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No Foul, No Harm: The Real Measure of Damages under Rule 10b-5

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NO FOUL, NO HARM: THE REAL MEASURE OF DAMAGES UNDER RULE 10b-5

*Michael J. Kaufman**

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The federal securities laws do not contain an express private right of action for violations of Securities and Exchange Commission (SEC) Rule 10b-5.¹ The private right of action under rule 10b-5 emerges from judicial implication.² Thus, the measure of damages must be implied as well. In the absence of clear statutory guidance,³ the United States Supreme Court and the lower federal courts seem to have embraced a variety of damage theories,

1. 17 C.F.R. § 240.10b-5 (1988). The rule was promulgated pursuant to § 10(b) of the Securities Exchange Act of 1934 (Act). 15 U.S.C. § 78j(b) (1982). Section 78u(d) of the Act of 1934 authorizes the Securities and Exchange Commission (SEC) to file an injunction action against defendants violating the Act or any rule or regulation promulgated under its authority. 15 U.S.C. § 78u(d) (1982). In addition, violators of rule 10b-5 face potential administrative and criminal sanctions. See 15 U.S.C. § 78ff(a)-(c) (1982).

2. See *Basic, Inc. v. Levinson*, 108 S. Ct. 978, 982-83 (1988).

3. Although 15 U.S.C. § 78bb(a) (1982) limits recovery to "actual damages," the Supreme Court has held that this limitation does not preclude a measure of recovery in excess of mere compensation. See *Randall v. Loftsgaarden*, 478 U.S. 647, 660-63 (1986).

including the benefit-of-the-bargain measure,⁴ the out-of-pocket rule,⁵ disgorgement,⁶ and rescission.⁷

The benefit-of-the-bargain measure is generally understood as the difference between the represented value of the security purchased or sold and the fair value of the security on the date of the trade.⁸ Out-of-pocket relief, which has been termed the "traditional" 10b-5 measure of recovery,⁹ represents "the difference between the fair value of all that the [plaintiff] received and the fair value of what he would have received had there been no fraudulent conduct."¹⁰ This measure constitutes the disparity between the fair value of the security purchased and the fair value of the consideration paid, generally measured at the time of the transaction.¹¹ Disgorgement, as it applies to the securities laws, returns to the plaintiff the amount of the defendant's unjust enrichment. Under the disgorgement theory, the plaintiff recovers the defendant's profit resulting from the fraud, rather than the plaintiff's losses.¹² Finally, rescission, by contrast, is the judicial act of undoing a transaction. Rescission typically precedes restitution, which restores each party to its pre-transaction condition.¹³

4. See *infra* text accompanying notes 8, 24-34.

5. See *infra* text accompanying notes 9-11, 35-65.

6. See *infra* text accompanying notes 12, 66-71. Some have celebrated this process. See A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5 § 260.03[a], 11-17 (2d ed. 1988). Jacobs asserts:

The major principles guiding judges were deterrence of 10b-5 violations and compensation of victims. Additionally, judges tried to (1) return the parties to the status quo ante, (2) permit a claimant to recover the fruits of a fraud, (3) make a defrauded individual whole, (4) encourage meritorious suits by adopting a generous measure of damages, (5) assess damages against a public company without bankrupting it, and (6) find measures of damages which were neither so severe that judges would not use them nor so inflexible that they obstructed enforcement of 10b-5 duties.

Id. (footnote omitted). Others have found utter chaos in the law of damages. See Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349 (1984). Others have found no law of damages at all. See FEDERAL SECURITIES CODE § 1723 commentary (1980). Still others have found a consistent and "optimal" damages theory amidst the apparent chaos. Easterbrook & Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611 (1985). No one as yet has argued that the various damage theories are alternate methods of quantifying materiality.

7. See *infra* text accompanying notes 13, 77-152.

8. See A. JACOBS, *supra* note 6, § 260.03[c][v], at 11-45 (citing D. DOBBS, HANDBOOK ON THE LAW OF REMEDIES § 9.2, at 595 (1973)).

9. *Id.* § 260.03[c][iii], at 11-23.

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

11. See A. JACOBS, *supra* note 6, § 260.03[c][ii], at 11-25.

12. See *Affiliated Ute*, 406 U.S. at 155.

13. See *Randall v. Loftsgaarden*, 478 U.S. 647, 659 (1986); see also *infra* text accompanying notes 77-152 (discussion of case).

This Article surveys the United States Supreme Court and lower federal court cases addressing these various measures of recovery under rule 10b-5. Although these cases announce a variety of different damage theories and labels, they apply a singular damage rule. This Article contends that the singular measure of damages in rule 10b-5 actions is a quantification of the materiality of the defendant's misstatement or omission. Courts use the various damage theories only to the extent that these theories prove useful in approximating the materiality of the defendant's misstatement or omission.

Section I of this Article demonstrates that a misstatement or omission is material if it creates any disparity between the price at which the plaintiff purchased or sold a security and the real value of that security at the time of the transaction. The materiality of the misstatement or omission constitutes both the degree of the disparity and the amount of the damages. Section II concludes that the United States Supreme Court has accepted the various theories of recovery only to the extent that these theories approximate the materiality of the defendant's misstatement or omission. Section III reviews the relevant federal circuit court cases and concludes that, despite their apparent differences, the circuits agree that damages are limited to a quantification of materiality. Finally, the Article concludes by crystallizing the case law into a unitary rule of damages.

I. QUANTIFYING MATERIALITY

This Article contends that the measure of damages in rule 10b-5 cases rests upon a quantification of the materiality of the defendant's misstatement or omission. While under rule 10b-5 a material misstatement or omission is a necessary and, perhaps, a sufficient condition for liability,¹⁴ the very fact that this *liability* requires a material misstatement or omission provides the basis for the assumption of this thesis. Accordingly, the quantification of materiality requires an analysis of the particular misstatement or omission, the materiality of which has rendered the defendant liable.

According to the Supreme Court, a material misstatement or omission requires a "substantial likelihood" that the disclosure of the omitted or misstated fact "would have assumed actual significance in the deliberations of the reasonable" purchaser or seller of securities.¹⁵ Information is material if

14. See *Santa Fe Indus. v. Green*, 430 U.S. 462, 471-77 (1977) (breach of duty absent a material misstatement or omission not actionable). I have argued so in other contexts. See M. KAUFMAN, *SECURITIES LITIGATION: DAMAGES* (1989); Kaufman, *Living in a Material World: Strict Liability Under Rule 10b-5* (forthcoming: *Capital University Law Review*, Vol. 19).

15. See *Basic, Inc. v. Levinson*, 108 S. Ct. 978, 983 (1988) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

its disclosure at the time of a securities transaction “would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information [already] made available.”¹⁶ Resolving the question of materiality¹⁷ requires the determination of whether, under all of the circumstances, a strong probability exists that the information would have significantly altered the process by which the reasonable investor made the decision to purchase or sell the securities.¹⁸

In *TSC Industries, Inc. v. Northway, Inc.*, the Supreme Court stressed that a section 14(a) plaintiff need not prove that the withheld or misleading information would have actually “caused” him to change his vote.¹⁹ A rule 10b-5 plaintiff, however, must prove that the information was so significant as to create a substantial likelihood of altering the “total mix” of information available to a reasonable investor when deciding whether to buy or sell securities, to show that the information similarly affected his decision in some way.²⁰ Information that affects the reasonable investor’s investment decision may alter the very decision to invest. At a minimum, such information will alter the price at which a reasonable investor decides to invest in securities.

Hence, in light of the Supreme Court’s definition of materiality, a material misstatement or omission is one that alters the price at which a reasonable investor would have decided to purchase or sell securities. If, for example, a defendant sells stock by misstating the true financial condition of the issuer, the misstatement is deemed material only if a reasonable buyer would have paid less for the stock had the buyer known the truth. If, however, a reasonable investor would not have paid less for the stock absent a defendant’s misstatement, either because he would otherwise have known the true financial status of the company or would not have cared, then the misstatement is not material.

The materiality of a defendant’s misstatement or omission depends on whether the statement or silence creates a disparity between the price at which a reasonable investor actually traded securities (the transaction price) and the price at which a reasonable investor would have traded securities had he known the truth (the “true or real value”).²¹ Material misstatements or omissions thus create a disparity between the price at which a reasonable

16. *TSC Indus.*, 426 U.S. at 449.

17. *Id.*

18. *Id.* at 445, 448-50.

19. *Id.* at 449. *See also* section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a) (1982) (solicitation of proxies in violation of rules and regulations).

20. *TSC Indus.*, 426 U.S. at 449.

21. Any quarrel with this definition of “value” exceeds the scope of this Article, and is inconsequential to the Article’s thesis.

investor traded securities and the true value of those securities at the time of the transaction. This incongruity is referred to as the price-value disparity. In order to state a claim upon which relief may be granted under rule 10b-5, the plaintiff must show that the defendant's misstatement or omission created a detrimental or adverse disparity between the price at which he traded securities and the true value of those securities.²² In other words, a material misstatement or omission must create a negative price-value disparity.²³

The quantification of materiality, therefore, is measured by the disparity, created by the defendant's precise misstatement or omission, between the purchase price and the real value of the securities which the plaintiff traded. While the Supreme Court and the lower federal courts have used a variety of damage theories, they have done so only in an effort to approximate the amount of that disparity.

II. THE SUPREME COURT'S SUBTLE EMBRACE OF MATERIALITY

The Supreme Court has offered little explicit guidance to the lower courts regarding the proper measure of damages under rule 10b-5. This section analyzes the few Supreme Court cases relevant to the issue of rule 10b-5 damages. These cases stand for the general proposition that out-of-pocket damages typify recovery for rule 10b-5 violations.²⁴ This section illustrates, however, that the Supreme Court has subtly rejected each of the various theories of damages in its pure form. The Court has instead demonstrated its willingness to accept whichever theory best quantifies the materiality of the defendant's misstatement or omission in any given case as the proper standard of recovery for rule 10b-5 violations.

A. *Benefit-of-the-Bargain Rejected as a Measure of Materiality*

Before the adoption of the federal securities laws, the Supreme Court voiced its disapproval of the benefit-of-the-bargain measure of damages for

22. While the innocent dissemination of a misstatement that creates a disparity between the transaction price and the value of a security could conceivably benefit the recipient, that recipient of a material misstatement will not be able to state any claim for relief under rule 10b-5 because the disparity was favorable. Suppose, for example, the seller unwittingly depresses the transaction price by understating the issuer's rosy financial future. Under the definition of materiality espoused in this Article, that understatement would be material because it would have created a disparity between the transaction price and the true value of the stock. Yet, that positive disparity would not give rise to a cause of action for damages.

23. This definition of materiality is indistinguishable from a definition of harm or loss. Indeed, as I have suggested elsewhere, *see, e.g.*, M. KAUFMAN, *supra* note 14, the proper measure of damages in securities cases is a quantification of the materiality of the misstatement or omission.

24. *See* A. JACOBS, *supra* note 6, § 260.03[c][iii], at 11-30.

securities fraud. In *Smith v. Bolles*,²⁵ the plaintiff alleged that defendant sellers had induced him and other investors to buy worthless mining stock by falsely representing that the stock had great value. The investors purchased stock at a price between \$1.50 and \$2.00 per share. They claimed that “had the [stock] been as represented by defendant it would have been worth at least ten dollars per share” and sought to recover \$40 per share as the benefit of their bargain.²⁶ Although the trial court instructed the jury that the plaintiff’s damage theory was correct, the jury nonetheless returned a general verdict in an amount that represented only the purchase price of the shares, plus interest.²⁷

The Supreme Court reversed.²⁸ It reasoned that damages are properly measured by the price the plaintiff paid for the stock reduced by any “value” that the stock in fact had at the time of sale.²⁹ The difference between the value of the consideration that the plaintiff relinquished and the real, as opposed to represented, value of what the plaintiff received, represented the measure of damage. The Court asserted that the difference between value paid and value received necessarily represents “the *natural and proximate consequence* of the act complained of.”³⁰

The acts complained of in *Bolles* really involved two kinds of misrepresentations about the value of the stock sold. First, the defendant represented that the mining property was not “wholly worthless.”³¹ Second, the defendant stated that the stock might be worth \$10 per share in the future.³² The Court essentially concluded that the first misrepresentation was material. Statements from insiders about the value of mining property do have a substantial likelihood of assuming importance to the reasonable investor. The price that the plaintiff and other investors paid for their stock reflected their

25. 132 U.S. 125 (1889).

26. *Id.* at 127.

27. *Id.* at 129-30.

28. *Id.*

The measure of damages was not the difference between the contract price and the reasonable market value if the property had been as [the defendant represented]. . . . What the plaintiff might have gained is not the question, but what he had lost by being deceived into the purchase. . . . [T]he defendant was liable to respond in such damages as naturally and proximately resulted from the fraud. He was bound to make good the loss sustained, such as the moneys the plaintiff had paid out and interest, and any other outlay legitimately attributable to defendant’s fraudulent conduct; but this liability did not include the expected fruits of an unrealized speculation.

Id.

29. *Id.* at 130.

30. *Id.* (quoting 2 GREENLEAF § 256).

31. *Id.* at 127.

32. *Id.*

judgment as to the value of the mining property. Thus, the proper measure of recovery could reflect the disparity between the price paid by the investors and the value that the investors received because a material misstatement created that disparity. This disparity is simply a quantification of the materiality of the defendant's first misstatement.

The second misrepresentation, however, that the property value may increase and the property and the stock might in the future command \$10 per share, was not material. The Court suggested that a reasonable investor would not allow such "puffing" to affect his investment decision. The Court's classic statement that damages cannot include "the expected fruits of an unrealized speculation" represents nothing more than that when the defendant asserts facts that create only "speculation," such facts are not material.³³ Any disparity between the fair value of stock received and the expected fruits of an unrealized speculation would not be "legitimately attributable to defendant's fraudulent conduct," that is, not attributable to the materiality of the misstatement or omission.³⁴ The Court, therefore, rejected the benefit-of-the-bargain measure not so much because it is speculative, but rather because the facts that gave rise to such speculation lacked materiality. The decision recognized that the proper measure of damages for securities fraud rests upon a quantification of the materiality of the defendant's misstatement or omission.

*B. The Out-of-Pocket Rule as a Measure of Materiality:
Affiliated Ute Citizens v. United States*

Since the enactment of the federal securities laws, the Supreme Court has offered similar guidance on the proper measure of damages for liability within the specific context of rule 10b-5. The Court's declaration in *Affiliated Ute Citizens v. United States*³⁵ provides the starting point for this guidance:

In our view, the correct measure of damages under [section] 28 of the Act, 15 U.S.C. § 78bb(a), is the difference between the fair value of all that the . . . seller received and the fair value of what he would have received had there been no fraudulent conduct . . . except for the situation where the defendant received more than

33. *Id.* at 130.

34. *Id.*

35. 406 U.S. 128 (1972).

the seller's actual loss. In the latter case damages are the amount of the defendant's profit³⁶

In *Affiliated Ute*, the Affiliated Ute Citizens (AUC), an association of mixed-blood Indians, filed suit against a bank, its employees, and the United States, alleging that all had violated rule 10b-5. Through First Security Bank of Utah, AUC's transfer agent, the plaintiffs sold 1,387 shares of stock in Ute Distribution Corporation (UDC) to two bank employees and to thirty-two other "whites."³⁷ They sold a total of 120 shares from 1963-1965 at \$300 to \$700 per share.³⁸ At the same time, the price range on transfer of the shares between "whites" was between \$500 and \$700 per share.³⁹ Defendants Gale and Haslem, bank employees, received commissions for their services in connection with the transfer of the UDC stock from the plaintiffs to the whites. They also solicited contracts for open market purchases of the stock.

The United States District Court for the District of Utah found that Gale and Haslem acquired, with bank approval and governmental awareness, UDC stock for themselves from the plaintiffs at less than open market value and had sold it or transferred it to customers for sale to others at the higher market price.⁴⁰ The district court found each of the defendants liable and assessed damages by finding that the UDC stock was worth \$1,500 per share at the time of sale.

The district court based the damage computation upon a complex series of factors. It considered the value of the oil shale, gas, and coal underlying the plaintiffs' reservation. It also calculated the plaintiffs' potential interest in damage awards stemming from the Indian Claims Commission and the as yet unadjudicated claims against the government as part of the assets of UDC.⁴¹ Furthermore, the court analyzed the specific price at which the plaintiffs sold to whites and the fact that the defendants pressured the plaintiffs, who were without investment expertise, to sell. Experts testified that the stock was worth more than \$700 per share.⁴² Considering all of those factors, the district court concluded that the measure of damages for each

36. *Id.* at 155 (citing *Myzel v. Fields*, 386 F.2d 718, 748 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965)).

37. *Affiliated Ute*, 406 U.S. at 146. Ute Distribution Corporation (UDC) was created by the Ute Partition Act to manage oil, gas, and mineral rights. *Id.* at 143.

38. *Id.* at 147.

39. *Id.*

40. *See Reyos v. United States*, 431 F.2d 1337 (10th Cir. 1970), *aff'd in part and rev'd in part sub nom. Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972).

41. *Affiliated Ute*, 406 U.S. at 155.

42. *Id.* at 156.

seller represented the difference between the fair value of the UDC stock at the time of sale (\$1,500) and the fair value of what each seller had received. Hence a plaintiff who sold to, or transferred through, the defendants, stock at \$300 per share would receive \$1,200 per share as damages.

The United States Court of Appeals for the Tenth Circuit, however, reversed the district court's theory of liability and remanded the case for a recomputation of damages.⁴³ The court of appeals concluded that the trial court erred in valuing the shares at \$1,500 for computing damages. Moreover, the court asserted that the trial record did not support the proposition that the defendants depressed the market value.⁴⁴ The court then announced what it perceived to be the correct measure of rule 10b-5 damages:

The measure of damages for breaches of duty under Regulation 10b-5 is the profit made by the defendant on resale of stock purchased from the plaintiffs. If no resale was made or if the resale was not at arm's length, then the measure is the prevailing market price at the time of the purchase from the plaintiffs.⁴⁵

The court anchored the damage figure in the "profit" received from the resale because it believed that the plaintiffs had properly shown liability only against the bank and its employees for sales from which they received a higher resale price.⁴⁶ If, for example, defendant Gale had purchased plaintiffs' stock at \$300 and resold it for \$1,500, the court would measure the damages the same way the district court measured damages — \$1,200 per share. But if Gale had received less in the open market for the stock, then the court would correspondingly reduce the plaintiffs' damages.

The court of appeals was willing to accept the district court's primary measure, the difference between the value of the plaintiffs' stock and the amount they received, but only if the defendants had not resold the stock. Nonetheless, the court of appeals rejected the district court's \$1,500 multifactorial price tag. Instead, it instructed the lower court to rely on the "prevailing market price" to determine the stock's fair value. That prevailing market price was between \$500 and \$700 per share. Thus, according to the Tenth Circuit's damage measure, the plaintiffs would receive a maximum of \$400 per share in damages, unless the defendants actually exacted a profit greater than that generally available in the open market.

43. *Reynos*, 431 F.2d at 1349.

44. *Id.* at 1348.

45. *Id.* at 1348-49.

46. *Id.* at 1347.

The United States Supreme Court confronted these two very different views⁴⁷ and reconciled the two damage measures in favor of the plaintiffs. It reasoned that the plaintiffs could receive either the difference between the fair value they received and the fair value they would have received absent the fraud (the district court's figure), or if the defendants' profit would be greater, then that measure could be used.⁴⁸ The Court also accepted the lower court's factual finding that the "fair value" of UDC stock at the time of sale was \$1,500 per share.⁴⁹ Hence, under the particular facts of *Affiliated Ute*, the Supreme Court's damage measure allowed the plaintiffs to recover between \$1,000 and \$1,200 per share.

In reaching this result, the Supreme Court gave considerable deference to the district court. It agreed with the district court that the plaintiffs' proposed "fair value" of \$28,000 per share was "unrealistic and speculative."⁵⁰ It also agreed that the lower court could draw reasonable inferences when determining a "fair value" and was not restricted to actual sale prices in a market so isolated and thin as this one.⁵¹

The Court relied on two principles, revealed by its citations, to support its conclusion: first, the district court generally is entitled to deference regarding its factual findings;⁵² and, second, the district court should begin with the market price: "the price at which property would change hands in a transaction between a willing buyer and a willing seller, neither being under any compulsion to buy nor to sell and both being informed."⁵³ The Court relied on the decision of the United States Court of Appeals for the Eighth Circuit in *O'Malley v. Ames* for this second principle.⁵⁴ Moreover, *Ames* suggested that, in the absence of evidence of purchase and sale transactions, a court should use the price commanded for the stock in an open market to determine fair value.⁵⁵ In the absence of either traceable transactions or an

47. *Affiliated Ute*, 406 U.S. at 154-56. Specifically, these views were first, the district court's determination of the difference between the fair value of the shares at the time of sale less the fair value of what the seller received, and second, the court of appeals' determination of the amount of profit made by the defendant on resale, if any, less the amount the plaintiff received for the sale. *Reynos*, 433 F.2d at 1348-49. If the defendants did not resell the stock, or if the resale was not at arm's length, then the plaintiff stood to receive only the market price at the time of the sale less the amount paid to the plaintiffs. *Id.*

48. *Affiliated Ute*, 406 U.S. at 155.

49. *Id.* at 155-56.

50. *Id.* at 155.

51. *Id.*

52. See *Bigelow v. RICO Pictures, Inc.*, 327 U.S. 251, 264 (1946); *Harry Alter Co. v. Chrysler Corp.*, 285 F.2d 903, 907 (7th Cir. 1960).

53. *O'Malley v. Ames*, 197 F.2d 256, 257 (8th Cir. 1952).

54. *Affiliated Ute*, 406 U.S. at 155; see also *Ames*, 197 F.2d at 257-58 (providing a list of factors that may be considered to determine fair market value).

55. *Ames*, 197 F.2d at 258.

open market for the stock, however, courts should “consider all the circumstances connected with the corporation in determining its fair market value.”⁵⁶

Relying on *Ames*, the Supreme Court approved the district court’s multifactorial valuation process in an isolated and thin market.⁵⁷ Presumably, in light of *Ames*, the market price would suffice as a measure of “fair value” in an open, well-developed, and efficient market. But absent that market, the Supreme Court will allow district courts to exercise their discretion in affixing value to stock. Thus, in *Affiliated Ute*, the Court found itself in agreement with the district court’s approach.⁵⁸

Finally, the Supreme Court seemingly approved a measure of value that reflected not only a weighing of numerous factors, but also a balance between the sale prices of the stock and the “ultimate worth” of the interest underlying the shares. *Affiliated Ute* ultimately produced a “rule” with which to measure damages in a 10b-5 case involving selling plaintiffs. The rule measures the greater of: (a) the difference between the fair value of all that the seller received and the consideration paid; or (b) the difference between the consideration paid to the defendant and the resale price actually received or that could have been received in the market. In calculating the “fair value” of the stock sold, the Court approved an approach that begins with actual transaction prices if available, or with market prices if the sale

56. *Id.* These circumstances include: corporate assets; corporate earnings; dividends; earning power of the corporation; prospects of the corporation; book value; bid and asked quotations; comparable sales; and any other factor which an informed purchaser or an informed seller would take into account. *Id.*

57. *Affiliated Ute*, 406 U.S. at 155.

58. *Id.* at 155-56. That approach involved an analysis of the following factors:

[T]he existence of extensive oil shale deposits on the reservation; the possession by those deposits of substantial present value and of great potential value; the presence of gas, coal and other minerals; the administrative cost deposit retained by the United States with respect to each member of the tribe; each [plaintiff’s] remaining interest in the 1965 award by the Indian Claims Commission; the existence of claims against the United States not yet fully adjudicated; and the specific prices at which UDC shares were sold by mixed-bloods and between white persons. The court noted that prices paid for the shares were somewhat influenced by the improper activities of [the defendants]; by the excess of sellers over buyers; by the fact that the typical Indian seller was not so well informed about the potential value of the stock as was the typical non-Indian buyer; by the fact that the Indian seller was under heavy economic pressure to sell; by opinion evidence as to worth in excess of \$700 per share; and by the fact that some portion of the depressant factors in the market was attributable to the defendants. On the other hand, the court noted that not all the market’s depressant factors were so attributable to the defendants and that the tribe itself, despite the opportunity so to do, had declined to purchase UDC shares at prices ranging from \$350 to \$700.

Id.

occurred within an efficient, well-developed market. Conversely, where no market exists, the approach permits the district court to engage in a discretionary balancing of factors.

