# Divorce and Executive Compensation: Issues to Consider with Employee Stock Awards and Carried Interest

by David A. Typermass, CFA® and Kyle J. Cox, CFA®, Financial Advisors with the Tremont Group at Morgan Stanley

One of the great things about being a financial advisor is that we learn something new every time we meet with a prospective client. Everyone has a unique story to tell and a different set of financial circumstances. One area we find fascinating is the constantly evolving world of executive compensation for highly paid individuals. Forecasting potential future returns on assets is inherently difficult but becomes even more challenging when the assets are illiquid, have uncertain vesting schedules, and need to be analyzed in the context of a divorce. Executive compensation comes in many forms and this article will focus on three of the more complex areas: employee stock options, restricted and performance stock, and carried interest. We will discuss our process in dealing with these types of equity compensation and highlight some issues we believe family law practitioners should consider as they grapple with these complex forms of executive compensation.

## Employee Stock Options

We work with many clients who have employee stock options at publicly traded companies. Part of our job is to advise our clients as to when they should exercise these options. In order to make this determination we will first go through a discovery process, gather and review current statements, transaction history and stock option agreements which provide relevant information such as grant dates, number of shares the options will purchase, the strike price, and the vesting schedule. We will incorporate this information into a financial plan as we talk to our clients about their risk tolerance and their views on their company. Our goal is to evaluate how the options fit within their overall financial picture and to make sure they appreciate the risks and rewards. If their wealth is heavily concentrated in their company stock and stock options we will discuss the pros and cons of diversification and hedging strategies.

We will want to consider whether or not the client's employee stock options are incentive stock options ("ISOs") or non-qualified stock options ("Non-quals" or "NSOs"). With NSOs the spread between the stock price and the exercise price is federally taxable at ordinary income rates, which can be as high as 37% for top earners. The spread on ISOs, on the other hand, may be taxed at lower long-term capital gains rates.[1] ISOs have an additional advantage of not being taxable until the stock received on exercise is sold, while with NSOs the spread is taxable immediately upon exercise.[2]

Once we have completed our discovery we will work with the client to develop a selling strategy. There is no rule of thumb for the ideal time to exercise a stock option and the process is more art than science. Once an option is vested and "in the money", i.e., the current market price

---

[1] Profit on the sale of ISOs is taxed as long-term capital gains provided that the stock is sold at least 2 years after the grant date and one year after exercise.

[2] However, clients need to consider the potential impact of the Alternative Minimum Tax (AMT) with the exercise of incentive stock options (ISOs). They should consult with their tax advisors.

exceeds the exercise price, there are many different approaches one could take. First, it is important that our clients understand that the value of an option includes not only its intrinsic value, the difference between the market value of the stock and the option's exercise price, but also its time value, the premium over the intrinsic value based upon the amount of time the option has until expiration.[3]

Selling the options immediately upon vesting, or right before they expire, are rarely good strategies. As the options approach their expiration date there is very little time value left and you run the risk of the stock price declining and the option expiring worthless. One could exercise immediately upon vesting but the options may have little intrinsic value and you might risk leaving significant time value on the table. As advisors we also avoid setting arbitrary rules for the client to exercise the options at a set time, say one or two years before the expiration date.

In his book *Consider Your Options*, Kaye Thomas writes that option holders should exercise their options when the advantage of protecting their profit (intrinsic value) outweighs the disadvantage of abandoning the remaining time value.[4] This may be a good approach; if the company's stock price is a lot higher than the exercise price then chances are the intrinsic value is far greater than the remaining time value. That being said, each client needs a thoughtful customized approach, taking into consideration taxes, while balancing the need for diversification against the potential upside in holding the options.

During a divorce in which a spouse is entitled to a share of employee stock options, a financial advisor can assist that spouse and their attorney in evaluating the potential future cash flows that would derive from those options. Running scenario analyses through our financial planning software, we can help the spouse and attorney better appreciate the risks and rewards inherent in the options. Understanding these types of issues and the optimal asset and support mix for their client should provide the attorney with a leg up during settlement discussions.

**Restricted and Performance Stock**

Restricted stock and restricted stock units (RSUs) gained in popularity as a form of equity compensation relative to stock options in large part because they are easier for the employees to understand and value. [5] This trend accelerated following a 2006 rule which required companies to expense options based compensation. [6] Restricted stock and RSUs, can vest on a ratable schedule, or partial basis, over a period of years, such as 25% per year over four years. They can also vest all at once on a future date, this is known as cliff vesting.

One of the shortcomings of restricted stock is that the employee receives them as long as they remain employed, regardless of company performance. In order to better incentivize employees, performance stock and performance stock units are increasingly used. Performance stock and PSUs are awards whereby the number of shares received will vary depending on the company

[3] An option that has intrinsic value is often referred to as an "in the money" option and an option that has no intrinsic value is often referred to as "underwater" or "out of the money".

