired recently within our family court system, it occurred to me that perhaps we have installed *best practices* without first distilling what the paramount goal of our family court system should be.

We now have a system in which the trial courts themselves are actually graded. The grade they receive is not predicated upon a review of the quality of their decisions…or the number of reversals from the Appellate Division…. It is based upon one thing only: How fast they process their cases.

The family part, as with all of our court system, is in the business of providing a service. It neither manufacturers anything nor produces a tangible item. Rather, it seeks to effectuate a resolution of disputes through established procedures, thereby providing an effective and efficient service to our community. The question is: Should the goal be mere efficiency of the service or the quality of the final product? While speed, or clearing the calendar is a laudable goal, and, in fact, has driven the establishment of best practices, it should not be the most important goal. The paramount goal of the family court system is to do justice; to render fair and appropriate results in difficult and compelling cases. While we all have heard the cry that the most prevalent criticism of the system has been "it takes too long and it costs too much," I venture to guess that if we asked those same participants if they were willing to sacrifice an equitable result for speed or cost, they would say no.

We now live within a system where speed, deadlines and tracking have become a way of life. While these procedures in and of themselves are not detriments to the system, if we become slaves to them we may sacrifice, or at least tarnish, the ultimate goal of the system.

There certainly are ways to speed up the process and reduce the cost. For example, in Denver, Colorado, there is currently in place a requirement that all matrimonial cases be completed in 180 days. Imagine that, the case is over before you can even get a motion listed in some of our counties. It sounds great. It also comes with costs. In that system, you have no right to discovery; you must petition the court for it. There is one initial financial filing, and, absent relief of the court, that is it. Are we willing to establish a system which takes processing numbers to that degree? I hope not, but I fear we may be headed in that direction.

We now have a system in which the trial courts themselves are actually graded. The grade they receive is not predicated upon a review of the quality of their decisions (admittedly subjective) or the number of reversals from the Appellate Division (perhaps objective). It is not, as many businesses would do in the real world, predicated upon consumer surveys. It is based upon one thing only: How fast they process their cases. How many cases are processed, and how long it takes from commencement to completion, are the current grading criteria. In fact, the trial courts are segregated into three groups, those receiving three stars, those receiving two stars and those receiving one star. As a trial court, you are either in the top third, middle third or lower third, as each group contains the same amount of trial courts within it. Thus, someone is always at the bottom and someone is always at the top, as not every court can or does receive three stars.

Some claim these are not grades. But they are in fact a grading system, which our trial judges know full well, and are concerned about. No one wants to be in the bottom third regardless of the unintended costs. Thus, we are now faced with a system where courts have even refused

to accept mutual voluntarily dismissals because the case is too old.

Everyone has their own individual war stories regarding best practices, and the purpose of this editorial is not to rehash them. Instead, what we need to examine is whether we have selected the appropriate goal for the business of our court system, which best practices is designed to foster.

If the ultimate goal of the family court system is justice, then true best practices must be those procedures which insure that goal is, above all, accomplished, despite the myriad of issues faced by the family court and the difficult circumstances that must be analyzed by the trial courts in this area. If we were running the family court system as a business with such a goal, then perhaps some of the following might be considered *new* best practices:

1. As in business (where we would not squander experienced resources), we should have experienced judges, who could be recalled at less than one-third of the cost of a new judge, stay on the job.
2. Since we know from experience what happens in cases in which one side or the other believes they have achieved a victory in a *pendente lite* support determination, we would mandate an automatic six-month review of such *pendente lite* determinations. Unfortunately, we all know that the ability to get those orders reconsidered is limited at best, and often its perpetuation continues for the length of the case, while either an insufficient or exorbitant support award is in place.
3. While mandatory education of our family court judges is now being implemented in a more broad-based way, we should encourage judges to take time off from the bench to attend seminars and educational programs to improve their knowledge of the subject matter and keep them up to date regarding the latest developments in the area.
4. We would eliminate grading courts based upon the number of cases they push through the system, and instead evaluate them in a more particularized manner by having, for example, retired judges evaluate the procedures in various vicinages, allowing their experience to assist others. This approach would de-emphasize quantity and re-emphasize pursuing uniformly qualitative and comprehensive determinations by the trial court.
5. We would require family court judges, as we do certified matrimonial attorneys, to submit to an initial testing and periodically attend educational programs. A testing of our family court judges would not be done to grade them or publish the results, but to focus upon areas where further education can best improve the system. Again, if this were a business we would want the people making the critical determinations to have the most up-to-date information available, and the most comprehensive knowledge of the area in which they are making these critical determinations.
6. We would provide the judges with more time off the bench to examine and review the difficult cases they have, and render, in as timely a manner as possible, determinations. To do so we would eliminate from their requirements all non-judicial roles, from administering early settlement panel (ESP) conferences to a variety of other things that occupy much of their day.
7. We would assign more judges to the system commensurate with the demands of the job. I think it is clear to most practitioners in this area that family court judges, both on and off the bench, put in an enormous number of hours. Handling trials, reviewing motions, interviewing children, analyzing expert reports, examining financial and non-financial issues, dealing with emergent matters, resolving domestic violence cases and a variety of other dissolution and non-dissolution matters, creates a situation where the demands on a judge's time become more than is reasonable in this system. If that is the case, and it appears to be the case currently, the quality of judging is likely affected, and there needs to be an examination of the allocation of resources.
8. Attorneys must be required to adhere to the rules, and while (and perhaps because I am a practicing attorney) sanctions don't seem to be the answer, the failure to submit papers in accordance with the time requirements of the rules should uniformly result in the requirement to resubmit such applications. Similarly, counsel should be required to prepare the judge for contested matters by pre-submissions of legal briefs and the exhibits to be introduced into evidence. Such a trial book would greatly assist the court in focusing on the particular issues in the case and managing the introduction of proofs in a more efficient way.

While the above is only a small sampling of best practices that have an eye toward the quality of the decision making, rather than the quantity of the decision making, it is only a start. However, before we embark upon that course, it is imperative that we focus on the end of the trail. The end of the trail should be that each litigant believes they have received a full, complete and fair adjudication, and that the quality of the decisions affecting the very core of their lives has not been compromised by a system that seeks to define its effectiveness by the quantity of the cases it determines. With an eye toward that goal, best practices can and should be able to assist the court in shifting the emphasis from when a case gets determined to how a case gets determined. In the business of the family court system, that, I believe, is what the constituency demands, and what should be provided. ■

FROM THE EDITOR EMERITUS

A Bane of Our Existence

by Lee M. Hymerling

We have probably all regularly received computer-generated notices which read something like the following:

> With reference to your Notice of Motion, please be advised that the date you requested cannot be accommodated. The Motion will be heard on..."

The practical effect of such notices is that a motion, sometimes vitally needed to enforce a litigant's rights or to establish a support order, may be delayed for one, two or even more weeks. Although these notices are commonplace in many vicinages, a careful review of the rules governing New Jersey's courts does not reveal authority for such notices to be forwarded. In some counties, they represent among the most invidious forms of what might be called a local practice rule.