The portability of this rule carries two impediments. First, it applies only to cases where the sellers have been defrauded, begging the issue of its applicability to other 10b-5 situations. Second, the "rule" in *Affiliated Ute* is flexible enough to allow indiscriminate application, thereby undermining any real guidance potentially offered by the Supreme Court.

Perhaps the real guidance provided by *Affiliated Ute* is that the proper measure of damages rests upon the "materiality" of the defendant's omissions. The Supreme Court affirmed the court of appeals' judgment that the bank's employees, by misstating a material fact, had violated rule 10b-5.⁵⁹ But the Supreme Court reversed the court of appeals' conclusion, holding instead that the defendants also had a duty to disclose the material fact that they "were in a position to gain financially from their sales and that their shares were selling for a higher price in that market."⁶⁰ Once the Court found that the bank had an affirmative duty to disclose as agent for the plaintiffs, it concluded that the failure to disclose a material fact established the "requisite element of causation in fact."⁶¹

The measure of damages emanates from the material facts involved. The "cause" of the plaintiffs' losses, in the Court's judgment, was not that they individually "relied" to their detriment upon the conduct of the defendants. Reliance need not be shown in a case "involving primarily a failure to disclose."⁶² Rather, the plaintiffs' sale of their stock at prices lower than those available in the market produced the losses. The material fact omitted by the defendants was that the market price was higher than the price they were willing to pay to the plaintiffs. The defendants failed to disclose to the plaintiffs the "fair value" of the stock, instead suggesting that the amount they paid to the plaintiffs equaled the fair value of the stock.⁶³ Thus, the Court's measure of damages in the case functionally equals the definition of materiality. As such, proof of the materiality of the omission also serves as proof that the defendants' conduct caused the plaintiffs' losses.

59. *Id.* at 152. The misstatement was "namely, that the prevailing market price of the UDC shares was the figure at which their purchases were made." *Id.*

60. *Id.* at 153.

61. *Id.* at 154.

62. *Id.* at 153.

63. *Id.* at 155. The material omission, therefore, was the disparity between the "fair value of all that the mixed-blood seller received and the fair value of what he would have received had there been no fraudulent conduct." *Id.* Note that the "fair value" discussed by the Court in this context corresponds to the value this Article has discussed as the "true or real value." See *supra* text accompanying note 21.

Moreover, the materiality of the omission supplies proof of the amount of the plaintiffs' losses. The plaintiffs sold their stock at prices between \$300 and \$500 per share. They were not told the "fair value" of the stock, which the district court found to equal \$1,500 per share. The district court arrived at that fair value figure by balancing a number of factors. Those factors simply assess the materiality of the defendants' omissions. The defendants breached their duty to disclose material facts from which the plaintiffs could reasonably have determined the fair value of the stock.⁶⁴ The very factors that the Court deemed material to determine the stock's fair value also guided the plaintiffs' investment decisions. Thus, the \$1,500 per share figure settled upon by the lower court and approved by the Supreme Court resulted from quantifying and weighing the facts regarding the fair value of the stock.

Moreover, this measure of damages also considered that some of the facts were not "material" in the legal sense that their disclosure would have taken on importance, or altered the total mix of relevant information available, to the reasonable investor.⁶⁵ Indeed, the plaintiffs had enough information available to them to know that their stock was worth at least the price at which they sold it. Accordingly, not all of the facts that the Court used to determine fair value would have altered the total mix of information available to the plaintiffs because some of it was, or reasonably should have been, already available to them. The fair value of what the plaintiffs received reflected information already available to them. The fair value that the plaintiffs surrendered consists of an aggregate of all facts relevant to the stock's value. A material fact affects the fair value of the stock, but is a fact not already part of the total mix of information available to the reasonable investor. The difference between the value actually received by the seller based on facts already available to it and measured by the price received, and the fair value of the stock that emerges from *all* facts affecting the stock's value and measured at \$1,500, reflected the material facts not disclosed to the plaintiffs. The measure of damages, therefore, rested upon a quantification of the materiality of the defendants' nondisclosures.

C. *Disgorgement as the Proper Yardstick of Materiality*

Even in the situation where the defendant receives more than the seller's actual losses, and thus damages equal the amount of the defendant's profit, the measure of those damages still reflects the materiality of the defendant's

64. *Affiliated Ute*, 406 U.S. at 155-56. For a list of the factors, see *supra* note 58.

65. *Affiliated Ute*, 406 U.S. at 156 ("the [district] court noted that not all the market's depressant factors were so attributable to the defendants and that the tribe itself, despite the opportunity so to do, had declined to purchase UDC shares at prices ranging from \$350 to \$700").

nondisclosures.⁶⁶ The Supreme Court considered the disgorgement theory of damages in *Affiliated Ute* because the court of appeals previously had considered it appropriate. In the earlier case, *Reynos v. United States*, the Tenth Circuit concluded that disgorging the defendants' profit represented the only proper measure of damages where the buyers had defrauded the sellers.⁶⁷ A decision from another circuit, *Janigan v. Taylor*,⁶⁸ set forth the reasoning behind this position. The Supreme Court ultimately relied upon *Janigan* in *Affiliated Ute* for its alternative damage formula.⁶⁹ In *Janigan*, the United States Court of Appeals for the First Circuit explained that a fraudulent buyer should not benefit from an even unexpected windfall profit on the securities purchased because the unanticipated profit resulted from fraud.⁷⁰ Rather, the profit more appropriately belonged to the defrauded seller.⁷¹

The *Janigan* measure of damages is designed for situations where the plaintiff sells stock which increases greatly in value after the sale, even if the defendants could not foresee the amount of the increase. The theory, however, depends upon a showing that the defendants acquired the stock by fraud; that is, by a material misstatement or omission. In *Janigan*, the defendant served as president, general manager, and director of Boston Electro Steel Casting, Inc. (BESCO). He purchased stock from his shareholders without disclosing the material fact that the corporation had undertaken changes that would revitalize it. At the time of sale, the "market" price of BESCO stock coincided with the price that the defendant offered the plaintiffs. Yet, two years later the stock's value multiplied.⁷² If the court measured the damages as the difference between the market price of BESCO

66. *Reynos v. United States*, 431 F.2d 1337, 1348-49 (10th Cir. 1970), *aff'd in part and rev'd in part sub nom. Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972).

67. *Id.* at 1348-49.

68. 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

69. *Affiliated Ute*, 406 U.S. at 155.

70. *Janigan*, 344 F.2d at 786.

[I]f the property is not bought from, but sold to the fraudulent party, future accretions not foreseeable at the time of the transfer even on the true facts, and hence speculative, are subject to another factor, viz., that they accrued to the fraudulent party. It may, as in the case at bar, be entirely speculative whether, had plaintiffs not sold, the series of fortunate occurrences would have happened in the same way, and to their same profit. However, there can be no speculation but that the defendant actually made the profit and, once it is found that he acquired the property by fraud, that the profit was the proximate consequence of the fraud, whether foreseeable or not. It is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them.

Id.

71. *Id.*

72. *Id.* at 783.

stock at the time of sale and the price paid to plaintiffs, damages would have been negligible. However, the *Janigan* court did not reject this measure of damages because of its inconsequential amount. Rather, the court rejected the measure because it had nothing to do with the materiality of the nondisclosures involved. In *Janigan*, the court deemed material the facts regarding the changes reasonably anticipated to increase the company's profitability, facts that the defendant failed to disclose.⁷³ The fair value of the stock at the time of sale was not the market price, but rather what the market price of the stock would have been had the market known the defendant's information. Thus, the defendant's resale price, including his profit intake, provided a more accurate method for measuring the stock's fair value. The defendant's profit actually serves as a surrogate for the difference between the uninformed price paid to plaintiffs and the higher, informed price received from the market.

For example, assume that in *Affiliated Ute* a plaintiff sold his UDC stock at \$500 per share to defendant Gale at a time when the otherwise prevailing market price also stood at \$500 per share. Suppose then, that Gale retained the stock long enough to sell it at a \$200 per share profit. A court could measure damages in either of two ways. On the one hand, the plaintiff could recover the \$1,000 per share difference between the amount received (\$500) and the fair value relinquished (\$1,500). However, if a court determined that the fair value equalled the market price at the time of sale (\$500), then the plaintiff would have suffered no damages because he had received that price. Consequently, the defendant's omission would not have been material. On the other hand, if the defendant omitted material information not only about the market price, but also about factors that affected the future value of the stock, then the "price-value disparity"⁷⁴ would be more than negligible, although not reflected in the present fair value. Thus, relying on *Janigan*, the Supreme Court, in *Affiliated Ute*, provided an alternative measure.⁷⁵

In this instance, the plaintiff could recover the difference between the price received for the stock and the price at which the defendant resold the stock. In order to recoup the resale profit, however, the plaintiff must first prove that the defendant fraudulently acquired the stock from him. Once the plaintiff establishes this fraud, the court will assume that the defendant's resale profits were a "proximate consequence of the fraud."⁷⁶ Therefore, the profit must ultimately have resulted from the material misrepresentation or

73. *Id.* at 786.

74. See *supra* text accompanying notes 21-23.

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

76. *Janigan*, 344 F.2d at 786.

omission that constituted the fraud. Any contrary rule would allow sellers to recover any time buyers received subsequent profits.

For example, in the hypothetical above, the plaintiff could have recovered the measure of Gale's resale profit because a material misstatement or omission produced the profit. Under this theory, so long as fair value is measured by all material facts, and not the market price alone, and so long as defendant's profit resulted from a material misstatement or omission, the measure-of-profit recovery will never exceed the price-value disparity. Therefore, even the Supreme Court's alternative profit-recovery measure of damages demands a quantification of the materiality of the misstatement or omission, regardless of the foreseeability of the consequences.

D. Rescission as a Measure of Materiality

1. *Randall v. Loftsgaarden*

The United States Supreme Court further magnified the role of materiality in measuring damages in *Randall v. Loftsgaarden*.⁷⁷ In *Loftsgaarden*, the Court held that, in cases brought under the federal securities laws, a successful plaintiff need not offset a rescissory damage award by any tax benefits the plaintiff may have received from the tax shelter investment.⁷⁸ The petitioners in *Loftsgaarden*, limited partners in a motel venture promoted as a tax shelter, brought suit against the general partners⁷⁹ after an investigation initiated by the limited partners revealed that the general partners had sold them a worthless investment.⁸⁰ Alleging that the respondents' offering plan used to solicit the petitioners' investments contained material misrepresentations and omissions, the petitioners asserted causes of action under section 10(b) of the Securities Exchange Act of 1934⁸¹ and section 12(2) of the Securities Act of 1933.⁸² After trial in the United States District Court for the District of Minnesota, a jury found that the petitioners had been defrauded, and awarded damages in an amount equal to the consideration paid for their limited partnership interests, plus prejudgment interest.⁸³

77. 478 U.S. 647 (1986).

78. *Id.* at 667.

79. *Loftsgaarden* was the president and sole shareholder of Alotel, Inc., another respondent. Together, they formed the general partnership. *Id.* at 650.

80. *Id.* at 651. After finding the initial offering of respondent unacceptable, the petitioners invested in a revised proposal. *Id.*

81. Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1982); *see also* 17 C.F.R. § 240.10b-5 (1985) (SEC Rule 10b-5).

82. *Loftsgaarden*, 478 U.S. at 651; *see also* Securities Act of 1933, § 12(2), 15 U.S.C. § 77l(2) (1982).

83. *Loftsgaarden*, 478 U.S. at 652.

On appeal, the United States Court of Appeals for the Eighth Circuit held that under a rescissory theory, any tax benefits received by the petitioners as a result of their investment should be subtracted from their recovery.⁸⁴ The court, therefore, vacated the district court's award of damages.⁸⁵ On remand, the district court reduced the petitioners' damages,⁸⁶ but both petitioners and respondents appealed again.⁸⁷ The Eighth Circuit, sitting en banc, reaffirmed its original decision and directed the computation of tax benefits.⁸⁸ The Supreme Court then accepted the case to resolve the tax benefits issue.

Justice O'Connor, writing for the majority, first focused on section 12(2) of the Securities Act, which gives a defrauded securities investor the right "to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon."⁸⁹ The Court held that the language of section 12(2) was sufficiently clear to invoke the "plain language" canon,⁹⁰ and concluded that tax benefits are not "income received" within the meaning of section 12(2) and, therefore, could not be used to offset rescissory damages.⁹¹ The respondents had urged the Court to interpret the language of section 12(2) in light of the common law remedies of rescission and restitution, which aim to restore the parties to their precontract positions, and thus require the plaintiff to return everything of value received in the transaction.⁹² The Court held, however, that this argument fell short of the showing necessary to overcome the plain language of section 12(2). The Court also rejected the argument that tax benefits constitute a

84. *Austin v. Loftsgaarden*, 675 F.2d 168, 181 (8th Cir. 1982) (*Austin I*).

85. *Id.* (the Eighth Circuit reasoned that proper application of the "actual damages principle" of sections 12(2) and 10(b), required reducing the rescissory damages by any value that the plaintiffs received as a result of the fraudulent transaction); see also *Garnatz v. Stifel, Nicolaus & Co.*, 559 F.2d 1357, 1361 (8th Cir. 1977), *cert. denied*, 435 U.S. 951 (1978).

86. *Loftsgaarden*, 478 U.S. at 653. "On remand, the District Court . . . calculated each petitioner's damages as the purchase price of his partnership interest plus simple interest, minus net tax benefits." *Id.*

87. *Austin v. Loftsgaarden*, 768 F.2d 949 (8th Cir. 1985) (*Austin II*) (en banc), *rev'd sub nom.* *Randall v. Loftsgaarden*, 478 U.S. 647 (1986).

88. *Id.* at 960-61.

89. 15 U.S.C. § 771(2) (1982); *Loftsgaarden*, 478 U.S. at 655.

90. See *Aaron v. SEC*, 446 U.S. 680, 685 (1980) (explaining "plain language" canon); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 n.33 (1976) (same).

91. *Loftsgaarden*, 478 U.S. at 656. In its interpretation of the definition of "income received," the Court looked to the Internal Revenue Code for guidance. Because the receipt of tax deductions or credits is not itself a taxable event, the Court concluded that "income" under section 12(2) did not contemplate such tax benefits in the absence of "compelling evidence" of congressional intent to the contrary. See also *United Hous. Found. v. Forman*, 421 U.S. 837 (1975).

92. *Loftsgaarden*, 478 U.S. at 658.

reduction in consideration paid by the petitioners and therefore must offset any recovery.⁹³

The Court also asserted that the respondents misconstrued the purpose of rescissory damages under section 12(2) as requiring only the return of the parties to their *status quo ante*.⁹⁴ According to the Court, section 12(2) attempts to encourage full disclosure and deter fraud to the same degree that it attempts to compensate defrauded investors.⁹⁵

The Court next focused on the respondents' argument regarding section 28(a) of the Securities Exchange Act, which governs the measure of damages in actions brought under section 10(b). The respondents successfully argued to the court of appeals that section 28(a), by limiting a plaintiff's recovery to his "actual damages," requires a court assessing damages under a section 12(2) rescissory remedy to restrict damages to the net economic losses suffered by the plaintiff.⁹⁶ The Supreme Court again disagreed. In the Court's view, Congress designed the federal securities laws not only to compensate defrauded investors but also to deter fraud, and "[t]his deterrent purpose is ill-served by a rigid insistence on limiting plaintiffs to recovery of their 'net economic loss.'"⁹⁷ The parties in *Loftsgaarden* did not object to a rescissory measure of damages; thus the Court left undecided the issue whether, and under what circumstances, rescissory damages are available under section 10(b).⁹⁸

93. *Id.* at 659-60. In addition, the Court concluded that the common law ignored tax benefits for the purposes of a rescissory remedy under the "direct product" rule, which requires returning only the gains that are the "direct product" of the transaction. Tax benefits, the Court reasoned, accrue only when combined with other income produced by the investor, and, therefore, are not deemed a "direct product" of the transaction at common law. *Id.* at 658.

94. *Id.* at 659.

95. *Id.*; see also S. REP. NO. 47, 73d Cong., 1st Sess. 1 (1933). The Court also rejected the respondents' alternative characterization of tax benefits as a return of or a reduction in "consideration paid," reasoning that Congress did not intend the term to apply to anything other than the money or property given by the investors in exchange for the security. *Loftsgaarden*, 478 U.S. at 659-60.

96. *Austin v. Loftsgaarden*, 768 F.2d 949, 954 (8th Cir. 1985) (en banc), *rev'd sub nom. Randall v. Loftsgaarden*, 478 U.S. 647 (1986).

97. *Loftsgaarden*, 478 U.S. at 664 (quoting *Salcer v. Envicon Equities Corp.*, 744 F.2d 935, 940 (2d Cir. 1984), *vacated*, 478 U.S. 1015 (1986)).

98. *Id.* at 666-67. The Court stated:

We also have no occasion in this case to decide whether, assuming that a rescissory recovery may sometimes be proper under [section] 10(b), plaintiffs in such cases should invariably be free to elect a rescissory measure of damages rather than out-of-pocket damages. Consequently, we do not consider whether courts may ever refuse to allow a rescissory recovery under [section] 10(b) where the 'premium' for expected tax benefits represented a large portion of the purchase price, in which event the out-of-pocket measure might yield a significantly smaller recovery.

The distinction between the proper measures of damages under section 12(2) of the Securities Act and under section 10(b) of the Exchange Act formed the basis for Justice Blackmun's concurring opinion.⁹⁹ Justice Blackmun concluded that, because the respondents were found liable under both sections 12(2) and 10(b), petitioners were entitled to choose the more favorable rescissory measure of damages: that available under section 12(2).¹⁰⁰ In Justice Blackmun's view, however, the proper measure of damages in a case brought solely under section 10(b) is *normally* the investor's out-of-pocket losses.¹⁰¹ Under Justice Blackmun's analysis, when liability in a tax shelter case stands solely upon a section 10(b) violation, a court should examine the investor's purchase price to ascertain what portion of that price was paid for the investor's tax benefits and what portion was paid for the underlying asset.¹⁰² When the fraud relates only to the underlying asset the defendant's liability would extend only to the part of the purchase price representing payment for the asset, and not for that part representing tax benefits the investor received.

In his dissent, Justice Brennan agreed with the Eighth Circuit that both sections 10(b) and 12(2) require a court to reduce a plaintiff's rescissory damages in the amount of his tax benefits.¹⁰³ Criticizing the majority's reliance on the Internal Revenue Code (IRC or Code) in interpreting the meaning of "income received" under section 12(2), Justice Brennan argued that an examination of common law equitable rescission provided more appropriate guidance to discern the meaning of this phrase.¹⁰⁴ At common law, rescission and rescissory damages sought to restore the parties to their precontract positions. Common law rescission required the defrauded plaintiff to return the property, money, or other benefits for which he bargained, and required a defendant to return the consideration, plus the value of any other direct benefits, such as interest, received from the plaintiff. Applying these common law principles, Justice Brennan concluded that the petitioners' award must be offset by their tax benefits under a rescissory theory.¹⁰⁵

Id.; see also *Salcer*, 744 F.2d at 940 & n.5.

99. *Loftsgaarden*, 478 U.S. at 667 (Blackmun, J., concurring).

100. *Id.*

101. *Id.* at 668.

102. *Id.*

103. *Id.* at 670 (Brennan, J., dissenting).

104. *Id.* at 671-72.

105. *Id.* at 672-73. Justice Brennan wrote:

[T]he facts that an investment is marketed as a tax shelter and that the investor generally pays a higher price for a tax sheltering investment than he would for one simply producing future growth or income, indicates that the tax shelter aspect of the investment is a bargained-for part of the agreement, rather than an incidental benefit. It would be ignoring reality to maintain that the economic benefit that flows to an

The tenor of the majority's analysis in *Loftsgaarden*, however, revealed an unspoken basis for the decision. The Court primarily argued that the plain meaning of section 12(2) mandates the conclusion that "income received" does not include tax benefits and, therefore, tax benefits need not offset the recovery of the consideration paid. However, the language of section 12(2) is not "plain." Indeed, *Loftsgaarden* argued that the statutory language plainly represented an attempt to codify the common law theory of rescission, which required the complete restoration of the parties to their pretransaction position.¹⁰⁶ Prior to the transaction, petitioners did not have tax benefits. Accordingly, *Loftsgaarden* argued, the plain meaning of the statute's codification of rescission dictated that a plaintiff could not retain his tax benefits.

The Supreme Court responded to this competing interpretation of the plain language of the statute by declaring that congressional intent allowed the Court to "infer that Congress chose a rescissory remedy when it enacted [section] 12(2) in order to deter prospectus fraud and encourage full disclosure as well as to make investors whole."¹⁰⁷ Thus, the Court ultimately relied upon legislative intent, rather than the plain language of the statute, without any reference to the legislative history. Instead, the Court buttressed its argument that the "income received" language of section 12(2) does not include tax benefits by referring to the Internal Revenue Code.¹⁰⁸ The Code, the Court reasoned, distinguishes between income received and tax benefits used to offset income.¹⁰⁹ The Code, however, defines income in broad terms that include indebtedness.¹¹⁰ Yet, even if the Code did draw such a narrow distinction, the fact that the provision containing this distinction *post-dated* section 12 attenuates the relevance this distinction might otherwise hold for securities analysis. The lack of support for the Court's result in the language of section 12(2) seems propelled mostly by the majority's desire to maximize the deterrent force of the federal securities laws.

investor from a tax shelter investment is not as direct a benefit of his bargain as are dividends that flow from a securities investment.

Id. (citations omitted). Justice Brennan did not accept the majority's view that Congress' use of the terms "income received" under section 12(2) required a different result. Rather than looking to the tax code definition of "income," Justice Brennan thought it proper to rely on an ordinary dictionary meaning under which "income" encompasses any monetary gain or benefit. *Id.*

106. *Id.* at 656-59.

107. *Id.* at 659.

108. *Id.* at 657 (citing 26 U.S.C. § 61 (1982)).

109. *Id.*

110. *Id.*; 26 U.S.C. § 61 (1982) (definition of income).

One can also explain the Court's holding as an implicit acceptance of a measure of damages for section 10(b) based upon the materiality of the misrepresentation or nondisclosure at issue. The Court assumed, without deciding, that a "rescissory recovery may sometimes be proper on a [section] 10(b) claim . . ." ¹¹¹ Based on that assumption, the Court proceeded to find that the limitation on "actual damages," as provided by section 28(a)'s limitation for violations of the 1934 Act, did not preclude a rescissory recovery in a proper case. ¹¹²

In his concurring opinion, however, Justice Blackmun spelled out his position on section 10(b) damages in greater detail. ¹¹³ Justice Blackmun agreed with the minority that when rescission properly remedies the fraud, tax benefits should not play any role. But he did caution that "normally, however, the proper measure of damages in a 10(b) case is an investor's out-of-pocket loss; that is, 'the difference between the fair value of all that [the plaintiff] received and the fair value of what he would have received had there been no fraudulent conduct.'" ¹¹⁴ Thus, Justice Blackmun first elevated the out-of-pocket measure of damages set forth in *Affiliated Ute* to make it the normal or general rule. Then, by substituting "the plaintiff" for the phrase "mixed-blood seller" in *Affiliated Ute*, Justice Blackmun indicated his belief that the *Affiliated Ute* principle applies equally to defrauded sellers and defrauded buyers. ¹¹⁵

Yet, the *Affiliated Ute* out-of-pocket damages principle, which applies equally to defrauded buyers and sellers, requires a court to undertake a quantification of materiality. ¹¹⁶ In determining damages, Justice Blackmun recognized that the investor who invests in a tax shelter may fall victim to two kinds of material misstatements or omissions: "First, the promoter may have misled him with respect to the level of potential tax benefits . . . Second, the promoter may have misled him with respect to the value of the underlying asset." ¹¹⁷ Justice Blackmun concluded that the measure of damages must be tied to the materiality of the particular omission. Here, the

111. *Loftsgaarden*, 478 U.S. at 662.

112. *Id.* at 662-63.

113. *Id.* at 667 (Blackmun, J., concurring).

114. *Id.* at 668 (quoting *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972)).

115. *Id.*

116. *Id.* Justice Blackmun instructed lower courts on how to determine damages:

To ascertain out-of-pocket loss requires taking into account all the elements that go into the price of a tax shelter. That price will reflect both the value of the underlying asset . . . and the value of the tax write-offs that the construction and operation of the underlying assets will generate.

Id.

