2003

Aligning Incentives with Equity: Employee Stock Options and Rule 10b-5

Matthew T. Bodie
Saint Louis University School of Law

Recommended Citation
Bodie, Matthew T., Aligning Incentives with Equity: Employee Stock Options and Rule 10b-5. Iowa Law Review, Vol. 88, No. 3, pp. 539-600, March 2003.

Aligning Incentives with Equity: Employee Stock Options and Rule 10b-5

*Matthew T. Bodie**

* Associate Professor of Law, Hofstra University School of Law. A.B., 1991, Princeton University; J.D., 1996, Harvard Law School. I would like to thank Sam Estreicher, Catherine Fisk, Peter Spiro, Susan Stabile, Lynn Stout, Nelson Tebbe, Rebecca Hollander-Blumoff, and the participants at the New York University Workshop for Labor and Employment Law for their invaluable comments. Special thanks are due to Alan Hyde, who steered me to this topic and provided expert guidance throughout.

"Looking at the economic realities, it seems clear that an employee is selling his labor primarily to obtain a livelihood, not making an investment."[1]

Many corporate employees behave less like old-fashioned workers than they do like investors. Rather than think, I need to stay here and do my best because I have an investment in this company, they think, I am going to keep a close eye on this ship, in case it starts to sink and my options become worthless.[2]

I. INTRODUCTION

Stock options were the preferred compensation of the Internet boom. Once the exclusive domain of top-tier executives, stock options became a crucial part of the employment packages for employees at all levels.[3] Although specific numbers are difficult to come by, estimates of the number of employees with stock options in the late 1990s ranged from seven to ten million,[4] up from one million in 1992.[5] Given the stratospheric stock prices of many technology companies at the time, options represented a potential gold mine for employees, while the tight job market made employers more willing to offer such options to lure the best talent.[6] For high-tech

1. Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 560 (1979).

2. Michael Lewis, *The Artist in the Gray Flannel Pajamas*, N.Y. TIMES, Mar. 5, 2000, § 6 (Magazine), at 45, 46–47.

3. *See* Sheila Muto, *Stock Options Spur Lawsuits as Mergers Roil High Tech*, WALL ST. J., Sept. 27, 2000, *available at* 2000 WL-WSJ 26611067 (noting that newly hired Silicon Valley executives are given stock options averaging 117,588 shares valued at $685,234, while hourly workers receive, on average, 1603 shares valued at $12,576). According to a study by consulting firm William M. Mercer, Inc., 54% of large United States companies have a broad based stock option plan, up from 30% in 1997. *See* Press Release, William M. Mercer, Inc., Sustained Bull Market Drove Use of Broad-Based Stock Options to New Heights, *available at* http://www.mercerhr.com/pressrelease/details.jhtml?idContent=1048255 (last visited Jan. 27, 2003) (on file with the Iowa Law Review). A study by Joseph Blasi, Douglas Kruse, and Aaron Bernstein revealed that 98 out of the top 100 high tech firms offer stock options to most or all of their employees. JOSEPH BLASI ET AL., IN THE COMPANY OF OWNERS 92 (2003).

4. *Employee Stock Options: Top 10 Things to Know*, http://money.cnn.com/pf/101/plus/lessons/10/topten.html (seven million) (last visited Jan. 27, 2003) (on file with the Iowa Law Review); The National Center for Employee Ownership, *Employee Stock Options Fact Sheet*, *available at* http://www.nceo.org/library/optionfact.html [hereinafter NCEO *Fact Sheet*] (ten million) (last visited Jan. 27, 2003) (on file with the Iowa Law Review). A survey by the Bureau of Labor Statistics determined that 1.7% of all private industry employees received stock options in 1999. Press Release, Bureau of Labor Statistics, Pilot Survey on the Incidence of Stock Options in Private Industry in 1999, Oct. 11, 2000, *at* http://www.bls.gov/ncs/ocs/sp/ncnr0001.txt (last visited Jan. 27, 2003) (on file with the Iowa Law Review).

5. Corey Rosen, *Employee Stock Options Are Here to Stay, available at* http://www.neco.org/library/heretostay.html (last visited Feb. 26, 2003) (on file with the Iowa Law Review).

6. Options also do not cost companies cash value to issue, other than diluted share value, and potentially save them money on payroll costs. *See* Gretchen Morgenson, *Options Seem to Be Coming Home to Roost*, N.Y. TIMES, Oct. 8, 2000, § 3, at 1, *available at* 2000 WL 28280871.

employees, the value and vesting dates of one's options became more important numbers than one's salary.

Then, in spring 2000 the boom went bust. Many stocks, particularly in technology and telecommunications companies, have seen their prices fall to pennies.[7] The heady hysteria that disparaged companies in the "old economy" and brought new methods of valuation into vogue left in its wake a junk heap of companies whose IPOs had only recently been heralded. For some of these companies, investors are finding that fraud and deception helped create the illusion that the bull market fostered. Firms such as Enron, Global Crossing, and WorldCom—once top-fliers in the new new economy—now are the subject of wide-ranging criminal investigations and massive securities fraud actions.[8] Like other investors, employees with stock options have also seen the value of those options fall off the charts.[9] No longer able to cash in on their options, employees may now seek to exercise other powers behind those options—powers which potentially include the right to sue.

Under section 10(b) of the Securities Exchange Act of 1934[10] and the Securities and Exchange Commission's effectuation of the Act, Rule 10b-5,[11] private holders of securities may bring actions against those who have used fraud or misrepresentation in connection with the sale or purchase of a security. Rule 10b-5 offers perhaps the most important legal protection for holders of securities against fraud, deception, insider trading, and corporate malfeasance. However, in two recent decisions involving Cendant Corporation, a federal district court dismissed claims under Rule 10b-5 brought by employees who held stock options.[12] The court based its decisions on Rule 10b-5's requirement that the alleged fraud must have

7. *See, e.g.*, Danny Hakim, *Former Workers at Lucent See Nest Eggs Vanish, Too*, N.Y. TIMES, Aug. 29, 2001, at A1, *available at* 2001 WL 27393203; Christopher Saunders, *theglobe.com to Close Communities*, ATNEWYORK.COM, Aug. 3, 2001, *at* http://www.atnewyork.com/news/article.php/8471_860141 (last visited Jan. 27, 2003) (on file with the Iowa Law Review).

8. *See, e.g.*, *In re* WorldCom, Inc. Sec. Litig., No. 02 Civ. 3288 (DLC), 2002 WL 31867720 (S.D.N.Y. Dec. 23, 2002); SEC v. WorldCom, Inc., No. 02-CV-4963 (JSR), 2002 WL 31748604 (S.D.N.Y. Aug. 27, 2002); Newby v. Enron Corp., [2001–2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,706 (S.D. Tex. Feb. 15, 2002), 2002 WL 31989193; PETER C. FUSARO & ROSS M. MILLER, WHAT WENT WRONG AT ENRON (2002).

9. *See* Gretchen Morgenson, *Outrage Is Rising as Options Turn to Dust*, N.Y. TIMES, Mar. 31, 2002, § 3, at 1, *available at* 2002 WL 18535027 (last visited Jan. 27, 2003) (on file with the Iowa Law Review) (discussing WorldCom employees); Jeff Manning & Gail Kinsey Hill, *Portland Subsidiary Mirrors Enron's Rapid Rise, Fall*, OREGONIAN, Dec. 16, 2001, *available at* 2001 WL 3627620, *reprinted in* THE BEST BUSINESS STORIES OF THE YEAR: 2003 EDITION 84–86 (Andrew Leckey & Allan Sloan eds., 2003) (discussing employees of Enron Broadband whose stock options are now worthless).

10. 15 U.S.C. § 78j(b) (2000).

11. 17 C.F.R. § 240.10b-5 (2002).

12. *See* Wyatt v. Cendant Corp., 81 F. Supp. 2d 550, 558 (D.N.J. 2000); McLaughlin v. Cendant Corp., 76 F. Supp. 2d 539, 550 (D.N.J. 1999).

taken place "in connection with a purchase or sale" of the security.[13] Because the employees had received their options through a company-wide plan, rather than through individual negotiations with the company, they had not "purchased" their security and thus were not entitled to bring a 10b-5 action.[14] The decisions in the *Cendant* litigation are the logical outgrowth of reasoning first set forth in *International Brotherhood of Teamsters v. Daniel*,[15] in which the Supreme Court held that employees did not "contribute" to their pension plans and therefore were not protected under the federal securities laws.[16] This line of reasoning, premised on the assumption that employees have not bargained for benefits such as pension plans or stock options, is fundamentally flawed.

Of course, employees are different than outside investors, and one may question whether employees need or deserve the protections of federal securities regulation. For example, employees have access to different information about the company and are arguably better able to protect themselves against fraud or malfeasance by company executives.[17] The recent scandals at Enron and WorldCom demonstrate, however, that most employees are just as vulnerable to insider fraud as the public. Unprotected by Rule 10b-5, employees must watch the value of their options disintegrate without a legal remedy against the employer that misled them.

This Article argues that employees deserve the basic antifraud protection afforded by Rule 10b-5—a protection that public investors are not even permitted to waive. Sections II and III provide an overview of Rule 10b-5 litigation and employee stock options. Section IV analyzes the logic behind the *Cendant* decisions, beginning with the framework established by the Supreme Court in *Daniel*. Section V argues that the *Cendant* distinction is flawed on both doctrine and policy. Section VI discusses—and rejects—potential reasons for a broader rule barring all employees from Rule 10b-5 private actions related to their options. Ultimately, the best rule is uniform antifraud protection for all employees who receive stock options.

II. AN OVERVIEW OF RULE 10B-5

Rule 10b-5 is considered the "crown jewel" out of the many provisions for securities regulation deriving from the Securities Act of 1933 (the 1933 Act) and the Securities Exchange Act of 1934 (the 1934 Act) (collectively, the Securities Acts).[18] Having sprung from famously inconspicuous

13. *See Wyatt*, 81 F. Supp. 2d at 555–56; *McLaughlin*, 76 F. Supp. 2d at 544 (noting that Rule 10b-5 "prohibits the use of fraudulent schemes or devices in connection with the purchase or sale of securities").

14. *See Wyatt*, 81 F. Supp. 2d at 557–58; *McLaughlin*, 76 F. Supp. 2d at 544–45.

15. 439 U.S. 551 (1979).

16. *Id.* at 570.

17. *See infra* Section VI.B.

18. Donald C. Langevoort, *Rule 10b-5 as an Adaptive Organism*, 61 FORDHAM L. REV. S7, S19 (1993).

circumstances,[19] the rule has now become the "catch-all" cause of action for cases of corporate malfeasance.[20] Rule 10b-5 generally prohibits any fraud, deception, or omission relating to a material fact in the context of a purchase or sale. The rule has been held to prohibit accounting fraud, insider trading, misleading or deceptive solicitations, and failures to disclose.[21] Although Rule 10b-5 is the primary method of prosecuting insider trading,[22] it finds perhaps a more important role as the vehicle for shareholder derivative class actions. Shareholder suits against Enron, Arthur Andersen, WorldCom, and Global Crossing all have been filed under the flag of Rule 10b-5.[23]

The rule derives from section 10(b) of the 1934 Act, which makes it unlawful to "use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance" that contravenes any rule promulgated by the SEC.[24] Rule 10b-5 tracks this language and sets forth three types of unlawful practices:

> To employ any device, scheme or artifice to defraud,
>
> To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person . . . .[25]

The rule requires that the alleged wrongful actions be committed

---

19. Former SEC staff attorney Milton Freeman, in an oft-recounted tale, described how the rule was created in response to a specific incident of fraud relating to an executive's efforts to buy, rather than sell, securities. The rule borrows the language of section 17 of the 1933 Act, except that it applies to sales and purchases, rather than sales and offers to sell. *See* 15 U.S.C. § 77q(a) (2000). After Freeman and an SEC director wrote up the rule, it was approved by the Commission without controversy. The only comment allegedly made about the rule came from Commissioner Sumner Pike, who said, "Well, we are against fraud, aren't we?" Milton Freeman, *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967), *quoted in* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 767 (1975) (Blackmun, J., dissenting).

20. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 203 (1976).

21. Langevoort, *supra* note 18, at S11–15.

22. Most recently, the Supreme Court affirmed a conviction under Rule 10b-5 using the "misappropriation" theory, which concerns a person's use of confidential information for securities trading purposes in breach of a duty owed to the source of the information. United States v. O'Hagan, 521 U.S. 642 (1997).

23. *In re* Global Crossing Ltd. Sec. and ERISA Litig., 223 F. Supp. 2d 1384 (J.P.M.L. 2002); *In re* MCI WorldCom, Inc. Sec. Litig., 191 F. Supp. 2d 778 (S.D. Miss. 2002); *In re* Enron Corp. Sec. Litig., 206 F.R.D. 427 (S.D. Tex. 2002).

24. 15 U.S.C. § 78j(b) (2000).

25. 17 C.F.R. § 240.10b-5 (2000).

through means of interstate commerce and "in connection with the purchase or sale of any security."[26] Upon its creation in 1942, Rule 10b-5 was used solely by the SEC in its enforcement of the securities acts. However, in *Kardon v. National Gypsum Co.*,[27] a district court found an implied private right of action under the rule. This private right was not approved by the Supreme Court until twenty-five years later, in summary fashion.[28] By then, as the Court recognized in *Blue Chip Stamps v. Manor Drug Stores*, the Rule 10b-5 private action was a "judicial oak which ha[d] grown from little more than a legislative acorn."[29]

To bring a private action under Rule 10b-5, a plaintiff must prove the following: "the defendant made (1) a misstatement or an omission (2) of a material fact (3) with scienter . . . (4) in connection with the purchase or sale of a security (5) upon which plaintiff reasonably relied, and (6) that reliance proximately caused injury to the plaintiff."[30] One of the legal issues that soon arose in the development of Rule 10b-5's private action was the meaning of the phrase "in connection with the purchase or sale of any security." In *Birnbaum v. Newport Steel Corp.*,[31] the Second Circuit held that only direct purchasers and sellers of securities, rather than those who were connected in some other way to a sale (or those who had chosen not to make a sale or purchase), could bring private actions. The court based its decision on the purpose behind the rule, which it viewed as limiting redress to those engaged in an actual transaction.[32] The Supreme Court ratified the *Birnbaum* rule many years later in *Blue Chip Stamps*.[33] The Court based its holding, in part, on *Birnbaum*'s longstanding acceptance by the circuit courts and Congress's failure to overturn the decision, despite the SEC's efforts to do so.[34] However, because the Rule 10b-5 private action was primarily a judicial creation, the Court felt it "proper" to take policy considerations into account as well.[35] The court recognized that many commentators, as well as the SEC, viewed the limitation to direct buyers and sellers as an arbitrary restriction that prevented aggrieved plaintiffs from getting relief, and

26. *Id.*

27. 73 F. Supp. 798 (E.D. Pa. 1947).

28. *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971); *see also* Affiliated Ute Citizens v. United States, 406 U.S. 128, 150–54 (1972).

29. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

30. McLaughlin v. Cendant Corp., 76 F. Supp. 2d 539, 543 (D.N.J. 1999).

31. 193 F.2d 461, 463 (2d Cir. 1952).

32. The court quoted an SEC release, which stated that the rule was intended to close a "loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase." *Id.* at 463 (quoting Securities Exchange Act of 1934 Release No. 3230 (May 21, 1942), 1942 WL 34443.

33. 421 U.S. 723 (1975).

34. *Id.* at 733.

35. *Id.* at 737.

admitted that this was "indeed a disadvantage."[36] Despite this disadvantage, however, the Court argued that the *Birnbaum* rule also had several advantages, primarily cordoning off suits that would be more speculative than those brought by actual buyers or sellers. The Court feared that suits by parties not involved in an actual transaction "would throw open to the trier of fact many rather hazy issues of historical fact the proof of which depended almost entirely on oral testimony."[37] Noting that Rule 10b-5 actions presented "a danger of vexatiousness different in degree and kind from that which accompanies litigation in general," the Court feared that even suits with little chance of success would have a significant settlement value.[38] Without the *Birnbaum* rule, plaintiffs could fill complaints with vague allegations about what they would have done but for the fraud and then engage in extensive and abusive discovery to drive up the value of settlement.[39] These considerations led the Court to limit the plaintiff class for Rule 10b-5 private actions to actual purchasers or sellers of securities, rather than any party who had been defrauded.

Further concern about vexatious litigation led Congress to pass the 1995 Private Securities Litigation Reform Act (PSLRA).[40] The PSLRA heightened pleading requirements and changed class action procedures in an effort to discourage frivolous Rule 10b-5 litigation. Following passage of the PSLRA, some plaintiffs began to seek relief through state securities laws. Congress largely eliminated that option, however, by passing the Securities Litigation Uniform Standards Act (SLUSA), which preempts most state court securities fraud class actions.[41] Thus, Rule 10b-5 remains the focus for almost all securities class actions seeking relief for alleged fraud.

III. A BRIEF DISCUSSION OF EMPLOYEE STOCK OPTIONS

Stock options are a deceptively straightforward type of contract: the issuer of a stock gives to the recipient the "option" to purchase a share or shares of the stock at a particular price with whatever restrictions the contract may contain. The option is only valuable if the value of the stock rises above the price term set within the option. While this basic notion of an option is quite simple, stock options themselves often are not, given the array of contractual restrictions that can be placed on them. In the context of employee stock options, it is common for the company to require that the options "vest" over time; that is, the employee can only exercise the options

36. *Id.* at 738.

37. *Id.* at 743.

38. *Blue Chip Stamps*, 421 U.S. at 739.

39. *Id.* at 740–41.

40. Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified throughout various sections of 15 U.S.C.).

41. Securities Litigation Uniform Standards Act (SLUSA), Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified throughout various sections of 15 U.S.C.).

after a period of time has elapsed. Moreover, employees may forfeit their options under the contract once they leave the company, even if they leave involuntarily.[42] Further provisions may control what happens if the issuing company is bought or merges with another company, or may even give management the prerogative to buy back the options at their original strike price.[43]

Employee stock options are covered by a complex cross-pattern of regulation and common law. Employee stock options are considered securities and thus are covered by federal securities regulation. However, stock options also represent a contract, and thus fall within the ambit of state common law. Congress has largely not preempted state common law with respect to securities regulation, with some notable exceptions.[44] In addition, state corporate law regulates the decision to offer employees stock options, sometimes requiring a proxy vote on options to executives and employees.[45] However, because options are simply that—options—employees do not have an actual ownership stake in the firm until they exercise their options and purchase shares. Employee stock option plans are generally not covered under the Employee Retirement Income Security Act (ERISA),[46] as they are not considered welfare or retirement plans, even though employees may consider their options as part of their retirement savings.[47] Finally, if the plan meets the requirements of an "incentive stock option" or an "employee stock purchase plan," the options will receive certain federal tax benefits.[48] However, the requirements for obtaining such tax treatment are somewhat restrictive, requiring employers to offer the options to all employees (in the case of stock purchase plans)[49] or requiring

42. The issue of whether employees who are wrongfully discharged can obtain relief for lost stock options and, if so, how these options should be valued, has been the subject of recent litigation. *See, e.g.*, Knox v. Microsoft Corp., 962 P.2d 839 (Wash. Ct. App. 1998).

43. The story of how Steve Jobs used such a provision to reorganize Pixar and divest employees of their options is told in CHARLES H. FERGUSON, HIGH ST@KES, NO PRISONERS 98–99 (1999).

44. *See, e.g.*, SLUSA, Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified throughout various sections of 15 U.S.C.) (discussed *supra* Section II).

45. *See, e.g.*, N.Y. BUS. CORP. LAW § 505(d) (McKinney 1986). However, Delaware law does not require shareholder approval. *See* DEL. CODE ANN. tit. 8, § 157(c) (1974).

46. 29 U.S.C. §§ 1001–1461 (2000).

47. 29 U.S.C. § 3(2) (2000); 29 C.F.R. § 2510.3-2(c) (2001).