The reason for such notices has often been justified by the length of a particular motion list; judicial vacations; or administrative problems. Again, there is no rule that specifically addresses how or why motions should be administratively adjourned.

In order to fully consider the propriety of such notices, it is necessary to review motion procedure in general. Rule 1:6-3 and Rule 5:5-4(c) carefully and clearly define the time constraints for the filing and disposition of motions. Motions that are pre-judgment, enforcement or involve the status of a child are to be filed and served 16 days in advance of the designated motion date. Responses are due eight days prior to the designated return date, with final papers due four days prior to the return date. In the case of post-judgment motions (other than those involving enforcement or the status of a child), the schedule is 29/15/8. Although some have questioned whether these time limits should be extended, nowhere in Rule 1:6-3 or Rule 5:5-4(c) is there any procedure for the court, without consulting counsel or litigants, to administratively adjourn motions. The practice is one that is frequently abused.

If a dependent spouse caring for several children does not receive child support, it should not take 30 or more days for the matter to be heard by a judge. If parenting time is sought, it should not take 30 days or more for the issue to be resolved.

Such administrative adjournments should be discouraged. On the other hand, administrative adjournments cannot be entirely eliminated.

The first reason given for administrative adjournments is often that there is an inherent limit as to the number of motions each family court judge should be required to consider on a given Friday. Should that limit be 20, 25, 30, 40? There can be no doubt that frequently matrimonial motions are complex, involving enumerable requests and sub-requests. Indeed, the more complex the case, the more likely it is that motions filed will be multifaceted, involving substantial judicial time.

On the other hand, one cannot lose sight of the reality that with the adoption of Rule 5:5-4(b), the length of individual motion filings has been limited by the page limits that have been imposed. Many challenged that rule when it was first adopted upon the recommendation of the Supreme Court Special Committee on Matrimonial Litigation. But now, several years later, the rule has gained general acceptance, and those who would stretch the rule have probably come to realize what its drafters knew — that brevity is a

virtue, and that brevity is a small price to pay for motions to be heard promptly.

Family part judges work very hard. Their assignment is the most difficult in the courthouse. Motions are an important part of the workload. They come with the territory. Each judge must cope with the burdens of his or her motion list as best he or she can. Fortunately, even in strained economic times, family part judges are usually assigned their own individual law clerks. Ultimately, however, even with the best of law clerks, a family part judge is confronted with the daunting task of personally dealing with each motion — reviewing its content, preferably issuing a tentative disposition and then conducting a hearing. But with the burdens of the job comes the satisfaction of knowing that, more so than any other judges in the courthouse, family part judges affect for the better the lives of those who come to court.

The problem with administrative adjournments is the adjournment frequently occurs before the judge or the law clerk ever sees the papers. Such adjournments have nothing to do with the complexity of the case or the scope and problems of the individual motions. They just happen to the considerable consternation of counsel and litigants.

The simple problem is that in those counties where administrative adjournments routinely occur, litigants and counsel are not assured of hearings 16 days from filing, but as many as 30 or more days from filing, and that is simply not right. If an initial adjournment is granted counsel or a litigant, the delay might grow to 44 or more days. If a dependent spouse caring for several children does not receive child support, it should not take 30 or more days for the matter to be heard by a judge. If parenting time is sought, it should not take 30 days or more for the issue to be resolved. And even with more mundane issues such as discovery, in standard track cases one-third of the discovery time should not run before a discovery dispute is resolved.

Ultimately, one is forced to prioritize whether a motion list should be cut at a finite number. It is my view that it should not. If a list becomes so burdensome that it cannot be easily accommodated in a single day, some portions of the list should be split off, but special arrangements should then be made for the motion to be heard expeditiously. In those counties in which motions are heard in alternate weeks, overflow motions could be heard on the off week. In those counties in which motions are heard every week, the presiding judge should give serious consideration to spreading the motions among a larger number of judges, recognizing that where possible complicated motions should be heard by the eventual designated trial judge. What should not happen is the unwarranted delay of justice.

This issue is intrinsically interrelated to best practices, and the timeline the system as now given for the adjudication of most divorces. If most divorces are to be resolved in a year, individual motions should not be inordinately delayed before resolution.

A much more difficult question relates to the second reason frequently given for administrative adjournments — judicial vacations. This is more difficult, because, by definition, it is better for a motion to be heard by the particular judge who is managing a case and who will eventually try the case. Undoubtedly, judicial consistency is always a virtue. Consistency will not exist when more than one judge hears parts of a given matter. This, too, must be balanced against the exigencies of each particular situation.

On the one hand, it is difficult for a fill-in judge to involve him or herself in a matter that has commanded frequent attention. On the other hand, many motions involve finite issues that may be resolved by any family court judge.

On balance, I suggest that judicial vacations should not automatically cause an administrative adjournment, but instead, motions assigned to a judge on vacation should be diverted to other judges hearing motions that particular motion day. With every rule, however, there are exceptions. In complex matters, if nothing requires emergent attention, the motion should be heard by the regularly assigned judge. If a motion imposes an acute burden, either in the time it will take to prepare or hear, special arrangements should be made. As needed, such motions should be adjourned not by the uncritical eye of a functionary in the clerk's office but by the judge's immediate staff, preferably after consulting with counsel.

And what should not happen? No lawyer or litigant should be confronted with an adjournment simply because the court system cannot handle the motion at that time. Courts and those who appear before them exist for the prompt resolution of important matters. Justice delayed is frequently justice denied. Recognizing that even without administrative adjournments, adjournments by consent will always occur — with first adjournments likely to be granted — motions should not be recycled week after week. Just as cases become old, motions can become old as well. To permit motions to age is not in the public's interest.

There is no best practice condoning administrative adjournments. It is not even a good practice. Automatic administrative adjournments cannot be reasonably justified. The courts must find a way for motions to be heard when litigants want them to be heard. Our readers sit or practice in a people's court. The people deserve no less. ■

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EXECUTIVE STOCK OPTIONS

Valuation Issues Facing the Matrimonial Attorney

by Lester Barenbaum

Executive stock options (ESO) have become a dominant component of executive compensation for senior executives as well as middle management in public companies. According to one survey, 74 percent of public companies with sales under $50 million and 45 percent of public companies with more than 5,000 employees now grant options to all employees.[1] The 200 largest U.S. companies allocated 13.7 percent of their equity for employee stock incentive plans in 1999, almost double the 1990 amount.[2]

Executive stock options are generally not transferable, and thus represent non-traded assets. Consequently, their value cannot be observed. This makes valuation a more difficult undertaking. This article begins with an overview of the characteristics of executive stock options and discusses why traded stock options generally have a value that is significantly greater than their liquidation value. The article then moves on to discuss how executive stock options are similar and different from traded options, and how this impacts their valuation. The article concludes by asserting that just because ESO value cannot be observed, does not imply that their value cannot be determined with sufficient confidence for use in equitable distribution.

