Compensatory Damages in Rule 10b-5 Actions: Pragmatic Justice or Chaos?

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INTRODUCTION & BACKGROUND

Damage awards in private actions under section 10(b) of the Securities Exchange Act of 1934 (Exchange Act or 1934 Act)[1] and Securities and Exchange Commission (SEC) Rule 10b-5 promulgated thereunder[2] may be either an area where flexibility, pragmatism, and

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1 *See* 15 U.S.C. § 78j (1997). Section 10(b) of the Exchange Act specifically provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id.

2 *See* 17 C.F.R. § 240.10b-5 (1998). Securities and Exchange Commission (SEC) Rule 10b-5, first promulgated in 1942, now provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of 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 in order to make the statement made, in 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 which

justice prevail or "a confused area of the law where the courts, forced to rely on their own wits, have created a myriad of approaches."[3] Or perhaps both descriptions are accurate and together render a more complete description of the state of the law of compensatory damages under Rule 10b-5. The reader will have to judge for himself. In any event, there is no clear rule guiding the measure of damages under Rule 10b-5 and hence little predictability for counsel or the client.[4]

The genesis of this lack of guidance and predictability lies with the legislature and the provisions of the 1934 Act. Some sections of this statute, such as sections 9(e)[5] and 18(a),[6] contain express provisions for damages as do sections 11(e)[7] and 12(a)[8] of the Securities Act of 1933 (Securities Act or 1933 Act). But neither section 10(b) nor Rule 10b-5 contains such express damage provisions. It thus has been left to the courts to create a body of law fashioning damage remedies under Rule 10b-5.

In the following sections we will first address Exchange Act section 28(a),[9] the statutory provision that the United States Supreme Court has interpreted as governing the measure of damages that are permissible under section 10(b) and Rule 10b-5.[10] Second, we will analyze the two Supreme Court cases, *Affiliated Ute Citizens v. United States*[11] and *Randall v. B.J. Loftsgaarden*,[12] which set guideposts for flexibility and pragmatism and ultimately perhaps for confusion and unpredictability in determining the proper measure of damages

> operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

[3] Koch v. Koch Indus., Inc., 6 F. Supp.2d 1192, 1201 (D. Kan. 1998).

[4] *See* Michael J. Kaufman, *No Foul, No Harm: The Real Measure of Damages Under Rule 10b-5*, 39 CATH. U. L. REV. 29, 34 (1989); John H. Matheson, *Corporate Disclosure Obligations and the Parameters of Rule 10b-5:* Basic Inc. v. Levinson *and Beyond*, 14 J. CORP. L. 1, 29-31 (1988).

[5] *See* 15 U.S.C. § 78i(e) (1997).

[6] *See* 15 U.S.C. § 78r(a) (1997).

[7] *See* 15 U.S.C. § 77k(e) (1997).

[8] *See* 15 U.S.C. § 77*l*(a) (1997).

[9] *See* 15 U.S.C. § 78bb(a) (1997).

[10] *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972) ("In our view the correct measure of damages under § 28 of the Act . . . is the difference between the fair value of all that the . . . seller received and the fair value of what he could have received had there been no fraudulent conduct . . . ."); Randall v. B.J. Loftsgaarden, 478 U.S. 647, 664 (1986) ("[T]his court has noted that Section 28(a) of the 1934 Act . . . limits recovery in any private damages action brought under the 1934 Act to actual damages.") (internal quotations omitted).

[11] 406 U.S. 128 (1972).

[12] 478 U.S. 647 (1986).

under section 10(b) and Rule 10b-5. Third, we will discuss certain leading decisions in the federal circuit and district courts which in the great variety of damage measures applied reflect the lack of a clear mandate for a specific Rule 10b-5 damage measure from either the legislature or the Supreme Court. Fourth, we will address selected federal district court decisions that harshly criticize this lack of mandate and lament the "set of unsupportable assumptions and arbitrary rules that result in irrational damage awards" under Rule 10b-5.[13] Lastly, we will analyze Exchange Act section 21D(e),[14] enacted as part of the Private Securities Litigation Reform Act of 1995.[15]

Damages in customer cases against broker-dealers are rarely discussed because most of these cases are now decided in arbitration without written decisions so there is little recorded precedent. As a result, and combined with the more general equitable standards sometimes used in arbitration,[16] damage measures in arbitration are, in the Authors' experience, even more diverse than in court cases.

Damages are not available to the SEC in its enforcement actions. But it can obtain monetary relief in the form of equitable disgorgement.[17]

I. APPLICABLE STATUTE

As stated above, neither section 10(b) nor Rule 10b-5 contains any express provision for damages. Faced with this situation, the first time the United States Supreme Court addressed the issue of the measure of damages under Rule 10b-5, the Court appears to have assumed, without any analytical reasoning, that Exchange Act section 28(a)[18] was the applicable provision.[19] Subsequent decisions have followed the Supreme Court's assumption, also without any analytical reasoning.[20] Exchange Act section 28(a) reads in relevant part:

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[13] *In re* Clearly Canadian Sec. Litig., Nos. C-93-1037-VRW, C-93-1278-VRW, C-93-4313-VRW, C-95-0699-VRW, C-95-2295-VRW, 993, 1999 WL 707737 at *5 (N.D. Cal. Sept. 3, 1999).

[14] *See* 15 U.S.C. § 78u-4(e) (1997).

[15] *See* Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4 (1999).

[16] *See* Karen Halverson, *Arbitration and The Civil Rights Act of 1991*, 67 U. CIN. L. REV. 445, 449 (1999) (finding that arbitrators often decide disputes according to "equitable principles instead of legal rules").

[17] *See* Stephanie F. Barkholz, Comment, *Insider Trading, the Contemporaneous Trader, and the Corporate Acquirer: Entitlement to Profits Disgorged by the SEC*, 40 EMORY L.J. 537, 563 (1991) (explaining that disgorgement is a remedy available in an action initiated by the SEC).

[18] *See* 15 U.S.C. § 78bb(a) (1997).

[19] *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972).

[20] *See* discussion *infra* Part III (discussing opinions of circuit courts of appeals and

"[N]o person permitted to maintain a suit for damages under the provisions of this title shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of."[21] At the time of the *Affiliated Ute* decision, the quoted language was part of a cumulative remedies section captioned "Effect on Existing Law" and contained the only general reference to damages in the statute.[22] The meaning of the term "actual damages" is not clear, and there is no indication or even hint in section 28(a) regarding the proper measure or theory of damages to be used in determining "actual damages" in a particular case. Therefore, it has been left to the federal courts to provide a response on a case-by-case basis.[23]

II. UNITED STATES SUPREME COURT DECISIONS

The United States Supreme Court has issued two important decisions addressing the measure of damages under Rule 10b-5: *Affiliated Ute Citizens v. United States*[24] and *Randall v. B.J. Loftsgaarden*.[25] First, we will discuss *Affiliated Ute* and then we will examine *Randall*.

Although *Affiliated Ute* involved damages to sellers[26] and *Randall* damages to buyers,[27] their principles can be applied to either kind of plaintiff. But sellers are in a better position than buyers to obtain windfall damages, as discussed below.

In *Affiliated Ute*, mixed-blood Indians sought damages against a bank, two of its employees, and the United States for alleged securities law violations in connection with the sales by plaintiffs of their shares in a corporation created to manage interests in tribal assets not susceptible to equitable and practicable distribution under the Ute Indian Supervision Termination Act.[28] The bank employees were assistant managers of the bank, which served as transfer agent for the corporation.[29] The employees were found to have violated Rule 10b-5 by making misstatements of material fact, namely that the prevailing market price for the plaintiffs' shares was the figure at

district courts).

[21] 15 U.S.C. § 78bb(a) (1997).

[22] *See* 15 U.S.C. § 78bb (1997).

[23] *See* Analisa F. Sama, *Note*, 18 SETON HALL L. REV. 124, 134 (1988) (finding that the calculation of actual damages is often left to the discretion of the federal courts).

[24] 406 U.S. 128 (1972).

[25] 478 U.S. 647 (1986).

[26] *See Affiliated Ute*, 406 U.S. at 153.

[27] *See Randall*, 478 U.S. at 650.

[28] *See Affiliated Ute*, 406 U.S. at 135.

