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THEORIES OF MEASURING DAMAGES IN SECURITY CASES AND THE EFFECTS OF DAMAGES ON LIABILITY

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I. INTRODUCTION

The measure of damages in securities fraud actions brought under section 10(b) of the Securities Exchange Act of 19341 and its corollary, rule 10b-5,2 and under related provisions3 has long been a neglected stepchild of the securities laws. The specter of ruinous damages if cases are tried to completion has often resulted in settlement of securities fraud cases after the court's decision on the defendant's motion to dismiss the complaint, or on the plaintiff's motion to certify the case as a class action,4 thereby avoiding any decision on the measure of damages. Because there have been comparatively few decisions on the measure of damages under rule 10b-5, a consensus has been slow to develop. As one commentator

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1. 15 U.S.C. § 78j(b) (1970). The section 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—

   (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, 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. 17 C.F.R. § 240.10b-5 (1977). The rule 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,

   (a) To employ any device, scheme, or artifice to defraud,

   (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

   (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

   in connection with the purchase or sale of any security.” Id.


4. The in terrorem effect of a securities fraud case was discussed in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739-43 (1975).
has noted, rule 10b-5 "has spawned many plaintiffs but few judgment creditors."5

This tendency to avoid a court determination of damages may be about to change. Recent decisions of the Supreme Court6 may encourage defendants to litigate cases they might otherwise have settled, and thereby produce more litigation on the issue of damages.7

The process of arriving at a proper measure of damages in securities fraud cases is complicated by the fact that many of those cases are class actions, in which it is alleged that a fraudulent statement has been widely disseminated to a large group of people who relied on such statement to their detriment. Such actions are brought by a representative plaintiff or plaintiffs on behalf of others who are similarly situated, but neither the representative party nor the class members need have had any direct dealings with the defendants.

In computing damages in a class action case, it is seductively easy for plaintiffs to prove the prices at which class members purchased and sold (or sold and repurchased) their securities, and arrive at an aggregate damage figure which represents the number of shares outstanding multiplied by the price range during the period of defendant's fraudulent activity. However, such an approach takes no account of the seriousness of the defendant's alleged fraud, or the market impact it may have had from time to time, or the impact which it may have had on the trading of particular class members.8

In view of the large sums which may result from such sterile exercises in multiplication,9 courts have recently begun to take two main approaches


6. Three major recent cases in which the Court declined to expand the scope of liability under rule 10b-5 to cover the actions complained of are: Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

7. Another effect of the decisions referred to in note 6 supra may be to shift the locus of securities fraud litigation from federal to state courts, where actions could be pursued under state securities and fraud laws. State courts do not have subject matter jurisdiction under the 1934 Act and therefore are not subject to the limitation contained in § 28 of that Act, 15 U.S.C. § 78bb (1970). See notes 17-21 infra and accompanying text. However, it is submitted that state courts will be subject to the factors which have motivated the federal courts in this area. For example, New York now has a class action procedure, N.Y. Civ. Prac. Law §§ 901-909 (McKinney 1976), which is closely based upon Rule 23 of the Federal Rules of Civil Procedure. If state courts become the locus of future securities litigation, they will feel the same pressures as federal courts have felt to charge defendants only with those losses which were proximately caused by their actions. See generally Brodsky, Suing Brokerage Firms for Negligence Under State Law (pts. 1-2) 178 N.Y.L.J., Sept. 7, 1977, at 1, col. 1, Sept. 21, 1977, at 1, col. 1.

8. The use of such a simplistic approach was cautioned against in Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1341 (9th Cir. 1976) (Sneed, J., concurring). See notes 99-103 infra and accompanying text.

to limit the impact of damages in the interest of justice. First, some courts, with the help of expert witnesses, have undertaken a detailed, technical analysis of securities prices, in an attempt to factor out those losses which were attributable to market forces from those losses caused by the defendants’ conduct.\textsuperscript{10}

Second, other courts have shown a tendency to be more cautious in finding liability in cases where damages will necessarily be large. The damage issue may influence the court’s decision on the adequacy of plaintiff’s claim,\textsuperscript{11} and may also affect the plaintiff’s burden of proof.\textsuperscript{12}

This Article will first consider the traditional rules used to measure damages,\textsuperscript{13} and then discuss the approaches courts have begun to take to limit liability in the face of large potential damages.\textsuperscript{14}

\section{A. The Nature of the Problem}

The basic problem with computing damages under rule 10b-5 is that one is dealing with an implied remedy, under a rule which was drafted to provide a basis for injunctive relief.\textsuperscript{15} The cases computing civil damages under the rule have proceeded to apply judicial remedies in the absence of legislative guidance. As a result, rule 10b-5 has been described by the Supreme Court as “a judicial oak which has grown from little more than a legislative acorn.”\textsuperscript{16}

