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CORPORATE EXECUTIVE DEFERRED COMPENSATION: SHOULD THE EXERCISE OF STOCK APPRECIATION RIGHTS (SARs) TRIGGER SECURITIES LAW LIABILITY?

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I. INTRODUCTION

As the marketplace for the sale of goods and services becomes more competitive, so too does the effort companies expend to attract and keep highly-skilled corporate executives. Since Internal Revenue Code section 162(m) places limitations on the annual amount of executive compensation corporations may deduct from their taxes,[1] and because securities laws make it difficult to profit from material inside information, firms are looking to new financial products to compensate their executives. Some of the more intriguing attempts are phantom stock concepts. Such products generally create book values that accumulate personal value for the executive in proportion to the firm's common stock pricing but are never converted into actual equity in the firm. One of the most popular forms of this strategy is the stock appreciation right, or SAR.

A SAR is a form of deferred compensation in which a firm grants a corporate executive a right to a proportionate benefit that occurs as a consequence of an increase in the price of the firm's common stock above a base or benchmark price, also known as the exercise price. The

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1. Specifically, section 162(m) of the Internal Revenue Code prohibits a publicly-held corporation from deducting compensation as an expense item that exceeds one million dollars paid to the chief executive officer (CEO) or the four most highly-compensated officers, excluding the CEO. *See* Internal Revenue Code, 26 U.S.C. § 162(m) (1994). The preceding limitation does not apply to "qualified performance-based compensation." *Id.* In the Notice of Special Meeting of Shareholders for the purpose of considering a merger between NationsBank and Bank of America, Hugh McColl, CEO of NationsBank, stated:

> Because stock options and SARs granted under the Stock Plan must have an exercise price equal at least to the fair market value at the date of grant and because the Stock Plan limits the number of shares that may be the subject of awards granted to any employee during any calendar year, compensation from the exercise of stock options and SARs should be treated as 'qualified performance-based compensation' for Code Section 162(m) purposes.

NATIONSBANK NOTICE OF SPECIAL MEETING OF SHAREHOLDERS 81-82 (1998) [hereinafter NATIONSBANK NOTICE]. Apparently, Mr. McColl was not prepared to say explicitly that the SARs would qualify as "qualified performance-based compensation." The NationsBank Notice also did not address whether the options and SARs conveyed under the plan were securities. *Id.* This did not appear to matter, given the performance-based wording of section 162(m). *See id.*

company sets the exercise price when it awards the SAR. The executive gains if the stock price exceeds the exercise price, and when the right is exercised, or "cashed in," the gain is paid in either cash or stock, depending upon the terms of the compensation agreement. In the case of a cash redemption, the value is tied directly to the stock value increase from the date of issuance to the date of exercise.

While originally designed for privately-owned firms, SARs became quite popular during the 1980s, when the largest public firms often used them. Their popularity declined somewhat as a result of changes in tax and securities laws, yet the desire to make aggressive use of the bull market through stock price appreciation has led to a current revival of interest in SARs. As they become more common, however, there are still several unclear issues concerning their use. One such issue is whether an executive could exercise SARs while knowing material, non-public information which would be sufficient to trigger sanctions by the securities statutes. The most obvious question concerns the application of insider trading laws, and whether the exercise of SARs constitutes a violation thereof.

This is an important and current issue, as demonstrated by *Clay v. Riverwood International Corp.*[2] a recent Eleventh Circuit Court of Appeals decision. Two firms were considering a corporate merger[3] that included a large number of SARs and PSARs (premium stock appreciation rights) for executives of the newly-merged firm.[4] The

2. 176 F.3d 1381 (11th Cir. 1999). The facts of the case appear most completely in the district court opinion, Clay v. Riverwood International Corp., 964 F. Supp. 1559 (N.D. Ga. 1997).

3. 964 F. Supp at 1561. Riverwood International Corporation is a world-wide packaging and packaging-machinery company. When this suit began, the Manville Corporation held a majority of Riverwood's common stock. *Id.* In April 1995, because of Manville's liability in unrelated asbestos litigation, the boards of directors of both firms established a Joint Special Committee (JSC) to evaluate any and all options for enhancing Riverwood's value, including acquisition. *Id.* On June 28, a number of forest products companies, after hearing verbal presentations by members of the Riverwood management team, expressed interest in acquiring Riverwood. *Id.* at 1562. By mid-August 1995, the plan was that a consortium of companies, led by a company called CD&R, would acquire Riverwood through a merger transaction involving both cash and equity interest in the surviving corporation. *Id.*

During the time Riverwood and Manville were reviewing their alternatives, the financial press published numerous articles that speculated on exactly what was happening within the inner sanctum of both companies with regard to Riverwood's future. *Id.* at 1563-64. On October 25, 1995, the boards of directors of both Riverwood and Manville concluded that the proposed offer was "fair to and in the best interest of the stockholders," so they approved the proposal and recommended that the stockholders do so as well. *Id.* at 1563. On October 26, 1995, Riverwood publicly announced an agreement by which the acquiring firm would purchase the company for $20.25 per share, in cash, subject to various financing conditions and approval by the shareholders of both Riverwood and Manville. *Id.* The shareholders approved this proposed transaction, and the company redeemed outstanding stock shares at the acquisition price. *Id.*

4. *Id.* at 1563-64. Riverwood, in March 1993, issued its executives a certain number of SARs that entitled them to a payment from the corporation which equalled "the difference between the grant value of the SAR and the fair market value of Riverwood stock on the date the executive exercised the SAR." *Id.* at 1564. The SAR was payable in either cash or stock, at the company's discretion, and the agreement granting the SARs stated explicitly that these rights were "not granted in tandem with

plaintiff, Forrest Clay, purchased a significant number of stock shares prior to the official announcement of the merger.[5] He eventually suffered an acute loss when forced to accept a buyout price for his shares significantly below his purchase cost, while company executives exercised their SARs and PSARs with extremely propitious timing and reaped a large benefit.[6]

Clay brought a class action suit alleging both insider trading violations and securities fraud, claiming that Riverwood did not adequately inform the public of the merger and that he was injured, while the executives gained, as result.[7] The district court ruled that Clay lacked standing under section 20A of the Securities Act on the ground that SARs were not "privileges with respect to securities" within the meaning of section 20(d) of the Securities Act, which allows insider-trading suits based on the alleged insider trading of securities of the same class as those the plaintiff possessed.[8] Clay had argued that SARs were such privileges,[9] but the court rejected his argument, noting