48. *See* 26 U.S.C. §§ 422–23 (2000). For example, the grant of the options will not be a taxable event as long as the employee exercises them while still an employee and holds the stock for at least a year. *See* 26 U.S.C. § 422 (2000). The tax consequences for employees who cash in on options can be quite significant. *See* Gretchen Morgenson, *Some Suffer Tax Hangovers From Microsoft Option Spree*, N.Y. TIMES, Apr. 18, 2001, at A1, *available at* 2001 WL 18773094.

49. *See* 26 U.S.C. § 423(b)(4) (2000). This provision led the Ninth Circuit to find that Microsoft workers who had been labeled as independent contractors and thereby excluded from the stock option plan were actually employees and thus entitled to participate in the plan. *See* Vizcaino v. Microsoft Corp., 120 F.3d 1006 (9th Cir. 1997).

that the option be for at least fair market value with a ten-year expiration date (for incentive stock options).[50]

Employers have several incentives for offering their employees stock options. First, as discussed in more depth below, these options are not reported as expenses against earnings. Unlike wages, which are part of net expenses, stock options are not given a fixed value and are not counted as costs.[51] Employers may nevertheless be permitted to take a tax deduction for options if they are not incentive stock options. Second, options are often seen as a way to align employees' incentives with the interests of the shareholders.[52] Like other forms of employee ownership, stock options give employees a direct stake in the value of the employer's equity.[53] Third, stock options may bind the employee to the company, at least for as long as it takes for the employee's options to vest. While this may not be a long period of time, it does provide some stability, particularly in a labor market with accelerated turnover. Fourth, stock options may signal to investors that managers and employees are willing to accept contingent compensation, thus demonstrating that they believe in the enterprise. If those running the company are unwilling to take some risk in the firm's success, investors may deem the enterprise unworthy of their own risk.[54] Finally, employees may demand stock options based on a cultural sense of compensation. Stock options bring not only investment opportunities but prestige; if employees in a company or industry are receiving options, it may spur other employees to bargain for them.

One recent source of concern with respect to stock options has been their treatment under the generally accepted accounting principles (GAAP). As previously noted, firms are not required under GAAP to count options as expenses against earnings.[55] Recent legislative efforts to change that, most

50. *See* 26 U.S.C. §§ 422(b)(3)–(4) (2000).

51. However, since 1998, accounting standards have required companies to disclose the dilutive effect that options have on share value. *See* FIN. ACCOUNTING STANDARDS BD., FIN. ACCOUNTING STANDARDS NO. 123, ACCOUNT FOR STOCK-BASED COMP. § 49 (1998), *cited in* Charles M. Yablon, *Bonus Questions—Executive Compensation in the Era of Pay for Performance*, 75 NOTRE DAME L. REV. 271, 284 (1999).

52. *See, e.g.*, Arthur H. Dean, *Employee Stock Options*, 66 HARV. L. REV. 1403, 1403–04 (1953).

53. Of course, stock options do not actually provide employees with stock (unless those options are exercised), so employers need not worry about employees exercising control of the corporation upon receipt of the options. Further research is needed into how many employees exercise their options, and how long they hold on to the stock once it has been purchased.

54. *See* Edward Lazear, Output-based Pay: Incentives or Sorting?, National Bureau of Economic Research Working Paper Series, Nov. 1999, *available at* http://www.nber.org/papers/w7419 (last visited Jan. 27, 2003) (on file with the Iowa Law Review). An illustration of the risks of using critical personnel who have no stake in a venture can be found in PO BRONSON, THE NUDIST ON THE LATE SHIFT 98–138 (1999).

55. *See supra* note 51.

notably by Senators Levin and McCain, have not been successful.[56] Despite these legislative failures, however, some companies, such as Coca-Cola, General Motors, and General Electric, have decided to voluntarily list their stock options as expenses.[57] Opponents of the current accounting rules claim that the failure to expense stock options artificially inflates the bottom line of those companies that grant options and therefore contributed to the recent boom and bust in technology stocks. Proponents of the current rules argue that stock options are administratively difficult to price and note that companies already disclose their stock option grants to investors. Some proponents have also expressed concern that companies with broad-based stock option plans would be forced to curtail or end those plans if the accounting rules changed.[58]

Finally, it is important to note that stock options are just one form of ownership interest in an employer that an employee may hold. Employees can purchase an employer's stock on the open market or through their 401(k) plans; they may also receive such stock directly from their employer as a bonus. Other ownership interests include phantom stock, which provides employees with the right to receive the appreciation in value of the employer's stock without actually holding the stock, as well as employee stock ownership plans or ESOPs (retirement plans that invest primarily, if not exclusively, in employer stock). While all of these forms of ownership interest provide employees with a financial stake in the success of the firm, they each differ in important respects. For example, stock generally provides voting rights to the holder, but stock options and phantom stock do not provide voting rights, and ESOP participants are often represented by a trustee before their shares vest. ERISA provides protection for employees with employer stock held through an ESOP or 401(k) plan, but not for

56. The Ending the Double Standard for Stock Options Act, introduced by Senator Levin along with Senator McCain and other co-sponsors, would provide that corporate tax benefits from stock option compensation expenses are allowed only to the extent such expenses are included in a corporation's financial statements. *See* S. 1940, 107th Cong. (2002). The bill was before the Senate Committee on Finance in 2002; Senator McCain unsuccessfully tried to attach it to the recently enacted Corporate Reform Act. *See* Helen Dewar & David S. Hilzenrath, *McCain Accounting Proposal Scuttled; Senate Rejects Listing of Stock Options as a Corporate Expense*, WASH. POST, July 12, 2002, at A1, A7, *available at* 2002 WL 23852949. The Stock Option Accounting Reform Act, which would require the Financial Accounting Standards Board to develop standards requiring stock options to be expensed, was referred to committee. *See* H.R. 5147, 107th Cong. (2002).

57. *See* Danny Hakim, *G.M. Plans to List Its Options as Expenses*, N.Y. TIMES, Aug. 7, 2002, at C3, *available at* 2002 WL 25399658; Floyd Norris & Sherri Day, *Coke to Report Stock Options as an Expense*, N.Y. TIMES, July 15, 2002, at A1, *available at* 2002 WL 24462267.

58. *See The NewsHour with Jim Lehrer*, (PBS television broadcast, July 16, 2002), *available at* http://www.pbs.org/newshour/bb/business/july-dec02/options_7-16.html) [hereinafter *NewsHour* Transcript] (featuring a statement by Rick White, president and CEO of Technet, a national association of technology firms: "what we're particularly concerned about is [that] the effect will be that companies can no longer give options to rank-and-file employees").

employees with stock options or with stock bought on the open market. Some of the analysis discussed below concerning stock options could apply to other employee ownership interests; for example, a court could find that stock provided to employees through a stock bonus plan did not represent a "purchase or sale" for purposes of Rule 10b-5. However, because the recent *Cendant* cases concern stock option plans, as well as the recent popularity of stock options for employees, this Article will focus its analysis on stock options.

IV. EMPLOYEE STOCK OPTIONS AND RULE 10B-5'S "PURCHASE OR SALE" REQUIREMENT

In the *Cendant* cases, employees who held stock options brought suits under Rule 10b-5 alleging that they had been defrauded by Cendant when those options were issued.[59] The district court, however, held that the employees, who had received their options through a stock option plan, could not sue for fraud under Rule 10b-5.[60] The court determined that the employees had not acquired their options through a purchase or sale, and thus did not meet the requirements of Rule 10b-5.[61] To explain how the court reached this decision, this Article begins with a discussion of the Supreme Court's decision in *International Brotherhood of Teamsters v. Daniel*, which held that pension plans were not "securities" for purposes of federal securities regulation.[62] Although this holding is not directly relevant to the issue in the *Cendant* cases, the Court's reasoning in *Daniel* is the progenitor of the *Cendant* Court's holding that employees do not "purchase" stock options from their employer. For this reason, it is the appropriate place to begin the analysis.

A. *THE DEFINITION OF A "SECURITY" AND THE* DANIEL *CASE*

The prototypical plaintiff in a securities fraud case is the public investor who buys stock through a regulated exchange. Of course, federal securities regulation is not limited to such cases—an investor in leasehold interests for a potential oil field,[63] a holder of demand notes issued by an agricultural cooperative,[64] and even a business that purchases another business[65] have all been protected under federal securities laws. As the Court stated in *Landreth Timber Co. v. Landreth*, "we cannot agree . . . that the Acts were intended to

59. Wyatt v. Cendant Corp., 81 F. Supp. 2d 550, 552–53 (D.N.J. 2000); McLaughlin v. Cendant Corp., 76 F. Supp. 2d 539, 542 (D.N.J. 1999).

60. *Wyatt*, 81 F. Supp. 2d at 555–56; *McLaughlin*, 76 F. Supp. 2d at 544.

61. *Wyatt*, 81 F. Supp. 2d at 558; *McLaughlin*, 76 F. Supp. 2d at 545.

62. 439 U.S. 551, 570 (1979).

63. *See* SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 345 (1943).

64. *See* Reves v. Ernst & Young, 494 U.S. 56 (1990).

65. *See* Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985).

cover only 'passive investors.'"[66] The Securities Acts both provide broad definitions of the term "security." Section 2(1) of the 1933 Act defines security, in part, to include any "stock," "transferable share," "investment contract," or "any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."[67] The 1934 Act uses similar language.[68]

The Court addressed the question of whether an employer's pension plan constituted a "security" under the Acts in *International Brotherhood of Teamsters v. Daniel*.[69] For a case that turns on the workings of such a plan, the Court provided little analysis of the actual plan at issue. Pension plans are generally categorized as "defined benefit" or "defined contribution" plans, based on their method of asset allocation. A defined benefit plan is a plan that provides its members with a predetermined award of benefits upon retirement. A defined contribution plan is one in which the employer makes a predetermined amount of contributions into a fund on behalf of employees; upon retirement, employees receive benefits based on how much money those contributions have earned.[70] Although the Court's opinion provides little detail about the pension plan at issue in its opinion, the plan appears to have been a defined benefit plan.[71] The Court did take pains, however, to emphasize two other aspects of the plan: that it was "compulsory," in that all employees were enrolled in the plan under the collective-bargaining agreement, and that it was "noncontributory," in that the employer, and not the employees, paid money into the plan.[72] Members of the plan received a set monthly stipend upon retirement, which was larger for those employees who retired later.[73] Twenty years of continuous service were required to be eligible for a pension.[74]

The plaintiff in *Daniel*, a truck driver who was disqualified from the plan

66. *Id.* at 692.

67. 15 U.S.C. § 77b(1) (2000).

68. 15 U.S.C. § 78c(a)(10) (2000). In *Landreth*, the Court held that the definitions of "security" used in both Acts "are virtually identical and will be treated as such in our decisions dealing with the scope of the term." *Landreth*, 471 U.S. at 686 n.1.

69. 439 U.S. 551 (1979).

70. *See* 26 U.S.C. §§ 414(i)–(j) (2000). A 401(k) plan is a type of defined contribution plan.

71. *Daniel*, 439 U.S. at 553–54. Some of the aspects of the plan were similar to a defined contribution plan, in that employers were required to put a certain amount into the fund per employee. However, upon retirement employees received a predetermined monthly stipend, the hallmark of a defined benefit plan. *See id.* at 554. In addition, the employer contributed to the fund based on the number of employee man-weeks worked; it did not contribute on behalf of particular employees. *See id.* at 560–61.

72. *Id.* at 553.

73. *Id.* at 554.

74. *Id.*

for an alleged break in service, brought suit under the securities laws, including Rule 10b-5, alleging misrepresentations and omissions on the part of the plan's trustees.[75] Holding that the pension plan was not a security for purposes of the 1933 and 1934 Acts, the Court first noted that neither statutory definition of "security" listed the term "pension plan" within it. Plaintiff contended that the plan constituted an "investment contract," a grab-bag term included within the definitions.[76] In the 1946 case, *SEC v. W.J. Howey Co.*,[77] the Court had set forth a working definition of the term "investment contract" to determine whether a particular investment interest should be treated as a security. According to *Howey*, "the test [for an investment contract] is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."[78] Looking to the first "prong" of the test—"an investment of money"—the *Daniel* Court found that the employees covered under the plan had not made an investment of money into the fund.[79] Plaintiff argued that he had invested in the fund "[b]y allowing his employer to pay money into the Fund, and by contributing his labor to his employer in return for these payments."[80] The Court found, however, that "[o]nly in the most abstract sense may it be said that an employee 'exchanges' some portion of his labor in return for these possible benefits."[81] Comparing plaintiff to other purchasers of securities, the Court found that in every other case, the purchaser had given up "some tangible and definable consideration" in return for the security.[82] In plaintiff's case, however, "the purported investment is a relatively insignificant part of an employee's total and indivisible compensation package."[83] The Court was unwilling to look at the pension plan as a separate and discrete security; instead, the Court determined that an employee covered by the plan "surrenders his labor as a whole, and in return receives a compensation package that is substantially devoid of aspects resembling a security."[84] Having thus cabined the analysis, the outcome is foreordained: "Looking at the economic realities, it seems clear that an employee is selling his labor primarily to obtain a livelihood, not making an investment."[85]

75. *Id.* at 554–55.
76. 15 U.S.C. § 77b(a)(1) (2000); 15 U.S.C. § 78c(a)(10) (2000).
77. 328 U.S. 293 (1946).
78. *Howey*, 328 U.S. at 301, *quoted in Daniel*, 439 U.S. at 558.
79. *Daniel*, 439 U.S. at 559.
80. *Id.*
81. *Id.* at 560.
82. *Id.* (citing cases that involved money paid for bank capital stock; money paid for purchase, maintenance, and harvesting of orange grove; money paid for land and oil exploration; portion of premium paid for variable component of mixed annuity; and premium paid for variable annuity contract).
83. *Id.*
84. Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 560 (1979).
85. *Id.*

The *Daniel* Court also found that the plaintiff could not meet the second part of the test, as the pension plan obtained its funds primarily through employer contributions.[86] Since profits from the investment of those funds only constituted a small slice of the fund's assets, the Court concluded that the fund was not a "common enterprise with profits to come solely from the efforts of others."[87] Moreover, the Court noted that an employee's benefits were not affected by the financial success of the fund, but rather by the employee's age at retirement. As the Court noted, "even if it were proper to describe the benefits as a 'profit' returned on some hypothetical investment by the employee, this profit would depend primarily on the employee's efforts to meet the vesting requirements, rather than the fund's investment success."[88] Since employees would not profit (or lose) from the investment choices of the fund, the plan failed to meet the second part of the *Howey* test. In further defense of its decision, the Court also analyzed the legislative history of the Acts, as well as SEC past practice, and found that neither contradicted its holding.[89] Finally, the Court found that the enactment of ERISA, which specifically regulated pension plans, undercut the rationale for securities regulation of those plans.[90] "Whatever benefits employees might derive from the effect of the Securities Acts are now provided in more definite form through ERISA."[91]

Despite the variety of arguments the *Daniel* Court employed in its decision, the Court characterized the primary issue as "whether a noncontributory, compulsory pension plan constitutes a 'security',"[92] and framed its holding in similar language.[93] By centering the case on whether a plan was compulsory or noncontributory, the court focused on the first prong of the *Howey* test—namely, that the employee had not made an "investment of money" in the plan. This focus was not lost on those who subsequently interpreted *Daniel*. As an amicus curiae in *Daniel*, the SEC had argued that pension plans should be considered securities under the Acts, as per its own past practice.[94] However, after the *Daniel* decision the agency issued a release setting forth its revised opinion as to the coverage of employee benefit plans by the Acts.[95] In that release, the SEC described the *Daniel* holding as follows:

86. *Id.* at 562.

87. *Id.* at 558 (quoting SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946)).

88. *Id.* at 562.

89. *Daniel*, 439 U.S. at 563–69.

90. *Id.* at 569–70.

91. *Id.* at 570.

92. *Id.* at 553.

93. *Id.* at 570 ("We hold that the Securities Acts do not apply to a noncontributory, compulsory pension plan.").

94. *Id.* at 565–66.

95. Securities Act of 1933 Release No. 6188 (Feb. 1, 1980), 1980 WL 29482.

> The *Daniel* decision dealt with an involuntary, noncontributory plan which was also a defined benefit plan. The Supreme Court's opinion in that case, however, did not rest on the fact that the plan was a defined benefit one. Instead, the Court based its decision on the involuntary nature of the plan (unlike all prior cases of the Court involving securities, the employees did not have a choice whether to participate) and the fact that the plan did not provide for direct, identifiable contributions by employees (the employees' labor could be considered a contribution "only in the most abstract sense"). This view is supported both by the Court's statement of the issue presented by the case ("whether a noncontributory, compulsory pension plan constitutes a 'security'") and by its later statement that "We hold the Securities Acts do not apply to a noncontributory, compulsory pension plan." In neither instance did the Court refer to the defined benefit nature of the plan.[96]

The SEC went on to state that it would only consider voluntary, contributory pension plans to be "securities" under the Act. Plans to which the employees contributed "involuntarily" were not securities, since *Daniel* had noted that unlike other securities purchasers, employees had not "chose[n] to give up specific consideration."[97] Plans in which the employees chose to participate, but which were funded by employer contributions, were also not securities, as the employees had not made an "investment of money."[98]

Reading between the lines, it seems clear that the SEC was following the logic of *Daniel* to its absurd conclusion. The SEC's initial distinction between defined benefit and defined contribution plans seems a much more logical way to exclude pension plans like the one in *Daniel* from securities regulation. In a defined benefit plan, the employee does not risk anything, as the employer is required to pay a certain amount to the employee during retirement. Rather than an investment, a defined-benefit pension plan is a method of deferring compensation. Defined contribution plans, on the other hand, are an investment, as the employee is risking the money that the employer has invested on her behalf.[99] Using the *Howey* test, defined-benefit

96. *Id.* at *7.

97. *Id.* at *8.

98. *Id.*

99. *See* Daniel Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105, 1112–13 (1988) (noting that "[d]efined contribution and defined benefit plans allocate investment risk oppositely," with employers bearing the risk under defined benefit plans and employees bearing the risk under defined contribution plans). Interestingly, Fischel and Langbein note that multiemployer plans, like the one in *Daniel*, are defined benefit plans from the employee's perspective, but defined contribution plans from the employer's perspective. Under such plans, it is up to the plan's trustee to adjust employer contributions so as to provide the defined benefits. *See id.* at 1113.

plans fail the test based on the second prong, as the benefits employees receive are unaffected by the "profits" that the fund may generate.[100] Instead of following this analysis, however, the Court in *Daniel* emphasized that the employees had not invested their "own" money and had no "choice" as to what to do with the money that was invested, both factors which relate to the "investment of money" prong. This choice has led to a variety of confused distinctions when applied to employee investments. This confusion is perhaps best illustrated by a discussion of how courts have treated employee stock ownership plans.

B. DANIEL*'S REACH: EMPLOYEE STOCK OWNERSHIP PLANS AS SECURITIES*

The use of the "involuntary" and "noncontributory" factors by the *Daniel* Court, subsequently followed by the SEC, has led to considerable confusion among the lower courts as to whether employee stock ownership plans, or ESOPs, should be considered "securities." Summarized briefly, an ESOP is a fund which invests in the securities of a particular employer. Set up by the employer, the ESOP often begins by borrowing money in order to purchase a stake in the employer's stock.[101] The ESOP then transfers this stock to the lender and pays off the loan over time, using contributions from the employer. As the loan is paid off, the lender releases the shares back to the ESOP. The ESOP then may allocate the shares to the accounts of particular employees, who can then either receive shares of the stock directly or receive the market value in cash once their interest in the ESOP has vested.[102] When established in this fashion, ESOPs are given substantial benefits under the tax code.[103]

ESOPs are clearly defined contribution plans, as employers simply provide set contributions to the plan, and employees receive shares of the employer's stock.[104] Moreover, since employees are investing in an employer's stock through an ESOP, it seems clear that this investment

100. *See* Sean S. Hogle, Note, *The Employee as Investor: The Case for Universal Application of the Federal Securities Laws to Employee Stock Ownership Plans*, 34 WM. & MARY L. REV. 189, 205–06 (1992).

