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Damages for Insider Trading in the Open Market: A New Limitation on Recovery Under Rule 10b-5

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RECENT DEVELOPMENT

DAMAGES FOR INSIDER TRADING IN THE OPEN MARKET: A NEW LIMITATION ON RECOVERY UNDER RULE 10b-5

I. INTRODUCTION

In *Kardon v. National Gypsum Co.*[1] a federal court implied for the first time a private civil cause of action[2] for aggrieved investors under section 10(b) of the Securities Exchange Act of 1934[3] and its administrative counterpart, rule 10b-5.[4] Since that time courts have struggled to delineate the proper scope of a defendant's liability in a way that will effectuate the purposes of the

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1. 69 F. Supp. 512 (E.D. Pa. 1946).

2. The Supreme Court has affirmed this implied right and has held that it applies to open market as well as face-to-face transactions. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12, 13 n.9 (1971).

3. 15 U.S.C. § 78j(b) (1976). Section 10(b) states,

> 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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> . . . .
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> (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.

4. 17 C.F.R. § 240.10b-5 (1980). Rule 10b-5 is the result of the grant of rulemaking authority provided for in section 10(b) of the Securities Exchange Act of 1934 and 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 necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or,
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> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

implied private right.[5] After *Kardon* there was a steady judicial expansion of rule 10b-5's general availability to complainants, mainly through a relaxation of common-law proof requirements.[6] Recently, however, the Supreme Court has begun to reverse this trend in several landmark decisions that narrow the scope of section 10(b) and rule 10b-5.[7]

Not surprisingly, the issue of the measure of damages in such actions has failed to emerge unscathed from this judicial confusion. Part of the problem is that few rule 10b-5 cases have actually proceeded to a final judgment on the merits, since most are either resolved at the pleading stage or settled by the litigants themselves.[8] Perhaps even more troublesome is the transformation of rule 10b-5 into a catch-all antifraud provision,[9] with the result that any at-

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5. *E.g.*, SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) (courts should construe securities fraud provisions flexibly to effectuate their remedial purposes); SEC v. R.J. Allen & Assocs., 386 F. Supp. 866 (S.D. Fla. 1974) (equitable ancillary remedies are appropriate to effectuate remedial purposes of the Act and protect the investing public); Note, *Rule 10b-5 Damages: The Runaway Development of a Common Law Remedy*, 28 U. FLA. L. REV. 76, 76-77 (1975).

6. *See, e.g.*, Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972) (proof of materiality suffices to establish reliance and causation in fact in a nondisclosure case); Blackie v. Barrack, 524 F.2d 891, 905-06 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976) (proof of subjective reliance is not necessary); Reeder v. Mastercraft Elecs. Corp., 363 F. Supp. 574, 580-81 (1973) (materiality satisfies causation in fact, priority is not necessary, and proof of reliance is not required in an open market case even if there is misrepresentation); Note, *supra* note 5, at 76.

7. *See, e.g.*, TSC Indus. Inc. v. Northway, Inc., 426 U.S. 438 (1976) (materiality means that there must be a "substantial likelihood" that a reasonable investor's decision would have been affected); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (scienter required for a finding of liability); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (plaintiff must be either a purchaser or seller of securities).

8. Abrahamson v. Fleschner, 392 F. Supp. 740, 745-46 (S.D.N.Y.), *decision reserved pending further briefs*, 537 F.2d 27 (2d Cir. 1975), *aff'd in part, rev'd in part on other grounds*, 568 F.2d 862 (2d Cir. 1977), *cert. denied*, 436 U.S. 913 (1978); Gottlieb v. Sandia Am. Corp., 304 F. Supp. 980, 991 (E.D. Pa. 1969), *aff'd in part, rev'd in part on other grounds*, 452 F.2d 510 (3d Cir.), *cert. denied*, 404 U.S. 938 (1971); Kohler v. Kohler Co., 208 F. Supp. 808, 824 (E.D. Wis. 1962), *aff'd*, 319 F.2d 634 (7th Cir. 1963); Cobine, *Elements of Liability and Actual Damages in Rule 10b-5 Actions*, 1972 U. ILL. L. F. 651.

Another reason why so few cases have reached the damage issue is that plaintiffs rarely prove all the requisite elements of a cause of action. 11 LOY. L.A.L. REV. 233, 248 (1978).

9. Garnatz v. Stifel, Nicolaus & Co., 559 F.2d 1357, 1361 n.1 (8th Cir. 1977); SEC v. R.J. Allen & Assocs., 386 F. Supp. 866, 876 (S.D. Fla. 1974); Note, *Damages to Uninformed Traders for Insider Trading on Impersonal Exchanges*, 74 COLUM. L. REV. 299 (1974). Initially, the Securities and Exchange Commission promulgated § 10(b) and rule 10b-5 to correct an oversight in § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a) (1976), which had afforded protection to defrauded purchasers but not to defrauded sellers. Pappas v. Moss, 257 F. Supp. 345, 363 (D.N.J. 1966). For a comprehensive discussion of all the available fraud provisions in the securities statutes, see 3 L. LOSS, SECURITIES REGULATION 1421-1528 (2d ed. 1961).

tempt to design a uniform damage rule would necessarily be inconsistent and confused. Finally, since section 27 of the Securities Exchange Act of 1934[10] endows the courts with general equity powers,[11] those courts that have awarded "actual damages"[12] have tended to seek the best solution for the case at hand rather than formulate a hard and fast rule of law.[13] As a result, the law on damages in rule 10b-5 cases remains unsettled.[14]

Nowhere is this disagreement over the measure of damages more apparent than in cases concerning insider trading on undisclosed or misrepresented material information in the open market. As discussed below, application of conventional damage standards to this area is usually unsatisfactory and can lead to recoveries far out of proportion to any evil that the defendant may have committed.[15] Both courts and commentators have acknowledged the need to limit recoveries for insider trading in the open market in violation of rule 10b-5,[16] but no consensus has emerged on how best to accomplish this end.

Recently, the United States Court of Appeals for the Second Circuit, in *Elkind v. Liggett & Myers, Inc.*,[17] confronted the question of what measure of damages should be levied against a corporation for "tippee trading" on material inside information. The court held that an uninformed purchaser whose decision would have been affected by knowledge of the inside information may re-

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10. 15 U.S.C. § 78aa (1976).

11. SEC v. R.J. Allen & Assocs., 386 F. Supp. 866, 880 (S.D. Fla. 1974).

12. Section 28(a) of the 1934 Act limits a plaintiff's recovery to actual damages:

> The rights and remedies provided by [the 1934 Act] 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 [the 1934 Act] 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.

15 U.S.C. § 78bb(a) (1976). Most courts and commentators agree that this section prohibits the imposition of punitive damages. Green v. Wolf Corp., 406 F.2d 291, 302-03 (2d Cir. 1968), *cert. denied*, 393 U.S. 977 (1969); Note, *supra* note 9, at 305. *But cf.* 16 U.C.L.A. L. Rev. 404, 417-20 (1969) (punitive damages can and should be allowed in rule 10b-5 cases).

13. Garnatz v. Stifel, Nicolaus & Co., 559 F.2d 1357, 1360 (8th Cir. 1977); Gottlieb v. Sandia Am. Corp., 304 F. Supp. 980, 991 (E.D. Pa. 1969), *aff'd in part, rev'd in part on other grounds*, 452 F.2d 510 (3d Cir.), *cert. denied*, 404 U.S. 938 (1971).

14. 304 F. Supp. at 991.

15. *See* notes 109-17 *infra* and accompanying text.

16. Fridrich v. Bradford, 542 F.2d 307, 323 (6th Cir. 1976) (Celebrezze, J., concurring), *cert. denied*, 429 U.S. 1053 (1977); Green v. Occidential Petroleum Corp., 541 F.2d 1335, 1343 (9th Cir. 1976) (Sneed, J., concurring in part); Cobine, *supra* note 8, at 683; Jacobs, *The Measure of Damages in Rule 10b-5 Cases*, 65 Geo. L.J. 1093, 1131 (1977); Note, *supra* note 9, at 308; Note, *supra* note 5, at 99.

17. 635 F.2d 156 (2d Cir. 1980).

cover an amount equal to any postpurchase decline in the market value of his stock up to a reasonable time after the public disclosure of that information.[18] The court, however, added a crucial caveat to its holding by limiting the total amount of these plaintiffs recovery to the amount that the tippee gained from trading on the inside information.[19]

The *Elkind* decision is certain to have an effect not only upon the size of monetary recoveries, but also upon the scope of insider liability generally in the open market setting. After examining the methods and measures of recovery in securities fraud actions, this Recent Development analyzes whether the *Elkind* result was a departure from or the logical outgrowth of prior case law. This Recent Development then examines whether the proffered solution in *Elkind* was the best of all available alternatives.

II. The Pool from Which to Choose: Methods and Measures of Recovery in Variable Contexts

A. *The SEC Disgorgement Method*

Apart from referring possible securities fraud cases to the Attorney General for criminal prosecution,[20] the only enforcement mechanism traditionally thought to be available to the Securities Exchange Commission (SEC) was a request for injunctive relief.[21] It is well settled, for example, that the SEC is not entitled to levy penal sanctions or impose its administrative remedies in a punitive fashion.[22]

In *SEC v. Texas Gulf Sulphur Co.*,[23] however, the Second Circuit held that the SEC could require defendants to disgorge their profits to defrauded plaintiffs as ancillary relief to the normal action for an injunction.[24] Since that time courts have continued to allow the SEC to engage in this type of restitutionary enforce-

18. *Id.* at 170.
19. *Id.*
20. Securities Act of 1933, § 20(b), 15 U.S.C. § 77t(b) (1976); Securities Exchange Act of 1934, § 21(d), 15 U.S.C. § 78u(d) (1976).
21. *See* SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262 (S.D.N.Y. 1966), *aff'd in part*, 401 F.2d 833 (2d Cir. 1968), *on remand*, 312 F. Supp. 77 (S.D.N.Y. 1970), *aff'd*, 446 F.2d 1301, 1308 (2d Cir. 1971).
22. Ellsworth, *Disgorgement in Securities Fraud Actions Brought by the SEC*, 1977 Duke L.J. 641, 652.
23. 258 F. Supp. 262 (S.D.N.Y. 1966), *aff'd in part*, 401 F.2d 833 (2d Cir. 1968), *on remand*, 312 F. Supp 77 (S.D.N.Y. 1970), *aff'd*, 446 F.2d 1301 (2d Cir. 1971).
24. 446 F.2d at 1308.

ment.[25] The practice, however, is intended purely to provide an added deterrent to securities fraud and does not attempt to make investors whole.[26] Thus, in *Texas Gulf Sulphur* the court made defendants' disgorged profits available for the claims of injured investors, but it did not make allowance for the possibility that the amount claimed might exceed the amount disgorged.[27]

B. Measures of Damages in Face-to-Face Transactions

Courts have fashioned a variety of remedies for defrauded buyers and sellers in situations in which the parties deal directly with one another rather than through an impersonal market. Measures of damages and forms of relief under rule 10b-5 can loosely be classified as the "out-of-pocket" measure, the "cover" and *Chasins* measures, and rescission and restitutionary relief. In addition, although courts have begun to require defendants to disgorge their excess profits, they have refused to award punitive damages. These methods of measuring recovery ostensibly fit into traditional damages and relief theories. In practice, however, courts have not hesitated to modify these theories to reach an equitable result.

