SECURITIES REGULATION—DAMAGES—DISGORGEMENT MEASURE OF DAMAGES APPLIED TO TIPPEE TRADING VIOLATIONS OF RULE 10b-5—*Elkind v. Liggett & Meyers, Inc.*, 635 F.2d 156 (2d Cir. 1980).

The threat of excessive damage awards in cases involving violations of rule 10b-5[1] has often prompted corporations faced with potential liability to settle before fully litigating the issue of damages.[2] Therefore, courts have had little opportunity to establish an accepted method for measuring damages in the context of tippee trading.[3] The Court of Appeals for the Second Circuit recently was presented with such an opportunity in *Elkind v. Liggett & Myers, Inc.*[4] The court responded by applying a "disgorgement" measure of damages which limited the amount assessable against the corporation to the ill-gotten profit derived by those who used the confidential information.[5] Although the adoption of this measure of damages remedies the problem of large damage awards, it is uncertain whether the *Elkind* rationale can form the foundation for a consensus regarding damage measures.

In 1969, Liggett & Myers instituted an "analyst program" designed to stimulate the growth of corporate earnings.[6] Under this program company officials were encouraged to contact financial analysts outside the company so as to inform the business community of the breadth and diversity of Liggett's operations.[7] Although the cor-

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[1] This anti-fraud provision states that:

> It shall be unlawful for any person, directly or indirectly, by use of any means of instrumentality of interstate commerce, or of the mails or any facility of any national securities exchange:
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> (a) To employ any device, scheme, or artifice to defraud,
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> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading, or
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> (c) To engage in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1980) (promulgated pursuant to section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1976)).

[2] *See* Huddleston v. Herman & MacLean, 640 F.2d 534, 554 (5th Cir. 1981); Mullaney, *Theories of Measuring Damages in Security Cases and the Effect of Damages on Liability*, 46 FORDHAM L. REV. 277, 277-78 (1977). *See also* 5B A. JACOBS, THE IMPACT OF RULE 10b-5, § 269.03 (c)(vii)(3), at 72 (1980 Supp.); Comment, *Damages to Uniformed Traders for Insider Trading on Impersonal Exchanges*, 74 COLUM. L. REV. 299, 306 (1974).

[3] *See* Mullaney, *supra* note 2, at 277-78.

[4] 635 F.2d 156 (2d Cir. 1980).

[5] *Id.* at 172-73.

[6] *Id.* at 159.

[7] *Id.* at 158-59. Although Liggett is traditionally identified with the tobacco business, the company also maufactures various other products, including pet food, cereal, watchbands,

poration experienced a marked increase in earnings following the initiation of this program, by May 1972 Liggett's financial status began to weaken.[8] Pessimistic internal audits forced company officials to temper any expressions of optimism in their meetings with analysts.[9] Company officials, however, did not comment on the analyst reports, which continued to be favorable.[10] Liggett & Myers delayed disclosure of the full extent of the disappointing developments until July 18, 1972.[11]

On July 17, one analyst called Liggett's chief financial officer to make inquiries about the corporation's performance and declining stock prices. The officer grudgingly confirmed the analyst's suggestion that "there was a good possibility that earnings would be down" in the second quarter of 1972.[12] Despite the officer's warnings that the information was confidential, the analyst divulged it to a stockbroker[13] who sold 1800 shares of Liggett stock prior to the July 18 press release.[14]

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cleansers, and rugs, and is the exclusive importer of J&B Scotch. *Id.*; Brief for Plaintiff-Appellee-Cross-Appellant at 9-10, Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980) [hereinafter cited as Brief for Plaintiff].

According to corporate sources, the general misconception that Liggett was no more than a tobacco company may have been a primary cause for the company's failure to reach its full growth potential. *See* Brief of Defendant-Appellant-Cross-Appellee at 3-4, Elkind v. Liggett & Myers, Inc., 635 F.2d. 156 (2d Cir. 1980) [hereinafter cited as Brief for Defendant].

[8] 635 F.2d at 159-60. Liggett's earnings in 1971 of $34,206,000, or $4.22 per share, were up by a record-breaking 18.5% from the previous year's earnings of $3.56 per share. *Id.* at 159; Brief for Plaintiff at 11. The outlook for 1972 was so optimistic that a number of analysts predicted a 10% increase over the record figures set in 1971. Statistics for April and May of 1972, however, revealed a decline in earnings as compared to the same month in the previous year. April 1972 earnings were $.03 per share as compared to $.30 per share in April 1971. Although earnings for May 1972 jumped to $.23 per share, this was below the $.27 per share mark set in 1971. Furthermore, internal budget projections called for a 6.4% decrease in overall earnings for 1972. 635 F.2d at 159-60.

[9] 635 F.2d at 160.

[10] *Id.* at 159, 163. Liggett merely commented with respect to certain factual errors contained in the reports it reviewed. Liggett officials never went so far as to verify any of the analysts' earnings projections. *Id.*

[11] *Id.* at 160.

[12] *Id.* at 161.

[13] A typographical error appears on page 161 of the *Federal Reporter*, second series: "stockholder" should read "stockbroker."