In many matrimonial situations, executive stock options were granted prior to the date of the divorce complaint, but the employee does not receive full title (vest) until he or she has had continued employment with the firm beyond the complaint date. Thus, the determination of what component of the executive stock options, if any, represents marital property for distribution is a difficult issue to resolve. How courts in New Jersey have approached this issue is another focus of this article.

The appropriate distribution mechanism must be chosen once the extent of the ESO grants represent marital property. The relative benefits and costs of off-set distribution or if and when distribution is made form the next topic in this article. The article ends with a checklist of information necessary for analyzing executive stock options. Appendix A reprints the executive stock option disclosure found in the Johnson & Johnson 1999 annual report. Appendix B contains a brief overview of the valuation logic used in valuing executive stock options, and Appendix C contains a glossary of terms often encountered when dealing with executive stock options.

WHAT ARE EXECUTIVE STOCK OPTIONS?

Executive stock options represent a contract between the employer and the individual employee that grants the employee the right to purchase company stock at a designated price for a designated length of time. The fixed purchase price granted by the option is called the exercise price or the striking price. The executive must often wait a period of time prior to exercising the option. This time period is known as the vesting provision. Executive stock options have an expiration date, after which the executive loses the right to exercise the option. The right to acquire the firm's common stock usually becomes effective in one to five years (vesting provision) and lasts through a specified expiration date, which can be as long as 10 years beyond the date of the executive stock option grant. The difference between the strike price and the market price for the stock is known as the option's intrinsic value. As discussed below, the right without the obligation to purchase shares of stock can give an option significant value.

Executive stock options are generally granted through a firm's long-term incentive plan. The issuance normally is communicated in a grant letter containing the characteristics of the stock option grant. Typically, executive stock options are granted at the money, that is, the exercise price is equal to the firm's current share price. Thus, at the time of grant the executive stock option has no intrinsic value. However, this does not mean the option does not have significant value. This can be easily seen through an examination of publicly traded long-term options.

TRADED STOCK OPTIONS HAVE MORE VALUE THAN ONE MIGHT THINK

It is important to recognize that

executive stock options often have significant value beyond their intrinsic value. The data for the publicly traded Pfizer long-term options, shown below, was published in the June 7, 2002, edition of the *Wall Street Journal*.

Current Stock Price	Firm	Expiration Date	Exercise Price	Option Price	Intrinsic Value
$33.91	Pfizer	January 2003	$30.00	$7.50	$3.91
$33.91	Pfizer	January 2003	$40.00	$ .95	$0
$33.91	Pfizer	January 2004	$40.00	$2.80	$0

A common misconception in the valuation of long-term options is that option value is best represented by its intrinsic value. Long-term options to purchase Pfizer stock through January 2003 for an exercise price (also called a striking price) of $30 per share were selling for $7.50 in June 2002. At that time, Pfizer stock was trading at the price of $33.91. The difference between the Pfizer stock price of $33.91 and the call options striking price of $30 represents the option's intrinsic value, which is $3.91. The intrinsic value represents the liquidation value of the option. Given that this option was actually selling for $7.50, $3.59 above its intrinsic value ($7.50 - $3.91), illustrates that traded options generally have a value beyond their intrinsic value.

It is also important to recognize that the expected holding period of an option will materially influence its value. The Pfizer option, which expires in January 2004, sells for $2.80, relative to $.95 for the identical option that expires a year sooner.

IT IS VITALLY IMPORTANT TO UNDERSTAND THAT OPTIONS HAVE SIGNIFICANT VALUE BEYOND THEIR INTRINSIC VALUE

In fact, options generally have value even when they are out of the money, as illustrated by the second Pfizer option. An out of the money option is one in which the exercise price of the option is greater than the market price of the stock. In the Pfizer example, the exercise price of the option is $40, and the current market price of Pfizer is $33.91. Thus, the intrinsic value for the option is $0. Negative intrinsic values have no economic meaning, as an investor would never exercise such an option. This illustrates yet another benefit of owning a stock option — the option holder's downside risk is limited to the cost of the option. However, investors were still paying $.95 for the right to purchase Pfizer stock at $40 per share for the next six months, while the actual share price is $33.91. This further reinforces the conclusion that the value of a traded option is greater than its intrinsic value.

THE VALUE OF NON-TRADED OPTIONS — EXECUTIVE STOCK OPTIONS

The valuation principles for traded options also apply to those of non-traded options, such as executive stock options. Certain valuation parameters are more difficult to estimate, but the underlying valuation concepts apply. The fact that executive stock options are non-transferable applies to their marketability, and thus their fair market value, not their inherent value to the holder. This is evidenced by the fact that executives will accept non-transferable stock options as a major component of their overall compensation package. Additionally, if executives truly viewed out-of-the-money executive stock options as having no value, then for equitable distribution purposes they should have no problem transferring potential proceeds to the non-titled spouse with little if any offset of other assets. However, this is rarely the case.

SPECULATIVE IN VALUE — IS THE BLACK SCHOLES VALUE OVERLY SPECULATIVE?

In contrast to the accounting profession, the Securities and Exchange Commission (SEC), and the Internal Revenue Service, and some courts have been reluctant to use the Black-Scholes option pricing model (BS-OPM) to value executive stock options. Courts that have rejected the BS-OPM as a tool in evaluating employee stock options for equitable distribution purposes base their reluctance on the fact that the Black-Scholes option pricing model provides a value, which is no more than a "mere expectancy."[3]

While we agree with the court that it is impossible to know what a stock will be worth on any future date, it is not the case that the present value of an unvested stock option cannot be measured with reasonable accuracy. For example, assume that an employee has Pfizer executive stock options which are out-of-the-money identical to those which are freely traded. Does the lack of marketability bring their value to zero when as traded they have a value of $2.80? We do not believe so. The lack of marketability will reduce value but having the option to purchase Pfizer stock for 18 months at a fixed price of $40 per share, even when the current share price is $33.91, is a valuable asset whose value can be determined with reasonable accuracy.