101. ESOPs that borrow money to purchase employer securities are known as leveraged ESOPs. The ability to borrow money is one aspect that distinguishes ESOPs from other retirement plans. *See* Alan Hyde & Craig Harnett Livingston, *Employee Takeovers*, 41 RUTGERS L. REV. 1131, 1141–44 (1989) (discussing the advantages of borrowing through an ESOP).

102. Employees must be given the choice of receiving the benefits in cash or receiving the stock directly in order for the ESOP to be qualified for benefits under the Internal Revenue Code. *See* 26 U.S.C. §§ 409(h), 4975(e)(7) (2000).

103. *See id.* §§ 401, 4975(e)(7) (establishing such plans as "defined contribution plans" and thereby "qualified trusts" entitled to the tax benefits afforded to qualified pension plans).

104. *See* Hogle, *supra* note 100, at 211 ("Unlike defined benefit plans, in which investment performance has little or no effect upon the amount of the benefit to be paid, the entire risk of the [ESOP] plan falls on employee participants.").

should constitute a security under the Acts.[105] However, courts have split over whether ESOPs constitute securities, mainly due to conflicts over the application of *Daniel*'s "compulsory, noncontributory" analysis. Courts have characterized ESOPs with similar characteristics—in one situation, the very same plan[106]—as both voluntary and involuntary, and both contributory and non-contributory.

Two district courts have found employee interest in ESOPs not to be securities. In *Childers v. Northwest Airlines*,[107] Republic Airlines negotiated with unions representing its employees for a fifteen percent wage cut in exchange for participation in an ESOP. Considering a subsequent suit by employees raising a Rule 10b-5 claim, the court held that the ESOP was not a security under the Acts. The court found that the plan was compulsory, as all employees were bound by the collective bargaining agreement to participate in the plan and thereby made no "individual affirmative decision" to join the ESOP.[108] Likewise, in *Bauman v. Bish*,[109] an ESOP which formed part of a proposed employee buy-out plan was also found to be noncontributory and involuntary, despite the need for union approval of a thirty-two percent wage reduction.[110] In contrast, three courts have held that ESOPs do represent securities. In *Uselton v. Commercial Lovelace Motor Freight, Inc.*,[111] the Tenth Circuit found the ESOP at issue to be both voluntary and contributory. The court found that employees contributed to the plan by forfeiting seventeen percent of their wages through a collective-bargaining agreement similar to the agreement in *Childers*.[112] Unlike the agreement in *Childers*, however, employees had the option of participating in the ESOP; they could also choose not to participate and continue to receive their

105. *See* Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985) (noting that traditional stock represents to many "the paradigm of a security").

106. *Compare* Childers v. Northwest Airlines, Inc., 688 F. Supp. 1357 (D. Minn. 1988) (finding that Republic Airlines ESOP is not a security), *with* Harris v. Republic Airlines, Inc., [1987–1988 Transder Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,772 (D.D.C. May 19, 1988), 1988 WL 56256 (finding that Republic Airlines ESOP is a security).

107. *Childers*, 688 F. Supp. at 1357.

108. *Id.* at 1363. The court also found no "common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others." *Id.* (quoting Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 561 (1979)). According to the court, "any appreciation in the value of the stock would not be attributable to the management of the ESOPs but to the financial recovery of Republic as a whole." *Childers*, 688 F. Supp. at 1363.

109. 571 F. Supp. 1054 (N.D. W. Va. 1983).

110. *Id.* at 1063. The court did not base its decision on this finding, but instead concluded that no offer, sale, or purchase of securities had taken place. *See id.* at 1063–64.

111. 940 F.2d 564 (10th Cir. 1991).

112. *See id.* at 575 ("The economic reality of the transaction, therefore, was that plaintiffs contributed their legal right to a portion of their wages to [the employer] in return for the right to acquire [the employer's] stock via the [employer's] ESOP and to participate in [the employer's] profit-sharing plan.").

current wages.[113] The ESOP in *Hood v. Smith's Transfer Corp.*[114] also allowed employees to choose whether to participate; it also was found to be a voluntary and contributory plan, based on the fifteen-percent wage reduction that was required for participation.[115] In *Harris v. Republic Airlines, Inc.*,[116] the court only notes that the employees "agreed to participate in" the ESOP without explaining how.[117] However, it too found that the employees' agreement to continued wage reductions constituted contributions by employees sufficient to make the ESOP a security.[118]

Since *Daniel* applied its "compulsory and noncontributory" test in the context of whether a pension plan was an "investment contract" under the Acts, it may seem logical to distinguish ESOPs based on the fact that ESOP participants eventually receive stock, while the *Daniel* pension plan participants receive a fixed amount of money.[119] However, ESOP participants do not receive stock directly from the company; instead, the stock is sold to the ESOP. Only later, generally after vesting requirements have been met, is the stock distributed to employee accounts. Upon vesting, an employee can often request the cash value of the stock, rather than the stock itself. Thus, just as an interest in a pension plan with stock holdings is analyzed under the "investment contract" test, rather than being seen as a "stock," an employee's interest in an ESOP may also be deemed sufficiently removed from the stock itself to warrant analysis solely as an investment contract.[120] As the court noted in *Harris*, however, "[t]he introduction of an ESOP as a device for distributing [the company's] stock in accordance with employee's investments (presumably to take advantage of favorable tax

113. *See id.*

114. 762 F. Supp. 1274 (W.D. Ky. 1991).

115. *Id.* at 1290–91. While finding the plan to be voluntary and contributory, the court also claimed that the *Howey* "investment contract" analysis was inapplicable, as participants in the ESOP acquired shares of common stock.

116. [1987–1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,772 (D.D.C. May 19, 1988), 1988 WL 56256.

117. *Id.*, 1988 WL 56256, at *4.

118. *Id.*, 1988 WL 56256, at *9–*10. Interestingly, no court has found that an ESOP was voluntary but noncontributory, or contributory but involuntary.

119. The courts in *Hood* and *Harris* both took this approach. *See Hood*, 762 F. Supp. at 1290–91 (arguing that the ESOP was not a pension plan but instead a method of delivering shares in the company to employees); *Harris*, 1988 WL 56256, at *8, *10 (same); *see also* Foltz v. U.S. News & World Report, Inc., 627 F. Supp. 1143, 1159 (D.D.C. 1986) (concluding that a stock bonus plan represented either "stock" or "voting–trust certificates" and thus was a security).

120. Neither *Uselton* nor *Bauman* explained why they chose to use the "investment contract" analysis, rather than the "stock" analysis used in *Hood* and *Harris*. *See* Uselton v. Commercial Lovelace Motor Freight, Inc., 940 F.2d 564, 572 (10th Cir. 1991); Bauman v. Bush, 571 F. Supp. 1054, 1063 (N.D. W. Va. 1983). *Bauman* recognized, however, that ESOPs are different than standard pension plans and thus did not view *Daniel* as dispositive. *Id.* In *Childers*, the plaintiffs did not argue that they had purchased a security simply because the ESOPs were funded by shares of stock, and thus the court did not address this issue. *See* Childers v. Northwest Airlines, Inc., 688 F. Supp. 1357, 1363 n.5 (D. Minn. 1998).

provisions), cannot and simply does not change the fundamentals of the underlying transaction"[121]—namely, the distribution of employer stock to employees.

C. EMPLOYEE STOCK OPTIONS AS SECURITIES

Employees holding stock options can only sue under Rule 10b-5 if such options are deemed to be "securities" for purposes of the Acts. Thus far, courts have held that employee stock options are securities.[122] Stock options are enumerated in the text of the definition of a "security": the definition lists "stock" as well as "the right to . . . purchase any of the foregoing" explicitly, thus including the right to purchase stock.[123] As long as the stock that is the subject of the option possesses "some of the significant characteristics typically associated with stock,"[124] the stock option meets the definition of a security under the Acts. The confusion generated from the *Daniel* analysis has not been a factor, since a direct grant of options would obviate the need for an "investment contract" analysis when considering a stock option plan.[125]

Courts have considered and rejected a potential argument for excluding employee ownership interests from the definition of a "security": namely, that these interests are not securities because the "context otherwise requires." The definitional sections for the 1933 and 1934 Acts begin with similar provisos—"[w]hen used in this subchapter, unless the context otherwise requires . . . ."[126] Courts and commentators have debated over the exact meaning of this exception, particularly whether "context" means "in the context of the statute's text," or "in the context of the facts of the case."[127] In two Rule 10b-5 cases involving employee ownership interests—

121. *Harris*, 1988 WL 56256, at *10.

122. *See, e.g.,* Yoder v. Orthomolecular Nutrition Inst., Inc., 751 F.2d 555, 559 (2d Cir. 1985); McLaughlin v. Cendant Corp., 76 F. Supp. 2d 539, 545 (D.N.J. 1999); Collins v. Rukin, 342 F. Supp. 1282, 1286 (D. Mass. 1972).

123. 15 U.S.C. §§ 77b(1), 78c(a)(10) (2000).

124. Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 (1985).

125. In *Landreth*, the Court made clear that the *Howey* economic realities test, which *Daniel* was applying in developing its "involuntary and noncontributory" analysis, should be used only when determining whether a particular instrument is an investment contract. *See Landreth*, 471 U.S. at 691–92. However, one might imagine that if a stock option plan were created with an intermediary step in which the options were distributed to a plan and then, after vesting, to employees, that middle step could turn a stock option plan into the equivalent of an ESOP using options. A court might then apply the *Daniel* "investment contract" analysis to the plan. If an employer set up a stock option plan without explicit bargaining by employees such that there was no explicit "contribution" by employees to the plan, and employees had no "choice" as to whether to join the plan or not, the plan would fail *Daniel*'s requirement that such plans be voluntary and contributory. This possibility is, however, purely hypothetical.

126. 15 U.S.C. § 77b (2000); *see also id.* § 78(c) ("When used in this chapter, unless the context otherwise requires . . . .").

127. *See. e.g.,* Rubin v. United States, 449 U.S. 424, 429–31 (1981); Superintendent of Ins. v.

one involving stock, the other stock options—defendants argued that the securities laws should not apply in the "context" of securities that form part of an employment contract.[128] In both cases, while the courts noted that the securities laws were designed to protect investors, they nevertheless found the securities protections broad enough to encompass employees with interests in their companies.[129] As Judge Friendly wrote in the *Yoder* case, "We see no reason why 'the context requires' us to hold that an individual who commits herself to employment by a corporation in return for stock or the promise of stock should not be considered an investor."[130]

D. Employees as Purchasers of Securities

While courts have held that employee stock options are covered as securities under the Acts, employees must overcome another threshold to meet the requirements of Rule 10b-5. As discussed above,[131] only *actual* purchasers and sellers of securities can bring private actions under Rule 10b-5. Moreover, the fraud or misrepresentation in an action must be connected to the actual sale or purchase by which the plaintiff became a "purchaser" or "seller."[132] Section 2(3) of the 1933 Act defines "sale" and "sell" to "include every contract of sale or disposition of a security or interest in a security, for value,"[133] while section 3(a)(14) of the 1934 Act defines these terms to "include any contract to sell or otherwise dispose of."[134] The question at issue, then, is whether an employee's receipt of an opportunity for ownership in his or her company through means of an ESOP, stock purchase plan, or stock options, is a "sale" of securities by the employer.

In its 1980 release on employee benefit plans, the SEC found that generally no sale takes place when employees acquire ownership interests through stock bonus plans.[135] Defining a stock bonus plan as a plan "under

Bankers Life & Cas. Co., 404 U.S. 6, 10–12 (1971); SEC v. Nat'l Sec., Inc., 393 U.S. 453, 466 (1969); 2 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 873–74 (3d ed. 1989); Marc I. Steinberg & William E. Kaulbach, *The Supreme Court and the Definition of "Security": The "Context" Clause, "Investment Contract" Analysis, and Their Ramifications*, 40 VAND. L. REV. 489, 504 (1987).

128. *See* Yoder v. Orthomolecular Nutrition Inst., Inc., 751 F.2d 555, 559 (2d Cir. 1985); Collins v. Rukin, 342 F. Supp. 1282, 1286 (D. Mass. 1972).

129. *See Yoder*, 751 F.2d at 560–61; *Collins*, 342 F. Supp. at 1286.

130. *Yoder*, 751 F.2d at 560.

131. *See supra* Section II.

132. 17 C.F.R. § 240.10b-5 (2001).

133. 15 U.S.C. § 77b(3) (2000).

134. 15 U.S.C. § 78c(a)(14) (2000). Section 3(a)(13) defines "buy" and "purchase" to "include any contract to buy, purchase, or otherwise acquire." *Id.* § 78c(a)(13). Courts have held that the definitions of "sale" in the two Acts, despite their differences in wording, should be construed similarly. *See* Lawrence v. SEC, 398 F.2d 276, 280 (1st Cir. 1968), *quoted in Collins*, 342 F. Supp. at 1288 n.12.

135. Securities Act of 1933 Release No. 6188 (Feb. 1, 1980), 1980 WL 29482. Examples of such stock bonus plans include ESOPs, Tax Reduction Act Stock Ownership Plans (TRASOPs), and stock appreciation right plans (SARs). *See id.*

which an employer awards shares of its stock to covered employees at no direct cost to the employee," the SEC found that such awards are not sales because employees "do not individually bargain to contribute cash or other tangible or definable consideration to such plans."[136] Interestingly, the agency makes an exception in a footnote:

> The staff's position generally is applicable only in the context of bonus plans which are made available to a relatively broad class of employees. With respect to stock awarded to, or acquired by, employees pursuant to individual employment arrangements, the staff generally has concluded that such arrangements involve separately bargained consideration, and that a sale of the stock has occurred.[137]

Thus, the SEC makes a fundamental distinction: if the plan awards stock to a large percentage of employees, no sale has occurred, but if select employees receive stock on an individual basis, a sale has taken place.

This distinction is on display in a collection of SEC no-action letters concerning large-scale employee stock bonus plans created by European companies.[138] In Europe, the companies had structured these plans so that employees could purchase company stock at a discount only with money they had saved through an employer savings plan. Since such a transaction would clearly be a sale of the stock, the companies altered the plans for U.S. consumption by giving shares to employees merely for saving a certain amount of money. For example, in the *Thorn EMI* no-action letter,[139] counsel for Thorn EMI set forth a plan in which employees would be required to save money in a savings account for one year. At the end of the year, the employee would be awarded a number of shares based on the amount the employee invested, as well as the stock's appreciation over the previous year.[140] Since employees made no "payment" for their stock award, other than keeping money in an interest-bearing account for a year, the SEC determined that "the employee bonus share plan involve[d] no offers or

136. *Id.*

137. *Id.* at *15 n.84.

138. "No-action" letters are prepared by SEC staff in response to letters from private attorneys regarding a proposed course of action. If a staff member agrees that the proposed action is in compliance with the law, she will compose a response stating that the staff will recommend to the Commission that no enforcement action be taken. These "no-action" letters are made public by the SEC and offer important guidance to practitioners. However, they are not binding on the five-member Commission, and the staff is free to change its position in the future. *See* RICHARD W. JENNINGS ET AL., SECURITIES REGULATION: CASES AND MATERIALS 103 (8th ed. 1998).

139. Thorn EMI PLC, SEC No-Action Letter, 1992 WL 56547 (Mar. 18, 1992).

140. *See id.* at *2. If the employee was forced to leave employment under certain "compassionate" circumstances prior to the end of the year, she would be entitled to partial vesting of the shares. *See id.* at *3.

sales of securities."[141] Similar plans have also received no-action letters.[142] All these plans were available to a broad class of employees.[143]

In determining whether an employer's distribution of stock or stock options is a sale for the purposes of Rule 10b-5, courts have largely followed the division set forth by the SEC. In cases involving individually negotiated stock or stock options, courts have found that the negotiation of those securities constitutes a sale. In *Collins v. Rukin*,[144] the court puzzled over whether the "absence of cash consideration flowing from [employee to employer]" with regard to a stock option plan disqualified the offering of those options from being considered a sale.[145] The plaintiff in *Collins* had been working at Magnavox as an electrical engineer when he was wooed to join the defendant employer by defendant, the employer's president and majority shareholder.[146] Part of the compensation plan offered to plaintiff was a stock options agreement.[147] Finding a lack of precedent as to whether "plaintiff's acceptance of employment with [employer] and his subsequent performance of services as an electrical engineer and executive officer qualifies as value," the court noted defendants' analogy of its stock option plan to other "bonus" plans which gave employees profits or stock without the need for consideration.[148] The court distinguished the plan in *Collins* from such bonus plans, however, by noting that the option plan was not given gratuitously, but rather was "a *quid pro quo* offered to induce plaintiff to enter into the employ of [defendant]."[149] The court concluded that the plaintiff's performance of services satisfied the requirement in section 2(3)

141. *Id.* at *7.

142. *See* Compass Group PLC, SEC No-Action Letter, 1999 WL 311797 (May 13, 1999); Guinness PLC, SEC No-Action Letter, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,672 (Apr. 9, 1993), 1993 WL 113137; Fisons PLC, SEC No-Action Letter, 1990 WL 286992 (Oct. 22, 1990). In all of these cases, the letters sought to avoid registering the securities under section 2(3) of the 1933 Act.

143. *See Compass Group* No-Action Letter, 1999 WL 311797 at *1 (stating that all non-union employees with at least six months of service may participate in the plan); *Guiness* No-Action Letter, 1993 WL 113137 at *2 (stating that all employees of the Guiness joint venture with several other European companies may participate in the plan); *Thorn EMI* No-Action Letter, 1992 WL 56547 at *1–*2 (stating that all employees (including 10,200 in the U.S.) may participate in the plan); *Fisons* No-Action Letter, 1990 WL 286992 at *2 (noting that all U.S. employees may participate in the plan).

144. 342 F. Supp. 1282 (D. Mass. 1972).

145. *Id.* at 1289.

146. *Id.* at 1284.

147. The stock options offered under the plan were personal and non-transferable, and therefore non-negotiable. *See id.* at 1286. However, the employer falsely suggested that the company was about to "go public," thus making its stock more valuable. *Id.* at 1284.

148. *Id.* at 1289.

149. *Collins*, 342 F. Supp. at 1289.

of the 1933 Act that the sale be made "for value," and therefore found that a sale had taken place.[150]

In *Yoder v. Orthomolecular Nutrition Institute, Inc.*,[151] plaintiff was a specialist in the field of food allergies who reached an agreement to sell her business to defendant. As part of the agreement, plaintiff became defendant's employee, and defendant agreed to issue shares in itself to plaintiff if a certain amount of sales were generated.[152] The Second Circuit, in an opinion authored by Judge Friendly, held that this agreement constituted a sale of securities.[153] Citing to *Collins*, the court noted that "[l]ike Ms. Yoder, the plaintiff [in *Collins*] alleged that he was induced to accept employment with the defendant at least partly on the basis of the latter's promises of stock and stock options."[154] Other courts, in turn, have cited to *Yoder* for the proposition that "[a]n agreement exchanging a plaintiff's services for a defendant corporation's stock constitutes a 'sale' under the terms of the Securities Exchange Act."[155] These courts have all found securities sales in contexts similar to *Collins* and *Yoder*. In *Rudinger*, the plaintiff became defendant employer's president and chief operating officer

150. *Id.* at 1290 (discussing 15 U.S.C. § 77b(3) (2000)).

151. 751 F.2d 555 (2d Cir. 1985).

152. *See id.* at 556–57.

153. *Id.* at 560.

154. *Id.* (citing *Collins*, 342 F. Supp. at 1287–88). *Yoder* involved much more than an employment contract, as the assets of Ms. Yoder's business were also part of the sale. The court noted:

> [T]his case does not require us to hold that an action under Rule 10b-5 can be maintained . . . where the plaintiff merely promises to work for a defendant in return for the latter's promise to issue stock, whether with or without the payment of salary—although, as developed above, we see little reason for not holding to that effect.

Id. at 561.