[29] *See id.* at 146.

which their sales were made. In fact, higher prices prevailed among non-Indian buyers.[30]

The Supreme Court did not require reliance upon the misrepresentations in order to find liability.[31] All that was necessary was that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of his decision.[32] The bankers had encouraged a non-Indian market, solicited and accepted standing buy orders from non-Indians, received deposits from prospective non-Indian buyers so purchase funds would be on hand, and encouraged Indians to sell. The bank's liability was held to be co-extensive with that of its employees.[33] With respect to measuring the damages to be awarded to plaintiffs, the Supreme Court wrote:

> In our view, the correct measure of damages under § 28 of the Act, 15 U.S.C. § 78bb(a), is the difference between the fair value of all that the mixed-blood seller received and the fair value of what he would have received had there been no fraudulent conduct, . . . except for the situation where the defendant received more than the seller's actual loss. In the latter case damages are the amount of the defendant's profit.[34]

It is interesting to note that the Supreme Court has combined two different measures of damages in an effort to reach a fair result. The difference between the fair value of what the seller in fact received and the fair value of what the seller would have received had there been no fraud is often denominated as the out-of-pocket measure of damages.[35] As we shall see, the courts usually pay lip service to this damages measure as the most common measure of damages in a private action under Rule 10b-5 and cite the Supreme Court's language in *Affiliated Ute* as authority.[36] In *Affiliated Ute*, the Supreme Court combined this out-of-pocket measure with an exception for the situation in which the defendant, presumably upon resale, received profits in excess of the seller's actual loss.[37] Here the

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[30] *See id.* at 148.

[31] *See id.* at 152-53.

[32] *See id.* at 153-54.

[33] *See id.* at 154.

[34] *Affiliated Ute*, 406 U.S. at 155 (citing Myzel v. Fields, 386 F.2d 718, 748 (8th Cir. 1967); Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir. 1965)).

[35] *See* Kaufman, *supra* note 4, at 72 ("[T]he out-of-pocket rule . . . measures the disparity between fair value paid and received at the time of sale.").

[36] *See, e.g.*, DCD Programs Ltd. v. Leighton, 90 F.3d 1442, 1446 (9th Cir. 1996); Shores v. Sklar, 647 F.2d 462, 482 (5th Cir. 1981).

[37] For example, one court noted that

damages would be the amount of the defendant's profit. This measure of damages, while employed much less frequently by the courts than the out-of-pocket measure, is often denominated as the windfall measure of damages and sometimes as a constructive trust, unjust enrichment, or disgorgement measure.[38]

The Supreme Court concluded its opinion in *Affiliated Ute* by finding that the district court's valuation of $1500 for each share sold by plaintiffs had sufficient support in the record.[39] The Supreme Court's enumeration of the factors that determined this valuation is interesting for its broad mix of factors, some intrinsic to the security sold and others relating to the situation and conduct of the parties.[40] The Court wrote:

> In arriving at the $1,500 figure the District Court considered the existence of extensive oil shale deposits on the reservation; the possession by those deposits of substantial present value and of great potential value; the presence of gas, coal, and other minerals; the administrative cost deposit retained by the United States with respect to each member of the tribe; each petitioner's remaining interest in the 1965 award by the Indian Claims Commission; the existence of claims against the United States not yet fully adjudicated; and the specific prices at which UDC [Ute Distribution Corporation] shares were sold by mixed-bloods and between white persons. The court noted that prices paid for the shares were somewhat influenced by the improper activities of Gale and Haslem [bank employees]; by the excess of sellers over buyers; by the fact the typical Indian seller was not so well informed about the potential value of the stock as was the typical non-Indian buyer; by the fact that the Indian seller was under heavy economic pressure to sell; by opinion evidence as to worth in excess of $700 per share; and by the fact that some portion of the depressant factors in the market was attributable to the defendants. On the other hand, the court noted that not all the market's depressant factors were so attributable to the defendants and that the tribe itself, despite the opportunity so to do, had

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> [w]hile "actual damages" has been most often translated as "out of pocket loss," Section 28(a) has been interpreted so as to allow a defrauded buyer to choose rescission instead of the difference between the value of what he gave up and the value of what he received, and to allow a defrauded seller to recover any profits that the buyer has made on resale.

Abrahamson v. Fleschner, 392 F. Supp. 740, 746 (S.D.N.Y. 1975).

[38] *See* Nashville Lodging Co. v. Resolution Trust Co., 59 F.3d 236, 246 (D.C. Cir. 1995) (describing several measures of available damages).

[39] *See Affiliated Ute*, 406 U.S. at 156.

[40] *See id.* at 155-56.

declined to purchase UDC shares at prices ranging from $350 to $700.[41]

Randall v. B.J. Loftsgaarden[42] further emphasized the theme of flexibility with respect to damage remedies under Rule 10b-5 exhibited in *Affiliated Ute.* In *Randall*, the Supreme Court held that damages awarded to investors in a fraudulent tax shelter who sued under Securities Act section 12(2) (now 12(a)(2))[43] and Exchange Act section 10(b) need not be offset by any tax savings realized from the investment.[44] First, the Court addressed the specific language of Securities Act section 12(2) and found that that section does not permit the offset of tax benefits from its rescission measure of damages either as "income received" or as a return of "consideration."[45] The Court then turned its attention to the "actual damages" limitation of Exchange Act section 28(a) and declined to read section 28(a) as mandating a different result.[46] The Supreme Court's opinion, however, illustrates a number of threads or themes that emphasize flexibility in applying a measure of damages under Rule 10b-5.

The following excerpt from the *Randall* opinion emphasizes flexibility in (1) assuming that a rescissory rather than out-of-pocket measure of damages may be applied under section 28(a) and Rule 10b-5; (2) rejecting a rigid interpretation of section 28(a), which requires that every recovery on an express or implied right of action under the 1934 Act must be limited to the net economic harm suffered by the plaintiff; (3) emphasizing *Affiliated Ute*'s flexibility in combining a "windfall" with an "out-of-pocket" measure of damages in interpreting section 28(a) to prevent defendant's unjust enrichment; and (4) contrasting the section 28(a)–Rule 10b-5 flexible damages remedy with the more rigid, circumscribed damages remedy of Securities Act Section 12(2).

> The issue whether and under what circumstances rescission or a rescissory measure of damages is available under §10(b) is an unsettled one. In *Affiliated Ute Citizens v. United States*, . . . which involved violations of §10(b) and Rule 10b-5 by a buyer of securities, this Court held that ordinarily "the correct measure of damages under §28 of the Act, . . . is the difference between the

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[41] *Id.*

[42] 478 U.S. 647 (1986).

[43] *See* 15 U.S.C. § 771(a)(2) (1997).

[44] *See Randall*, 478 U.S. at 656.

[45] *See id.* at 657-58.

[46] *See id.* at 663.

fair value of all that the [plaintiff] received and the fair value of what he would have received had there been no fraudulent conduct." Courts have also generally applied this "out-of-pocket" measure of damages in §10(b) cases involving fraud by a seller of securities.... But there is authority for allowing the §10(b) plaintiff, at least in some circumstances, to choose between "undoing the bargain (when events since the transaction have not made rescission impossible) or holding the defendant to the bargain by requiring him to pay [out-of-pocket] damages." [See, e.g., *Blackie v. Barrack*, 524 F.2d 891, 909 (9th Cir. 1975) ("While out of pocket loss is the ordinary standard in a 10b-5 suit, it is within the discretion of the district judge in appropriate circumstances to apply a rescissory measure ....].

Respondents do not dispute that rescission or a rescissory measure of damages may sometimes be appropriate under §10(b), nor do they dispute that in this case a rescissory recovery is appropriate on petitioners' §10(b) claims as well as on their §12(2) claims. Instead, they contend that §28(a) strictly limits any such rescissory recovery to the plaintiff's net economic harm. We shall therefore assume, arguendo, that a rescissory recovery may sometimes be proper on a §10(b) claim, and that this is such a case.

In enacting §28(a), Congress did not specify what was meant by "actual damages." It is appropriate, therefore, to look to "the state of the law at the time the legislation was enacted" for guidance in defining the scope of this limitation.... When §28(a) was enacted §12(2) stood as a conspicuous example of a rescissory remedy, and we have found that Congress did not intend that a recovery in rescission under §12(2) be reduced by tax benefits received. Accordingly, we think §28(a) should not be read to compel a different result where rescissory damages are obtained under §10(b).