The Financial Accounting Statements Board in statement of financial accounting standards (SFAS) #123 requires firms to explicitly state the value of executive stock options.[4] In *Davidson v. Davidson,*[5] the court adopted the BS-OPM model based upon the accounting profession adoption of the BS-OPM. The accounting profession in 1995

formally recognized that executive stock options have an ascertainable value beyond their intrinsic value. In addition, the Black-Scholes option pricing model was recognized as an appropriate method to calculate the value of executive stock options by the accounting profession, as reprinted here:

> The Board's conclusion that recognizing the costs of all stock-based employee compensation, including fixed, at-the-money stock options, is the preferable accounting method stems from the following premises:
>
> a. Employee stock options have value.
> b. Valuable financial instruments given to employees give rise to compensation cost that is properly included in measuring an entity's net income.
> c. The value of employee stock options can be estimated within acceptable limits for recognition in financial statements.
>
> FASB states further that,
>
> An employee stock option has value when it is granted regardless of whether, ultimately, (a) the employee exercises the option and purchases stock worth more than the employee pays for it or (b) the option expires worthless at the end of the option period.
>
> The fair value of a stock option (or its equivalent) granted by a public entity shall be estimated using an option-pricing model (for example, the Black-Scholes or a binomial model) that takes into account as of the grant date the exercise price and expected life of the option, the current price of the underlying stock and its expected volatility, expected dividends on the stock (except as provided in paragraphs 32 and 33), and the risk-free interest rate for the expected term of the option.[6]

Appendix A shows the required stock option disclosure for Johnson & Johnson, as presented in their 1999 annual report. As indicated, Johnson & Johnson has 12 stock-based compensation plans with 80.5 million options outstanding at the end of 1999. The average fair value of the non-transferable executive stock options granted in 1999 was $30 per option, based upon the Black-Scholes option pricing model. In addition, it is important to recognize that the intrinsic value of these options is zero, as the options were granted at the money. However, the fair value is estimated to be $30 per option.

SECURITIES EXCHANGE COMMISSION DISCLOSURE

In addition, the disclosure format adopted by the SEC for long-term options issued to executives explicitly includes information on the value of granted executive stock options.

As stated by the SEC:

> As an alternative to use of hypothetical values, presentation of grant-date option values calculated through use of a recognized valuation formula, such as the "Black-Scholes" option-pricing model, will be permitted.

IRS REVENUE RULING 98-34

Recently, the IRS, in Rev. Proc 98-34, adopted the Black Scholes option pricing model as an appropriate valuation methodology when determining the value of executive stock options for gift and estate tax valuations. It is worth noting that marketability discounts are not allowed to account for the lack of transferability of executive stock options. The reduction in value is captured by using the options expected time to exercise not the time to expiration. The adoption of the Black Scholes option pricing model by the IRS is significant in that the methodology analysts use to value closely held businesses for equitable distribution also flow from IRS revenue rulings geared to estate and tax valuations.

VALUE BASED UPON TIME TO EXPIRATION OR THE EXPECTED HOLDING PERIOD

As discussed above in the Pfizer example, an option's value will increase as the time to exercise increases. This is because the potential for upside gain, through increases in the underlying stock price, increases based on the expected life of an option. However, executive stock options, which cannot be traded, will likely be exercised prior to their expiration date. Both financial theory and empirical evidence support this proposition. Thus, when valuing executive stock options, the expected time to exercise of the option should be the determining factor rather than the expiration date, in order to avoid overstating the option's value. As discussed below, using the expected life of an executive stock option may materially reduce the value of option relative to using its time to expiration.

We use the executive stock options granted by Johnson & Johnson in 1999 to show the impact of changing the expected holding period. Appendix A presents their financial statement stock option disclosure that provides the valuation parameters utilized to calculate option value. Johnson & Johnson used an expected life or holding period for the options of five years, which resulted in an option value of $30. If we change only the assumption regarding the expected life of the option, and assume that they will be exercised on expiration in 10 years, the value of the option would increase to approximately $40.

Thus, we can see the selection of an appropriate option life is an important valuation parameter. When determining the executive stock option value in an equitable distribution setting, one should examine the exercise history of the executive and, if possible, that of other executives at the firm. This analysis will help form an opinion of the expected life of the option so this important valuation input can be appropriately estimated.

WHEN ARE EXECUTIVE STOCK OPTIONS MARITAL PROPERTY?

As discussed above, an executive stock option is property in that it

provides the owner the right but not the obligation to buy shares of a specific stock within a designated time period at a designated price. Corporations choose to grant stock options to their employees for different reasons, such as: (1) to attract and retain personnel; (2) to compensate employees for past and/or future performance; and (3) to conserve cash.

Courts have found that stock options granted and vested during the marriage represent an asset subject to division upon divorce. Whether unvested options are marital property until vesting takes place through post-separation efforts is a controversial issue. A common theme running through case law is the issue of whether a particular option granted has been or will be earned for past, current, or future services. As stated in *Mayer v. Mayer*:

> When a substantial portion of the time and labor of a spouse has been expended during marriage to obtain retirement benefits but the right in retirement benefits has not yet vested, the worker has still accrued a valuable right in a contingent benefit. Likewise, although Michael would not have a vested right in the options unless he continued to work for Qual-Med after the divorce, his contract with Qual-Med provided a valuable right in a contingent benefit.[7]

In *Pascale v. Pascale*,[8] the wife received options for 5,800 shares of her employer's stock 10 days after filing a divorce complaint. She argued on appeal that 1,800 of the shares were issued in recognition of past performance, and the remaining shares were reflective of a job promotion, which would impose additional future responsibilities. The wife argued that the latter 4,000 shares should be considered non-marital because they were not a "fruit" of her marital efforts. The Supreme Court held that *all* of the shares were marital property because they all resulted from *efforts expended during the marriage.* The Court noted: "Like a spouse who cooks and cleans while one spouse rises to the top of a company, [husband] in his role as husband and father contributed in some way to wife's success."[9] Even though the options were granted shortly after the filing of the divorce complaint, the Court included them in the marital estate, thereby deterring manipulation of the timing of the grant of options to a date after the complaint was filed.

In the unpublished opinion in *Klein v. Klein*,[10] the husband argued that unvested Warner-Lambert options at the date of complaint should not be considered marital property, since continued employment at Warner-Lambert was required for the options to vest, indicating that the options were granted as an incentive for future work. The lower court decision that the unvested options should be included as part of the marital estate was affirmed. However, the language of the decision indicates that the classification of unvested options must be made on a case-by-case-basis. The court, in its ruling, relied on the language of the Warner-Lambert stock option plan and the annual grant letter, as well as the composition of Mr. Klein's overall compensation package. The court stated that:

> [t]here can be little doubt from the grant letter, the plan's terms giving a range of possible grants, and the annual award of a grant, that the options were intended to reward defendant's work for the year preceding the grant. Presumably, if the stock option plan were not in place, defendant would have expected or perhaps could have bargained for additional compensation for those periods. Such compensation would unquestionably have been subject to equitable distribution.

The *Klein* and *Pascale* rulings are examples of when the court was willing to look beyond the date the options were granted and focus on the time period relating to when the options were earned. For many executive stock option grants, the underlying forces which resulted in the option grant is a combination of past work performance coupled with an incentive to perform in the future.

In *Whitfield*, the Court summarized the issue in the following passages:

> The touchstone of this inquiry is not whether defendant's pension interest was vested at the time of the divorce but whether that interest constitutes property acquired during the marriage. In *McGrew* and *Kikkert*, we recognized a pension plan as a form of deferred compensation for services rendered. As a substitute for wages such benefits unquestionably constitute property.
>
> The includability of property in the marital estate does not depend on when, during the marriage, the acquisition took place. It depends solely on the nature of the interest and how it was earned.[11]

In the *Pascale* and *Klein* cases, vested and unvested options were classified as being earned during the marriage. Whether unvested options can have both a marital and non-marital component was not directly addressed. The language in both cases seems to allow for this possibility.