[4] Kaye A. Thomas, *Consider Your Options*, 2019 Edition, Chapter 12.

[5] There are some advantages of restricted stock over RSUs including, but not limited to, voting and dividend rights and the ability to make an 83(b) election under the Internal Revenue Code.

[6] FAS 123R Financial Accounting Standards Board (FASB).

achieving certain goals. For example, on 12/1/2019 a company grants an executive 1000 PSUs with a vesting date of 12/1/2022. Per the PSU agreement the actual number of shares awarded in 2022 will vary based on how the company performs on its earnings per share target at the end of this three-year performance period and contains a schedule of potential multiples to be applied to the 1000 PSU award. The executive might receive 2000 shares because the company significantly exceeded its target earnings (a 2x multiple) or they could receive zero shares if the company's earnings were far below the target (a 0x multiple).

Similar to stock options, when a client has restricted or performance stock (or units) we will want to review the relevant stock plan agreements and the transaction history. We can model the shares into the client's financial plan, and run different scenarios for future stock prices and the number of shares the performance shares or PSUs may yield. We can map out with the client a selling strategy that is appropriate given their risk tolerance, concentration in company stock, financial goals and taxes.

**Carried Interest**

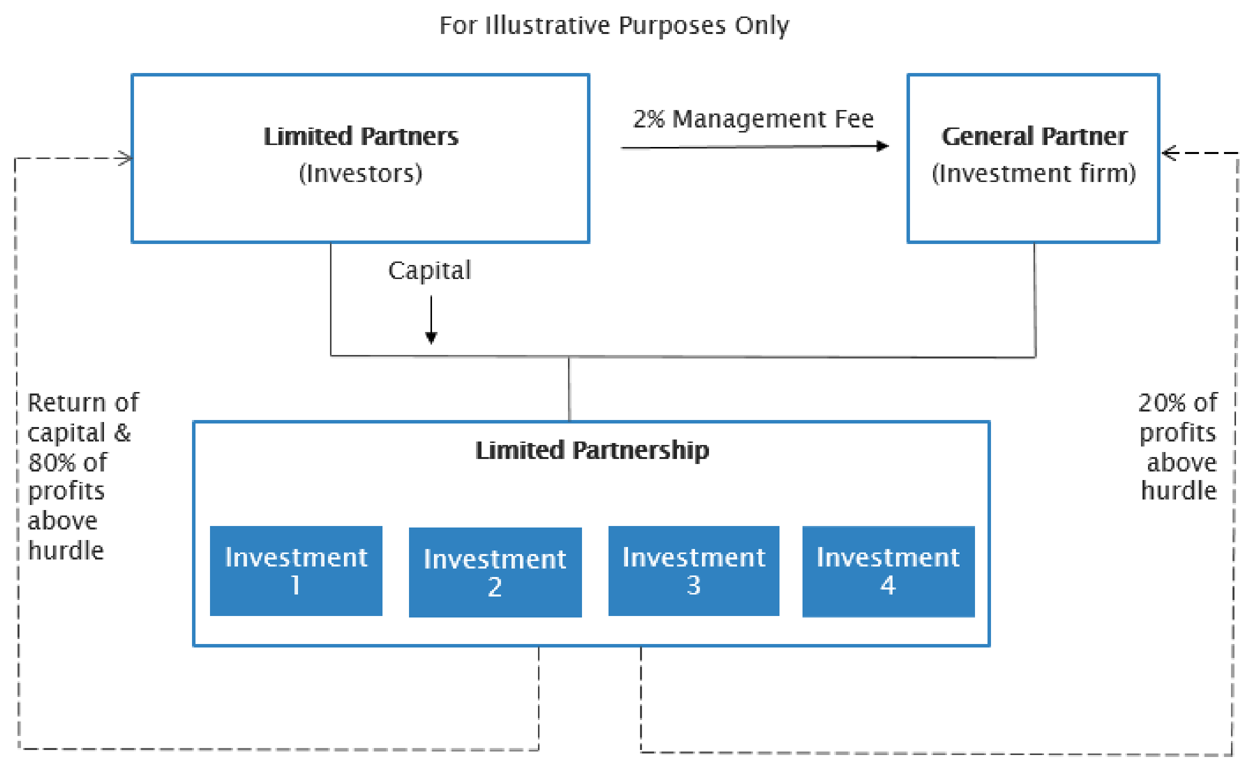
Forecasting the future income for certain investment professionals is challenging in large part due to the form of compensation known as carried interest. Carried interest, or carry, is a performance or incentive fee paid to investment firms. [7] The fee is a share of the profits, often around 20%. Note that the carry may not be paid to the investment firm if the return fails to clear a hurdle rate of return, often 7% or 8%, as applicable.