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any Option, [did] not relate to any Option or other awards granted under the [1992 Long Term Incentive Plan])." *Id.* The SAR grant provided that the executive would not have stockholder rights with respect to the SARs and that they were not offers to sell securities. *Id.* Riverwood in 1994 also granted thirty executives premium stock appreciation rights (PSARs), each allowing the recipient "a payment from Riverwood equal to the difference between the grant value of the PSAR and the fair market value of Riverwood stock on the date the executive exercised the PSAR." *Id.* Like the SARs, the PSAR agreement expressly announced that they did not give the recipient any stockholder rights and that they did not represent company securities. *Id.* On September 21, 1995, a number of Riverwood executives, all individual defendants in this litigation, exercised both SARs and PSARs, receiving payments in cash. *Id.* The individual executives did not exercise all of the SARs or PSARs they had in their possession, but they all had a positive cash value. *Id.*

5. *Id.* at 1563. Throughout September 1995 Clay purchased 36,400 shares of Riverwood common stock at prices ranging between $23 to $26 per share. *Id.* Ironically, Clay purchased his Riverwood common stock on September 21, 1995, the exact date of which many of the corporate executives had exercised their previously mentioned SARs and PSARs. *Id.* at 1568.

6. *Id.* The leveraged buyout price of the stock was $20.25 per share, meaning Clay lost between $2.75 and $45.75 on each share, for a total loss between $100,100 and $209,300. *Id.*

7. *Id.* at 1564-65.

8. *Id.* at 1571-72. The court also rejected the fraud claim. *Id.* at 1572-75

9. The critical issue the court faced was whether or not the SARs and PSARs were covered by the law of insider trading. *Id.* at 1568. As expected, Clay claimed they were, and the companies argued they were not. *Id.* Clay's contention was that the executives were the recipients of inside information and thus were liable through the exercise of the SARs and PSARs for any sanctions provided by the securities statutes relative to fraud or insider trading. *Id.* His theory depended on an interpretation of section 20A of the Securities Exchange Act which asserted that each SAR or PSAR was, in fact, a "privilege with respect to" Riverwood stock, which would bring them within the meaning of section 20(d). *Id.* This connection between Riverwood common stock and the SARs and PSARs was crucial to Clay's case, because in order to constitute insider trading a transaction must involve "securities of the same class" as those of the plaintiff. *Id.* This is because "traders of different classes do not suffer because of the insider's superior access to information." *Id.*

In essence, Clay's position was that the SARs and PSARs were the equivalent of Riverwood stock, and any exercise of those rights was tantamount to trading in company stock, requiring the same standard to which any transaction that involved any type of corporate security would be subject. He based this argument on the theory that SARs and PSARs were "privileges with respect to" the common stock of the company, putting them within the stricture of the limited provisions of Section 20(d):

> Wherever communicating, or purchasing or selling a security while in possession of, material nonpublic information would violate, or result in liability to any purchaser or

that the statute does not expressly list SARs as it does other securities, most notably options, and that it was unwilling to read the statute broadly enough to cover SARs.[10]

Clay appealed, and on October 14, 1998, a panel of the Eleventh Circuit Court of Appeals agreed with the district court's holding.[11] The circuit initially went farther than the district court, however, and analyzed why SARs generally should never violate insider-trading laws, not merely holding that the securities in this case did not convey standing to Clay.[12]

> seller of the security under any provision of this chapter, or any rule or regulation thereunder, such conduct in connection with a purchase or sale of a put, call, straddle, option, or privilege with respect to such security or with respect to a group or index of securities including such security, shall also violate and result in comparable liability to any purchaser or seller of that security under such provision, rule, or regulation.

Id. (citing Securities & Exchange Act of 1934, 15 U.S.C. § 78t(d)).

10. *Id.* at 1570-72. In disposing of Clay's arguments, the district court focused on whether there was a "transactional nexus" between the exercise of the SARs and PSARs by the Riverwood executives that would be sufficient to trigger insider trading liability. *Id.* The court relied heavily on the fact that the recipients of the SARs did not have any rights as stockholders and that the SARs were not offers to sell Riverwood securities. *Id.* The most important point, according to the court, was that there was no market on which the SARs or PSARs could be traded in the same way that stock or options could be traded. *Id.* at 1572. Therefore, the court held that SARs and PSARs could not be "privileges with respect to securities" as that phrase was used in section 20(d). *Id.* The court reasoned that even if the individual defendants had access to insider information, there was no transactional nexus between the exercise of the rights contained in the SARs and PSARs and Clay's stock purchases. *Id.*

According to the court, linking the value of the SARs and PSARs to the stock market price constituted no more than a device commonly used by many in order to adjust or enhance an executive's cash or non-cash compensation for his or her value to the company. *Id.* In terms of the overall effect on the stock market, the value of the SARs and PSARs when exercised could have just as easily been connected to the Dow Jones Index or another such index, but such a correlation would not have provided the type of equity measurement that could be easily used in a compensation environment. *Id.*

11. Clay v. Riverwood Int'l Corp., 157 F.3d 1259, 1266 (11th Cir. 1998) ("*Riverwood II*").

12. *Id.* at 1263-68. In his opinion for the circuit, Chief Judge Hatchett stated that the case presented a question of first impression for the federal courts: "Whether corporate insiders' exercise of stock appreciation rights for cash from their employing company implicates the insider trading laws [of the securities statutes]." *Id.* at 1261. Notably, this was later vacated by another panel of the circuit, which saw the issue much more narrowly. Clay v. Riverwood Int'l Corp., 176 F.3d 1381, 1381-82 (11th Cir. 1999) ("*Riverwood III*"). Nevertheless, the original analysis is worth reviewing, as it provides an expression of the argument against treating SAR's and options similarly, discussed *infra* Part III.

Hatchett began by considering Clay's allegation that the Riverwood officers had violated the "disclose or abstain" rule regarding insider trading. *Riverwood II*, 157 F.3d at 1264. This allegation was based on long-standing securities law that, in this case, would hold that the corporate executives had violated securities laws by exercising their SARs and PSARs with the knowledge that there was a major corporate transaction in the offing that "would cause the value of a share to drop substantially less than current market value." *Id.* According to Hatchett, Clay's principal problem was analogizing SARs and PSARs to "options." *Id.* at 1266. The only authority Clay could cite for this proposition was a Seventh Circuit observation that SARs had attributes like options, although they were in fact not options. Hatchett disagreed with Clay on this point:

> [A]ll stock options when exercised involve a market transaction—even if it takes a split-second for holders to sell on the market the stock that they received in order to capture the difference between the grant and market values. Holders of SARs, like the ones in this case, in material contrast, receive cash directly out of the issuer-company's treasury. They do not sell stock at any time.

Id.