[14] 635 F.2d. at 161. Numerous other inquiries were made, including a July 10 inquiry in which Liggett's Director of Corporate Communication told an analyst that a preliminary earnings statement would be issued in the near future. The officer also confirmed the analyst's assumptions that sales of J&B Scotch were declining due to earlier stockpiling, and that pet food sales were being hurt by competition. The analyst conveyed this information to three of his clients, two of whom collectively owned over 600,000 shares of Liggett stock, and one of whom owned 100 shares. The minority shareholder sold his 100 shares between the date of the disclosure by the Liggett official and the date of the official press release. *Id.* at 160-61. This

Based on this activity, plaintiffs brought a class action against Liggett & Myers under rule 10b-5. Among other allegations, plaintiffs claimed that the defendant corporation was liable to individuals who purchased Liggett stock between the July 17 tippee trade and the July 18 press release.[15] The District Court for the Southern District of New York held the company liable,[16] and assessed damages by applying an "out-of-pocket" measure based on the difference between the market price of the security and its actual value on the date that the uninformed investor traded.[17] The Court of Appeals for the Second Circuit affirmed the district court's holding with respect to liability for the July 17 trade.[18] After an extensive discussion of various measures of damages, however, the court rejected the out-of-pocket approach as inappropriate, and adopted the disgorgement measure of damages.[19]

Judge Mansfield, writing for the court, recognized that liability under rule 10b-5 is imposed to assure an "honest market."[20] He noted that all who trade in a corporation's stock are entitled to deal in a market in which no contemporaneous trader has an advantage of confidential, material information regarding a particular stock.[21] Thus, the court stated that the tip in combination with the

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activity served as one of the bases of the complaint brought by plaintiffs, and received extensive attention in the opinions of both the district court and court of appeals. *See* notes 16 & 18 *infra*.

[15] 635 F.2d at 158. Plaintiffs set forth two additional claims. First they alleged that damages should be recovered by those investing between June 19, 1972, and July 18, 1972, when Liggett officials failed to correct the analysts' public reports which they knew to be erroneous, and continued to issue favorable statements that were misleading with respect to Liggett's actual financial standing. Second, they claimed that Liggett was liable for damages to those investing between June 28, 1972, and July 18, 1972, when there had been trading with the benefit of tipped inside information. *Id.* at 158. *See also* Brief for Plaintiff at 28-30 (regarding the liability between June 28 and July 18).

[16] Elkind v. Liggett & Myers, Inc., 472 F. Supp. 123, 126-28 (S.D.N.Y. 1978), *rev'd*, 635 F.2d 156 (2d Cir. 1980). The district court also held Liggett & Myers liable for damages caused by a tip made on July 10. The court denied liability, however, to those alleging that fraudulent tips had been made as early as July 28. The court further held that liability could not be based on Liggett's failure to correct the erroneous analyst reports and come forth with their actual financial status. *Id.* at 126-29.

[17] *Id.* at 129-35. Although plaintiffs offered expert analysis as proof of the stock's actual value, this was rejected as being too speculative. *Id.* at 130. *See also* Brief for Plaintiff at 54-58; notes 28 & 29 *infra* and accompanying text.

[18] 635 F.2d at 165-68. Although the court of appeals found liability with respect to the July 17 trade, it overturned the district court's finding of liability for a tip allegedly made on July 10. The court of appeals also affirmed the lower court's denial of liability for the corporation's failure to supply the analysts with correct financial information. *Id.* at 162-68.

[19] *Id.* at 168-73.

[20] *Id.* at 169.

[21] *Id.* This information balance is maintained through imposition of a duty to "disclose or abstain." In the Second Circuit, this duty imposes an alternative obligation on the recipient of

tippee trading posed "the evil against which the open market investor must be protected."[22] Were it otherwise, the tippee trader could profit unfairly at the expense of the uninformed trader.[23]

With the above principles in mind, the court acknowledged that securities legislation should be liberally construed so as to carry out its remedial purposes.[24] Therefore, the court reasoned that damages should be applied flexibly, not only to deter further tipping by corporate insiders and trading by recipients of the tipped information, but also to compensate the wronged trader for any injury he might have suffered.[25] In reaching its decision, the court analyzed several measures of damages before adopting the disgorgement method.

The court of appeals first addressed the out-of-pocket measure of damages. This approach equates damages to the difference between

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the tipped information either to abstain from trading in the stock of the subject corporation or, if he chooses to trade, to disclose the inside information to the public. The duty is breached, therefore, by the continuing non-disclosure of the inside information that was used in the unlawful trade. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 235-36 (2d Cir. 1974). *Cf.* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 967 (1969) (such an absolute duty exists in SEC enforcement actions). *But see* Wilson v. Comtech Telecommunications Corp., 648 F.2d 88, 93-94 (2d Cir. 1981) (breach of duty to disclose or abstain only causes injury to those trading contemporaneously with wrongful trader).

Application of the duty to disclose or abstain in determining civil liability is, however, by no means settled. For example, the Court of Appeals for the Sixth Circuit has held that there is no per se duty to disclose; rather, rule 10b-5 is violated only by the act of tippee trading. Fridrich v. Bradford, 542 F.2d 307, 318 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977). Although Chiarella v. United States, 445 U.S. 222 (1980) (cited favorably in *Elkind*), speaks of an affirmative duty to disclose, it does not fully resolve the issue. *Chiarella* may be distinguished because it involved a criminal prosecution. *Cf. Fridrich*, 542 F.2d at 314-18 (distinguishing *Texas Gulf Sulphur* as SEC enforcement action).