Even apart from the analogy furnished by §12(2), this Court has never interpreted §28(a) as imposing a rigid requirement that every recovery on an express or implied right of action under the 1934 Act must be limited to the net economic harm suffered by the plaintiff. To be sure, this Court has noted [in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 734 (1975)] that "Section 28(a) of the 1934 Act... limits recovery in any private damages action brought under the 1934 Act to 'actual damages'" [and] *Affiliated Ute Citizens* clearly interpreted §28(a) as governing the measures of damages that are permissible under §10(b).... But the Court in *Affiliated Ute Citizens* also indicated that "where the defendant received more than the seller's actual loss... damages are the amount of the defendant's profit."... This alternative standard

> aims at preventing the unjust enrichment of a fraudulent buyer, and it clearly does more than simply make the plaintiff whole for the economic loss proximately caused by the buyer's fraud. Indeed, the accepted rationale underlying this alternative is simply that "[i]t is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them." . . . Thus, the mere fact that the receipt of tax benefits, plus a full recovery under a rescissory measure of damages, may place a §10(b) plaintiff in a better position than he would have been in absent the fraud, does not establish that the flexible limits of §28(a) have been exceeded.[47]

Justice Blackmun's concurring opinion emphasized the difference in measure of damages between a case brought under Securities Act section 12 and a similar case brought under Rule 10b-5. Justice Blackmun wrote:

> The measure of damages in a §12(2) case brought by an investor who still owns the security involved is rescissory: the statute permits the defrauded investor to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security. I agree with the Court that tax benefits cannot be considered either "income" or "consideration." Recovery in a case brought under §10(b) is governed by §28(a) which, unlike §12(2), does not set out a specific method of calculating damages. Rather, §28(a) merely limits recovery to the actual damages on account of the act complained of. A rescissory measure of damages may sometimes be appropriate. I agree with the Court that when rescission is the appropriate remedy tax benefits should not be taken into account. Normally, however, the proper measure of damages in a §10(b) case is an investor's out-of-pocket loss, that is, the difference between the fair value of all that [the plaintiff] received and the fair value of what he would have received had there been no fraudulent conduct.[48]

Justice Blackmun then stated that the out-of-pocket measure takes into account all the elements that go into the price of a tax shelter. Essentially, Justice Blackmun stated that an investor in a tax shelter bargains for potential tax benefits as well as for an underlying asset. Therefore, it may be proper in a case brought solely under Rule 10b-5 to limit the recovery to the portion of the purchase price

[47] *Id.* at 663 (quoting Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir. 1965)).

[48] *Id.* at 667 (Blackmun, J., concurring) (citing *Affiliated Ute*, 406 U.S. at 155).

attributable to payment for the asset that the investor never received.[49]

> An investor who receives the promised tax benefits, but not the promised income stream or appreciation, of course has been injured. But this injury—the difference between the value of what he received and the value of what he was promised—is represented, not by the entire purchase price, but rather by that portion of the purchase price which went toward a high quality underlying asset when what was received was a lower quality asset. In other words, the investor received the benefit of his bargain with respect to that part of the purchase price which went toward buying the tax benefits. The proper measure of recovery in such a case is therefore the part of the purchase price attributable to payment for an asset that was never received. The Court recognizes that it may be proper to reduce recovery in cases brought solely under §10(b) and involving securities as to which tax consequences provided a major inducement to investment, and I therefore join its opinion.[50]

Affiliated Ute was a seller's suit; *Randall* was a buyer's suit. The damage measures and principles developed in these two cases, however, can apply equally to buyers and to sellers.

III. FEDERAL CIRCUIT AND DISTRICT COURT DECISIONS

In light of the discussion above, the federal circuit and district courts have been faced with a dilemma. The governing statute offers little guidance as to how to measure or apply section 28(a)'s standard of "actual damages" to a specific private action under Rule 10b-5. In addition, the two leading Supreme Court cases addressing this issue, *Affiliated Ute* and *Randall*, enumerate at least three possible measures of damages: out-of-pocket, windfall, and rescissory, which may be applicable to a particular Rule 10b-5 action. Moreover, the Supreme Court gave no indication that this articulated list of possible damage measures is either exhaustive or all-encompassing. As a result, the circuit and district courts first acknowledge, as the Supreme Court did in *Affiliated Ute* and *Randall*, that "[t]he usual measure of damages for securities fraud claims under Rule 10b-5 is out-of-pocket loss; that is, the difference between the value of what the plaintiff gave up and the value of what the plaintiff received."[51] The federal circuit and

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[49] *See id.* at 669 (Blackmun, J., concurring).

[50] *Randall*, 478 U.S. at 669 (citing Salcer v. Envicon Equities Corp., 744 F.2d 935, 940 n.5 (2d Cir. 1984)).

[51] Ambassador Hotel Co. v. Wei-Chuan Inv., 189 F.3d 1017, 1030 (9th Cir. 1999).

district courts, however, then digress into alternative measures of damages that sometimes consist of combining the out-of-pocket measure with an additional measure or measures as in *Affiliated Ute* or using a basically different measure as in *Randall*.[52] In this section, we will analyze the damages measures in a number of these court opinions, including the out-of-pocket measure, the benefit-of-the-bargain measure, disgorgement, unjust enrichment or the constructive trust measure, consequential damages, and other measures. Although divided by type, the reader should appreciate that the categories are imprecise and tend to overlap.

A. *Out-of-Pocket Measure*

In *Ansin v. River Oaks Furniture, Inc.*,[53] the directors of a close corporation fraudulently repurchased a shareholder's interest in the company a number of months before taking the company public.[54] There was a failure to disclose material information about the contemplated initial public offering (IPO), including negotiations with an investment banking firm and valuation analyses performed by the firm.[55] The materiality of the discussions with the investment banking firm was shown by evidence that, less than two weeks after the repurchases in November, 1992, management was looking at a July or August of 1993 IPO and had adjusted its accounting strategies accordingly.[56]

The defrauded shareholders sued certain insiders and the company under Rule 10b-5 and a host of other provisions.[57] With regard to the Rule 10b-5 claim, the defrauded shareholders were awarded damages equal to the difference between what they received for the stock and the twelve dollars per share public offering price.[58] As in the great majority of Rule 10b-5 damage decisions, at the outset the First Circuit paid lip service to *Affiliated Ute*'s out-of-pocket measure and then digressed to articulate its own particular reasoning and reach its own particular version of a just measure of damages.[59] The court's reasoning is worth quoting at length:

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[52] *See id.*
[53] 105 F.3d 745 (1st Cir. 1997).
[54] *See id.* at 748.
[55] *See id.* at 750-52.
[56] *See id.* at 752.
[57] *See id.* at 748-49. In addition to the § 10(b) claim, the plaintiffs also brought suit for "conversion, breach of contract, breach of fiduciary duty, common law fraud, legal malpractice," and state law violations. *Id.* at 749.
[58] *See id.*
[59] *See Ansin*, 105 F.3d at 757.

The Supreme Court [in *Affiliated Ute*] has held that damages under Rule 10b-5 should be "the difference between the fair value of all that the . . . seller received and the fair value of what he would have received had there been no fraudulent conduct." . . . On the Ansins' securities law claim, the court instructed the jurors to find "the difference between what the Ansins actually received for their stock and what you believe they would have received had they refused to sell or, instead, insisted on different terms." The jury was told that "the issue is not hindsight," and that they "must evaluate the Ansins' decision in light of the facts and circumstances that existed at the time that the decision to sell was made."

Defendants argue that the district court's jury instructions as to the damages for the fraud claims were flawed, in that the district court failed to tell the jury to determine value as of the time of the fraudulent transaction, i.e., in November 1992. The jury awarded damages of $12 per share, the public offering price of River Oaks. This was less than the $17.40 a share which plaintiffs sought and more than the damages defendants say are the maximum allowable. Defendants contend that the pre-IPO value of the company was much lower, and support this contention by pointing to the immediate resale of the Ansin shares to knowledgeable insiders at the same price paid to the Ansins.