155. Rudinger v. Ins. Data Processing, Inc., 778 F. Supp. 1334, 1338–39 (E.D. Pa. 1991); *see also* Campbell v. Nat'l Media Corp., [1994–1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,449 (E.D. Pa. Nov. 3, 1994) ("An employment contract whereby an employee exchanges his services in return for stock options has been held to constitute a purchase with the meaning of the 1934 Act."); Sanzone v. Phoenix Technologies, Inc., No. Civ. A. 89-5397, 1990 WL 50732, at *14 (E.D. Pa. Apr. 19, 1990) ("[I]f established at trial, the purported agreement exchanging plaintiff's services as an employee for defendant corporation's stock constitutes a 'sale' under the terms of the Securities Exchange Act."); Dubin v. E.F. Hutton Group Inc., 695 F. Supp. 138, 145 (S.D.N.Y. 1988) (holding that plaintiff who accepted employment in exchange for equity interest, "like the plaintiffs in *Yoder* and *Collins*, made a decision like that of an 'investor,' who must be able to depend on the representations made by the transferor of any securities"). Even the court in *McLaughlin v. Cendant Corp.* cites *Yoder* for this proposition. *See* McLaughlin v. Cendant Corp., 76 F. Supp. 2d 539, 544 (D.N.J. 1999) ("When an individual 'commits herself to employment by a corporation in return for stock or the promise of stock,' she will be considered an investor worthy of protection under the federal securities laws." (quoting *Yoder*, 751 F.2d at 560)).

after signing an agreement that included a promise of stock options.[156] In *Campbell*, the defendant employer executed an employment agreement with plaintiff, its corporate secretary and vice-president for investor relations, which included stock options.[157] The plaintiff in *Sanzone* allegedly accepted employment as defendant employer's vice-president of manufacturing after negotiating for salary, benefits, and five percent of the employer's stock.[158] Similarly, in *Dubin* the plaintiff joined defendant employer to oversee its public power and resource recovery group after negotiating for participation in the employer's equity ownership plan.[159] In all of these cases, plaintiffs were high-level executives or managers with individual agreements for stock or stock option plans; in all but one, the plaintiff had agreed to join the defendant as an employee pursuant to the agreement.[160]

In contrast, for those cases in which employer securities were offered to employees as a group, courts have largely held that no "sale" has taken place. As discussed earlier, *Bauman v. Bish*[161] involved an ESOP which formed part of a proposed employee buy-out plan; under the plan, employees would take a thirty-two percent wage cut in exchange for control of a newly-formed company through the ESOP.[162] The court held that, if executed, the creation of the ESOP would not constitute a "sale" under the Acts, as there was no furnishing of "value" by participating employees.[163] According to the court, "[t]he notion that the exchange of labor will suffice to constitute the type of investment which the Securities Acts were intended to regulate was rejected in *Daniel*."[164] Plaintiffs contended that the employees' reduction in wages in exchange for the ESOP constituted "value" or consideration under the Acts. Calling this a "strained interpretation" of the facts, the court found that "the proposed ESOP is a method of deferring income, not reducing wages or paying for stock."[165]

In two recent cases involving the Cendant Corporation, employees who had received stock options through a company-wide plan were held not to have participated in a "sale" of those options, and therefore could not bring

156. *See Rudinger*, 778 F. Supp. at 1336.

157. *See Campbell*, 1994 WL 612807, at *1.

158. *See Sanzone*, 1990 WL 50732, at *1.

159. *See Dubin*, 695 F. Supp. at 140–41.

160. In *Campbell*, the plaintiff was already an employee when he executed the agreement. *See Campbell*, 1994 WL 612807, at *1.

161. 571 F. Supp. 1054 (N.D. W. Va. 1983).

162. *Id.* at 1057.

163. *See id.* at 1063–64.

164. *Id.* (citing Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 559–61 (1979)).

165. *Id.* (citing AM. JUR. 2D., PENSION REFORM ACT § 187 (1975)); *see also* Childers v. Northwest Airlines, Inc., 688 F. Supp. 1357, 1363 (D. Minn. 1988) (finding that wage concessions were "a method of deferring income, not a method of reducing wages to pay for stock").

Rule 10b-5 claims. In the first case, *McLaughlin v. Cendant Corp.*,[166] plaintiff Eileen McLaughlin was a former Cendant employee who had received 66,863 stock options through an employee stock option plan.[167] While these options were apparently not individually negotiated, the plaintiff did allege that they had been provided as "an incentive to key employees of the Company and . . . to offer an additional inducement in obtaining the services of such individuals."[168] The New Jersey district court recognized that, in cases where employer securities are specifically bargained for, the agreement to provide those securities does constitute a sale under the Acts.[169] However, the court noted that the plaintiff "acquired her options when she was already employed by Cendant under a plan that offered the options not to her as an individual, but as a member of an employee group."[170] Citing to SEC Release No. 33-6188 as well as a prior no-action letter, the court noted the SEC's position that stock bonus plans do not constitute a purchase or sale when employees have not given anything of value other than continued employment.[171] The court, citing to *Daniel* and *Bauman*, then said that other courts had found no sale had taken place when a plan was compulsory and non-contributory.[172] Holding that courts had rejected continued labor as a "contribution," the court held that Cendant's stock option plan was compulsory, as employees had no option other than to refuse the plan, and non-contributory, as there had been no bargained-for exchange of value.[173] The court noted: "Though the plan stated that it was created to provide an incentive for employees to remain with Cendant, that language does not change the actual structure of the plan."[174]

In *Wyatt v. Cendant Corp.*, plaintiffs were management employees at Interval International, a subsidiary of CUC International (one-half of the eventual Cendant Corporation, after a merger with HFS, Inc.).[175] In 1992, CUC's board of directors adopted a stock option plan for senior

166. 76 F. Supp. 2d 539 (D.N.J. 1999).

167. *Id.* at 541. Plaintiff also asserted that she purchased 7777 options for cash. *Id.* The claims relating to these options were dismissed for failure to satisfy the heightened pleading requirements for fraud in a Rule 10b-5 claim. *See id.* at 545–48.

168. *Id.* at 544 (quoting Plaintiff's Brief at 17 (ellipsis in original)). The decision does not specify McLaughlin's position at Cendant.

169. *See id.*

170. *Id.*

171. *See McLaughlin*, 76 F. Supp. 2d at 544 (citing to Compass Group PLC, SEC No-Action Letter, 1999 WL 311797 (May 13, 1999); Securities Act of 1933 Release No. 6188 (Feb. 1, 1980), 1980 WL 29482).

172. *See id.* at 544–45 (citing Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 558–59 (1979); Bauman v. Bish, 571 F. Supp. 1054, 1064 (N.D. W. Va. 1983)).

173. *See id.* at 545.

174. *Id.*

175. 81 F. Supp. 2d 550, 552 (D.N.J. 2000).

management in which plaintiffs participated.[176] Pursuant to merger discussions with HFS, CUC decided to divest itself of Interval prior to the merger.[177] Under the terms of the stock option plan, plaintiffs would be required to exercise their options within four months of the divestiture or forfeit those options.[178] However, working through Interval's president, plaintiffs managed to negotiate a two-year exercise period, as well as accelerated vesting for their unvested options.[179]

In bringing a private action under Rule 10b-5, plaintiffs alleged that the modifications to their option agreement that took place upon divestiture constituted a "sale or purchase" of those options.[180] Again, however, the court found the stock option plan, even with the modifications, to be a compulsory, noncontributory plan.[181] First, the court noted that plaintiffs had not altered their employment relations in any way that would provide specific consideration for the sale.[182] Since they had not made any concrete changes to their employment relationship to "pay" for the options, the plan remained noncontributory.[183] And since the plaintiffs could have only chosen to participate in the plan or reject it, the plan was compulsory in that plaintiffs had not made a voluntary "investment decision" to participate.[184] Plaintiffs maintained that their bargaining with CUC (through Interval's president) for better terms constituted a collective investment decision on their part.[185] However, the court held that "[t]he admittedly collective bargaining here negates the existence of any individual, voluntary investment decision."[186]

Thus, when individual employees have bargained to receive employer securities in return for employment, courts have generally found that such agreements should be considered a "sale" for purposes of Rule 10b-5. However, when employees receive employer securities as part of a group plan, the transfer of securities through the plan will not be considered a sale, unless employees give specific consideration and have a "choice" that goes beyond simply accepting or rejecting the plan. This distinction

176. *Id.*

177. *Id.* at 552–53. The merger between CUC and HFS resulted in the creation of Cendant.

178. *Id.* at 553. Barring divestiture, the plan gave employees ten years to exercise the options.

179. *Id.*

180. *Wyatt*, 81 F. Supp. 2d at 555. Plaintiffs did not contend that the initial distribution of options through the plan was a sale.

181. *Id.* at 556–58.

182. *Id.* at 556 ("Unlike *Yoder* and *Rudinger*, where the employee changed his employment status in return for individually bargained-for compensation including stock options, the *Wyatt* plaintiffs remained as at-will Interval employees with the same responsibilities and compensation they had pre-divestiture.").

183. *Id.* at 557.

184. *Id.* at 557–58.

185. *Wyatt*, 81 F. Supp. 2d at 558.

186. *Id.*

obviously favors those employees who individually bargain for their employment terms, and disadvantages those employees whose employment terms are negotiated or dictated as a group. The former group is more likely to be officers, executives, or other high-placed employees within a company, while the latter group is likely to be lower-ranking employees. This distinction is illustrated by the cases: the plaintiffs in *Yoder*, *Collins*, *Rudlinger*, *Dubin*, *Campbell*, and *Sanzone* were all owners or executives, while the plaintiffs in the *Cendant* cases were lower-ranking employees, and the plaintiffs in *Bauman* were union-represented employees.[187]

Two unpublished district court decisions from the Eastern District of Pennsylvania bucked this trend, but with little comment. Both cases concern Rule 10b-5 claims brought by employees pursuant to participation in a "Long-Term Incentive Plan" or LTIP, through which executives and "key employees" were eligible for stock options.[188] Although the employees thereby received their options through a plan, the courts held that this transfer was a sale for Rule 10b-5 purposes.[189] Citing to *Campbell*, *Rudinger*, and *Sanzone*, both cases held that the exchange of plaintiff's services for stock options constituted a sale.[190] Neither case discussed the SEC Release on the issue.

Ironically, a recent Ninth Circuit decision found that employees received their stock options through a "sale"—but did so in order to dismiss the employees' claims.[191] In *Falkowski v. Imation Corp.*, the Ninth Circuit was interpreting the Securities Litigation Uniform Standards Act of 1998 (SLUSA), which preempts class actions involving allegations of fraud "in connection with the purchase or sale of a covered security" when such actions are based on state law.[192] The plaintiffs were employees who had received stock options through a company plan.[193] They brought a class

187. Of course, executives and other high-ranking employees may also receive their options through a plan. The point here is a general one: low-level employees are unlikely to receive their options through individual negotiations, and higher-level executives are more likely to get such individualized attention.

188. *See* Feret v. CoreStates Fin. Corp., No. Civ. A. 97-6759, 1998 WL 426560, at *11 n.14 (E.D. Pa. July 27, 1998); Tafuri v. Air Prods. and Chems., Inc., No. Civ. A. 97-3413, 1997 WL 643598, at *1 (E.D. Pa. Oct. 8, 1997).

189. *See Feret*, 1998 WL 426560, at *14; *Tafuri*, 1997 WL 643598, at *2.

190. *See Feret*, 1998 WL 426560, at *14; *Tafuri*, 1997 WL 643598, at *2.

191. Falkowski v. Imation Corp., 309 F.3d 1123, 1130 (9th Cir. 2002), *amended*, No. 01-16113, 2003 WL 350840 (9th Cir. Feb. 18, 2003) (amending the 2002 decision slightly without changing the holding or reasoning).

192. 15 U.S.C. §§ 77p(b)(1)–(2), 78bb(f)(1)–(2) (2000). The purpose of SLUSA was to prevent plaintiffs from circumventing heightened pleading requirements for federal securities class action by bring actions based on state law instead. *See Falkowski*, 309 F.3d at 1128.

193. More precisely, the employees had been working at another company (Cemax-Icon, Inc.) until the company was acquired by the defendant Imation. The employees' Cemax-Icon stock options, which they had received through a company plan, were then converted to Imation stock options. *Falkowski*, 309 F.3d at 1126–27.

action suit raising California state law claims that alleged that Imation had misrepresented the underlying value of their options.[194] Imation moved for dismissal of the suit, arguing that the class action alleged "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security,"[195] and therefore was preempted by SLUSA.[196] The Ninth Circuit agreed that the action was preempted, as it held that "[t]he grant of an employee stock option on a covered security is . . . a 'sale' of that covered security."[197] In reaching this determination, the court noted that the federal securities acts define the purchase or sale of a security to include any contract to buy or sell a security.[198] The court found that since an option contract is a contract to sell a security, "that contract is a 'sale' even if the sale is never consummated."[199] The employees argued that the grant of an employee stock option was not a sale because the only thing given in return was continued employment and cited the *Cendant* cases and the 1980 SEC Release.[200] The Ninth Circuit distinguished the SEC Release by arguing that "[u]nlike stock bonus plans, stock option plans involve contracts to sell stock for money at a later date."[201] Therefore, because the option itself was a "sale," it did not matter whether the grant of the option was a sale.[202] Recognizing that the *Cendant* case also involved a stock option plan, the Ninth Circuit simply noted its rejection of *Cendant*'s contrary holding.[203] By finding that the stock options were themselves a sale of a covered security, the court thereby held that plaintiffs' action was preempted under SLUSA and ultimately dismissed the plaintiffs' securities fraud claims.[204]

While it may appear at first glance that *Falkowski* signals a rejection of the *Cendant* distinction in the Ninth Circuit, the decision is in fact much less positive for employees. First, the *Falkowski* court was interpreting SLUSA, not Rule 10b-5, a point the court makes clear.[205] Second, the court did not reject the fundamental distinction made by the SEC in its 1980 release—namely, the difference between a broad-based grant of employer securities and an

194. *Id.* at 1127.

195. 15 U.S.C. § 78bb(f)(1)(A) (2000).

196. *Falkowski*, 309 F.3d at 1128.

197. *Id.* at 1129–30.

198. *Id.* at 1129 (citing 15 U.S.C. §§ 77b(a)(3), 78c(a)(13)–(14) (2000)).

199. *Id.* The court described this result as "the aborted purchaser-seller doctrine." *Id.* (quoting Mosher v. Kane, 784 F.2d 1385, 1388–89 (9th Cir. 1986)).

200. *Id.* at 1130.

201. *Falkowski*, 309 F.3d at 1130. The court therefore held that "[e]ven assuming that SLUSA contains a similar exemption [to the one discussed in the 1980 SEC Release], it is inapplicable here." *Id.*

202. *See id.* at 1129–30.

203. *Id.* at 1130.

204. *See id.* at 1131.

205. *Id.* at 1130.

individually negotiated grant. Instead, the court held that this distinction did not apply to stock option plans, because options themselves are a "sale."[206] The SEC has nowhere supported such a distinction—indeed, the only support the *Falkowski* court could find for its distinction were two Ninth Circuit decisions from 1986 concerning the "aborted purchaser-seller doctrine."[207] The anomalous result of the *Falkowski* logic, if ever extended to Rule 10b-5, would be that employees could sue for fraud in connection with an employee stock option plan, but not for fraud in connection with a plan that directly gave stock to employees. In the meantime, however, the distinction between group stock option plans and individually negotiated option grants—a distinction dictated by the SEC as well as the *Cendant* cases—still stands with regard to Rule 10b-5.

V. THE ILLOGIC OF THE CURRENT DISTINCTION

Is it good law, from both a doctrinal and a policy perspective, to include employees who individually bargain for stock options within the ambit of Rule 10b-5 while excluding those who receive them *en masse*? This issue is discussed below, first as a matter of doctrine, and then as a matter of policy.

A. ISSUES OF DOCTRINE: "SALE" AS CONTRACT

The definitions for "sale" and "purchase" under the Securities Acts are based on notions of contract. As noted earlier, Section 2(3) of the 1933 Act defines "sale" and "sell" to "include every contract of sale or disposition of a security or interest in a security, for value."[208] Section 3(a)(14) of the 1934 Act defines these terms to "include any contract to sell or otherwise dispose of," and defines "buy" and "purchase" to "include any contract to buy, purchase, or otherwise acquire."[209] Interestingly, both definitions of "sale" move beyond contracts "of sale" or contracts "to sell" to include other "dispositions" for "value."[210] The definition of sale could be read to require

---

206. *Falkowski*, 309 F.3d at 1130.

207. *See id.* at 1129 (citing Mosher v. Kane, 784 F.2d 1385, 1388–89 (9th Cir. 1986), *overruled on other grounds by In re* Wash. Pub. Power Supply Sys. Sec. Litig., 823 F.2d 1349, 1352 (9th Cir. 1987), *and* Sec. Investor Prot. Corp. v. Vigman, 803 F.2d 1513, 1518 (9th Cir. 1986). Moreover, the aborted purchaser-seller doctrine concerns situations where a contract for the sale of securities was allegedly aborted as a result of fraud—not situations involving employee stock options.

208. 15 U.S.C. § 77b(3) (2000).

209. *Id.* § 78c(a)(13)–(14).

210. Since we are interpreting section 10(b) of the 1934 Act, arguably only the definition of "sale" in section 3(a)(14) of that act is relevant to the inquiry. *Cf.* SEC v. Nat'l Sec., Inc., 393 U.S. 453, 466 (1969) (noting that the meaning of "purchase or sale" may differ, even in different provisions of the Securities Acts, based on the context). However, courts have noted the similarities between the two provisions, particularly in the context of antifraud actions. *See, e.g.,* Lawrence v. SEC, 398 F.2d 276, 280 (1st Cir. 1968) (holding that the definitions of "sale" in the two Acts should be construed similarly), *quoted in* Collins v. Rukin, 342 F. Supp. 1282, 1288 n.12 (D. Mass. 1972).

that one party provide money in exchange for goods or services provided by the other party.[211] However, the 1933 Act defines "sale" and "sell" to include any "disposition of a security . . . for value."[212] And the 1934 Act definition includes any contract to sell or "otherwise dispose of." Thus, any contract through which a security (or an interest in a security) is transferred from one party to another should suffice to constitute a "sale," as long as the seller "dispose[s] of" the stock.[213]

Courts have emphasized this broad definition of sale, particularly in the context of Rule 10b-5. In *SEC v. National Securities, Inc.*,[214] the Court held that a shareholder vote approving a merger between two companies constituted a "sale" for purposes of Rule 10b-5, based on "[t]he broad antifraud purposes of . . . the rule."[215] The vote had wiped out the shareholders' stock in the old company and given them stock in the new company.[216] The Court concluded that the shareholders had "'purchased' shares in the new company by exchanging them for their old stock," and therefore met the section 10(b) requirement of a "sale or purchase."[217] In *SEC v. Continental Commodities Corp.*,[218] the Fifth Circuit held that a sale had taken place when a company issued notes to customers in exchange for the promise not to institute legal proceedings based on a previous transaction.[219] Similar to the transactions in these other cases, the transfer of employer securities to employees would appear to constitute a contract, whether done on an individual or group basis. In both situations, the employer is providing the security in exchange for "value"—namely, the employees' continued labor.

The notion that employee benefits, such as pension plans or stock options, are not bargained-for contracts but rather employer-provided gratuities has its roots in early common law decisions about such benefits. For example, in *McNevin v. Solvay Process Co.*,[220] a New York state court rejected plaintiff's attempt to recover his share of a pension fund after he left the employer. The court characterized the pension fund as a "voluntary"

211. *See, e.g.*, THE AMERICAN HERITAGE DICTIONARY 1085 (2d coll. ed. 1982) (defining "sale" as "[t]he exchange of goods or services for an amount of money or its equivalent"); WEBSTER'S NEW WORLD DICTIONARY AND THESAURUS 563 (1996) (defining "sell" as "to exchange (goods, services, etc.) for money etc.").

212. 15 U.S.C. § 77b(3) (2000).