In any event, the obligation to disclose or abstain is only triggered when the confidential information disclosed by the corporation is material and when such information is disclosed with scienter. Information is material when it is of a nature that *would* influence the reasonable investor in his decision to trade in a security. T.S.C. Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (replacing less stringent "might" test set forth by Supreme Court only six years earlier in Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970)). A tip is made with scienter if divulged with the knowledge and intent that a tipper could use the information to his advantage. Ernst & Ernst v. Hochfelder, 425 U.S. 158, 197 (1976). *See also* G.A. Thompson & Co. v. Partridge, 636 F.2d 945, 961 n.32 (5th Cir. 1981) (severe recklessness generally constitutes scienter).

[22] 635 F.2d at 169.

[23] *Id.*

[24] *Id.* at 169-70. One commentator suggests that there are eight purposes underlying rule 10b-5. They are: (1) maintaining free securities markets; (2) equalizing access to information; (3) insuring equal bargaining strength; (4) providing for disclosure; (5) protecting investors; (6) assuring fairness; (7) building investor confidence; and, (8) deterring violators while compensating victims. 5 A. JACOBS, *supra* note 2, § 6.1, at 132-48.

[25] 635 F.2d at 169-70.

the market price and the actual value of the stock on the date of the uninformed trade.[26] Although this measure seeks to compensate the defrauded trader with the entire amount of money lost in the transaction, the court found it inappropriate for several reasons. The court considered out-of-pocket damages to be appropriate only when the investor's injuries are directly caused by the defendant's fraud. Tipper and tippee trading, however, contains no element of fraud, and unwary investors are not induced to buy or sell.[27] Judge Mansfield also noted that this method of calculating damages would entail great difficulty in proving the stock's actual value at the time of the uninformed trade. The court found this value to be hypothetical and stated that any approximation through expert value analysis, as offered by the plaintiff, would be speculative.[28] Concern was expressed, therefore, that some courts would equate the actual value on the pertinent date to the market price after public disclosure of the material information, as the district court had done. Judge Mansfield explained that using a theory based on the market price would be improper because it is founded on the often incorrect assumption that the tip and the later public disclosure are "substantially the same," and that the actual market reaction parallels "how the market would have reacted to the public release of the tipped information at an earlier time."[29] Furthermore, the court rejected the out-of-pocket approach because of the potential for imposing damages disproportionate to the wrong committed,[30] thereby granting a windfall to "all

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[26] *Id.* at 170. This is perhaps the most widely recognized measure of damages in rule 10b-5 cases. It seeks to provide the defrauded trader with the amount of money he lost in the transaction. This measure of damages works equally well for both defrauded sellers and buyers. *See, e.g.*, Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972); Harris v. American Inv. Co., 523 F.2d 220, 225 (8th Cir. 1975); 5B A. JACOBS, *supra* note 2, § 260.03(c)(ii), at 19-21; Mullaney, *supra* note 2, at 281; Comment, *The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities*, 26 STAN. L. REV. 371, 383-84 (1974).

[27] 635 F.2d at 170.

[28] *Id.*

[29] *Id.* Judge Mansfield illustrated this problem by stating: "One could not reasonably estimate how the public could have reacted to the news that the Titanic was near an iceberg from how it reacted to the news that the ship had struck an iceberg and sunk." *Id. See also* Bonime v. Doyle, 416 F. Supp. 1372, 1384-86 (S.D.N.Y. 1976) (measure of damages should reflect actual pressures on market).

[30] 635 F.2d at 170-71. The assessment of punitive damages in cases such as *Elkind* which are brought under the Securities Exchange Act of 1934 is generally prohibited. *E.g.*, Gould v. American-Hawaiian S.S. Co., 535 F.2d 761, 781 (3d Cir. 1976); Green v. Wolf Corp., 406 F.2d 291, 302-03 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969); Comment, *supra* note 2, at 305.

interim investors and their counsel."[31] Recognizing that this expense ultimately would be borne by innocent stockholders, the court hesitated to authorize such damages absent a statutory mandate.[32]

Secondly, the court addressed the "causation-in-fact" alternative. Based on the rationale that no wrong is perpetrated unless the tippee trading has an effect on the market, this measure of damages would only allow recovery when the plaintiff showed that the fraudulent trading had repercussions on the market which induced him to trade.[33] The court considered this measure of damages to be advantageous when the market impact can be measured, because it limits plaintiffs' recovery to the loss actually caused by the wrongdoing.[34] Nevertheless, this advantage was outweighed by the possibility that no damages could be proven when a wrongful but insubstantial trade was at issue. The court of appeals expressed dissatisfaction because the causation-in-fact alternative would not allow recovery for violation of the tippee's obligation to come forward with the privileged information before trading.[35] The court also stated that it was "difficult of [*sic*] not impossible" to prove the actual extent of any market repercussions caused by the wrongful conduct.[36] Furthermore, even if the market effect were easily provable, the court was concerned that any fluctuations in price occurring after the date of the tortious trade would not be an actionable injury because they are not " 'in connection with the purchase and sale of securities' " as required by rule 10b-5.[37]

Finally, the court discussed and adopted the disgorgement measure of damages. This theory, recommended by the American Law Institute,[38] allows a defrauded plaintiff to recover the difference between the market price of the stock on the date of the uninformed trade and the price within a reasonable time after the plaintiff learns of the tipped information or after public disclosure. Recovery is limited, however, to the amount of profit reaped by the wrongful

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[31] 635 F.2d at 170. Section 28(a) of the Securities Exchange Act of 1934 forbids recovery "in excess of . . . actual damages." 15 U.S.C. § 77bb(a) (1976).