The opinion also considered whether SARs and PSARs were "privileges with respect to"

One year later, the Eleventh Circuit reconsidered the case, and on May 17, 1999, it issued an opinion vacating its original decision.[13] For all practical purposes, this new opinion reinstated the district court's decision while retaining some parts of the original circuit opinion.[14] As a result, Riverwood executives made a large profit, while Clay suffered a staggering loss.

This article discusses the issue of treating SARs as securities. Part II provides a detailed discussion of various options, including calls, puts and straddles, derivative securities that do trigger insider-trading laws. Part III argues, based on corporate financial literature, that SARs should be treated like other derivative securities. This section considers and rejects the distinctions between securities and SARs, distinctions that can be seen in the *Riverwood* decisions.[15]

II. OPTIONS: CALLS, PUTS AND STRADDLES

The following discussion provides background on options, both generally and of several specific kinds. This will equip the reader with the knowledge and vocabulary required for the next section, which argues that options and SARs are fundamentally economically similar and, as such, must be treated similarly for purposes of insider-trading laws.[16]

A. BACKGROUND

Generally, an option is a contract to buy or sell an underlying asset at a specified price anytime before a specified date. They are commonly divided into "calls" and "puts"; calls permit the purchase of an asset,

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securities. Hatchett dismissed this argument quickly, noting that the "exercise of the SARs . . . did not affect the legal or beneficial ownership of any stock or the right to own, purchase, or sell any stock." *Id.* He also distinguished traditional options, which are actually traded on established securities markets, from the SARs in this case, whose transfer to any other individual was expressly prohibited by the granting agreement. *Id.* Accordingly, the 11th Circuit originally affirmed the lower court's summary judgment, although it did so on broader grounds that reached the substantive question of the connection between SARs and other derivative securities. *Id.* This opinion affirmed the district court's analysis of the fraud claim, although with greater analysis.

13. *Riverwood III*, 176 F.3d 1381.

14. *Id.* at 1381-82. The new opinion vacated the original introduction and discussion of insider trading, substituting in its place a concurrence from the original opinion. *Id.* The new opinion, however, left unchanged the analysis of the fraud claim. *Id.*

15. As mentioned, Clay also alleged that the press releases Riverwood released regarding its future were fraudulent. *Riverwood*, 964 F. Supp at 1572-75. The district court rejected this claim. *Id.* The original circuit court opinion agreed with this holding, but it provided much greater detail as to why they were not a violation of disclosure rules. *Riverwood II*, 157 F.3d at 1268-69. The final circuit opinion did not affect this analysis. *Riverwood III*, 176 F.3d at 1381-82. The issues raised by these opinions are beyond the scope of this article, which focuses on the insider-trading implications of the decisions. However, the opinions could have effects on the law of corporate disclosure, as they seem to go further than the established law in that area.

16. *See generally infra* Part III.

while puts permit the sale of an asset.[17] Like SARs, all options have an exercise price and a maturity date.

As mentioned, options can be calls or puts, and both may be bought and sold. Hence, an option contract may be any of four possible types. While pure options exist, it is more common to find various types of options embedded or implied in business contracts.[18] Options can be traded on options exchanges or over the counter (OTC). Exchange-traded options have the advantage of greater liquidity, convenience and less credit risk than OTC-traded or non-traded options. However, OTC and non-traded options have the advantage of flexibility and completeness. Options contracts available on exchanges are limited in number, while other options contracts are practically infinite in their numbers and conditions.

Among the non-traded options contracts are executive stock options and SARs. The variations of these contracts are quite numerous, although the basic types are qualifying and non-qualifying. In general, when used as part of compensation arrangements, executive options permit an individual executive to purchase company stock at a favorable exercise price until a specified maturity date.[19]

One of the key issues in a discussion of options is valuation. For all options, the underlying asset provides the largest component of value, which is why the securities are referred to as "derivative" of the under-

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17. For a detailed discussion of these types of options, *see infra* Part II.B.

18. For example, convertible bonds consist of a straight bond plus a bundle of call options on the common stock. *See* PETER RITCHKEN, OPTIONS: THEORY, STRATEGY AND APPLICATIONS 348-54 (Scott, Foresman & Company eds., 1987) (providing a conceptual overview of this process). Convertible bonds are valued by discounting at the discount rate appropriate for the issuing firm's straight bonds, while the coupon payments are necessarily below the market rates on straight bonds. *See id.* This combination of factors provides a bond value of a convertible that will be less than par value, typically $1,000. *See id.* The bond will nevertheless be sold for approximately $1,000, because buyers of convertibles recognize that they receive the right to convert them into shares of the issuing firm's common stock. *See id.* The exercise price is the par value divided by the number of shares per bond, and the maturity is frequently quite long, as much as 15 years, although a shorter period is generally preferred. *See id.* Hence, the exercise price on the options for a convertible giving 40 shares per bond would be $25, and should the common stock rise above $25 per share, the conversion value of the bond rises above $1,000. *See id.* If the original purchase of the convertible included a bond value of $800 plus 40 options for a total price of $1,000, the premium on the options would have been $200 divided by 40, or $5 per option. *See id.* Initially, the options would be worthless, but when the stock price exceeded $25 per share, the options would have values commensurately higher. *See id.*

19. The firm typically grants the executive the right to purchase shares at a favorable price for a few years. For example, the terms might permit purchase of up to 50,000 share as $60 per share at any time up to four years from the date of issuance. If the stock price rises to $75, the executive can call in the stock at $75 per share for as many shares as desires. The entire package would cost $3 million to purchase at the exercise, and the gain to the executive would be the 50,000 shares times the gain per option of $15, or a total of $750,000. Sometimes the problem arises that the executive does not have sufficient cash either to purchase the share or to pay tax on the gain, and he or she must face ultimate issues of liquidation in order to take full advantage of the call. *See* C.W. Smith, Jr. & J.L. Zimmerman, *Valuing Employee Stock Option Plans Using Option Pricing Models*, 14 J. ACCT. RES., Autumn 1976, at 357-64.

lying asset. However, one can identify several other factors that determine value in options, discussed in detail *infra* Part II.B. However, it is critical to note that while all of the sources of value can fluctuate, the term to maturity can only decrease. Hence, one characteristic of options that differs from other securities, such as common stock, is the time delay in value.[20]

"Intrinsic value," "at-the-money," "out-of-the-money" and "premium" are also important option contracts terms. The intrinsic value is the difference between the asset price and exercise price. For example, if the exercise price of a common stock issue is $40 and the market price is $50, the intrinsic value is $10. If this condition exists when the stock price is higher than the exercise price, the call is said to be in-the-money. If the stock price were $40 and the exercise price $50, the option would be out-of-the-money, since the stock price is below the exercise price. If the stock price and exercise price are both $40, then the option is at-the-money. The premium is the amount paid for the option; using the above numbers, the intrinsic value of $10 would also be the premium. One reason for having another term is that options usually sell at a price above their intrinsic value because of the volatility component mentioned above. If the stock price was $50, the exercise price $40, and the market price of the option $12, the premium would be $12, while the intrinsic value would remain.