In contrast to the explicit provision regarding damages for a misstatement in a registration statement under section 11 of the Securities Act of 1933,\textsuperscript{17} the subject is mentioned in the most general fashion in

\begin{itemize}
\item \textsuperscript{11}See Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977), discussed at notes 88-90 infra and accompanying text. See also Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974), discussed at notes 85-87 infra and accompanying text.
\item \textsuperscript{12}See Kohn v. American Metal Climax, Inc., 458 F.2d 255 (3d Cir.), cert. denied, 409 U.S. 874 (1972).
\item \textsuperscript{13}See pt. II infra.
\item \textsuperscript{14}See pt. III infra.
\item \textsuperscript{16}Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975).
\item \textsuperscript{17}15 U.S.C. § 77k(e) (1970) provides, in part: “[D]amages shall represent the difference between the amount paid for the security (not exceeding the price at which the security was
section 28(a) of the Securities Exchange Act of 1934, which states: "[N]o person permitted to maintain a suit for damages under the provi-
sions 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." Courts have cited this general provision in resolving a wide range of problems. Section 28(a) has been held to bar punitive damages under the 1934 Act. The restriction to "actual" damages has also been interpreted to prevent awards from being based upon conjecture. Thus, the Supreme Court has cited section 28(a) in support of the doctrine which limits the class of persons protected under rule 10b-5 to actual purchasers and sellers of securities. Section 28(a) has also been interpreted as restricting recovery to the net losses on a particular transaction, thus barring a plaintiff from keeping the profits and suing for the losses. As will be shown, section

offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought: Provided, That if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement . . . not being true or omitting to state a material fact . . . , such portion of or all such damages shall not be recoverable . . . ."


However, it has been held that punitive damages are available under a state law claim of common law fraud which is pendent to a rule 10b-5 claim. See Flaks v. Koegel, 504 F.2d 702, 706-07 (2d Cir. 1974) (dictum); Coffee v. Permian Corp., 474 F.2d 1040, 1044 (5th Cir.), cert. denied, 412 U.S. 920 (1973); Evans v. Kerbs & Co., 411 F. Supp. 616, 624-25 (S.D.N.Y. 1976); Comment, Punitive Damages and the Federal Securities Act: Recovery Via Pendent Jurisdiction, 47 Miss. L.J. 743 (1976).

20. In Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), the Court reasoned: "Section 28(a) . . . , which limits recovery in any private damages action brought under the 1934 Act to 'actual damages,' likewise provides some support for the purchaser-seller rule. While the damages suffered by purchasers and sellers pursuing a § 10(b) cause of action may on occasion be difficult to ascertain, in the main such purchasers and sellers at least seek to base recovery on a demonstrable number of shares traded. In contrast, a putative plaintiff, who neither purchases nor sells securities but suits instead for intangible economic injury . . . is more likely to be seeking a largely conjectural and speculative recovery in which the number of shares involved will depend on the plaintiff's subjective hypothesis." Id. at 734-35 (citations omitted).
28(a) has not prevented courts from applying a variety of theories in computing compensatory damages in rule 10b-5 cases.

II. TRADITIONAL APPROACHES TO MEASURING DAMAGES

A. The Basic Rule: Out-of-Pocket Damages

The basic rule on damages for a defrauded purchaser under rule 10b-5, which has been most favored by the courts, is the "out-of-pocket" rule. Pursuant to this rule, the plaintiff will recover:

the difference between the contract price, or the price paid, and the real or actual value at the date of the sale, together with such outlays as are attributable to the defendant's conduct. Or in other words, the difference between the amount parted with and the value of the thing received.22

This rule is said to give the plaintiff his "actual damages" as mandated by section 28(a) of the 1934 Act, without awarding him any profits he might have expected to receive on the transaction. The question is "not what the plaintiff might have gained, but what he has lost by being deceived."23 The plaintiff is therefore not entitled to "the expectant fruits of an unrealized speculation."24

The out-of-pocket rule is held to bar the application of a state's "benefit of the bargain" rule.25 If the plaintiff fails to prove that there was a difference between the price he paid and the value of the security he purchased, his complaint is subject to dismissal.26 Although the out-of-pocket rule depends upon the valuation of the security as of the transaction date, the best evidence of that value may be the price of the security on a subsequent date, a short time after proper disclosure has been made and the market is aware of the

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23. Id. Of course, the amount lost must have been paid because of the fraud and not some supervening cause. Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1051 (7th Cir.), cert. denied, 46 U.S.L.W. 3207 (U.S. Oct. 3, 1977) (additional amounts paid because of bad legal advice not recoverable).