The federal securities statutes are not explicit as to the proper measure of damages. Section 28 of the Securities Exchange Act limits recovery to "actual damages on account of the act complained of." . . . The definition of "actual damages," however, has been left to the courts. This question presents difficulties, which are greatest in cases involving closely held securities that have no readily ascertainable market value. [citing 3 Bromberg & Lowenfels, Securities Fraud and Commodities Fraud, § 9.1, at 228 (2d ed. 1996).]

The trier of fact may draw reasonable inferences in determining "fair value," and "is not restricted to actual sale prices in a market so isolated and so thin" as one for a close corporation's stock. [quoting *Affiliated Ute*, 406 U.S. at 155.] A variety of factors, including anticipated future appreciation, may affect the value of stock, so that an appraisal of value "demand[s] a more sophisticated approach than the simple application of a price index to the shares." . . .

Here the very nature of the fraud was to induce the plaintiffs to sell their stock at a time before the stock would appreciate in value due to the contemplated IPO and stock split. To adopt defendants' argument that damages cannot exceed the price of the shares at the time of the sale would be to reward and

encourage such chicanery. Defendants' attempt to limit plaintiffs' recovery to a hypothetical "market" price as of November 1992 is unavailing. The trier of fact was entitled to infer that a reasonable investor, fully informed of the IPO discussions, including the conditions set by J.C. Bradford [underwriter], would not have sold his stock in November 1992 for less than his proportionate share of the IPO proceeds.

The anticipated appreciation in the value of the stock was not unforeseeable. Internal River Oaks documents as to planning and projections indicated that a 1993 IPO was anticipated. J.C. Bradford analysts had suggested a range of values for the company in light of the anticipated IPO, information which was withheld from the plaintiffs. That these analyses and projections were, to some extent, contingent does not mean that they are irrelevant to determining fair value. As another Court of Appeals has said:

> The relevance of the fact [that the defendant close corporation was involved in merger negotiations] does not depend on how things turn out. Just as a lie that overstates a firm's prospects is a violation even if, against all odds, every fantasy comes true, so a failure to disclose an important beneficent event is a violation even if things later go sour. The news . . . allows investors to assess the worth of the stock. . . . Investors will either hold the stock or demand a price that reflects the value of that information. [quoting Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 440 (7th Cir. 1987).]

In these circumstances, the IPO price was a reasonable approximation of fair value. We note it was less than the aftermarket price plaintiffs suggested as damages.

Defendants draw our attention to two district court cases. In *Ross v. Licht* [263 F. Supp. 395 (S.D.N.Y. 1967)], the court based damages for failure to disclose IPO plans not on the IPO price, but on the lower price obtained in an intervening private placement. However, as one commentary has pointed out, the court was "probably justified" in using the lower measure because the private placement was a necessary precondition to the public offering. [quoting 3 Bromberg & Lowenfels, Securities Fraud and Commodities Fraud, § 9.1, at 228 n.12 (2d ed. 1996).] Defendants have pointed to no such determinative intervening event here. Defendants also point to *Hutt v. Dean Witter Reynolds Inc.* [737 F. Supp. 128 (D. Mass. 1990)]. In *Hutt*, the accretion in value was due to the stock's trading in a public market over time. The court accordingly found plaintiffs' potential profits to be "too

speculative . . . ." Here, by contrast, plaintiffs point to a specific, planned-for event.[60]

By finding the value of plaintiffs' stock at the time they sold to be the same as the later IPO price, the *Ansin* jury effectively awarded plaintiffs a windfall measure of damages: the profits the defendants obtained or could obtain when they resold the shares in the IPO.[61]

B. Benefit-of-the-Bargain Measure

Benefit of the bargain damages may be awarded in Rule 10b-5 cases if they can be established with reasonable certainty.[62] In *McMahan & Co. v. Wherehouse Entertainment, Inc.*,[63] plaintiffs alleged that one of the important selling points of debentures they had purchased from the company was a promised redemption at par plus 6.25% if a consolidation or merger occurred that was not approved by a majority of independent directors.[64] A merger occurred and the company refused to redeem the debentures, claiming directors' approval.[65] Plaintiffs sued, alleging that the documents offering the debentures were materially misleading, that the right of redemption had been portrayed as valuable and creating a duty on the part of the "independent directors" to act in the debentureholders' interests, and that this right had proved to be illusory.[66] The Second Circuit held that if the investors could establish, under their theory of the case, that independent directors acting on behalf of the debentureholders would not have approved the merger, then damages could be assessed at the promised redemption of par plus 6.25%. The court's reasoning is an interesting summary of the law addressing benefit-of-the-bargain damages under Rule 10b-5. The Second Circuit wrote:

> Section 28(a) of the 1934 Act provides that "no person permitted to maintain a suit for damages under the provisions of this chapter shall recover . . . a total amount in excess of his actual damages on account of the act complained of." [quoting 15 U.S.C. 78(b)(b).] The statute does not prescribe a particular

[60] *Id.* at 758-59 (footnotes omitted).

[61] *See id.*

[62] *See* Laurence A. Steckman & Charles J. Hecht, *1998 Securities Arbitration Remedies*, 1131 PLI/CORP. 903, 914-15 (1999).

[63] 65 F.3d 1044 (2d Cir. 1995).

[64] *See id.* at 1046-47.

[65] *See id.* ("Wherehouse refused to redeem the Debentures at this price, claiming that the right to tender had not been triggered because the Board had approved the merger.").

[66] *See id.* at 1047.

method of calculating damages, and, in fact, we have allowed benefit-of-the-bargain damages under section 10 . . . and Rule 10b-5 promulgated thereunder.

In *Osofsky v. Zipf* [645 F.2d 107 (2d Cir. 1981)], the plaintiffs were offered a specific price if they tendered their common stock in connection with a tender offer. Plaintiffs tendered their stock, but received a lesser amount than they originally had been offered. . . . We held that benefit-of-the-bargain damages, under Rule 10b-5, were particularly appropriate in the context of tender offers where, despite the fraud, the shareholders normally will receive an amount in excess of market value. . . . We noted that the key to awarding benefit-of-the-bargain damages is the degree of certainty to which they can be established. . . .

In *Levine v. Seilon, Inc.* [439 F.2d 328, 334 (2d Cir. 1971) (Judge Friendly)] the court stated that, under Rule 10b-5, a defrauded buyer of securities "was entitled to recover only the excess of what he paid over the value of what he got, not, as some other courts had held, the difference between the value of what he got and what it was represented he would be getting." In *Osofsky*, we noted that this language in *Levine* was dicta, and we distinguished *Levine* on the ground that damages sustained by a defrauded buyer of securities are more speculative and thus different from the damages of a defrauded seller who does not get what he was promised. . . . In cases following *Osofsky*, we have focused on the plaintiff's ability to establish benefit-of-the-bargain damages with some reasonable degree of certainty. For example, in *Barrows v. Forest Labs, Inc.* [742 F.2d 54, 59-60 (2d Cir. 1984)], we refused to allow benefit-of-the-bargain damages where such damages were based on the speculation of what plaintiff's securities would have been worth if the company had disclosed its true financial forecast. More recently, in *Commercial Union Assurance Co. v. Milken* [17 F.3d 608, 614-15 (2d Cir. 1984)], we acknowledged the possibility of awarding benefit-of-the-bargain damages in a Rule 10b-5 case, but declined to do so because the plaintiff's claims were speculative.

In this case, we believe that plaintiffs could establish benefit-of-the-bargain damages with reasonable certainty. We acknowledge, however, that this is not a case like *Osofsky*, where plaintiffs were offered a certain price during a tender offer and then received some lesser amount. In this case, plaintiffs purchased debentures, allegedly relying in part on the possibility that a merger that was not approved by the Independent Directors might occur and thus trigger the right to tender. This possibility, we have previously held, could reasonably be considered a "valuable right" to plaintiffs. [citing McMahon I, 900 F.2d 576, 579 (2d Cir. 1990).]

Whether plaintiffs can establish with a reasonable degree of certainty, the amount of that value is a different question.