The above discussion is a brief sketch of general options principles. The following sections explore specific options in more detail.

B. BASIC OPTIONS: CALLS AND PUTS

The two basic types of option contracts in the marketplace today are calls and puts. The call option gives the holder the right, but not the obligation, to purchase an asset at a specified price for a specified time period, while the put gives the holder the right, but not the obligation, to sell an asset at a specified price for a specified time period. The price is known as the exercise price or the strike price, and the time period is denoted as the expiration date or maturity date. In general, these two features must exist in order to create a valid option contract. Furthermore, the buyer generally must also pay a premium price to obtain the right to exercise the contract if desired.

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20. *See* FRANK J. FABOZZI, INVESTMENT MANAGEMENT 380 (2d ed. 1999). Thus, a three-month call option might have a value of $10, while a one-month call option with the same exercise price and volatility measure would have a lower price, such as $4. *See id.* At maturity, the value of the call option goes to zero; generally, no exceptions to this rule are permitted, because the option becomes void the day after maturity. *See id.*

Both call and put contracts can be either purchased or sold, but they are typically viewed from the buyer's perspective. The buyer of an option is said to be in a long position;[21] if the contract is not exercised by the maturity date, it expires unexercised. The fact that the buyer of a call has no legal obligation to purchase, and the buyer of a put has no obligation to sell, the asset if it appears to have no value above the exercise price means that the buyer cannot be forced to exercise a worthless contract and incur additional loss. The buyer of an option can walk away from the contract and permit its expiration. The original premium price, therefore, represents the maximum loss for the buyer.

The seller of an option contract, also known as the writer,[22] gives the buyer the right to purchase or sell the asset at a specified exercise price prior to the maturity or expiration date. The writer is said to be a short position.[23] If the writer is notified that the buyer wishes to exercise, the writer must deliver the asset to, or purchase the asset from, the buyer for the exercise price. If the asset is worth too little to trigger the buyer's call, or worth too much to trigger a put, the writer retains all of the premium purchase price, but receives no further payments. After the maturity date, the contract expires and has no further value to either party or anyone else.[24] Thus, the security interest in an option exists until either expiration or cancellation.

The sources of value in options contracts are based on the underlying asset.[25] More fundamentally, there are several reasons for options to have significant economic value. These formulations are essentially opposite for calls and puts. For example, a call's value increases with the value of the underlying asset, while a put's value increases as the value of the underlying asset decreases. The following formulas are for calls; in each case, the opposite is true for a put.

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21. Buyers or options are said to be "long position," while sellers of options are said to be in a "short" position. ROBERT A. JARROW & ANDREW RUDD, OPTION PRICING 5 (Richard D. Irwin ed., 1983).

22. *Id.* at 5. Thus, a seller writes the contract and places him or herself in a short position. For example, a writer sells a call giving the buyer the right to buy an asset at $40 at any time during the next three months. *See* GARY L. GASTINEAU, THE OPTIONS MANUAL 42-43 (3d ed. 1988).

23. The short position of the seller implies that if the buyer exercises the call, the seller would need to come up with the asset, if he or she was not already in possession of same. Furthermore, the seller can hold a more conservative position by currently owning the asset, but if a call contract is sold without owning the asset, the sell is said to be "naked," and naked positions are more risky than covered positions. *See* GASTINEAU, *supra* note 22, at 42-43.

24. Unexercised options expire as worthless contracts when the time to maturity reaches zero, regardless of values of other variables. *See* FABOZZI, *supra* note 20, at 380.

25. *See* JOHN C. HULL, INTRODUCTION TO FUTURES AND OPTIONS MARKETS 12 (3d ed. 1998). "Derivatives" as a term has come into general usage only since the mid 1980s. *Id.* The term refers to many contracts such as options (puts, calls, warrants), futures contracts and swaps and implies that all value must be based on another underlying asset or security. *Id.*

The first formula is the example above: A call's value increases with the value of the underlying asset (while a put's decreases). Second, the smaller the value of the exercise price, given the same asset price, the greater the value of the call. Third, the greater the value of risk-free market interest rates, which provides an alternative opportunity for investment, the greater the value of the call. Fourth, the longer the maturity date or expiration date from the present, the greater the value of the call. This source of value derives from the fact that the greater the time allowed for the underlying asset to appreciate in value, the greater the value of the call associated with the asset. Fifth, the greater the volatility of the asset value, with the asset price remaining the same, the greater the call's value.[26]

Options based on common stock may be traded OTC or on an organized exchange. Prior to 1972, all option trading was between interested parties without an intermediary.[27] Since then, organized exchanges have existed for limited numbers of common stock issues. However, for many options based on common stock issues, and for most other assets, trading exists only between the two interested parties, although agents such as attorneys and brokers may be involved in the transactions. Hence, there exist very liquid options exchange markets for a limited number of common stock issues; all other option trading is considered OTC.[28]

Some options are not traded at all; foremost among these are executive stock options and SARs. These tend to be part of executive

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26. *Id.* at 170. This source of value derives from the fact that greater volatility means a greater probability that the underlying asset will increase in value above the exercise price prior to its expiration, while if the value of the asset decreases or remains below the exercise price, the holder or buyer simply permits the option to expire without exercising the right, because to do otherwise would create an additional, unnecessary loss.

As noted previously, the fact that options convey a "right without an obligation" implies that for a call option, the buyer cannot be forced to buy an asset that is not in his or her own interest. For example, with an exercise price of $50, the call has no value if the market price is $40, and so the long call holder would have no economic interest in paying $50 for an asset whose market price makes it available at $40.