213. *See* SEC v. Nat'l Sec., Inc., 393 U.S. 453, 466 n.8 (1969) (noting that the statutory definitions of "sale" and "purchase" "indicate the breadth of the statutory terms by using the definitional word 'include' and by including within the definitions contracts 'to buy, purchase, or otherwise acquire' and 'to sell or otherwise dispose of' securities").

214. *Id.*

215. *Id.* at 467.

216. *Id.* at 455.

217. *Id.* at 467.

218. 497 F.2d 516 (5th Cir. 1974).

219. *Id.* at 528.

220. 53 N.Y.S. 98 (N.Y. App. Div. 1898).

creation of the employer that should be treated as an "inchoate gift" until the money was actually given to the employee.[221] According to the court, "the scheme by which this fund is created is simply a promise on the part of the defendant to give its employees a certain sum in the future with an absolute reservation that it may at any time determine not to complete the gift."[222] Noting that the defendant had nowhere reserved the right to rescind the pension fund, the dissent took issue with this analysis: "A promise, founded upon a valuable consideration . . . , to pay a sum of money upon specified contingencies, is not a promise to make a gift . . . ."[223] Nevertheless, the "gratuity theory" of pension rights continued into the 1950s.[224]

Admittedly, the individually bargained-for stock option agreement is closer to the Platonic ideal of a "contract" than a company-wide stock option plan. Under the "bargain theory" of contracts, an agreement under which only one side contributes consideration is not a legally-binding contract.[225] An agreement which is not a "bargain"—namely, each party giving something of value in exchange for something else of value—does not deserve legal enforcement as a contract, as it is not generally a commercial enterprise.[226] In those cases in which an employee individually bargains for some form of employer securities, the courts have taken pains to describe the agreement as the result of negotiations between the two sides. For example, in *Collins v. Rukin*, the court notes that the employer's president "invited plaintiff to leave California and to join [the employer] in Massachusetts" and "offered plaintiff, in addition to salary, certain so-called fringe benefits, one of which was an opportunity to purchase shares of stock in [the employer]."[227] In *Dubin v. E.F. Hutton Group Inc.*, the court notes that the employer's executive vice president "contacted plaintiff by telephone to solicit his interest in employment," and later, "in order to persuade plaintiff to join [the employer]," offered him a higher salary and bonus, as well as 10,000 shares of the employer's stock.[228] In *Campbell v. National Media Corp.*, a case concerning options which were given to a current employee, the court makes sure to note that the plaintiff received his options "as compensation for his work as corporate secretary and vice-president for investor

221. *Id.* at 99, 100.

222. *Id.* at 100.

223. *Id.* at 103 (Green, J., dissenting).

224. JOHN H. LANGBEIN & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 127 (3d ed. 2000).

225. E. ALLAN FARNSWORTH, CONTRACTS § 2.2, at 43 (2d ed. 1990).

226. *Id.* § 2.2, at 44.

227. Collins v. Rukin, 342 F. Supp. 1282, 1284 (D. Mass. 1972).

228. Dubin v. E.F. Hutton Group Inc., 695 F. Supp. 138, 140 (S.D.N.Y. 1988); *see also* Rudinger v. Ins. Data Processing, Inc., 778 F. Supp. 1334, 1336 (E.D. Pa. 1991) (noting that, upon hiring, plaintiff signed an "employment contract" which included salary, bonus, and participation in a stock option plan).

relations."[229] By contrast, in the *Cendant* cases, where the court found no sale, the court describes the transfer of options to employees almost as a gift. In *McLaughlin v. Cendant Corp.*, the court does not explain how the stock option plan came into effect; it only notes that plaintiff "received" 66,863 options under her employee stock option plan.[230] In *Wyatt v. Cendant Corp.*, the court notes that the employer's board of directors "adopted a stock option plan for [its] employees."[231] There is no discussion of how or why these stock option plans were created.[232]

Are stock option plans, when given to employees as a whole, a gift? If these plans are created by an employer without any employee request or negotiation, it may appear that they have been given without any exchange of consideration by employees. After all, if employees are working for wage X on Monday, and then are working for wage X plus stock options on Tuesday, it would be hard to argue that the employees would not have worked Tuesday had it not been for the stock options. Might an employer's stock option plan, if provided without consideration, be considered not a contract, but instead evidence of the employer's munificence?

The concept that an employer provides benefits out of its generosity seems laughable today. It is doubtful that even the court in the *Cendant* cases would find the stock option plans to be unenforceable contracts due to lack of consideration. Even though a stock option plan that appears from the mists may appear to be a unilateral gift, it is clear that the plan is part of the overall consideration offered by an employer in return for the employees' labor. Because the bargaining that takes place in the workplace is often not overt, employment contracts may be difficult to pin down. They rely generally on oral agreements and may consist of implied terms, oral promises, and even consistent employer practices.[233] Most courts have found the employment at-will contract to be a unilateral one, in which the employer offers a promise of compensation in exchange for performance by the employee.[234] However, it is generally recognized that an employee's continued labor in an at-will regime, given her freedom to quit and seek employment elsewhere, is ample consideration for all express and implied

229. Campbell v. Nat'l Media Corp., [1994–1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,449 (E.D. Pa. Nov. 3, 1994), 1994 WL 612807, at *1.

230. McLaughlin v. Cendant Corp., 76 F. Supp. 2d 539, 541 (D.N.J. 1999).

231. Wyatt v. Cendant Corp., 81 F. Supp. 2d 550, 552 (D.N.J. 2000).

232. The court in *Childers*, which found an ESOP not to be a security, said that the ESOP had been formed "in an effort to improve [the company's] weak financial position." *See* Childers v. Northwest Airlines, 688 F. Supp. 1357, 1359 (D. Minn. 1988).

233. *See* Alan Hyde, *Employment Contracts Implied in Fact*, *at* http://andromeda.rutgers.edu/~hyde/contract.html (last visited Jan. 27, 2003) (on file with the Iowa Law Review).

234. *See, e.g.*, Demasse v. ITT Corp., 984 P.2d 1138, 1142–43 (Ariz. 1999); Pine River State Bank v. Mettille, 333 N.W.2d 622, 627 (Minn. 1983); Woolley v. Hoffman-La Roche, Inc., 491 A.2d 1257, 1267 (N.J. 1985).

promises made by the employer.[235] The only exception to this rule has been the requirement of additional consideration for certain job security provisions, such as permanent employment.[236] This exception, which has fallen out of favor, was apparently based on evidentiary concerns.[237] For all other benefits offered by employers, the employee's continued labor is enough. Just as a five percent wage increase granted to all employees would not be considered a gift, even if it had not been bargained for, so too should a stock option plan not be considered a gift.[238]

So why, then, have courts and the SEC found plans offering employer securities not to involve "sales," when the definition of a "sale" is so clearly related to contract? As a review of those cases demonstrates, courts have relied on the analysis of "investment contract" provided by the Court in *Daniel*. Recall that the *Daniel* Court found that the employees did not meet the "investment of money" prong of the test[239] because the employees failed to make any specific contributions to the plan. The Court could have based its holding on the fact that the employees did not pay for their share in the plan with "money," i.e., cash. However, the Court explicitly noted that an "investment of money" need not take the form of cash, but could also be made through goods and services.[240] Instead, the Court contended that the employees had not really contributed anything to the plan, since "[o]nly in the most abstract sense may it be said that an employee 'exchanges' some portion of his labor in return for [the plan's] possible benefits."[241] The Court was unwilling to "segregate" the benefits from the employees' other

235. *See, e.g.*, *Woolley*, 491 A.2d at 1267–68; Note, *Protecting At Will Employees against Wrongful Discharge: The Duty to Terminate Only in Good Faith*, 93 HARV. L. REV. 1816, 1819–20 (1980). The employee's freedom to quit at any time also provides the necessary reliance to bring a Rule 10b-5 claim. When an employer provides a stock option to employees, the employee values that option based on the current value of the underlying stock. If that value is based on fraud or deceit committed by the employer, then the employee has relied on the fraud in valuing the option, just as a public investor relies on the market price of the stock. For a discussion of the "fraud-on-the-market" theory used in Rule 10b-5 actions, see Basic Inc. v. Levinson, 485 U.S. 224 (1988).

236. *See, e.g.*, Pugh v. See's Candies, Inc., 171 Cal. Rptr. 917, 925 (Cal. Ct. App. 1981) (citing cases).

237. *See id.* at 924–25. Several courts have required additional consideration on the part of the employer in order for the employer to remove job security provisions from the employment contract. *See, e.g.*, *Demasse*, 984 P.2d at 1144–45; Doyle v. Holy Cross Hosp., 708 N.E.2d 1140 (Ill. 1999).

238. For a broader discussion about the implicit bargain struck between a firm and its employees, see Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 276–87 (1999), and Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1195–99 (2002).

239. Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 559–61 (1979). The *Howey* test for investment contracts is "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." SEC v. W.J. Howey, 328 U.S. 293, 301 (1946).

240. *Daniel*, 439 U.S. at 560 n.12.

241. *Id.* at 560.

compensation and say that part of the employees' labor was compensated through the pension plan. Instead, the Court insisted that an employee "surrenders his labor as a whole, and in return receives a compensation package that is substantially devoid of aspects resembling a security."[242] Since, overall, an employee labored to obtain his wages and not his pension plan, the Court held that the employee had not made any "investment" in the plan.

What the Court seems to be saying in *Daniel* is that the employment contract as a whole is not really an investment contract for purposes of the *Howey* test.[243] But that was not really the question posed by the "investment" prong of the test, which only requires that some investment of value be made. There is no requirement that the investment must be made singularly, or that the investment must not be only one part of a more complex transaction.[244] Thus, to show that no investment had been made, the Court was forced to argue that the employees had not really *invested* in the plan, since they did not directly contribute.[245] Clearly, though, the employees were invested in the plan; even though they did not directly contribute, the employer made contributions to the plan based on employee work-hours, and those contributions eventually ended up in employees' pockets. Moreover, the employees' collective bargaining representatives had negotiated these contributions on the employees' behalf.[246] Thus, employees had chosen to have the employer invest monies in the pension plan; the contributions were akin to a wage. As the court in *Harris* explained, in holding that a distribution of employer stock through an ESOP was a "sale" under the securities laws:

> Plaintiff's actions in this case can be likened to an individual who receives compensation from his or her employer and then turns around and buys the stock of the employer. If this two-step transaction had in fact taken place, there could be little quarrel that the federal securities laws would apply. The collapse of this two-step transaction into a single step does not remove the applicability of the federal securities laws.[247]

This same analysis applies to the *Daniel* scenario: employees could have

242. *Id.*

243. *Id.*

244. As one commentator noted: "[D]oes it make sense to hold that a standard equity share acquired for a week's work is a security whereas the same share acquired together with $200, indivisibly in consideration for two weeks' work, is not?" Scott FitzGibbon, *What is a Security?—A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 MINN. L. REV. 893, 905 (1980).

245. *Daniel*, 439 U.S. at 560.

246. *Id.* at 553–54.

247. Harris v. Republic Airlines, Inc., [1987–1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,772 (D.D.C. May 19, 1988), 1988 WL 56256, at *10.

had the employer give the money to them and then could have invested that money in the pension plan.

Courts have applied the reasoning in *Daniel* to the analysis of whether a "sale" of employer securities to employees has taken place under section 10(b) of the 1934 Act.[248] Since the *Daniel* Court held that employees had not contributed to the pension plan, even though the employer had paid into the plan on employees' behalf, it was a small step for courts to reason that employees had not "contributed" to similar stock or stock option plans and therefore had not provided any consideration.[249] This reasoning construes contribution, as well as "sale," too narrowly. As a matter of contract law, the transfer of stock options from employer to employee is a "sale" regardless of whether this transfer is explicitly bargained for. As one commentator explained:

> Many employment relationships lack a bargaining process, but all involve an outcome that fairly can be described as a bargain. A bargain involving only an outcome is just as much a contract as a bargain involving both a process and an outcome.[250]

The distinction between individually negotiated options and group option plans is therefore a meaningless one for purposes of contract law and the Acts' definition of "sale." Courts and the SEC must recognize the obvious and conclude that groups plans are just as much of a "sale" as individual option agreements.

B. Policy Concerns: Employees as Investors

If the distinction between employees evidenced in the *Cendant* decisions is flawed on a doctrinal level, that distinction is even more troubling from a policy perspective. It provides the protection of Rule 10b-5 actions to executives, managers, and other high-level employees who negotiate private agreements for themselves and leaves employees who receive their options from a group plan out in the cold. If anything, policy would suggest an opposite course: protect the workers in a group plan and leave the executives to fend for themselves. Because executives are likely to have greater access to information that is material to investment decisions, as well as greater control over the firm's successes and failures, they are less in need of securities fraud protection than lower level employees.

---

248. *See* McLaughlin v. Cendant Corp., 76 F. Supp. 2d 539, 544 (D.N.J. 1999) ("[C]ourts apply the SEC's 'no sale' doctrine when an employee's plan is found to be compulsory and noncontributory." (citing *Daniel*, 439 U.S. at 558–59)).

249. *See* Wyatt v. Cendant Corp., 81 F. Supp. 2d 550, 556–57 (D.N.J. 2000) (finding that plaintiffs had not provided any "'specific consideration' or added value" that was "traceable" to the option plan); Bauman v. Bish, 571 F. Supp. 1054, 1064 (N.D. W. Va. 1983) (finding that the reduction in employees' wages did not satisify the "notion of consideration or value necessary to find a sale of securities").

250. Stephen M. Bainbridge, *Participatory Management Within a Theory of the Firm*, 21 J. CORP. L. 657, 706 (1996).

1. Greater Access to Information

The *raison d'être* of the Securities Acts is to protect the common investor through disclosure. While the Acts are certainly not limited to passive investors[251] or to the public markets, they were created in response to widespread misinformation and fraud that had shattered investor confidence in the stock exchanges.[252] The Acts are designed to require disclosure of information about securities and to punish the use of misinformation.[253] These measures are necessary since investors need information to assess the value of a security,[254] and this information may not be accessible to an investor without regulation. As the court explained in *Slevin v. Pedersen Associates, Inc.*,[255] "securities laws were enacted to provide surveillance for those not in a position to monitor their own investments . . . [and to] protect the integrity of financial interests that unsuspecting investors are incapable of investigating for themselves."[256]

Given the importance of information in securities regulation, it would seem logical to provide greater protections to those who are less likely to have access to material information about the security. However, the *Cendant* cases upend this distinction: managers and executives, who are more likely to have the type of information that the Acts regulate, are more likely to be able to sue under Rule 10b-5, while rank-and-file employees who get their options through a plan cannot. Although lower-level employees may have pockets of information about the firm's financial health, high-level managers and executives have much greater proximity and access to the type of information that affects the price of the company's stock. Moreover, executives with the power to bargain for stock options are in a much better position to bargain for the information about the company necessary to evaluate the options' value. Employees who receive their options through a company plan often have little bargaining power to insist on such disclosure.[257]

The collapse of the Enron Corporation provides a contemporary example of the differences in information access between high-level

251. *See* Landreth Timber Co. v. Landreth, 471 U.S. 681, 692 (1985).

252. *See* S. REP. NO. 73-47, at 1 (1933).

253. *See id.*; *see also* Kahan v. Rosenstiel, 424 F.2d 161, 173 (3d Cir. 1970).

254. *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 1 (1991) ("The securities laws exist because of the unique informational needs of investors. . . . Deciding whether to buy or sell a security thus requires reliable information about such matters as the issuer's financial condition, products and markets, management, and competitive and regulatory climate.").

255. 540 F. Supp. 437 (S.D.N.Y. 1982).

256. *Id.* at 441.

257. *Cf.* Landreth Timber Co. v. Landreth, 471 U.S. 681, 699 (1985) (Stevens, J., dissenting) (arguing that the securities laws should protect "an investor who is not in a position to negotiate appropriate contractual warranties and to insist on access to inside information before consummating the transaction").

executives and lower-level employees. Enron was brought down almost entirely by accounting tricks and secret partnerships created and maintained by the company's highest leadership.[258] The special purpose entities set up by chief financial officer Andrew Fastow were known only by those in the very upper levels of management; Sherron Watkins, whose secret memo to firm president and CEO Kenneth Lay expressed concern about such entities, was a vice-president who had previously worked at Arthur Andersen.[259] The great bulk of the company's employees appear to have had no knowledge of these improprieties. Moreover, many of Enron's high-level executives had been dumping their stock and stock options prior to the company's breakdown;[260] many Enron employees, on the other hand, held onto their Enron stock and stock options until the bitter end.[261]

The *Cendant* flip is even more ironic given that Rule 10b-5 is the primary weapon against insider trading. The rule, on its face, does not appear to concern insider trading, since its text focuses on fraud or misrepresentation, not failures to disclose.[262] However, the SEC and the courts have found that failure to disclose special knowledge on the part of the buyer or seller violates the antifraud provisions. In defining the cause of action against insider trading under Rule 10b-5, the SEC created two prerequisites for an obligation to disclose material information: "first, the existence of a relationship giving access . . . to information intended to be available only for a corporate purpose . . . and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing."[263] The SEC further described insiders as "those persons who are in a special relationship with a company and privy to its internal affairs."[264] Such insiders are barred from cashing in on their inside information by trading with ignorant investors.[265] As the Second Circuit stated in *SEC v. Texas Gulf Sulphur Co.*,[266]

258. *See* FUSARO & MILLER, *supra* note 8, at xi-xii; John R. Emshwiller & Rebecca Smith, *Corporate Veil; Behind Enron's Fall, A Culture of Operating Outside Public's View*, WALL ST. J., Dec. 5, 2001, at A1, *available at* 2001 WL-WSJ 29679873, *reprinted in* THE BEST BUSINESS STORIES OF THE YEAR: 2003 EDITION 62–73 (Andrew Leckey & Allan Sloan eds., 2003).

259. *See* FUSARO & MILLER, *supra* note 8, at 154–55.

260. *See id.* at 115, 122. Enron insiders allegedly sold more than $1 billion in company stock before the stock's collapse. *Id.* at 115; *see also* David Barboza, *Ex-Executives Say Sham Deal Helped Enron*, N.Y. TIMES, Aug. 8, 2002, at A1, *available at* 2002 WL 25399978.

261. One former Enron employee said he was "dumb" and "gullible" for not exercising his options, while another said: "If I had just dumped [my options], I would have been rolling in cash. But I didn't because upper management—Jeff Skilling and Ken Lay—were telling us the stock would easily hit one-ten, one-twenty. . . . And it did—Skilling just had the decimal in the wrong place." Manning & Kinsey Hill, *supra* note 9, at 85–86.

262. *See* COX ET AL., *supra* note 254, at 824.

263. In the Matter of Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961).

264. *Id.*

265. *Id.*

266. 401 F.2d 833 (2d Cir. 1968).

the policy behind Rule 10b-5's ban on insider trading is "the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information."[267]

While the SEC and the courts have not provided a specific definition of "insiders," the term includes those who owe fiduciary duties directly to the corporation's shareholders, such as directors and officers.[268] Managers and executives who receive their options through individual negotiations are likely to owe such fiduciary duties.[269] Lower-level employees are much less likely to have access to "insider" information, and thus would not be considered insiders. For example, in *SEC v. Fox*,[270] the court found that defendants, all supervisory employees within a division of the company, did not have a duty to disclose the information they had about the corporation because they were not insiders.[271] While the employees had knowledge that certain corporate reductions in production were being considered, they did not participate in the actual corporate decision to reduce production and project losses, which the parties acknowledged to be the event that triggered a decline in the stock.[272] Thus, while employees may owe a duty not to disclose or trade on information about high level firm decisions,[273] they may not be deemed insiders when shop-level information is at issue.

Because Rule 10b-5 is meant to protect against fraud committed by firm insiders, it is bizarre that the courts and the SEC have created an interpretation of Rule 10b-5 that protects those likely to be insiders but not those likely to be outsiders. Yet that is the result of the *Cendant* decisions and SEC policy.

2. Greater Control Over Firm

Employees who receive their stock options as part of a group plan are also less likely than executives to have control over the direction of the firm.