Plaintiffs contend that determining damages in this case is a simple task—upon a merger, they are entitled to 106.25% of par for each Debenture. In reality, the matter is more complex than plaintiffs' contention would indicate. Because the value of plaintiffs' right to tender was contingent on the occurrence of certain events, the value of this right is somewhat speculative. Nevertheless, if plaintiffs could establish, under their theory of the case, that independent directors, acting on behalf of the debentureholders, would not have approved this merger, then damages could be assessed at the promised redemption of par plus 6.25%.[67]

C. Disgorgement, Unjust Enrichment, or Constructive Trust Measure

Disgorgement damages may be recovered in private actions under Rule 10b-5 based primarily on a theory that the defendant was unjustly enriched.[68] These damages are sometimes referred to as windfall damages for the plaintiff. Disgorgement damages are typically measured by a buyer defendant's profits upon resale as in *Affiliated Ute* and *Janigan v. Taylor*.[69]

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[67] *Id.* at 1049-50 (internal citations omitted). For additional Rule 10b-5 cases not discussed in *McMahan* that follow *McMahan*'s test of awarding benefit-of-the-bargain damages only if they can be established with reasonable certainty, see *International Motor Sports Group, Inc. v. Gordon*, No. 82709, 98 CIV 5611(MBM), 1999 WL 619633 (S.D.N.Y. Aug. 16, 1999) (finding that benefit of bargain damages cannot be established by a buyer with requisite degree of certainty based on the facts at bar; motion to strike benefit of bargain damages was granted); *Edward J. DeBartolo Corp. v. Coopers & Lybrand*, 928 F. Supp. 557 (W.D. Pa. 1996) (determining that the plaintiff cannot recover benefit of the bargain damages from a defendant who was not a party to the underlying contract and, therefore, stock purchasers were limited to recovering their out-of-pocket losses in Rule 10b-5 claims brought against an accounting firm); *Panos v. Island Gem Enterprises, Ltd., NV*, 880 F. Supp. 169 (S.D.N.Y. 1995) (concluding that purchasers of apartment leases for a Caribbean resort could not recover benefit-of-the-bargain damages under Rule 10b-5 on the basis of the seller's alleged concealment of a flaw in the title to the property in connection with their initial purchases; further, such damages would be speculative, since there was no basis on which to calculate, with reasonable certainty, what the leases would have been worth had the representations of granting full and clear property rights been true).

[68] *See* Patrick Diaz & Rosemary Maxwell, *Insider Trading and the Corporate Acquirer: Private Actions Under Rule 10b-5 Against Agents Who Trade on Misappropriated Information*, 56 GEO. WASH. L. REV. 600, 650 (1988). The authors explain that "to the extent that damages in a private cause of action under Rule 10b-5 should be assessed to prevent unjust enrichment, the plaintiff should be entitled to disgorgement of the defendant's profits." *Id.*

[69] 344 F.2d 781, 786 (1st Cir. 1965); *see also* Rochez Bros., Inc. v. Rhoades, 491

Disgorgement damages were demanded by a buyer, but not awarded in *Commercial Union Assurance Co. v. Milken.*[70] In *Commercial Union,* plaintiffs who recovered more than their investment had no damages and could not recover either under Rule 10b-5, Securities Act section 12(2), or RICO.[71] The plaintiffs had invested $10.5 million for interests in a limited partnership organized by Ivan F. Boesky, Michael Milken, and others to engage in arbitrage. The plaintiffs claimed nondisclosure of the criminal acts of Boesky and Milken.[72] During the next five years, plaintiffs received distributions from the partnership's liquidating trustee equal to 114.6% of their investment and still owned their partnership interests.[73] The plaintiffs unsuccessfully argued three theories of Rule 10b-5 damage:[74]

(1) They were out-of-pocket compared to the 9% prejudgment interest that they should have received at New York's statutory rate.[75] The Second Circuit's response was that the trial court had broad discretion whether to award prejudgment interest and could properly conclude that the 14.6% excess return to plaintiffs was a suitable substitute for prejudgment interest.[76]

(2) They were entitled to the benefit of their bargain, calculated by extrapolating the partnership's rate of return during its first three months and supported by returns of other arbitrage firms in the same period.[77] The court replied that the reasonable certainty required for benefit-of-the-bargain damages was missing.[78]

(3) They were entitled to disgorgement from defendants. The court stated that the theory would require plaintiffs to prove that defendants' profits from their $10.5 million investment exceeded the amount defendants had already disgorged. Since Milken had agreed to pay a total of $1.1 billion, the theory bordered on frivolous. The disgorgement to the SEC left no unjust enrichment on which to base disgorgement in a private suit.[79]

F.2d 402, 416-17 (3d Cir. 1973).

[70] 17 F.3d 608, 611 (2d Cir. 1994).

[71] *See id.* at 613-15.

[72] *See id.* ("The crux of the [plaintiffs'] theory . . . is that had they known about the criminal activities of Boesky and the Milkens . . . they would not have purchased their partnership interests.").

[73] *See id.* at 611.

[74] *See id.*

[75] *See id.* at 614.

[76] *See Commercial Union,* 17 F.3d at 613-14.

[77] *See id.* at 614-15.

[78] *See id.* at 615.

[79] *See id.* (citing Litton Indus., Inc. v. Lehman Bros., Huhn Loeb Inc., 734 F.

The constructive trust measure—gauged by the defendant's profit rather than the plaintiff's out-of-pocket loss—applies only to insider trading cases, where it has been described as disgorgement.[80] In *Litton Industries, Inc. v. Lehman Bros. Kuhn Loeb, Inc.*,[81] an open market buyer of, and tender offeror for, Itek shares was allowed to recover (in an implied private action) the profits of the defendants, who traded Itek shares with tipped, material, nonpublic information about the planned tender offer.[82] However, amounts already disgorged to the SEC were subtracted.[83] Recovery of already SEC-disgorged profits would go beyond the unjust enrichment rationale for disgorgement and amount to impermissible punitive damages.[84]

> It is clear that the underlying purpose of allowing disgorgement as an exception to the traditional out-of-pocket measure is to prevent unjust enrichment. Thus, the Court finds that once ill-gotten gains have been disgorged to the SEC, there remains no unjust enrichment and, therefore, no basis for further disgorgement in a private action.[85]

There was a fact question whether all profits had been disgorged in the SEC litigation. The offeror alleged that it had to bid higher in the tender offer because the defendants' trading inflated the market price of Itek securities.

A bank engaged in insider trading was required to disgorge, in addition to its own trading profits (less SEC disgorgement), the fees and commissions it received on the purchase and sale of Itek securities by itself and its officers and employees with tipped material, nonpublic information about the planned tender offer.[86] The bank was permitted to offset the commissions it paid to third-party brokers on the trades.[87]

In *Wilson v. Great American Industries, Inc.*,[88] a buyer defendant's profit (rather than seller plaintiff's loss) measure of damages was

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Supp. 1071, 1076 (S.D.N.Y. 1990)).

[80] *See* William R. McLucas & Joseph I. Goldstein, *Recent SEC Enforcement Developments*, 417 PLI/LIT. 163, 198-99 (1991) (discussing SEC v. Levine et al., 881 F.2d 1165 (2d Cir. 1989)).

[81] 734 F. Supp. 1071 (S.D.N.Y. 1990).

[82] *See id.* at 1073, 1075-76.

[83] *See id.* at 1076.

[84] *See id.*

[85] *Id.*

[86] *See id.* at 1077.

[87] *See Littleton Indus.*, 734 F. Supp. at 1077.

[88] 979 F.2d 924 (2d Cir. 1992).

applied.[89] This we have described as a constructive trust measure and also as a windfall measure. The court described it as the benefit-of-the-bargain measure from *Janigan*,[90] which held that "a shareholder induced by fraud into selling his shares for less than fair consideration may recover future accretions in value of the stock, even if those damages are not foreseeable."[91] The court also cited *Affiliated Ute*, summarized as "where defendant receives more than seller's actual loss, damages are the amount of defendant's profit."[92]

In *Wilson*, plaintiffs were minority shareholders squeezed out in a merger with a 73% shareholder by means of a misleading proxy statement.[93] Arguably, they lost their state law appraisal rights by voting for the merger or by failing to make timely dissent. The court expressed its rationale as giving the plaintiffs what they would have received if full disclosure had resulted in a better consideration in the merger.