26. See, e.g., Kohler v. Kohler Co., 208 F. Supp. 808 (E.D. Wis. 1962), aff'd, 319 F.2d 634 (7th Cir. 1963). Moreover, it is considered to be reversible error in a jury charge to call the jury's attention to a time period after the transaction date, during which the value of a security may have risen, since the value is to be determined as of the transaction date. See, e.g., Investors Thrift Corp. v. Sexton, 491 F.2d 768 (8th Cir. 1974).
In one case, sales made within two weeks after the transaction in question were held to be \"[t]he best evidence of the actual value of the shares\" at the date of plaintiffs' sale.\(^{28}\)

In *Harris v. American Investment Co.*,\(^ {29}\) the plaintiff admitted that he could not establish the actual value of his securities at the time of his purchase. The district court granted summary judgment to the defendant. The court of appeals reversed on the theory that, even if the plaintiff could not prove by direct evidence the value of the security as of the transaction date, he might be able to prove such value by introducing evidence concerning the price after the public discovery of defendant's fraud.\(^ {30}\) It should be noted that the significant date for purposes of valuation was the date at which the public, rather than the plaintiff, discovered the fraud, since it was the public's discovery which corrected the market price and revealed the securities' true value.\(^ {31}\)

In picking the date of public disclosure, the Eighth Circuit in *Harris* expressly disagreed with the Tenth Circuit's opinion in *Esplin v. Hirschi*,\(^ {32}\) which upheld use of the date plaintiffs discovered the fraud as the valuation date. In the *Esplin* case, the district court had submitted special interrogatories to the jury asking them to ascertain the value of the securities purchased by plaintiffs as of three different dates: the date of plaintiffs' purchase, the date suit was filed and the date of trial. The jury found that plaintiffs' damages were minimal as of the date of their purchase, but as of the dates of suit and trial they had lost the entire amount invested, $20,800. The district court then disregarded the jury's verdict and fixed the value as of a fourth date, the date when the plaintiffs received notice of the fraud. The court computed plaintiffs' damages as $15,600 as of that date, precisely three-quarters of the amount at issue. Despite the fact that this was the fourth choice of the trial judge, the Tenth Circuit affirmed the judgment and the proposition that the extent of plaintiffs' loss \"may be ascertained as of the date the purchaser realizes, or should realize, that he has been defrauded.\"\(^ {33}\)

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27. Of course, the time period involved must not be too long, or irrelevant circumstances will affect the price on the subsequent date.


30. Id. at 227.

31. Id. at 226.


33. Id. The opinion was written by Judge Hill, who also wrote the opinions in *Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 303 F.2d 527 (10th Cir. 1962), discussed at notes 22-24 *infra* and accompanying text, and *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir.), cert. denied, 404 U.S. 1004 (1971), 405 U.S. 918 (1972), discussed at notes 49-51 *infra* and accompanying text.
This rule may have some application in cases like *Esplin*, where the plaintiffs and defendants dealt face to face and the security in question was not traded on any market. In that limited situation, the date plaintiff learned of the fraud is the first date on which he can act to protect himself or minimize his loss. However, in a case where a security is traded on a public market, the date of public disclosure should be the relevant date, for the reasons stated in the *Harris* case.34

**B. Out-of-Pocket Damages Plus Recovery of Subsequent Profit**

The out-of-pocket rule is subject to the variation that if a defendant purchases a plaintiff’s securities by fraud and subsequently enjoys a profit, that profit, even if a windfall, should be recovered by the plaintiff. The leading case on this variation is *Janigan v. Taylor*,35 in which a director of a corporation had misrepresented the corporation’s prospects to his fellow directors and had purchased their shares. Subsequent to the purchase, the corporation prospered to an extent that was not foreseeable at the time of the purchase. The court nevertheless found that the plaintiffs were entitled to recover the full value of defendant’s profit on the ground that “[i]t is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them.”36 The court acknowledged one situation in which the full amount of the profit might not be recoverable:

There are, of course, limits to this principle. If an artist acquired paints by fraud and used them in producing a valuable portrait we would not suggest that the defrauded party would be entitled to the portrait, or to the proceeds of its sale. However, those limits are not reached in the case at bar.37

This limitation has been narrowly construed and seldom applied in securities fraud cases. In *Gerstle v. Gamble-Skogmo, Inc.*,38 the court found that shareholder approval of a merger had been procured by fraud. The plaintiffs, who had surrendered their shares in the acquired corporation, were held to be entitled to recover the profits earned by

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34. See notes 29-31 supra and accompanying text.
35. 344 F.2d 781 (1st Cir.), cert. denied, 382 U.S. 879 (1965).
36. Id. at 786. Of course, this assumes that the defrauded party would have retained the securities and earned the profit, but for the fraud. Where the opposite can be shown, this measure is inappropriate. Capital Inv., Inc. v. Bank of Sturgeon Bay, 430 F. Supp. 534, 537 (E.D. Wis. 1977).
37. 344 F.2d at 787. A similar result was reached in *Myzel v. Fields*, 386 F.2d 718, 736 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968), wherein the defendants' efforts, in their capacity as corporate management, in improving the corporation's prospects were completely disregarded by the court. Both *Janigan* and *Myzel* were cited with approval, in dictum, in *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972).
38. 478 F.2d 1281 (2d Cir. 1973).
the acquiring corporation as a result of its sale of the assets of the acquired corporation within nine months of the merger. However, the plaintiffs were not entitled to recover the increase in the value of certain other assets up to the time of judgment, which was a nine-year period. In one case of excess administrative zeal, the Securities and Exchange Commission demanded and got disgorgement of unearned paper profits.\(^3^9\)