Virtually every stock option is conferred pursuant to a plan or agreement, which may be supplemented by documents, related to each particular round of stock option grants. These documents should be examined, because they may provide input into the purpose of the option grant. Additionally, upon analysis of the individual's work record it may be discerned that options granted shortly after separation replaced the existing options the individual had forfeited when changing jobs. The link between the old and the new options may result in the new options granted becoming classified as marital property.

THE COVERTURE RATIO: A PROPOSED SOLUTION TO THE EARNING DILEMMA?

Often it is concluded that executive stock options have been earned through a combination of past and future service. The growing trend is to treat stock options in the same manner as pensions, and use the time rule approach, which is similar to a coverture fraction in pension valuation. The coverture fraction is designed to capture the *efforts of the marriage* in determining the proportion of non-vested stock options that should be subject to property division. The basic format of a coverture ratio is shown below.

The number of months between the beginning of option holder's efforts to earn the option and the date of complaint

The number of months between the beginning of option holder's efforts to earn option and the date of vesting.

In a long-term marriage, when options are granted just prior to a complaint being filed, a change in the *coverture* ratio can dramatically alter the proportion of option value that is considered marital. For example, lets assume the following:

Date of Marriage	January 1, 1970
Date of Employment at Ace	January 1, 1990
Date of Option Grant	January 1, 1997 (options vest December 31, 2001)
Date of Complaint	January 1, 1998

Using the date of marriage or date of employment as the beginning date results in a coverture ratio that will capture most of the option value. The date of marriage coverture ratio would be 28/32 (87.5 percent) and the date of employment coverture ratio is 8/12 (66.7 percent). These coverture ratios would be upon a determination that the fruits of the marriage enabled the titled spouse to develop their career which ultimately resulted in executive stock options being granted.

If the date of the grant is utilized, this will result in a coverture ratio of 1/5 (20 percent). This coverture ratio would be appropriate if it is determined that the option is earned solely through the future efforts of the employee.[12]

RELOAD OPTIONS

When reload options exist, the matrimonial attorney must decide whether reloads which occur after the date of complaint represent marital property, and if so how to provide an equitable distribution of the property.

A reload feature automatically grants new options to the option holder when an existing option is exercised. New options are granted to replace the number of shares used to exercise the original option. Typically, the reload option has the same expiration date as the original option. The number of reload options has grown from 5.5 percent of option grants in 1992 to 11.7 percent of option grants in 1997.

For example, lets say Ms. Powers is granted 1,000 executive stock options with a one-time reload feature at December 31, 1996, with an exercise price of $15. The options vest at December 31, 1999, and have a 10-year life. On January 1, 2000, Ms. Powers decides to exercise her options and sell the underlying securities. The underlying stock is currently trading at $25 per share. The cost of the exercise is $15,000 (1,000 * $15). She pays for the exercise of her options by turning in 600 (600 * $25) of the 1,000 shares to be received. However, since the options have a reload feature, her employer will issue her an additional 600 options. These new options will have an exercise price of $25 and a seven-year life. The end result is that Ms. Powers then has netted the $10,000 through exercising her options and selling her 400 shares at $25 per share. She also has an additional 600 new options. Reload options can also be issued to cover the tax impact of an exercise that further enhances the value of compensation through reload options. One-time reload options can add as much as 25 percent to the value of a option without a reload feature. Many option plans allow for multiple reloads that further increase their value.

ISSUES RELATED TO DEFERRED DISTRIBUTION

The equitable distribution of executive option value can either follow an offset based upon the estimated value of the options at the relevant date, or a deferred equitable distribution upon exercise, often called an if and when distribution. Both of these distribution methods have strengths and weaknesses.

The offset method has the advantage of fixing value at the relevant date, whether it is the date of complaint or the date of the trial. However, this method imposes the full risk of a downturn in the value of the option to the titled spouse. The issue of the potential tax liability for unexercised options must also be resolved.

A deferred distribution for executive stock options was first handled in New Jersey through a constructive trust.[13] Using a constructive trust, the untitled spouse can instruct the titled spouse to exercise the options at a date chosen by the untitled spouse, subject to the terms of the plan under which the options were granted. The advantage of this method is that both the titled spouse and

the untitled spouse share in the gains and losses in the underlying security. A disadvantage to this method is that it does not afford a clean break at the date of divorce.

DRAFTING A DISTRIBUTION AGREEMENT

Most executive stock option plans forbid assignment of the rights created by the options granted. The rationale for this is that companies want to keep the options with the employees in the hope of keeping the employee with the company, as well as providing a performance incentive. The practical effect is that while a court may confer upon a non-employee spouse a right to the proceeds from a stock option, the options themselves are non-transferable. This tends to create drafting problems for the parties and the court, since the rights are to the option proceeds rather than the option themselves. Agreements or orders, following *Callahan* addressing future exercises should take into consideration:

- An explicit description of which options are marital and which are non-marital;
- A recitation of the terms for which the non-owner can compel the owner to exercise options after they have vested;
- A precise calculation of the tax consequences arising from the transaction. For example, are taxes to be measured based upon their incremental impact or the average tax rate paid by the owner in the year the options are exercised;
- What happens if the owner changes jobs and loses options;
- An explicit discussion addressing whether the option value captured as property will or will not be treated as income for child support and alimony;
- An explicit discussion addressing how reload options will be distributed if they exist.

TAXATION OF EXECUTIVE STOCK OPTIONS AND THE IMMEDIATE OFFSET METHOD OF DISTRIBUTION

When the option value is distributed through an immediate offset, the impact of tax upon future exercise must be considered. There are two types of executive stock options for purposes of federal taxation: incentive stock options (ISO) and non-qualified stock options (NQSO). Upon exercise of a NQSO, the difference between the underlying share price at the time of exercise and the exercise price becomes part of the employee's gross income, and is subject to tax at the prevailing ordinary income tax rates. The gain would also be subject to personal income tax at the state and local level.

Assets that are not being sold as part of a property division are generally not tax-affected for possible capital gains tax. This is because the factual basis for determining the tax is highly speculative. It may be appropriate to tax-effect NQSO for purposes of equitable distribution. The value of a NQSO at any point in time is based upon a gain occurring at the time of exercise. All option-pricing models use an explicit holding period in determining value. Given that the total option value is based upon that gain occurring at a specific point in time, and taxes must be paid at that time, it may be reasonable to tax impact this gain.

In other words, the tax impact from exercising options is based upon the same information that was used to value the option. However, it is also true that the prevailing tax rates at the time of exercise will not be known. Therefore, the certainty of the taxable event, along with the uncertainty of the precise tax impact at that event, must be balanced.