> But to place plaintiffs in substantially the same position they would have occupied absent the fraud, they should be entitled to the profits attributable to the extra stock they would have received had the proxy statement provided a fair exchange ratio. Although the fraud may not be the proximate cause of the merger, it did cause the forfeiture of appraisal rights, which in turn prevented plaintiffs from realizing a fair exchange ratio. Thus the injury caused by the fraud cannot be measured by the shares that were exchanged, rather by the value of the additional shares that should have been exchanged but because of the fraud were not.[94]

A defendant's profits from a violation can limit a plaintiff's recovery in some instances. In *Hutt v. Dean Witter Reynolds Inc.*,[95] a customer selling to a broker-dealer market maker a security that later rose significantly in value has been limited to the broker-dealer's profit as a cap on the plaintiff's "actual damages."[96] "[I]f the alleged fraud . . . has not resulted in any benefit to the defendant, then calculation of the potential profits the plaintiff would have enjoyed absent the defendant's action is too speculative to permit recovery."[97]

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[89] *See id.* at 932-33.
[90] *See id.* at 932 (citing Janigan v. Taylor, 344 F.2d 871, 786-87).
[91] *Janigan*, 344 F.2d at 786-87.
[92] *Wilson*, 979 F.2d at 932 (quoting *Affiliated Ute*, 406 U.S. at 155).
[93] *See id.* at 926.
[94] *Id.* at 932-33.
[95] 737 F. Supp. 128 (D. Mass. 1990).
[96] *See id.* at 133.
[97] *Id.*

The plaintiff alleged that the broker-dealer made misrepresentations to induce him to sell the stock and failed to disclose that the firm would make a commission or markup on the sale of the stock.[98] The court allowed discovery to determine what, if any, profits the broker-dealer made.[99]

D. Consequential Damages

Consequential damages (special damages) are available under Rule 10b-5 if their relationship to the defendant is not too remote.[100] These damages must be shown with reasonable certainty to be caused by the defendant's violation.[101] But they are recoverable even if the plaintiff suffered no loss on the purchase or sale considered separately.[102]

In *Grubb v. Federal Deposit Insurance Corp.*,[103] a buyer of a bank was not allowed to recover his $2.5 million of capital contributions; they were not reasonable measures to minimize his losses since they were made after he knew the bank had $14 million of potential losses.[104]

In *In re Crazy Eddie Securities Litigation*,[105] certain incidental expenses incurred were sufficiently connected to Eddie Antar's fraud so as to constitute consequential damages.[106] The facts surrounding the takeover of Crazy Eddie's demonstrated that the individual plaintiffs were induced by Antar's fraud to purchase Crazy Eddie stock and to engage in a proxy fight to gain control of the company.[107] On the other hand, certain expenses claimed by the plaintiff entity after it took control over the management of Crazy Eddie were too attenuated from Antar's fraud to be recoverable as consequential damages.[108]

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98 *See id.* at 129.

99 *See id.* at 135.

100 *See* Meyers v. Moody, 693 F.2d 1196, 1212 (5th Cir. 1982).

101 *See, e.g.*, James v. Meinke, 778 F.2d 200, 205 (5th Cir. 1985) (holding that consequential damages are recoverable under Rule 10b-5 if the plaintiff can prove with reasonable certainty that the fraud caused the damages); *see also* Foster v. Financial Tech. Inc., 517 F.2d 1068, 1072 (9th Cir. 1975) ("[P]laintiffs' burden on the issue of causation is not a light one.").

102 *See Moody*, 693 F.2d at 1212.

103 868 F.2d 1151 (10th Cir. 1989).

104 *See id.* at 1165-67.

105 948 F. Supp. 1154 (E.D.N.Y. 1996).

106 *See id.* at 1173-74.

107 *See id.* at 1165.

108 *See id.* at 1174.

In *Three Crown Limited Partnership v. Salomon Brothers,*[109] a securities trader alleging manipulation of the market for Treasury notes was unable to maintain its claim for consequential damages.[110] Plaintiff tried to recover profits it would have earned trading the notes on a "butterfly strategy" during a seven-month period but for defendant's manipulation of the market.[111] Moreover, plaintiff claimed that it would have earned additional profits during the immediately following eleven-month period had it reinvested the profits gleaned from its "butterfly strategy" in an unmanipulated market.[112] The court rejected both of these damage claims as too speculative because they were based on trades never negotiated and never made.[113]

E. Other Measures

Perhaps it is appropriate to conclude this section with the Ninth Circuit's opinion in *Ambassador Hotel Co. v. Wei-Chuan Investment,*[114] which covers a number of possible measures of damages under Rule 10b-5 and then remands for the district court to solve the specific problem.

In *Ambassador Hotel,* alleged fraudulent misrepresentations were made in the course of negotiating a joint venture agreement.[115] The statement induced a hotel company to invest in a joint venture to construct a hotel in exchange for stock in the construction company.[116] The fraud related to the value of the stock. The district court erred in finding that the stock had no value. The Ninth Circuit's opinion with respect to the measure of damages is an interesting compendium of the present multifarious state of the law of damages under Rule 10b-5.

> Defendants argue that the district court improperly awarded Ambassador [hotel company] double recovery, in that Ambassador received in damages the full measure of its lost investment in the project and also retained its stock in Kopin [construction company], which received the separate award of $14 million. We agree.

[109] 906 F. Supp. 876 (S.D.N.Y. 1995).
[110] *See id.* at 889-90.
[111] *See id.* at 883.
[112] *See id.* at 882.
[113] *See id.* at 886.
[114] 189 F.3d 1017 (9th Cir. 1999).
[115] *See id.* at 1021-24.
[116] *See id.*

Section 28(a) of the Securities Exchange Act of 1934 provides, in relevant part:

> "[T]he rights and remedies provided by this chapter . . . shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of."

In *Affiliated Ute Citizens of Utah v. United States*, . . . the Supreme Court "clearly interpreted §28(a) as governing the measure of damages that are permissible under §10(b)." [quoting *Randall*, 478 U.S. at 663.] Neither section 10(b) nor Rule 10b-5 sets forth any more specific measure of damages.

The usual measure of damages for securities fraud claims under Rule 10b-5 is out-of-pocket loss; that is, the difference between the value of what the plaintiff gave up and the value of what the plaintiff received. Consequential damages may also be awarded if proved with sufficient certainty. [citing DCD Programs v. Leighton, 90 F.3d 1442, 1449 (9th Cir. 1996).]

> The general rule allows plaintiffs defrauded in violation of section 10(b) and Rule 10b-5 to recover the difference between the value of the consideration they gave and the value of the security they received, plus consequential damages that can be proved with reasonable certainty to have resulted from the fraud.

[Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 651 F.2d 615, 621 (9th Cir. 1981).]

The district court may apply a rescissory measure of damages in appropriate circumstances. [citing *DCD programs*, 90 F.3d at 1449; *Arrington*, 651 F.2d at 621; Blackie v. Barrack, 524 F.2d 891, 909 (9th Cir. 1975).]

In the proceedings below, the district court applied a modified out-of-pocket measure. Ambassador paid $8.4 million for its shares of Kopin stock. The district court valued the Kopin stock at zero, measured at the time of the discovery of the fraud, or the time Ambassador learned of the structural defects in the hotel shell. Consequently, the court arrived at an out-of-pocket figure of $8.4 million. The court then added consequential damages of $[500,000], because Ambassador spent that amount in an attempt to mitigate the harm it suffered. Thus, the court awarded Ambassador $8.9 million in compensatory damages.

However, the district court erred. The Kopin stock did not have zero value at the time the fraud was discovered. At that time, defendants had already siphoned off millions from the Kopin bank account and had fraudulently caused Kopin to sign the loan assumption, making Kopin liable for the entire $10 million loan, due and payable within six months. Thus, at that time, Kopin had valid legal claims against defendants. These unadjudicated claims were corporate assets; unadjudicated claims held by a corporation are among its assets and may materially affect the value of the corporation's stock. [citing *Affiliated Ute*, 406 U.S. at 154-56.] Thus, the district court erred in setting the value of the Kopin stock at zero.