[32] 635 F.2d at 170-71.

[33] *Id.* at 171. This is the same measure as was applied by the majority in Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977).

[34] 635 F.2d at 171.

[35] *Id.* *See* note 21 *supra* for a discussion of a tippee's obligation to come forward with privileged information.

[36] 635 F.2d at 171.

[37] *Id.* (quoting rule 10b-5(c)).

[38] ALI Federal Securities Code, § 1708(b) (1980).

trader.[39] Where the amount of plaintiffs' claims exceed the wrongful trader's gain, either because of a large volume of uninformed trading or a sizeable differential between the two prices, plaintiffs share the total disgorged profit proportionally.[40] The court found this alternative to be advantageous because it would not only deter tipping and tippee trading, but would also provide compensation "roughly commensurate to the actual harm" done by the tortious trade.[41] Judge Mansfield further posited that this approach would avoid the extraordinary problems of proof associated with the out-of-pocket[42] and causation-in-fact measures of damages.[43] Under this theory each plaintiff need only show: the volume and the price per share of his purchase; the time of his transaction; that a reasonable investor would not have traded in the stock had he known the confidential information; and, the amount by which the price was affected at the time the investor learned of the information or at a reasonable time after public disclosure.[44]

The court acknowledged that, as with other tippee trading damage theories, the disgorgement measure is not without its drawbacks. The panel noted that this approach was disadvantageous because: it modifies the concept that gain on the part of the wrongful trader is generally immaterial to a finding of liability; [45] it might be duplicitous if the Securities and Exchange Commission chose to bring a similar proceeding against the defendant; [46] it might discourage class actions resulting in damage awards which are insignificant when pro rated among members of the plaintiff class; [47] and, it might result in wind-

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[39] 635 F.2d at 172.

[40] *Id.*

[41] *Id.*

[42] *See* notes 28 & 29 *supra* and accompanying text.

[43] *See* notes 35 & 36 *supra* and accompanying text.

[44] 635 F.2d at 172.

[45] *Id.* The basis for damages stems from the tort, which concentrates on the injury to the plaintiff rather than the profits reaped by the defendant. Myzel v. Fields, 386 F.2d 718, 750 (8th Cir. 1967). *See also* Comment, *supra* note 2, at 315.

Rule 10b-5 has no specific provisions for a private right of action. Nevertheless, courts reason that the undertaking of acts proscribed by statute generally gives rise to an implied private cause of action. *E.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185, 196 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971); Huddleston v. Herman & MacLean, 640 F.2d 534, 540-41 (5th Cir. 1981); Herpich v. Wallace, 430 F.2d 792, 803-05 (5th Cir. 1970); Kardon v. National Gypsum, 69 F. Supp. 512, 513-14 (E.D. Pa. 1946); 5 A. JACOBS, *supra* note 2, § 8.02.

[46] 635 F.2d at 172. *See also* 5B A. JACOBS, *supra* note 2, § 261.03(b).

[47] 635 F.2d at 173. *See also* Petition of Plaintiff-Appellee for Rehearing *En Banc* and/or Reconsideration at 6-10, Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980).

falls where the market price is affected by unrelated causes.[48] Notwithstanding these concerns, the court adopted the disgorgement approach because it was convinced that the theory "offer[ed] the most equitable resolution of the difficult problems created by" tipping liability.[49]

Another approach which the court could have analyzed is the "cover" measure of damages. Based upon the legal principle that a person who has been fraudulently induced into entering a transaction has a duty to minimize damages within a reasonable time after learning of the fraud,[50] this measure of damages awards a defrauded seller the difference between the amount of consideration received for his security and the peak value of the stock within a reasonable time after he has or should have become aware of the fraud,[51] and has had the opportunity to decide whether to reinvest.[52] Conversely, a defrauded purchaser receives the difference between the amount of consideration paid for the security and its lowest value within a reasonable time after he has or should have become aware of the fraud,[53] and has had the opportunity to decide whether to sell the stock.[54] Although the court explicitly declined to discuss the merits of this theory,[55] it could have easily dismissed the theory by employing a rationale similar to that used in rejecting the out-of-pocket approach.[56] The threat

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[48] 635 F.2d at 172-73.

[49] *Id.* at 173.

[50] *See* Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 105 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971) (liability for material misrepresentations in press release); 5B A. JACOBS, *supra* note 2, § 260.03(c)(iii).

[51] This suggests an examination of the circumstances to discover when the investor should have become aware of the fraud. *See* 5A A. JACOBS, *supra* note 2, § 235.03, at 28-35.

[52] Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 105-06 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971). Recovery should be limited if the defrauded seller actually reinvests before the security has reached the cover price. 5B A. JACOBS, *supra* note 2, § 260.03(c)(iii), at 32.

[53] *See* note 51 *supra*.

[54] This is often referred to as the "Chasins" measure of damages. 5B A. JACOBS, *supra* note 2, § 260.03(c)(iv) (citing Chasins v. Smith Barney & Co., 438 F.2d 1167 (2d Cir. 1970)). *But see* Mullaney, *supra* note 2, at 288 (questions the applicability of the measure of damages set forth in *Chasins*).