In contrast, the recipient of an ISO generally will not generate any taxable income when an ISO is granted or exercised. This tax advantage is viewed as the major benefit of an ISO relative to a NQSO. When the underlying stock is sold, the resulting gain will be taxed at either the prevailing long-term capital gains rate or the ordinary income tax rate, depending upon how long the option was held prior to exercise and sale. It is worth noting that the unrealized gain from the exercise of ISO is subject to the federal alternative minimum tax (AMT).

Overall, the tax characteristics of ISO are typical of many marital assets where latent capital gains may at a point in time exist, but it is highly uncertain when or if taxes will ultimately have to be paid.

Revenue Ruling 2002-22 now views the transfer of executive stock options if permitted by the option plan, pursuant to a divorce as a non-taxable event. When the option is exercised, Federal Insurance Contribution Act (FICA) and Federal Unemployment Tax Act (FUTA) taxes will be due by the non-employee spouse to the same extent as if the options were exercised by the employee spouse.

AVOIDING THE DOUBLE DIP

When options are valued as property, the analyst must be careful that the same options are not also viewed as income for purposes of support. Assume the titled spouse has unexercised options, which have been valued as property for purposes of equitable distribution. In addition, the options remain with the titled spouse as part of the property distribution.

Two years later, these same options are exercised, resulting in additional income for the titled spouse. It may be inappropriate to treat this income as part of the income stream used to determine spousal support. A divorce settlement agreement should be explicit in determining how future option income and tax liability will be characterized.

In *Murray v. Murray*,[14] the court opined that the vesting of executive stock options generates gross income for the calculation of child

support, even when those options are not exercised.

> The stock options at issue cannot be excluded from 'gross income' as 'non-recurring or unsustainable' sources of income or cash flow. The options are granted annually to appellant as an integral of his compensation package. We are not persuaded by appellant's argument that the options must be excluded from 'gross income' because they produce actual cash income only when exercised, but once exercised, they constitute nonrecurring income.

ADDITIONAL MARKETABILITY ISSUES

Executive stock options represent non-transferable assets. However, even after exercise it is possible that the resulting stock may not be marketable. When this is the case, a marketability discount may be appropriate.

An insider is defined as a matter of securities law. Because of the threat posed by investor lawsuits based upon inside information, it is quite common to subject executives and directors to some rather onerous restrictions in terms of when and how they may sell securities they hold in a corporation. In general terms, insiders are often not permitted to trade in certain 10-20 day windows, which are tied to the publication of quarterly earnings reports. There are also blackout periods in which they are prohibited to trade by reason of a Securities Exchange Commission investigation or in anticipation of a new stock or debt offering. The purpose of these restrictions is to prevent insiders from capitalizing on information that comes to them in their capacity as corporate executives, and which is not generally available to the public.

These types of restrictions may warrant some kind of marketability discount. The option to purchase a stock at $40 per share may seem quite valuable when it is trading at $50 per share, but unless the option holder has the right to sell the option, the value of the option may go unrealized, at least until a trading window opens. Rule 144 spells out the parameters under which an insider can sell their shares acquired through the exercise of stock options. A careful examination of liquidity considerations post-exercise will determine whether a marketability discount is warranted.

BASIC INFORMATION REQUEST FOR VALUING EXECUTIVE STOCK OPTIONS

In order to make a determination of when executive stock options have been earned and to determine their value the following information should be collected and reviewed:

Schedule of granted options between relevant dates, which indicate:

- Date of each option grant;
- Number of options granted at each date;
- Exercise price of options granted at each date;
- Expiration date for each set of options granted;
- Date of vesting for each set of options granted;
- Date and number of any options exercised;
- Grant date of exercised options.

Company information listed below will provide insight into why the firm awards executive stock options, how the firm values stock options, and provides further detail around the employee's compensation package.

- All short-term or long-term employee incentive plans covering the titled spouse;
- All employment agreements with titled spouse;
- All company plans, handbooks, memoranda, option award letters, etc., related to executive stock options granted;
- Copies of the firm's 10K and 8K;

The purpose of collecting employee background information listed below is to develop a better understanding of how the executive stock options fit into the overall compensation package of the individual. This information can be important in determining the type of coverture ratio, which might be applied to determine the percentage of option value, classified as marital.

- Educational history;
- Employment history;
- Date of hire of each full-time job;
- Name of employer;
- Date of promotions;
- Positions held;
- Brief job description of each position;
- Salary history indicating all forms of compensations. ■

ENDNOTES

1. *Forbes;* May 18, 1998.
2. *Investor Relations Business,* Sept. 11, 2000.
3. *E.g. Wendt v. Wendt,* D.N. FA 960149562S, CN. Super. (1998).
4. Statement of Financial Accounting Standards No. 123, Paragraphs 19, 75, 68, Financial Accounting Board, October 1995.
5. 254 Neb. 656, 578 N.W. 2d 848, 1998 WL 271334 (Neb.).
6. Statement of Financial Accounting Standards No. 123, Paragraphs 19, 75, 68, *Financial Accounting Board,* October 1995.
7. *Mayer v. Mayer,* NM Ct. App, Nos. 16663 & 16817 (May 1996).
8. 140 N.J. 583,(1995).
9. *Id.* at 609, 498.
10. A-5019-97T1 (N.J. Super. App. Div. 1999),
11. *Whitfield, supra* 44-47.
12. *See, Miller v. Miller,* 915 P.2d 1314 (Colo. 1996) and *DeJeus v. DeJeus,* 687, N.E.2d, 1319 (NY 1997) for further discussion of effort.
13. *See Callahan v. Callahan,* 142 N.J. Super. 323 (Ch. Div 1976).
14. 128 Ohio App. 3d. 662 (1999).

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Appendix A

Stock Option Disclosure In Johnson & Johnson's 1999 Annual Report

10 Common Stock, Stock Option Plans and Stock Compensation Agreements

On January 2, 2000 the company had 12 stock-based compensation plans. Under the 1995 employee stock option plan, the company may grant options to its employees for up to 56 million shares of common stock. The shares outstanding are for contracts under the company's 1986, 1991 and 1995 employee stock option plans, the 1997 non-employee directors' plan and the Mitek, Cordis, Biosense, Gynecare and Centocor stock option plans.

Stock options expire 10 years from the date they are granted and vest over service periods that range from one to six years. All options granted are valued at current market price. Shares available for future grants amounted to 3.0 million, 15.0 million and 22.7 million at the end of 1999, 1998 and 1997, respectively.

A summary of the status of the company's stock option plans as of January 2, 2000, January 3, 1999 and December 28, 1997, and changes during the years ending on those dates, is presented here.