117. *Id.* at 669 (citations omitted).

investors did not allege any material misstatements or omissions regarding the tax consequences of their investments. Instead, they claimed that defendants materially misstated the profitability of the underlying asset. Thus, the petitioners sustained injuries, if at all, because the respondents materially misstated the fair value of the underlying asset. The precise measure of damages, then, must reflect the material misstatement involved.¹¹⁸

In *Loftsgaarden*, petitioners received something of value, tax benefits, and they received at least a low-quality asset. Justice Blackmun suggested that to return to the plaintiffs their entire purchase price in such a case would result in awarding them an amount unrelated to the materiality of the misrepresentation. Instead, Justice Blackmun concluded, “[t]he proper measure of recovery in such a case is therefore the part of the purchase price attributable to payment for an asset that was never received.”¹¹⁹ Justice Blackmun’s example demonstrated that this proper measure is rooted precisely in the materiality of the misstatement or omission.¹²⁰

118. *Id.* Justice Blackmun defined the limited injury:

But this injury — the difference between the value of what he received and the value of what he was promised — is represented, not by the entire purchase price, but rather by that portion of the purchase price which went toward a high-quality underlying asset when what was received was a lower-quality asset.

Id.

119. *Id.*

120. In the example, Justice Blackmun demonstrated that the amount a defrauded investor may recover depends upon whether the investor was materially misled regarding both the underlying asset and the tax benefit. If the misstatement materially impacted only a portion of the investment, then damages relating only to that portion may be recovered. Consequently, Justice Blackmun suggested that a court should quantify the damages according to the proportional damage caused by the misstatement with respect to the whole investment. The following hypothetical illustrates the point:

Investor A, who invests in a non-tax sheltered security, pays \$100 for shares in a corporation that runs hotels, expecting to receive \$10 in dividends each year plus \$5 in appreciation of the value of the stock. Investor B pays \$110 for a comparable share in a partnership that runs hotels, expecting to receive in addition to the same amount of income and appreciation in the value of the partnership, \$25 in deductions to offset income from another source. The additional \$10 premium that investor B pays is directly attributable to the receipt of tax benefits rather than asset benefits. *Id.* at 668-70 nn.1-2. Suppose both investors fall victim to material misrepresentations about the value of the underlying assets which render the assets worthless. If investor A sued under section 10(b), Justice Blackmun declared the investor would be entitled to damages of \$100. If investor B actually received the promised tax benefits, he too would be entitled only to \$100, despite the fact that investor B paid \$110. The measure of recovery for both investors is “that part of the purchase price of the security that represented payment for the asset that was claimed to be worth \$100 [and] was in fact worthless.” *Id.* at 670 n.2.

Investor B received from the defendant two material facts: (1) the fair value of the asset was worth \$100 and (2) the fair value of the tax benefits was \$10. The investor’s potential exposure was \$110, and, as the Court suggests, if both facts were false, the measure of recovery would be \$110. That figure quantifies two material omissions. But, as was true in *Loftsgaarden*, where

Viewed another way, when tax benefits factor into the purchase price, the total mix of information significant to a reasonable investor expands, making the defendant's misstatement less significant and resulting in a smaller damage figure relative to the purchase price. Where tax benefits do not factor into the bargain, the mix of information significant to the reasonable investor contracts, making the defendant's misstatements more significant and resulting in a larger damage figure relative to the purchase price. More than merely rejecting a pure rescissory measure of damages in such section 10(b) cases, Justice Blackmun's concurrence signals the importance of the materiality of the defendant's misstatement or omission to the measure of damages.

2. Tax Benefits: Are They Material?

The opinion of the majority of the Court and Justice Blackmun's concurrence in *Loftsgaarden* reveal little about the type of situations in which rescission would provide a proper section 10(b) remedy. The Court stated that, "[t]he issue whether and under what circumstances rescission or a rescissory measure of damages is available under [section] 10(b) is an unsettled one."¹²¹ The Court then found "authority" among the lower courts to allow the section 10(b) plaintiff, "at least in some circumstances," to elect between rescission and out-of-pocket damages,¹²² and to support the view that section 28(a) does not preclude such an election under the proper circumstances.¹²³ Yet, Justice Blackmun's concurrence left open the possible issue of the propriety of a court's refusal to allow a rescissory remedy under section 10(b) at least where "the 'premium' for expected tax benefits represented a large portion of the purchase price, in which event the out-of-pocket

only the fair value of the underlying asset was misstated, the measure of damages is lower because the information misstated relative to the whole investment was not as material.

The final hypothetical further buttressed the assertion that Justice Blackmun's damage principle quantifies the materiality of the misstatement. *Id.* If the underlying asset is not worth zero, but \$40 per share, the measure of damages would be \$60 for both investors. Here, damages are decreased because the defendant's misstatements are not as material. Defendant promised and delivered a tax benefit worth \$10 and promised and delivered an asset worth at least \$40. If the plaintiff purchased at \$50 per share, there would have been no material misstatement and, therefore, no damages. But if the defendant told the plaintiff that the shares were worth \$110 (or if the market received information to that effect), when in fact they are only worth \$50, then there has been some material misstatement and damages are measured accordingly. The precise misstatement in such a case was that the asset was worth \$100 when in fact it was only worth \$40. Whatever falsehoods defendant communicated altered the price at which the investor was willing to buy the securities. The falsehoods altered the total mix of information available to the investor by \$60 per share.

121. *Id.* at 661.

122. *Id.* at 662.

123. *Id.* at 662-63.

measure might yield a significantly smaller recovery."¹²⁴ As Justice Blackmun's examples made clear, in those cases rescission would result in a measure of recovery inconsistent with the material misstatements that are the subject of liability.¹²⁵ The Court hinted, therefore, that a rescissory remedy under section 10(b) would not be appropriate where it would result in a measure of damages not precisely related to the defendant's material misstatement or omission.

That result fosters the illusion of a marked distinction between damages recoverable under section 12(2) and those recoverable under section 10(b). *Lofsgaarden* held that "[section] 12(2) does not authorize an offset of tax benefits received by a defrauded investor against the investor's rescissory recovery."¹²⁶ The Court suggested, by contrast, that section 10(b) may authorize such an offset when a significant portion of the price of the security is attributable to tax benefits.¹²⁷ Therefore, the Court appears generally willing to tolerate a rescissory damage recovery under section 12(2), even when it may exceed the plaintiff's economic losses, but it seems reluctant to tolerate a similar "windfall" under rule 10b-5.

Once one dispels the arguments about the plain language of section 12(2),¹²⁸ two possible bases for the Court's authorization of windfall damages under that section emerge. First, the Court may believe so strongly that "rescission adds an additional measure of deterrence as compared to a purely compensatory measure of damages"¹²⁹ that it willingly tolerates windfall damages under section 12(2). Second, the Court may believe that the possibility of tax benefits from securities investments is immaterial as a matter of law. The latter presents the more sound hypothesis.

The Court's deterrence rationale for the rescissory remedy under section 12(2) does not explain its result. Such a policy-based, liberal construction has been repeatedly rejected by the Court¹³⁰ in light of the statute's remedial purposes. Moreover, the same rationale, based upon the greater deterrent value of recovery in excess of economic loss, applies equally to section 10(b) actions. If plaintiffs were allowed to recover their full consideration in section 10(b) actions involving tax benefits, that too would add "an additional measure of deterrence as compared to a purely compensatory measure of

124. *Id.* at 667 (Blackmun, J., concurring). Justice Blackmun stated that the recovery under section 10(b) may be reduced where "tax consequences provided a major inducement to investment." *Id.* at 670.

125. *Id.* at 668 nn.1-2; see also *supra* note 120.

126. *Lofsgaarden*, 478 U.S. at 668.

127. See *supra* text accompanying notes 124-25.

128. See *supra* text accompanying notes 89-93.

129. *Lofsgaarden*, 478 U.S. at 659.

130. See, e.g., *Pinter v. Dahl*, 108 S. Ct. 2063, 2082 (1988).

damages.”¹³¹ An argument suggesting that congressional language justified the Court’s authorization of the additional deterrent measure under section 12(2) fails because the Court argued only that Congress remained silent on the issue, leaving it to the Court to determine the proper result.¹³² Yet, the Court suggested that the congressional silence underlying section 10(b) may be construed to require an offset of tax benefits. This rationale is an anomaly within the Court’s characteristic treatment of legislative silence, and fails to explain any distinction between damages under section 12(2) and those under section 10(b).

a. The Majority: Tax Benefits Are Immaterial

The result the majority of the Supreme Court reached in *Loftsgaarden* must be founded upon its implicit assumption that tax benefits are immaterial. The Court agreed with arguments presented by the United States and the SEC as *amici curiae* that tax benefits, because they accrue only in conjunction with taxes owed and other income generated by the investor, do not produce a benefit attributable exclusively to the securities transaction independent of other intervening transactions by the investor.¹³³ Accordingly, the fair value of all that the investor receives does not include tax benefits. On the other hand, the Court found that the fair value of the consideration paid by the investors also did not include tax benefits.¹³⁴ Thus, according to the Court’s logic, tax benefits would likewise have no impact upon the *Affiliated Ute* out-of-pocket measure of damages. The difference between the fair value of all that the plaintiffs received and the fair value of the consideration they relinquished would not reflect tax benefits at all.

The Court did not base, then, its rationale for excluding tax benefits in the calculation of damages on their theoretical incompatibility with the rescissory measure of damages under section 12(2). Indeed, pure rescission, which requires returning both parties to their pretransaction condition, may require an offset. Rather, the Court constructs its argument upon the premise that tax benefits have no place in determining the fair value of securities or consideration. Because the calculation of the difference between the fair value of the securities and the fair value of consideration is equivalent to a

131. *Loftsgaarden*, 478 U.S. at 659.

132. *See id.*

133. *Id.* at 658. In addition, both Hon Industries, Inc. and Envitex Realty filed amici briefs with the Court, Hon Industries urging reversal and Envitex Realty urging affirmance. *Id.* at 649.

134. *Id.* at 660 (“The consideration given by petitioners in exchange for their partnership interests took the form of money, not tax deductions, and the fact that [investors] received tax deductions from which they were able to derive tax benefits therefore cannot constitute a return of that consideration.”).

quantification of the materiality of the misstatement or omission,¹³⁵ the Court's judgment that tax benefits have no place in that calculation results in a judgment that such benefits are not material to the purchase or sale of securities.

That the Court felt obliged to argue that its position does not defy economic reality¹³⁶ further supports this interpretation of its decision. The economic reality at the time of the decision suggests that realizing tax benefits primarily motivated investing in limited partnerships.¹³⁷ The Supreme Court itself noted that some lower courts recognized an investor's right to sue for securities fraud when the defendant misrepresents the tax benefits of the investment. Such a cause of action indicates the materiality of those benefits.¹³⁸

Yet, the Supreme Court rejected those cases and the so-called economic reality approach. First, the Court found no evidence "that Congress intended tax benefits to be treated as 'income received' " when it drafted section 12(2).¹³⁹ Second, the Court rejected the notion that tax benefits constitute a separate asset, severable from the partnership interest and independently valuable.¹⁴⁰ Third, and most significant, the Court recognized that tax benefits are not liquid; they cannot be transferred freely from one person to another apart from the partnership interest.¹⁴¹ This lack of both severability and liquidity makes it impossible to attach a reasonable or objective market value to a tax benefit because each investor's benefits would differ from one taxable year to the next. The lack of certain and determinable fair value for tax benefits makes it impossible to assess the significance such benefits might hold for the "reasonable" investor. Thus, the Court essentially held that tax benefits are not material.¹⁴²

135. See *supra* text accompanying notes 113-18.

136. *Loftsgaarden*, 478 U.S. at 665-66.

137. *Id.* at 665.

138. *Id.* (citing *Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982)).

139. *Id.* at 657.

140. *Id.* at 665-66.

141. *Id.*

142. *Id.* at 667. In other words, the Court suggested that the materiality of statements or omissions about tax benefits is impossible to assess in any given case. *Id.* The Court really had to decide, however, whether tax benefits are always or never material; perhaps by a case-by-case method. The Court decided that tax benefits were never material because assessing the materiality of tax benefits is difficult on a case-by-case basis, and computing the *amount* of damages if tax benefits were found material presents difficulties. The Court recognized that calculating damages based upon the materiality of tax benefits presented "formidable difficulties in predicting the ultimate treatment of the investor's claimed tax benefits." *Id.* at 665. The Supreme Court in *Loftsgaarden*, therefore, authorized the lower courts to ignore tax benefits in their calculation of damages under section 12(2) not because consistency with a rescis-

b. Justice Blackmun: Tax Benefits Are Sometimes Material

In his concurrence, Justice Blackmun questioned whether tax benefits are, as the majority suggested, always immaterial.¹⁴³ First, he agreed with the majority that tax benefits should not be considered in calculating "income" or "consideration" under section 12(2) or section 10(b). He also agreed that the disparity between fair value received and relinquished typically represents the proper measure of section 10(b) damages. Furthermore, he concurred that the materiality of the misrepresentation is tantamount to the unreceived portion of the purchase price attributable to an asset.¹⁴⁴

Justice Blackmun observed, however, that in calculating the price-value disparity, all of the constituent elements of the tax shelter's price should be considered, including the value of the tax writeoffs themselves.¹⁴⁵ Unlike the majority, Justice Blackmun believed that the level of potential tax benefits could be separately valued and qualified as a portion of the fair value that the securities buyer received.¹⁴⁶ He reasoned that an investor could be materially misled about the value of those tax benefits, as well as about the value of the underlying asset. Therefore, Justice Blackmun found that tax benefits could be material in some cases.¹⁴⁷

c. Justice Brennan: Tax Benefits Are Always Material

While the majority concluded that tax benefits are never material and the concurrence observed that they may sometimes be material, Justice Brennan dissented because he perceived that tax benefits are always material to tax shelter investment decisions.¹⁴⁸ Justice Brennan concluded that under both section 12(2) and rule 10b-5, the benefits that purchasers receive from their investments should be considered in calculating the disparity between fair value paid and fair value received.¹⁴⁹ Justice Brennan claimed that economic realities support the view that "a major portion of what the investor bargains for and purchases in a tax shelter is the tax benefit."¹⁵⁰ Thus, tax

sory measure of damages demands it, but rather because tax benefits are immaterial as a matter of law.

143. *Id.* at 669 (Blackmun, J., concurring).

144. *Id.* at 668.

145. *Id.*

146. *Id.*

147. *Id.* Justice Blackmun wrote a separate opinion "merely to explain why it may be proper to take tax benefits into account in a case brought solely under [section] 10(b) and [r]ule 10b-5 of the SEC, a question the Court leaves open." *Id.* at 667 (citation omitted).

148. *Id.* at 670 (Brennan, J., dissenting).

149. *Id.* at 672.

150. *Id.*

benefits are a major portion of the fair value that the investor receives.¹⁵¹ Justice Brennan therefore concluded that tax benefits are material and that the Court should have considered the petitioners' tax benefits when calculating the difference between the fair value received by the investor and the fair value that the investor relinquished.¹⁵²

Throughout *Loftsgaarden*, the Justices clearly found the distinction between the statutory measure of damages under section 12(2) and the implied measure of damages under section 10(b) insignificant. Most understood section 12(2) as a *rescissory* measure of damages and section 10(b) as an *out-of-pocket* measure of damages. In calculating the section 12(2) rescissory measure, however, courts must measure the price-value disparity between the consideration paid and the income received. If a majority of the Court had found promised tax benefits to be a material part of an investment, then it would have included them in the section 12(2) calculation of the fair value of the income received. The same may be said of the measure of damages under rule 10b-5. If, as a majority of the Court believed, tax benefits are not material, then, as under section 12(2), courts should not factor them into the section 10(b) damages calculation. Hence, despite their different labels, section 12(2) and rule 10b-5 employ identical measures for damages: the difference between the fair value of all that the investor received and the fair value of all that the investor paid at the time of purchase or sale. Stated differently, damages under both section 12(2) and rule 10b-5 equal a quantification of the materiality of the misstatement or omission.

E. The Basic Decision

In *Basic, Inc. v. Levinson*,¹⁵³ the Supreme Court amplified the theme that quantifying the materiality of a defendant's misstatement or omission properly measures the damages under rule 10b-5. Although the *Basic* Court expressly declared that its decision "is not to be interpreted as addressing the proper measure of damages"¹⁵⁴ in fraud-on-the-market cases, the Court's reasoning does reflect a proper theory of damages.

Basic, Inc. (Basic), a publicly-traded company, had engaged in merger negotiations with Combustion Engineering.¹⁵⁵ During these negotiations, Basic publicly issued three statements "denying that it was engaged in merger negotiations."¹⁵⁶ However, Basic ultimately accepted Combustion's merger

151. *Id.*

152. *Id.* at 674.

153. 108 S. Ct. 978 (1988).

154. *Id.* at 992 n.28.

155. *Id.* at 980-81.

156. *Id.* at 981 (the statements are set forth by the Court in footnote 4).

offer.¹⁵⁷ Consequently, a group of former Basic shareholders, who sold their stock after the release of the merger denial statements and before the subsequent tender offer for the outstanding shares, brought a class action suit against Basic.¹⁵⁸ The plaintiffs in *Basic* sought certification of a putative class consisting of all those who sold their stock in Basic during the span of time between the public statements and the suspension of trading in Basic stock. The complaint alleged that Basic and its directors violated rule 10b-5 when they materially misled the plaintiffs by issuing the public denials of pending merger talks.¹⁵⁹

The United States District Court for the Northern District of Ohio certified the plaintiffs as a class because "common questions of fact or law predominated over particular questions pertaining to individual plaintiffs."¹⁶⁰ However, the court granted the petitioners' motion for summary judgment, reasoning that any misstatements made by Basic were not material.¹⁶¹ The United States Court of Appeals for the Sixth Circuit agreed with the district court regarding the class certification, but reversed the granting of summary judgment, holding that Basic's statements regarding the merger negotiations were "misleading," and, therefore, were material as a matter of law.¹⁶² The Supreme Court granted certiorari¹⁶³

to resolve the split . . . among the Courts of Appeals as to the standard of materiality applicable to preliminary merger discussions, and to determine whether the courts below properly applied a presumption of reliance in certifying the class, rather than requiring each class member to show direct reliance on Basic's statements.¹⁶⁴

The Supreme Court first decided to adopt the *TSC Industries, Inc. v. Northway, Inc.*¹⁶⁵ standard of materiality to determine whether a party's misstatement or omission violates section 10(b) and rule 10b-5.¹⁶⁶ The Court then applied the standard to the dispute in *Basic*.¹⁶⁷ The Court re-

157. *Id.*

158. *Id.*

159. *Id.*

160. *Id.* at 981-82.

161. *Id.* at 982.

162. *Id.*; see also *Levinson v. Basic, Inc.*, 786 F.2d 741, 748-49 (6th Cir. 1986), *vacated and remanded*, 108 S. Ct. 978 (1988).

163. *Basic, Inc. v. Levinson*, 479 U.S. 1083 (1987).

164. *Basic*, 108 S. Ct. at 982.

165. 426 U.S. 438 (1976).

166. *Id.* at 449. "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding [whether or not to sell her shares]." *Id.*

167. 108 S. Ct. at 983-88.

jected several of petitioner's policy arguments favoring a "bright-line rule" specifically applicable to the disclosure of information in premerger negotiations. It held that *any* omission or misstatement that had a substantial likelihood of taking on significance to the reasonable investor and significantly altering the total mix of information available to that investor constituted actionable fraud under section 10(b).¹⁶⁸ Under this definition of materiality, the majority reasoned that "materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information."¹⁶⁹ Consequently, it remanded the case "for reconsideration of the question [of] whether a grant of summary judgment [was] appropriate on this record."¹⁷⁰

The Court thus addressed the propriety of the lower courts' reliance on the presumption set forth in the fraud-on-the-market theory.¹⁷¹ This theory creates a rebuttable presumption that, in the currently voluminous securities market, a plaintiff allegedly defrauded by a public misstatement relied on that misstatement when either selling or purchasing securities.¹⁷² The Court held that "[b]ecause most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations . . . may be presumed for purposes of a Rule 10b-5 action."¹⁷³

Having held that an investor's reliance on a public misstatement may be presumed under the fraud-on-the-market theory, the Court then adopted the court of appeals' holding that the presumption could be overcome if the petitioners could rebut the five factors comprising the plaintiffs' prima facie showing,¹⁷⁴ or "show that the misrepresentation in fact did not lead to a

168. *See id.* "Disclosure, and not paternalistic withholding of accurate information, is the policy chosen and expressed by Congress." *Id.* at 984.

169. *Id.* at 988.

170. *Id.* (footnote omitted).

171. *Id.*

The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business. . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements. . . . The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.

Id. (quoting *Peil v. Speiser*, 806 F.2d 1154, 1160-61 (3d Cir. 1986) (citations omitted)).

172. *See id.* at 990-92.

173. *Id.* at 992.

174. *Id.* at 992 n.27. The court of appeals established five threshold facts that a plaintiff must plead and prove in order to establish a loss. *Basic*, 786 F.2d at 751. The Supreme Court modified these five into four by adopting the *TSC* standard of materiality.

[I]n order to invoke the presumption, a plaintiff must allege and prove: (1) that the defendant made public misrepresentations; (2) that the misrepresentations were material; (3) that the shares were traded on an efficient market; (4) that the misrepresentations

distortion of price or that an individual plaintiff traded or would have traded despite his knowing the statement was false.”¹⁷⁵ Thus, severing the link between a defendant’s conduct and a plaintiff’s losses rebuts the reliance presumption.¹⁷⁶

The Court’s reasoning suggests that whether and how much the respondents “lost” as a result of Basic’s premerger misstatements equals the materiality of Basic’s misstatements or omissions. The Court found that, because the class of plaintiffs showed that the defendants made material misrepresentations in a public market, they “established the threshold facts for proving their loss.”¹⁷⁷ Loss is established at the “threshold” because material misrepresentations are those that distort or affect the price at which securities are sold. Thus, the amount of loss is established because material misrepresentations create a disparity between the fair value that the investor paid and the fair value that he received — the price-value disparity.

The Court’s reasoning further manifested the relationship between the loss and the materiality of the misstatement or omission when it determined that a defendant could refute the face amount of a plaintiff’s losses by breaking the causal link between the “alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price”¹⁷⁸ To illustrate the point, the Court stated: “if petitioners could show that the ‘market makers’ were privy to the truth about the merger discussions . . . , and thus that the market price would not have been affected by their misrepresentations, the causal connection could be broken”¹⁷⁹ Significantly, at this point in its discussion the Court penned its footnote disclaiming any intention to address the proper measure of damages in fraud-on-the-market cases.¹⁸⁰ The Court thereby recognized the direct connection between the materiality of the defendants’ misstatements and the measure of damages. Where the defendants’ conduct affected neither the fair value received by the investor nor the fair value paid out by the investor, that conduct was immaterial. Conversely, if the plaintiffs could show that

tations would induce a reasonable, relying investor to misjudge the value of the shares; and (5) that the plaintiff traded the shares between the time the misrepresentations were made and the time the truth was revealed.

Given today’s decision regarding the definition of materiality, . . . elements (2) and (4) may collapse into one.

Basic, 108 S. Ct. at 992 n.27 (citation omitted).

175. *Basic*, 108 S. Ct. at 992; *see also* 786 F.2d at 750 n.6.

176. *Basic*, 108 S. Ct. at 992.

177. *Id.*; 786 F.2d at 751.

178. *Basic*, 108 S. Ct. at 992.

179. *Id.*

180. *Id.* at 992 n.28.

the defendants' conduct created an adverse price-value disparity, that conduct would be material and the plaintiffs would have established their loss.¹⁸¹

The proper measure of damages in rule 10b-5 cases such as *Basic*, therefore, depends upon a quantification of the materiality of the defendant's misstatements or omissions. In *Basic*, the damages issue was twofold. First, the plaintiffs had to demonstrate that the question of damages could be resolved either on a class-wide basis or by creating subclasses for damages purposes. Attempting to decertify the class as the litigation proceeded, the defendants argued that individual questions of damages predominate over questions of law and fact common to all members of the class.¹⁸² Second, the plaintiffs should have undoubtedly presented the related claim that damages could and should be calculated on a class-wide basis by taking the difference between the tender offer price and the price at which they sold their shares. Thus, if a plaintiff had sold stock during the class period of \$26 per share and the tender offer price was \$46 per share, his damages would be \$20 per share.