Recovery should be limited, as under the cover measure, if the defrauded buyer actually sells before the price has bottomed out. 5B A. JACOBS, *supra* note 2, § 260.03(c)(iv), at 37. This is what actually happened in *Chasins*. 438 F.2d at 1173.

[55] 635 F.2d at 168 n.25. The merits of this measure of damages were not discussed because the issue was not raised in the lower court. *Id.*

[56] *See* notes 26-32 *supra* and accompanying text. Although the cover and out-of-pocket approaches are based on differing rationales, application of the out-of-pocket measure of damages as used by the district court in *Elkind* is essentially identical to the application of the cover approach in Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 104-06 (10th Cir.), *cert. denied*,

of imposing impermissibly punitive and over-compensatory awards outweighs the benefit of fulfilling the deterrent and compensatory purposes of rule 10b-5.[57] In addition, by evaluating the loss in relation to the reaction to the disclosure of the information, recovery may well be unrelated to the fraud.[58] Even if these drawbacks could be overcome, it is uncertain whether this equitable remedy should be applied in tipping liability cases where there is a lack of privity between the wrongful and defrauded traders, and no direct inducement to trade is exerted on the defrauded investor by the tippee trader.[59]

The court of appeals also could have adopted an approach which would have limited damages by allowing only those individuals trading contemporaneously with the tippee to maintain an action under rule 10b-5.[60] If the number of plaintiffs were restricted, liable corporations would no longer face the possibility of paralyzing verdicts. This measure of damages is consistent with the concept that recovery should not be based upon the tortfeasor's gain. Furthermore, the theory can conceivably be used in connection with the out-of-pocket or cover measures of damages because of the introduction of a "semblance of privity."[61] This restriction would be artificial, however, because no actual privity exists between the fraudulent and innocent traders.[62] Those investors fortunate enough to have traded on the same date as the wrongdoer would undoubtedly be compensated for their loss, but the award would be to the exclusion of those injured by the continuing non-disclosure of privileged information after the wrongful trade.[63] Furthermore, there is a possibility that verdicts

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404 U.S. 1004 (1971). *Compare* Elkind v. Liggett & Myers, Inc., 472 F. Supp. 123, 129-35 (S.D.N.Y. 1978) *with Mitchell.*

[57] *See* notes 30 & 31 *supra.*

[58] *See* note 29 *supra.*

[59] *See* note 28 *supra. See also* note 76 *infra* and accompanying text.

[60] Fridrich v. Bradford, 542 F.2d 307, 323-27 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977) (Celebrezze, J., concurring). Although the Court of Appeals for the Second Circuit recently handed down Wilson v. Comtech Telecommunications Corp., 648 F.2d 88 (2d Cir. 1981), a decision following *Fridrich*, it is unclear what period of time is contemporaneous with the date of the wrongful trade.

[61] Fridrich v. Bradford, 542 F.2d 307, 328 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977) (Celebrezze, J., concurring).

[62] *See* 5B A. JACOBS, *supra* note 2, § 260.03(c)(vii)(3), at 75-78; Comment, *Fashioning a Lid for Pandora's Box: A Legitimate Role for Rule 10b-5 in Private Actions Against Insiders Trading on a National Stock Exchange*, 16 U.C.L.A. L. REV. 404, 406-07 (1969).

[63] *See* 5B A. JACOBS, *supra* note 2, § 260.03(c)(vii)(3), at 77.

would be limited to such an extent as to have no deterrent effect on tipper and tippee trading.[64]

In adopting the disgorgement measure of damages, the main concern of the circuit court was to limit damages in the most equitable way. Although the court propounded a measure of damages which imposes a limit on the damages assessed, it is unclear whether this approach is the most equitable possible. A further study of the court's analysis reveals a number of factors which bring the applicability of the disgorgement method into question.

When the court concluded that damages under the disgorgement measure would be commensurate to the injury, it correctly observed that small amounts of wrongful trading would yield small damages, whereas greater amounts of trading would mean greater damages.[65] It is not necessarily correct, however, to view the amount of damages solely in relation to the number of shares wrongfully traded and the amount of profit derived thereby.[66] The volume of trading is no doubt an important element in determining damages because tippee trading is an "evil against which the open market investor must be protected."[67] It is not, however, the only factor to be considered.

A further consideration in assessing damages is the nature of the tip and the wilfulness of the tipper. If the tip were unsolicited and disclosed with a clear intent to upset the information balance in the open market, the wrong presumably would be greater than if the tip were made, as in *Elkind*, in reluctant response to inquiries by those outside the company. The difference in intent in these two situations indicates a difference in the severity of the wrong which may properly lead to an assessment of large damages.[68]

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[64] *E.g.*, Fridrich v. Bradford, 542 F.2d 307, 323-27 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977) (Celebrezze, J., concurring).

[65] 635 F.2d at 172.

[66] *See* note 45 *supra*.

[67] 635 F.2d at 169. *But see* Note, *Limiting the Plaintiff Class: Rule 10b-5 and the Federal Securities Code*, 72 MICH. L. REV. 1398, 1429 (1974). *See also* Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972); *Elkind*, 635 F.2d at 172-73; Nelson v. Serwold, 576 F.2d 1332, 1338-40 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978); Note, *Deterrence of Tippee Trading under Rule 10b-5*, 38 U. CHI. L. REV. 372, 384 (1971).