1. The Out-of-Pocket Measure

The traditional damage measure in rule 10b-5 cases ostensibly follows the "out-of-pocket" rule,[28] which is a legacy from the

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25. *See* SEC v. Shapiro, 494 F.2d 1301, 1309 (2d Cir. 1974); SEC v. R.J. Allen & Assocs., 386 F. Supp. 866, 881 (S.D. Fla. 1974); Ellsworth, *supra* note 22, at 641-42.

26. Dolgow v. Anderson, 43 F.R.D. 472, 483 (E.D.N.Y. 1968), *rev'd on other grounds*, 438 F.2d 825 (2d Cir. 1970). The court in *Dolgow* stated,

> *Because of budgetary limitations and alternative demands on available manpower, the Commission cannot fully investigate or take action in every case of possible violation. . . .*
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> . . . While in rare cases, as an adjunct to injunctive relief, the Commission has urged a court to deprive violators of their illegal gains by directing that those be paid to individuals who have been injured by their violations, *even in such cases the Commission does not seek to make investors whole;* it serves merely to deter violators by making violations unprofitable. . . .
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> . . . .
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> Thus, "[p]rivate enforcement . . . provides a necessary supplement to Commission action," by both affording relief to those injured by violations of the securities laws and serving as a deterrent for future wrongdoing.

Id. at 483-84 (emphasis in original).

27. 312 F. Supp. at 93.

28. Garnatz v. Stifel, Nicolaus & Co., 559 F.2d 1357, 1360 (8th Cir. 1977); Blackie v. Barrack, 524 F.2d 891, 909 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976); Harris v. American Inv. Co., 523 F.2d 220, 224-25 (8th Cir. 1975), *cert. denied*, 432 U.S. 1054 (1976); Madigan, Inc. v. Goodman, 498 F.2d 233, 239 (7th Cir. 1974).

method of calculating damages in common-law fraud cases.[29] The out-of-pocket rule awards a defrauded buyer or seller the difference between the price paid or received for the securitiy and its actual fair market value, with both values measured at the time of the fraudulent transaction.[30] The rule focuses on what the plaintiff has lost rather than on what he might have gained,[31] making no allowance for any disgorgement of the defendant's gain in excess of the plaintiff's loss.[32]

The out-of-pocket rule works well when "the defendant's fraud conceals the actual value of the item purchased, yet does not affect the overall market value of that item."[33] A plaintiff's loss, however, will often not materialize until after the fraudulent transaction[34]—for example, when the consideration given equals the consideration received[35] and the value of the security is affected

29. Harris v. American Inv. Co., 523 F.2d 220, 225 (8th Cir. 1975), *cert. denied,* 432 U.S. 1054 (1976); Estate Counseling Serv. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527, 532-33 (10th Cir. 1962).

30. Nelson v. Serwold, 576 F.2d 1332, 1338 (9th Cir.), *cert. denied,* 439 U.S. 970 (1978); Estate Counseling Serv. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527 (10th Cir. 1962); Kohler v. Kohler Co., 208 F. Supp. 808, 825 (E.D. Wis. 1962), *aff'd,* 319 F.2d 634 (7th Cir. 1963). Thus, if defendant fraudulently induced plaintiff to purchase a security for consideration worth $50 when its fair value was only $40 at the time of the fraudulent transaction, then plaintiff could recover $10 per share, regardless of any subsequent change in the price of the security. Conversely, a defrauded seller could recover $10 per share if he or she sold a security with a fair value of $50 for consideration worth $40.

31. Garnatz v. Stifel, Nicolaus & Co., 559 F.2d 1357, 1360 (8th Cir. 1977); Harris v. American Inv. Co., 523 F.2d 220, 225 (8th Cir. 1975), *cert. denied,* 432 U.S. 1054 (1976); Madigan, Inc. v. Goodman, 498 F.2d 233, 239 (7th Cir. 1974); Estate Counseling Serv. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527 (10th Cir. 1962).

If courts allowed the plaintiff to recover what he might have gained, they wonld award damages in accordance with the "benefit-of-the-bargain" measure, which is the difference between the fair value received and the value as represented by the defendant. Jacobs, *supra* note 16, at 1108-09.

32. As the court stated in the early case of Kohler v. Kohler Co., 208 F. Supp. 808 (E.D. Wis. 1962), *aff'd,* 319 F.2d 634 (7th Cir. 1963):

> "Actual damages" are to be computed under the federal "out of pocket" rule applied in fraud actions, i.e., the difference between the price received by the plaintiff and the real or actual value of the stock at the date of the sale. Under this rule, a plaintiff is entitled to recover what he has lost by the sale but may not recover any actual or potential gain that was received by the defendants.

Id. at 825.

33. Garnatz v. Stifel, Nicolaus & Co., 559 F.2d 1357, 1360 (8th Cir. 1977).

34. Harris v. American Inv. Co., 523 F.2d 220, 226 (8th Cir. 1975), *cert. denied,* 432 U.S. 1054 (1976); Esplin v. Hirschi, 402 F.2d 94, 104 (10th Cir. 1968), *cert. denied,* 394 U.S. 928 (1969).

35. *See* Garnatz v. Stifel, Nicolaus & Co., 559 F.2d 1357, 1360 (8th Cir. 1977) (refusal to deny plaintiff recovery when value of bonds equals their purchase price).

only later when the fraud becomes known.[36] In these common situations courts have modified the rigid out-of-pocket formula to ensure that injured plaintiffs obtain an adequate recovery.[37]

Courts usually have achieved this qualification of the out-of-pocket rule by determining the fair market value of the security at the time of the fraudulent transaction by reference to the security's value at some posttransaction date, usually the date on which the fraud was or should have been discovered. For example, in *Esplin v. Hirschi*,[38] in which defendants defrauded purchasers by failing to give a prospectus or to disclose the rights and privileges of various classes of stock, the court stated that only when the fraudulent conduct is made public can the true value of a security as an investment be determined.[39] Consequently, the *Esplin* court awarded the defrauded buyer the difference between the price paid for the securities[40] and the actual value of the securities determined as of the date of discovery of the fraud.[41] Similarly in *Ross v. Licht*[42] plaintiffs sold stock to defendants at $120 per share without knowledge that the stock would later be offered at $300 per sbare. The court looked to the date on which the stock was offered for $300 to determine its value at the date of the fraudulent sale.[43] Courts have continued to follow this practice since *Esplin* and *Ross*, stating straightforwardly that they are modifying

36. Harris v. American Inv. Co., 523 F.2d 220, 226 (8th Cir. 1975), *cert. denied*, 432 U.S. 1054 (1976); Esplin v. Hirschi, 402 F.2d 94, 104 (10th Cir. 1968), *cert. denied*, 394 U.S. 928 (1969).

37. Gottlieb v. Sandia Am. Corp., 304 F. Supp. 980, 991 (E.D. Pa. 1969), *aff'd in part, rev'd in part on other grounds*, 452 F.2d 510 (3d Cir.), *cert. denied*, 404 U.S. 938 (1971) ("courts on several occasions have exercised equitable discretion to modify traditional remedies strictly interpreted so as to grant relief which is fair and appropriate in the circumstances before them"); Cobine, *supra* note 8, at 675 ("courts are willing to modify application of the out-of-pocket rule under any number of special circumstances"); Note, *Measurement of Damages in Private Actions Under Rule 10b-5*, 1968 WASH. U.L.Q. 165, 179 ("Courts have taken an ad hoc approach, the initial reference point being the common law out-of-pockot loss measure of recovery. Beyond this, the courts have exercised discretion traditionally left to trial courts in finding damages appropriate to the facts of the case.").

38. 402 F.2d 94 (10th Cir. 1968), *cert. denied*, 394 U.S. 928 (1969).

39. *Id.* at 104.

40. The court in *Esplin* computed the purchase price by adding interest from the date of the transaction to the actnal price paid. *Id.* at 105.

41. *Id.* A buyer in this situation is also entitled to recover any additional outlays attributable to the defendant's fraudulent conduct, minus any dividends or other payments the purchasers might have received from the defendant. *Id. See also* Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); Estate Counseling Serv. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527, 533 (10th Cir. 1962).

42. 263 F. Supp. 395 (S.D.N.Y. 1967).

43. *Id.* at 410.

the dates on which out-of-pocket valuations are to be made in order to make injured plaintiffs whole.[44]

2. The "Cover" and *Chasins* Measures

Another method of measuring damages—also more flexible than the strict out-of-pocket rule—is the so called "cover" measure, which allows a defrauded seller to recover the difference between the highest value attained by a security within a reasonable period after he discovered or should have discovered the fraudulent conduct and the fair value of the consideration received, measured at the time of the wrongful transaction.[45] A case in point is *Baumel v. Rosen*,[46] in which defendant buyers induced plaintiffs to sell by misrepresenting that the company was in a poor financial condition.[47] The court held that rescission[48] was unavailable to plaintiffs because they had been dilatory in requesting it;[49] nevertheless, the court awarded damages in the amount of the mean price of the stock on the day after plaintiff knew or should have known of the fraud,[50] minus the purchase price received for the

44. Harris v. American Inv. Co., 523 F.2d 220, 226 (8th Cir. 1975), *cert. denied*, 432 U.S. 1054 (1976) (when defendant's conduct creates an artificial market of long duration, damages are fixed at the date of discovery of the fraud rather than at the date of purchase); Richardson v. MacArthur, 451 F.2d 35, 43 (10th Cir. 1971) (complaining party is entitled to be made whole, so calculation of out-of-pocket damages is to he made at time of discovery of fraud).

45. For instance, if plaintiff sold stock with a fair value of $50 at the time of the fraudulent transaction for $40, and the stock's highest attained value within a reasonable time after disclosure (two weeks, for example) was $100, then plaintiff could recover $60 per share. If plaintiff is a defrauded buyer, then the fact setting would differ but the theory would not. If he buys stock with a fair value of $40 for $50, and the lowest attained value of the stock within a reasonable time after disclosure is $20, then plaintiff could recover $30 per share. No court, however, has strictly followed this theory in the case of a defrauded buyer. *See* notes 55-57 *infra* and accompanying text; Jacobs, *supra* note 16, at 1102-03; Note, *The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities*, 26 STAN. L. REV. 371, 378-81 (1974). Courts will not use the highest price within a reasonable period when, for example, plaintiff covers for less than the highest price during the reasonable period. Jacobs, *supra* note 16, at 1105-16. Additionally, although the RESTATEMENT OF RESTITUTION requires plaintiff to prove that he would have sold at this highest price, in practice courts have not required this proof. *Id.* at 1103 n.61.