27. *Id.* at 5. Calls options were actually the first to trade on the Chicago Board Options Exchange (CBOE), and puts followed somewhat later. Other exchanges followed with options contracts on other securities, and for several years there was no overlap in trading among the various exchanges. That is, if IBM options were traded on the CBOE, they were not concurrently traded on the American, Pacific or Philadelphia Exchanges. That practice has changed, such that multiple or overlap trading presently occurs in some securities. *Id.*

28. Only a small number of securities, approximately 50 to 200, ever have listed options on exchanges. However, the number of options contracts is a few thousand in total because each possible maturity and strike price, on both calls and puts, are separate contracts. Hence, if a firm has three maturities trading, with ten strike prices, with both calls and puts on each combination, there would be a total of 60 contracts (3 maturities x 10 strike prices x 2 option types). These numbers are tiny when compared with the thousands of common and preferred stock securities available for trading on any given business day, which typically run in a range with a minimum of five to ten thousand. *See* JARROW & RUDD, *supra* note 21, at 3-4.

deferred compensation contract packages, based on a valid personal-services contract. Hence, no current market exists for trading in such options. However, the sources of value remain the same as other traded options. This is the underlying asset, which in most cases would be the common stock of the firm. Frequently, the need to estimate the value of such contracts arises, and if traded options exist for the firm, the same methods are employed to find a first approximation to the value of the executive stock options. If no traded options exist, then similar fundamental methods must be employed to estimate a fair value for the call options. It is clear that the terms "call" and "put" have the same implication as previously defined: The owner of the option has the right to purchase or sell an underlying asset, typically common stock, at a specified exercise price until the maturity date. Thus, the fact that some options are not traded would not necessarily imply a significant difference in magnitude of the current value.[29]

The creation and cancellation of option contracts are generally quite simple. Generally, creation requires the agreement of mutually interested parties willing to create a contract, and cancellation occurs with its exercise by the holder. If the option is traded, then two separate transactions are necessary: The purchaser buys the option from an exchange, while the exchange effectively buys the option from its seller, or writer. If the option is not traded, agreement of both parties is required to void or cancel the contract. If the contract is traded, cancellation or destruction of the contract is much simpler, since the buyer can cancel his or her position by selling an option contract with identical terms to the one that was purchased initially. Notification to brokers and exchanges is required to guarantee that the contractual arrangement is terminated to the satisfaction of the party wishing to cancel. Hence, creation and destruction of option contracts is straightforward. The notion regarding canceling is that the buyer has already paid the premium for the option, and canceling is equivalent to the cancellation of a service contract prior to its expiration. The buyer may be entitled to a

29. *See* Eric Noreen & Mark Wolfson, *Equilibrium Warrant Pricing Models and Accounting for Executive Stock Options*, 19 J. ACCT. RES., Autumn 1981, at 385-86. The results here show that Black-Scholes Option Pricing methods could be used for executive stock options based on their similarity to warrants. The executive stock options are non-traded until exercised. *See* Smith & Zimmerman, *supra* note 19, at 357-64. The basis for noting that the security interest is significant is that the conceptual value of a put option can be employed to determine the "fair value." While traded, put options have market prices to confirm the "fair value," the determination of the fair value proceeds accomplished in a manner similar for non-traded options. Market values of traded options correlate quite closely with conceptual or fail value calculations. For a more complete explanation of put valuation, see Karen L. Farkas & Robert L. Hoskin, *Testing a Valuation Model for American Put*, FIN. MGMT., Autumn 1979, at 51-56.

partial refund of the unused premium, minus any costs or penalties associated with the cancellation.

C. STRADDLES AND OTHER COMBINATION OPTIONS

A straddle option is defined as a combination of a put and a call.[30] Other simple strategies with similar, but not identical, combinations are strips,[31] straps[32] and strangles.[33] Straddles, however, represent the prototypical combination strategy. The creation of a straddle includes the purchase of a call and a put on the same underlying security. The exercise price and expiration date will be the same for both. A straddle strategy would be appropriate if an investor expected a significant move in the underlying asset, such as common stock, but the direction of the move was uncertain over the time period.

The buyer of a straddle is in a long position as to both a call and a put. If the underlying security moves significantly up or down, the investor gains from the long straddle. If the security fails to move outside a predetermined range, the investor has no gain in the straddle and may lose up to the entire premium paid. For example, assume a stock issue trading at $59 per share. A two-month call with an exercise price of $60 per share costs $4 and a put with similar characteristics costs $3 a share. An investor expecting a large move would purchase a straddle.

If the price moves to $75 a share, there is a recognized $8 gain, since the $67 cost is equal to the total of the exercise price plus the costs of both the put and call. In reality, the put is worthless, while the call is worth at least $15. If the price drops to $45 per share, a gain of $8 is recognized, as the exercise price is diminished by the cost of the put and call. Again, in reality, the call becomes worthless and the put is worth at least $15 per share. However, if the stock price remains within $7 of the

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30. A long straddle is the purchase of a call option and a put option with the same maturity and strike price. For example, a call contract and a put contract, each with an exercise price of $60, and each maturing in two months, would a long straddle. The buyer pays for each option, and the seller received the prices of the premium on the two options. *See* JACK CLARK FRANCIS, INVESTMENTS: ANALYSIS AND MANAGEMENT 715-17 (5th ed. 1991).

31. A strip is a position in one call and two puts with the same strike price and expiration date. Thus, the buyer pays the premium for three options. *See* ZVI BODIE ET AL., INVESTMENTS 572-73 (1989).

32. *Id.* A strap is a position in two calls and one put with each having the same strike price and expiration date. Thus, the buyer of a strap pays for three options. *Id.*

33. A strangle is a position with a put and call on the same security with the same expiration date, but with different strike prices. The long straddle would require that the put have a lower than the call strike price. A long strangle is similar to a straddle, but the maximum loss is minimized. Accordingly, professional traders favor strangles. *See* ROBERT A. STRONG, SPECULATIVE MARKETS: OPTIONS, FUTURES AND HARD ASSETS 54-56 (Longman Fin. Servs. Publ'g eds., 1989).

$60 exercise price, only losses occur, depending on the exact price at the time the contract is closed.

If an investor expects a small movement, or no movement, in a stock, then selling a straddle would produce a gain. The writer sells a call and put on the same asset with the same exercise price and maturity date. The maximum gain to a straddle writer is the premium received from the buyer of the straddle. In the example above, the seller would receive the $7 per straddle and keep a maximum of $7 if the price failed to move. Small moves would reduce the premium the seller receives. Only after a greater than $7 move would a seller lose, but he or she is exposed to a potentially unlimited loss once the price changes beyond the established range, here $7.

The sources of value in straddles are based on the same factors that support the basic call and put valuations. However, a straddle represents a strategy that attempts to profit from changing volatility, in which an increasing volatility would imply that buying would be appropriate. A belief in decreasing volatility would imply that selling a straddle would be more profitable. While the gains and losses appear to be symmetrical for buyers and sellers, the risk is substantially greater for the seller than the buyer. The buyer has no liability beyond the initial premium paid, and the maximum loss is known in advance. The seller has unlimited liability, and although this theoretical level is not expected in practice, the size of the loss is more difficult to predict in advance when planning the strategy.[34]

Straddles may be traded using exchange-traded calls and puts or they may be employed by an investor who has a contract with another interested party. Therefore, while straddles seem to require exchange trading, there is in fact no difference in value between traded and OTC straddles. However, there are questions relating to liquidity of OTC calls and puts (and straddles) that are not identical for exchange-traded calls and puts.