[68] *Cf.* Osofsky v. Zipf, 645 F.2d 107 (2d Cir. 1981); Huddleston v. Herman & MacLean, 640 F.2d 534 (5th Cir. 1981); Garnatz v. Stifel, Nicholas & Co., Inc., 559 F.2d 1357 (8th Cir. 1977); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971) (these courts were comfortable with measures that yielded higher damage awards based on facts that went beyond mere grudging responses to material misrepresentations). *But see* 5B A. JACOBS, *supra* note 2, § 260.03(a), at 16.

Another important factor in assessing damages is any discrepancy between the tip and the actual public disclosure, and the presence of outside pressures on the market price of the security. Although summarily accepted by the court as a tolerable disadvantage, this was one of the most decisive reasons for the court's rejection of the out-of-pocket measure of damages.[69] If a court were to use the disgorgement approach when price fluctuations are based more on outside influences than on a reaction to the actual tip, the damages recovered would not be related to the injury caused by the fraud. Therefore, the plaintiff would receive an improper windfall.[70] The measure of damages adopted by the court of appeals would be more commensurate with the injury if the market price upon which recovery was based were revised to reflect any discrepancies between the tip and the information finally disclosed, as well as the presence of outside pressures. This revision could be accomplished through expert analysis.[71] Although such a revision would necessarily be speculative, it would be no more uncertain than equating an award based on a price reflecting pressures external to the tipped information to a value roughly representative of the harm inflicted. By using the above factors to adjust the market price, courts can devise damage awards which come closer to compensating for the actual harm done than those calculated under the disgorgement method.[72]

The court of appeals also should have been more concerned about the disadvantageous possibility of aggregate damages exceeding the amount of profit. Although investors assume the risk that the price of their stock may fluctuate unfavorably, they at least have the right to rely upon the integrity of the market. Where plaintiffs invest in a stock whose market price reflects unequal access to material information regarding that stock, they are injured.[73] To force an investor to recover less than the approximate actual value of the stock by pro rating, as is often mandated by the disgorgement measure, would not compensate the plaintiff with an award that is "roughly commensu-

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[69] 635 F.2d at 170. *See also* note 29 *supra* and accompanying text.

[70] 5B A. JACOBS, *supra* note 2, §§ 260.03(c)(i)(ii), 260.03(c)(vi)(2), at 60-61, 147-52.

[71] *See* Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1344 (9th Cir. 1976) (Sneed, J., concurring); Bonime v. Doyle, 416 F. Supp. 1372, 1384-86 (S.D.N.Y. 1976); Brief for Plaintiff at 54-58.

[72] *See* Bonime v. Doyle, 416 F. Supp. 1372, 1384-86 (S.D.N.Y. 1976).

[73] *See, e.g.*, 635 F.2d at 169; Fridrich v. Bradford, 542 F.2d 307, 314-18 (6th Cir. 1976), *cert. denied*, 429 U.S.1053 (1977); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F.2d 228, 235 (2d Cir. 1974); 5 A. JACOBS, *supra* note 2, § 6, at 132-48.

rate" to the injury caused by the wrongful trade.[74] Furthermore, such limited damage awards might discourage plaintiffs from bringing actions under rule 10b-5, thereby allowing the wrongful trader and corporation, though culpable, to escape liability.[75] In such situations it may be more equitable to remove the limit imposed by the disgorgement measure of damages so as to fully compensate the injured plaintiffs and achieve a desired deterrent effect by punishing the defendant.

In addition to these serious disadvantages, the disgorgement measure of damages lends itself to some of the same criticism put forth by the court in rejecting the causation-in-fact and out-of-pocket approaches. Although the disgorgement approach provides an advantageous limit on damages, it is restitutional in nature, as is the out-of-pocket approach. Therefore, it is questionable whether this measure is applicable where neither privity nor direct inducement exists.[76] As with the causation-in-fact measure of damages, it can be argued that the disgorgement approach does not compensate for the injury caused by the breach of defendant's continuing duty to disclose because the approach is primarily concerned with the tippee's act of trading.[77]

Another disturbing aspect of the *Elkind* decision is the court's reliance upon the rationale that deterrence of tipping and resultant trading would be achieved by a disgorgement award. It is questionable whether a tippee trader would be deterred, however, because disgorgement only threatens to leave the trader no worse off than if he had chosen to trade after the tipped information was disclosed. Similarly, the assessment of a small amount of damages against a large corporation may only be a minor setback, if any.[78] A court wishing to deter future violations should assess all relevant factors to determine the quantum of damages necessary.[79] Such a determination

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[74] *See* 5B A. JACOBS, *supra* note 2, § 260.03(c)(vii)(3), at 75.

[75] Just as the wrongful trader should not be allowed to profit from his trade, the tipping corporation should not be allowed to escape without having damages assessed against it. *See* Comment, *supra* note 2, at 309-11, 313-15. *Cf.* SEC v. Golconda Mining Co., 327 F. Supp. 257 (S.D.N.Y. 1971) (unclaimed damage award should not be returned to liable corporation).