46. 412 F.2d 571 (4th Cir. 1969), *cert. denied*, 396 U.S. 1037 (1970).

47. *Id.* at 573.

48. *See* notes 58-73 *infra* and accompanying text.

49. 412 F.2d at 574.

50. Since the reasonable period after discovery of the fraud was only one day due to the volatile nature of first-offering stock prices, the court did not explicitly use the highest value attained. The court in *Baumel*, however, harmonized its calculation with that of the trial judge, who had specifically mentioned that the proper figure in a damage measurement was the highest attained value. *Id.* at 576.

shares, both figures being calculated together with interest.[51] The cover measure assumes in theory that plaintiff either would have reentered the market to purchase the stock he had sold previously to the defendant,[52] or that he would not have sold at all until the price reached its highest value.[53] This measure makes plaintiff whole by awarding the appreciation in value of the stock from the time he was fraudulently induced to sell until the time he knew or should have known of the defendant's deceptive conduct.[54]

Chasins v. Smith, Barney & Co.[55] arguably embodies a counterpart to the cover measure. Defendant had induced plaintiff to purchase securities without disclosing that he was making a market in those securities in the over-the-counter market. The court granted damages in the amount of the difference between the purchase price to Chasins and the amount he received when he

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51. In accord with the *Baumel* court in using the highest intermediate value method of calculating damages is Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281 (2d Cir. 1973), a case brought under § 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a) (1976), for fraudulent proxies during a merger. For a discussion of the use of the cover method in the open market, see notes 118-23 *infra* and accompanying text.

52. Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 105 (10th Cir.), *cert. denied,* 404 U.S. 1004 (1971). *See* notes 118-23 *infra* and accompanying text.

53. Myzel v. Fields, 386 F.2d 718, 745 (8th Cir. 1967) (dictum in approving trial court's jury instruction).

54. Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 105 (10th Cir.), *cert. denied,* 404 U.S. 1004 (1971); Myzel v. Fields, 386 F.2d 718, 745 (8th Cir. 1967) (dictum in approving trial court's jury instruction).

55. 438 F.2d 1167 (2d Cir. 1970). Some commentators have characterized *Chasins* as a special form of rescissory damages that merely employs an atypical valuation date. Cobine, *supra* note 8, at 672-73; Note, *supra* note 45, at 376. A more recent commentary on rule 10b-5 damages, however, suggests that *Chasins* should be considered apart from the rescission remedy as the mirror image of the cover measure. Jacobs, *supra* noto 16, at 1107-08. The latter position is more sound analytically, even though it is true that the *Chasins* measure is in part motivated by the fact that the plaintiff resells prior to discovery of the fraud. Whereas a rescissory theory of damages calculates plaintiff's recovery at the date of judgment, the *Chasins* court was concerned solely with the amount the plaintiff-purchaser received on the resale of his depreciated security (minus his original purchase price). This is far more analogous to awarding an aggrieved investor the amount it would take to reinvest in an appreciated security (minus the plaintiff's original selling price) than to attempting to place parties in their status quo ante through voidance of the transaction. *See* notes 58-73 *infra* and accompanying text. Moreover, if one focuses on the language in *Chasins* to the effect that the wrongdoing consisted not of price manipulation but of inducing plaintiff to purchase at all, it is implicit in the court's holding that without defendant's fraud plaintiff would never have entered the transaction. Note, *supra* note 45, at 376. This subjective determination of what the investor would have done absent fraud is precisely analogous to the underlying rationale of the cover measure. In practice, this distinction between *Chasins* and rescissory damages is more theoretical than real, since courts utilizing a rescissory measure of damages often make the calculation prior to the date of judgment at some posttransaction date. Garnatz v. Stifel, Nicolaus & Co., 559 F.2d 1357, 1360-61 (8th Cir. 1977); Jacobs, *supra* note 16, at 1119.

subsequently sold the securities prior to his awareness of defendant's deceptive conduct.[56] The court in *Chasins* justified its departure from the traditional rule of damages by noting that the evil was not that plaintiff's purchase price was inflated, but that plaintiff was made to purchase at all without knowledge of defendant's interest in the securities.[57]

3. Rescission and Restitutionary Relief

In addition to modifying conventional measures of damages, courts may fashion equitable relief by allowing a plaintiff who moves with reasonable dispatch[58] to rescind a fraudulent transaction and seek specific restitution.[59] If the plaintiff or defendant no longer possesses the security, then the aggrieved party may obtain rescissory damages in lieu of specific restitution.[60] A contractual relationship with at least one defendant is a prerequisite to rescission,[61] but the transaction may be voided through operation of law pursuant to section 29(b) of the 1934 Act,[62] rather than through overt action by the plaintiff.[63]

In theory, the objective of rescissory damages is the return of parties to the status quo ante the sale; these damages constitute

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56. 438 F.2d at 1173.

57. *Id.* The court in Sarlie v. E.L. Bruce Co., 265 F. Supp. 371, 376 (S.D.N.Y. 1967), measured damages in a similar fashion, grounding its departure from the out-of-pocket rule in the fact that plaintiff sold his stock prior to discovery of the fraud, so that the actual value of the shares at the time of the fraudulent transaction, free of defendant's deceptive manipulation, could not be accurately determined.

58. *See, e.g.*, Baumel v. Rosen, 412 F.2d 571, 574 (4th Cir. 1969), *cert. denied*, 396 U.S. 1037 (1976) (plaintiffs' failure to act vigilantly cost them the right to rescind); Estate Counseling Serv. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527, 532 (10th Cir. 1962) (law requires plaintiff to act promptly or waive right to rescind).

59. Jacobs, *supra* note 16, at 1109-10. Courts, however, consider the rescission remedy a radical one. Baumel v. Rosen, 412 F.2d 571, 574 (4th Cir. 1969), *cert. denied*, 396 U.S. 1037 (1970); Cobine, *supra* note 8, at 673.

60. Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1342 (9th Cir. 1976) (Sneed, J., concurring in part); Myzel v. Fields, 386 F.2d 718, 742 (8th Cir. 1967); Note, *supra* note 45, at 371.

61. *See, e.g.*, Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1343 (9th Cir. 1976) (Sneed, J., concurring in part) (theory of rescission is rooted in a contract of sale); Estate Coanseling Serv. v. Merrill Lynch, Pierce, Feimer & Smith, Inc., 303 F.2d 527, 531 (10th Cir. 1962) (rescission remedy is based on invalidity of a contract); Jacobs, *supra* note 16, at 1110, 1120 & n.166 (citing Gordon v. Burr, 596 F.2d 1080 (2d Cir. 1974)).

62. 15 U.S.C. § 78cc (1976) (any contract made in violation of 1934 Act is void).

63. *See* Myzel v. Fields, 386 F.2d 718, 741-42 (8th Cir. 1967)(§ 29(b) renders void any contract made in violation of rule 10b-5). *Cf.* Mills v. Electric Auto-Lite Co., 396 U.S. 375, 387-88 (1970) (contract is voidable at the option of the innocent party); Jacobs, *supra* note 16, at 1111.

the monetary equivalent of specific restoration of the security in question on the day judgment is rendered.[64] Thus, as the court stated in *Gottlieb v. Sandia American Corp.*,[65] "damages will be awarded in the amount of the difference between the present market value of the consideration originally given and the consideration received."[66] This statement typically means that a defrauded seller will receive the fair market value of the security sold at the time of judgment, minus the purchase price he originally received; a defrauded buyer will receive the price he originally paid for the security, minus the security's fair market value at the time judgment is rendered.[67]

Just as the courts have modified the out-of-pocket rule, so have they injected some flexibility into the dates on which they measure rescissory damages. The most important and frequently used technique is to value the security on some earlier, posttransaction date rather than on the day of judgment.[68] The principal motivation for this change is a desire to induce plaintiffs to sue promptly, along with a corresponding reluctance to compensate plaintiff for his delay or to punish defendant for accretions beyond those resulting from the disposition of his stock or the perpetration of his fraud.[69] Accordingly, courts will often award rescissory damages equal to the difference between the fair market value of the security at the time the plaintiff discovered or should have discovered the fraud and the original consideration paid or received for

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64. Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1342 (9th Cir. 1976) (Sneed, J., concurring in part); Myzel v. Fields, 386 F.2d 718, 742 (8th Cir. 1967).

65. 304 F. Supp. 980 (E.D. Pa. 1969), *aff'd in part, rev'd in part on other grounds,* 452 F.2d 510 (3d Cir.), *cert. denied,* 404 U.S. 938 (1971).

66. *Id.* at 990 (citation omitted).

67. Assume, for example, that stock with a fair market value of $50 at the time of the transaction is sold for $40 in cash, and that the fair value of the stock is $100 on the date of judgment. A defrauded seller would recover $60 per share—the difference between this $100 and the value of the consideration received as of the judgment date (which is still $40). Similarly, if a defrauded buyer purchased for $50 cash a stock with a fair value of $40 on the date of the wrongful transaction and $20 on the date of judgment, he would recover $30 per share ($50 minus $20, or the fair value of the stock and consideration paid, both measured at the date of judgment).

68. Note, *supra* note 45, at 372. *See* Garnatz v. Stifel, Nicolaus & Co., 559 F.2d 1357, 1361 (8th Cir. 1977).

69. Note, *supra* note 45, at 372-73. *See also* Baumel v. Rosen, 412 F.2d 571, 574 (4th Cir. 1969), *cert. denied,* 396 U.S. 1037 (1970) (courts should require prompt movement for rescission because plaintiff should not be allowed to speculate, and with every day's lapse it is more difficult to return parties to status quo ante); Estate Counseling Serv. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527, 532 (10th Cir. 1962).

the stock.[70] A classic example of this flexible measure of recovery appears in *Garnatz v. Stifel, Nicolaus & Co.*,[71] in which defendants fraudulently induced a plaintiff of limited sophistication to purchase into a special bond margin account program by misrepresenting the safety of the investment. The Eighth Circuit in *Garnatz* noted that the out-of-pocket rule is not a talisman and that when use of this measure would deny plaintiffs any recovery, the measure should be varied to fashion a remedy best suited to the harm.[72] Consequently, the court awarded plaintiff damages equal to the decline in the value of his bonds, as determined by the losses sustained up to the time of plaintiff's actual or constructive notice of the fraud concerning both the bonds held and those sold.[73]

4. Disgorgement of Profits

In addition to developing several ways in which to compensate plaintiffs for losses resulting from rule 10b-5 violations, courts have also begun to award to an injured plaintiff that part of a defendant's unjust enrichment that exceeds plaintiff's loss.[74] This practice clearly runs counter to the early statement made by the court in *Kohler v. Kohler Co.*[75] that while a defrauded party may recover his loss, he may not recover any actual or potential gain received by the defendant.[76] The seminal authority for the proposition that a court should give a wrongdoer's profits to the injured party is

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70. Thus, in the example in note 67 *supra*, if the stock had risen to a value of only $90 at the time of discovery of the fraud, or conversely had only fallen to a value of $30 in the case of a defrauded buyer, these figures would be used instead of the respectively higher or lower values on the date of judgment. The defrauded seller wonld recover $50, and the defrauded buyer would recover $20.