A quantification of the materiality of the nondisclosures, however, requires more than simply subtracting the tender offer price from the price received. In the language of *Affiliated Ute*¹⁸³ and *Loftsgaarden*,¹⁸⁴ damages equal the difference between the fair value of all that the seller received and the fair value of all that the seller would have received absent the material omission. In *Basic*, the Supreme Court supplied factors for assessing the materiality of the omission of a contingent or speculative event such as a merger:

Generally, in order to assess the probability that the event will occur, a factfinder will need to look to indicia of interest in the transaction at the highest corporate levels. . . . [B]y way of example . . . board resolutions, instructions to investment bankers, and actual negotiations between principals or their intermediaries may serve as indicia of interest. To assess the magnitude of the transaction to the issuer of the securities allegedly manipulated, a factfinder will need to consider such facts as the size of the two corporate entities and of the potential premiums over market value.¹⁸⁵

181. *Id.*

182. See FED. R. CIV. P. 23(b)(3) (stating the prerequisites to establishing and maintaining a class action suit).

183. *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972); see also *supra* text accompanying notes 35-65.

184. *Randall v. Loftsgaarden*, 478 U.S. 647, 661-62 (1986); see also *supra* text accompanying notes 77-152.

185. *Basic*, 108 S. Ct. at 987.

While these factors hold particular interest for the investor because they carry direct relevance in an evaluation of the issuer's stock, as the fraud-on-the-market theory suggests, the probability that an event such as a merger will occur and its magnitude to the issuer will affect the trading price of the stock. A remote contingency of little or no magnitude to the issuer will only slightly affect the trading price, if it does so at all. On the other hand, if a merger is probable, and will have a tremendous effect on the issuer, the stock price will respond accordingly. The probability-magnitude test, therefore, provides one way to adjudge the effect of the defendant's omission on the price at which stock trades. The fair value of the stock, which the *Basic* plaintiffs relinquished, reflected, as it did in *Affiliated Ute*, factors such as the probability and magnitude of contingent events. If the plaintiffs prove that the defendants' omissions were so material, given the probability and magnitude of the merger, that the fair value of their stock at the time of sale was really \$46, then they may receive, as the measure of the materiality of the omission, the difference between that fair value and the value they actually received.

By contrast, defendants trying to sever the link between their omissions and a plaintiff's losses will endeavor to show that those omissions did not affect the price at which the plaintiffs sold; that is, they were not material. The Court, in *Basic*, offered guidance on how to prove the absence of damages to defendants trying to sever the link.¹⁸⁶ A defendant may demonstrate that: (1) if she had made the requested disclosures, it would not have affected the fair value that a plaintiff received because it would not have altered the total mix of information already available to her or would not have significantly affected her investment decision; or (2) if the defendant disclosed the pertinent information, the fair value which the plaintiff relinquished would not have been affected.¹⁸⁷ If the plaintiff, for example, wanted to get out of the market for *Basic* stock regardless of contingent events, then the disclosure of those events would not have taken on significance in its investment decisions. Alternatively, if the plaintiff already knew of the contingent events, or if the market had communicated that knowledge to the plaintiff, then the disclosures would not have altered the total mix of information already available to it.¹⁸⁸

Although these damages inquiries seem individualized, they are not. In a fraud-on-the-market case, the market price impounds all information available to the reasonable investor.¹⁸⁹ Even an investor who sells regardless of

186. *Id.* at 992.

187. *Id.*

188. *Id.*

189. *Id.* at 988-89.

the market price receives an amount for his stock that reflects material non-disclosures. Not even the most unreasonable investor can say that his decisions are unaffected by material nondisclosures. Even if the investor is privy to the truth about material contingent events, the materiality of the nondisclosures to the market will affect the price that he receives for his stock. Indeed, where leaks have occurred and trading accelerates, the market price reflects that degree of available information as well, decreasing the price-value disparity. Because the determination is so dependent upon an objective standard of materiality, a court can resolve the issue of damages on a class-wide basis with the help of expert testimony.

In quantifying the materiality of the defendant's misstatement or omission, the disparity between the fair value received and the fair value relinquished by the plaintiff is the lodestar. District courts possess considerable discretion in calculating the fair value of stock. They may, guided by expert testimony, consider a number of factors, including the value of the underlying assets owned by the issuer, the transaction price, market prices over a period of time, the supply and demand for the stock, and external depressant factors in the market.¹⁹⁰ The courts, though, may not factor the tax benefits of the investment into the fair value calculation. Likewise, the courts may not consider the "expected fruits of an unrealized speculation" because those are also immaterial as a matter of law.¹⁹¹ But in assessing the effect of contingent or speculative events upon the fair value of stock, the courts should weigh the magnitude of the events to the issuer against the probability of their occurrence.¹⁹² On the other hand, in calculating the fair value of the price paid for stock, a court has the relatively simple task of determining consideration, making sure only that the fair value of the consideration is not reduced by anticipated tax benefits.¹⁹³

By calculating in this manner the difference between the fair value of consideration paid and the fair value of stock received, the lower courts will arrive at a damages figure that represents only the amount by which the defendant's misstatement or omission altered the total mix of information already made available to the plaintiff through the market or otherwise. The lower courts should use this price-value disparity as a way to quantify the materiality of the defendant's misstatement or omission.

190. *See generally* *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972).

191. *See id.*; *Smith v. Bolles*, 132 U.S. 125, 130 (1889); *see also supra* notes 25-34 and accompanying text.

192. *Basic*, 108 S. Ct. at 987; *see also supra* text accompanying notes 177-79.

193. *See Randall v. Loftsgaarden*, 478 U.S. 647 (1986); *see also supra* text accompanying notes 77-152.

III. RULE 10b-5 DAMAGES IN THE LOWER FEDERAL COURTS

Absent explicit Supreme Court guidance, the lower federal courts have applied, indeed have created, a variety of damage measures for rule 10b-5 liability. Finding clarity or consistency among the circuits is virtually impossible, particularly because some circuits have not yet addressed many significant rule 10b-5 damage issues. Nevertheless, this section endeavors to identify a common theme running through the lower court decisions. The lower federal courts have given a variety of labels to their damages theories. Those labels, however, represent only different ways to achieve a quantification of the materiality of the defendant's misstatement or omission.

A. *The First Circuit*

The United States Court of Appeals for the First Circuit adheres to the general measure of damages for section 10(b) liability: "the difference between the fair value of what the seller received and the fair value of what he would have received in the absence of fraudulent conduct"¹⁹⁴ measured as of the date of the sale.¹⁹⁵ Plaintiffs generally may recover "such outlays as were legitimately attributable to the defendant's conduct, but not damages covering 'the expected fruits of an unrealized speculation.'"¹⁹⁶

The First Circuit, however, recognizes an exception to this general rule when stock is not purchased from, but sold to the fraudulent party. If, in that case, the defendant buyer gains more than the plaintiff seller loses, damages are "that portion of the defendant's profits as are not due to the defendant's own special efforts after the fraud occurred."¹⁹⁷

In *Holmes v. Bateson*, the court applied the general rule,¹⁹⁸ while in *Janigan v. Taylor*, the court applied the exception.¹⁹⁹ The court's application of these principles to the facts of both cases, however, reveals that the difference in the measure of damages is only an attempt to quantify the materiality of the defendant's misstatements and omissions.

194. *Holmes v. Bateson*, 434 F. Supp. 1365, 1388 (D.R.I. 1977), *aff'd in part and rev'd in part*, 583 F.2d 542, 562 (1st Cir. 1978).

195. See *Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

196. *Id.* (quoting *Sigafus v. Porter*, 179 U.S. 116, 125 (1900)).

197. *Holmes*, 583 F.2d at 562 (quoting *Holmes*, 434 F. Supp. at 1388 (citing *Janigan*, 344 F.2d at 786)); see also *Kravitz v. Pressman, Frohlich & Frost, Inc.*, 447 F. Supp. 203, 216 (D. Mass. 1978).

198. *Holmes*, 583 F.2d at 562.

199. *Janigan*, 344 F.2d at 786-87.

1. Holmes v. Bateson

In *Holmes*, the executors of Howard Holmes' estate brought a rule 10b-5 action against Holmes' former partners, Bateson and Bronson, and the Maguire Corporation, alleging that they " 'willfully participated in a scheme . . . designed to communicate false and misleading information about the condition, status, affairs and prospects of the [Maguire] Corporation and Partnership so as to cause the sale by plaintiffs of the Holmes shares of the Corporation.' "200

Maguire, an engineering firm, operated as a partnership in Rhode Island.²⁰¹ However, in January 1969, the partnership incorporated to avoid continuing losses resulting from cash flow problems.²⁰² The shareholders of the new corporation then decided that they needed to agree on "some method of determining the value of the stock in the event of death."²⁰³ "Holmes, Bateson, and Bronson agreed . . . 'that should anything happen to any one of them, until such agreement was entered into, that the determination of the value of the deceased or withdrawing or discharged partner would be as if they were still a partnership.' "204 Holmes died shortly thereafter, owning a 41.7% interest in the corporation.²⁰⁵

Bronson and Bateson, on behalf of the corporation, entered into a settlement agreement with Holmes' estate for a total of \$815,000.²⁰⁶ The partners arrived at this figure, which represented Holmes' share of both the partnership and the corporation and included loans made to the corporation by Holmes and his estate, through a complex computation system.²⁰⁷

200. 583 F.2d at 545 (quoting Complaint).

201. *Id.* In addition to Holmes, Bateson, and Bronson, the partnership included a fourth partner, Nelson, whose relevance to this case was limited to the terms of his sellout arrangement. *Id.* at 545 n.2.

202. *Id.* at 546. Overall, the partnership was considered a promising enterprise, yet poor accounting practices continually plagued it. To avoid these problems, the partners individually transferred certain assets to the newly formed corporation and received, in exchange, a share of the new corporation's stock. *Id.* The corporation issued 850 shares of common stock; Holmes received 350 shares, and Bronson and Bateson each received 250 shares; Nelson elected to have his 26% interest bought out and received \$400,000 for that interest. *Id.*

203. *Id.*

204. *Id.* at 546-47. The preexisting partnership had devised a method for distributing a deceased or withdrawing partner's interest in the business. *Id.* at 547.

205. *Id.* The corporation was also indebted to Holmes for \$244,000. *Id.*

206. *Id.* at 550. The Maguire corporation owed the estate \$581,603.62. "Payment was to be made in seven annual installments of \$83,086 without interest." *Id.* The remaining \$233,397 was due the estate from the partnership. *Id.*

207. *Id.* at 549 n.7, 555. When the amount of the loans was deducted from the total settlement amount, the actual value paid to the estate for the stock was \$4,453.62. *Id.* at 555. Out of the \$815,000, the amount attributable to the corporation for working capital by Holmes and

Meanwhile, however, Bronson and Bateson were engaged in merger negotiations with Combustion Engineering, Inc.²⁰⁸ These negotiations indicated that Maguire was much more valuable than disclosed to Holmes' estate in the settlement negotiations.²⁰⁹ Furthermore, the corporation adopted the accrual method of accounting, rather than the cash basis method which the partnership employed, and thereby experienced a higher yearly profit than that revealed to the estate.²¹⁰ Consequently, the defendants never fully informed the estate about the true value of its share in Maguire.²¹¹

When Holmes' estate discovered the merger and subsequently realized its share in Maguire had been undervalued, the estate brought an action under section 10(b) and rule 10b-5 "to obtain compensatory damages for the sales of securities allegedly induced by [Maguire] . . . in violation of the [Securities Exchange] Act and the Rules promulgated pursuant to it."²¹² The estate also brought a claim for fraud under Rhode Island common law.²¹³

The district court found and the appellate court affirmed that the defendants had made two material omissions: (1) failure to disclose the accrual of profit to the corporation; and (2) failure to disclose the continuing negotiations.²¹⁴ These material omissions created a disparity between the value that the estate received for its Maguire stock at settlement and the fair value of that stock. Holmes' estate accepted the sum of \$4,453.62 for its 41.6% share of Maguire stock.²¹⁵ The court of appeals determined the fair value of that 41.6% share to be \$2,153,424.00. Therefore, the price-value disparity amounted to \$2,148,554.38.²¹⁶

the estate totalled \$577,150. Therefore, the amount paid for Holmes' share of stock in the corporation could only be \$4,453.62. *Id.*

208. *Id.* at 550. Maguire also entertained merger discussions with Science Management Corporation, but ultimately settled on Combustion Engineering, Inc. *Id.* at 548, 550.

209. *See id.*

210. *See id.*

211. *Id.* at 551.

212. *Id.* at 544-45; *see also* 15 U.S.C. § 78j(b) (1982).

213. *Holmes*, 583 F.2d at 544-45.

214. *Id.* at 551.

215. *Id.* at 564. It is recognized that Holmes' share of the corporation was previously described as 41.7%. *See supra* text accompanying note 205. The opinion of the court actually states both figures as cited herein.

216. *Id.*

Contributions to capital [made by Holmes] must be deducted from the \$6,000,000 value of the corporation before damages can properly be assessed. These contributions totaled \$824,500, comprised of two advances of \$412,250 made by each of the two officers. The \$6,000,000 figure is, therefore, reduced to \$5,175,500. When this figure is multiplied by the estate's share of the corporate stock (41.6%), the result is \$2,153,424. From this must be deducted the \$4,453.62 already paid to the estate for its stock, leaving a remainder of \$2,148,554.38 instead of the district court's figure of \$2,465,746.38.

In affirming in substantial part the district court's measure of the fair value of the stock relinquished, the court of appeals sanctioned the lower court's reliance on expert testimony, finding such reliance "exclusively within [the] province" of the district court.²¹⁷ Based upon that testimony, the lower court found that Maguire Corporation had a fair value of \$6 million and not \$1,489,000 as originally reported by the appellants. The expert, Professor Hunt, based his valuation of Maguire primarily upon an analysis of "the future funds flow which the company offers to its owners."²¹⁸

The \$6 million fair value figure calculated by Professor Hunt and generally approved by the court was not based upon the market price of Maguire stock on the date of the challenged trades. Although the First Circuit agreed with the appellants' contention that the market price, defined as the price at which the stock was sold on an open market in a contemporaneous transaction, "is generally recognized as the best evidence [of fair value] when it is available and reliable,"²¹⁹ the court rejected that measure in this case. The court asserted that: (1) the sale of Maguire did not take place on the open market; (2) the stock involved in the transaction was unregistered, and thus could not have been sold on the open market; and (3) the market value of the acquiror's stock had no bearing on the value of Maguire stock.²²⁰ Accordingly, the First Circuit concluded that the "determination of the value of Maguire's stock demanded a more sophisticated approach than the simple application of a price index to the shares of [the acquiror's] stock."²²¹

Id. (footnote omitted).

217. *Id.*

218. *Id.* at 562. Professor Hunt, a member of the Harvard Business School specializing in corporate finance, described the future funds flow as a figure:

obtained partially by using the history of the company to see the trends and partly by studying other elements to predict [the] future course of it's [sic] funds flow and earnings, and equal importance is given to the price earnings ratio as an indication of . . . the investment world's evaluation of this type of risk.

Id. Hunt also testified that book value "is almost never one of the factors used in determining the true value of a corporation, particularly with a service company such as Maguire." *Id.* at 562-63.

219. *Id.* at 563 (citing *Mills v. Electric Auto-Lite Co.*, 552 F.2d 1239, 1247 (7th Cir.), *cert. denied*, 434 U.S. 922 (1977); *Chris-Craft Indus. v. Piper Aircraft Corp.*, 516 F.2d 172, 185 (2d Cir. 1975), *rev'd on other grounds*, 425 U.S. 910 (1977)).

220. *Holmes*, 583 F.2d at 563.

221. *Id.* at 563-64. That sophisticated approach adopted by the court involves a balance of the following factors:

'[T]he companys [sic] history and management, its operating expenses and earnings, the book value and adjusted book value of its shares, the selling price of its stock and its profit trends.' . . .

. . . .

. . . [Other factors] to be considered in determining the value of . . . a going business [are] what [the defendants] themselves thought it was worth [and expert testimony as

These factors are designed to show the degree to which the defendants' failure to disclose merger negotiations and the accrual profits of the corporation affected the plaintiffs' decision to sell at a price lower than the stock's fair value. The \$6 million fair value figure was discussed during the nondisclosed merger negotiations.²²² Those aware of the potential merger valued the stock at a minimum of \$6 million. That information alone would have substantially affected any decision by a reasonable investor to sell his Maguire stock for less than the investor's proportionate share of \$6 million. Furthermore, that valuation reflected the acquiror's knowledge of material facts not disclosed to the plaintiffs: the accrual profit of the company, measured primarily by the future flow of funds that the company offers its owners.

Clearly, when informed of these material facts not disclosed to the plaintiffs, a reasonable investor would not have sold his stock for less than his proportionate share. But the Holmes' estate administrators, acting on the total mix of information available to them, reasonably evaluated their stock at only \$4,453.62.²²³ The difference between the value they received and the fair value they exchanged in return precisely measured the effect of the nondisclosures on the price at which they could have sold their stock. That differential clearly measures the degree to which the nondisclosures affected the reasonable investor, or, a quantification of the materiality of the defendants' silence.

2. Janigan v. Taylor

In *Janigan*,²²⁴ the class plaintiffs, former stockholders of BESCO, similarly claimed that the defendant, who served as BESCO's president, general manager, and director, induced them to sell their BESCO stock by misrepresenting that no material events had occurred within the company that would alter its present value.²²⁵ Based on the defendant's representation that the value of BESCO would remain the same, the plaintiffs immediately sold their BESCO stock to the defendant for \$40,000, or about \$20 per share. Two years later, the defendant resold the stock for \$700,000 or about \$300

to the predicted future flow of funds that the company offers to the owners of its stock].

Id. (quoting *Holmes v. Bateson*, 434 F. Supp. 1365, 1388 (D.R.I. 1977), *aff'd in part and rev'd in part*, 583 F.2d 542 (1st Cir. 1978).

222. *Id.* at 550.

223. *Id.*

224. 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

225. *Id.* at 783.

per share.²²⁶ The First Circuit held that the plaintiffs were entitled to the amount of the defendant's profits not attributable to his own labors. This measure of recovery returns to the plaintiffs the amount lost as a "proximate consequence of the fraud."²²⁷

The court, however, would not award to the plaintiffs all the defendant's profits from the eventual sale of the BESCO stock because not all the profits resulted directly from the fraud.²²⁸ The court made clear, by way of analogy, that limiting the profit recovery properly measures materiality: "If an artist acquired paints by fraud and used them in producing a valuable portrait we would not suggest that the defrauded party would be entitled to the portrait, or to the proceeds of its sale."²²⁹

In *Janigan*, the company's stock price rose to its \$300 per share level after the plaintiffs sold because of "price rises, increased efficiency, and an improvement in the business cycle."²³⁰ The plaintiffs claimed that the defendant failed to disclose to them these very facts at the time of sale.²³¹ The First Circuit found that almost the entire measure of the defendant's profit (\$300/share minus \$20/share) was attributable to these material omissions. The court, however, reduced the district court's damage award slightly because it found that the plaintiffs expected the defendant to continue to receive his 10% bonus on net pretax profits under an already established company plan.²³² The court suggested that had the plaintiffs remained unaware of any information regarding this bonus, this ignorance would nonetheless not have altered the total mix of information already reasonably available to the plaintiffs and, thus, would not have been material. Accordingly, the First

226. *Id.*; see also *Taylor v. Janigan*, 212 F. Supp. 794, 798 (D. Mass. 1962), *remanded*, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

227. *Janigan*, 344 F.2d at 786.

228. *Id.* at 787. The court found that the defendant could still have expected to continue to receive 10% of net pretax profits under the terms of the agreement, notwithstanding the misrepresentation and subsequent sale. The court did not disallow the defendant this bonus. *Id.*; see also *infra* text accompanying notes 229, 232.

229. *Janigan*, 344 F.2d at 787. The artist, who buys paint for \$10 (which has a fair value of \$20) by materially misrepresenting its quality, is liable under this theory for his profit attributable only to his misrepresentation, or \$10. If the artist paints a portrait worth \$1,000, he has profited, but that profit is unrelated to any material misrepresentation. Similarly, if the artist had failed to disclose his intention to paint a \$1,000 portrait, he still would not be liable for his total profit because no reasonable paint seller would alter an investment decision because of information that the paint would greatly increase in value, but only in someone else's hands. The painter's recoverable profit, therefore, is still limited to the materiality of the challenged nondisclosure.

230. *Id.*

231. See *Taylor v. Janigan*, 212 F. Supp. 794 (D. Mass. 1962), *remanded*, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

232. *Janigan*, 344 F.2d at 787.

Circuit reduced the damage award by an amount designed to discount as immaterial the nondisclosure of the defendant's bonus, thereby attempting to find a precise measure of the materiality of the defendant's omission.

3. SEC v. MacDonald

The First Circuit further demonstrated that the unjust enrichment or disgorgement remedy in *Janigan* serves as a surrogate for a quantification of materiality in its en banc decision in *SEC v. MacDonald*.²³³ In *MacDonald*, the court held that in an insider trading case, if the defendant buys stock without disclosing material information in breach of a duty to disclose, the proper measure of the SEC's disgorgement remedy is limited to the amount of the defendant's profits that resulted from the material omission.²³⁴ Although this holding pertained to SEC enforcement actions, the court's reasoning involved analogies to private rule 10b-5 damages actions. The case, therefore, indicated the proper amount of the defendant's profit which a court can disgorge in such private actions.

MacDonald served as the Chairman of the Board of Trustees of Realty Income Trust (RIT) when RIT accepted title to a twenty-five story building in Cincinnati, Ohio, in settlement of a lawsuit it had filed against the building's owners.²³⁵ Although during this time RIT had publicly announced the lawsuit and a decline in its earnings reflected in its quarterly financial report, it did not announce its acquisition of the building until twelve days after it occurred.²³⁶ Between the acquisition date and the announcement date, MacDonald purchased 9,600 shares of the company at between 4 1/2 and 4 5/8 per share.²³⁷ RIT subsequently announced its valuable acquisition, and the price of its stock climbed to 5 3/4. Two years later, MacDonald sold his 9,600 shares for an average of \$10 per share, reaping a profit of \$53,013.²³⁸

The SEC alleged, and the trial court found, that MacDonald's purchase of 9,600 shares, without disclosing material information to his sellers, consti-

233. 699 F.2d 47 (1st Cir. 1983).

234. *See id.* at 53-54.

235. *Id.* at 48.

236. *Id.* On December 12, 1975, "the case was settled by [the owner's] surrendering to RIT ownership of the Kroger Building That day, however, RIT . . . release[d] its quarterly financial report, which, basically, contained nothing but bad news." *Id.* On December 24, RIT announced "for the first time the acquisition of the Kroger Building," which substantially brightened its financial picture. *Id.* at 48-49.

237. *Id.* at 48. MacDonald's wife, acting on his behalf, purchased 100 shares at 4 1/2, and MacDonald, on December 23, purchased 9,500 shares at 4 5/8. *Id.*

238. *Id.* at 49.

tuted a breach of his duty to disclose and violated rule 10b-5. The court ordered MacDonald to disgorge his entire profit.²³⁹

The First Circuit affirmed the finding of liability, but remanded the issue of damages to the lower court with instructions to limit the amount of the profit recovered to that caused by the material omission.²⁴⁰ The court thus rejected a recovery based on the difference between the purchase price and the resale price, and limited recovery to the difference between the purchase price and the stock price at a "reasonable time after public dissemination" of the material information.²⁴¹ The First Circuit reasoned that an award of damages for profits earned during the period of effective nondisclosure would approximate the materiality of the nondisclosure, rather than the defendant's independent business acumen. This rationale takes into account the degree of the materiality of the defendant's nondisclosure.

Moreover, the court reasoned, where the stock involved is publicly traded and the seller has learned of the previously undisclosed facts, he "cannot later claim that his failure to obtain subsequent stock appreciation was a proximate consequence of his prior ignorance."²⁴² This rationale also relied on the notion that the plaintiff's recovery should be an accurate measure of the length, if not the degree, of the materiality of the nondisclosure. When the nondisclosure ceases to be material, the link between the defendant's conduct and plaintiff's losses has been broken. Recovery based upon the difference between the purchase price and the market price a reasonable time after the disclosure of material information reflects an accurate measure of the materiality of the information concealed.

The First Circuit felt the need to reconcile its partial disgorgement remedy with the so-called full disgorgement remedy awarded in *Janigan*.²⁴³ It did so by arguing first that the profits awarded in *Janigan* were wholly attributable to the defendant's material omissions, and second, that the plaintiff sellers in *Janigan* could not have reinvested in the stock after the disclosure of the information because the stock was not publicly traded.²⁴⁴ The measure of damages in *Janigan*, whether denominated partial or full disgorgement, consisted of the defendant's profit which represented the materiality of his nondisclosures. That amount, in the case of a closely held corporation whose president grossly misrepresented the company's future prospects,

239. *Id.* at 52. The district court assessed MacDonald's profit at \$53,012. *Id.*

240. *Id.* at 55.

241. *Id.*

242. *Id.* at 53.

