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OPTIONS DAMAGES: DANGEROUS ASSIGNMENTS WITH A TWIST

Frederick W. Rosenberg[1]

An option is a derivative security whose value depends on the market price and volatility of the underlying stock and the time value until expiration. A call option gives the purchaser the right to take 100 shares of the stock from the seller at a given strike price, and a put option gives the purchaser the right to deliver 100 shares of stock to the seller at the strike price in the future. The intrinsic value of a call option is the difference between the market value of the stock and the strike price, with any excess being time value. As expiration nears, the time value of the call option steadily decreases to zero at expiration.

By selling (writing) a call option, the "Writer" receives a premium in exchange for the Purchaser's right to take the stock at the strike price prior to expiration. When the seller of the option holds the stock, the call option is referred to as a "covered" call. With a covered call, the risk to the writer is limited to being obligated to sell the shares held at the strike price between the date the option is written and the expiration date. That risk is an opportunity loss and is limited to the difference stock price at the time the option is exercised and the strike price. If the stock price increases above the strike price before expiration, the value of the call option increases and the Writer must either repurchase the option or the shares will be assigned at the strike price. When the market price of the underlying stock is below the strike price at expiration, the call option will expire worthless and the Writer keeps the premium and the stock.

Writing out-of-the-money call options frequently has been used as a portfolio strategy to generate premium income through expiration of out-of-the money calls.[2] Writing in-the-money calls increases premium but likely

1. For additional information on covered calls, see Frederick W. Rosenberg, *Analyzing Covered Call Writing Claims*, 13 PIABA B.J. 30 (2006)

2. A call option is considered "out of the money" (OTM) when the strike price is greater than the market price of the stock. A call option is considered "in the money" when the market price of the stock is greater than the strike price.

assures the stock will be assigned (exercised) unless repurchased. Unfortunately, when misapplied, the strategy can lead to substantial and unexpected losses and tax consequences. Calculating those losses requires careful analysis as will be discussed in the following study based upon an actual case.

Covered call writing is often recommended as a low-risk means of generating premium income without loss of shares, particularly for retired executives with large positions in low-basis company stock or trusts or family accounts with large positions in low-basis stock. Commonly, an executive retires with thousands of shares of company stock that were accumulated at a very low cost. Upon retirement, the executive, who is still in love with the company, transfers those shares to a brokerage firm at a market price that is well above cost. Despite the overconcentration, the executive specifically states their objective is to hold all the shares for appreciation and to avoid having to pay taxes on the gains. The broker advises a "conservative" call option writing strategy to generate additional return (in the form of premiums on the sales of the options) without putting the shares in jeopardy. The growth the executive was hoping for occurs, but the gains in the stock were impaired by in-the-money short positions taken on the entire holdings. To preserve the position, the broker buys back the short calls at a substantial and quantifiable loss.

But, what if the options are assigned? An assignment is an exercising of the call option by the buyer who takes delivery of the shares at the strike price. Every in-the-money option will be assigned at expiration unless the short call option position is bought back and closed out. Furthermore, all in-the money options can be exercised any time prior to expiration, which often happens as here.

How are damages usually calculated? The short option is zeroed out resulting in an option profit, and the shares are delivered well below market price but still at profit when measured by cost or transfer price. Consequently, unless you know the market price of the stock on delivery and the strike price in addition to the option price at exercise you will not be able calculate the lost value caused by the short calls since both positions are profitable. I have calculated lost value as "Phantom Cost" in the attached exhibit. In summary, assignments hide options losses, intentionally or not, that would have been identified had the position been bought back prior to exercise.

Here is an illustration of the problem based upon facts from an actual case. A husband retired from UPS with 30,000 shares of UPS stock at a cost basis of $12 per share, (total cost basis of $360,000). At retirement, the price of UPS was $73 per share, which meant that the shares of stock had a market value of $2,190,000. The brokerage firm opened separate accounts for the husband and wife and divided the shares equally between the husband and wife's separate accounts (15,000 shares each). The broker advised the husband and wife to utilize a covered call program and instituted the program in both accounts. The broker ultimately began shorting long expirations and deep in the money calls to churn the premium and ultimately shorted the call LEAPS with expirations over a year seen in the illustration. Damages ensued.