Alternatively, the award to Ambassador can be seen as an award under the rescissory measure of damages. Rescission reverses the fraudulent transaction and returns the parties to the position they occupied prior to the fraud. It restores the status quo ante. Under true rescission, the plaintiff returns to the defendant the subject of the transaction, plus any other benefit received under the contract, and the defendant returns to the plaintiff the consideration furnished, plus interest. [citing Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1342 (9th Cir. 1976) (Sneed, J., concurring); D. DOBBS, LAW OF REMEDIES § 9.3(3) (2d ed. 1993).] If true rescission is no longer possible (perhaps because the plaintiff no longer owns the subject of the sale), the court may order its monetary equivalent. This remedy entitles the plaintiff to the return of the consideration paid less any value received on the investment. [citing Volk v. D.A. Davidson & Co., 816 F.2d 1406, 1413 (9th Cir. 1987).]

In this case, under the district court's order, Ambassador was awarded damages equivalent to its full investment in Kopin, but was also allowed to keep the Kopin stock. Ambassador was not required to tender the stock or otherwise account for the benefit it received. This result violates the principle of rescission. Ambassador may not receive the full purchase price of the stock and also retain the stock itself. The stock now has considerable value, since the district court has awarded Kopin judgment on its claims against defendants.

True rescission is not available in this case, since it would require the dissolution of Kopin. Also, it would not be appropriate to order that Ambassador turn the Kopin stock back to WCC [the defendants who induced Ambassador to invest in Kopin], since WCC did not sell the stock to Ambassador. In turn, it would not be appropriate to require Ambassador to tender the stock to Kopin; if that occurred, WCC would own all outstanding Kopin stock, which does have some value, and thus WCC would

> benefit from its own wrongdoing. Therefore, the monetary equivalent of rescission should be awarded if the district court opts to proceed under this theory of relief. Ambassador should not be required to give up its Kopin stock. However, under the rescissory measure, the damage award to Ambassador must be offset by the value of the Kopin stock, including any money judgment awarded to Kopin in this case.
>
> Under either measure of damages, the $8.9 million damage award overcompensates Ambassador. Therefore, the compensatory damage award should be vacated.[117]

For another decision showing great flexibility and lack of adherence to any specific rules with respect to both the measure and the allocation of damages under Rule 10b-5, see *Arthur Young & Co. v. Reves.*[118]

A cash flow measure of damages was considered but rejected in *Koch v. Koch Industries, Inc.*[119]

IV. FEDERAL DISTRICT COURT CONFUSION

Any analysis of the subject of compensatory damage awards under Rule 10b-5 would not be complete without some representative examples of the reactions of the district courts around the country to the lack of guidelines and general confusion in this area.

In *Koch v. Koch Industries, Inc.*, the court held that "[d]amages by the cash flow method" was an inappropriate measure of damages in a minority shareholders' Rule 10b-5 action against a corporation which alleged that the corporation failed to make certain disclosures before buying out the minority interests. The shareholders were entitled to recover only their actual loss, that is, the difference between the "fair value" of their stock on the date of sale and the price paid for their stock. The "cash flow method," which was based on what the corporation could afford to borrow and pay back from its cash flows, focused not on what the stock was worth, but rather, on what the corporation could afford to pay for the stock. This "cash flow method," therefore, was rejected.

The court then proceeded to summarize the existing state of the law with respect to Rule 10b-5 damages. The court wrote:

> Anyone researching the issue of Rule 10b-5 damages would be immediately confronted with the repeated observation that this is

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[117] *Id.* at 1030-31.

[118] 937 F.2d 1310 (8th Cir. 1991).

[119] 6 F. Supp.2d 1192, 1204-07 (D. Kan. 1998).

> a confused area of the law where the courts, forced to rely on their own wits, have crafted a myriad of approaches. [citing *DCD Programs*, 90 F.3d at 1446.]

In a footnote, the court observed that:

> Commentators almost universally agree on this observation. [citing 3B HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW § 9.49(1) (1989); IX LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 4410 (1992); Andrew L. Merritt, *A Consistent Model of Loss Causation in Securities Fraud Litigation: Suiting the Remedy to the Wrong*, 66 TEX. L. REV. 469, 469-70 (1988).]

In the same footnote, the court also quoted one commentator who, in the court's words, "summed up the situation quite astutely":[120]

> The measure of recovery in a Rule 10b-5 action always has been confusing. Not coincidentally, it always has been an afterthought in Rule 10b-5 case law. Litigants seeking to establish the existence and then the elements of a private cause of action under Rule 10b-5 were content to leave the measure of recovery to be resolved another day. In almost all cases "another day" never came as cases settled without the need to precisely define the measure of recovery. In those cases where the courts have been forced to state a measure, they have provided a bewildering mix of standards, often using the same terms, but frequently giving them radically different interpretations and doing little to resolve the inconsistencies. For those cases that made it to the end, judges seemed more partial to providing rough justice than to establishing a clean theoretical formula for recovery.[121]

Returning to its analysis, the court wrote:

> Section 28 of the Securities Exchange Act limits recovery "to actual damages on account of the act complained of." . . . Because Congress left actual damages undefined, "it is the duty of the courts to be alert to provide such remedies as are necessary to make effective [the] congressional purpose" behind the securities statutes. [citing J.I. Case v. Borak, 377 U.S. 426, 433 (1964); Hackbart v. Holmes, 675 F.2d 1114, 1121 (10th Cir. 1982) (holding that the trial court has discretion to fashion "a remedy to suit the particular case").] "Courts have interpreted the statute as permitting all forms of loss-based relief, whether articulated under out-of-pocket, benefit-of-the-bargain, or other loss theories." [quoting Panos v. Island Gem Enterprises, Ltd., N.V.,

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[120] *Id.* at 1202 n.6.

[121] *Id.* (quoting Robert B. Thompson, *"Simplicity and Certainty" in the Measure of Recovery Under Rule 10b-5*, 51 BUS. LAW 1177, 1179 (1996)).

880 F.Supp. 169, 175 (S.D.N.Y. 1995); see also Sowell v. Butcher & Singer, Inc., 926 F.2d 289, 297 (3d Cir. 1991).] In sum, courts routinely understand "actual damages" to be out-of-pocket losses [citing Anixter v. Home-Stake Prods. Co., 977 F.2d 1549, 1553 (10th Cir. 1992); Astor Chauffeured Limousine Co. v. Runnfeldt Inv. Corp., 910 F.2d 1540, 1551-52 (7th Cir. 1990); Garnatz v. Stifel, Nicolaus & Co., Inc., 559 F.2d 1357, 1360 (8th Cir. 1977)], but they have varied that measure or looked to other measures when the facts required it. [citing Pelletier v. Stuart-James Co., Inc., 863 F.2d 1550, 1557-58 (11th Cir.); *Garnatz*, 559 F.2d at 1360; *Hackbart*, 675 f.2d at 1121.][122]

In *In re Clearly Canadian Securities Litigation*,[123] a federal district court in California confronted with the problem of approving two fraud-on-the-market class action settlements articulated the following harsh criticism of the method of measuring compensatory damages under Rule 10b-5:

> The difficulty in performing an accurate out of pocket damage calculation is, in and of itself, cause to question the rationality of the out of pocket measure of damages in open market cases.
>
> Even when statistical analysis identifies a reasonably accurate measure of a fraud's impact on the stock price, current damage calculations make a number of problematic assumptions in the estimation of the harm inflicted by that price distortion. For example, use of the first in, first out [FIFO] method of pairing purchases and sales of shares will identify damages where in reality there may be none; the FIFO assumption is in no way based on actual trading practices in general, let alone the trades of actual claimants.
>
> Similarly, the choice between constant shares versus constant dollars damage calculations is a choice between two potentially valid but diametrically opposed assumptions. The constant shares method assumes that, absent the alleged wrongdoing, the investor would have purchased the same number of shares for less money while the constant dollars method assumes he would have spent the same amount of money and purchased more shares. While the latter theory is generally presumed to be a more accurate description of actual practice, it is inherently misdescriptive of a certain portion of the investing population.
>
> The difficulty of identifying the number of shares in the class is the most fundamental problem confronting a rational calculation

[122] *Id.*

[123] Nos. C-93-1037-VRW, C-93-1278-VRW, C-93-4313-VRW, C-95-0699-VRW, C-95-2295-VRW, 993, 1999 WL 707737 at *5 (N.D. Cal. Sept. 3, 1999).

of out of pocket damages. Investors who have both bought and sold during the class period are not entitled to recover their overpayment for inflated shares because they received a windfall when they sold at a price still inflated by the misrepresentation or omission. The need to estimate and discount such trades, and to compensate for irregularities in reporting conventions and market structures, presents a substantial barrier to the development and application of accurate proportional decay models and consequently an obstacle to calculating out of pocket losses.