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34. With written straddles, the writer prefers that the stock price move very little, because he or she then keeps the premium and the straddle expires almost worthless. However, if the price moves outside the break-even levels on the upside or downside, then losses occur because the long straddle might be exercised. The break-even levels are determined by adding to, and subtracting from, the exercise price the premiums for the two options. The loss cannot be predicted because it is not evident in advance how quickly the straddle writer could extricate himself from the contract in the case where prices move enough to create losses. For example, assume that the exercise price was $50, the call premium was $6 and the put premium was $4; the seller would receive a total premium of $10 per straddle. Of course, all options trade in round lots analogous to stock trades, so the total dollars involved would be $600 for the calls and $400 for the puts, or $1,000 for the straddle contract. The loss boundaries would be $40 and $60, and price moves beyond these figures would lead to increasing losses for the writer. HULL, *supra* note 25, at 227-28.

The creation of a straddle consists of setting up a combination strategy either buying or selling calls and puts with the same exercise price and maturity date. The strategy must be identified as a straddle to the broker or agent responsible for assisting in the trading. When one wishes to cancel an exchange-traded straddle, one merely notifies the broker-agent that an offsetting trade is to be ordered. If a purchase of a straddle is followed by an expected large stock move, the strategy could be canceled by selling a straddle and eliminating the position. The gain or loss would depend on the price change that had occurred in both the underlying stock and the two derivatives. An attempt to cancel a non-traded straddle cannot be guaranteed, since the mutual assent of both parties would be required to cancel the contract.

Notably, all of the derivative securities discussed above are classified as "privileges with respect to" common stock, bringing them within the purview of insider trading laws.[35] The next section argues that SARs have the same economic consequences as options, and as such should also be subject to insider trading laws.

III. TREATING SARS AS SECURITIES

This section focuses on the relationship between traditional, exchange-traded options and SARs and argues that SARs and other forms of executive options should be regulated like traded options for purposes of insider trading laws. Essentially, this section argues that similar economic entities with similar payoffs and risks should be valued as like-kind. From an accounting perspective, the costs of comparable executive compensation components should be accounted for in a similar manner.[36] Such a treatment is appropriate because the economic and financial characteristics of SARs are quite similar to those of compensatory stock options, as is the accounting treatment.[37]

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35. Clay v. Riverwood Int'l Corp., 157 F.3d 1259, 1266 (11th Cir. 1998) ("*Riverwood II*") (citing Securities & Exchange Act of 1934, 15 U.S.C. § 78t(d) (1994)).

36. The accounting for SARs and executive options is covered in Accounting Principles Board Opinion No. 25 and Financial Accounting Standards Board (FASB) Interpretation No. 28.

37. The specific accounting for SARs is not identical to that for stock options. *See generally* LOREN A. NIKOLAI & JOHN D. BAZLEY, INTERMEDIATE ACCOUNTING (5th ed. 1991). Yet, many accounting scholars argue quite convincingly that they should be, and a significant difference of opinion exists within the accounting profession. *See generally* Steven Balsam, *Extending the Method of Accounting for Stock Appreciation Rights to Employee Stock Options*, 8 ACCT. HORIZONS, Dec. 1994, at 52.

As *Riverwood* shows, SARs are an important part of executive compensation. The underlying motivation for granting executive compensatory stock options has always been to "tie" or "closely relate" the fortunes of the firm and the executives responsible for its success over a reasonable time period. Loyalty to the firm and ability to induce or motivate all employees to perform at the highest level throughout the firm has often been seen as justification for inclusion of a stock-based incentive as part of the total compensation contract, typically a package of options and SARs.[38] Furthermore, use of such plans provides a partial deferral of current income, which provides another reason contributing to the popularity of such plans among both executives and corporate boards.

SAR contracts are usually stated as following: If the common stock price rises above a given benchmark stock price, then the executive will be paid the difference between the market value at the time of exercise and the given or exercise price.[39] The executive cannot then trade the SARs; he or she is in fact tied to the firm at least until the values are vested. This is how the *Riverwood* SARs and PSARs operated.[40] The accounting treatment of SARs sets out procedures for allocating the costs, including those in excess of the exercise price, over the time in which the contract is valid. As with executive stock options, the only way in which the owner of a SAR gains or benefits is when the market price of the common stock rises above the exercise price. The executive has an incentive to exercise the option in part or in total as soon as the market price exceeds the exercise price, or near the end of the option period, whichever is more advantageous.[41] Thus, one could reasonably argue

38. Since the cash problems of executive options are well known, firms frequently create a package of benefits as part of an entire compensation package. No similar problems exist with SARs: They can be exercised in cash and taxes paid, and if stock options are also available in the package, some of them may be exercised with the SAR cash. The entire combined value of the package of SARs and options would be considered by the firm as the required benefit for the executive's services. The cost to the firm is considered a necessary cost, regardless of the implications of Internal Revenue Code section 162(m), even though a possible negative cash flow would ensue that could have some stock market implications. The important issue in this instance is whether, once SAR cash is received as the result of inside information and is used to exercise existing stock options, insider trading rules have been violated. *See* Amanda Bennett, *Firms May Eliminate Spin-Off of Stock Options*, WALL STREET J., Feb. 13, 1991, at B1.

39. The method of determining the gain, ignoring cash flow implications, would be the same for the SARs as for the stock options. The cost accounting details would, however, differ slightly for the two financial instruments. *See generally* NIKOLAI & BAZLEY, *supra* note 37.

40. *See* Clay v. Riverwood Int'l Corp., 964 F. Supp. 1559, 1564 (N.D. Ga. 1997).

41. A possible problem arises, however, when the exercise of the options requires a significant amount of cash to pay for the exercise, since the entire exercise price must be paid by the recipient of the options. Due to the large numbers of options that are usually involved, a significant amount of cash must be raised by the executive to pay the taxes on the gain. A gain must exist when the market price rises above the exercise price, thus creating a gain for the executive and will be taxable at either long-term or short-term rates. Also, there are often cash flow problems associated with the exercise

that SARs are securities because their values are determined in a manner analogous to that by which the values of traditional stock options are determined.