243. *Janigan v. Taylor*, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965). *See also supra* notes 224-32 and accompanying text.

244. *MacDonald*, 699 F.2d at 53.

happened to be virtually all of the profit. In *MacDonald*, by contrast, the amount of the windfall attributable to the defendant's nondisclosure happened to reflect less than the full extent of his profits. Both cases, however, stand for the proposition that in private rule 10b-5 actions, the proper measure of damages is a quantification of the materiality of the nondisclosure.

B. *The Second Circuit*

Judge Friendly announced the general rule that the United States Court of Appeals for the Second Circuit applies to measure damages under rule 10b-5:

[A] defrauded buyer of securities is entitled to recover only the excess of what he paid over the value of what he got, not, as some other courts had held, the difference between the value of what he got and what it was represented he would be getting²⁴⁵

As the foregoing statement indicates, the Second Circuit follows the majority of courts in generally embracing the out-of-pocket measure of damages and rejecting the benefit-of-the-bargain measure of damages in rule 10b-5 actions.

However, the court has also created exceptions to its general rule. First, in *Chasins v. Smith, Barney & Co.*, the court held that a defrauded buyer may, in some circumstances, recover the difference between the value of the consideration paid and the resale value or the value of the security within a reasonable time after the concealed material facts are disclosed.²⁴⁶ Unlike the out-of-pocket rule, which measures the disparity between fair value paid and received at the time of sale, the *Chasins* rule measures the disparity between value paid and resale value or value received at a reasonable time after the disclosure of the material facts.²⁴⁷ Second, a defrauded buyer may occasionally recover a measure of the defendant's profit resulting from the fraud.²⁴⁸ Finally, the Second Circuit recognizes that a defrauded seller may recover:

not only the difference between the actual value and what he received at the time of sale, but added profits which the buyer has realized through accretions in value subsequent thereto, or which the seller would have realized had he retained the stock for a reasonable period after the disclosure.²⁴⁹

245. *Levine v. Seilon, Inc.*, 439 F.2d 328, 334 (2d Cir. 1971).

246. 438 F.2d 1167 (2d Cir. 1970).

247. *Id.* at 1173. See *infra* notes 272-89 and accompanying text.

248. *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973); see also *infra* text accompanying notes 290-99.

249. *Levine*, 439 F.2d at 334 (citations omitted).

Defrauded sellers thus have available three alternative damages theories: (1) out-of-pocket, or the difference between fair value paid and received at the time of sale; (2) disgorgement, or the amount of the defendant's profit attributable to his material nondisclosures or misstatements; or (3) the cover measure of damages, which, by awarding the plaintiff the difference between the fair value of the consideration paid to the seller on the date of sale and the fair value of the stock measured at the highest value attained within a reasonable time after the disclosure of the fraud,²⁵⁰ theoretically approximates the cost to the plaintiff of *replacing* the securities.²⁵¹ However, the court has not suggested any "decisive" legal distinction to identify the proper measure of damages for defrauded sellers and defrauded buyers.²⁵²

1. *The General Rule: Damages Rooted in Materiality*

Although the general rule and its exceptions can be identified and supported with a variety of underlying theoretical foundations, the cases in which the Second Circuit has applied them manifest a unity of purpose and result: The court awards the plaintiff damages in an amount directly attributable to the materiality of the defendant's misstatements or omissions.

In Judge Friendly's germinative decision in *Levine v. Seilon, Inc.*,²⁵³ the measure of recovery clearly represented a quantification of the materiality of the defendant's misrepresentation. In *Levine*, the plaintiff, a preferred stockholder of Seilon, Inc. (Seilon), alleged under rule 10b-5 that Seilon had falsely represented that it would provide him an opportunity to exchange his preferred shares of stock for common stock, thereby inducing him to consent to its new credit arrangements. Seilon subsequently used these credit arrangements to redeem rather than to exchange the preferred stock.²⁵⁴

250. *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1306 n.27 (2d Cir. 1973).

251. See A. JACOBS, *supra* note 6, § 260.03[c][iii], at 11-39.

252. *Zeller*, 476 F.2d at 802 n.10.

253. 439 F.2d 328 (2d Cir. 1971).

254. *Id.* at 329-32. Plaintiff alleged that Seilon developed a plan to acquire all its preferred stock by redemption. Seilon allegedly wanted to redeem the stock to free itself from several restrictions on its activities contained in its certificate of incorporation. Seilon allegedly needed the fraudulent scheme as a consequence of not having enough cash on hand to redeem the stock.

Seilon's preferred shareholders had previously refused to give the approval necessary to create new funded debt. In order to induce such consent, Seilon promised to allow its preferred shareholders to exchange their shares for common shares. It also represented that its board of directors had authorized such an exchange program, that it would not redeem any of the preferred shares until after the close of the exchange offer period, and that it would register the necessary number of common shares for the exchange plan under the Securities Act of 1933.

Based upon these representations, the preferred shareholders consented to Seilon's desired credit arrangements. Seilon entered into the new credit arrangements and then undertook the sale or transfer of stock it owned as well as some of its own assets. Seilon then filed the S-1

Leaving aside the issue of whether the plaintiff's actions amounted to a purchase or sale of securities, the court found two problems with the plaintiff's theory. First, the court found that no causal connection existed between the stockholders' consent to the new credit arrangement and the challenged redemption, meaning that the alleged misrepresentation could not have affected the plaintiff's *investment* decision.²⁵⁵ Second, because the plaintiff failed to allege that his preferred shares had an investment value greater than the price at which they were redeemed, he could not demonstrate an adverse price-value disparity with respect to his stock.²⁵⁶ Levine suffered no compensable loss precisely because the challenged misrepresentations, while they may have been false, did not affect any reasonable investment decision, and therefore were not material. Furthermore, the court found that the alternate remedy of disgorgement was not available to the plaintiff, purportedly a forced seller, for the same reason: Whatever profits Seilon may have received were not the product of any material misstatement.²⁵⁷

Even in a case where the Second Circuit seemed to adopt a benefit-of-the-bargain measure of damages, in reality it attempted to calculate the materiality of the defendant's misrepresentations. In *Osofsky v. Zipf*,²⁵⁸ shareholders were induced to sell their controlling block of stock in a corporation by misstatements concerning the value of consideration they would receive as a result of a subsequent tender offer and merger.²⁵⁹ The court distinguished *Levine* and held that such shareholders could recover nonspeculative, compensatory damages measured by the benefit of their bargain.²⁶⁰ After observing that the *Levine* court rejected the benefit-of-the-bargain measure only because it was too speculative, the *Osofsky* court concluded that where the misrepresentation concerned the amount of consideration to be paid for the stock, the plaintiffs were entitled to receive the difference between the

Registration Statement for the common stock offered in the exchange program, stating therein that it did not intend to call any of the preferred stock before the close of the exchange period. Seilon then substituted stock in one of its subsidiary companies for cash that had earlier been pledged as collateral for another loan. It then had the cash it acquired in that transaction available for the redemption it had allegedly planned all along. Seilon then issued a call for the preferred stock and redeemed it with the cash obtained in the exchange of collateral.

255. *Id.* at 332, 333-34. By finding that the misrepresentations did not affect Levine's investment decision, the court simply held that the misstatement was not material.

256. *Id.* at 332-35. Essentially, the court found that Levine "suffered no compensable loss." *Id.* at 335.

257. *Id.* at 334-35.

258. 645 F.2d 107 (2d Cir. 1981).

259. *Id.* at 109-10, 114.

260. *Id.* at 111-12, 114.

fair value of the securities they gave up and the fair value of the consideration defendants represented that the plaintiffs would receive.²⁶¹

Unlike *Levine*, the facts of *Osofsky* indicate that the benefit-of-the-bargain measure of recovery reliably gauged the materiality of the defendant's misstatement. In *Osofsky*, the defendants misstated the price that they would pay for the plaintiffs' stock.²⁶² The court found the misstatement material because the amount of consideration promised, unlike the fruits of speculation or puffing, had a substantial likelihood of assuming importance to the reasonable investor.²⁶³ The degree of materiality of the misstatement, as the court recognized, was defined easily by the disparity between the consideration agreed upon and the consideration received.

In fact, the court of appeals recognized that its measure of damages was rooted in the materiality of the misstatement. The district court noted that the value of consideration actually received by plaintiffs was "approximately" the same as the value represented.²⁶⁴ In reversing and remanding, the Second Circuit reasoned that the key question for purposes of measuring damages in the case was whether that disparity was material.²⁶⁵ The court concluded that the trier of fact, on remand, must be allowed to award damages in the amount of that disparity if it finds "a substantial likelihood that a reasonable investor would consider it important" in making an investment decision.²⁶⁶ "[W]hether the measure of those compensatory damages be out-of-pocket loss, the benefit of the bargain, or some other appropriate standard," the plaintiff is entitled to recover the economic loss suffered as a result of a material misstatement or omission.²⁶⁷ If, as in *Osofsky*, the benefit-of-the-bargain measure best approximates the materiality of the misstatements, then that measure is appropriate. But the measure itself is not ipso facto appropriate; rather its propriety lies in the fact that it approximates the materiality of the misstatements. Consequently, the Second Circuit has re-

261. *Id.* at 114.

262. *Id.* at 110. The defendant, J. Ray McDermott & Co., Inc. (McDermott), represented that it would compensate the Babcock & Wilcox shareholders, in exchange for each of their shares, a package of securities valued at \$62.50. *Id.* This final price resulted from a takeover battle for Babcock between McDermott and United Technologies Corporation. *Id.* at 109.

263. *Id.* at 114-15.

264. *Id.* at 114. The district court determined that the plaintiff received \$59.88, " 'approximately' the same as the consideration allegedly represented." *Id.* The court of appeals disagreed stating that "the difference between \$59.88 and \$62.50 is some 4%, which is not so obviously unimportant that it can be viewed as immaterial as a matter of law." *Id.* (footnote omitted).

265. *Id.* at 114-15.

266. *Id.* (quoting *TSC Indus. v. Northway, Inc.*, 426 U.S. 438 (1976)).

267. *Id.* at 111.

jected the benefit-of-the-bargain measure when it does not quantify materiality.

In *Barrows v. Forest Laboratories, Inc.*,²⁶⁸ the Second Circuit declared that “[a] claim for benefit-of-the-bargain damages must be based on the bargain that was actually struck, not on a bargain whose terms must be supplied by hypotheses about what the parties would have done if the circumstances surrounding their transaction would have been different.”²⁶⁹ The court rejected benefit-of-the-bargain damages in *Barrows* as “speculative,” not because they were difficult to measure, but because the effect of the defendant’s deflation of the value of plaintiffs’ stock upon plaintiffs’ decision to enter the transaction was difficult to gauge.²⁷⁰ In other words, the materiality of the defendant’s misrepresentations was too speculative to allow the plaintiffs to amend their complaint to seek damages covered by those misrepresentations.²⁷¹ Judge Friendly’s embrace of the out-of-pocket measure and rejection of the benefit-of-the-bargain measure in *Osofsky* thus reflected a judgment that, generally, the disparity between fair value obtained and fair value relinquished provided a better measure of the materiality of the defendant’s conduct than the disparity between fair value obtained and fair value promised.

2. *The Chasins Measure of Damages*

Even the *Chasins v. Smith, Barney & Co.*²⁷² measure of damages for defrauded buyers of securities demonstrates a judicial effort to approximate the materiality of the nondisclosure. The *Chasins* method measures the differential between the fair value of the consideration paid and the lowest fair value of the stock within a reasonable time after the concealed material facts are disclosed. Chasins, a commentator on a radio program sponsored by Smith, Barney & Co., opened an account with the brokerage firm.²⁷³ In a series of

268. 742 F.2d 54 (2d Cir. 1984).

269. *Id.* at 60. The Barrows’ sold their pharmaceutical manufacturing business to Forest Laboratories in 1969 in exchange for 22,000 shares of Forest common stock then valued at \$550,000, or \$25 per share. *Id.* at 56. Eight years later, Forest officials publicly disclosed that between 1963 and 1974 “Forest officers had engaged in a scheme to misstate Forest’s financial condition and earnings.” *Id.* The Barrows sued, alleging violations of 15 U.S.C. § 77q(a) (1982) (section 17(a) of the Securities Act of 1933), 15 U.S.C. § 78j(b) (1982) (section 10(b) of the Securities Exchange Act of 1934), and rule 10b-5. They claimed that the stock, in 1969, was worth no more than \$1.50 per share. Therefore, they “sought rescission of the 1969 Agreement or . . . \$550,000 plus interest.” *Id.* By 1980, however, the Barrows had sold their 22,000 shares of Forest common stock for a total of \$748,229.30. *Id.*

270. *Id.* at 60.

271. *Id.*; see also *Whitbread (US) Holdings, Inc. v. Baron Philippe de Rothschild*, 630 F. Supp. 972, 979 (S.D.N.Y. 1986).

272. 438 F.2d 1167 (2d Cir. 1970).

273. *Id.* at 1169.

four transactions, Smith, Barney sold securities to Chasins in the over-the-counter (OTC) market without disclosing to him that by trading in those stocks on its own account it was making a market in the securities.²⁷⁴ The brokerage house also failed to disclose to Chasins the amount that it had paid for the securities sold to him.²⁷⁵ The securities cost Chasins \$34,950.²⁷⁶ On June 20, 1962, Chasins sold the securities for \$16,333.36.²⁷⁷ The district court awarded Chasins damages in the amount of \$18,616.64, plus interest, which represented the disparity between his purchase price and the price at which he sold *before* discovering Smith, Barney's material nondisclosures.²⁷⁸

On appeal, Smith, Barney argued that the difference between the price charged Chasins and the fair market value of the securities on the date of purchase provided the sole proper measure of Chasins' damages. The firm filed an affidavit stating that the price that Chasins paid for his stock was "the same as that generally available from other dealers for the same securities at the time of sale."²⁷⁹ Smith, Barney contended that in the absence of any price-value disparity, Chasins suffered no cognizable damages.²⁸⁰

The Second Circuit disagreed. Affirming the lower court's award to Chasins of the difference between his high purchase price and his low resale price before discovery of the omission, the court of appeals reasoned that Chasins was entitled to recover damages resulting from the precise violation alleged.

274. *Id.* The *Chasins* court stated in footnote 4:

Market maker has been defined by SEC Rule 17a-9(f)(1), 17 C.F.R. § 240.17a-9(f) as follows:

- (1) The term 'market maker' shall mean a dealer who, with respect to a particular security, holds himself out (by entering indications of interest in purchasing and selling in an inter-dealer quotations system or otherwise) as being willing to buy and sell for his own account on a continuous basis otherwise than on a national securities exchange.

Id. at 1170 & n.4. The precise nondisclosure at issue in *Chasins*, therefore, was that Smith, Barney had made a market which would give rise to conflicting financial and fiduciary duties.

275. *Id.* at 1170. Smith, Barney took positions in the securities while it sold them to Chasins in the over-the-counter (OTC) market as follows:

<u>Date</u>	<u>Number of Shares</u>	<u>Issuer</u>
July 19, 1961	200	Welch Scientific Co.
July 19, 1961	200	Tex-Star Oil and Gas Corp.
July 19, 1961	200	Howard Johnson Co.
August 22, 1961	200	Welch Scientific Co.

Id. at 1169 n.3.

276. *Id.* at 1173.

277. *Id.*; see also *Chasins v. Smith, Barney & Co.*, 305 F. Supp. 489, 496 (S.D.N.Y. 1969), *aff'd*, 438 F.2d 1167 (2d Cir. 1970).

278. *Chasins*, 305 F. Supp. at 496; 438 F.2d at 1173.

279. *Chasins*, 438 F.2d at 1173.

280. *Id.*

The price at which Chasins purchased stock did not result in any violation; rather, the "evil" lay in Smith, Barney's inducement of Chasins to invest without disclosing the conflict between its financial interest and its fiduciary duty.²⁸¹ The material omission was not the failure to disclose facts that would have altered the price paid for the stock, but the failure to disclose the fact that Smith, Barney's recommendation of those stocks, based on their investment potential, was also colored by self interest, not the best interests of Chasins.²⁸²

The *Chasins* measure of damages, then, reflected the material omission: Smith, Barney's true motives for recommending the purchase of the securities that affected Chasins' decision to purchase them, not the price he was willing to pay. If Chasins had known of Smith, Barney's conflict of interest, the court concluded, he may not have purchased the stock at all.²⁸³ Thus, the measure of the materiality of the nondisclosure in this case represented the difference between the purchase price of \$34,950 and the price of non-purchase, or zero. But, the court reduced that measure by any value that the plaintiff received as a result of the fraudulent transaction. Accordingly, the court deducted from his recovery the amount that Chasins received when he sold his securities.

This so-called resale price measure of damages is rescissory. As one court has noted, the *Chasins* measure sought "to return the parties to the status quo ante the sale. In effect, the plaintiff is refunded his purchase price, reduced by any value received as a result of the fraudulent transaction."²⁸⁴ If, as the lower court in *Chasins* observed, the plaintiff learns of the fraud before reselling his securities, the recovery of his purchase price will decrease by the price at which he could have resold the stock "as of the time [the] plaintiff became aware that the material facts had not been disclosed to him."²⁸⁵ Regardless of whether the plaintiff resells his stock before or after discovery of fraud, the court based the *Chasins* measure of damages upon the assumption that if the materiality of the nondisclosure is so great as to affect the decision

281. *Id.*

The issue is not whether Smith, Barney was actually manipulating the price on Chasins or whether he paid a fair price, but rather the possible effect of disclosure of Smith, Barney's market-making role on Chasins' decision to purchase at all on Smith, Barney's recommendation. It is the latter inducement to purchase by Smith, Barney without disclosure of its interest that is the basis of this violation

Id.

282. *Id.*

283. *Id.* at 1172.

284. *Garnatz v. Stifel, Nicolaus & Co.*, 559 F.2d 1357, 1361 (8th Cir. 1977), *cert. denied*, 435 U.S. 951 (1978).

285. *Chasins v. Smith, Barney & Co.*, 306 F. Supp. 177, 178 (S.D.N.Y. 1969), *aff'd*, 438 F.2d 1167 (2d Cir. 1970).

to invest at all, rather than the decision to invest at a certain price, the measure of damages should quantify that degree of materiality by returning to plaintiff the entire purchase price.

The reduction in damages for resale value obtained, or which could have been obtained, is a separate issue. That reduction is based upon the duty of the plaintiff to take reasonable steps after notice of the fraud to mitigate his damages.²⁸⁶ The *Chasins*, or resale, measure of damages, therefore, measures the materiality of a nondisclosure which affects an investor's decision whether or not to enter the market for stock, not the decision to purchase stock at a certain price.

Not surprisingly, Judge Friendly dissented from the denial of reconsideration en banc in *Chasins*, arguing that the damage award was improper because Smith, Barney's nondisclosure would not have been as material to the reasonable investor's decision to enter the market as the majority of the court had supposed.²⁸⁷ Judge Friendly reasoned first that Smith, Barney owed no duty to *Chasins* to disclose its market making function. Alternatively, he stated his belief that disclosure by the broker of its "market maker" status in the particular securities would neither have decreased the price that a reasonable investor would be willing to pay for the stock, nor, for that matter, would it discourage the investor from entering the market at all.²⁸⁸ Accordingly, given the lack of materiality of the nondisclosure, a court should find the damages negligible.

Chasins was criticized not because it was inappropriate generally, but rather because the measure it applied does not quantify the materiality of the nondisclosure involved.²⁸⁹ However, when the defendant's omission *truly* affects the plaintiff's decision to invest, rather than the price of the investment, the purchase price quantifies the materiality of the nondisclosure and, therefore, properly measures the damages under rule 10b-5.

3. *Permitting Defrauded Buyers to Recover Damages*

The Second Circuit has allowed defrauded buyers to recover a measure of the defendant's profit only when it would approximate the materiality of the defendant's conduct. In *Zeller v. Bogue Electric Manufacturing Corp.*,²⁹⁰ Judge Friendly concluded that despite the general rule limiting damages to

286. See, e.g., *Garnatz*, 559 F.2d at 1361. "That decline in value is determined by the losses . . . so long as all such losses were incurred prior to the date that plaintiff knew, or should have known, of the fraud." *Id.* (emphasis added, footnote omitted).

287. *Chasins*, 438 F.2d at 1176 (Friendly, J., dissenting).

288. *Id.* at 1174-76.

289. *Id.*

290. 476 F.2d 795 (2d Cir.), cert. denied, 414 U.S. 908 (1973).

out-of-pocket losses, a plaintiff could endeavor to establish that the defendant's profit properly measured damages under rule 10b-5.²⁹¹ In doing so, however, the plaintiff would encounter formidable obstacles: he would have to show that the defendant's profits resulted from his material misstatements or omissions.²⁹²

In *Zeller*, the plaintiff, a stockholder of Belco Pollution Control Board Corp. (Belco) brought a derivative action against its parent, Bogue Corporation (Bogue), directors of both corporations, and their accountants. The plaintiff alleged that the parent caused its subsidiary, Belco, to loan it money at no interest which, when disclosed, scuttled a profitable public offering of Belco shares.²⁹³ The Belco shareholders sought damages under rule 10b-5, including the amount by which the loans enabled Bogue to profit from its subsequent sale of Belco stock at a higher price than it would have received absent the loan.²⁹⁴

Noting that this theory of recovery sounded in disgorgement, the court reasoned that the remedy might be available to a defrauded buyer of securities, but the defrauded buyer would encounter serious difficulties when trying to establish that the defrauding seller profited from the sale.²⁹⁵ In this case, the plaintiff would have difficulty not in showing that the defendants profited, but in demonstrating that those profits resulted as a consequence of the omission of the material fact that the interest free loans existed.

When analyzing the theoretical underpinnings of restitution, the court made clear that any recoverable profits must be based on the materiality of the nondisclosure:

Restitution seems to be based not only on a feeling that the party who has acted wrongfully should not be permitted to benefit from his conduct but also that the injured party should be given the benefits of a transaction he would otherwise have been in a position to enter into.²⁹⁶

Where the defrauded party is a seller and the defendant resells the securities at a profit, the defrauded party would have been equally induced to sell at the higher market price, rendering the plaintiff's losses equal to the measure of the defendant's profit. The nondisclosure in such a case includes the existence of subsequent resale profits.

291. *Id.* at 802-03.

292. *Id.* at 803.

293. *Id.* at 797.

294. *Id.* at 801.

295. *Id.* at 801-02.

296. *Id.* at 802 n.10. See also RESTATEMENT OF RESTITUTION §§ 150, 202 (1936).

However, the court concluded here that when the defendant seller defrauds a buyer and uses the proceeds from the sale to enter into a second profitable transaction, it is "far more difficult to say as a general proposition that, if the fraud had not occurred, the defrauded party would also have done this."²⁹⁷

The distinction between profit recovery from buyers and sellers is not a "decisive" legal one; rather, it is based on the difficulty of proving the affect of the material omission on the transfer of benefits from one party to another.²⁹⁸ Thus, the court concluded that "absent unusual circumstances," when a seller induces a buyer, consequent to a material misstatement or omission, to transfer benefits to a seller of securities, the buyer may recover the seller's benefits "if these can be traced with sufficient certainty" to the material misstatement or omission.²⁹⁹

4. *Measuring Damages in Tippee Trading*

Similarly, in *Elkind v. Liggett & Myers, Inc.*,³⁰⁰ the Second Circuit concluded that the disgorgement remedy was proper if it approximated the materiality of a tippee's nondisclosure.³⁰¹ In this pre-*Dirks v. SEC*³⁰² tippee trading case, class plaintiffs purchased Liggett stock from individuals to whom the corporation had tipped nonpublic figures showing a substantial downturn in its earnings.³⁰³ The lower court awarded the plaintiffs an out-of-pocket measure of damages, the difference between the price that they

297. *Zeller*, 476 F.2d at 802 n.10.

298. *Id.* at 802.

299. *Id.* at 802 n.10.

300. 635 F.2d 156 (2d Cir. 1980).

301. Tipping "has become a form of corporate brinkmanship-non-public disclosure of business-related information to financial analysts." *Id.* at 158. For a more complete discussion of tipping, and the role of tippee and tippor, see *Dirks v. SEC*, 463 U.S. 646 (1983). In *Elkind*, the court stated that "[t]he knowing use by corporate insiders of non-public information for their own benefit or that of 'tippees' by trading in corporate securities amounts to a violation of Rule 10b-5, . . . which may give rise to a suit for damages by uninformed outsiders who trade during a period of tippee trading." 635 F.2d at 165 (citing *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969); *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*, 495 F.2d 228 (2d Cir. 1974), *cert. denied*, 429 U.S. 1053 (1977)); *see also Chiarella v. United States*, 445 U.S. 222 (1980) (trust relationship between tippee and tippor must exist before section 10(b) and rule 10b-5 violated).