The attached exhibit simplifies the data extracted from that case into a single comparison for illustration purposes. Except for the assignment in the Wife's account, the activities were identical. Both transferred 15,000 shares valued at $1,095,000 (at $73 per share). Both wrote the identical call for 6,000 shares taking in $60,834 in Premium. The wife's account experienced an assignment of the 6,000 shares well before expiration triggering unplanned for taxes on the gain. Both accounts closed out the same time and both accounts showed virtually identical profits, $336,366 and $339,373.

The husband's account is easy to assess. He made an unrealized profit on his stock and suffered ($57,834) in losses when he bought back the call at a loss. The wife's account is not quite so easy. As you can see, traditional computations now show the option to be profitable when it was not. The option's monetary losses were netted into the profits realized from the sale of low-basis UPS stock called away on November 11, 2013 at $80, $19.28/share below market ($115,680). The husband's repurchase cost was $118,668, for a loss of ($57,834). Consequently, the wife's erroneous options profits of $60,834 must be adjusted to reflect the phantom cost of the option to properly calculate option damages, ($54,846), to equate to the husband's loss on the same closing transactions. Otherwise her analysis would show no NOP loss whatsoever on Assigned calls using normal damage calculations.

Now here is the twist I alluded to in the title. Merely asking for the money damages as with the husband, would seem to be equally appropriate for the wife, *but it is decidedly not!* Focus on the November 12, 2013 transfers-out for both the husband and the wife and it should be immediately clear. The husband transferred out 15,000 shares worth $1,489,200, while the wife after her repurchase only transferred 13,835 shares worth $1,373,539, which is a difference of ($115,661) at closing prices attributable solely to the assigned 3,000 shares taken from her. Despite equal monetary damages and assuming a repurchase of UPS stock, the wife's account ends up with 1,165 fewer UPS shares, with a value of ($115,666) less than her husband. This equates to an additional loss more than double her adjusted option loss of ($54,840) and brings her total losses to ($170,507), which is nearly triple that of the husband ($57,834). It cannot be said that her damages equate to his. On accounts with multiple assignments the unrecognized losses in options and share loss can be substantial.

In cases with options assignments, particularly covered call cases pertaining to retired executives' company stock, the traditional profit and loss analyses are woefully deficient, and the statements of claim in such cases must incorporate demands for restitution of shares lost through assignment or liquidated to repurchase the calls as the principal claim when the facts support doing so. The husband lost a quantifiable amount. The wife also lost about the same amount after analysis, but she also lost the equivalent of 1,165 shares and arguably is entitled to their restoration regardless of price.

Over the past few years I have seen several instances where attorneys have declined options cases or advised small settlements based upon apparent minimal NOPs, but where, like the wife's account, there were multiple assignments hiding options losses and where share loss was substantial and unrecognized. When evaluating an options case where the broker allows multiple assignments mere monetary damages will be inadequate. Account analyses must not simply attribute option losses, but must also track shares lost to the strategy that would otherwise have been held but for the strategy. The wife lost more than money, she also lost 1,165 shares unnecessarily and her pleadings need to reflect that loss if restitution is to be obtained.