71. 559 F.2d 1357 (8th Cir. 1977).

72. *Id.* at 1360.

73. *Id.* at 1361. Note that it is here, when plaintiff sells securities prior to the discovery of the fraud, that the distinction between this modified rescissory measure of damages and the *Chasins* measure breaks down. *See* notes 55-57 *supra* and accompanying text. *See also* Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1342-43 (9th Cir. 1976) (Sneed, J., concurring in part).

74. For example, if plaintiff suffered only a $10 loss attributable to defendant's misconduct, but defendant reaped a $100 gain due to unrelated market forces, then plaintiff could recover defendant's $100 windfall. This does not mean, however, that a plaintiff may cause a defendant to disgorge his unjust enrichment in the absence of a showing of some loss. Abrahamson v. Fleschner, 392 F. Supp. 740, 747 (S.D.N.Y.), *decision reserved pending further briefs*, 537 F.2d 27 (2d Cir. 1975), *aff'd in part, rev'd in part on other grounds*, 568 F.2d 862 (2d Cir. 1977), *cert. denied*, 436 U.S. 913 (1978).

75. 208 F. Supp. 808 (E.D. Wis. 1962), *aff'd*, 319 F.2d 634 (7th Cir. 1963).

76. *Id.* at 825.

Janigan v. Taylor,[77] in which defendants reaped substantial profits from the resale of stock that they acquired fraudulently through misrepresentations and omissions concerning a company's future growth prospects. The court in *Janigan* held that simple equity demands that defendants' future profits, even though unforeseeable at the time of the fraudulent transfer, be disgorged and awarded to the defrauded party.[78] Other federal courts have followed *Janigan*,[79] and the Supreme Court has placed its stamp of approval on the use of this method at least in defrauded seller cases.[80]

As originally formulated, the disgorgement of profits rule was applicable only to defrauded seller cases.[81] In *Zeller v. Bogue Electric Manufacturing Corp.*,[82] however, the Second Circuit eliminated this distinction by requiring disgorgement of a seller's windfall profits to a defrauded buyer. *Zeller* was a shareholder's derivative action in which a parent caused its subsidiary to make interest-free loans, the disclosure of which aborted the subsidiary's public offering. Plaintiffs sued for the profit that the parent realized on the loaned money, in addition to recovery of the principal and interest. The court found that prior case law did not distinguish between defrauded buyers and sellers and held that the law

77. 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

78. *Id.* at 786. In theory, the amount that defendant must disgorge does not include any amount that he ohtains through his own special efforts apart from the fraud. *Id.* at 787. In practice, however, courts have interpreted this limitation quite broadly. *See* Rochez Bros. v. Rhoades, 491 F.2d 402 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976) (court allowed disgorgement of profits on deal subsequent to one that motivated fraud, even though first deal fell through).

79. *See, e.g.*, Nelson v. Serwold, 576 F.2d 1332 (9th Cir. 1978), *cert. denied*, 439 U.S. 970 (1979); Rochez Bros. v. Rhoades, 491 F.2d 402 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976); Levine v. Seilon, Inc., 439 F.2d 328 (2d Cir. 1971) (no recovery because no loss shown); Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967).

80. Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972).

81. *Id.*; Levine v. Seilon, Inc., 439 F.2d 328, 334 (2d Cir. 1971); Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965). The rationale behind this distinction appears to have been twofold. First, since disgorgement of unjust enrichment is based in theory upon the proposition that an injured party should receive benefits he would otherwise have been in a position to obtain for himself, and since a defrauding seller normally uses the proceeds of his sale to enter into an entirely separate transaction, it is difficult for a defrauded buyer to contend that he would have made the same use of those funds. Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795, 862 n.10 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973). A defrauded seller, on the other hand, can show far more easily tbat he would have sold tbe security at the same time and for the same price as the fraudulent purchaser. *Id.* Second, a more practical consideration is "not any decisive legal difference but the difficulty generally confronting the defrauded buyer in showing that the fraudulent seller has in fact reaped such a profit." *Id.* at 802.

82. 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973).

of restitution could require that a defrauding seller disgorge his profits.[83] Moreover, in *Ohio Drill & Tool Co. v. Johnson*[84] the Sixth Circuit flatly stated that "[t]he proper standard of damages for either a defrauded seller or buyer under Rule 10b-5 is 'disgorgement of profits.' "[85]

5. Punitive Damages

For both policy and statutory reasons, courts generally agree that an aggrieved investor may not recover punitive damages when suing under section 10(b) and rule 10b-5.[86] Several courts have based their decision upon section 28(a) of the Exchange Act, holding that this section precludes punitive damages because it limits plaintiffs' recoveries to "actual damages."[87]

The Tenth Circuit discussed comprehensively the availability of punitive damages in securities fraud cases in *de Haas v. Empire Petroleum Co.*[88] The court stressed that absent direction from either section 28(a) itself or from the Act's legislative history, policy considerations should be overriding.[89] Noting that punitive damages serve the purposes of deterrence and retribution, as well as that of giving individuals an incentive to sue, the court then stated that the last purpose "could be especially important since private enforcement of the security laws is necessary due to the limited resources of the SEC."[90] Nevertheless, the court felt that, when combined with criminal sanctions, the already available deterrence mechanisms were potent if not adequate:

> [T]here is the threat of suspension of registrations, suspension of trading, or expulsion from a national securities exchange. Besides these express deterrents, there is the nebulous social stigma of being branded a knowing violator of the law.
>
> Perhaps the most important strengthening of securities laws enforcement has occurred with the liberalization of the class action under the revised Fed.

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83. *Id.* at 802.
84. 498 F.2d 186 (6th Cir. 1974).
85. *Id.* at 190.
86. *See* Gould v. American-Hawaiian S.S. Co., 535 F.2d 761, 784 (3d Cir. 1976); Flaks v. Koegel, 504 F.2d 702, 706 (2d Cir. 1974); Richardson v. MacArthur, 451 F.2d 35, 45 (10th Cir. 1971); de Haas v. Empire Petroleum Co., 435 F.2d 1223, 1229-31 (10th Cir. 1970); Green v. Wolf Corp., 406 F.2d 291, 302-03 (2d Cir. 1968).
87. *See* Gould v. American-Hawaiian S.S. Co., 535 F.2d 761, 784 (3d Cir. 1976); Richardson v. MacArthur, 451 F.2d 35, 45 (10th Cir. 1971); Green v. Wolf Corp., 406 F.2d 291, 302 (2d Cir. 1968).
88. 435 F.2d 1223 (10th Cir. 1970).
89. *Id.* at 1230. *Accord*, Green v. Wolf Corp., 406 F.2d 291, 302-03 (2d Cir. 1968) (must look at Act's purpose since legislative history does not deal with intent behind § 28(a)).
90. 435 F.2d at 1230.

> R. Civ. P. 23. . . . Since these procedural devices allow many small claims to be litigated in the same action, the overall size of compensatory damages alone may constitute a significant deterrent.[91]

Moreover, the *de Haas* court pointed out that one potential problem with punitive damages was that the burden of these recoveries might fall on innocent stockholders if the defendant is a public corporation.[92] Additionally, the court noted that juries might award excessive amounts; even though the court acknowledged that judicial controls over verdicts could reduce this danger, it felt that postverdict procedures were only indicative of initial failures in the judicial process. Perhaps the greatest problem, in the Tenth Circuit's view, was how to deal with the case in which multiple plaintiffs sue in different courts or at different times, since this might result in either excessive recoveries or windfalls to plaintiffs who sue promptly and inequitable restrictions on those who are late. The court therefore concluded that these problems outweighed any need for added deterrence and held that punitive

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91. *Id.* at 1230-31. Other courts have stressed the same factors in much the same way. For example, in Green v. Wolf Corp., 406 F.2d 291 (2d Cir. 1968), the court said,

> We do not believe that Congress intended the Securities and Exchange Act to be used as a vehicle for the recovery of judgments that could often be grossly disproportionate to the harm done.
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> . . . .
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> Nor are punitive damages needed as a deterrent in this area. In cases such as this it is possible that corporations and even other individuals such as officers, would be subject to crushing liabilities simply on the basis of actual damages because of the cumulative injury that a misstatement concerning widely held stock can cause. . . . [C]lass actions, derivative suits and other such procedural devices provide sufficient incentive to insure that those injured by a violation of 10b-5 will have adequate opportunity to confront alleged malefactors and to have appropriate sanctions imposed upon them. Moreover as an added deterrent the Securities Exchange Act of 1934 contains provisions imposing criminal penalties on violators.

Id. at 303 (citations omitted). In a later action, the Second Circuit applied the same rationale in a case decided under § 17(a) of the Securities Act of 1933. After noting that there is deterrence through criminal sanctions, SEC expulsions and suspensions, and the possibility of being labelled a knowing violator of the law, the court stated,

> Furthermore, private actions often lead to sizable [sic] recoveries and to considerable deterrent clout. In Green v. Wolf Corp. . . . we recognized that a class action under Fed. R. Civ. P. 23 could be particularly effective and appropriate in remedying violations of the securities acts when the injury to any individual was not large enough to provoke him to legal action. Thus, a recurring rationale for punitive damages—that the lure of a windfall is required to encourage suits to enforce the Act—has lesser impact where the class action for the small litigant would be appropriate. Compensatory damages, especially when multiplied in a class action, have a potent deterrent effect.

Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1285 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970) (citations omitted).

92. 435 F.2d at 1230. Another court has made the same point. Green v. Wolf Corp., 406 F.2d 291, 303 (2d Cir. 1968).

damages were not recoverable in a private action under rule 10b-5.[93]

Although *de Haas* is clearly representative of the great weight of authority, not all courts have completely foreclosed the possibility of punitive damages in a rule 10b-5 case. For example, some courts have held that a court may award punitive damages on a pendent state claim brought in conjunction with a federal securities law cause of action.[94] Perhaps the most notable case to award punitive damages is *Hecht v. Harris, Upham & Co.*,[95] in which a federal district court reasoned that since section 28(a) applies only to damage suits "permitted to be maintained . . . under the provisions of this chapter," implied causes of action based on tort principles are free from that section's limitations.[96] This rationale, however, may not have been necessary, because the *Hecht* court applied it on the expressed assumption that the term "actual damages" is used in section 28(a) in contradistinction to punitive damages, rather than merely in contradistinction to a possible double recovery on more than one cause of action, or to a recovery in excess of a plaintiff's loss.[97] Indeed, some courts have at least implicitly acknowledged that this latter construction is a defensible one.[98]

6. Summary

If a trend can be distilled from the myriad remedies and measures of damages used by courts in face-to-face transactions, it is a movement away from traditional rigid formulae in order to effectuate the dual purposes of rule 10b-5—to deter misconduct and to compensate injured investors.[99] Thus, practical distinctions among the out-of-pocket rule as modified,[100] the *Chasins* measure,[101] and the rescissory damages measure as calculated prior to the date of judgment[102] often evaporate,[103] so that regardless of the theoretical

93. 435 F.2d at 1230-32.