302. 463 U.S. at 648 (officer of a broker-dealer firm who received inside information concerning an insurance company, in which neither he nor his firm owned any stock, passed it on to clients who then traded in that company's stock, held not to have violated section 10(b) or rule 10b-5).

303. *Elkind*, 635 F.2d at 158.

paid during the first material tip and subsequent public disclosure, and the price of the stock at a reasonable time after the disclosure.³⁰⁴

The Second Circuit reversed and remanded, reasoning that although most courts accepted the out-of-pocket damages theory in cases involving a fiduciary's failure to disclose material facts to his buyer of stock, that measure was improper in this case.³⁰⁵ The court enunciated several reasons for its reluctance to employ the out-of-pocket theory. First, the measure would not be linked to the corporation's act of tipping information to outsiders.³⁰⁶ Second, the court found that measuring the price-value disparity of the purchased stock was too difficult because of the speculative character of the stock's hypothetical market value and price.³⁰⁷ Thus, the court of appeals rejected the lower court's use of the post-public disclosure market price to evaluate the materiality of the information.³⁰⁸ The court rejected the post-public release market price as an inadequate indicator of the materiality of the nondisclosure because it found the first alleged tip completely immaterial and the second alleged tip *less* material than the information subsequently disclosed to the market.³⁰⁹ In light of its finding that the price-value disparity would not approximate the materiality of the tip, the court concluded that the out-of-pocket measure would permit recovery "out of all proportion to the wrong committed."³¹⁰

The court also rejected the direct market repercussion recovery based upon the loss in the market value of the stock purchased by plaintiffs attributable to the erosion of the market price resulting from tippees' trades.³¹¹ The court found this theory unacceptable because proving the affect on the market price of each tippee's trades using material nonpublic information

304. See *Elkind v. Liggett & Myers, Inc.*, 472 F. Supp. 123, 129 (S.D.N.Y. 1978), *rev'd in part*, 635 F.2d 156, 168 (2d Cir. 1980).

305. *Elkind*, 635 F.2d at 168, 170.

306. *Id.* at 170.

307. *Id.*; see *Harris v. American Inv. Co.*, 523 F.2d 220, 227 (8th Cir. 1975) (applying this theory), *cert. denied*, 423 U.S. 1054 (1976).

308. *Elkind*, 635 F.2d at 170. The court stated:

Whatever may be the reasonableness of the nunc pro tunc 'value' method of calculating damages in other contexts, it has serious vulnerabilities here. It rests on the fundamental assumptions (1) that the tipped information is substantially the same as that later disclosed publicly, and (2) that one can determine how the market would have reacted to the public release of the tipped information at an earlier time by its reaction to that information at a later, proximate time. . . . One could not reasonably estimate how the public would have reacted to the news that the Titanic was near an iceberg from how it reacted to news that the ship had struck an iceberg and sunk.

Id.

309. *Id.*

310. *Id.*

311. *Id.* at 171.

exceeded the realm of possibility.³¹² Moreover, the court asserted that this approach would not fully measure the materiality of the nondisclosure in cases where the tippees have a fiduciary duty to disclose.³¹³ The market erosion theory would not approximate the materiality of the defendant's nondisclosure.

The court did adopt the disgorgement measure³¹⁴ as the best indication of the materiality of the defendants' conduct. Under this approach, a plaintiff may recover any post-purchase decline in the value of his shares up to a reasonable time after disclosure, limited by the profit of the tippee.³¹⁵ This measure, however, presumes that the plaintiff has shown that a "reasonable investor" would not have paid as high a price for the stock had the information been disclosed.³¹⁶ In calculating recovery, the court found that only those plaintiffs, who purchased stock between the time that the defendant traded based on material information and the time that the nonpublic information became "effectively disseminated," had any claim to damages. Those purchasers could recover the difference between their purchase price and the price to which the market declined after disclosure.³¹⁷ Because the total loss from market decline exceeded the gain realized by the tippees, the amount of the gain attributable to the fraud was the proper measure of recovery that should be distributed, pro rata, among the plaintiff class.³¹⁸

The court's decision to limit damages to the amount of the tippees' profit resulting from their nondisclosures reflected its view that those nondisclosures did not directly affect the price at which plaintiffs purchased stock. Indeed, the court rejected the out-of-pocket measure on those grounds.³¹⁹

312. *Id.*

313. The court faced precisely this situation in *Elkind*.

314. *Elkind*, 635 F.2d at 173.

315. *Id.* at 172.

316. *Id.*

A plaintiff would simply be required to prove (1) the time, amount, and price per share of his purchase, (2) that a reasonable investor would not have paid as high a price or made the purchase at all if he had had the information in the tippee's possession, and (3) the price to which the security had declined by the time he learned the tipped information or at a reasonable time after it became public, whichever event first occurred.

Id.

317. *Id.* at 173. The stock traded and closed on July 17, 1972, the day the tippee acted on the tipped information and sold 1,800 shares of Liggett stock at 55 1/4. The market price of Liggett shares declined to 46 3/8 on July 19, 1972, after the tipped information was disclosed publicly and disseminated. Therefore, the court determined that "[t]he total recovery . . . would be limited to the gain realized by the tippee from the inside information, . . . 1,800 shares multiplied by approximately \$9.35 per share." *Id.* (footnote omitted).

318. *Id.*

319. *Id.* at 170.

However, the basis for liability in *Elkind*, the tippees' breach of their duty to "abstain or disclose," has been rendered suspect by the United States Supreme Court's decisions holding that rule 10b-5 liability attaches only to those who fail to disclose material information in breach of a duty to disclose.³²⁰

In other words, the court's sense that damages could not be measured in *Elkind* because of the tenuous link between the tippees' conduct and the plaintiffs' losses is based on its sense that the nondisclosure was not material. Therefore, as part of the measure of damages, the court insisted that the plaintiffs prove that their investment decisions were "recoverable," that, in some fashion, the nondisclosures were significant to the reasonable investor.³²¹ Yet, despite other theories,³²² *Elkind* clearly supports the proposition that disgorgement properly represents the quantification of the materiality of Liggett's nondisclosure.

5. *The Cover Measure of Damages*

The Second Circuit's approval of the "cover" measure of damages, under which a defrauded seller receives the difference between the highest value that the security achieves within a reasonable time after disclosure of the concealed information and the value of the security at the time of the transaction, is likewise limited to those circumstances in which that measure reflects the materiality of the nondisclosure. In *Gerstle v. Gamble-Skogmo, Inc.*,³²³ a class of minority shareholders of General Outdoor Advertising Co. (GOA) claimed that they were induced by defendant Skogmo and its officers to sell their stock for inadequate consideration.³²⁴ The sale of shares by minority shareholders resulted in a merger procured by the defendants' failure to disclose, in their proxy statement, the material fact that after the merger the defendants intended to pursue an aggressive policy of selling GOA's

320. See *Dirks v. SEC*, 463 U.S. 646, 654 (1983); *Chiarella v. United States*, 445 U.S. 222, 228 (1980).

321. *Elkind*, 635 F.2d at 172-73; see also Easterbrook & Fischel, *supra* note 6, at 643. Judge Easterbrook and Professor Fischel noted that the court, in *Elkind*, "doubted that there was a causal connection between the withholding and the losses. People would have traded (and some would have suffered loss) no matter whether some investors got tips, and the truth would have led to loss anyway." *Id.* Moreover, they explain the profit measure result as "just another way of stating the point that gains and losses net out when the revelation of the truth is delayed." *Id.* Yet, this Article proposes that the *Elkind* result supports the thesis that disgorgement properly measures damages when it represents a quantification of the materiality of the defendants' nondisclosure.

322. See *Dirks*, 463 U.S. at 646; *Chiarella*, 445 U.S. at 228.

323. 478 F.2d 1281 (2d Cir. 1973).

324. *Id.* at 1283-89.

plants, which had already produced a substantial excess of receipts over book value.³²⁵

The district court, after finding that the nondisclosures were material and that restoring the parties to their premerger condition was impossible, held that the plaintiffs were entitled to restitution, which amounted to the profits that Skogmo received from the sale of GOA assets.³²⁶ The lower court measured those profits by taking the highest value attained by all of the assets transferred from GOA to Skogmo after the date of the merger, including postmerger appreciation of the assets.³²⁷ That total asset value was then reduced by the amount of consideration the plaintiffs received and the proportionate share of the assets owned by Skogmo. The lower court effectively awarded plaintiffs the difference between the consideration they received and the "highest intermediate value" of the stock between the sale date and the judgment date.³²⁸ But the lower court reconsidered that measure, recalculating the difference between the value received and the value sold by plaintiffs at the time of the merger.³²⁹

The court of appeals addressed the issue of whether the plaintiffs' recovery should reflect the defendants' profit from the postmerger appreciation of assets, measured by their highest intermediate value. The court found two possible bases for such an award. First, based upon *Janigan v. Taylor*, plaintiffs should be able to recover the defendants' profit from the nondisclosures.³³⁰ Second, because a defrauded seller should be placed in the position he would have occupied absent the fraud, he should be able to recover the appreciation on the securities that he sold on the theory that he would have otherwise been able to do so.³³¹ The court paid little heed to the first argument, apparently seeing no connection between the defendants' nondisclosures and the subsequent appreciation of assets.³³² The court more subtly rejected the second rationale.

325. *Id.* at 1284-85, 1302-03.

326. *Gerstle v. Gamble-Skogmo, Inc.*, 298 F. Supp. 66, 103-04 (E.D.N.Y. 1969), *modified*, 478 F.2d 1281 (2d Cir. 1973).

327. *Gerstle*, 478 F.2d at 1290.

328. *Id.*; *see also Gerstle*, 298 F. Supp. at 104. The "highest intermediate value" represents the highest market price reached by the stock between the date on which the plaintiff resold the stock and the date of the judgment.

329. *Gerstle*, 478 F.2d at 1290; *see also* 332 F. Supp. 644, 649-50 (S.D.N.Y. 1971), *modified*, 478 F.2d 1281 (2d Cir. 1973).

330. *Gerstle*, 478 F.2d at 1304; *Janigan v. Taylor*, 344 F.2d 781, 786-87 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); *see also supra* text accompanying notes 224-32.

331. *Gerstle*, 478 F.2d at 1304.

332. *Id.* at 1305; *see also Baumel v. Rosen*, 412 F.2d 571, 575-76 (4th Cir. 1969), *cert. denied*, 396 U.S. 1037 (1970).

According to the court, plaintiffs argued that but for the defendants' non-disclosures, no merger would have occurred and the plaintiffs, still holders of GOA stock, would have obtained the benefits of asset appreciation. After acknowledging that a plaintiff could, in "a proper case," recover unrealized appreciation of securities sold through fraud, the court concluded that this was not such a case because, as observed in the court's discussion of "materiality," the nondisclosures would not have led to the complete abandonment of the merger. At most, the disclosure would have produced an adjustment of its terms.³³³ The nondisclosures were not so material as to account for the disparity between consideration received and the highest intermediate value obtained. As the court stated, "[t]he crucial fact here is the misrepresentations . . . related only to the sales of plants, as to which Skogmo's liability for profits is conceded."³³⁴ The "nexus" between the material omission and the appreciation of assets, however, was "too thin."³³⁵ Accordingly, the plaintiffs could recover the defendants' profits in a rule 10b-5 action only when those profits accurately measured the materiality of the defendants' misstatements or omissions. Similarly, the "cover" measure of damages is available to a seller only when the difference between sale price and the highest intermediate value of the stock represents the materiality of the concealed facts.

6. *The Rolf Series: Linking Recovery to Materiality*

Even when the Second Circuit applies the more traditional out-of-pocket remedy, based on a plaintiff's loss rather than the defendant's gain, its methods of calculating that recovery are linked directly to the materiality of the nondisclosure. In *Rolf v. Blyth, Eastman Dillon & Co.*,³³⁶ David Rolf sued Blyth, Eastman Dillon & Co. (BEDCO) for mismanagement of his investment portfolio.³³⁷ Rolf also sued Michael Stott for aiding and abetting Akiyoshi Yamada, Rolf's investment advisor, in the perpetration of securities fraud. The United States District Court for the Southern District of

333. *Gerstle*, 478 F.2d at 1305.

334. *Id.* at 1306.

335. *Id.*

336. 637 F.2d 77 (2d Cir.) (*Rolf V*), *aff'g remand from*, 570 F.2d 38 (2d Cir. 1978), *cert. denied*, 439 U.S. 1039 (1980).

337. *Id.* at 79. For a chronology of the litigation, see *Rolf v. Blyth, Eastman Dillon & Co.*, 424 F. Supp. 1021 (S.D.N.Y. 1977) (*Rolf I*), *remanded*, 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978) (*Rolf II*) (remanding for an assessment of damages with guidelines set forth by court of appeals); *Rolf v. Blyth, Eastman Dillon & Co.*, 1979 Fed. Sec. L. Rep. (CCH) ¶ 96,919 (S.D.N.Y. 1979) (*Rolf III*) (establishing Stott's knowledge of Yamada's fraudulent intuition at September 1969), *aff'd in part and rev'd in part*, 637 F.2d 77 (2d Cir. 1980) (*Rolf V*); *Rolf v. Blyth, Eastman, Dillon & Co.*, No. 73 Civ. 2967 (S.D.N.Y. 1980) (*Rolf IV*).

New York found Stott liable to Rolf.³³⁸ The remaining issues focused upon assessing damages in the aiding and abetting claims.³³⁹

Upon remand, the district court determined that liability in an aiding and abetting case began on the date that the defendant-broker must have known of the primary fraud, and ceased on the date the plaintiff's stock portfolio shifted to another broker.³⁴⁰ At the onset of liability, the market value of Rolf's portfolio, calculated based on closing bid prices for his stock owned, was \$597,140.99.³⁴¹ On the date that liability ceased, the market value of the portfolio had fallen to \$211,129.98, experiencing a gross economic loss of \$386,011.01.³⁴² The district court then reduced the plaintiff's gross economic loss by the percentage decline in an appropriate index.³⁴³ Finding from that index a general decline of 7.5%, the district court reduced the gross economic loss by that amount.³⁴⁴ The court added to the net economic loss figure of \$199,788.58 the amount of the plaintiff's commissions during the liability period, plus interest; but denied prejudgment interest on the net loss award.³⁴⁵

The Second Circuit concluded, however, that liability began earlier, when the broker's representations to the plaintiff about the trustworthiness of the primary wrongdoer became material, not when the broker must have known of the primary fraud.³⁴⁶ Moreover, the court corrected its own instructions to the district court. Initially, the court of appeals had instructed the lower

338. *Rolf I*, 424 F. Supp. at 1043. The Second Circuit remanded this case for the proper assessment of aiding and abetting damages awards. *Rolf II*, 570 F.2d at 48.

339. *Rolf II*, 570 F.2d at 49. In its remand opinion, the Second Circuit set forth guidelines for damages:

First, the district court should determine as near as possible the time when Stott began to aid and abet Yamada's fraud and compute the market value of Rolf's portfolio on that date. Second, the district court should subtract the value of the portfolio on the date when Stott's participation in and assistance to the fraudulent scheme ceased from the value on the date when Stott became an aider and abettor. This amount is Rolf's gross economic loss. The district court should then reduce Rolf's gross economic loss by the average percentage decline in value of the Dow Jones Industrial, the Standard & Poor's Index, or any other well recognized index of value, or combination of indices, of the national securities markets during the period commencing with Stott's aiding and abetting and terminating with its cessation.

Id. (citations and footnotes omitted).

340. *Rolf V*, 637 F.2d at 81.

341. *Id.* at 81-82.

342. *Id.* at 82.

343. *Rolf IV*, No. 73 Civ. 2967 at 6-7. The district court chose the Standard & Poor's Low Priced Common Stocks Index because "in only four instances did the price of the shares in the portfolio on January 31, 1970 exceed \$20." *Rolf V*, 637 F.2d at 82.

344. *Rolf V*, 637 F.2d at 82 (citing *Rolf IV*, No. 73 Civ. 2967 at 6-7).

345. *Rolf IV*, No. 73 Civ. 2967 at 7-8.

346. *Rolf V*, 637 F.2d at 83-84 (citing *Rolf I*, 424 F. Supp. at 1029-31).

court to reduce the plaintiff's gross economic loss by a market index to account for decline not caused by the defendants' conduct. The Second Circuit realized, however, that the reduction should be made to the initial market value of the portfolio on the date the liability began, not to the gross economic loss figure.³⁴⁷ Further, the Second Circuit concluded that any gross economic loss figure should be reduced by withdrawals, which the plaintiff made, that were not attributable to the material misstatements or omissions, and that his net economic loss should be reduced by any settlement value received.³⁴⁸ Finally, the court of appeals found that the district court had abused its discretion in failing to award the plaintiff prejudgment interest on the "principal sum" used by the defendants during the period of liability.³⁴⁹

The Second Circuit's various *Rolf* decisions thus stand for the proposition that the lower federal courts should calculate damages for securities fraud in a manner that approximates the trading losses resulting precisely from the defendant's material misstatements or omissions. Calculating the gross economic loss to the plaintiff during the period of the material misstatements or omissions and then finding what portion of that loss is attributable to the misstatements or omissions produces this effect. By eliminating external market forces through a market index, the court can define that portion of the market decline which resulted from the defendant's conduct.

In the *Rolf* cases, that figure approximated the true materiality of the misstatements or omissions made by the defendants. The disparity between the portfolio value before fraud and after fraud discounted by external market forces appropriately measures the materiality of the defendants' omissions and misstatements because the conduct that gave rise to the liability rested upon the ongoing concealment of the fraudulent mismanagement of the plaintiff's account. The concealment was material precisely because it permitted the mismanagement to continue until discovery, affecting the value of the plaintiff's portfolio during that period. Consequently, the court's damage measure, including its reduction for market decline, quantifies the materiality of the aider and abetter's conduct.

Indeed, the Second Circuit has rejected a market index reduction where such a reduction would not approximate the materiality of the defendant's conduct. In *Sirota v. Solitron Devices, Inc.*,³⁵⁰ for example, the Second Circuit refused to reduce the plaintiffs' damage award to account for a contem-

347. *Id.* at 84.

348. *Id.* at 83-84.

349. *Id.* at 86-87. The Second Circuit reasoned that prejudgment interest was proper (1) as compensation for actual losses sustained by the plaintiff and (2) in the interests of justice and fairness, given the defendant's conduct. *Id.* at 87.

350. 673 F.2d 566 (2d Cir. 1982).

poraneous market decline because the misstatements that induced them to purchase stock at inflated prices were unrelated to any subsequent market decline.³⁵¹ Where, as in *Sirota*, the materiality of the misstatements is calculated amply by the disparity between purchase price and fair value of stock at the time of purchase, no need arises to track a market index. Where, as in cases similar to *Rolf*, however, the defendant's misstatements continue and losses develop, a market index properly calculates the materiality of the misstatements.

Whether the Second Circuit terms its damage calculation out-of-pocket, benefit-of-the-bargain, disgorgement, resale price, or cover, the measure of damages selected represents an effort to quantify the materiality of the defendant's misstatement or omission. Moreover, even when the out-of-pocket measure is chosen, the price-value disparity is calculated in a manner that hinges on the precise materiality of that misstatement or omission.

C. The Third Circuit

1. Theories of Damages in Rule 10b-5 Actions

The United States Court of Appeals for the Third Circuit subscribes to the traditional out-of-pocket measure of damages in rule 10b-5 cases.³⁵² It follows the rationale of *Affiliated Ute Citizens v. United States*³⁵³ that a defrauded seller may recover "the difference between what the seller received for his stock and what he would have received had there been no fraudulent conduct."³⁵⁴ Furthermore, the Third Circuit applies this measure of damages to a defrauded buyer: "the measure of damages is the difference between what the [buyer paid] for his stock and what he would have [paid] had there been no fraudulent conduct."³⁵⁵ Both defrauded buyers and defrauded sellers may elect to recover damages measured by the disparity in the fair value of what they received and the fair value of what they transferred.

The court has also held that a defrauded seller may elect to recover the amount of the defendant's profit rather than his own losses.³⁵⁶ If a defendant, upon resale, receives more than the plaintiff loses, "then the award is the

351. *Id.* at 577-78. The Second Circuit rejected the application of *Rolf II*, 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978) and *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 586 (E.D.N.Y. 1971), reasoning that "[a]ny subsequent decline in the market had no effect on that fraudulent sale." *Sirota*, 673 F.2d at 578.

352. *See Sharp v. Coopers & Lybrand*, 649 F.2d 175, 190 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982).

353. 406 U.S. 128, 155 (1972); *see also supra* text accompanying notes 35-65.

354. *Thomas v. Duralite Co.*, 524 F.2d 577, 586 (3d Cir. 1975).

355. *Sharp*, 649 F.2d at 190 (citing *Duralite*, 524 F.2d at 586); *see also Glick v. Campagna*, 613 F.2d 31, 36 (3d Cir. 1979).

356. *Glick*, 613 F.2d at 36; *Duralite*, 524 F.2d at 586.

amount of the defendant's profit over and above what he had paid to the plaintiff."³⁵⁷ When a defrauded seller elects to recover a defendant's profits as damages, the seller is entitled only to those profits that are not a result of the defendant's special efforts.³⁵⁸ Clearly, the defendant's profit must represent a "proximate consequence" of the material misstatements or omissions.³⁵⁹

Finally, the Third Circuit allows the plaintiff to choose "to seek the equitable remedy of rescission rather than common law damages."³⁶⁰ Thus, if a defendant still owns the stock sold by a plaintiff, the plaintiff may have the shares returned and seek an accounting of the amount of money the plaintiff would have received during the period in which the defendant owned the stock.³⁶¹ If, on the other hand, the defendant no longer owns the stock or the stock otherwise is unavailable because of a merger or other intervening event, a court may award "rescissory damages to place the plaintiff in the same financial position he would have been were it possible to return the stock."³⁶² The rescissory award presumably is available to defrauded buyers as well as to defrauded sellers of securities. The Third Circuit thus allows a plaintiff to choose from out-of-pocket, disgorgement, and rescission, based upon the measure that affords the greatest recovery.

2. Application of the Third Circuit's Theories of Damages

When applying these damages principles, the Third Circuit has effectively limited the plaintiff's recovery to an approximation of the materiality of the challenged conduct. For example, in *Rochez Bros. v. Rhoades*,³⁶³ the Third Circuit permitted the plaintiff to elect to recover either its out-of-pocket losses or the profits that the defendant buyers received, but the court circumscribed the measure of those profits.³⁶⁴ Defendant Rhoades purchased 50% of the shares of MS&R Corporation held by plaintiff Rochez Brothers, Inc. for \$598,000. Within the year, Rhoades had consummated ongoing and undisclosed negotiations to sell 100% of MS&R stock to a third party for more

357. *Duralite*, 524 F.2d at 586.

358. *Glick*, 613 F.2d at 36; *Duralite*, 524 F.2d at 586.

359. *Duralite*, 524 F.2d at 586; see also *Rochez Bros. v. Rhoades*, 491 F.2d 402, 411-12 (3d Cir. 1973).

360. *Glick*, 613 F.2d at 36.

361. *Id.*

362. *Id.* at 37 (citing *Speed v. Transamerica Corp.*, 135 F. Supp. 176, 186-94 (D. Del. 1955), modified, 235 F.2d 369 (3d Cir. 1956)).

363. *Rochez Bros.*, 491 F.2d at 402.

364. *Id.* at 416. Here again, plaintiffs brought suit against defendants alleging violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Securities and Exchange Commission Rule 10b-5. *Id.* at 402.

than \$4,250,000.³⁶⁵ The district court found that Rhoades had failed to state the material fact that he had received higher offers for the plaintiff's stock before the plaintiff sold the stock to him. The court therefore awarded as damages the difference between the third-party offeror's valuation of the stock and what the plaintiff received.³⁶⁶ The court refused to award the plaintiff the full amount of the defendant's profit because some of the defendant's profit primarily resulted from the defendant's special efforts: his aggressive and enterprising management ability.³⁶⁷

The Third Circuit, however, concluded that although Rhoades may have engaged in special managerial efforts, those efforts took place before the date of the plaintiff's sale.³⁶⁸ Those efforts were also not disclosed to the plaintiff. Accordingly, defendant's omission was not simply that negotiations were taking place with third-party purchasers, as the district court supposed; rather, the material omission was the third-party purchaser's valuations of MS&R.³⁶⁹ The proper measure of the materiality of the omissions, therefore, was "the difference between the value of 50% of MS&R stock on the basis of the [resale price] and the amount Rochez received from Rhoades."³⁷⁰

The court further demonstrated that this measure of damages rested upon the materiality of the defendant's nondisclosure.³⁷¹ The circuit court rejected the defendant's claim that the district court improperly based the measure of damages on the plaintiff's knowledge of the nondisclosed facts³⁷² or their materiality. The circuit court reasoned that the value of what the defendant gained should be measured by profit proximately caused by material omissions and that the omission in these circumstances included the ma-

365. *Id.* at 405-06. Rhoades and Rochez Brothers each owned 50% of the shares of MS&R Corporation as of May 1967. However, after fundamental business differences, both parties agreed to try to procure a third party to purchase MS&R. *Id.* at 405. Unable to find any interested buyers, Rochez Brothers agreed to sell to Rhoades their 50% share in MS&R. *Id.* Meanwhile, however, Rhoades had generated, through the help of a solicitor, substantial interest in a third party purchase of MS&R, yet failed to disclose this information to Rochez Brothers. *Id.* at 406.