Certain investment structures are set up as Limited Partnerships. The investment firm is usually the General Partner or the Manager (GP) and the investors are the Limited Partners (LPs). LPs can be high-net worth individuals, or institutions, like a college endowment or pension fund. When a limited partner commits capital to an investment, that investor typically agrees to pay a management fee to the GP in addition to agreeing to pay the incentive fee. The colloquial term for these two payments in the industry is "two and twenty". The two refers to the 2% management fee the investor pays the GP to do their job, the twenty refers to the GP's incentive fee (carried interest).

As an example, let's assume an investment firm creates a new opportunity and receives capital commitments from a group of limited partners. Over the next several years, the investors will provide capital to the fund. The GP or investment manager will take the capital and allocate accordingly. During the lifetime of the investment, the GP intends to exit some of the positions in the underlying companies and return capital to the LPs along the way. Of the profit, 80% went to the limited partners and 20% went to the GP.

---

[7] The term carried interest dates back to shipping in the 16th and 17th centuries, when European shipping captains carrying cargo across the oceans to Asia and the Americas would take 20% of the value of the cargo. *Inside Private Equity*, James Kocis, James C. Bachman IV, Austin M. Long III, Craig J. Nickels, Wiley Finance, 2009.




In addition to the variability of their employment income, these investment professionals may participate themselves and accumulate over time a portfolio of investments managed by their firm.

When we build financial plans for our clients, we attempt to forecast the cash flows they are likely to receive from their carried interest and individual stakes in their investments. Again, this is often more art than science requiring many assumptions. We will typically run multiple analyses looking at base, best and worst case scenarios.

For well-established investment firms with decades long track records, estimates of the value of "carry" can be more predictable than younger firms with less of a track record. The specific strategy of the investment also matters. For example, a firm might invest in early-stage, speculative companies with investment outcomes that can range from abysmal to spectacular.

**How Financial Advisors Can Help**

A financial advisor with an understanding of the divorce process and the various forms of executive compensation can help attorneys and their divorcing clients evaluate their various settlement and support options. By running scenario analyses and cash flow projections we can provide insight into which mix of assets would best fit within a client's overall financial profile and goals while taking into consideration the clients their risk tolerance. These types of projections are also helpful in assessing what the income stream may be, for both the payor and recipient, under various potential support scenarios. Dividing assets in-kind on an "if as and when basis" may be the simplest approach with complex hard to value assets but is not always ideal. The non-titled spouse may have a different appetite for risk and need for liquidity.

**David Typermass** is a Financial Advisor with the Tremont Group at Morgan Stanley. Prior to joining Morgan Stanley, David worked at Bronstein Van Veen, a family law firm, where he represented high net worth individuals and families. Before that he worked as an equity research analyst with Alliance Bernstein and Dresdner Bank and as a fixed income research analyst with MetLife Investments. David is a graduate of Stanford University (cum laude) and Cornell Law School. He is a CFA® charterholder, a Certified Divorce Financial Analyst ®, and a non-practicing member of the Boston Bar Association, the New York Bar Association, and the State Bar of California.

**Kyle Cox** is a Financial Advisor with the Tremont Group at Morgan Stanley. With over 14 years of experience in the financial services industry, he builds investment portfolios and financial plans for corporate executives in the technology, bio-tech, and finance industries. Kyle grew up outside Chicago before heading east to earn his B.A. in Economics at Trinity College. After College, he worked as an equity analyst and portfolio manager at Hagin Investment Management, a New York City based hedge fund. During that time, he became a CFA® charterholder.

Morgan Stanley Smith Barney LLC offers a wide array of brokerage and advisory services to its clients, each of which may create a different type of relationship with different obligations to you. Please visit us at https://advisor.morganstanley.com/the-tremont-group or consult with your Financial Advisor to understand these differences.

Morgan Stanley Smith Barney LLC ("Morgan Stanley"), its affiliates and Morgan Stanley Financial Advisors or Private Wealth Advisors do not provide tax or legal advice. Clients should consult their tax advisor for matters involving taxation and tax planning and their attorney for matters involving trust and estate planning and other legal matters. The use of the CDFA designation does not permit the rendering of legal advice by Morgan Stanley or its Financial Advisors which may only be done by a licensed attorney. The CDFA designation is not intended to imply that either Morgan Stanley or its Financial Advisors are acting as experts in this field.

The information contained in article is not a solicitation to purchase or sell investments. Any information presented is general in nature and not intended to provide individually tailored investment advice. The strategies and/or investments referenced may not be suitable for all investors as the appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. Investing involves risks and there is always the potential of losing money when you invest. Morgan Stanley and its Financial Advisors do not provide tax or legal advice. Information contained herein has been obtained from sources considered to be reliable, but we do not guarantee their accuracy or completeness. The views expressed herein are those of the author and may not necessarily reflect the views of Morgan Stanley Wealth Management, or its affiliates. Morgan Stanley Smith Barney, LLC, member SIPC. Rebalancing does not protect against a loss in declining financial markets. There may be a potential tax implication with a rebalancing strategy.  Investors should consult with their tax advisor before implementing such a strategy.

CRC 2762764 11/19