94. *See* Flaks v. Koegel, 504 F.2d 702, 706-07 (2d Cir. 1974); Gilbert v. Bagley, 492 F. Supp. 714, 742-43 (M.D.N.C. 1980).

95. 283 F. Supp. 417 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970).

96. *Id.* at 444 (quoting § 28(a)).

97. *Id.*

98. *See* de Haas v. Empire Petroleum Co., 435 F.2d 1223 (10th Cir. 1970); Green v. Wolf Corp., 406 F.2d 291, 302-03 (2d Cir. 1968).

99. *See* Note, *supra* note 5, at 77-79; note 26 *supra*.

100. *See* notes 37-44 *supra* and accompanying text.

101. *See* notes 55-57 *supra* and accompanying text.

102. *See* notes 67-73 *supra* and accompanying text.

underpinnings of an award, the court calculates it as the difference between the fair market value of the security upon discovery of the fraud (or the resale price if plaintiff sells prior to this discovery[104]) and the consideration paid or received.[105] In this way, courts compensate plaintiffs for posttransaction declines or appreciations in their manipulated securities. In addition, courts under rule 10b-5 have required disgorgement of a defendant's unjust enrichment in order to ensure that violations of the rule are unprofitable and that its deterrence purpose is attained.[106] Perhaps the best summary of this trend is in *Nelson v. Serwold*,[107] in which the court said,

> The early cases generally awarded the difference between the value given and the value received, but the recent trend looks to defendant's profits, rather than to plaintiff's losses, in measuring damages. . . .
>
> . . . .
>
> This rule provides full compensation for injury caused by fraudulent conduct, and, significantly, it removes all incentive to engage in such conduct.[108]

C. *The Open Market Problem and Initial Attempts to Find a Solution*

A court can achieve the dual goals of compensation and deterrence relatively easily in face-to-face transactions, since a plaintiff's losses are generally equivalent to a defendant's gains in direct "deals." In the open market, however, this balance is often disrupted[109] and thus the policy of reasonable deterrence may collide with the goal of compensating fully each individual plaintiff.[110] As a result, the measures of damages used in face-to-face situations may not be suitable in the open market setting.[111]

A rescissory measure of damages, for example, is grounded in

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103. *See* notes 55-57 *supra* and accompanying text; note 73 *supra* and case cited therein.

104. *See* notes 55-57 *supra* and accompanying text; note 73 *supra* and case cited therein.

105. *See* notes 41, 56 & 68-73 *supra* and accompanying text.

106. Nelson v. Serwold, 576 F.2d 1332, 1338-39 (9th Cir. 1978), *cert. denied,* 439 U.S. 970 (1979). *See* notes 74-85 *supra* and accompanying text.

107. 576 F.2d 1332 (9th Cir. 1978), *cert. denied,* 439 U.S. 970 (1979). This case has been noted in 12 LOY. L.A.L. REV. 233 (1978).

108. 576 F.2d at 1338.

109. *See* Note, *Insiders' Liability Under Rule 10b-5 for the Illegal Purchase of Actively Traded Securities,* 78 YALE L.J. 864, 891 (1969). The basic problem stems from the fact that buyers' and sellers' orders are extremely difficult and often impossible to match in an impersonal market.

110. *See* Note, *supra* note 5, at 79.

111. *See* Note, *supra* note 9, at 306; Note, *supra* note 45, at 371; notes 112-15 *infra* and accompanying text.

the notion that a contract of sale is voided and restitution achieved; yet in the open market there is no privity between purchasers and sellers, nor is there a contract of sale.[112] Moreover, while a subjective determination of what a plaintiff would have done absent any deceptive misconduct is necessary for most damage calculations in face-to-face transactions, such a precise determination for each of the potentially thousands of plaintiffs in an impersonal market is impracticable.[113] Additionally, conflicts may arise among different plaintiffs concerning the valuation of securities on particular trading days;[114] while this does not necessarily defeat class action certification,[115] it is nevertheless unwieldy. By far the largest problem with the use of any of the conventional measures of damages in the open market, however, is the potential for recoveries vastly disproportionate to either the defendant's gain or his wrongdoing, since to compensate each plaintiff's loss during the period of nondisclosure or ignorance of the fraud could result in staggering sums.[116] Prior to *Elkind,* courts had not definitively resolved these problems, although they had set forth some possible solutions. In this connection current courts are confronted with two questions: first, to what class of plaintiffs are defendants liable, and second, what is the amount that each plaintiff will receive?[117]

The first case squarely to consider damages in a private 10b-5 action[118] against insiders in an impersonal market was *Mitchell v. Texas Gulf Sulphur Co.*[119] The court held defendant company liable for failure to make timely disclosure of a substantial drilling

112. Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1342-43 (9th Cir. 1976) (Sneed, J., concurring in part).

113. *See* Jacobs, *supra* note 16, at 1107-08; Note, *supra* note 45, at 373, 376.

114. *See* Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1341-46 (9th Cir. 1976) (Sneed, J., concurring in part); Blackie v. Barrack, 524 F.2d 891, 907-09 (9th Cir. 1975), *cert. denied,* 429 U.S. 816 (1976).

115. Blackie v. Barrack, 524 F.2d 891, 909 (9th Cir. 1975), *cert. denied,* 429 U.S. 816 (1976).

116. Fridrich v. Bradford, 542 F.2d 307, 323 (6th Cir. 1976) (Celebrezze, J., concurring), *cert. denied,* 429 U.S. 1053 (1977); Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1343 (9th Cir. 1976) (Sneed, J., concurring in part); Jacobs, *supra* note 16, at 1130-31; Note, *supra* note 9, at 306.

117. Jacobs, *supra* note 16, at 1130.

118. Prior to *Mitchell,* the Second Circuit in SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262 (S.D.N.Y.), *aff'd in part,* 401 F.2d 833 (2d Cir. 1968), *on remand,* 312 F. Supp. 77 (S.D.N.Y.), *aff'd,* 446 F.2d 1301 (2d Cir. 1971), had ordered defendants to disgorge their profits from the same transaction involved in *Mitchell,* leaving it to private litigants to file their claims for compensation from this fund. 312 F. Supp. at 92.

119. 446 F.2d 90 (19th Cir.), *cert. denied,* 404 U.S. 1004 (1971).

discovery, as well as for the issue of a press release that was inaccurate, misleading, and deceptive in its guarded assessment of the size of the discovery. Plaintiffs in *Mitchell* were investors who sold their shares prior to a later curative press release, which resulted in a sharp upturn in the market price of Texas Gulf Sulphur (TGS) stock. After rejecting the argument that open market investors should be protected by rule 10b-5 only through SEC enforcement actions,[120] the court held that all investors who had relied on the misleading release could recover, since the release was a substantial factor contributing to plaintiffs' course of conduct.[121] As for damages, the court determined that the case was inappropriate for any form of restitution[122] and decided that the proper measure was the amount it would have taken plaintiffs to reinvest in TGS stock within a reasonable time after being informed of the curative press release. The court thus used the "cover" measure, calculating the difference between the highest value achieved by the TGS stock—during the period allowed after disclosure for plaintiffs to become apprised of the situation and to reinvest—and the consideration originally received for the shares.[123]

After *Mitchell*, a district court reached an entirely different result in *Reeder v. Mastercraft Electronics Corp.*,[124] although it still attempted to rely upon conventional damage computations used in face-to-face transactions. Plaintiffs in *Reeder* purchased stock in a corporation that had misrepresented its marketing prospects. Employing a broad interpretation of the scope of rule 10b-5, the court held that reliance is unnecessary in an open market transaction even if the wrongdoing involves misrepresentation.[125] In awarding damages, the *Reeder* court held that "plaintiffs [who have not sold their stock] may recover their entire purchase price. . . . Plaintiffs who sold their stock may recover the difference between their purchase price and the price at which they sold their shares."[126] Thus, the court fashioned an eclectic remedy that gave strict rescission to plaintiffs who still possessed their shares and

120. *Id.* at 101.

121. *Id.* at 101-02.

122. *Id.* at 105. The court found that there was no privity between the parties upon which to base the remedy, and that to make restitution for each investor would cause undue hardship on the corporation. *Id.*

123. *Id.* at 104-06.

124. 363 F. Supp. 574 (S.D.N.Y. 1973).

125. *Id.* at 581.

126. *Id.* at 581-82.

Chasins-type recovery to those investors who had already resold.[127]

Judge Sneed of the Ninth Circuit refuted the use of a rescissory method of calculating damages in an often cited concurrence in *Green v. Occidental Petroleum Corp.*[128] *Green* concerned an attempt by defendants to attack class action certification by way of a writ of mandamus, which the majority refused to issue. Judge Sneed argued that if the court based certification upon the assumption that it would use a rescissory measure of damages, then it would be an abuse of discretion for the trial judge to certify the class action.[129] While noting that there are theoretical difficulties with a rescissory theory in the open market because there is neither privity nor an undertaking by defendant to assume responsibility for plaintiff's loss, Judge Sneed asserted that it would be inappropriate to hold defendant liable for the full decline in value of plaintiff's stock between the purchase date and the date of the disclosure of the fraud, when only a portion of that diminution may have been proximately caused by the defendant's wrong.[130] If, on the other hand, the court based certification upon the assumption that a strict out-of-pocket measure of damages would be used, Judge Sneed felt that certification would not be an abuse of the trial judge's discretion.[131] A "price line" and a "value line" could be set up for each day between the misrepresentations and the date of disclosure, and plaintiffs could recover the difference between the price paid or received for the security and its actual value on the date of the fraudulent transaction.[132] According to Judge Sneed, this out-of-pocket measure "furthers the purpose of rule 10b-5 without subjecting the wrongdoer to damages the incidence of which resembles that of natural disasters."[133]

Perhaps the most well-known case to address the scope of a plaintiff class for an open market violation is *Shapiro v. Merrill*

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127. *See* Note, *supra* note 5, at 99.

128. 541 F.2d 1335 (9th Cir. 1976).

129. *Id.* at 1341-44 (Sneed, J., concurring in part).

130. *Id.* at 1341-43 (Sneed, J., concurring in part). Judge Sneed stated that the measure is what the purchasers lost as a result of defendant's wrong, not what the defendant gained. Thus, he claimed that the rescissory measure of damages does not accurately measure that loss; instead, it awards market decline unrelated "both to any benefits derived by the defendant from his fraud and to the blameworthiness of his conduct." *Id.* at 1342 (Sneed, J., concurring in part).

131. *Id.* at 1344-46 (Sneed, J., concurring in part).

132. This formula would be modified somewhat for those investors who sell prior to disclosure. *Id.* (Sneed, J., concurring in part).