267. *Id.* at 848; *see also Cady, Roberts*, 40 S.E.C. at 912 n.15 ("A significant purpose of the Exchange Act was to eliminate the idea that the use of inside information for personal advantage was a normal emolument of corporate office.").

268. *See, e.g.*, Chiarella v. United States, 445 U.S. 222, 230 (1980).

269. Even if executives may not be labeled as "officers" of the corporation under its bylaws, they will often have the same fiduciary duties as agents of the firm. *See* ROBERT CHARLES CLARK, CORPORATE LAW §3.3, at 114 (1986).

270. 654 F. Supp. 781 (N.D. Tex. 1986).

271. *Id.* at 791.

272. *See id.* at 791–92.

273. *See, e.g.*, Ross v. Licht, 263 F. Supp. 395, 409 (S.D.N.Y. 1967) (holding that employees who are not officers or directors were insiders when they possessed information that should be used only for a corporate purpose); Brophy v. Cities Serv. Co., 70 A.2d 5, 7 (Del. Ch. 1949) (holding that an employee does have a fiduciary duty when he acquires "secret information relating to his employer's business" in the course of employment); CLARK, *supra* note 269, §8.10, at 323.

They are less likely to have any influence over or participation in the firm's ultimate decisions about direction, products, earnings, or growth strategies. Because they lack power within the firm, they have a greater need for the protection of the securities laws. The big players who individually negotiate for options are more likely to have a hand in the management of the firm—and thus more likely to have input into or control over a firm's decision to defraud its investors. Again, the distinction between high-level executives and lower-level employees at Enron is instructive. The chief executives at Enron were responsible for the decisions that led to the alleged fraud; the rest of the employees had no influence or control over these decisions.

Courts have used the extent of control over the firm as another factor in determining whether certain investors should be protected by federal securities regulation.[274] Unlike the *Cendant* distinction, however, courts have held that those with more control over the firm do not need federal protection.[275] Under the *Howey* test as originally promulgated, an investment contract required an investment of money in a common enterprise in which profits come "solely from the efforts of others."[276] This requirement has apparently since been softened: in *United Housing Foundation, Inc. v. Forman*,[277] the Supreme Court restated the test, requiring profits "to be derived from the entrepreneurial or managerial efforts of others."[278] If a person is deeply involved in managing or directing the firm's efforts, her investment in that entity will not be deemed an investment contract and thus will not be a "security." Executives, however, are far more likely to exert "entrepreneurial or managerial efforts" than are lower-level employees. As the Court noted in *Forman*, the *Howey* test "embodies the essential attributes that run through all of the Court's decisions defining a security."[279] If one of the essential elements of a security is that its profits be derived from the entrepreneurial or managerial efforts of others, stock options held by executives and managers are less likely to have that attribute than such options held by lower-level employees.

In many ways managers and executives are similarly situated to partners

274. *See infra* text accompanying notes 279–87.

275. *See id.*

276. SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946).

277. 421 U.S. 837 (1975).

278. *Id.* at 852. The Court explicitly chose not to pass on whether the word "solely" should be read literally. *See id.* at 852 n.16. However, it did note that the Ninth Circuit did not read the term literally, but rather "realistically, so as to include within the definition those schemes which involve in substance, if not in form, securities." *Id.* (citing SEC v. Glenn W. Turner Enters., 474 F.2d 476, 482 (9th Cir. 1973)). The lower courts have generally used the less stringent *Turner* formulation. *See* COX ET AL., *supra* note 254, at 133–35.

279. *Forman*, 421 U.S. at 852, *cited in* Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 558 n.11 (1979). To be sure, the *Howey* analysis would not prevent an executive's stock options from meeting the definition of a "security" under the Acts, as those options need not meet the requirements of "investment contract."

in a business venture seeking to sue the partnership under the securities laws. In most cases, the partnership interests of general partners will not meet the second prong of the *Howey* test because a partner has too much control over the enterprise.[280] Courts generally assume that general partners "possess powers and responsibilities that would enable them to protect their partnership interests."[281] Thus, because partners can protect themselves, they do not need the protection of the Securities Acts. As one court put it, "[t]he managerial powers vested in general partners and the express right of inspection of documents gives them the kind of leverage and ability to protect themselves that takes them outside the intended scope of the '34 Act."[282]

Courts have differed over whether the legal powers of partnership are sufficient to remove general partners from the definition of a security. While some courts have focused solely on partnership rights and duties mandated by law,[283] others have found a security, despite these rights and duties, when the partner can show that he actually depended on managing partners to exercise control over the business.[284] In *Williamson v. Tucker*,[285] the court held that a general partnership would be a security if (1) the agreement distributed powers as would a limited partnership, (2) the partner-plaintiff was so "inexperienced and unknowledgeable" that he was unable to exercise his partnership powers "intelligently," or (3) the partner-plaintiff was so dependent on the "unique entrepreneurial or management ability" of a promoter or manager that such promoter or manager was irreplaceable.[286] The Rule 10b-5 suits by managers or executives with stock options, however, cut across this grain; they are not dependent investors, but rather active

280. Partnership interests are not listed within the definition of "security" in the Acts. *See* 15 U.S.C. § 77b(1) (2000); *id.* § 78c(a)(10). "Because 'general partnership interests' are not explicitly enumerated as 'securities' in these definitions, the question remains whether, nonetheless, they are included within that definition because they are 'investment contracts.'" Holden v. Hagopian, 978 F.2d 1115, 1118 (9th Cir. 1992).

281. Douglas M. Fried, *General Partnership Interests as Securities Under the Federal Securities Laws: Substance over Form*, 54 FORDHAM L. REV. 303, 303–04 (1985).

282. Odom v. Slavik, 703 F.2d 212, 215 (6th Cir. 1983).

283. *See, e.g.*, Goodwin v. Elkins, 730 F.2d 99 (3d Cir. 1984).

284. For example, the Ninth Circuit, in Holden v. Hagopian, 978 F.2d 1115 (9th Cir. 1992), stated the following:

> The heart of this inquiry is whether, although on the face of the partnership agreement the investor *theoretically* retains substantial control over the investment and an ability to protect the investment from the managing partner or hired manager, the investor nonetheless can demonstrate such dependence on the promoter or on a third party that the investor was *in fact* unable to exercise meaningful partnership powers.

Id. at 1119 (emphasis in original); *see also* Williamson v. Tucker, 645 F.2d 404 (5th Cir. 1981).

285. 645 F.2d 404 (5th Cir. 1981).

286. *Williamson*, 645 F.2d at 424.

participants. In fact, many of the suits brought by managers or executives with security interests in their firms are rooted in claims that they were given less authority or control over the enterprise than they had bargained for.[287]

High-level employees who bargain for stock options will generally have greater access to information and more control over the enterprise than employees who receive their options through a group plan. These advantages render them less in need of protection from securities regulation, more specifically Rule 10b-5. Yet these employees are the ones who will receive that protection under current law. From a doctrinal perspective, the current distinction between employees is wrong; from a policy perspective, it is completely backwards. Regardless of whether employees as a whole should receive Rule 10b-5 protection, the current doctrine represents the most illogical of all possible solutions.

VI. SHOULD ALL EMPLOYEES BE EXCLUDED FROM RULE 10B-5 PRIVATE ACTIONS?

The previous Section explained why the law should not provide higher-level employees with the protections of Rule 10b-5 while excluding lower-level employees from that same protection. This Section takes the analysis a step further, arguing that all employees who receive their stock options in the course of employment should be permitted to bring private actions under Rule 10b-5. To that end, Subsection A first examines the text of the Rule, with reference to whether employees should be deemed to have "purchased" their options. Subsection B considers the argument that employees have advantages over other investors that make them less susceptible to fraud, and therefore less likely to need Rule 10b-5. Subsection C addresses concerns that employees could abuse Rule 10b-5 or use it to gain improper advantages over management or shareholders. Subsection D discusses the potential that the imposition of Rule 10b-5 liability will lead employers to stop providing employees with stock options. Finally, Subsection E discusses the possibility that other regulatory protections, such as ERISA or state common law, are better vehicles for providing employees with protections against fraud or deception.

A. EMPLOYEES AND RULE 10B-5'S "PURCHASE" REQUIREMENT

The doctrinal hinge for the current distinction between employees as to Rule 10b-5 protection is the rule's "purchase or sale" requirement. As

287. *See, e.g.*, Yoder v. Orthomolecular Nutrition Inst., Inc., 751 F.2d 555, 557 (2d Cir. 1985) (plaintiff alleged that company misrepresented amount of funds available to develop new product line); Rudinger v. Ins. Data Processing, Inc., 778 F. Supp. 1334, 1337 (E.D. Pa. 1991) (plaintiff alleged that owner promised him "complete operating control" of the company but never intended to grant this); Collins v. Rukin, 342 F. Supp. 1282, 1284 (D. Mass. 1972) (plaintiff alleged that firm falsely told him he would have access to significant funds to develop and market a product line).

discussed in Section III, Rule 10b-5 only protects against fraud that was committed "in connection with the purchase or sale of any security."[288] Looking solely at the colloquial definitions of the words "sale" and "purchase," an argument could be made that employees do not "purchase" securities when they receive them in exchange for labor. The common definition of a sale or purchase is "the exchange of goods or services for an amount of money or its equivalent."[289] While economists may not have any difficulty perceiving that an employer purchases labor from its employees, we do not generally envision ourselves as "selling" our services to our employers. In most securities transactions, the security represents the "good" that is exchanged for "money or its equivalent." In the employment context, however, a good (the security) is being exchanged for a service (labor). This type of transaction fits the definition of "barter," rather than purchase.[290] One could argue that the colloquial definition of "sale" limits Rule 10b-5's application to transactions that involve the exchange of a security for money, rather than for other goods or services. If employees did not actually provide money to the employer in exchange for the option, there would be no purchase.

However, this argument completely ignores the definitions of "sale" and "purchase" provided by the 1933 and 1934 Acts. Rule 10b-5 is based on section 10(b) of the statute, which also requires that the prohibited activity be committed "in connection with the purchase or sale of any security."[291] And the statute defines "sale" and "purchase" in very broad terms. The definition of purchase "include[s] any contract to buy, purchase, or otherwise acquire,"[292] while a sale includes contracts "to sell or otherwise dispose of."[293] By including contracts that "acquire" and "dispose of" securities in the definition of purchase and sale, the statute removes the implication that money must exchange hands in the process. Courts have therefore not required a "purchase" or "sale" to involve the exchange of money. In *SEC v. National Securities*,[294] the Supreme Court held that a shareholder vote to exchange the shareholders' current securities for stock in a different company, in order to effectuate a merger, was a "sale" for purposes of the 1934 Act.[295] And in *SEC v. Continental Commodities Corp.*,[296] the Fifth Circuit found a sale when a company issued notes to its customers

288. 17 C.F.R. § 240.10b-5 (2002).
289. THE AMERICAN HERITAGE DICTIONARY 1085 (2d coll. ed. 1982) (definition of "sale").
290. *See id.* at 160 (defining "barter" as "to trade goods or services without the exchange of money").
291. 15 U.S.C. § 78j(b) (2000).
292. *Id.* § 78c(a)(13).
293. *Id.* § 78c(a)(14).
294. 393 U.S. 453 (1969).
295. *Id.* at 467.
296. 497 F.2d 516 (5th Cir. 1974).

in exchange for the customers' promise not to institute legal proceedings.[297]

Thus, to fence out employee stock options from the realm of purchase or sale, courts would have to single out the employment contract from other contracts in which something other than money is exchanged for a security. Courts might choose to do so, for some of the reasons discussed below. But as a matter of textual interpretation, the statute forecloses the possibility that a court might use the definition of purchase, by itself, to exclude employees.[298]

B. EMPLOYEE INFORMATION ADVANTAGES

Just as a company's grant of employee stock options is not the prototypical "sale" of a security, employees do not seem to fit the prototype of the "public investor." By virtue of their employment, workers necessarily have access to information that the average market purchaser does not. However, is such information sufficient to obviate the need for anti-fraud protection?

The SEC has treated employees differently than members of the investing public in other contexts. For example, Rule 701,[299] created by the SEC in 1988, permits private companies to offer shares to employees without adhering to the Section 5 registration requirements.[300] Under the rule, companies whose stock is not publicly traded may offer shares (or derivatives such as options) to employees or certain consultants as a private placement under Section 3(b) of the 1933 Act.[301] The securities must be offered through a written compensatory benefit plan or compensation contract.[302] The SEC justified the exception on the grounds that the shares were offered for compensatory and incentive purposes, rather than for capital raising.[303]

297. *See id.* at 528; *cf.* Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 560 n.12 (1979) (noting that a person's "investment," for purposes of the *Howey* test, may be made through goods or services, as well as cash).

298. As a doctrinal matter, a court could also use a definitional escape hatch to elude the statute's definition of purchase and sale. The definitional section of the 1934 Act provides for the use of those definitions "unless the context otherwise requires." Courts and commentators have differed over the meaning of this clause. *See supra* text accompanying notes 126–30. However, this move would require some factor (such as policy reasons) external to the definition of "security" itself.

299. 17 C.F.R. § 230.701 (2002).

300. 15 U.S.C. § 77e (2000).

301. *Id.* § 77c(b). However, while Section 3(b) refers to exempted securities, securities issued under Rule 701 are restricted securities as defined under Rule 144, 17 C.F.R. § 230.144 (2002).

302. 17 C.F.R. § 230.701(5)(c) (2002).

303. *See* Exemption for Certain Employee Benefit Plans, Securities Act of 1933 Release No. 6683, 52 Fed. Reg. 3015 (Jan. 16, 1987) ("It has been suggested that since such plans and arrangements are primarily compensatory in nature and incentive oriented, rather than designed to raise capital, special accommodation should be made under the federal securities laws.").

In 1999, after some prodding from Congress,[304] the SEC removed the $5 million cap on the exception, noting that the cap had become "unnecessarily restrictive in light of inflation, the increased popularity of equity ownership as a retention and incentive device for employees, and the growth of deferred compensation plans."[305] In place of the cap, issuers are required to provide certain disclosures to employees when the offering exceeds the $5 million threshold. Issuers must provide copies of the benefit plan, a summary of the plan's terms, an analysis of the risk factors associated with the security, and certain financial statements.[306]

In justifying the 1999 changes, the SEC stated:

> The type and amount of disclosure needed in a compensatory securities transaction differs from that needed in a capital-raising transaction. In a bona fide compensatory arrangement, the issuer is concerned primarily with compensating the employee-investor rather than maximizing its proceeds from the sale. Because the compensated individual has some business relationship, perhaps extending over a long period of time, with the securities issuer, that person will have acquired some, and in many cases, a substantial amount of knowledge about the enterprise. The amount and type of disclosure required for this person is not the same as for the typical investor with no particular connection with the issuer. The current standards of financial statement disclosure contained in Regulation A should satisfy our concerns for a level of disclosure that will provide basic protections in a compensatory transaction but may not be available as a result of ordinary employment or business dealings.[307]

Thus, the SEC has carved out an exception to its reporting requirements based on the potentially "substantial" knowledge that employees have about their employers. At the same time, however, the SEC has indicated that this base of knowledge is not sufficient to insulate employees from fraud—after all, in offerings greater than $5 million, Rule 701 does require the disclosure of information sufficient to provide "basic protections" that "may not be available" to ordinary workers.[308] In addition, the rule notes that issuers "have an obligation to provide investors with disclosure adequate to satisfy the antifraud provisions of the federal

304. *See* Securities Act of 1933 Release No. 7645 (Feb. 25, 1999), 1999 WL 95489, at *17 n.6 (citing H.R. REP. NO. 104-622, at 38 (1996) and S. REP. NO. 104-293, at 16 (1996)).

305. *Id.*

306. *See* 17 C.F.R. § 230.701(5)(e) (2002). The financial statements are the same as those required under Regulation A, which provides an exception to Section 5 registration for limited (under $5 million) public offerings. *See* 17 C.F.R. §§ 230.251–.263 (1992).

307. Securities Act of 1933 Release No. 7645 (Feb. 25, 1999), 1999 WL 95489, at *5.

308. *Id.*

securities laws."[309] As the SEC made clear, "[c]ompliance with the minimum disclosure standards for Rule 701 may not necessarily meet the antifraud standards . . . ."[310] Exemption from the disclosure laws is an order of magnitude less than an exemption from Rule 10b-5.

Moreover, it is important to note that Rule 701 is an exception carved out of the general rule that employees are public investors for purposes of registration requirements. In *SEC v. Ralston Purina Co.*,[311] the company had sold shares of its stock to certain "key employees" without registration.[312] The company contended that these employees, who occupied positions such as bakeshop foreman, clerical assistant, and production trainee, were sufficiently sophisticated that the offering should be considered a private placement under section 4(2) of the 1933 Act.[313] However, the Court held that the offering must be considered public, and therefore had been carried out illegally. The Court acknowledged that an offering to certain employees could be considered a private placement—for example, "executive personnel who because of their position have access to the same kind of information that the [1933] act would make available in the form of a registration statement."[314] However, the company failed to show that the "key employees" who were offered securities had this kind of access.[315] Without such information, "employees are just as much members of the investing 'public' as any of their neighbors in the community."[316] Noting that Congress had rejected a 1934 amendment excluding employee stock offerings from registration requirements, the Court quoted the following passage from the House Managers: "[T]he participants in employees' stock-investment plans may be in as great a need of the protection afforded by the availability of information concerning the issuer for which they work as are most other members of the public."[317]

Elsewhere in securities regulation, employees as a whole are not

309. *See* 17 C.F.R. § 230.701(1) (1999).

310. Securities Act of 1933 Release No. 7645 (Feb. 25, 1999), 1999 WL 95489, at *13.

311. 346 U.S. 119 (1953).

312. *Id.* at 121–22.

313. 15 U.S.C. § 77d(2) (2000). At the time of the case, this section was designated section 4(1) of the 1933 Act. It was redesignated in 1964. *See* 78 Stat. 580 (Aug. 20, 1964).

314. *Ralston Purina*, 346 U.S. at 125–26.

315. *Id.* at 126.

316. *Id.* As the SEC General Counsel noted in 1935:

> [A]n offering to members of a class who should have special knowledge of the issuer is less likely to be a public offering than is an offering to the members of a class of the same size who do not have this advantage. This factor would be particularly important in offerings to employees, where a class of high executive officers would have a special relationship to the issuer which subordinate employees would not enjoy.

Id. at 126 n.12 (quoting 11 Fed. Reg. 10,952 (1935)).

317. *Id.* (quoting H.R. REP. NO. 73-1838, at 41 (1934)).

assumed to have the kind of information that would eliminate their need for protection. As noted earlier, employees are only considered "insiders" in the context of insider trading if they trade on high-level information, and even then may escape liability if they did not take part in corporate decision-making regarding the information.[318] Liability under section 16 of the 1934 Act for "short-swing" profits—profits from trading by insiders within a six month period—applies only to trading done by 10 percent owners, directors, or officers.[319] Such short-swing trades are prohibited "[f]or the purpose of preventing the unfair use of information" obtained by the insider "by reason of his relationship to the issuer."[320] The SEC rules define officers to include, along with presidents and chief financial officers, "any other person who performs similar policy-making functions for the issuer."[321] The SEC notes that in determining section 16 coverage, "the proper focus should be on whether a person is 'a corporate employee performing important executive duties of such character that he would be likely, in discharging these duties, to obtain confidential information about the company's affairs that would aid him if he engaged in personal market transactions.'"[322] In *Merrill Lynch, Pierce Fenner & Smith, Inc. v. Livingston*,[323] cited with approval by the SEC,[324] the Ninth Circuit held that a securities salesman who was given the title of vice-president was not an officer for purposes of section 16. The court acknowledged that the salesman had access to information that was "not generally available to the investing public."[325] However, the court explained:

> Insider information, to which Section 16(b) is addressed, does not mean all information about the company that is not public knowledge. . . . Information that is freely circulated among non-management employees is not insider information within the meaning of Section 16(b), even if the general public does not have the same information. Employees of corporations know all kinds of things about the companies they work for and about the personnel of their concerns that are not within the public domain. Rather, insider information to which Section 16(b) refers is the kind of information that is commonly reserved for company management

318. *See supra* text accompanying notes 270–73.
319. 15 U.S.C. § 78p(a) (2000).
320. *Id.* § 78p(b).
321. 17 C.F.R. § 240.16a-1 (1995).
322. 56 Fed. Reg. 7243 (Feb. 21, 1991) (quoting Colby v. Klune, 178 F.2d 872, 873 (2d Cir. 1949)).
323. 566 F.2d 1119 (9th Cir. 1978).
324. 56 Fed. Reg. 7242, 7243 (Feb. 21, 1991).
325. *Livingston*, 566 F.2d at 1121 (noting that defendant had access to information on the growth production rankings on the various Merrill Lynch retail offices).