[76] *See, e.g.*, Comment, *supra* note 2, at 314-15; Comment, *supra* note 26, at 373-74, 376-77; Comment, *supra* note 62, at 406-09. *See Elkind*, 635 F.2d at 170.

[77] *See Elkind*, 635 F.2d at 171.

[78] *See* 5B A. JACOBS, *supra* note 2, § 260.03(c)(vii)(3), at 73.

[79] *See, e.g.*, Afro-American Pub. Co. v. Jaffee, 366 F.2d 649, 662 (D.C. Cir. 1966) (assessment of punitive damages depends on particular circumstances of each case); Wagner v. Rodeo Cowboys Ass'n, 290 F. Supp. 369 (D.Colo. 1968).

would evaluate: the defendant's earnings;[80] any prior record of similar violations;[81] and, the availability and pursuit of other remedies against the defendant.[82]

Before arriving at his decision, Judge Mansfield acknowledged that a court must be flexible in assessing damages.[83] Therefore, he analyzed various measures of damages in light of the general characteristics of tippee trading. By opting for one measure of damages, however, the court put forth an approach which is inflexible, and, therefore, as vulnerable as the measures it rejects. An attempt should be made to reconcile the current array of approaches.

An examination of the limited number of tipping liability cases which have addressed the issue of damages reveals a dissatisfaction with those measures of damages having the potential for consistently resulting in excessive damage awards.[84] Courts have employed two methods in imposing limits on the amount of damages that can be levied. One line of cases seeks to limit damages through the imposition of greater causation[85] and privity requirements.[86] Other cases, including *Elkind*, seek to limit damages through the use of direct monetary restraints.[87] Although the rationales underlying each approach are difficult to reconcile, a common thread runs through both[88]—each seeks resolution of the damages issue.

Judicial attempts to find one theory that is generally applicable to all tippee trading cases have not been sensitive to the particular facts of each case. In examining the various measures of damages, courts such as *Elkind* have limited their inquiries to the general characteristics of the wrong involved.[89] Using a similar approach the court in *Fridrich v. Bradford*[90] applied the causation-in-fact measure of

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[80] *See, e.g.*, E.C. Ernst, Inc. v. Manhattan Constr. Co. of Texas, 551 F.2d 1026, 1036 (5th Cir. 1977); Herman v. Hess Oil-Virgin Islands Corp., 542 F.2d 767, 772 (3d Cir. 1975).

[81] *See* 5B A. JACOBS, *supra* note 2, § 260.03 (e), at 99.

[82] *See* Fridrich v. Bradford, 542 F.2d 304, 320-21 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977); 5B A. JACOBS, *supra* note 2, § 260.03(h), at 133-42.

[83] 635 F.2d at 169-70.

[84] *See, e.g.*, 635 F.2d at 156; Fridrich v. Bradford, 542 F.2d 304 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977); Mullaney, *supra* note 2, at 279, 290-94.

[85] *See* notes 33-37 *supra* and accompanying text.

[86] *See* notes 60-64 *supra* and accompanying text.

[87] *See* notes 38-49 *supra* and accompanying text.

[88] This is not to suggest that the two categories can be totally reconciled. *See* note 21 *supra*.

[89] *See* 635 F.2d at 170-73; Fridrich v. Bradford, 542 F.2d 307, 318-19 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F.2d 228, 242 (2d Cir. 1974) (dictum); 5B A. JACOBS, *supra* note 2, § 260.03(c)(vii)(3), at 78-79; Mullaney, *supra* note 2, at 294.

[90] 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977).

damages which grants recovery only when the wrongful conduct is severe enough to actually affect the market.[91] The concurring opinion in *Fridrich* would grant recovery to those trading on the same day as the tippee on the theory that the wrongful trade is generally only severe enough to cause injury to a contemporaneous trader.[92] Similarly, the *Elkind* solution is purportedly based on the amount of harm done.[93]

A useful comparison can be made between the above cases and those involving other violations of rule 10b-5. Several cases not dealing with tippee liability reflect an increased sensitivity to the facts of the particular case.[94] In *Mitchell v. Texas Gulf Sulphur Co.*,[95] a case involving liability for material misrepresentations, the court held that the wrong was so grave that only the cover measure of damages could provide an adequate remedy.[96] In so holding, however, the court wisely cautioned that such a measure of damages should only be used under the extraordinary circumstances confronting it because "it would be unwise to set forth a uniform rule with broad applications to all securities cases."[97]

Clearly, a more flexible approach to the issue of damages in tippee trading cases can be put forth. Such an approach should be sensitive to the severity of the wrong, while pegged to the various damage formulations already set forth by the courts.[98] A pegged-severity-analysis-of-wrong approach would weigh the compendium of facts to determine which measure of damages would best provide for compensation and deterrence. Under this approach a court would calculate damages by assessing the following factors: (1) the solicited

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[91] *Id.* at 318-19.

[92] *Id.* at 323-27 (Celebrezze, J., concurring).

[93] 635 F.2d at 172.

[94] *E.g.*, Osofsky v. Zipf, 645 F.2d 107, 112-15 (2d Cir. 1981) (tender offer misrepresentation); Huddleston v. Herman & MacLean, 640 F.2d 534, 553-56 (5th Cir. 1981) (prospectus misrepresentation); Garnatz v. Stifel, Nicolas & Co., Inc., 559 F.2d 1357, 1360-61 (8th Cir. 1977) (broker misrepresentation); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 102-06 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971) (press release misrepresentation); Myers v. Moody, 475 F. Supp. 232, 237-40, 248 (N.D. Tex. 1979) (tender offer misrepresentation); Bonime v. Doyle, 416 F. Supp. 1372, 1384-86 (S.D.N.Y. 1976) (press release, annual report, and filing misrepresentations).