366. *Id.* at 412.

367. *Id.* The district court recognized that the *Janigan v. Taylor* measure of damages governed this case, but disregarded it here because of the seemingly unjust result it would have produced. *Id.*; see *Janigan v. Taylor*, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); see also *supra* text accompanying notes 224-32.

368. *Rochez*, 491 F.2d at 412.

369. *Id.*

370. *Id.* The circuit court believed "that [they were] bound by the clear rule of damages enunciated in [*Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972)]." *Id.*

371. *Rochez*, 491 F.2d at 414 (opinion denying the petition for rehearing).

372. *Id.*

terial fact that the defendant had negotiated for resale at the profit price.³⁷³ Hence, the measure of the defendant's "profit" (sometimes labeled disgorgement, sometimes benefit-of-the-bargain)³⁷⁴ available to defrauded buyers or sellers of stock is limited to the materiality of the omissions or misstatements.³⁷⁵

Similarly, when the district court failed to limit plaintiff's recovery to the materiality of the challenged conduct, the Third Circuit, in *Sharp v. Coopers & Lybrand*,³⁷⁶ rejected disgorgement or benefit-of-the-bargain damages. In *Sharp*, the United States District Court for the Eastern District of Pennsylvania adjudged an accounting firm in violation of rule 10b-5 for preparing an opinion letter that misstated material facts about the tax consequences of the plaintiffs' limited partnership interests in an oil and gas venture.³⁷⁷ Adopting the out-of-pocket measure of damages and rejecting contrary expert testimony, the trial court instructed the jury to find the difference between the price paid by the plaintiffs and the actual worth of the investment at the time of purchase.³⁷⁸ The court then asked the jury to find the "actual value, if any" of the plaintiffs' purchase on the date of sale. The jury, adopt-

373. *Id.* at 416-17.

374. *Id.* at 414.

375. *Id.* at 416-17.

376. 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982).

377. *Sharp v. Coopers & Lybrand*, 457 F. Supp. 879, 887 (E.D. Pa. 1978), *rev'd in part*, 649 F.2d 175 (3d Cir. 1981) (reversed on the issue of damages), *cert. denied*, 455 U.S. 938 (1982).

378. *Sharp v. Coopers & Lybrand*, 83 F.R.D. 343, 347-48 (E.D. Pa. 1979), *vacated*, 649 F.2d 175 (3d Cir. 1981). The jury instruction read:

We are asking you to find what was the actual value of this investment in 1971. You heard Mr. Wilson testify that he would have projected in 1971 400 million cubic feet of gas and oil, . . . and that that would give a return of . . . somewhere around . . . \$7900 over a nine-year period.

However, when he adopted the same method of Mr. Templeton, who took the average production over . . . five years, . . . he came out with 250 million cubic feet of gas and oil.

I am now instructing you to disregard Mr. Wilson's testimony as to the 400 million cubic feet because the test is: *What was the actual value in 1971, not its theoretical value in 1971.*

So, you will disregard that, and you will make your choice on the actual value of these investments between the testimony of Mr. Whitman who in effect said it had no value because it was not saleable and that he would not advise anybody to touch it, the testimony of Mr. Templeton who gave you a figure of \$1240, and the testimony of Mr. Wilson who gave you a figure of \$4,080 for a 1/8 interest but who also said that if he knew of fraud, if he knew that the General Partner was dishonest, that he wouldn't touch it with a 10-foot pole.

Sharp, 649 F.2d at 189-90 (quoting Record at 2691a-92a) (emphasis added).

ing a witness' testimony, concluded that the theoretical value of the investment equaled \$1,240 in 1971.³⁷⁹

The Third Circuit reversed, finding that the proper "goal in formulating a damage instruction must be to compensate appellees precisely for the damage directly resulting from the appellant's wrongful acts," that is defendant's material misstatements and omissions.³⁸⁰ Accordingly, damages must be measured by the "actual value" of the investment at the time of the transaction, assuming that all of the facts withheld by the defendant are known. By allowing the jury to consider "subsequent production data unknown to anyone at the time the investment was made," the lower court effectively permitted a price-value disparity not based on the materiality of defendant's nondisclosures.³⁸¹ Any promise of future appreciation from the oil wells, the court suggested, was not a material fact; rather, it was puffing that would not have had a substantial likelihood of influencing the reasonable investor's decision.³⁸² However, a public accounting firm's promise of tax benefits in the limited partnership represented a material misstatement. The court concluded, "[i]f the opinion letter contained omissions and misrepresentations impacting only on the validity of the tax opinion, the proper measure of damages is the amount of money invested minus the value of the speculative investment at the time of purchase, derived from all information available to investors."³⁸³ The remainder of the purchase price minus the value received will equal the value that the court assigns to the materiality of the misrepresentation at issue. Thus, damages reflected the amount by which the defendant's false opinion letter affected the price that investors were willing to pay for their investments. The Third Circuit, therefore, instructed the lower court on remand to isolate and quantify each material misstatement.³⁸⁴

The Third Circuit has also allowed a rescissory method of recovery when doing so approximates the materiality of the nondisclosures or misstatements. In *Glick v. Campagna*,³⁸⁵ for example, the court held that rescission and restitution secured through an accounting properly remedied the damages that were sustained by the plaintiff. The defendant made material misstatements about the existing and prospective financial condition of their closely held corporation, and these misstatements induced the plaintiff to sell

379. *Sharp v. Coopers & Lybrand*, 491 F. Supp. 55, 56 n.2 (E.D. Pa. 1980) (district court's interpretation of the jury's response to the interrogatories), *vacated*, 649 F.2d 175 (3d Cir. 1981).

380. *Sharp*, 649 F.2d at 190.

381. *Id.*

382. *Id.*

383. *Id.*

384. *Id.* at 191.

385. 613 F.2d 31 (3d Cir. 1979).

his stock at a deflated price.³⁸⁶ The district court awarded plaintiff damages in the amount of his 50% share of all monies that the corporation had paid to the defendant, excluding the defendant's salary, and reduced the damages by the price plaintiff actually received for his stock.³⁸⁷ In justifying the award, the lower court reasoned that a hybrid form of relief, which attempted to place the plaintiff in his pretransaction condition, was proper.³⁸⁸

The Third Circuit held that the lower court should have granted rescission, requiring the defendant to return the stock to the plaintiff. Then, the district court should have ordered restitution, based on an accounting from the defendant of the profits they received as a result of the material misstatements or omissions.³⁸⁹ In doing so, the Third Circuit suggested that when a plaintiff elects rescission, he need not establish the value of the stock at the time of the transaction, particularly the stock of a close corporation.³⁹⁰ Rather, the theory of rescission rests upon the assumption that the transaction never took place; the defendant returns the stock and profits, which absent the fraud, would have run to the plaintiff.³⁹¹ The circuit court had little difficulty awarding the return of the stock. The court reasoned that the material omissions regarding the close corporation affected the plaintiff's decision to get out of the market entirely, rather than to sell stock at a given price. The court, however, remanded the case for an accounting of whether any other "profits" received by the defendant would be recoverable as a measure of the materiality of his omissions, rather than as an impermissible "punishment."³⁹²

Hence, the Third Circuit has held that the district court has broad equitable powers to fashion any remedy "tailored to fit the circumstances of the

386. *Id.* at 35. Glick and Campagna each owned 50% of the stock in Washington Marketing & Financial, Inc. (WMFI), a company that arranged and financed computer equipment leases. *Id.* at 33. After some financial difficulties, Campagna informed Glick that the company faced an unprofitable future due to its inability to procure the proper insurance and its inability to pay the proper withholding taxes. *Id.* at 34. Campagna then induced Glick to sell his 50% share of WMFI to him for Glick's original \$2,000 investment and repayment of a \$10,000 loan that Glick made to WMFI. In reality, however, Campagna did procure several profitable equipment lease contracts through negotiations with another company, EFM Capitol Corporation, and Campagna failed to disclose the procurement of these leases to Glick. *Id.*

387. *Id.* at 35. The opinion of the district court was unreported.

388. *Id.* at 36.

389. *Id.* at 37.

390. *Id.*

391. *Id.*

392. *Id.* "The purpose of rescission and restitution is to restore the plaintiff to where he would have been had the sale not taken place. To place him in a better position is beyond the scope of the remedy and amounts to punishment of the defendant." *Id.*

individual case”³⁹³ and has held that “rescission is an appropriate remedy” for a securities violation.³⁹⁴ Further, it has carefully ensured that, in returning the parties to the status quo ante, the fraud is defined with such precision that the remedy quantifies the materiality of the concealed information.

D. The Fourth Circuit

The United States Court of Appeals for the Fourth Circuit gives a plaintiff the right to choose, and lower courts the discretion to apply, the proper measure of damages in rule 10b-5 cases. In the Fourth Circuit, a plaintiff may elect to rescind the securities transaction.³⁹⁵ Moreover, a court may grant rescission where the contract is illegal per se, or where the fraud is collateral to the transaction, making the transaction voidable at the option of the injured party.³⁹⁶

Alternatively, a plaintiff may choose to affirm the transaction and sue for damages.³⁹⁷ Damages are measured as “the difference between the fair value . . . received and the fair value of what . . . would have [been] received had there been no fraudulent conduct.”³⁹⁸ However, “if the plaintiff’s damages . . . are not equal to or greater than the profit which accrued to defendants as a result of their fraudulent conduct, [a] [c]ourt will measure [the damages] by the restitution of the latter amount.”³⁹⁹ Moreover, the lower courts have exercised their discretion to affix a measure of recovery that combines damages and rescission.⁴⁰⁰ A lower court within the Fourth Circuit has based this rescissional measure of recovery either on the plaintiff’s out-of-pocket losses or on the defendant’s profit.⁴⁰¹

393. See *Pittsburgh Terminal Corp. v. Baltimore & O.R.R.*, 586 F. Supp. 1297, 1302-05 (W.D. Pa. 1984), *aff’d mem.*, 760 F.2d 257, 260 (3d Cir.), *cert. denied*, 474 U.S. 919 (1985).

394. *Id.* at 1305.

395. *Baumel v. Rosen*, 412 F.2d 571 (4th Cir. 1969), *cert. denied*, 396 U.S. 1037 (1970). Plaintiffs must make this election within a reasonable time after the fraud is disclosed. *American Gen. Ins. Co. v. Equitable Gen. Corp.*, 493 F. Supp. 721, 756 (E.D. Va. 1980).

396. *American Gen.*, 493 F. Supp. at 755. In exercising its discretion to grant rescission, a court should consider: (1) whether the fraud is collateral to the contract; (2) the balance of equities; (3) the public interest; (4) the length of time between fraud and judgment; (5) changes in position since the fraud occurred; (6) degree of changes in position; (7) interests of third-parties; (8) difficulty of rescinding transaction; (9) fairness of fraudulent transaction; and (10) whether damages are adequate relief. *Id.* at 756 n.63.

397. *Baumel*, 412 F.2d at 575.

398. *American Gen.*, 493 F. Supp. at 760 (quoting *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972)).

399. *Id.* at 760-61.

400. *Id.*

401. *Id.* at 760-61.

This variety of approaches to damages by the Fourth Circuit has led one commentator to observe that it has joined other circuits in cross-pollinating the analytically distinct concepts of out-of-pocket damages and unjust enrichment.⁴⁰² Indeed, the courts have mixed tort concepts of causation with contractual notions of rescission in an effort to approximate the materiality of the concealed information in each case.

I. *Baumel v. Rosen*

The Fourth Circuit, in *Baumel v. Rosen*,⁴⁰³ rejected rescission and embraced disgorgement as the proper remedy precisely because the latter more accurately quantified the materiality of the defendants' concealments. Plaintiffs Milton Baumel and Earl Weiner alleged that the defendants induced them to sell their "units" in a corporation engaged in the sale of real estate.⁴⁰⁴ Specifically, the plaintiffs alleged that the defendants misrepresented the desperate financial state of the corporation, by omitting the material facts that the corporation had a ready source of funds, that its property sales exceeded its expectations, and that potential profits were excluded from an exhibited stockholders' report.⁴⁰⁵ Although Baumel and Weiner sold their stock to the defendants at a 900% profit, the district court found that their profit could have been "far handsomer" and ordered the defendants to rescind the transaction, returning to plaintiffs the current equivalent of the shares they had purchased.⁴⁰⁶

The Fourth Circuit, however, held that the plaintiffs were not entitled to rescission because they had waited eighteen months after the discovery of the concealed information to renounce their sales.⁴⁰⁷ The court did, however, award the plaintiffs damages in the amount of the defendants' profit resulting from the fraud.⁴⁰⁸ In rejecting rescission, the court reasoned: "Rescission is a radical move, and the law exacts the election of that course to be asserted without wait. The demand is that advice of the determination be given within a reasonable time after discovery of the ground for rescis-

402. See Thompson, *supra* note 6, at 373-78.

403. 412 F.2d 571 (4th Cir. 1969), *cert. denied*, 396 U.S. 1037 (1970).

404. *Id.* at 573.

405. *Id.* For a comprehensive and clear account of the facts, see *Baumel v. Rosen*, 283 F. Supp. 128, 132-39 (D. Md. 1968), *aff'd in part and rev'd in part*, 412 F.2d 571 (4th Cir. 1969), *cert. denied*, 396 U.S. 1037 (1970).

406. *Baumel*, 412 F.2d at 573-74.

407. *Id.* at 574-75; see also Friedman, *Delay as a Bar to Rescission*, 26 CORNELL L.Q. 426, 432 (1941) (discussion of time limitations on plaintiff's election for the remedy of rescission).

408. *Baumel*, 412 F.2d at 575-76 (the court relied upon the decision in *Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965)); see also *supra* text accompanying notes 224-32.

sion.”⁴⁰⁹ The court asserted that the election must be made within a reasonable time because: (1) in an equitable action, generally the plaintiff must have clean hands; (2) in a securities action, particularly, a court should not permit the plaintiff to wait to see whether the price of the stock sold increases in value before electing to have it returned rather than sue for damages, thus placing all market risk on the defendant for a long period of time; and (3) the aim of rescission, to return the parties to their pretransaction condition, is frustrated by the lapse of time.⁴¹⁰

While these considerations justified the court’s rejection of rescission, the rescission remedy would also fail to reflect the materiality of the concealment in this case. The plaintiffs sought to recover the full increase in the value of their shares resulting from two independent stock splits.⁴¹¹ The court determined that the plaintiffs knew or should have known of material facts concealed by the defendants after the first stock split, but well before the second.⁴¹² Accordingly, the court rejected rescission because the value of the stock eighteen months after the disclosure of the material facts clearly would not have reflected the materiality of the nondisclosures.

The court also embraced a qualified “profit” measure of damages because that measure would reflect the materiality of the concealed information. Although the court began with the general proposition that the plaintiffs are entitled to damages as an alternative to rescission, in the amount of the defendants’ profit, it calculated that profit by taking the sale of the stock one day after the concealed facts were disclosed.⁴¹³ By limiting the damages to defendants’ profit resulting from their misstatements, the court’s approach more accurately reflected the materiality of those misstatements. *Baumel* stands for the proposition that no matter what the lower courts within the Fourth Circuit label their damage measure, they should endeavor to quantify the materiality of the concealed information at issue.

2. Nondisclosure of Merger Negotiations

In *American General Insurance Co. v. Equitable General Corp.*,⁴¹⁴ the United States District Court for the Eastern District of Virginia, followed the Fourth Circuit’s direction in *Baumel*. In *American General*, the defend-

409. *Baumel*, 412 F.2d at 574.

410. *Id.* at 574-75.

411. *Id.* at 574. A stock split is the division of the outstanding shares, or class of shares, of a corporation into more units without altering each shareholder’s original proportional interest. See 11 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5362.1 (rev. perm. ed. 1986).

412. *Baumel*, 412 F.2d at 576.

413. *Id.*

414. 493 F. Supp. 721 (E.D. Va. 1980).

ants induced the plaintiffs to sell their stock back to the corporation by failing to disclose the existence of merger negotiations. The defendants eventually sold the stock at a substantially higher price to a third party.⁴¹⁵ As a result of the omission of the merger negotiations, American General brought suit against Equitable alleging violations of rule 10b-5. The court first analyzed the availability of rescission. Unlike *Baumel*, after finding that the plaintiffs had sought rescission in a timely fashion after full disclosure of the concealed facts, the court determined that the equitable factors favored that remedy. The court found that: (1) the defendants suffered no hardship because the merger proceeded despite the lawsuit; (2) the public interest in enforcing rule 10b-5 supported the election of remedies; (3) the defendants did not change their position prior to learning of the action for rescission; (4) the parties considered the rescission action in determining the merger price, thus avoiding undue harm to third parties; and (5) although specific restitution of the shares of stock was not possible, the court was capable of finding a "money substitute."⁴¹⁶

The money substitute, which the court ordered, measured the materiality of the nondisclosure of the ongoing merger negotiations. The court then set out to determine "what precise action the plaintiff would have taken" if the existence of merger negotiations had been disclosed.⁴¹⁷ The court decided that the plaintiff would not have realized the full \$51 per share price, even if the fraud had not occurred. Rather, it found that the plaintiff would have held onto the shares until presented with an opportunity to sell them at their fair value.⁴¹⁸

Under the label of rescission, therefore, the court determined the price-value disparity. The fair value of the stock could not be measured by the market price on the date of the transaction because the nondisclosures tainted that price.⁴¹⁹ Following the Restatement of Restitution,⁴²⁰ the court valued the shares sold at their highest value attained within a reasonable

415. *Id.* at 727-28 (plaintiffs sold their stock to Equitable General Corporation for \$32.50 per share, and Equitable eventually resold the shares to Gulf United for \$51 per share).

416. *Id.* at 756-59.

417. *Id.* at 759.

418. *Id.*; see also *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 757-58 (1975) (Powell, J., concurring) (offeree who waited two years after shares were issued and until after market price soared could not maintain suit); but see *Capital Invs., Inc. v. Bank of Sturgeon Bay*, 430 F. Supp. 534, 537-38 (E.D. Wis. 1977), *aff'd*, 577 F.2d 745 (7th Cir. 1978) (plaintiffs collaterally estopped from maintaining suit where they did not rely on any misrepresentations and suffered no damages).

419. *American Gen.*, 493 F. Supp. at 761.

420. *Id.* at 763; see RESTATEMENT OF RESTITUTION § 151 comment c (1936).

time after disclosure of the merger negotiations.⁴²¹ The court accepted the asking price, determined two weeks after disclosure, rather than the bid price to reflect roughly the premium to the plaintiffs of selling their block of shares.⁴²²

The court's rescissional damage award therefore reflected the materiality of the nondisclosure of merger negotiations. First, the plaintiffs' purchase price represented their reasonable appraisal of the stock's worth without the concealed information. Second, the fair value settled upon by the court represented a reasonable investor's appraisal of the stock when the concealed information became known. In fact, the court considered the fair value of the stock on the date and at a price that reflected the significance that a reasonable investor would attach to the announcement of an agreement in principle.⁴²³ Finally, the disparity between the uninformed price and the materially informed price, labeled the rescissional measure of damages in this case, was the measure of the materiality of the nondisclosure.

E. The Fifth Circuit

1. Damage Theories

A defrauded rule 10b-5 plaintiff may recover both general and special damages in the United States Court of Appeals for the Fifth Circuit.⁴²⁴ General damages necessarily and usually reward a plaintiff as a result of the

421. *American Gen.*, 493 F. Supp. at 765 n.79. The court determined that two weeks after the sale constituted a reasonable time. "[T]he [c]ourt . . . considered the sophistication of the plaintiff, the nature of the fraud in this case as being particularly resistant to discovery by the market, [and] the time necessary for the market to react to the disclosure of Equitable's agreement in principle" *Id.* See also A. JACOBS, *supra* note 6, § 260.03[c](iii), at 11-43 to 11-46.

422. *American Gen.*, 493 F. Supp. at 766 n.81. The asking price was \$44 per share as opposed to the \$42 per share bid price. *Id.* Consequently, the court calculated the rescissory measure of damages as follows:

\$44.00	(fair value per share of stock two weeks after disclosure)
—	
<u>\$32.50</u>	(price per share received by plaintiffs)
\$11.50	(rescissional damages per share)
×	
<u>315,000</u>	(plaintiffs' total shares)
\$3,622,500	in rescissional damages

Id.

423. *Id.* at 765.

424. *Meyers v. Moody*, 693 F.2d 1196, 1212-14 (5th Cir. 1982) (discussing the congruence between damages under rule 10b-5 and Texas state law). See also A. JACOBS, *supra* note 6, at

challenged wrong.⁴²⁵ Special damages or consequential damages do not represent necessary compensation for the wrong, but do flow from the allegedly wrongful conduct.⁴²⁶ Special damages cannot be awarded if their relationship to the defendant is too remote, if they redress the same injury compensated by general damages or prejudgment interest, or if they are not plead with "specificity."⁴²⁷ Special damages are obtainable, however, even if the plaintiff can show no general damages.⁴²⁸

In awarding general and special damages under rule 10b-5, the Fifth Circuit does not insist that the plaintiff prove the amount of damages with mathematical certainty.⁴²⁹ Rather, the defendant bears the risk of imprecise calculations of damages.⁴³⁰

Within these broad guidelines, the Fifth Circuit has followed the weight of authority and has applied the traditional measure of damages, based upon the out-of-pocket rule, to rule 10b-5 violations.⁴³¹ Under the out-of-pocket rule, a defrauded buyer of securities may recover the "difference between the price paid and the real value of the security at the time of the initial purchase."⁴³² The court has defined the real value of the securities as "the fair market value absent the misrepresentations, at the time of the initial purchase."⁴³³ The court has repeatedly applied this measure of damages in rule 10b-5 actions.⁴³⁴ When plaintiffs bring a class action under rule 10b-5,

§ 260.03[b], at 11-28. See D. DOBBS, *supra* note 8, at § 3.2. See also *infra* notes 425-30 and accompanying text.

425. *Meyers*, 693 F.2d at 1214.

426. *Id.*

427. See A. JACOBS, *supra* note 6, § 260.03[d], at 11-135; see also FED. R. CIV. P. 9(g) (claims for special damages must be specifically stated).

428. A. JACOBS, *supra* note 6, § 260.03[d], at 11-134.

429. *Meyers*, 693 F.2d at 1215.

430. *Id.* (citing A. JACOBS, *supra* note 6, § 260.02).

Although the plaintiff must present as much proof as he can, the defendant has no ground to complain if the plaintiff cannot prove the extent of his injury (as distinguished from the fact that he was harmed) with mathematical certainty. In effect, the defendant bears the uncertainty as to the amount of damages.

Id.

431. *Smoky Greenhaw Cotton Co. v. Merrill Lynch*, 785 F.2d 1274 (5th Cir. 1986); *Huddleston v. Herman & MacLean*, 640 F.2d 534, 554-56 (5th Cir. 1981), *aff'd in part and rev'd in part*, 459 U.S. 375 (1983). See also *supra* notes 35-65 and accompanying text.

432. *In re Letterman Bros. Energy Secs. Litig.*, 799 F.2d 967, 972 (5th Cir. 1986) (citing *Huddleston*, 640 F.2d at 556).

433. *Huddleston*, 640 F.2d at 556.