C. The Rescission Measure of Damages

Even where there has been no windfall profit, some courts have applied a so-called rescission measure of damages where there is privity of contract between the parties, and where strict rescission is not possible because the security parted with no longer exists. Gould v. American-Hawaiian Steamship Co.\(^4^0\) involved a merger transaction where extra consideration amounting to approximately $8.25 per share was paid to certain favored shareholders, chiefly the management of the corporation to be acquired. The plaintiffs, who were the "non-favored" shareholders, would have had no recovery under the "out-of-pocket" rule, since they did not contend that the consideration which they had received was worth less than the securities they had surrendered.\(^4^1\) Nor was this a situation like Janigan,\(^4^2\) where a fortuitous profit had materialized. The court awarded the plaintiffs their pro rata share in the premium that had been paid to the favored shareholders, since that was the amount which "the plaintiff might have obtained by renegotiation" if the fact of the premium had been disclosed.\(^4^3\)

The rescission measure of damages was defined in Gottlieb v. Sandia American Corp.\(^4^4\) as follows: "According to this measure, if the actual stock or assets which were orginally traded are no longer available, damages will be awarded in the amount of the difference between the present market value of the consideration originally given and the consideration received."\(^4^5\) In that case, the court first stated that such a measure of damages could not be applied, since the plaintiffs had surrendered their stock in a corporation which ceased to exist as a result of a merger and whose value could not be determined

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40. 535 F.2d 761 (3d Cir. 1976).
41. Id. at 781.
42. 344 F.2d 781 (1st Cir.), cert. denied, 382 U.S. 879 (1965), discussed at notes 35-37 supra and accompanying text.
43. 535 F.2d at 783.
45. Id. at 990 (footnote omitted).
as of the date of suit. Nevertheless, the court approximated the
rescission measure of damages by directing an evaluation of the shares
surrendered as of the date of the merger and adding 6% interest up to
the date of judgment, as an approximation of the present value which
those shares would have had.\footnote{46}

Although there have been some cases where rescission was directed
against parties not in privity with the plaintiff,\footnote{47} this remedy is
generally limited to those cases involving either privity between plain-
tiff and defendant or some specific fiduciary duty owed by brokers to
their customers, in order to provide some limitation on damages.\footnote{48}

\textbf{D. The Cover Remedy}

The cover remedy, derived from the measure of damages for conver-
sion, has been applied in one leading case, \textit{Mitchell v. Texas Gulf
Sulphur Co.}\footnote{49} The defendant corporation, which had made a rich ore
strike, put out a press release which falsely denied the rumors of the
ore strike. Subsequently, a second press release stated the true facts.
The plaintiffs in \textit{Mitchell} had sold in reliance on the first fraudulent
press release. The Tenth Circuit applied a measure of damages derived
from the tort of conversion on the theory that plaintiffs had the
opportunity to repurchase their stock within a reasonable time after
learning the true facts:

\textit{We believe the measure of damages used should award the reasonable investor the
amount it would have taken him to invest in the TGS market within a reasonable
period of time after he became informed of the [corrective] April 16 release . . . . After
the reasonable stockholder had opportunity to apprise himself of the April 16 release
and its import to investment, a reasonable time lapse may be allowed to expire to
permit the investor to decide whether or not he would reinvest and take advantage of a
spiralinng market. If he has failed to reinvest, as both Reynolds and Mitchell did, he
must suffer the consequences of his own judgment. The award proposed would permit
one to 'cover' by reinvestment and suffer neither loss nor forced sale.

The damages then should be based on the highest value of TGS stock between
Monday, April 20 and a reasonable time thereafter.}\footnote{50}

\footnote{46. Id. at 991. A rescissory measure of damages was also applied in Malik v. Universal
Resources Corp., 425 F. Supp. 350 (S.D. Cal. 1976), an individual action under rule 10b-5 where
the plaintiff was in privity with one of the defendants. The court noted that the plaintiff was also
entitled to rescission under California law. \textit{Id.} at 364.}
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the plaintiff was in privity with one of the defendants. The court noted that the plaintiff was also
entitled to rescission under California law. \textit{Id.} at 364.}
\footnote{50. \textit{Id.} at 105.}
The court expressly adopted the cover remedy as an alternative to rescission, since there had been no direct, personal dealings, no privity between the parties, and no unjust enrichment. Cover was therefore viewed as an alternative where the plaintiff is a defrauded seller, there is no windfall profit to award him, and rescission is improper.