> and is thus the type of information that would "aid (one) if he engaged in personal market transactions."[326]

Thus, while all employees may have some information unavailable to a public shareholder, only a small slice of employees have access to "insider" information.

Employees certainly have informational advantages over other investors. However, the extent of this advantage varies widely amongst employees. Employees as a whole do not have access to information sufficient to protect themselves against fraud by a company's true insiders. As discussed earlier, the recent examples of Enron, Global Crossing, and WorldCom demonstrate that most employees seem to have little or no awareness of fraud perpetrated at the highest levels. Carving out a blanket employee exception to Rule 10b-5 based on a presumed informational advantage grossly overestimates the advantage, and unfairly subjects employees to fraud without recourse by those with true control over the company.

C. *EMPLOYEE LITIGATION OPPORTUNISM*

Another potential argument for excluding employees from Rule 10b-5 protection is the fear of employee litigation opportunism: namely, that employees will use Rule 10b-5 litigation for illegitimate ends. The primary reason for the "purchase or sale" requirement is the Supreme Court's fear of speculative and vexatious litigation.[327] While suits by employees do not raise the same kinds of concerns as suits by non-sellers or almost-purchasers, they do present some potential concerns about improper use. Employees could file a meritless fraud suit in an effort to embarrass the company, or to extort an increase in wages from it. Or employees could use Rule 10b-5 discovery to find out information about the company that was not available to them otherwise, either through individual means or collective bargaining. Finally, employees could infiltrate a class of non-employee investors and agree to a settlement that was not in the interests of class members as a whole.

Concern about the proliferation of private 10b-5 litigation—particularly class actions—has long occupied commentators and policymakers. Such litigation is viewed as particularly susceptible to abuse, due to broad federal discovery procedures and the lack of sanctions for frivolous suits.[328] Federal rules permit extensive discovery once the claim has survived the pleading phase.[329] Because a securities fraud action concerns a company's failure to disclose material information relating to its value as a company, the discovery process has the potential to expose a wealth of information that the firm would normally keep private. Moreover, the process of producing

326. *Id.* at 1121, 1222–23 (alteration in original) (quoting *Colby*, 178 F.2d at 873).

327. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 743 (1975).

328. *See id.* at 741.

329. *See, e.g.*, *id.*

relevant documents siphons away time and resources from the ongoing business. Because a company has a strong interest in avoiding discovery, it may be willing to settle a non-meritorious claim for substantial sums. Although the extent of this phenomenon was never definitively established, commentators and Congress believe it to be a serious problem.[330]

Obviously, fencing out employees from the opportunity to bring 10b-5 suits would reduce the amount of such litigation in the system, frivolous or otherwise. But if employees are more likely to file frivolous claims than public investors are, in order to take advantage of their employers, it may make sense to prevent them from bringing Rule 10b-5 actions. Employees may be more likely to file a frivolous claim because it may be easier for them to obtain a quick and dirty settlement. Public investors generally do not file individual claims against a firm for securities fraud since the potential damages do not justify the litigation expenses. It is extremely difficult to assemble a class of investors without using the class action procedures, and a public investor who initiates a class action suit cannot settle the claim without a judicial determination that the settlement benefits the class.[331] Thus, it could be expensive for a firm to pay off a class action suit in a way that meets the lead plaintiff's litigation expenses. Employees, however, could much more easily join together as a group of plaintiffs without the need for a class action. And by not aspiring to represent a broader class, employees could accept a settlement that benefits only them: for example, an increase in wages. Thus, somewhat counterintuitively, employees may be more effective at coercing a settlement out of frivolous fraud claims because they can be bought off more cheaply.

In addition, employees may also have an interest in discovery beyond its value in coercing the company to settle. A public investor looking to coerce a settlement has no inherent interest in the information that could be obtained through discovery; the investor simply knows that the firm wants to avoid producing it. However, employees have an interest in such information apart from their role as investors; they may also be able to use it in their negotiations with the company as employees. Information about the company's actual and projected earnings, actual and projected profits, potential mergers or acquisitions, plant openings and closings, and other private financial data is all fodder for employees in their negotiations with

---

330. S. REP. NO. 104-98, at 14 (1995) (noting that plaintiffs' lawyers had incentives to "file frivolous lawsuits in order to conduct discovery in the hopes of finding a sustainable claim not alleged in the complaint"); H.R. CONF. REP. NO. 104-3691, at 31 (1995) (discussing "the abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle"). For contrasting commentators' views, compare Joseph A. Grundfest, *Why Disimply?*, 108 HARV. L. REV. 727 (1995), with Joel Seligman, *The Merits Do Matter: A Comment on Professor Grundfest's "Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority,"* 108 HARV. L. REV. 438 (1994).

331. *See, e.g.*, *In re* Cendant Corp. Litig., 264 F.3d 201, 217–18 (3d Cir. 2001).

the company over the terms of employment. This information may not be generally available to the employees or to their collective bargaining representative (if they have one).[332] Indeed, an employee group could file a non-meritorious lawsuit looking not for an expensive settlement but instead for secret financial information potentially available through discovery.[333]

These concerns only point to the reasons why employees may be more likely to file non-meritorious claims. Employees do not have any advantages, however, in getting their claims past the company's initial motion to dismiss. To address the general concern about 10b-5 litigation abuse, in 1995 Congress passed the Private Securities Litigation Reform Act (PSLRA).[334] The PSLRA instituted a number of procedural requirements designed to filter out frivolous suits. Along with "lead plaintiff" and other class action reforms, the PSLRA requires plaintiffs to plead the alleged fraud with greater particularity, both as to the alleged misstatements or omissions[335] and the alleged fraudulent intent.[336] Circuits are split as to whether the PSLRA actually heightened the requisite intent required to prove securities fraud.[337] However, the PSLRA certainly made it more difficult to get a fraud claim past a motion to dismiss based only on a drop in stock price. Plaintiffs must now plead the particular facts that allegedly constitute the fraud.[338]

332. *See, e.g.*, NLRB v. Truitt Mfg., 351 U.S. 149, 153 (1956); Pine Indus. Relations Comm. Inc., 118 N.L.R.B. 1055, 1061 (1957).

333. For a discussion of the use of a 10b-5 claim to obtain information about an employer, see *Bauman v. Bish*, 571 F. Supp. 1054, 1058 (N.D. W. Va. 1983), which noted that the "sole purpose of this litigation," which involved 10b-5 and other claims brought by employees against an employer, "is to obtain what has been labeled as a confidential appendix" to a study conducted by consultants about the viability of a proposed ESOP plan.

334. Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified throughout various sections of 15 U.S.C.).

335. *See* 15 U.S.C. § 78u-4(b)(1) (2000):

> In any private action arising under this chapter . . . the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

336. *See* 15 U.S.C. § 78u-4(b)(2) (2000):

> In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

337. *Compare In re* Silicon Graphics Inc. Sec. Litig., 183 F.3d 970, 974 (9th Cir. 1999) (holding that "a private securities plaintiff proceeding under the PSLRA must plead, in great detail, facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct," thereby heightening the pleading requirements), *with* Novak v. Kasaks, 216 F.3d 300, 310 (2d Cir. 2000) (concluding that "the enactment of paragraph (b)(2) did not change the basic pleading standard for scienter").

338. 15 U.S.C. § 78u-4(b)(1)–(2) (2000).

These heightened pleading requirements are the proper approach to preventing employee opportunism. Rather than disallowing all employee suits, meritorious and non-meritorious alike, courts should place greater effort on preventing spurious claims from exacting concessions from companies. Moreover, firms are likely to alert courts to the illegitimate agendas that lurk behind non-meritorious employee suits, and courts can thereby take steps to prevent the litigation from achieving such an agenda. For example, when a company asserts that its employees are attempting to use the discovery phase to get confidential information, a court alert to this goal could monitor discovery to limit its scope or protect confidentiality.

Courts should also monitor litigation so as to avoid conflicts of interest between employees and other shareholders. Obviously, employees should not be able to settle the claims of all shareholders based on a settlement that benefits only their own narrow interests.[339] However, it should be relatively easy for courts to avoid this result by either monitoring settlements to make sure all shareholders benefit or by separating employees into a separate action. Moreover, allowing employees to bring private 10b-5 claims likely would help other public investors obtain relief for fraud. Employees, who have daily contact with the company, may be more likely to detect signs of fraud before less connected investors could do so. Public investors will benefit if employees have an incentive to bring this fraud to light.[340] Even if employees settle their claims separately from other investors, these investors will at least be alerted to the opportunity to bring a suit themselves.

In sum, the risk of employee litigation opportunism is an insufficient concern, particularly if properly cabined, to deny employees the right to sue under 10b-5.

D. CHILLING EFFECTS ON EMPLOYEE OPTIONS

Although access to Rule 10b-5 litigation is ostensibly a valued right, employees may fear that employers will grant fewer options to them if employees were permitted to bring private Rule 10b-5 actions. This argument is based on simple cost-benefit analysis: employers may decide that Rule 10b-5 exposure increases the cost of granting options to a level where it is no longer economically sensible to provide them. Theoretically, an employer that did not plan on committing fraud should not have this concern: if no fraud suits are commenced, there are no litigation costs. However, an innocent employer may still fear frivolous litigation enough to eliminate its options program. Ultimately, if employers assume Rule 10b-5 liability for all employee stock option grants, employees as a whole may be

339. Nor should management employees be able to hijack litigation by settling shareholder claims for a nominal amount in order to protect the firm and its management.

340. *Cf.* Alan Hyde, *Ownership, Contract, and Politics in the Protection of Employees Against Risk*, 43 U. TORONTO L.J. 721, 730–33 (1993).

worse off. Those with options will have the power to sue for fraud, but fewer employees will receive options.[341]

This argument could, of course, be made about any form of regulation, since regulation generally imposes costs on the industry or activity it is regulating. And it could be applied to stock sales as a whole: stocks would be priced cheaper, and therefore people could buy more of them, if companies did not have to account for antifraud protection. But the antifraud protection of Rule 10b-5, like the rest of the substantive provisions of securities regulation, cannot be waived by investors.[342] Certainly, Rule 10b-5 imposes costs on the issuance of securities, and there may be some instances in which issuers and investors would choose to waive those protections if possible.[343] But the purpose of the regulation would be defeated if investors could waive out of their protections. As the Supreme Court noted in *Rodriquez de Quijas v. Shearson/American Express, Inc.*,[344] substantive securities regulation "cannot be waived under the rationale that [such regulation] was intended to place buyers of securities on an equal footing with sellers."[345] Antifraud protection is particularly important to free markets, because fraud distorts the information upon which bargains are struck.[346] The Coase

341. This argument may be best illustrated with a short hypothetical. Let's assume that under the current system, 100 employees in different companies receive stock options. Fraud committed against five of these employees renders their options worthless. Thus, employees as a whole have received the equivalent of ninety-five options. If employees are given the opportunity to sue under 10b-5, that fraud can be remedied. However, fewer employers will be giving out options. If only eighty employees get options under the new regime, and five suffer fraud that renders their options worthless, the net number of employee options will be eighty (after the five defrauded employees obtain relief equivalent to the option's value). The employees as a group are better off under the old system.

342. *See* 15 U.S.C. § 77h (2000) (section 14 of the 1933 Act) (prohibiting waiver of the 1933 Act's provisions); 15 U.S.C. § 78cc(u) (2000) (section 29 of the 1934 Act) (prohibiting waiver of the 1934 Act's provisions); Shearson/American Express Inc. v. McMahon, 482 U.S. 220, 228 (1987) (stating that section 29(a) "prohibits waiver of the substantive obligations imposed by the Exchange Act").

343. As the Court noted in *Shearson*:

> [A] customer cannot negotiate a reduction in commissions in exchange for a waiver of compliance with the requirements of the Exchange Act, even if the customer knowingly and voluntarily agreed to the bargain. Section 29(a) is concerned, not with whether brokers maneuvered customers into an agreement, but with whether the agreement weakens their ability to recover under the Exchange Act.

Shearson, 482 U.S. at 230 (quotations and citation omitted).

344. 490 U.S. 477 (1989).

345. *Id.* at 481.

346. *Cf.* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 122 (5th ed. 1998) ("Even when nothing has happened since the signing of the contract to make performance uneconomical, discharge may be permitted where the presumption that performance would produce a value-increasing exchange is rebutted, as when it is shown that the promisee induced the promise by a lie.").

theorem, which posits that parties will bargain to an efficient outcome whatever the regulatory scheme, assumes that parties cannot defraud each other.[347] Even those who argue that much of securities regulation is unnecessary or counterproductive assume that investors will have protection against fraud.[348]

Employees should not be saddled with the cost of employer fraud. Under the current system, management not only escapes the financial costs of the options to the bottom line,[349] but it also escapes the financial consequences of fraud against the employees. The *Cendant* distinction essentially permits employers to use fraud in promoting the value of their stock in order to deceive employees. If employers were claiming to give their employees bars of gold as compensation, but some of those bars turned out to be fool's gold, employers would not be allowed to continue this practice merely on the threat that some of them might choose to stop giving out the bars. Although some employers may potentially cut back on option grants if opened up to Rule 10b-5 liability, those employers are probably the ones whose employees need the most protection.

Moreover, it is far from clear that imposing Rule 10b-5 liability upon employers will lead to a sharp decrease in the number of options given to employees. In many (if not most) companies, employees with options represent only a small percentage of the shareholders with an equity stake in the firm. Giving such employees antifraud protection will only mean that they have the same protection afforded to other investors, who have their own incentives to bring Rule 10b-5 suits. Moreover, those employees who exercise their options and purchase stock unquestionably meet the Rule 10b-5 "purchase or sale" requirement, and thus are able to sue. Employers are probably not counting on the fact that they can perpetually escape fraud liability claims from their employees with options. Most employers probably recognize the baseline necessity of antifraud provisions; indeed, they may not even know that certain employees do not currently have that protection.

347. *See* John F. Barry III, *The Economics of Outside Information and Rule 10b-5*, 129 U. PA. L. REV. 1307, 1353–54 n.167 (1981) (discussing Ronald Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960)). Others have argued that investors should be allowed to bargain for their own level of fraud-prevention measures, such as mandatory disclosure. *See, e.g.*, Nicholas L. Georgakopoulos, *Why Should Disclosure Rules Subsidize Informed Traders?*, 16 INT'L REV. L. & ECON. 417, 418–19 (1996) (using the Coase theorem to argue that investors will bargain for the appropriate level of fraud-prevention measures). However, fraud-prevention measures such as required disclosure are different than the antifraud protections themselves, just as neighborhood watch programs are different than laws criminalizing theft.

348. *See, e.g.*, POSNER, *supra* note 346, at 486–89 (arguing that many aspects of securities regulation may impede the flow of information to investors, but noting that investors should be protected from fraud); Alan R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 COLUM. BUS. L. REV. 1, 130 ("A critical adjunct to my proposal of disclosure choice is that issuers in public offerings would be subject to a mandatory antifraud standard—namely, Rule 10b-5 liability.").

349. *See supra* Section III.

If employers assume employees are already covered, then changing the rule to meet this perception would not significantly frighten employers away from granting options.

Ultimately, antifraud protection—whatever its "costs" to employees and employers—is a central component of a free market system.[350] Employees should not be left vulnerable to fraud merely to assuage the fear of certain employers. Of course, Rule 10b-5 is not just any antifraud statute. Employees with options may find sufficient protection against fraud through the common law, ERISA, or other securities regulations. Such possibilities are addressed below.

E. Employee Legal Protections Beyond Rule 10b-5

Although Rule 10b-5 is a unique provision in many ways, it is possible that employees could seek redress against employers for fraud through other causes of action. If employees can address the same type of fraud and obtain the same relief through other actions, access to Rule 10b-5 becomes unimportant. However, other actions may not provide Rule 10b-5 scope of coverage, or may address the same types of fraud but entail different procedures or provide different relief. As a result, Rule 10b-5 protection may be necessary to provide adequate relief. The differences between Rule 10b-5 and other potential causes of action, and what these differences might mean to defrauded employees, are discussed below.

1. Other Federal Securities Regulation

Since the language of Rule 10b-5 is taken largely from section 17(a) of the 1933 Securities Act,[351] the antifraud provision of that statute, employees might first look to an action brought under section 17(a) as a replacement for a Rule 10b-5 action. However, while section 17(a) prohibits fraud in the "offer or sale" of a security, Rule 10b-5 prohibits fraud in the "purchase or sale" of the security.[352] This difference may not be that significant to employees, who are primarily concerned with fraud in the security's sale. More importantly, courts have rejected attempts to derive a private right of action from section 17(a).[353] Thus, Rule 10b-5 is far more useful to

350. *Cf.* Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 390 (1991) ("The social value of preventing fraud in the sale of securities is too clear to require elaboration.").

351. 15 U.S.C. § 77q(a) (2000).

352. *Compare id.*, *with* 17 C.F.R. § 240.10b-5 (2001).

353. *See* Finkel v. Stratton Corp., 962 F.2d 169, 175 (2d Cir. 1992) (citing cases from seven other circuits). In 1990, the Sixth Circuit permitted a private cause of action to go forward under section 17(a). *See* Craighead v. E.F. Hutton & Co., Inc., 899 F.2d 485 (6th Cir. 1990) (allowing a private action under section 17(a) by investors against their securities broker and account representative). However, the court held that "section 17(a) implies a private cause of action only for 'purchasers.'" *Id.* at 492. Thus, employees who were deemed not to be

defrauded employees than section 17(a).

The Acts' other civil liability provisions deal with specific situations, such as proxy fraud,[354] tender offer fraud,[355] short-swing profits,[356] violations of registration requirements,[357] or misrepresentations in registration statements[358] or prospectuses.[359] While these provisions may offer relief to employee options holders in some specific instances, Rule 10b-5 addresses the staple of most securities litigation: deception or fraud in the sale of a security.[360] Because of their limited scope, the other causes of action under federal securities law fall far short of Rule 10b-5 coverage and relief.

2. State Securities Regulation

State securities antifraud protections are part of a collection of state securities regulations commonly referred to as "blue sky" laws.[361] Blue sky laws provided the primary regulation for securities sales from the early part of the twentieth century up until the federal securities acts were passed in 1933 and 1934. Since then, the focus of investor protection has largely shifted to the federal arena. One area of state involvement has come in the so-called "merit" or substantive regulation of securities offerings. In the 1970s and 1980s, state agencies frequently used state registration requirements to deny registration for offerings that were not deemed "fair, just and equitable."[362] However, a sizeable number of exemptions from such requirements diminished their impact.[363] In 1996, Congress passed the National Securities Markets Improvement Act, which broadly preempted state blue sky registration requirements for nationally traded securities.[364]

State antifraud regulation has largely hovered around the edges of Rule 10b-5's coverage. While a panoply of different provisions exist, most state civil liability provisions have required both proof of reliance and privity of

---

purchasers for Rule 10b-5 purposes would be excluded for the same reason from a section 17(a) private action.

354. *See* 17 C.F.R. § 240.14a-9 (2002).

355. *See* 15 U.S.C. § 78n(e) (2000).

356. *See id.* § 78p(b).

357. *See id.* § 77*l*(a)(1).

358. *See id.* § 77k.

359. *See id.* § 77*l*(a)(2).