The company applies the provision of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," that calls for companies to measure employee stock compensation expense based on the fair value method of accounting. However, as allowed by the statement, the company elected continued use of Accounting Principle Board

	OPTIONS OUTSTANDING	WEIGHTED AVERAGE EXERCISE PRICE
	SHARES IN THOUSANDS	
Balance at December 29, 1996	81,605	27.99
Options granted	13,053	60.40
Options exercised	(11,157)	16.76
Options cancelled/forfeited	(2,240)	36.44
Balance at December 28, 1997	81,261	34.51
Options granted	10,852	78.20
Options exercised	(11,414)	18.65
Options cancelled/forfeited	(2,304)	44.92
Balance at January 3, 1999	78,395	42.55
Options granted	13,113	97.87
Options exercised	(9,235)	23.84
Options cancelled/forfeited	(1,722)	55.53
Balance at January 2, 2000	80,551	53.40

(APB) Opinion No. 25, "Accounting for Stock Issued to Employees," with *pro forma* disclosure of net income and earnings per share determined as if the fair value method had been applied in measuring compensation cost. Had the fair value method been applied, net income would have been reduced by $116 million or $.08 per share in 1999 and $77 million or $.05 per share in 1998. In 1997, net income would have been reduced by $35 million or $.02 per share. These calculations only take into account the options issued since January 1, 1995.

The average fair value of options granted was $30.00 in 1999, $19.62 in 1998 and $17.50 in 1997. The fair value was estimated using the Black-Scholes option pricing model based on the weighted average assumptions of:

	1999	1998	1997
Risk-free rate	6.32%	4.52%	5.89%
Volatility	24.0%	22.0%	21.5%
Expected life	5.0 years	5.0 years	5.3 years
Dividend yield	1.13%	1.30%	1.43%

The following table summarizes stock options outstanding and exercisable at January 2, 2000:

	Outstanding			Exercisable	
Exercise Price Range	Options	Average Life (A)	Average Exercise Price	Options	Average Exercise Price
	SHARES IN THOUSANDS				
$8.00–$25.99	20,256	3.0	$22.05	20,198	$22.06
$26.02–$50.94	19,858	5.5	$37.42	12,649	36.16
$51.22–$75.53	18,583	7.6	60.07	4,131	55.90
$76.09–$104.41	21,854	9.4	91.29	294	83.06
$8.00–$104.41	80,551	6.4	53.40	37,272	31.07

Appendix B

The Basics of Executive Stock Option Valuation

There are five factors that affect the market value of traded options:

1. An option's intrinsic value
2. An option's time to expiration
3. The volatility of the underlying security
4. Market interest rates
5. Dividends

INTRINSIC VALUE

The intrinsic value of an option is the difference between the market price of the stock and the exercise price (striking price) of the option, and sets the floor for option value. As discussed above, there are many situations where option value will exceed its intrinsic value. This is because options provide an investor significant potential for gain while limiting the potential for loss. One cannot lose more than the cost of the option while the potential to earn large gains exists, if the underlying security goes up in value. This is because the option provides the holder the right, but not the obligation, to purchase the underlying security.

EXPECTED HOLDING PERIOD

The expected life of an option has a material impact on its value. The longer the time to expiration, the more valuable the option. A longer time to expiration increases the value of an option, since it provides more time for the share price to increase.

VOLATILITY

The greater the volatility of the underlying security's returns, the greater the likelihood a security will increase and/or decrease in price. For example, securities A and B may have provided investors monthly returns of two percent over the past five years. However, security A's returns may have varied from -10 percent to +14 percent in any given month, while security B's returns may have varied from –3 percent to +7 percent in any given month. We would say that security A returns are more volatile. The standard deviation of the underlying security's returns is generally used to measure volatility.

The greater the volatility of security returns, the greater the value of an option. This trait is often viewed as counter intuitive, as increases in the uncertainty of return (risk) is typically viewed as reducing value. However this is not true for options. Option losses are limited to the cost of an option, while potential gains are unlimited. Thus, increased volatility increases the potential for gain while not changing the potential for loss.

MARKET INTEREST RATES

Options allow the holder to enjoy the full benefit of an increasing stock price by only making a down payment (the cost of the option). Since one can gain from the growth in the stock price without paying full price for the stock, the funds not utilized to purchase the stock outright can be re-invested elsewhere and earn a return. As a result, higher interest rates will generate a greater option value.

DIVIDEND YIELD

Owning a long-term option does not entitle the owner to receive the dividends paid by the underlying security. The loss of the dividend income from owning an option rather than the underlying security detracts from the value of the option. The magnitude of the loss is dependent upon the size of the security's dividend yield and on the length of time the investor expects to forgo the dividend.

To summarize, the value of a stock option will change as follows when the factors listed below increase:

Factor	Change in Option Value
Current Stock Price	Increase
Stock Volatility	Increase
Time to Expiration	Increase
Market Interest Rates	Increase
Divident Yield	Decrease
Exercise Price	Decrease

THE BLACK-SCHOLES OPTION PRICING MODEL

The factors discussed above represent what is now called the Black-Scholes option pricing model. Fischer Black and Myron Scholes developed the model in 1973. [Fischer Black and Myron Scholes, "The Pricing of Options and Corporate Liabilities," *Journal of Political Economy*, May/June 1973, pp.647-659.] The mathematics of the Black-Scholes pricing model is complex, however financial analysts can program the model into financial calculators and computer spreadsheets for use. In 1997, the Nobel Prize in Economics was awarded to Myron Scholes and Robert Merton for their work on option pricing

models. Unfortunately, Fischer Black died in 1995 and Nobel Prize awards are not awarded posthumously.

In its original form, it was designed to determine the value of a European-style option. That is, an option that can only be exercised on its expiration date. Since 1973, the model has been modified so it can be applied to American call options, options that pay dividends and other derivative instruments. An American call option is one that can be exercised prior to expiration. The binomial option-pricing model is one such model that captures the differences between American options and European options.

To use the Black-Scholes option pricing model one must simply make estimates of the six inputs listed above. Several of the inputs, namely the underlying stock price, market interest rates and the option's exercise price, are known and not subject to estimation bias. The future dividend yield and volatility of the underlying stock are generally estimated based upon the security's past performance with regard to these parameters. The time to expiration is known for traded options. However, when valuing non-traded options such as executive stock options, one must use the expected time to exercise not the time to expiration.

Appendix C

Glossary of Executive Stock Option Terms

Fair Value of an Executive Stock Option: The price an executive stock option could be bought or sold for in an open market transaction. Generally accepted accounting principles (GAAP) now require firms to estimate and disclose the fair value of executive stock options they have granted. The disclosure is required for both vested and unvested options.

Grant Date: The date an executive stock option is awarded to an employee. The award creates a contingent asset for the employee.

Intrinsic Value: The amount by which the market price of a security exceeds the exercise price of an option. The intrinsic value cannot be negative.

Coverature Ratio: A ratio designed to determine the proportion of option value subject to equitable distribution. It is generally employed when an executive stock option vests after the date of complaint.

In the Money: An option is in the money when the underlying stock price is greater than the exercise price of the option. An in-the-money option will have a positive intrinsic value.

Out of the Money: An option that is out of the money has an exercise price that is greater than the underlying share price. The intrinsic value of such an option is zero.