E. Damages Unrelated to Value: Churning and Margin Violations

Churning and margin requirement violations by stockbrokers are two specific areas where arbitrary rules of damages, which do not seek to measure the value of the securities traded, have been created. In cases of a churning violation, courts have awarded the plaintiff the amount of the commissions and interest charges generated by the wrongful activity. This measure has the theoretical effect of awarding a plaintiff some recovery, even if he has made a profit despite being churned. On the other hand, plaintiffs who have suffered net losses are not necessarily made whole by this rule. The rationale for not replacing plaintiff's total losses (when losses result) appears to be that the plaintiffs in these cases had some awareness of the trading in their accounts and, moreover, assumed the risks of stock market fluctuations.

The complicity of the plaintiff was also the dominant reason for the measure of damages set for a margin violation in *Pearlstein v. Scudder & German*. There, the plaintiff had requested several extensions of time to pay for securities purchased in his account. The Second Circuit had previously found the broker liable for granting an illegal extension of credit, rejecting contrary arguments based on the customer's fault.

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51. *Id.* Of course, the analogy of the reasonable time for replacement may also be applied in securities cases decided on a contract theory. *See, e.g.*, Madison Fund, Inc. *v.* Charter Co., 427 F. Supp. 597, 609 (S.D.N.Y. 1977). *But see Van Gemert v. Boeing Co.*, 553 F.2d 812 (2d Cir. 1977).

52. "The 'churning' of a securities account occurs when a dealer, acting in his own interests and against those of his customer, induces transactions in the customer's account which are excessive in size and frequency in light of the character of the account." *Note, Churning by Securities Dealers*, 80 Harv. L. Rev. 869 (1967). Section 7 of the 1934 Act, 15 U.S.C. § 78g (1970), authorizes the Board of Governors of the Federal Reserve System to regulate the amount of credit a broker or dealer may extend or arrange to have extended to a customer, and makes unlawful the violation of such regulations by a broker or dealer.


55. *Id.* at 850.

56. 527 F.2d 1141 (2d Cir. 1975).
and remanded for computation of damages.\footnote{57} When the case next came before the Second Circuit on the measure of damages question, the court expressed some misgivings about its prior opinion and strictly limited the broker's share of the market loss after an illegal extension of credit to that proportion of the purchase price of the securities which remained outstanding.\footnote{58}

It would appear that the churning and \textit{Pearlstein} cases were decided in this arbitrary fashion because there was some participation by the plaintiffs in the defendants' wrongful activities and no deception as to the value of particular securities. Therefore, such arbitrary measures of damages are more appropriate here than they would be in the typical securities fraud cases.

\section*{F. The Chasins Measure: A False Step}

There are a few cases which hold a defendant responsible for plaintiff's total economic loss. In \textit{Chasins v. Smith, Barney & Co.},\footnote{59} the defendant had allegedly failed to reveal to the plaintiff that it was a market maker in securities it recommended to him. The district court awarded the plaintiff the full amount which he paid for the securities in question, less the amount which he received when he sold those securities. The court chose this measure of damages because of the "absence of evidence as to the true value" of those securities.\footnote{60} In so doing, it effectively removed the burden of proof of that value from the plaintiff, who had failed to carry it, since he had been pursuing a breach of contract theory.

In support of that measure of damages, the district court cited \textit{Sarlie v. E. L. Bruce Co.}\footnote{61} However, in \textit{Sarlie}, the counterclaiming defendants were awarded a default judgment against the plaintiff, who had failed to appear for his deposition, thus rendering other methods of computing damages impossible. Therefore, the plaintiff was not heard to complain that he was held responsible for the full amount of money lost by the defendants.

\textit{Barthe v. Rizzo}\footnote{62} was another case where plaintiff was awarded his entire loss. There, a defendant induced a plaintiff to enter into a

\footnotesize{\begin{itemize}
\item 57. 429 F.2d 1136 (2d Cir. 1970), \textit{cert. denied}, 401 U.S. 1013 (1971).
\item 58. 527 F.2d at 1146 n.7. A recent opinion by Judge Pollack has refused to permit an implied right of action under Regulation T in a case involving option transactions where the customers were fully aware of the activity in their account. Drasner \textit{v. Thompson McKinnon Sec., Inc.}, 433 F. Supp. 485 (S.D.N.Y. 1977).
\item 60. \textit{Id.} at 496.
\end{itemize}}
venture capital deal wherein, unbeknownst to the plaintiff, the defendant had almost all of the equity ownership. The plaintiff was given debentures, but very little equity, for his investment. The entire investment rapidly collapsed. The court awarded plaintiff, as damages, the entire amount which he had invested, on the theory that he might never have invested at all had he known the true facts. Given the facts of the case, this measure of damages is probably not different from the result which would have been obtained under the out-of-pocket rule, since it appears that the investment in question was worthless from the very beginning.