360. *See* JENNINGS ET AL., *supra* note 138, at 1057 ("Rule 10b-5 is the basic federal securities antifraud provision of the federal securities laws.").

361. The origin of the term "blue sky" "indicates the evil at which it is aimed; that is . . . speculative schemes which have no more basis than so many feet of blue sky." Hall v. Geiger-Jones Co., 242 U.S. 539, 550 (1917) (quotations omitted). For a fuller discussion on the origin of this term, see Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273, 279 n.15 (1998).

362. *See* Mark A. Sargent, *A Future for Blue Sky Law*, 62 U. CIN. L. REV. 471, 473 & n.8 (1993).

363. *See id.* at 473–74.

364. Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified throughout various sections of 15 U.S.C.).

contract.[365] Defrauded investors thus generally opted for the more lenient requirements of Rule 10b-5. However, state antifraud provisions threatened to take center stage after passage of the PSLRA in 1995. With the tightening of pleading requirements and other procedural changes, securities plaintiffs looked to state courts to escape the PSLRA's new requirements.[366] The escape was short-lived; in 1998 Congress passed the Securities Litigation Uniform Standards Act (SLUSA), which preempted most securities fraud class actions brought in state court.[367] The law, which effectively reinstates Rule 10b-5 as the primary avenue for relief from securities fraud, applies to nationally-traded securities and enables federal courts to put a stay on discovery in state individual fraud actions.[368] In a particularly defendant-friendly move, SLUSA allows defendants to remove the state court class actions to federal court for dismissal, rather than wait for the state court to resolve the issue.[369]

For most investor-plaintiffs, SLUSA has eliminated the option of pursuing blue sky claims instead of Rule 10b-5 actions. However, employees may be less likely to need the class action procedural advantages of 10b-5 actions than public investors. While employees in large corporations may find it necessary to use the class action, employees in smaller firms may not need such aggregating mechanisms. In addition, other traditional blue sky law requirements will not faze the employee-investor; for example, in the traditional option grant, employees will clearly be in privity with the issuer.[370] State blue sky antifraud provisions thus appear to be a fruitful avenue for employees in smaller and/or privately-traded companies.

However, there is one cloud lurking in this blue sky[371] for employees—a familiar one. State antifraud provisions are focused on protecting buyers of

---

365. *See* David M. Levine & Adam C. Pritchard, *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California's Blue Sky Laws*, 54 BUS. LAW. 1, 14–15 (1998).

366. *See* H.R. CONF. REP. NO. 105-803, at 14 (1998).

367. Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified throughout various sections of 15 U.S.C.).

368. *See* 15 U.S.C. §§ 77r(a), 77v(b)(4) (2000); Levine & Pritchard, *supra* note 365, at 22, 26. A stay of discovery was issued in the Enron federal securities class action against a state action in Texas. *See* Newby v. Enron Corp., No. Civ. A. H-01-3624, 2002 WL 1001056 (S.D. Tex. May 1, 2002).

369. 15 U.S.C. § 77p(c) (2000).

370. The need to show reliance, however, could ultimately prove difficult for employees. Employees may not be able to show they were specifically aware of the fraudulent statements made by the company. They may also have difficulty showing they were considering other jobs, or that the value of their options was the only thing keeping them at the firm.

371. I can't believe I just wrote that. However, I'm not the first. *See, e.g.*, William L. Doerler, SEC v. Life Partners, Inc.*: An Extended Interpretation of the* Howey *Test Finds that Viatical Settlements are Investment Contracts*, 22 DEL. J. CORP. L. 253, 253 (1997) ("What was once covered by 'blue-sky' laws is now covered by dark clouds as the district court rains on LPI's parade and on the rest of the viatical settlement industry."); Kurt M. Saunders, *Proof of Fault in Actions for Securities Fraud: A Cloud in Pennsylvania's Blue Sky*, 46 U. PITT. L. REV. 1083 (1985).

securities—namely, those who have obtained their security through a purchase. Thus, if the definition of "purchase" tracks the definition in Rule 10b-5, employees will once again be unable to meet the requirements for standing. The civil fraud provision in the Uniform Securities Act of 1956, which was adopted by over 30 states, limits relief to the buyers of securities.[372] California Corporations Code section 25,400, which is considered one of the most plaintiff-friendly state antifraud provisions, requires that the fraud be "for the purpose of inducing the purchase or sale of such security."[373] It is possible, of course, that state courts would reject the federal analysis and decide that employees who receive options have obtained them through a purchase or sale.[374] However, given the potential "purchase-or-sale" exclusion, state blue sky laws do not appear to offer employees a reliable alternative to Rule 10b-5.

3. State Common Law

Absent the protection of the securities laws, employees may bring actions based on state common law: breach of contract, fraud, deceit, or even negligent misrepresentation. However, such common law remedies do not provide the same protections as Rule 10b-5. As the Supreme Court has noted, "an important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common law protections by establishing higher standards of conduct in the securities industry."[375] In several important respects, the common law falls short of federal securities law.[376] First, Rule 10b-5 extends beyond the common law definition of fraud to include misleading omissions that would not generally rise to a common law offense.[377] Negligent misrepresentation may cover such omissions, but the scope of that tort varies considerably from state to state.[378] Second, Rule 10b-5 actions presume that the investor has relied on defendant's false or

372. *See* UNIF. SEC. ACT § 410, 7C U.L.A. 102, 266–67 (1956) (amended 1958) (repealed 1985); JENNINGS ET AL., *supra* note 138, at 1448.

373. CAL. CORP. CODE § 25,400 (2002).

374. *Cf.* StorMedia Inc. v. Superior Court, 976 P.2d 214 (Cal. 1999) (finding that defendant firm had manipulated the market by "selling" stock to employees through an employee stock purchase plan, even though the sales were not on the open market).

375. Herman & MacLean v. Huddleston, 459 U.S. 375, 389 (1983); *see also* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).

376. As one state court noted, the purpose of securities regulation is to "afford the victims of securities fraud with a remedy without the formidable task of proving common law fraud." Mirkin v. Wasserman, 858 P.2d 568, 580 (Cal. 1993) (quoting Bowden v. Robinson, 136 Cal. Rptr. 871, 878 (Cal. Ct. App. 1977)).

377. 17 C.F.R. § 240.10b-5(b) (2002).

378. *See, e.g.*, Bily v. Arthur Young and Co., 834 P.2d 745 (Cal. 1992) (finding accountants not liable for negligent misrepresentation to third parties); Ultramares Corp. v. Touche, 174 N.E. 441 (N.Y. 1931) (same).

misleading actions through the "fraud-on-the-market" theory.[379] However, state common law actions require proof of reliance.[380] Thus, individual employees would need to show some form of reliance on the fraudulent statements—actual knowledge of those statements, for example, and the consideration of those statements in their own valuation of the option. Finally, as a federal cause of action, Rule 10b-5 provides access to federal courts and to federal class action procedures. Although the PSLRA tightened up those procedures, they still afford plaintiffs an aggregation mechanism that may not be available under state common law.[381] Ultimately, state common law does not appear to offer employees an adequate substitute for the Rule 10b-5 private cause of action.

4. ERISA

ERISA provides that fiduciaries of employee benefit plans must exercise "care, skill, prudence, and diligence" in overseeing such plans,[382] and provides for liability if a fiduciary participates in, conceals, or even simply knows about a breach of fiduciary duty without taking steps to remedy it.[383] Employees with stock options could potentially sue for fraud committed by plan fiduciaries if ERISA applied to their stock option plans. However, stock options, whether provided individually or through a plan, are neither welfare plans nor pension plans, and thus do not fall under ERISA's purview.

ERISA provides coverage for "employee benefit plans," which it divides into two groups: employee welfare benefit plans and employee pension benefit plans.[384] Employee welfare benefit plans are defined as those plans which provide benefits relating to certain employee needs: "medical, surgical, or hospital care or benefits, or benefits in the event of sickness, accident, disability, death or unemployment, or vacation benefits, apprenticeship or other training programs, or day care centers, scholarship funds, or prepaid legal services."[385] Courts have universally held that stock

379. *See* Basic Inc. v. Levinson, 485 U.S. 224, 241 (1988) ("Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action.").

380. *See, e.g.*, Kaufman v. i-Stat Corp., 754 A.2d 1188, 1201 (N.J. 2000) (rejecting the fraud-on-the-market theory to satisfy the reliance requirement for a state common-law fraud action). The court noted that "no . . . state appellate court had permitted the fraud-on-the-market theory to satisfy the reliance requirement of common-law fraud." *Id.* at 1191.

381. 15 U.S.C. § 78u-4 (2000).

382. 29 U.S.C. § 1104(a)(1)(B) (2000).

383. *Id.* § 1105(a).

384. *Id.* § 1002(3). A plan must be either a welfare benefit plan or a pension benefit plan to be covered. *See* Kaelin v. Tenneco, Inc., 28 F. Supp. 2d 478, 484–85 (N.D. Ill. 1998) (citing authority from five circuits).

385. 29 U.S.C. § 1002(1) (2000). Also included are benefits "described in [section] 302(c) of the Labor Management Relations Act," which relates to collective bargaining costs and

option plans do not provide any such benefits and thus cannot be considered welfare plans.[386]

An employee pension benefit plan "(i) provides retirement income to employees or (ii) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond."[387] Thus, a plan must push benefits back to either retirement or the termination of employment in order to be considered a pension benefit plan. In regulations concerning this definition, the Department of Labor specified that the definition of pension plan "shall not include payments made by an employer to some or all of its employees as bonuses for work performed, unless such payments are systematically deferred to the termination of covered employment or beyond, or so as to provide retirement income to employees."[388] Although individual plans may be tailored to a variety of purposes, stock option plans are generally not established as a means of providing retirement income. Instead, such plans provide employees with options to purchase employer stock much earlier than retirement.[389] Unless a stock option plan provides that the options cannot be exercised until retirement or employment termination, it does not fit within the definition of a pension plan.

Federal courts have overwhelmingly found that bonus plans such as stock option plans, phantom stock plans, or other bonus plans are not pension plans. In one of the earliest decisions on this issue, the Fifth Circuit excluded from ERISA coverage a bonus plan which provided employees with the right to receive a fraction of the proceeds from a certain project.[390] The court acknowledged that "while the primary thrust of the plan is to reward employees during their active years, payments to some employees . . . are likely to continue after the employee has retired or ceased work because of death or disability."[391] However, the court determined that "the mere fact that some payments under a plan may be made after an employee has

benefit plans established through collective bargaining.

386. *See, e.g.*, Estate of McCloone v. Intel Corp., 1 Fed. Appx. 715, 716 (9th Cir. 2001), Oatway v. Am. Int'l Group, Inc., 27 Employee Benefits Cas. (BNA) 2404 (D. Del. 2002), Goodrich v. CML Fiberoptics, Inc., 990 F. Supp. 48 (D. Mass. 1998); *see also* U.S. Dep't of Labor, Op. Letter No. 79-80A, 1979 WL 7016, at *3 (Nov. 13, 1979).

387. 29 U.S.C. § 1002(2)(A) (2000).

388. 29 C.F.R. § 2510.3-2(c) (2002).

389. Generally, stock option plans require a three to five year vesting period before employees can exercise their options. *See* BLASI ET AL., *supra* note 3, at 64–65. Thereafter, employees are free to exercise their options (i.e., buy the stock at the option price) and then sell the stock itself. In a study of the behavior of 50,000 in eight firms who gave their employees stock options, ninety percent of the employees who exercised their options sold the underlying stock immediately thereafter. *Id.* at 66.

390. Murphy v. Inexco Oil Co., 611 F.2d 570, 576 (5th Cir. 1980).

391. *Id.* at 574.

retired or left the company does not result in ERISA coverage."[392] Because payments under the plan began immediately, the court concluded that the plan provided current rather than retirement income. Similarly, the Tenth Circuit held in *Emmenegger v. Bull Moose Tube Co.*[393] that a phantom stock plan that allowed employees to redeem their shares any time after vesting was not a pension plan, despite the possibility that participants would not redeem their shares until after retirement.[394] Courts considering the application of ERISA to employee stock option plans have followed this analysis.[395]

A stock option plan may be considered a pension plan if it becomes a *de facto* method of deferring income to retirement or termination. ERISA provides that a bonus plan may result in the deferral of income "by its express terms or as a result of the surrounding circumstances."[396] A Department of Labor opinion letter outlined what such circumstances could potentially be:

> For example, the manner in which bonus percentages are negotiated by employees yearly may allocate the economic benefits earned in a year disproportionately to retirees and participants reaching retirement age as defined under the Plan; an inordinate percentage of the bonus recipients may be at one time at or nearly at retirement age; and payments may not be made under the plan often enough or within a reasonable time to avoid their actually serving as retirement income. Furthermore, if the plan is communicated to participants in a manner that causes them to act under the Plan so as to result in their deferring receipt of income until retirement, it may be deemed a pension plan.[397]

However, courts have yet to find that the circumstances surrounding any particular stock option plan (or other stock-related bonus plan) have

392. *Id.* at 575. The court memorably wrote that the definition of a pension plan is "not to be read as an elastic girdle that can be stretched to cover any content that can conceivably fit within its reach." *Id.*

393. 197 F.3d 929 (10th Cir. 1999).

394. *Id.* at 933; *see also* Hahn v. Nat'l Westminister Bank, 99 F. Supp. 2d 275, 279 (E.D.N.Y. 2000) (discussing a phantom stock plan) ("The mere fact that payments made pursuant to a plan continue after retirement does not transform an otherwise excluded bonus plan into one whose payments are 'systematically deferred' to the termination of employment or one whose purpose is to provide retirement income.").

395. *See* Oatway v. Am. Int'l Group, 27 Employee Benefits Cas. (BNA) 2404 (D. Del. Feb. 5, 2002); Raskin v. CyNet, Inc., 131 F. Supp. 2d 906, 910 (S.D. Tex. 2001); Butzburger v. Halliburton Co., No. Civ. A. 399CV2169R, 2001 WL 1636357, at *3 (N.D. Tex. Dec. 18, 2001); Long v. Excel Telecomms. Corp., No. Civ. A. 3:98-CV3015G, 2000 WL 1562808, at *4 (N.D. Tex. Oct. 18, 2000); *Goodrich*, 990 F. Supp. at 49–50; Int'l Paper Co. v. Suwyn, 978 F. Supp. 506, 511–12 (S.D.N.Y. 1997); *see also* U.S. Dep't of Labor, Op. Letter No. 79-80A, *supra* note 386, at *3.

396. 29 U.S.C. § 1002(2)(A) (2000).

397. *See* U.S. Dep't of Labor, Op. Letter No. 98-02A, 1998 Westlaw 103654, at *2 (March 6, 1998).

rendered the plan a pension plan.[398] Indeed, it seems unlikely that stock option plans would ever meet these circumstances. Stock options are designed not to provide for retirement, but to provide employees with an incentive to work harder for the company. While employers often stagger vesting of the options over several years, vesting generally takes place within five years, and many options have an expiration date after which they cannot be exercised.[399] As courts have frequently noted, the stated purpose of most stock option plans is to provide an incentive to employees to "promote the interests of the [employers] and their stockholder[s] by aligning the interests of [employees] . . . with those of the stockholder[s]."[400] Moreover, stock option plans are ill-suited to be retirement funds, given their lack of diversification. Recent events involving employees from Enron and Lucent have demonstrated the danger in concentrating pension fund investments in employer securities. A pension fund that consisted solely of employer stock or stock options, with the exception of employee stock ownership plans, would fail to meet the fiduciary duty of diversification.[401]

Stock options are just one form of employee investment in their company. It may seem inconsistent that employees are protected by ERISA when they invest in an ESOP or buy employer stock through a 401(k) plan, but not when they receive stock options through a plan. However, ERISA is not the proper regulatory vehicle for employee stock options, as option plans are generally not retirement funds. Perhaps the problem is not that stock options are not covered, but that other employee investments in their employer are.[402] The difficulties in reconciling ERISA with ESOPs, which are explicitly covered by ERISA, demonstrate that ERISA would be an awkward regulatory tool for stock option plans.[403] Instead of retirement funds, employee stock options should be treated as securities, embedded with the protections against risk of fraud that other shareholders receive.

398. *See, e.g.*, *Emmenegger*, 197 F.3d at 933.

399. In order to qualify for special tax treatment, options must have a limit requiring that they be exercised within ten years, five years, or twenty-seven months. *See* 26 U.S.C. §§ 422(b)(2), 423(b)(7) (2000).

400. *Emmenegger*, 197 F.3d at 931; *see also Long*, 2000 WL 1562808, at *3 (noting that the purpose of the plan is to "provide incentives for [employees] to exert maximum efforts for the success of the Company"); *Suwyn*, 978 F. Supp. at 511 (providing that the purpose of the plan is "to provide incentive . . . to improve the performance of the Company on a long-term basis").

401. 29 U.S.C. § 1104(a)(1)(C) (2000). However, employees are free to self-direct their funds into employer securities through § 401(k) plans. For a critique of this provision, see Susan J. Stabile, *Freedom to Choose Unwisely: Congress' Misguided Decision to Leave 401(k) Plan Participants to their own Devices*, 11 CORNELL J.L. & PUB. POL'Y 361 (2002).

402. *But cf.* Susan J. Stabile, *Pension Plan Investments in Employer Securities: More Is Not Always Better*, 15 YALE J. ON REG. 61 (1998) (arguing that ERISA should limit the percentage of employer securities that may be held by a pension plan).

403. *See, e.g.*, Moench v. Robertson, 62 F.3d 553, 568 (3d Cir. 1995) ("[I]ndeed, by its very nature an ESOP places employee retirement assets at much greater risk than does the typical diversified ERISA plan.") (citation omitted).

VII. CONCLUSION

The sight of executives from Adelphia, Enron, and WorldCom being led off in handcuffs may provide a sense of vindication to defrauded investors. However, our system provides monetary relief through compensation obtained by civil suits. Massive securities fraud actions are well underway against these companies and many others—actions designed to make investors whole again. If employees are excluded from such actions on the ill-conceived distinction between individual negotiations and group plans, the system will have failed them, permitting them to be defrauded without any avenue for obtaining civil justice.

Access to Rule 10b-5 is no small matter. As investors line up to bring civil actions against the many companies plagued by corporate scandal, employees with stock options will be the lone group unable to pursue relief.[404] Given that these employees may have also lost their jobs and suffered losses to their retirement plans, they may in fact be in a far worse position than public investors seeking relief. Moreover, Rule 10b-5 private actions not only provide compensation for past victims; they provide deterrence against future perpetrators. Along with the thousands of current employees without Rule 10b-5 protection are the many thousands more to come. Even under the currently poor economic conditions, more technology firms are increasing their stock option grants this year than are reducing them.[405] If employees are unable to seek redress for fraud in connection with a stock option grant, future employers will know that their deception of employees with regard to such grants will be exempt from Rule 10b-5 litigation.

Employees are different than public investors in many important ways, but they are not immune to fraud. The main purpose of employee stock options is to align the interests of employees with the interests of investors. If employees are expected to act like investors, they are entitled to basic investor protections. With the crisis of confidence that current events have engendered about our financial system, the exclusion of certain employees from Rule 10b-5 presents one more example of insiders out-gaming the little guy. In the current wave of corporate reform, this problem should not be overlooked.

---

404. It appears that Enron employees have only brought securities litigation based on the stock they purchased or received, not their stock options. *See, e.g.*, Newby v. Enron Corp., No. Civ. H-01-3624, 2002 WL 31989193 (S.D. Tex. Feb. 15, 2002).

405. A survey of technology firms in the western United States shows that nearly three in ten (28%) technology firms are increasing the number of awards, while only 19% are decreasing the number of awards. *See* William M. Mercer Inc., Press Release, *Tech Firms Continue to Refine Compensation Programs*, July 12, 2002, *available at* http://www.mercerhr.com/pressrelease/details.jhtml?idContent=1062030 (last visited Jan. 27, 2003) (on file with the Iowa Law Review); *see also* BLASI ET AL., *supra* note 3, at 92 (finding that 98 out of the top 100 high tech companies offer stock options to most or all of their employees).