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Joseph Wojciechowski

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a publication

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OPTIONS DAMAGES: DANGEROUS ASSIGNMENTS WITH A TWIST

Frederick W. Rosenberg

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

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

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

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

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

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

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

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

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

identified had the position been bought back prior to exercise.

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

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

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

both the husband and the wife and it should be immediately clear. The husband wife, but it is decidedly not! Focus on the November 12, 2013 transfers-out for damages as with the husband, would seem to be equally appropriate for the Now here is the twist I alluded to in the title. Merely asking for the money

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substantial. multiple assignments the unrecognized losses in options and share loss can be (\$57,834). It cannot be said that her damages equate to his. On accounts with brings her total losses to (\$170,507), which is nearly triple that of the husband shares, with a value of (\$115,666) less than her husband. This equates to an repurchase of UPS stock, the wife's account ends up with 1,165 fewer UPS 3,000 shares taken from her. Despite equal monetary damages and assuming a difference of (\$115,661) at closing prices attributable solely to the assigned transferred out 15,000 shares worth \$1,489,200, while the wife after her additional loss more than double her adjusted option loss of (\$54,840) and repurchase only transferred 13,835 shares worth \$1,373,539, which is a

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

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

Assignment vs. Buy Back Options Comparison Executive Retiree

Acct Name: Husband

UNITED PARCEL SERVICE-B Equities UNITED PARCEL SERVICE-B

		Eluş.
		Date 15-Apr-11 12-Nov-13
	UNITED PARCEL SERVICE-B Buys \$1,095,000) Sells \$1,489,200	III III III III III III III III III II
	PARCE	m2m_ Tfr Out
E	LSERV	Asgn Exer
ities B	ICE-B B	□ □
ays (\$1,0	ays \$1.0	
Equities Buys (\$1.095,000) Sells \$1,489.200	95,000) 9	B/S Buy Sell
iells §	ells §	⊞ 15,000
1,489,200	1,489,200	<u>Sid</u>
		Net Pos'n 0 15,000 1
P/L	P/L	price 73.00 99.28
\$394,200	P/L \$394,200	n <u>price Amount</u> 73.00 (\$1,085,000) 98.28 \$1,489,200
		stkeemkt
		in/out-of- money
		Days to Exp
\$0	\$0	<u>Phantom</u> <u>Cost</u> \$0 \$0
\$394,200	\$0 \$394,200	(Phantom Loss) / Ad Gain

Options UNITED PARCEL SRVC CALL 15-01 \$80

		l ıs
Hus	_	
Husband	ONHED FARCELSRYC CALL 15-01 580 buys 1 <u>\$118.668</u>) Sells	Date 07-May-13 11-Nov-13
UNITEL	PARCEL	Tr In
PARCE	SKYC	m2m m2m A Ifr ln Ifr Out E 3
L SERV	6	
ICE-B B	tions B	00#
UNITED PARCEL SERVICE-B Buys \$1,213,668) Sells \$1,550,034	Options Buys (\$118,668) Sells	Open
13,668)	18,668)	B/S Bt C Buy 6,000
Sells &	Sells	
1,550,034	\$60.834	9,000 BIS
		Net Pos'n -6,000
		_8 ₿
P/L	P/L	price 10.14 19.78
P/L \$336,366	(\$57,834)	Amount \$80,834 (\$118,668)
		in/out-of- stk#mkt money 88.66 \$8.66 99.28 \$19.21
		in/out-of- money \$8.66
		Days to Exp 618 430
\$0	8 8	Phantom Cost \$0
\$336,366	(\$57,834)	(Phantom Loss) / Adj Gain

Assignment vs. Buy Back Options Comparison

Executive Retiree

Acct Name: Wife
UNITED PARCEL SERVICE-B

Equities UNITED PARCEL SERVICE-B

\$560,059	(\$115,680)				\$675,739	몯		ᇹ	164,407	Sells \$3,464,407		(\$2,788,668)	Buys	Total		
\$223,693	(\$115,680) \$223,693				\$339,373	P/L		L914,373	Sells \$1	UNITED PARCEL SERVICE-B Buys \$1,575,000) Selis \$1,914,373	Buys 🗵	ERVICE-I	RCELS	ITED PA	Wife <u>un</u>	
(\$54,846)	(\$115,680)				\$60,834	P/L		\$60,834	<u>\$0</u> Sells	\$0	Buys	Options Buys				
(\$54,846)	(\$115,680)				\$60,834	P/L		\$60,834	Sells	20	Buys	, 15-01 \$8	CCALI	CELSRV	UNITED PARCEL SRVC CALL 15-01 \$80 Buys	
	\$0 (\$115,680)	618 430	\$8.66 \$19.28	88.66 99.28	\$60,834 \$0	10.14 0.00	-6,000 0	6,000	6,000	n Sell e Buy	Open				07-May-13 11-Nov-13	
(Phantom Loss) / Adj Gain	Phantom. Cost	Days to Exp	in/out-of- money	in/out-of- stk@mkt money	Amount	priœ	Net Pos'n	SId	臣	BAS		Exp Exp	≧m Asgr Out Exer	m2m m2m Tfr in Tfr Ou	Date I	Plug
										1 \$80	UNITED PARCEL SRVC CALL 15-01 \$80	RVCCA	CEL S	FED PAR		Options
\$394,219	(\$115,680)				\$278,539	P/L		1,853,539	Sells \$1	Equities Buys (\$1,575,000) Sells \$1,853,539	Buys (\$	Equities				
\$394,219	(\$115,680)				\$278,539	P/L		1,853,539	Sells \$1	UNITED PARCEL SERVICE-B Buys \$1,575,000 Sells \$1,853,539	3 Buys 🗏	ERVICE-I	RCELS	ITED PA	UN	
(Phantom Loss) / Adj Gain	Phantom Cost \$0 [\$115,680) \$0	Days to. Exp	in/out-of- <u>1991</u> money	in/out-of- stkemkt money 99.28 \$19.20	Annount (\$1,085,000) \$480,000 (\$480,000) \$1,373,538	price 73.00 80.00 99.28	Net Pos'n 15,000 9,000 13,835	SId 0 6,000 0	胆 15,000 0 4,835	Buy Sell Sell			CO COLL Exer	m2m m2m Tfr ln Tfr Ou	Date T 15-Apr-11 11-Nov-13 12-Nov-13	

Prepared by Frederick W. Rosenberg Esq. 27 Village Green Ct. So. Orange, NJ 973-761-5866 fredrosenberg45@optimum.net

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