There are several key similarities that justify treating exchange-traded options and SARs according to the same rules. First, both options and SARs can be valued accurately according to models. Though exchange-traded options are valued by market participants, their values can be determined by financial models, which generally are able to compute market value in excess of 99.5% accuracy, or within about five cents on a $10 option. The Financial Accounting Standards Board (FASB), an accounting rule-making body, has supported the use of these models when computing the value of executive stock options such as SARs.[42] While this approach is not without controversy, it allows determination of the value of non-traded executive stock options with similar levels of accuracy as valuations for exchange traded options.

Even without the benefit of market price discovery as exists in options markets, therefore, option values can be determined quite accurately. This is possible because the non-traded options behave as derivative securities identical to traded derivative securities. It is the economic substance of executive stock options that permits accurate valuation in the absence of current market trading. They are related to the underlying security of the firm, as are exchange-traded options.[43] If a contractual arrangement such as a SAR possesses the economic characteristics of options, then the intrinsic value of the contract should be determined in a manner similar to that used for options.[44] It should

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of compensatory executive stock options.

42. The primary model used for option valuation has been the Black-Scholes Option Pricing Model (OPM). While some controversy exists regarding the use of this model, along with its improved variations, the fact remains that its accuracy is the greatest of all financial models used today. Accuracy implies that the fair value found by the Black-Scholes OPM correlates with observed market prices to a very high level of significance. It could be said that while a conceptual model might be used to determine the value of non-traded options, the accuracy is probably greater than 99%. *See* Balsam, *supra* note 37, at 52-60 (providing a review of the accounting perspective); *see also* James D. MacBeth & Larry J. Merville, *An Empirical Examination of the Black-Scholes Call Option Pricing Model*, 34 J. FIN., Dec. 1979, at 1173-86 (providing an evaluation of model accuracy).

43. Executive stock options can be valued using the Black-Scholes OPM, but often they could also be compared to the listed options available on one of the listed exchanges, assuming that the firm's securities are among those traded. *See* STEPHEN A. ROSS ET. AL., CORPORATE FINANCE 578-82 (5th ed. 1999).

44. The SAR performs in an identical manner to an executive stock option, and contains economic payoffs based on identical variables and results. That is, the firm grants the executive the right to gain if the firm's common stock increases in value above a specified level. The specified level is the exercise price and the firm will set a maturity date similar or identical to the common stock options. As with options, if the market price of the common stock exceeds the exercise price, the executive is eligible for a gain. The gain can be accepted in cash or stock, and in either case, the taxes are paid by the recipient of the benefit. However, the special benefit of the SARs is that the cash payment alternative means that the executive need not sell some of all or the stock in order to pay for the exercise and the taxes. In all other ways, the economic behavior and predictability of the SAR payoff parallels the executive stock option alternative. *See id.*

also be noted that FASB No 28, which covers the accounting for "Stock Appreciation Rights and Other Variable Stock Option or Award Plans," does not distinguish any economic difference between options and SARs.[45]

Finally, a recent discussion paper by FASB comes to the conclusion that a cash-settled long-call option indexed to its own stock could be used as a cash flow hedge of the expected future cash flows attributable to changes in the company's stock price that arises in non-vested SARs, assuming that vesting is probable. Such a conclusion is identical with the use of a call option or other option that might also be traded on exchanges or OTC. This is the case since the accounting rules provide for similar treatment for contracts having comparable economic and financial implications.[46]

Despite the similarity of SARs and stock options, however, some argue that they should be treated differently.[47] Such arguments accentuate the differences between SARs and options and minimize or attenuate the similarities. While there might exist several minor differences and similarities, one should consider mainly the salient features of SARs compared to executive stock options, focusing primarily on the economic substance of the arguments.

First, consider the primary argument against the treatment of SARs as securities, as seen in various forms in the different *Riverwood* opinions. This argument is based on methods of valuation: While options must be valued by subtracting the exercise price from the market price at the time of exercise, option values during the pre-exercise period can be valued conceptually by financial models, as discussed above. Since there is always a true market connection with any valuation, this argument presumably implies that a market relationship does not exist

45. Since the payoff characteristics of SARs match that of executive stock options, the Black-Scholes OPM, as adjusted if necessary, could be employed to determine the "fair" value of the SARs just as certainly as for other securities such as options and warrants. For a more complete description of accounting principles for SARs and executive options, see NIKOLAI & BAZLEY, *supra* note 37, at 794-802.

46. SARs are treated similarly to options in accounting for variable executive compensation contracts. In each instance, while the SARs and stock options may not be traded or exchanged, the value continues to be determined by the market value of the underlying security, the firm's common stock. *Cash Flow Hedges: Hedging a SAR Obligation*, FASB DERIVATIVES IMPLEMENTATION GROUP STATEMENT 133, IMPLEMENTATION ISSUE, NO. G1, Sept. 1998.

47. For an example of such an argument, see the majority opinion in *Riverwood II*, 157 F.3d 1259, 1264-68 (11th Cir. 1998), discussed *supra* Part I and note 12.

for SARs, since SARs cannot be traded, and that this difference justifies differential treatment.[48]

In contrast, consider the two primary arguments for treating SARs as securities. The accounting treatment of SARs, as noted above, is completely analogous to the treatment for compensatory executive stock options. The FASB uses the economic substances of an activity as a significant basis for its accounting treatment. This is so because financial statements are intended to present fairly the economic and financial position of a firm at a point in time.[49] Furthermore, the economic and financial substance of SAR contracts mirrors that of the executive stock options with which they are often matched.

There are several such similarities between SARs and executive stock options. First, they provide similar incentives; by increasing per share values for all stockholders, the executives increase the value of both stock options and SARs. Further, both forms of compensation have value only when the market price of the common stock exceeds the exercise price. Finally, both require the executive to remain with the firm in order to benefit from the contract incentives, and both are forms of deferred compensation. Hence, one could argue that there is no essential economic difference between stock options and SARs. If stock options are securities, then SARs are securities, since the economic substance of a security is a claim against some asset, usually stated in financial or monetary terms.

Further, the claim that SARs differ from options because they cannot be traded is misleading. All securities may have disclaimers and

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48. To grasp this point better, it is necessary to refer to one of the models used to value options, such as Black-Scholes. The model includes variables including, but not limited to the exercise price, time to maturity, the risk-free rate of return, the common stock price and market volatility. Those exact variables would also be used to determine the fair value of a SAR at any point in time up to the time of exercising, a value that will always be more than or equal to the intrinsic value. Balsam, *supra* note 37, at 53; *see also* JOHN C. COX & MARK RUBENSTEIN, OPTIONS MARKETS 33-38 (1985).