It is submitted that the Chasins result is an aberration, caused by the fact that the district court imposed a different theory on the case than the one plaintiff tried to prove; the Sarlie result was a penalty for failure to comply with discovery; and the Barthe result can be harmonized with the out-of-pocket rule. There is no precedent for awarding plaintiff his entire loss, without asking whether defendant caused that entire loss.

III. RECENT TRENDS IN MEASURING DAMAGES

A. Use of Indexes and Sophisticated Value Computations

In awarding damages for securities fraud, courts have recently shown an increased willingness to apply formulas derived from experts' analyses of trading patterns. Such experts have not restricted themselves to a fundamental analysis of value, such as an examination of the earnings of the corporation in question by plaintiff's expert, but have shown a willingness to consider highly technical analyses of trading patterns.

In Bonime v. Doyle, the court analyzed the reasonableness of a proposed settlement of a class action involving alleged manipulations and fraudulent statements concerning the stock of Canadian Javelin Ltd. The court adopted an analysis by Dr. Roger F. Murray of Columbia University, who studied the trading in the stock. Dr. Murray's analysis attempted to do two things; first, to factor out those "losses attributable to general market forces" from those losses which were unique to Canadian Javelin (and presumably caused by defendants' fraud), and second, to separate the losses suffered by short-term speculators from those losses suffered by longer-term investors who, presumably, relied on defendants' statements.

63. This was the method of proof demanded by the court in Kohler v. Kohler Co., 208 F. Supp. 808 (E.D. Wis. 1962), aff'd, 319 F.2d 634 (7th Cir. 1963).
65. Id. at 1377. Dr. Murray first compared the prices of Canadian Javelin stock over the
The court expressly found that it was not possible to compute a value figure as of the purchase date, and that to consider the price of the stock after corrective disclosure would disregard "the many other factors which influence price fluctuation over time" and would indemnify the plaintiffs against "the risks of the vicissitudes of the market." This was especially true, since the time period of the alleged non-disclosure in the *Bonime* case covered four years, from 1969 to 1973, which the court described as "perhaps the most disastrous period in the post-1929 history of the stock market."

The court in *Feit v. Leasco Data Processing Equipment Corp.*, considered a decline in the Standard & Poor's Daily Stock Price Index in reducing the proportion of the trading losses which it awarded to the plaintiffs. The operative facts in the case occurred during the early portion of the same market slump as those in *Bonime*. The *Feit* case is more remarkable, however, because it was brought under section 11 of the Securities Act of 1933, and the court found that the Standard & Poor's index satisfied the defendants' statutory burden of proof that a portion of the decline in price of the securities was "other than the depreciation in value . . . resulting from . . . [the false] registration statement." The *Feit* opinion has been criticized for its "reference to a broad-based index" rather than to a particular index more closely related to the type of security involved.

A technical analysis of value was also made in the most recent opinion in *Mills v. Electric Auto-Lite Co.* In evaluating the fairness of the terms of a merger that had been procured by a misleading proxy

period in question to two comparable indexes of stock groups and found that Canadian Javelin's prices did not differ in any material respect from the indexes selected. *Id*. However, he then noted that during three periods in which there was great activity in Canadian Javelin stock, those who purchased the stock would have been unable to sell it before it declined in price and therefore suffered the loss of "activity premiums." *Id*. at 1378. From a study of the transfer agent's records he determined how many of those who purchased during the periods of excessive activity were short term traders and he subtracted their losses from the total loss. He was then left with a total which was intended to reflect the losses of those who were buying Canadian Javelin with reference to expected developments, and not simply to take advantage of a quick price change. *Id*.

66. *Id.* at 1384.
67. *Id.* at 1385.
69. *Id.* at 586.
73. Professor Murray's analysis in the *Bonnie* case was based on two such particular indexes.
416 F. Supp. at 1377.
74. 552 F.2d 1239 (7th Cir. 1977).
statement, the district court had found that the market value of each corporation's stock was not a reliable criterion and had relied instead on earnings and book value. The Seventh Circuit, however, found that the market price during the six months before the merger was the correct indicator of value despite certain inter-company purchases of stock:

We hold that when market value is available and reliable, other factors should not be utilized in determining whether the terms of a merger were fair. Although criteria such as earnings and book value are an indication of actual worth, they are only secondary indicia. . . . If we were to independently assess criteria other than market value in our effort to determine whether the merger terms were fair, we would be substituting our abstract judgment for that of the market. Aside from the problems that would arise in deciding how much weight to give each criterion, such a method would be economically unsound.

The court then applied the analysis of two commentators in requiring that minority shareholders be compensated for their share of the "synergistic effect" created by the merger. The court found that the minority shareholders had received more than their fair share of the value of the resulting corporation and that plaintiffs should recover no damages.

Although the facts and analyses in the preceding three cases differ widely, in each case a court has shown a willingness to go through a technical analysis of price information to give plaintiffs only that portion of any loss which was directly caused by defendants' conduct.