133. *Id.* at 1344 (Sneed, J., concurring in part).

Lynch, Pierce, Fenner & Smith, Inc.[134] In *Shapiro* an underwriter attempted to protect its customers' investments by disclosing nonpublic information to them about the imminent plunge in the earnings of a company. The customers naturally traded their shares in anticipation of the stock's decline. Plaintiffs asked for damages for their "substantial losses"[135] as well as an accounting of defendants' profits, claiming that they would not have purchased the stock had they been privy to the inside information. Defendants attempted to limit the class of plaintiffs to purchasers of the actual stock that defendants sold, but the court rejected this argument, saying that "it would make a mockery of the 'disclose or abstain' rule if we were to permit the fortuitous matching of buy and sell orders [to determine liability]."[136] The court went on to hold that, in order to effectuate the policy of the Act,[137] defendants could be held liable in a private action for damages to all persons who purchased the stock in the open market during the period of nondisclosure without knowledge of material inside information.[138] The *Shapiro* court refused to distinguish between nontrading tippers and trading tippees.[139] Defendants, however, claimed that since plaintiffs would have purchased the stock regardless of defendants' rule 10b-5 violations, those infractions neither caused plaintiffs' loss nor induced their reliance. Repudiating this argument, the court held that a plaintiff proves reliance and causation if he shows that he would have acted differently if the inside information had been disclosed to him.[140] The *Shapiro* court, however, declined to award damages, remanding the issue to the district court because certain facts were not apparent from the existing record.[141] In remanding, the court said that it was "not unmindful" of defendants' arguments against a potential "Draconian liability," and that it did not "foreclose the possibility" that the district court might limit the extent of defendants' liability according to

134. 495 F.2d 228 (2d Cir. 1974), *on remand*, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,377 (S.D.N.Y. 1975).

135. *Id.* at 236.

136. *Id.*

137. The court stated that "the purpose behind Section 10(b) and rule 10b-5 is to protect the investing public and to secure fair dealing in the securities markets by promoting full disclosure of inside information so that an informed judgment can be made by all investers who trade in such markets." *Id.* at 235.

138. *Id.* at 237.

139. *Id.*

140. *Id.* at 238-39.

141. *Id.* at 241. The court mentioned as absent facts such as the paramaters of the class action and the extent of defendants' trading and their expenses.

the character of their violations.[142]

The Sixth Circuit in *Fridrich v. Bradford*[143] reached a conclusion diametrically opposed to that in *Shapiro* concerning the scope of defendant's liability for an open market violation. Defendant in *Fridrich* violated rule 10b-5 by failing to disclose negotiations for an upcoming merger and by purchasing shares of the acquiring corporation in anticipation of a price surge in its stock. The district court held that all purchasers during the period of nondisclosure could recover in accordance with the "cover" measure of damages. On appeal, however, the Sixth Circuit expressed concern that this measurement would subject defendant to liability to investors who sold their stock to traders other than him when there was no proof that his trading activities had any impact upon the stock's price or upon the plaintiff's decision to trade.[144] The court concluded that it must place some limitation upon recovery in the open market in order to avoid individual injustice, discouragement of corporate ownership by officers and directors, and compensatory recoveries disproportionate to either a defendant's gain or to his wrongdoing.[145] This conclusion prompted the *Fridrich* court to de-

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142. *Id.* at 242. On remand the district court also failed to reach the question of measurement of damages, holding only that the class requested was appropriate. The court, however, did say that

> [p]olicy considerations favoring vigorous enforcement of the antifraud laws must be weighed against the potential consequences of unrestrained damages. Where a "Draconian" liability is possible, a court may be more reluctant than otherwise to find liability. Rnle 10b-5 was not intended to provide a general investors' indemnity. Lest its sweep destroy legitimate business activity in an attempt to preserve market integrity, this severe Rule must be applied carefully. Similarly, the various functions of 10b-5—compensatory, deterrent and prophylactic—must be examined in devising suitable damages. Availability of the class action procedure will profoundly affect the maintenance and prosecution of antifraud actions. For example, if recovery amounts to disgorgement of illegal profits, . . . it will be limited to a fixed sum determined by *X* dollars per share *sold by defendants.* The recovery by the class would be the same regardless of class size, a result which might in certain instances provide an incentive for the representative to limit the plaintiff class . . . . On the other hand, if damages are measured by *X* dollars per share *purchased by plaintiffs,* multiplied by tbe number of shares, purchased during the relevant period of liability, then the recovery will vary directly with the class size. This type of award is restitutional.
>
> . . . Unfortunately, the parties have not presented briefs addressing these questions, which must await trial for resolution.

Sbapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,377, at 98,883-84 (1975) (empbasis added) (citations omitted).

143. 542 F.2d 307 (6th Cir. 1976), *cert. denied,* 429 U.S. 1053 (1977).

144. *Id.* at 308.

145. *Id.* at 309, 313, 320, 322 n.33. As the court noted,

> Where private civil actions under Rule 10b-5 have been employed in essentially face-to-face situations, the potential breadth of the action was usually contained. How-

termine that the scope of the civil remedy need not invariably be coextensive with the reach of the SEC enforcement actions.[146] While the private right of action is a necessary enforcement supplement to SEC action, the court felt that the private action's primary purpose is to compensate plaintiffs for damages caused by a defendant's illegal acts.[147] The *Fridrich* court distinguished *Affiliated Ute Citizens v. United States*,[148] in which the Supreme Court held that proof of causation and reliance is subsumed in proof of materiality or "causation in fact." The court reasoned that the personal relationship among the parties and plaintiffs' justifiable expectation of full disclosure in *Affiliated Ute* were not present in the impersonal transaction in *Fridrich*.[149] The court then pointed to *Joseph v. Farnsworth Radio & Television Corp.*,[150] in which a district court held that some "semblance of privity" must exist between seller and purchaser,[151] and reversed the lower court's finding of liability because there was neither this semblance of privity nor a sufficient causal connection between defendant's misconduct and plaintiff's loss.[152] Thus, nnder this approach, a plaintiff must show more than the materiality of the undisclosed information[153] unless he is in the class of investors trading contemporaneously with the insider and thereby a proper beneficiary of the relaxed causation standard in *Affiliated Ute*.[154] According to *Fridrich*, the

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ever, extension of the private remedy to impersonal market cases where plaintiffs have neither dealt with defendants nor been influenced in their trading decisions by any act of the defendants would present a situation wholly lacking in the natural limitations on damages present in cases dealing with face-to-face transactions.

Id. at 321.

146. *Id.* at 320. The court stated that "[t]he key issue . . . is not whether . . . Rule 10b-5 should encompass open market transactions, *which they should*, but whether the civil remedy must invariably be coextensive in its reach with the reach of the SEC. . . ." *Id.* (emphasis added).

147. *Id.* at 314. The logical extension of these arguments is that if there is to be a limitation on recovery as well as compensation of all plaintiffs, the limitation must be in the nature of a smaller class of plaintiffs.

148. 406 U.S. 128 (1972).

149. 542 F.2d at 319-20.

150. 99 F. Supp. 701 (S.D.N.Y. 1951), *aff'd*, 198 F.2d 883 (2d Cir. 1952).

151. *Id.* at 706.

152. 542 F.2d at 317-19.

153. *Id.* at 326 (Celebrezze, J., concurring).

154. *Id.* As for deterrence, the court pointed out that SEC investigations, criminal sanctions, and SEC disgorgement actions are available in addition to this private action. The court further remarked that "[w]hether the sanctions imposed upon the defendants here together with others which were also available amount to a sufficient vindication of the public rights and to an adequate deterrent to future misconduct we need not say. We may at least observe that the impact is bound to be significant." *Id.* at 322.

logical inconsistency of *Shapiro* was its assumption that the denial of material information itself caused plaintiff's injury. *Fridrich*, however, assumed that the loss resulted from the *trading* on that information:

> We conceive it be the act of trading which essentially constitutes the violation of Rule 10b-5, for it is this which brings the illicit benefit to the insider, and it is this conduct which impairs the integrity of the market and which is the target of the rule. If the insider does not trade, he has an absolute right to keep material inside information secret. Investors must he prepared to accept the risk of trading in an open market without complete or always accurate information. Defendants' trading did not alter plaintiffs' expectations when they sold their stock, and in no way influenced plaintiffs' trading decision.
>
> We hold, therefore, the defendants' act of trading with third persons was not causally connected with any claimed loss by plaintiff who traded on the impersonal market and who were otherwise unaffected by the wrongful acts of the insider.[155]

In a noteworthy concurrence Judge Celebrezze expanded on the *Fridrich* majority's rationale. He noted that since the mechanics of an impersonal market make it impossible to match buy and sell orders, insiders owe a duty of disclosure to all investors who trade on the market during the period of insider trading.[156] Noncontemporaneous traders do not, according to Celebrezze, "require the special protection of the 'disclose or abstain' rule because they do not suffer the disadvantage of trading with someone who has superior access to information."[157] When tipping of inside information is at issue, however, the situation is changed because the insider has perpetuated the informational imbalance and created a situation that only full public disclosure will remedy. Since *Shapiro* was such a case, Judge Celebrezze conceded that the court in that case may have properly defined the class of potential plaintiffs.[158]

In addition to the solutions to the open market problem proffered by the courts, commentators have suggested even more possibilities.[159] A number of them have submitted that deterrence rather than compensation should be the overriding concern of courts in open market transactions.[160] One commentator in partic-

155. *Id.* at 318-19 (citations omitted).

156. *Id.* at 324 (Celebrezze, J., concurring).

157. *Id.* at 326 (Celebrezze, J., concurring).

158. *Id.* at 327 (Celebreeze, J., concurring).

159. For a discussion of several of these possibilities, see Jacobs, *supra* note 16, at 1131-37.

160. Note, *supra* note 5, at 100-01; Note, *Limiting the Plaintiff Class: Rule 10b-5 and the Federal Securities Code,* 72 MICH. L. REV. 1398, 1429-30 (1974).

ular suggested that the solution outlined in the American Law Institute's proposed Federal Securities Code,[161] which limits recovery by placing a ceiling on the amount of defendant's damages equal to his profits rather than by narrowing the plaintiff class, deserves serious consideration.[162] The court in *Elkind* agreed and adopted in full the proposed Code's measure of damages for open market fraud.