At the Money: The exercise price of an option equals the share price of the underlying security the option is denoted as being at the money.

Reload Option: A option which automatically grants new options to the option holder when the existing option is exercised. The exercise price is paid with shares of stock resulting from the exercise.

Time to Expiration: The contractual time remaining that allows the holder of an option to exercise the option.

Expected Holding Period: The expected time remaining before an option will be exercised. Generally, executive stock options have an expected holding period less than the time to expiration.

Executive Stock Option: A stock option which is part of an employee's compensation package. They are always call options, that is, they provide the employee the right but not obligation to purchase the underlying security at a fixed price for a fixed time frame.

Time Value: The component of option value beyond its intrinsic value.

Volatility: The scale fluctuations in returns of a security are called its volatility. The greater the volatility, the greater the risk. Volatility is typically measured by the standard deviation of returns.

ISO: When an executive stock option grant qualifies for certain federal tax benefits it is classified as an incentive stock option. The major tax benefits are the delay in a taxable event until the underlying security received through exercise is not realized until that security is sold. Furthermore, the gain from selling the underlying security will be treated as a long-term capital gain.

NSQ: When an executive stock option does qualify as been classified as an ISO it is called a non-qualified stock option. Recognition of taxable income occurs when the option is exercised.

LAW OFFICE MANAGEMENT

LAW CLERK REFERRAL PROGRAM

The Law Clerk Referral Program links young lawyers or law students who are seeking hands-on experience with firms in need of part-time or full-time office assistance.

This **free** employment service is offered in cooperation with the New Jersey State Bar Association's Law Office Management Committee and Young Lawyers Division, Rutgers Law School — Camden, Rutgers Law School — Newark and Seton Hall University School of Law.

Participating employers must be members of the State Bar Association.

Call NJSBA Member Services at 732-249-5000 for an employer registration form or for more information about the many other benefits of membership and mention code SCTN.

Young lawyers and law students seeking more information about the Law Clerk Referral Program are also encouraged to call.

NEW JERSEY STATE BAR ASSOCIATION

New Jersey Law Center • One Constitution Square • New Brunswick, NJ 08901-1520

FAMILY LAW

* SECTION *

Annual Retreat

Santa Fe, New Mexico

April 2–6, 2003

Family Law Section members will enjoy the scenic beauty and rich cultural diversity of Santa Fe, New Mexico from April 2–6 when the group holds its annual family law retreat in America's oldest capital city.

The retreat will feature continuing legal education programming on family law topics.

New Jersey family court judges, attorneys and forensic accountants are among the presenters scheduled. The seminar topics include favorite trial and motion techniques, family law hot tips and the latest developments in forensic accounting. Santa Fe offers a relaxing informal atmosphere for continuing legal education and networking. Programs with CLE credits are included with registration.

Attendees will stay at La Posada de Santa Fe Resort and Spa. Set on six landscaped acres in a village of adobe-style suites, La Posada resort is designed in the Old World and Spanish colonial style. The resort features the 4,500 square-foot Avanyu Spa, a heated outdoor pool and a cardiovascular workout and exercise room. The hotel also offers many complimentary activities that vary from day-to-day such as bike tours, morning walks, and Santa Fe history and culture walks.

Registration for the family law retreat includes social and entertainment activities. A welcome reception at La Posada is planned for the first evening and the Santa Fe Bar Association will host a cocktail reception on the second night. After the reception, there will be a dinner for NJSBA attendees at the Coyote Café. The next evening includes a scenic train ride on the Santa Fe Southern Railway followed by a catered western-style dinner with live entertainment in northern New Mexico's high desert. Plans for the fourth evening include a cocktail reception at the Hemington Art Gallery.

Known for its cultural heritage and ethnic diversity, Santa Fe has more than 225 restaurants and 250 art galleries. The city is recognized as a shopper's paradise with unique retail shops and boutiques, outlets and shopping malls. Much of the merchandise is made in Santa Fe and the Southwest, including specialty food products, clothing, jewelry, woven and leather goods, pottery and solid wood furniture.

Spring temperatures in Santa Fe range from the low 60s to the mid-30s.

Family Law Section Annual Retreat

REGISTRATION FORM

MAIL: NJSBA, One Constitution Square, New Brunswick, NJ 08901-1520
or **FAX:** Information Services, 732-249-2414

Your registration fee includes:

- Programs with CLE credits
- Welcome reception at La Posada
- Dinner at Coyote Café
- Cocktail reception at one of Santa Fe's finest art galleries.
- Scenic train ride on the Santa Fe Southern Railway, followed by a catered western-style dinner and a live band.

	PER PERSON FEE	NUMBER OF ATTENDEES	SUBTOTAL
Member	$500		
Guest	$350		
Children (up to 15 yrs.)	FREE		
Children (over 16 yrs.)	$350		

Name _____

Guest _____

Children (up to 15 yrs.) _____

Children (over 16 yrs.) _____

Registration Fee Total _____

Please charge my ☐ Visa ☐ MasterCard

Name on Card _____

Acct. No _____ Exp. _____

Signature _____

☐ Enclosed is my check made payable to the New Jersey State Bar Association

New Jersey State Bar Association
Family Law Section Annual Retreat

HOTEL REGISTRATION FORM

Do not send this form or payment for hotel rooms to the NJSBA

Phone or fax your registration to:
PHONE: 800-727-5276 *or* 505-986-0000
FAX: 505-986-9646

or mail your registration to:
La Posada de Santa Fe Resort & Spa
330 East Palace Avenue
Santa Fe, New Mexico 87501

Name _____

Guest _____

Arrival date _____ Departure date _____

Deposit equivalent to one night's room charge payable upon registration; balance due at checkout.

Acct. No _____ Exp. _____

Name on Card _____

Signature _____

☐ Enclosed is my check made payable to La Posada de Santa Fe Resort & Spa

Book early, as GROUP RATE rooms will only be available until March 9, 2003. Reservations received after the cutoff date of March 9, 2003, will be accepted on a space-available basis.

*Deluxe Room: $229 + 11.4375% tax/per night
*King or Queen with fireplace and/or patio
Children under 15 years of age – no charge
Over 16 years of age, please contact the reservations department for costs.

Facts:

- **Alcohol is the most widely used and destructive drug in America.**
- **Cocaine use causes marked personality changes; users become impatient, suspicious and have difficulty concentrating.**
- **Marijuana affects memory, concentration and ambition.**
- **Early intervention with alcohol and drug problems most often leads to complete recovery.**
- **Attorneys can and do suffer from alcohol and other drug abuse problems.**

NJLAP wants to help. You only need to call.
1.800.246.5527

Free, confidential help is available for you or a lawyer you know who has problems with alcohol or drugs. Assessment sessions are available to help define the problem and to recommend a helping hand.
Our conversations are understanding of your need for confidentiality.

NEW JERSEY LAWYERS ASSISTANCE PROGRAM

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