B. The Effect of the Amount of Damages on Findings of Liability

The measure of damages undoubtedly has an effect on a court's determination of liability. As was stated in Ultramares Corp. v. Touche, a court would hesitate to impose liability if the resulting hazards to legitimate businesses would be "so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that

75. Id. at 1244.
76. Id. at 1247-48 (footnote omitted).
78. 552 F.2d at 1248.
79. Id. at 1249. In addition, the court held that plaintiffs were not entitled to recover attorneys' fees and other expenses for the trial and appeals on the issue of damages, in the absence of any benefit conferred on a class of shareholders (or bad faith on the part of the defendants). Id. at 1249-50. The Supreme Court had earlier held that the Mills plaintiffs were entitled to recover attorneys' fees and other expenses for the trial and appeals on the issue of liability, because all shareholders had benefited from this form of "corporate therapeutics." 396 U.S. 375, 396 (1970) (quoting Murphy v. North Am. Light & Power Co., 33 F. Supp. 567, 570 (S.D.N.Y. 1940)).
80. 255 N.Y. 170, 174 N.E. 441 (1931).
exposes to these consequences."81 This issue often arises in securities fraud cases, where thousands of shareholders may be involved.

As discussed above, courts have hesitated to impose a rescissory measure of damages on defendants in cases where that would involve a ruinous burden.82 In Gerstle v. Gamble-Skogmo, Inc.,83 the court imposed rescissory damages for a violation of the proxy rules, but noted that the class of plaintiffs was limited to those in privity, that is, to those stockholders whose proxies were solicited. "While 'privity' is not required for most actions under the securities laws, its existence may bear heavily on the appropriate standard of culpability."84

The Second Circuit showed some sensitivity to the burden to be imposed on the defendants in Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,85 although it refused to limit liability to those defendants who were in privity with the plaintiffs.86 The court stated:

Other questions bearing upon the appropriate form of relief which must await trial include the extent of the selling defendants' trading in Douglas stock, whether such trading effectively impaired the integrity of the market, what compensation if any was paid by the selling defendants to Merrill Lynch for the inside information, what profits or other benefits were realized by defendants, what expenses were incurred and what losses were sustained by plaintiffs, and what should be the difference, if any, in the extent of liability imposed on the individual defendants and the selling defendants, respectively. Moreover, we do not foreclose the possibility that an analysis by the district court of the nature and character of the rule 10b-5 violations committed may require limiting the extent of liability imposed on either class of defendants.87

In a decision which is in conflict with the Shapiro case, the Sixth Circuit declined to find liability against a broker-dealer who purchased stock in the open market based upon favorable inside information. In Fridrich v. Bradford,88 plaintiffs who had sold in the open market at or about the time of defendants' purchases, sued for the full amount of the gain they would have had if they had not sold. The court of appeals reversed the district court's finding of liability, stating that a finding of liability "would present a situation wholly lacking in the natural limitations on damages present in cases dealing with face-to-face transactions."89 It cited the potential liability of one of the

81. Id. at 179-80, 174 N.E. at 444.
82. See note 48 supra and accompanying text.
83. 478 F.2d 1281 (2d Cir. 1973).
84. Id. at 1300 (citing Ruder, Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases, 63 Nw. U.L. Rev. 423, 437 (1968)).
85. 495 F.2d 228 (2d Cir. 1974).
86. Id. at 239; cf. Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701, 706 (S.D.N.Y. 1951), aff'd, 198 F.2d 883 (2d Cir. 1952) (requiring a "semblance of privity").
87. 495 F.2d at 242.
89. Id. at 321.
individual defendants in that case as an illustration of the dangers posed; his profit, which he had already disgorged, amounted to $13,000 and the holding of the district court might produce damages in excess of $7,000,000, if the case had been a class action. 90

In Kohn v. American Metal Climax, Inc., 91 a Third Circuit decision, the court noted that the size of the plaintiff class, and the resulting potential damages, may actually influence the standard of proof:

Where only one or a few parties are suing to recover, courts may well reach a different result from that when suit is brought on behalf of thousands of shareholders. . . . It is fitting that in the face-to-face confrontations, courts should impose a higher standard of disclosure by lessening the degree of culpability upon which liability can be imposed. From a practical standpoint, in such situations, the amount of damages is relatively finite, whereas in a suit on behalf of a class composed of thousands of shareholders, damages might well extend into millions of dollars. When faced with such huge potential payments . . ., the courts seem to have proceeded more slowly, by requiring that the plaintiff class prove conduct closer to the traditional concepts of actionable fraud. 92

In order to take advantage of the effects of damages on liability, defendants must be sure both issues are presented together. Professor Ruder has pointed out the dangers to defendants of separating issues of damages from those of liability in a “bifurcated trial,” noting that “the possibility that damages may be dramatic in amount may be the most important factor in determining whether liability should be imposed at all.” 93