When, if ever, these initial barriers are overcome, the fact remains that the out of pocket damage rule—whatever its theoretical appeal—appears in actual practice to be comprised of a set of unsupportable assumptions and arbitrary rules that result in irrational damage awards whether or not the damage calculation is further corrupted by inaccurate estimation of the shares in the class and the price change attributable to the fraud.

Absent allegations of insider trading, use of the out of pocket calculation in open market securities fraud cases targets parties who, while responsible for the fraud, do not profit directly from it. Not only does the damage rule seek to penalize a party who has not profited from the alleged wrongdoing, the penalty imposed is not rationally related to the social harm inflicted. For every dollar taken from an injured investor that same dollar is put in another innocent investor's pocket: every dollar lost by an investor who pays an inflated price for a stock is gained by the investor who sold at the inflated price.

The failure to incorporate this fact into the damage analysis results in a systematic over estimation of the social harm inflicted. Indeed, the out of pocket damage rule is not a damage rule at all. It is a wealth transfer formula whose impact is punitive in nature. It measures neither the harm to society nor the wrongful benefits to the alleged wrongdoers.

Moreover, the principal beneficiaries of securities litigation are likely larger, institutional stock traders who are also more likely to be beneficiaries of windfall fraud on the market profits. The first point is simply a result of a presumption that sophisticated stock traders with large holdings will be more likely to file claims than the average individual investor and will therefore recover a higher percentage of their losses. The second point is true because the heavy volume and diverse exposure of institutional transactions makes institutional stock traders more likely to capture the benefit of selling at an inflated price.

> Because the cost of securities fraud litigation is already spread across the market through the cost of insurance and through diversified portfolios, these surmises suggest that securities class action litigation simply transfers wealth from individual investors to institutional stock traders. Moreover, the goal of deterrence is lost in the sea of grossly overstated damage claims and the resulting comprehensive insurance coverage and indemnification agreements issuers have with their officers and directors [sic]. Litigation which fails effectively to deter wrongdoing and simply transfers wealth more or less randomly from one group to another (with a major cut for the lawyer intermediaries) must be questioned.
>
> And so, the court is faced with the dilemma of being asked to approve settlements that were reached on the basis of damage estimates and allocations that grossly failed accurately to anticipate actual claimed damages, estimates based on a theory of damages that bears no relationship to actual economic harm or the alleged wrongdoer profit and in fact likely results [in] a random but large multiple of social harm or wrongdoer gain. Nonetheless, approval of the settlements and their respective plans of allocation seems unquestionably in conformity with and perhaps even mandated by the current state of the law. In the absence of credible academic criticism or objections from class members or other interested parties, the court has no reasonable alternative but to approve the settlements.[124]

For similar criticism, see *Queen Uno Ltd. Partnership v. Couer D'Alene Mines Corp.*[125] In *Queen Uno*, the court wrote:

> Defendants' main argument is that Mr. Giedt [the plaintiff] was not damaged and is therefore atypical. It appears that during the class period, Mr. Giedt purchased 1000 shares of stock at $21.375 per share. During the class period, he also sold 1000 shares of stock at $24.25 per share. Thus, Mr. Giedt made, and did not lose, money during the class period. . . . Defendants contend he is subject to the unique defense that he has no damages and thus has no standing to sue. Defendants also contend that he conflicts with class members who did not sell during the period, but who bought in February 1996, when the stock was at its high point.
>
> However, as Plaintiffs correctly point out, in a Rule 10b-5 action, damages are determined by the out of pocket rule. The out of pocket rule dictates that damages are determined between the stock purchase price and the true value of the stock at the date of purchase. [citing Wool v. Tandem Computers, Inc., 818 F.2d

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[124] *Id.* at *4-*5.

[125] 183 F.R.D. 687 (D. Colo. 1998).

1433, 1436-37 (9th Cir. 1987).] Thus, Mr. Giedt only needs to prove that Defendants artificially inflated the price he paid for the stock at the time he bought the stock through their material misrepresentations. This means that Mr. Giedt was damaged.[126]

V. SECURITIES EXCHANGE ACT § 21D(e)

The Private Securities Litigation Reform Act of 1995 includes a new provision with respect to a limitation on the calculation of damages in private actions under the 1934 Act.[127] Section 21D(e) reads as follows:

(e) Limitation on Damages

> (1)In General. Except as provided in paragraph (2), in any private action arising under this title in which the plaintiff seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.
>
> (2)Exception. In any private action arising under this title in which the plaintiff seeks to establish damages by reference to the market price of a security, if the plaintiff sells or repurchases the subject security prior to the expiration of the 90-day period described in paragraph (1), the plaintiff's damages shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the security and the mean trading price of the security during the period beginning immediately after dissemination of information correcting the misstatement or omission and ending on the date on which the plaintiff sells or repurchases the security.
>
> (3)Definition. For purposes of this subsection, the 'mean trading price' of a security shall be an average of the daily trading price of that security, determined as of the close of the market each day during the 90-day period referred to in paragraph (1).[128]

[126] *See id.* at 693.

[127] *See* Pub. L. No. 104-67, 109 Stat. 737, 749-50 (1995).

[128] *Id.*

The Conference Report included the following explanatory statement:

> The current method of calculating damages in 1934 Act securities fraud cases is complex and uncertain. As a result, there are often substantial variations in the damages calculated by the defendants and the plaintiffs. Typically, in an action involving a fraudulent misstatement or omission, the investor's damages are presumed to be the difference between the price the investor paid for the security and the price of the security on the day the corrective information gets disseminated to the market.
>
> Between the time a misrepresentation is made and the time the market receives corrected information . . . the price of the security may rise or fall for reasons unrelated to the alleged fraud. According to an analysis provided to the Senate Securities Subcommittee, on average, damages in securities litigation comprise approximately 27.7[%] of market loss. Calculating damages based on the date corrective information is disclosed may end up substantially overestimating plaintiff's damages. [citing Baruch Lev & Meirind de Villiers, *Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis*, 47 STAN. L. REV. 7, 9-11 (1994).]
>
> The Conference Committee intends to rectify the uncertainty in calculating damages in new section 21D(e) of the 1934 Act by providing a "look back" period, thereby limiting damages to those losses caused by the fraud and not by other market conditions.
>
> This provision requires that plaintiff's damages be calculated based on the "mean trading price" of the security. This calculation takes into account the value of the security on the date plaintiff originally bought or sold the security and the value of the security during the 90-day period after dissemination of any information correcting the misleading statement or omission.

Thus, on the one hand, section 21D(e) was designed to solve the problem illustrated in *Executive Telecard, Ltd. Securities Litigation*,[129] in which an expert witness' testimony was deemed unreliable because the expert could not eliminate factors unrelated to the fraud from his Rule 10b-5 damages calculation.[130] At the same time, however, section 21D(e) was designed to eliminate the "crash" element from the Rule 10b-5 damages calculation described in Lev and deVillers' article cited above by giving the market price of the security a chance to "bounce back" from its "crash" on the date the misrepresentation was

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[129] 979 F. Supp.2d 1021 (S.D.N.Y. 1997).

[130] *See Executive Telecard*, 979 F. Supp. at 1024-27.

corrected.[151] This allowance for a "bounce back" in price should yield a more accurate and fairer estimate of the stock's true value and therefore a more accurate measure of the deviation from this true value and the resulting damages caused by the fraud.

CONCLUSION

We end where we began. Damage awards in private actions under Rule 10b-5 may be either an area in which flexibility, pragmatism, and justice prevail or "a confused area of the law where the courts, forced to rely on their own wits, have created a myriad of approaches."[152] Or perhaps both descriptions are accurate and together render a more complete description of the state of the law of compensatory damages under Rule 10b-5. The reader will have to judge for himself. The Authors, however, would prefer more clarity, consistency, and predictability in the area.

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[151] *See* S. Rep. No. 104-98 (1995).
[152] Koch v. Koch Indus., Inc., 6 F. Supp.2d 1192, 1201 (D. Kan. 1998).