III. Limited Recovery: The New Approach in *Elkind v. Liggett & Myers, Inc.*[163]

Elkind involved corporate officers who tipped material inside information to financial analysts, who in turn persuaded some of their customers to trade based upon that information. In 1971 Liggett & Myers, Inc. (Liggett) enjoyed a record year, and the consensus among analysts in the financial community was that 1972 would be an equally prosperous year for the company. Liggett itself, though less sanguine internally than were the analysts, was also optimistic and generally represented that it was going to have a "good year."[164]

Beginning in May of 1972, however, the Liggett board of directors began to receive information indicating that earnings for the second quarter would show a dramatic decline. As this information became more conclusive, the Liggett directors decided to issue a press release stating that earnings would be down. In anticipation of this press release, which was issued on July 18, two corporate insiders made two separate "tips" to financial analysts concerning the upcoming public statement. The first alleged "tip," which eventually resulted in the sale of 100 shares of Liggett stock, was made on July 10 by Liggett's Director of Corporate Communications to an analyst at Kuhn Loeb & Co. The tipper confirmed that certain sales were slowing and that competition was stiffening, and responded noncommittally to the question whether a ten percent decline in earnings was a realistic projection. Liggetts' chief

161. ALI Fed. Sec. Code §§ 1603, 1703(b), 1708(b), 1711(j) (1978 draft). The Code's solution focuses on deterrence and allows for compensation only if practicable. Note, *supra* note 160, at 1431. The court in *Fridrich* rejected this scheme because it felt that courts were unsuited for this type of rulemaking. Fridrich v. Bradford, 542 F.2d 307, 322 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977).

162. Note, *supra* note 160, at 1430-31.

163. 635 F.2d 156 (2d Cir. 1980).

164. *Id.* at 160. In fact, Liggett issued a press release in March of 1972 stating that the first two months of 1972 had been good months for the company; in April the company offered a $50 million debenture issue. *Id.* at 159.

financial officer made the second tip, which consisted of an affirmative response to the analyst's question whether earnings would be down, and which occurred one day before the company's press release. This second tip carried the qualification that this information was confidential, but it resulted in the sale of 1800 Liggett shares by the analyst's customers.[165]

In a class action plaintiffs contended, among other things, that both of these tips constituted violations of section 10(b) and rule 10b-5 for which defendant corporation should be held liable for damages. The trial court found both tips to be in violation of rule 10b-5 and held defendants liable for damages to all plaintiffs who purchased Liggett stock from the time of trading on the first "tip," which was on July 11, 1972, to the time the inside information was made public on July 17, 1972. Following the theory that the measure of damages should be the difference between the price paid and the price plaintiff would have paid had there been disclosure of the adverse information, the court turned to the *Mitchell* case to find that the latter figure was the *lowest* value reached by the Liggett stock during a reasonable period after disclosure long enough for investors to have become apprised of the situation.[166] The court then estimated that this method would yield a total recovery of approximately $740,000 and refuted defendant's claim that this was a "Draconian liability."[167]

On appeal, the Second Circuit reversed the finding of liability on the first tip because of a lack of either materiality or scienter. The court, however, held that the July 17 tip was sufficiently related to earnings to be material and that there was ample evidence to support a finding of scienter in connection with this tip. This

165. *Id.* at 161.

166. 472 F. Supp. 123, 130-35 (S.D.N.Y. 1978). The district court first set up a "price line" and a "value line" similar to that suggested by Judge Sneed in his *Green* concurrence and awarded each plaintiff the difference between the price paid for his Liggett shares and the lower amount he would have had to pay had the tipped information been disclosed. The court then estimated that the total amount of recovery would be approximately $791,000. In its opinion amending findings of fact and conclusions of law, however, the district court altered this method because it felt that the evidence used to arrive at the figures of what Liggett stock would have sold for on the days in question was unreliable.

167. 472 F. Supp. at 134-35. The court reasoned that the damages were "necessary to effectuate the purpose of 10b-5 as well as to partially compensate plaintiffs for the losses which they suffered." *Id.* at 134. It noted that not all plaintiffs would file claims and that Liggett's net operating profits had exceeded $30 million in both 1971 and 1972. The court also cited *Fridrich* for the proposition that a court is ill-suited to adopt the ALI Federal Securities Code solution, but it distinguished *Fridrich* by pointing to Judge Celebrezze's comment that liability should be broader when tipping is involved. *See* notes 156-58 *supra* and accompanying text.

partial reversal further limited the class of plaintiffs to those who purchased Liggett stock between the afternoon of July 17 and the close of the market on July 18.

The court then addressed the question of damages, noting at the outset that this was a matter of first impression.[168] Judge Mansfield's majority opinion pointed out that the lower court had used the "out-of-pocket" measure employed in face-to-face transactions, but it noted that the element of inducement by misrepresentation or omission found in face-to-face transactions was lacking in an impersonal market.[169] The court then reiterated the established rule that the public has no absolute right to know inside information, but that it is entitled to an honest market. Therefore, according to the court in *Elkind*, the combination of the tip and the tippee's trading in the market is the evil to be thwarted. Thus, if the insider chooses not to trade on the inside information, then the investor can claim no injury.[170]

Having thus differentiated the case at hand from face-to-face transactions, the Second Circuit stated that courts should construe flexibly the securities laws in general and damages in particular. Discussing several possible damage measures, the court rejected the lower court's out-of-pocket measure for three reasons: first, it presupposes an element of directly traceable inducement that is present in a face-to-face transaction but lacking in an impersonal market; second, proof of the actual value absent the fraudulent conduct is speculative;[171] and last, there is potential for the imposition of "exorbitant" damages that are disproportionate to the wrong committed and that "lin[e] the pocket of all interim investors and their counsel at the expense of innocent corporate stockholders."[172] The court also dismissed as unworkable the "causation-in-fact approach" to damages, which allows recovery solely for the erosion in market value of the stock that is directly traceable

168. 635 F.2d at 168.

169. *Id.* at 168-69.

170. *Id.* at 169.

171. *Id.* at 169-70. The court noted that this problem had led some courts, including the court below, to value the fair value of the stock by reference to postpublic disclosure market prices. *See* notes 37-44 *supra* and accompanying text. According to the court, this practice rested on the often invalid assumptions that the tipped information is virtually identical to that later disclosed, and that public reaction in the market to disclosure is approximately the same as it would have been at an earlier date. *Id.* at 170.

172. *Id.* According to the court, this would be particularly inequitable in a case in which a tippee sells a few shares of heavily traded stock that drops substantially when the public information is disclosed. *Id.*

to the tipper's wrongful trading. While conceding that the latter measure has the advantage of avoiding windfall damages and awarding only those losses that are actually caused by the fraud, the court held that these benefits are outweighed by the almost impossible burden of proving how the insider trading affected the market and by the measure's failure to allow recovery for violation of a duty to disclose.[173]

The *Elkind* court then adopted a third alternative:

> (1) to allow any uniformed investor, where a reasonable investor would either have delayed his purchase or not purchased at all if he had had the benefit of the tipped information, to recover any post-purchase decline in market value of his shares up to a reasonable time after he learns of the tipped information or after there is a public disclosure of it but (2) limit his recovery to the amount gained by the tippee as a result of his selling at the earlier date rather than delaying his sale until the parties could trade on an equal informational basis.[174]

The court thus embraced the "disgorgement measure" recommended by the proposed Federal Securities Code.[175] According to the court, a disgorgement calculation deters misconduct by depriving tippers and tippees of any gain, while simultaneously avoiding windfall recoveries and the proof problems of the other measures.[176] Additionally, the court reasoned that "[i]n most cases the damages recoverable under the disgorgement measure would be roughly commensurate to the actual harm caused by the tippee's wrongful conduct."[177]

The court acknowledged that there were difficulties with the

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173. *Id.* at 171. The court noted that it is especially difficult to isolate a rise or decline in market value attributable to a defendant's misconduct when the tippee trades only moderately in a heavily traded stock. *Id.*

174. *Id.* at 172. The court posod the hypothetical that if the tippee sold 5,000 shares at $50 per share and the stock dropped to $40 per share within a reasonable time after disclosure, then plaintiffs could recover their losses up to a ceiling of $50,000 (5,000 shares multiplied by the $10 per share decline in market value that is the tippee's gain). *Id.*

175. *See* notes 161-62 *supra* and accompanying text.

176. A plaintiff under the *Elkind* holding must prove only the following: First, his purchase price and the number of shares bought; second, that a reasonable invester would have altered his purchase decision if he had been in possession of the inside information; and last, the price to which the security had fallen when he learned of the information, or within a reasonable time after it became public. 635 F.2d at 172.

177. *Id.* The court reasoned that

> [i]n a case where the tippee sold only a few shares, for instance, the likelihood of his conduct causing any substantial injury to intervening investors buying without benefit of his confidential information would be small. If, on the other hand, the tippee sold large amounts of stock, realizing substantial profits, the likelihood of injury to intervening uninformed purchasers would be greater and the amount of potential recovery thereby proportionately enlarged.

Id.

measure. It noted that the disgorgement theory modifies the proposition that gain to a defendant should not be a touchstone for rule 10b-5 liability and partially duplicates SEC disgorgement proceedings. The court conceded the possibility of windfall recoveries when the market in a stock is unusually depressed due to causes unrelated to the insider trading, but it also recognized the possibility that claimants will sometimes be limited to pro rata shares and that class actions will be too nonremunerative to be worthwhile. Nevertheless, the *Elkind* court concluded that "as between the various alternatives we are persuaded, after weighing the pros and cons, that the disgorgement measure, despite some disadvantages, offers the most equitable resolution of the difficult problems created by conflicting interests."[178]

IV. Analysis

Although *Elkind* reached an unprecedented result, its limitation on recovery and its use of defendant's profits as a ceiling should not be surprising to one familiar with the background on rule 10b-5 damages. A number of commentators had agreed with the scheme envisioned by the proposed Federal Securities Code.[179] Moreover, the *Shapiro* holding that all plaintiffs during the period of nondisclosure can recover upon establishing materiality severely restricted the Second Circuit in its choice of damages limitations. Perhaps equally ominous was the trend in face-to-face transactions toward requiring disgorgement of a wrongdoer's profits[180] and the admonition by courts against a damage award that is disproportionate to defendant's gain or to his misconduct.[181] Furthermore, there can be no doubt that the limited recovery contemplated by *Elkind* represents a continuation of the current inclination in rule 10b-5 cases to narrow the rule's reach. Since the Supreme Court has more strictly defined the elements for determining liability, such as scienter and materiality,[182] it is only logical that damage awards should also be circumscribed. In fact, Judge Celebrezze in his *Fridrich* concurrence explicitly noted the implications of recent Supreme Court decisions for the direction that lower federal courts should take in fashioning civil remedies.[183] Thus, although at first

178. *Id.* at 173.
179. *See* notes 161-62 *supra* and accompanying text.
180. *See* notes 74-85 *supra* and accompanying text.
181. *See* note 16 *supra* and accompanying text.
182. *See* note 7 *supra* and accompanying text.
183. Fridrich v. Bradford, 542 F.2d 307, 323 (6th Cir. 1976) (Celebrezze, J., concur-

blush the *Elkind* decision may appear to signal a sharp departure from prior decisional law, recent trends in the area augured just such a result.

Whether one agrees that courts should abate the expansion of rule 10b-5 depends largely upon value judgments beyond the scope of this Recent Development. Regardless of one's view of the policy implications of rule 10b-5, however, there is little room for doubt that a grossly disproportionate award of damages is never desirable, no matter how logical its computation. It is equally indubitable, however, that there should at least be some recovery for rule 10b-5 violations in the open market,[184] since Congress was originally most concerned with the integrity of this market.[185] The question, then, is how to keep recoveries within reasonable bounds while still accomplishing the goals of the Act.