[95] 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971).

[96] *Id.* at 104-06.

[97] *Id.* at 105.

[98] It must be emphasized that this proposal is not based solely on the prospect of deterrence. Such a suggestion would be a revolutionary departure from the concept of a rule 10b-5 suit as an action in tort. Bangor Punta Operations, Inc. v. Bangor & Aroostook R. Co., 417 U.S. 703, 717 (1974). *But see* Note, *supra* note 67, at 1429.

or unsolicited nature of the tip;[99] (2) the difference between the tip and the actual public disclosure;[100] (3) the presence of outside pressures on the market;[101] (4) the magnitude of profits gained by the tortious trader;[102] (5) the size of the plaintiff class;[103] (6) the defendant's earnings;[104] (7) the defendant's prior record of similar violations;[105] and (8) the availability and pursuit of other remedies against the defendant.[106] Courts should also be aware of policy considerations, and should inquire into the socio-economic effects of ultimately passing the expense of rule 10b-5 damages along to the innocent stockholders of a liable corporation.[107] Under this approach, if there were privity of contact between the tippee-trader and the uninformed investor, rescissional remedies such as the out-of-pocket or cover measure of damages could be automatically applied.[108] Otherwise, the court could apply the disgorgement or causation-in-fact measures of damages. Finally, two important constants would exist independently of the factual circumstances. The wrongdoer should always be disgorged of any profits made on the transaction,[109] and compensation should always be commensurate with the actual harm suffered.[110] This pegged approach should provide uniformity and the flexibility required to meet the differing circumstances of each case with equity.

For example, if the tip were unsolicited, the tippee traded in great volume, and the tipper and tippee-trader had recently been found liable under rule 10b-5, a court could apply the out-of-pocket or cover measure of damages which would provide the compensation and deterrence necessary to assure an honest market. If, on the other hand, the violation were not a second offense and the tip were not

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[99] *See* note 68 *supra* and accompanying text.

[100] *See* notes 71 & 72 *supra* and accompanying text.

[101] *See* notes 71 & 72 *supra* and accompanying text.

[102] *See* note 67 *supra*.

[103] *See* note 73-75 *supra* and accompanying text.

[104] *See* note 80 *supra*.

[105] *See* note 81 *supra*.

[106] *See* note 82 *supra*.

[107] *See* 5B A. JACOBS, *supra* note 2, § 260.03(b), at 19.

[108] *See* 5B A. JACOBS, *supra* note 2, § 260.03(c)(vi), at 43-48.

[109] *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972) (dictum); Nelson v. Serwold, 576 F.2d 1332, 1338-40 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978).

If, for example, the court were to deem the causation-in-fact remedy appropriate under the circumstances, but the plaintiff could not meet the necessary burden of proof, the defendant would nevertheless be stripped of any profits made on the transaction.

[110] Section 28(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 77bb(a) (1976).

disclosed with malicious intent, limited damages could be imposed using the disgorgement or causation-in-fact approaches. In both cases the presence of outside influences on the market would necessitate an adjustment of the award. In addition, if there were a difference between the tip and the disclosure, a court would determine whether the difference warranted the introduction of an expert approximation of the loss.

By increasing the court's knowledge of the factual circumstances, a more sensitive attempt can be made to quantify the wrong done while at the same time resolving the problem of punitive and windfall damages.[111] Exemplary damages need no longer be earmarked for the purpose of deterrence because an assessment of the deterrent factors would be built into the award. As for the windfall issue, the measure would be sufficiently connected to the wrong so that large and small awards could be justified as compensatory.

Although the approach suggested is admittedly novel, it is not without foundation. The theory represents a compromise between those cases which have advocated the use of a particular method of damages,[112] and the concept that the severity of a defendant's conduct should be assessed in the determination of damages.[113] The recommended approach merely shifts the starting point of the assessment process from an immediate choice of a measure of damages to an analysis of the particular facts of the case before the court.

One leading commentator has stated that there is a clear need for uniformity.[114] The pegged-severity-analysis-of-wrong approach suggested above will lead to a uniform and equitable result. This system incorporates all previous approaches regarding rule 10b-5 damages, and gives courts great latitude in arriving at the measure of damages best suited to the particular case before it. It acknowledges that factual circumstances are important determinants of the amount of damages necessary to satisfy the rule's purposes. Although the *Elkind* court might well have reached the same result had it viewed the case in this manner, the result would have been based on a much more rational approach.

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[111] *See* notes 30 & 31 *supra*.

[112] *See* notes 89-94 *supra* and accompanying text.

[113] *See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 242 (2d Cir. 1974). One commentator has suggested that the mere existence of a list of important factors in *Shapiro* suggests a desire to have the damage award correspond with the degree of the defendant's culpability. Mullaney, *supra note 2, at 294. See also* Brief for Defendant at 31-39.

[114] Jacobs, *The Measure of Damages in Rule 10b-5 Cases*, 65 GEO. U.L.J. 1093, 1131 (1977).