In some cases, the amount of damages to be awarded has had a direct result on the class action determination under Federal Rule 23. 94 In Blackie v. Barrack, 95 a class action was brought on behalf of the open market purchasers of Ampex securities over a two year period, charging that the annual reports and other documents published by Ampex had inflated the corporation's earnings. One of the arguments made by the defendants in opposition to class certification was that each purchaser would be interested in maximizing the effects of the fraud at the time he purchased his securities, thereby minimizing the extent of damages at other times in the two-year class period. 96 The Ninth Circuit rejected this argument, noting that it depended entirely

90. Id. at 321 n.29.
92. Id. at 286.
95. 524 F.2d 891 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976).
96. Id. at 908.
upon the adoption of the out-of-pocket measure of damages. The court stated that it is "within the discretion of the district judge in appropriate circumstances to apply a rescissory measure."

The Blackie dictum on measure of damages is in sharp contrast to a concurring opinion in Green v. Occidental Petroleum Corp., which was also a Ninth Circuit decision. There, the court, on a mandamus petition, decided that it had not been an abuse of discretion for the district court to certify a class under Federal Rule 23(b)(3). As in Blackie, the complaint alleged that the corporate defendant had issued false press releases and reports to shareholders over the course of several years, which had artificially inflated the market price of its securities. In his concurring opinion, Judge Sneed (who had not been on the panel which decided Blackie) agreed that it was not an abuse of discretion to allow class status, but only on the presupposition that the "out-of-pocket" rule be used in computing damages. Since there were no face-to-face dealings between the parties, the purchasers' total economic "losses" were not equivalent to the defendants' "gains." Therefore, he concluded that the rescissory measure would not properly measure the amount of the losses caused by the defendants:

The rescissory measure of damages does not properly measure that loss. The reason is that it permits a defrauded purchaser to place upon the defendant the burden of any decline in the value of the stock between the date of purchase and the date of disclosure of the fraud even though only a portion of that decline may have been proximately caused by the defendant's wrong. The other portion is the result of market forces unrelated to the wrong. Moreover, this decline is unrelated both to any benefits derived by the defendant from his fraud and to the blameworthiness of his conduct.

Judge Sneed stated that plaintiff would have to establish a "price line" and a "value line" over the time period of the alleged manipulation, in order to show the difference, if any, between the price and the true value of the securities involved as of the date of purchase by any class member. He pointed out that the difference between the price and value lines would not necessarily remain constant during the entire period. He gave the example that, if a defendant falsely stated that it had discovered a quantity of oil, the difference between the price and value of its securities might well vary in accordance with the rise and fall of the price of oil, until the false disclosure was corrected. He acknowledged that this method was more complicated than simply permitting plaintiffs to prove their purchase and sale prices and collect

97. Id.
98. Id. at 909.
99. 541 F.2d 1335, 1341 (9th Cir. 1976) (Sneed, J., concurring).
100. Id. at 1344 (Sneed, J., concurring).
101. Id. at 1342 (Sneed, J., concurring).
102. Id. at 1345 (Sneed, J., concurring).
the differences. However, he stated that the wrongdoing defendants "should not be mulcted to make simple the management of a class proceeding under Rule 10b-5."103

IV. CONCLUSION

The foregoing discussion has attempted to show that the computation of damages for securities fraud is not a simple task, nor are the rules which have evolved easy to apply with scientific precision. Perhaps the most important conclusion to be drawn from these cases is that courts are beginning to appreciate the difficulties of computing a fair measure of damages and arriving at a fair overall result. The days may be over when a circuit court of appeals can make the overly facile suggestion that an award of rescissory damages is "within the discretion of the district judge" in, for example, a class action involving open market purchases over a two year period, with no privity between plaintiffs and defendants.104

Courts have been willing to consider whether part of the economic loss in a given transaction was caused by the plaintiff's complicity or by factors, such as market fluctuations, beyond the control of either party. Particularly in class actions, courts have stopped to consider whether there should be some relationship between the degree of a defendant's fault and the impact of a class judgment against him. The Second Circuit in Shapiro105 put forth a rather disjointed list of factors which might influence a district court, but the mere existence of such a list is some indication of a desire to have any ultimate damage award somehow correspond to the degree of culpability of the defendants.

As was shown by the Mills v. Electric Auto-Lite Co.106 litigation, the courts' function does not end with a finding of liability; the most difficult task yet may be the computation of damages. The ultimate goal, a fair overall result, should be pursued at all stages of a case, from the motion to dismiss the pleadings, to the class action motion, to the decision on liability, and, lastly, to the computation of damages. The computation of damages should not be neglected; it is a court's last chance to do justice.

103. Id. at 1343 (Sneed, J., concurring).
104. Blackie v. Barrack, 524 F.2d 891, 909 (9th Cir. 1975).
105. 495 F.2d 228, 242 (2d Cir. 1974), discussed at note 87 supra and accompanying text.
106. 552 F.2d 1239 (7th Cir. 1977).