The *Elkind* court rightly rejected any theory that would combine a *Shapiro* class of plaintiffs with a measure of damages used in face-to-face transactions. In other words, the court was correct in denying full compensation to all innocent traders during the period of nondisclosure, since this is precisely the type of Draconian liability that courts and commentators agree should be avoided.[186] Thus, *Elkind* properly refused to follow either *Mitchell* or *Reeder*, not ouly because both a cover measure and a rescissory theory could result in outlandish recoveries, but also because there are practical difficulties and theoretical inconsistencies involved in the application of either method to an open market setting.[187] Moreover, Judge Sneed's suggestion in *Green* that a strict out-of-pocket theory would further the purpose of rule 10b-5 and at the same time yield reasonable recoveries[188] is unsoimd. Rigid adherence to the out-of-pocket rule will fail to account for any posttransaction losses that result from fraudulent activity, which is most common in impersonal market transactions and which later affects the overall market value of a stock.[189] In any event, the fact that the lower court in *Elkind* employed the out-of-pocket rule and arrived at an excessive figure[190] should sufficiently refute any conten-

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ring), *cert. denied*, 429 U.S. 1053 (1977).

184. *See* note 146 *supra*.

185. Securities Exchange Act of 1934, § 2, 15 U.S.C. § 78b (1976). *See* Note, *supra* note 9, at 310.

186. *See* note 16 *supra* and accompanying text.

187. *See* notes 118-27 *supra* and accompanying text.

188. *See* notes 128-33 *supra* and accompanying text.

189. *See* notes 33-36 *supra* and accompanying text.

190. *See* note 167 *supra* and accompanying text.

tion that the measure yields reasonable recoveries.

Similarly, the Sixth Circuit's *Fridrich* approach[191] of narrowing the case through a reemphasis on traditional common law concepts of privity, reliance, and causation is not the proper way to limit recoveries. Admittedly, *Fridrich* has superficial appeal in that it compensates all suing plaintiffs while yielding a recovery figure for the purposes of deterrence that exceeds defendant's profits. This theory, however, does not necessarily preclude excessive recoveries—heavily traded stock might yet produce a large class of plaintiffs who traded contemporaneously with the defendants. Moreover, placing greater emphasis on common-law proof requirements for noncontemporaneous traders in the open market is anomalous when one considers that elements such as privity, reliance on *undisclosed* inside information, and direct causation are particularly lacking in an impersonal market. The *Fridrich* holding, therefore, is virtually tantamount to imposing as a prerequisite to recovery on the open market the type of direct dealing with noncontemporaneous traders that is found in face-to-face transactions, a proposition that is logically inconsistent.[192]

Those investors who under *Fridrich* would benefit from the relaxed causation standard of *Affiliated Ute*—contemporaneous traders according to Judge Celebrezze's concurrence[193]—would be allowed to sue purely because of a fortuitous and inequitable selection process.[194] Just because an investor purchased at the same time that an insider sold does not necessarily mean that there is privity between the two parties or that the one's buy order matches the other's sell order. Perhaps even more significantly, the act of contemporaneous trading does not mean that this innocent investor's loss is in any way different from that of a noncontemporaneous investor who bought or sold during the fraudulent period. Indeed, this is the ultimate flaw in the *Fridrich* analysis, for while it is true that the act of *trading* on the insider information is what injures investors, it does not necessarily follow that it *only* or *more directly* injures those investors who trade contemporaneously with

191. *See* notes 143-58 *supra* and accompanying text.

192. One commentator has even suggested that those plaintiffs trading on the open market who prove that they negotiated or traded with the defendant should be able to recover under an appropriate conventional measure of damages. Jacobs, *supra* note 16, at 1137.

193. Fridrich v. Bradford, 542 F.2d 307, 326 (6th Cir. 1976) (Celebrezze, J., concurring), *cert. denied*, 429 U.S. 1053 (1977).

194. *See* note 136 *supra* and accompanying toxt.

the defendants. On the contrary, there is normally no causal connection between the insider's trade and the transactional decision of an uninformed investor,[195] so that all the losses incurred by investors trading during the nondisclosure period[196] derive from a common source. Consequently, any attempt to limit recovery on the open market by reducing the plaintiff class beyond that which the *Shapiro* decision defined will necessarily entail a certain degree of fortuity and inequity.[197]

The *Elkind* approach properly limits recovery by placing a ceiling on the *amount* of damages. In this way, any reduction in compensation will be distributed evenly among all injured investors. Moreover, plaintiffs will in many cases be made whole under the *Elkind* rationale, since the plaintiff class will not always be large and defendant's profits will not always be disproportionate to plaintiffs' losses. The *Elkind* approach, however, does have serious drawbacks. The court itself recognized that the disgorgement measure duplicates almost exactly the remedy in SEC enforcement actions.[198] Thus, one would expect that the method would bolster the Commission's position by supplementing its deterrent efforts; instead, however, the method creates a disincentive for a plaintiff to bring a private action, since it holds out the possibility that a class action will engulf his recovery. Indeed, if the dual purposes of an implied civil cause of action under rule 10b-5 are compensation and deterrence, the *Elkind* court has fallen short on both scores. Not only is compensation restricted under the disgorgement measure, but deterrence is also minimal—a defendant in a private action has only his profits at risk, in addition to the litigation costs and loss of good name incident to any civil action. Although one could argue that SEC and criminal sanctions are sufficient deterrents, this argument is belied by the original desire for implied private damage actions to supplement the SEC's limited resources.[199]

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195. Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 162 (2d Cir. 1980).

196. This would not include those losses due to forces unrelated to defendant's conduct.

197. An argument can be made that *Shapiro* and *Elkind* were intended to be limited to cases of tippee trading, which Judge Celebrezze in *Fridrich* said might require an expansion of the plaintiff class. *See* notes 156-58 *supra* and accompanying text. Thus, the argument would continue, *Fridrich* should apply in all other cases. This is a specious argument, however, for it would be anomalous to allow a *smaller* monetary recovery in a situation that requires greater enforcement.

198. Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 172 (2d Cir. 1980).

199. In his *Fridrich* concurrence, Judge Celebrezze responded to a commentator's suggestion that compensation in the open market should be left to SEC investigation and criminal sanctions:

Because *Elkind* resolved the tension between full compensation and reasonable deterrence in favor of the latter—a correct result considering the debilitating effects of full compensation in an impersonal market—the court should have emphasized more strongly the deterrence element.

Nevertheless, the *Elkind* result would indeed offer the "most equitable resolution"[200] of the problem if some added deterrence and increased incentive to sue were factored into the disgorgement measure. In this connection, future courts should consider punitive damages as a means of improving upon the framework laid down in *Elkind*.[201] While it is true that exemplary damages have been generally unavailable in rule 10b-5 private actions,[202] the underlying reasons for this disallowance evaporate upon application of the disgorgement measure. It is true that the section 28(a) limitation of recovery to "actual damages" can be read either as a prohibition against exemplary damages or as a bar to double recovery.[203] There is, however, room to allow punitive damages without running afoul of either statutory construction, since under the disgorgement measure the amount recovered will often be less than plaintiffs' actual losses. In those cases in which plaintiffs' losses do not exceed or are equal to defendant's gain, no further punitive deterrent is needed because a recovery above defendant's profits would not have been allowed even under a scheme of full compensation for all plaintiffs during the period of nondisclosure. In any event, it is

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> SEC manpower is limited and the time necessary to investigate and prosecute cases which now are processed through the civil courts would, in many cases, be prohibitive. Another [problem with the suggestion] is the limitation on the scope of remedies available to the SEC. Although courts have ordered disgorgement of profits as "ancillary relief" in SEC injunctive actions, there is no such remedy if the Commission chooses to proceed through administrative actions against investment advisors or broker-dealers. *Also, merely requiring an insider to disgorge the profits he made through his illegal trading may not satisfy either the deterrent or compensatory goals of rule 10b-5.* Criminal sanctions are an inadequate substitute for civil proceedings because of the different standard of proof and other factors unrelated to securities regulation which make a conviction for criminal charges much more difficult to procure than a finding of civil liability. Civil liability serves both the deterrent and the compensatory functions of rule 10b-5. The prospect of a substantial money judgment is likely to cause an insider to pause and reflect before entering the market to trade on the basis of confidential information . . . .

Fridrich v. Bradford, 542 F.2d 307, 324 n.6 (6th Cir. 1976) (Celebrezze, J., concurring), *cert. denied*, 429 U.S. 1053 (1977) (emphasis added) (citations omitted).

200. Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 173 (2d Cir. 1980).

201. *See* notes 12 and 86-98 *supra* and accompanying text.

202. *See* notes 12 and 86-98 *supra* and accompanying text.

203. *See* notes 97-98 *supra* and accompanying text.

largely the threat of punitive damages rather than their actual imposition that constitutes the deterrent, as well as the incentive to sue, and presumably plaintiffs' damages would exceed the disgorged amount in a sufficient number of cases to create a deterrent.

Application of the disgorgement measure of damages to open market transactions also avoids the usual policy rationale behind disallowing punitive damages for rule 10b-5 violations. Those courts that have faced the issue have uniformly questioned the need for additional deterrence, primarily because of the availability of class actions and large monetary recoveries in addition to conventional deterrents.[204] Under the limited relief approach taken in *Elkind,* fewer alternative deterrents exist, and the balance between the need for deterrence and the potential problems presented by exemplary damages tilts in favor of punitive damage recoveries. Courts can use traditional judicial controls over verdicts to avoid awards that are disproportionate to the harm done and that may unduly burden innocent stockholders of public corporations. Furthermore, since recoveries are prorated under the disgorgement measure, the administrative difficulties normally encountered when multiple plaintiffs sue at different times or in different courts can be alleviated by including in the prorated disgorgement amount an initial punitive damage award to be distributed among the various injured investors in the same way as the defendant's profits.[205] In this manner, the courts can achieve goals of reasonable deterrence, added incentives to sue, and increased compensation without contravening the conventional policy and statutory arguments against allowing exemplary damages for rule 10b-5 violations.

V. CONCLUSION

The *Elkind* court's adoption of a "disgorgement measure" of damages for insider trading on undisclosed misrepresented material information in the open market is basically sound. In allowing compensation to the extent practicable,[206] the Second Circuit chose the best solution among the available alternatives. The decision's paramount problems arise in its shifted emphasis to deterrence; the court has neither provided plaintiffs with a sufficient incentive

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204. *See* notes 88-93 *supra* and accompanying text.
205. *See* notes 88-93 *supra* and accompanying text.
206. *See* notes 159-62 *supra* and accompanying text.

to sue nor created the level of deterrence that some cases might require. Future courts, however, can remedy this situation if they follow *Elkind* and also award punitive damages in cases in which plaintiffs' losses exceed defendant's profits.

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