Assignment vs. Buy Back Options Comparison

Executive Retiree

Acct Name: Husband

UNITED PARCEL SERVICE-B

Equities **UNITED PARCEL SERVICE-B**

Plug	Date	m2m Tfr In	m2m Tfr Out	Asgn Exer	Exp		B/S	Bt	Sld	Net Pos'n	price	Amount	stk@mkt	in/out-of-money	Days to Exp	Phantom Cost	(Phantom Loss) / Adj Gain
☐	15-Apr-11	☑	☐	☐	☐		Buy	15,000	0	15,000	73.00	($1,095,000)				$0	
☐	12-Nov-13	☐	☑	☐	☐		Sell	0	15,000	0	99.28	$1,489,200				$0	

UNITED PARCEL SERVICE-B	Buys	($1,095,000)	Sells	$1,489,200	P/L	$394,200	$0	$394,200
Equities	Buys	($1,095,000)	Sells	$1,489,200	P/L	$394,200	$0	$394,200

Options **UNITED PARCEL SRVC CALL 15-01 $80**

Plug	Date	m2m Tfr In	m2m Tfr Out	Asgn Exer	Exp		B/S	Bt	Sld	Net Pos'n	price	Amount	stk@mkt	in/out-of-money	Days to Exp	Phantom Cost	(Phantom Loss) / Adj Gain
☐	07-May-13	☐	☐	☐	☐	Open	Sell	0	6,000	-6,000	10.14	$60,834	88.66	$8.66	618	$0	
☐	11-Nov-13	☐	☐	☐	☐	Close	Buy	6,000	0	0	19.78	($118,668)	99.28	$19.28	430	$0	

UNITED PARCEL SRVC CALL 15-01 $80	Buys	($118,668)	Sells	$60,834	P/L	($57,834)	$0	($57,834)
Options	Buys	($118,668)	Sells	$60,834	P/L	($57,834)	$0	($57,834)

Husband	*UNITED PARCEL SERVICE-B*	Buys	($1,213,668)	Sells	$1,550,034	P/L	$336,366	$0	$336,366

Assignment vs. Buy Back Options Comparison

Executive Retiree

Acct Name: Wife

UNITED PARCEL SERVICE-B

Equities **UNITED PARCEL SERVICE-B**

Plug	Date	m2m Tfr In	m2m Tfr Out	Asgn Exer	Exp	B/S	Bt	Sld	Net Pos'n	price	Amount	stk@mkt	in/out-of-money	Days to Exp	Phantom Cost	(Phantom Loss) / Adj Gain
☐	15-Apr-11	☑	☐	☐	☐	Buy	15,000	0	15,000	73.00	($1,095,000)				$0	
☐	11-Nov-13	☐	☐	☑	☐	Sell	0	6,000	9,000	80.00	$480,000	99.28	$19.28		($115,680)	
☑	12-Nov-13	☐	☐	☐	☐	Buy	4,835	0	13,835	99.28	($480,000)				$0	
☑	12-Nov-13	☐	☑	☐	☐	Sell	0	13,835	0	99.28	$1,373,539				$0	

UNITED PARCEL SERVICE-B **Buys** ($1,575,000) **Sells** $1,853,539 P/L $278,539 ($115,680) $394,219

Equities **Buys** ($1,575,000) **Sells** $1,853,539 P/L $278,539 ($115,680) $394,219

Options **UNITED PARCEL SRVC CALL 15-01 $80**

Plug	Date	m2m Tfr In	m2m Tfr Out	Asgn Exer	Exp		B/S	Bt	Sld	Net Pos'n	price	Amount	stk@mkt	in/out-of-money	Days to Exp	Phantom Cost	(Phantom Loss) / Adj Gain
☐	07-May-13	☐	☐	☐	☐	Open	Sell	0	6,000	-6,000	10.14	$60,834	88.66	$8.66	618	$0	
☐	11-Nov-13	☐	☐	☑	☐	Close	Buy	6,000	0	0	0.00	$0	99.28	$19.28	430	($115,680)	

UNITED PARCEL SRVC CALL 15-01 $80 **Buys** $0 **Sells** $60,834 P/L $60,834 ($115,680) ($54,846)

Options **Buys** $0 **Sells** $60,834 P/L $60,834 ($115,680) ($54,846)

Wife *UNITED PARCEL SERVICE-B* **Buys** ($1,575,000) **Sells** $1,914,373 P/L $339,373 ($115,680) $223,693

Total Buys ($2,788,668) Sells $3,464,407 Inc P/L $675,739 ($115,680) $560,059

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