49. *See* NIKOLAI & BAZLEY, *supra* note 37, at 9-23. The authors provide a detailed summary of "Objectives of Financial Reporting by Business Enterprises." NIKOLAI & BAZLEY, *supra* note 37, at 9-23. The Financial Standards Accounting Board (FASB) is an organization created by private, academic and public entities with an interest in standard accounting procedures. The FASB is strongly influenced by the Securities & Exchange Commission (SEC), the American Institute of Certified Accountants (AICPA) and the American Accounting Association (AAA). The pressure from both academia and the SEC is to move accounting decisions closer and closer to full disclosure of true economic conditions. While such an objective may be difficult to define and achieve, the changes in financial statements during the last two decades has been toward correctly identifying real value, as opposed to market value. Financial analysts continually look behind the accounting methods to find the best economic and financial substance of a given action. Thus, a firm granting a package of SARs and executive options would be analyzed to include the possible impact on the firm's market price arising as a consequence of the firm's use of these financial products.

restrictions, as is seen in letter stock or restricted stock.[50] For example, some securities may not be traded for various periods of time. This fact undercuts the argument that SARs' inherent trading restrictions distinguish them from options. Therefore, the most reasonable interpretation of a SAR is that it is a security in the same sense as an executive stock option. Each has similar accounting and economic characteristics.

However, there is one sense in which SARs might have a superior position as a security as compared to an executive stock option. Stock options must be purchased with cash, thereby triggering a taxable event.[51] Normally, some shares of stock must be sold to satisfy the liquidity need associated with the stock option exercise.

SARs, contrarily, may be paid in either stock or cash, which clearly contributes to their popularity. The cash payment provides the means to pay the tax, and the remainder can be used, if so desired, to purchase stock. The critical element here is that in a financial or economic sense, the cash flow characteristic associated with SARs would be treated as equal to or superior to executive stock options. Conceptually, the value of a SAR would be greater than or equal in value to an executive stock option with the same exercise price on the common stock. Clearly, therefore, a contract that provides for a cash-flow stream identical to an executive stock option, with similar constraints on trading and with the same basis for ultimate value (the common stock), should be treated the same as executive stock options: as a security. Ultimately, similar treatment is required because both depend on the value of the market price of common stock to set the value of the contract.[52]

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50. These securities are typically not traded or are traded only under special circumstances. A firm might restrict the sale of stock until certain conditions are met, e.g., working for the company for a specified term. Letter stock requires a letter to the SEC stating the conditions under which the stock could be sold. *See* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 355-56 (4th ed. 1991); *see also* RAMESH K.S. RAO, FINANCIAL MANAGEMENT 739-40 (South-Western College Publ'g eds., 1995) (providing a comparison of letter and restricted stock).

51. A situation in which SARs may be the superior financial product to be holding is when the executive must borrow so he or she can pay taxes after exercise of options, whereas no such loan would be needed if the individual held SARs. The cost of the loan would reduce the value of the options as compared to the SARs. *See generally* Laura Jereski, *Poison Parachutes*, FORBES, Feb. 24, 1986, at 78.

52. The financial theory invoked here is the time value of money, which provides that similar cash flows should be evaluated in comparable fashion. Cash flows are similar if the elements of magnitude, risk and timing are approximately equivalent. All financial resources have opportunity costs, and cash flows are financial resources. In order to compare similar cash flow streams, all cash flow differences must be equalized in present value by making trade-offs based on differences in risk and timing. *See* JAMES C. VANHORNE, FINANCIAL MANAGEMENT AND POLICY 9-20 (11th ed. 1998).

IV. CONCLUSION

This Article has demonstrated that SARs are securities just as certainly as executive stock options, and, accordingly, the securities insider-trading rules should apply to SARs as they do to any other type of derivative security. The *Riverwood* opinions demonstrate the importance and confusion of this issue: The most important issue in *Riverwood*, and in this area, is that of value, not transactional nexus or marketability. Perhaps the cornerstone of this Article is the demonstration that the inability to trade SARs does not serve as a particularly convincing argument against categorizing them as securities. Therefore, Congress should amend § 20(d) to add SARs and PSARs to the list of derivative securities whose trading will trigger insider trading penalties.

Previous literature and research shows that SARs were popular because of their special status as a benefit to the company; they even included the ability to circumvent loan agreements or covenants restricting stock issuance, not to mention avoiding state and federal securities laws. It is understandable, and acknowledged, that some possible interpretations of the pertinent statutes would provide grist for the argument that SARs are not derivative securities. However, the fact remains that SARs are based on the economic substance of the actions undertaken by the firm establishing the compensation plan that uses them as an enticement to executives. SARs actually enhance a deferred compensation deal when used in tandem with executive stock options, without which the stock options would be much less attractive. The *sine qua non* in this controversy is that SARs do have a transactional nexus to the underlying common stock.

It is difficult to understand, within the context of the securities statutes, how a group of insiders can make important non-public decisions using inside information that will seriously affect the exchange price of the firm's stock without "transactional nexus"[53] to the underlying asset that would trigger insider trading liability.[54] The fact

53. Clay v. Riverwood Int'l Corp., 964 F. Supp. 1559, 1570 (N.D. Ga. 1997).

54. Professor Balsam agrees with this conceptual approach:

> Synopsis: In the Financial Accounting Standards Board (FASB) Exposure Draft "Accounting for Atock-Based Compensation," (June 1993) the FASB advocates valuing employee stock options using the fair value at the grant date. This paper discusses and illustrates the FASB approach, and presents as an alternative the method used to account for stock appreciation rights (SARs), which it shows are economically equivalent to stock options. Theoretically the SAR approach 1) reconciles accounting for economically equivalent transactions, 2) produces accounting results that are objective and verifiable, 3) recognizes as expenses an amount equal to the benefit to the employee and opportunity cost to the firm, and 4) matches expenses to the period(s) in which the benefits are

that there is no formal market trading is not the key. Clay may well have relied upon the company's press releases in deciding to speculate that Riverwood's stock price would increase. The corporate insiders made certain that this did not happen by withholding disclosure of the buyout until after they had exercised their SARs, which Congress should insure triggers insider-trading liability.

> received. Practically, when compared to the FASB proposal, compensation expense is easier to compute and understand if the SAR method is extended to stock options. The FASB's Exposure Draft rejects this approach. The board concludes that stock-based compensation settled in cash (SARs) differs from stock-based compensation settled in stock. The key difference is the former requires expenditure of an asset and is therefore defined as a liability, whereas the latter requires issuance of stock, which is not viewed as an asset of the company. Therefore, the FASB concludes a stock option is an equity instrument. This paper argues that the FASB should look beyond the definitions of liabilities and equities to the substance of the transaction. Since SARs and stock options are economically equivalent, the amount of compensation recognized should be the same whether a SAR or stock options is issued.

Balsam, *supra* note 37, at 52 (citation omitted).