434. See *Alley v. Miramon*, 614 F.2d 1372, 1387 (5th Cir. 1980) (*dicta*); *Nor-Tex Agencies, Inc. v. Jones*, 482 F.2d 1093, 1097 (5th Cir. 1973), *cert. denied*, 415 U.S. 977 (1974); *Wolf v. Frank*, 477 F.2d 467, 478 (5th Cir.), *cert. denied*, 414 U.S. 975 (1973); see also *Dupuy v. Dupuy*, 551 F.2d 1005, 1024-25 (5th Cir.) (damages measured by difference between amount for which defrauded buyer bought stock and amount he would have received absent misrepresentation), *cert. denied*, 434 U.S. 911 (1977). Compare *John R. Lewis, Inc. v. Newman*, 446

the Fifth Circuit has required district courts to calculate the real value of the stock on the date each member of the class entered into the fraudulent transaction.⁴³⁵ Once that value is determined, damages in the typical case become a “simple matter of subtraction of the ‘true’ value of the security on the date of the plaintiff’s purchase from the purchase price paid by the plaintiff on that date.”⁴³⁶

The Fifth Circuit, however, has recognized the inappropriateness of the out-of-pocket rule in certain circumstances: “The cases are uniform in stating that one remedy which may be available to a defrauded plaintiff under Rule 10b-5 is to seek rescission of the transaction”⁴³⁷ Rescission attempts to avoid or undo the transaction and return the defrauded party to the party’s position before the wrongful inducement to enter the transaction.⁴³⁸ Although the Fifth Circuit has recognized the legitimacy of rescission and “rescissional damages” for rule 10b-5 violations, it has placed limits on their availability. The court has declared that such recovery is usually available in cases where privity runs between the plaintiff and the defendant or where the recovery reflects losses proximately caused by the defendant’s conduct.⁴³⁹

The Fifth Circuit requires privity in rule 10b-5 cases that involve defrauded buyers because the rescissory remedy for those buyers under section 12(2) of the Securities Act of 1933 requires privity. According to the court, allowing buyers to seek implied rule 10b-5 remedies in the same action circumvents the express requirements of section 12(2) and produces inequitable results.⁴⁴⁰ In addition, in an open market transaction, the fiction of returning the consideration is strained.⁴⁴¹ In light of some recent United States Supreme Court decisions, however, the Fifth Circuit’s continued adherence to the privity requirement for rescission under rule 10b-5 is dubious.

F.2d 800, 805 (5th Cir. 1971) (court notes in dicta that although usual remedy is rescission or restitution, the out-of-pocket rule is appropriate where factual misrepresentation was coupled with seller’s default on express agreement) *with* *Woolf v. S.D. Cohn & Co.*, 515 F.2d 591, 605 (5th Cir. 1975) (plaintiff’s right to seek damages compatible with rescission including fair market value absent misrepresentation), *vacated and remanded*, 426 U.S. 944 (1976).

435. *Huddleston*, 640 F.2d at 556. Determination of the real value of the securities may be performed with the help of an expert or a special master. The court has suggested that in a class action, an expert or master should create a “value line,” indicating the true value of the stock on each date during the class period. *Id.* at 556 n.36.

436. *Id.* at 556.

437. *Id.* at 554 (quoting R. JENNINGS AND H. MARSH, *SECURITIES REGULATIONS* 1085 (4th ed. 1977)).

438. *Id.* at 554.

439. *Id.* at 555; see also Note, *The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities*, 26 *STAN. L. REV.* 371, 376-77 (1974).

440. *Huddleston*, 640 F.2d at 555.

441. *Id.*

First, the Supreme Court rejected both the strict privity and proximate cause tests of a "seller" under section 12(2), declaring that "privity is not essential" in a fraud action.⁴⁴² If privity is not required under section 12(2), no inequities result from relaxing the requirement under rule 10b-5. Second, the Supreme Court embraces the fraud-on-the-market concept in the class action context, suggesting that fraudulent transactions can be rescinded despite the impossibility of matching buy and sell orders.⁴⁴³ Hence, the Supreme Court has cast a suspicious light on the Fifth Circuit's privity requirement for rescission under rule 10b-5.

The court's additional requirement, however, prohibiting the awarding of rescissory relief beyond the measure of the plaintiffs' losses caused by the defendant's conduct, remains viable. Because the rescissory measure of damages permits the defrauded plaintiff to place upon the defendant the burden of any adverse change in the value of the securities between the date of purchase and the date of rescission, the court reasons that only a portion of the recovery may be proximately caused by the defendant's wrong.⁴⁴⁴ A court could appropriately permit rescissory damages only if it "adopt[ed] a theory of damages that views the entire loss as resulting from the fraud because, 'but for' the deceit, the buyer would not have purchased, and hence would have suffered no loss."⁴⁴⁵ Consistent with its view that a plaintiff must show both transaction causation and loss causation, the court discards that rescissory theory of damages in favor of the tort law's out-of-pocket rule, which usually reflects "the loss proximately caused by the defendants' deceit."⁴⁴⁶

The court's precise rejection of rescission rests upon the view that usually the materiality of the nondisclosure does not amount to a complete reflection of the full disparity between the purchase price and the subsequent rescissory value of the stock. But the court leaves open the possibility that in some cases rescission will approximate the materiality of the information concealed by the defendant. In those cases, rescission is proper. Yet, the propriety of rescission is not the result of a worthy goal with sound theoretical underpinnings; rather, the measure of damages is proper only to the ex-

442. *Pinter v. Dahl*, 108 S. Ct. 2063, 2079 n.23 (1988).

443. *See Basic, Inc. v. Levinson*, 108 S. Ct. 978, 992 (1988); *see also supra* text accompanying notes 153-93; Merritt, *A Consistent Model of Loss Causation in Securities Fraud Litigation: Suing the Remedy to the Wrong*, 66 TEX. L. REV. 469, 510-15 (1988) (advocating that the broker-dealer and privity distinctions be abandoned).

444. *Huddleston*, 640 F.2d at 555.

445. *Id.*; *see also Moody v. Bache & Co.*, 570 F.2d 523, 527 (5th Cir. 1978) (court rejected plaintiff's contention that where reliance and materiality are found, causation follows as a matter of law).

446. *Huddleston*, 640 F.2d at 555.

tent that it usefully approximates the materiality of the challenged misstatement or omission.

2. *Application of the Fifth Circuit's Standards*

The actual application of the Fifth Circuit's standards demonstrates the prominence of materiality in its measurement of general damages. In *In re Letterman Bros. Energy Securities Litigation*,⁴⁴⁷ the court affirmed the trial court's grant of a directed verdict against the plaintiffs who had sought damages under rule 10b-5 against a bank (BancTexas) that had financed an unsuccessful oil and gas venture.⁴⁴⁸ On appeal, the plaintiffs argued that the district court should have adopted a rescissional measure of damages rather than an out-of-pocket measure because the bank did not misstate the fair value of the stock, but rather it induced the plaintiffs to purchase in the first place.⁴⁴⁹

The Fifth Circuit rejected a rescissional measure of damages on the ground that the bank was not in privity with plaintiffs nor did it owe them a fiduciary duty.⁴⁵⁰ The bank, in other words, by its silence or even its misstatements was not in a position to induce a reasonable investor to purchase in the first place. Unlike the broker in *Chasins*,⁴⁵¹ whose advice was material to the investor's very decision to enter the market, the bank here had no substantial likelihood of altering a reasonable investor's decision.

The Fifth Circuit made clear that its rejection of rescission focused on the limited materiality of the bank's misstatements when it also found that the plaintiffs had failed to establish any out-of-pocket damages. Furthermore, the court found that the fair value of the oil and gas interests purchased by the plaintiffs was not zero because the investment included tangible assets in oil and gas leases and drilling equipment. The misstatements that the bank made were unrelated to the value of those assets; instead, the misstatements related only to the competence of the lease operators, whom the plaintiffs could remove at their option.⁴⁵² The plaintiffs, therefore, were unable to

447. 799 F.2d 967 (5th Cir. 1986), *cert. denied*, 480 U.S. 918 (1987).

448. *Id.* at 970-71. Letterman Brothers Energy Programs (Letterman) "suffered substantial financial losses as a result of investments in oil and gas leases that they entered into with Wells-Battelstein Oil & Gas, Inc." *Id.* at 969. Letterman sued BancTexas under section 10(b) and rule 10b-5 alleging that BancTexas wrongly induced Letterman to invest in Wells-Battelstein's drilling ventures. *Id.* at 970.

449. *Id.* at 972.

450. *Id.* (citing *Huddleston*, 640 F.2d at 554). *Cf.* *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1173 (2d Cir. 1970) (plaintiff purchased securities based on broker's misrepresentations, and thus broker breached fiduciary duty).

451. *See supra* notes 272-89 and accompanying text.

452. *Letterman Bros.*, 799 F.2d at 973.

show that the disclosure of the bank's misstatements would have significantly altered the total mix of information available to the reasonable investor. Thus, they could not show that the bank's misstatements were material, and, therefore, the plaintiffs could not show any price-value disparity of the interests at the time of the transaction. Their measure of damages depended upon a showing of the materiality of the bank's misrepresentations.

In *Huddleston v. Herman & MacLean*,⁴⁵³ by contrast, the court suggested that out-of-pocket damages were recoverable because the accountants who had participated in the preparation of a prospectus had misrepresented and omitted material facts about the value of the underlying assets, thereby affecting the price a reasonable investor would have been willing to pay for the stock.⁴⁵⁴ The court appointed a special master in *Huddleston* and charged him with the task of computing the degree of the materiality of the defendants' conduct. At the same time, however, the Fifth Circuit was unwilling to find that the misstatements and omissions made by these defendants, who were neither in privity with nor fiduciaries of the plaintiffs, were so material as to affect the fundamental decision to invest.⁴⁵⁵ Accordingly, the court remanded the case for a determination of the price-value disparity created by the defendants' misstatements and omissions, or, in other words, for a quantification of materiality.⁴⁵⁶ In a rule 10b-5 case, then, the Fifth Circuit measures general damages based on such a quantification.

This quantification is also used to measure special or consequential damages. While the Fifth Circuit generally allows consequential damages, it limits the amount of those damages to injuries caused by the material misrepresentations. Thus, in *Letterman*, the Fifth Circuit suggested that consequential damages were the preferred remedy because the misrepresentation charged went not to the value of the assets, but to the decision to

453. 640 F.2d 534 (5th Cir. 1981), *aff'd in part and rev'd in part*, 459 U.S. 375 (1983).

454. *Id.* at 555-56. The defendants filed a registration statement and prospectus with the SEC for the offering of securities "the proceeds of which were to be used to construct . . . the Texas International Speedway." *Id.* at 539. The company, Texas International Speedway, Inc. (TIS), however, went bankrupt soon thereafter. *Huddleston* was one of several investors in TIS who brought a section 10(b) and rule 10b-5 action against TIS and the accountants who prepared the prospectus. *Id.* The court considered on appeal the issue whether the preparers of the prospectus materially misled the investors regarding the cost of construction of the speedway, and how much damage the misstatements caused. *Id.* at 553-54. *See also* Securities Act of 1933, § 12(2), 15 U.S.C. § 77l(2) (1982); Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1982).

455. *Huddleston*, 640 F.2d at 555.

456. *See also* *Meyers v. Moody*, 693 F.2d 1196, 1215 n.16 (5th Cir. 1982) (rejecting out-of-pocket measure in complex, multi-count action because it was inadequate to account fully for the materiality of defendants-fiduciaries' misstatements and omissions), *cert. denied*, 464 U.S. 920 (1983).

choose an incompetent operator.⁴⁵⁷ The plaintiffs in *Letterman* could have recovered the additional expenses that resulted from the defendant's misstatements that led to the hiring of an incompetent operator.⁴⁵⁸ Even in computing consequential damages, therefore, the court uses as its guide the materiality of the challenged concealments.

F. The Sixth Circuit

The United States Court of Appeals for the Sixth Circuit accepts the Supreme Court's *Affiliated Ute*⁴⁵⁹ damages rule for both defrauded sellers and defrauded buyers. The court agrees that the correct measure of damages is the difference between the fair value of all that the plaintiff received and the fair value of what the plaintiff would have received absent the defendant's material misstatement or omission.⁴⁶⁰

But the Sixth Circuit also allows a plaintiff to recover the defendant's profit attributable to the fraud where that amount exceeds the plaintiff's actual losses.⁴⁶¹ In one case, the Sixth Circuit stated the extreme position that "[t]he proper standard of damages for either a defrauded seller or a defrauded buyer under [rule 10(b)(5)] is 'disgorgement of profits.'"⁴⁶² The court believed that disgorgement of the defendant's profits is proper because it represents the "simple equity that a wrongdoer should disgorge his fraudulent enrichment."⁴⁶³ That principle extends without a "decisive legal difference" to defrauded buyers of securities, provided they can show that the sellers reaped profits from their fraud.⁴⁶⁴

Simultaneously, however, the Sixth Circuit has insisted on limiting a plaintiff's recovery to losses caused by the defendant's misstatements or omissions. Thus, in *Fridrich v. Bradford*,⁴⁶⁵ the court found no cognizable damages because the plaintiffs could not establish that the defendants' failure

457. 799 F.2d at 973 n.5.

458. *Id.* at 974.

459. 406 U.S. 128 (1972). See also *supra* notes 35-65 and accompanying text.

460. See, e.g., *Nickels v. Koehler Management Corp.*, 541 F.2d 611, 617 (6th Cir. 1976), *cert. denied*, 429 U.S. 1074 (1977); *Ohio Drill & Tool Co. v. Johnson*, 498 F.2d 186, 190-91 (6th Cir. 1974), *modified in part on other grounds*, 625 F.2d 738 (6th Cir. 1980).

461. *Nickels*, 541 F.2d at 617.

462. *Ohio Drill*, 498 F.2d at 190.

463. *Id.* (citing *Janigan v. Taylor*, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965)).

464. *Id.* at 191 (citing *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795 (2d Cir. 1973), *cert. denied*, 414 U.S. 908 (1973)). Defrauded buyers experience much difficulty when attempting to meet this burden. See *supra* text accompanying notes 290-99.

465. 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977).

to disclose material, nonpublic information affected the price at which plaintiffs sold their stock.⁴⁶⁶

In April 1972, J.C. Bradford, Jr. purchased 1,225 shares of Old Line Life Insurance Company (Old Line) stock based on material, nonpublic information about a possible acquisition.⁴⁶⁷ He sold the stock two months later, reaping a \$13,000 profit on the transaction.⁴⁶⁸ After an SEC investigation, Bradford was forced to disgorge the \$13,000. Furthermore, the sellers of Old Line stock during the period of nondisclosure sought damages under rule 10b-5.⁴⁶⁹

The district court, after finding all the defendants liable under rule 10b-5 for trading while possessing material inside information, awarded the plaintiff sellers \$361,186.75 in damages.⁴⁷⁰ The district court did not base its damage formula on the profits that the defendants received from their transactions nor on an effort to capture the plaintiffs' losses by finding the price-value disparity on the date of the transaction. Rather, the district court, by ordering the defendants to return to the plaintiffs the difference between the sale price and the highest resale price after disclosure, adopted a version of the *Chasins v. Smith, Barney & Co.*⁴⁷¹ rescissory measure, whereby plaintiffs obtained a return of the highest value of the shares they sold less consideration received.

The Sixth Circuit rejected this theory of damages, and held that because defendants' act of trading with third parties in an open and impersonal market, "in no way affected plaintiffs' decision to sell," the trading was not causally connected to plaintiffs' losses.⁴⁷² Unlike *Chasins*, the plaintiffs could not show that their decision to invest or the price at which they invested was altered by the defendants' trades based on inside information. Accordingly, any recovery based on the highest resale value of the stock after disclosure to

466. *Id.* at 322.

467. *Id.* at 308.

468. *Id.*

469. *Id.*

470. *Id.* at 312. The court noted that the district court had made the following finding:

Each plaintiff sold Old Line stock during the period of nondisclosure and is therefore entitled to damages as a result of defendants' nondisclosure The measure of damages is the difference between the price each plaintiff received for his shares sold during the period of nondisclosure . . . and the highest value reached by Old Line stock within a reasonable time after the tortious conduct was discovered and the disclosure made of the information wrongfully withheld.

Id. at 312-13. The opinion of the district court was unreported.

471. 438 F.2d 1167 (2d Cir. 1970). See also *supra* text accompanying notes 272-89.

472. *Fridrich*, 542 F.2d at 318.

a plaintiff class would be so unlimited in scope as to be punitive.⁴⁷³ The court also felt powerless to limit the scope of such recovery by calculating only the disparity between fraud price and resale price for defendants' trades.

The court suggested, however, that the *Chasins* measure of damages might be appropriate if the defendants had a fiduciary duty to disclose to the plaintiffs the material nonpublic information. The court suggested that the silence of such a fiduciary would materially affect either the decision to invest or the price of the investment.⁴⁷⁴ Moreover, the court left unanswered the question of whether a plaintiff could recover his out-of-pocket losses if he could show that defendant's trading activity impacted the market price that the plaintiff received for the defendant's stock.⁴⁷⁵

The premises that led the Sixth Circuit to limit damages in the open market insider trading situation were subsequently undermined by the Supreme Court. In *Basic, Inc. v. Levinson*,⁴⁷⁶ the Supreme Court indeed agreed with a Sixth Circuit panel that the plaintiffs could recover damages under rule 10b-5 by showing that the market price of stock, even when sold in an open and impersonal market, was affected by material misstatements. However, by approving the fraud-on-the-market theory, the Supreme Court suggested that the causal link between plaintiffs' losses and defendants' conduct need not be established on an individualized, face-to-face basis; rather, by market price communications of all material nondisclosures.⁴⁷⁷ A plaintiff can show that the defendant's conduct was material by establishing that: (1) the defendant failed to disclose price altering information in breach of a fiduciary duty to disclose; or (2) the defendant's affirmative misstatements altered the price at which plaintiff bought or sold. In either case, the proper measure of damages in the Sixth Circuit for rule 10b-5 violations in either a personal or an impersonal market rests upon the disparity that the defendant's misstate-

473. *Id.* at 321. See also *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 242 (2d Cir. 1974); *Bangor Punta Operations v. Bangor & Aroostock R.R.*, 417 U.S. 703, 715-16 (1974); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, *reh'g denied*, 423 U.S. 884 (1975).

474. *Fridrich*, 542 F.2d at 320.

475. *Id.* at 320 n.27.

We specifically do not reach the question of availability of the remedy to open market situations where the insider trading with resultant price changes has in fact induced the plaintiffs to buy or sell to their injury. Here there was no proof that defendants' insider trading had any impact whatever upon the value of Old Line stock.

Id. (citation omitted).

476. *Basic, Inc. v. Levinson*, 108 S. Ct. 978 (1988).

477. For a more thorough discussion of *Basic*, see *supra* notes 153-93 and accompanying text.

ments or omissions created between the price and value of stock. Thus, damages are clearly rooted in materiality.

G. *The Seventh Circuit*

1. *Reluctance to Labelling*

The United States Court of Appeals for the Seventh Circuit has stated generally that the "usual measure of damages in a case under Rule 10b-5 is the difference between what the stock fetched and what it would have been worth had all the information been disclosed."⁴⁷⁸ A plaintiff must prove damages by establishing a disparity between the price paid and the price that would have been paid but for the fraud.⁴⁷⁹

The circuit court, however, has also declared that "[r]ecovery sometimes depends on the defendant's profit"⁴⁸⁰ rather than the plaintiff's losses and that the plaintiff may elect either.⁴⁸¹ Hence, the court has observed:

There are two standard measures of damages in securities law. One, the 'rescissionary' measure of damages, is based on defendants' gain. The court reverses the transaction and compels defendants to return the purchase price or disgorge any gains they received. Damages based on defendants' gain make the fraud unprofitable and therefore deter wrongdoing. The other, the 'market' measure of damages, is based on the plaintiffs' loss. If the investor sells for \$200 a security that on the day of the sale would fetch \$1,000 in an arms' length transaction between fully informed parties, he recovers his loss of \$800.⁴⁸²

The Seventh Circuit has not expressly decided when either the market measure or the rescissory measure should be used, and has suggested only that the issue is of "great subtlety and substantial moment,"⁴⁸³ and that both measures are sometimes used.⁴⁸⁴

Despite its professed reluctance to select a proper measure of damages, the Seventh Circuit has suggested that in every rule 10b-5 action, the proper measure of damages is a quantification of the materiality of the defendant's misstatements or omissions. The Seventh Circuit has indicated that a plaintiff establishes liability under rule 10b-5 by showing that the defendant's

478. *Flamm v. Eberstadt*, 814 F.2d 1169, 1179 (7th Cir.), *cert. denied*, 108 S. Ct. 157 (1987).

479. *Harris Trust & Sav. Bank v. Ellis*, 810 F.2d 700, 706 (7th Cir. 1987).

480. *Flamm*, 814 F.2d at 1179.

481. *Harris*, 810 F.2d at 706.

482. *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429, 441-42 (7th Cir. 1987), *cert. dismissed*, 108 S. Ct. 1067 (1988).

483. *Harris*, 810 F.2d at 707.

484. *Jordan*, 815 F.2d at 442.

nondisclosure was material in that it had a substantial likelihood of affecting the price at which a reasonable shareholder was willing to buy or sell securities. The court has declared that, “[c]ausation is an essential ingredient of any securities case” because the plaintiff must show that the price of securities has moved in response to the defendant’s omission.⁴⁸⁵ Yet an omission that does not alter the price of stock is not material. Therefore, a nondisclosure must cause a price-value disparity before a court in this circuit will consider it material. Then, materiality, as such, demonstrates the fact of damage.⁴⁸⁶

But the Seventh Circuit has gone further. Not only does the materiality of the defendant’s nondisclosure establish the fact of damage, it also establishes the amount of damages. The fairness of the price at which a plaintiff trades stock, the court has recognized, is not an either-or proposition; “‘fairness’ is a range, not a point.”⁴⁸⁷ Information is necessary so that the stock will reach a price within that range that is closer to its fair value.⁴⁸⁸ If all material information about the stock is disclosed, presumably the price and value of the stock will be the same. However, if some material facts are concealed, the range between price and value will widen. That range represents the materiality of the nondisclosures. When a defendant’s concealment creates that range, a plaintiff may then scale damages under rule 10b-5. The range between price and fair value created by the defendant’s material nondisclosures constitutes the amount of damages.⁴⁸⁹

2. Application of the Price-Value Range

*Jordan v. Duff & Phelps, Inc.*⁴⁹⁰ clearly supports the proposition that the measure of rule 10b-5 damages quantifies the materiality of the defendants’ nondisclosures. In this case, Jordan, an employee of Duff & Phelps, Inc., a closely-held corporation, purchased his employer’s stock under a purchase agreement. The agreement provided that upon his termination from employment with the corporation for any reason, the corporation would buy back his shares at the adjusted book value of the shares on December 31 of the year preceding his termination.⁴⁹¹ While Jordan had accumulated stock, the chairman of Duff & Phelps negotiated the sale of the corporation for about \$50 million to Security Pacific Corporation. The sale, however, was

485. *Harris*, 810 F.2d at 706.

486. *Id.*

487. *Id.*

488. *Id.*

489. *See id.*

490. 815 F.2d 429 (7th Cir. 1987), *cert. dismissed*, 108 S. Ct. 1067 (1988).

491. *Id.* at 432.

not consummated.⁴⁹² Jordan, meanwhile, sought and accepted a new job in Houston at a salary sufficiently higher than that which he had received at Duff & Phelps.⁴⁹³ Jordan resigned from Duff & Phelps on December 31, 1983, and received as consideration for his shares a book value on that date of \$123.54 per share.⁴⁹⁴ Jordan later learned that Duff & Phelps had consummated a merger with a subsidiary of Security Pacific, which would consequently value Duff & Phelps at \$50 million.⁴⁹⁵ If Jordan had been an employee on that date, he would have received at least \$452,000 for his shares.⁴⁹⁶ He sought damages measured by the disparity between the price he received and the price he would have received under the terms of the merger. However, when the merger ultimately fell apart, Jordan amended his prayer for relief, seeking rescission rather than damages.

In reversing and remanding the district court's grant of summary judgment for the corporation, the Seventh Circuit held that the question of the materiality of the nondisclosures and the related issues of causation and damages should have been sent to the jury. First, however, the court rejected Jordan's claim for rescission. It did so not because Jordan's delay in electing rescission evidenced his unclean hands and made that relief inequitable.⁴⁹⁷ Rather, the court found that rescission was impossible under the circumstances because Jordan's employment status at Duff & Phelps could not be recreated or restored.⁴⁹⁸

The court suggested that the remedy of rescission should be permitted only at a time and under circumstances that will approximate market dam-

492. *Id.*

493. *Id.* Jordan was offered about \$43,000 more per annum for the new position in Houston.

494. *Id.*

495. *Id.* at 433.

496. *Id.*

497. *See supra* text accompanying notes 407-10. Prompt election of rescission under the securities laws has the effect of preventing the defrauded party from speculating at the defendant's expense about the value of the stock after learning of the breach. *Jordan*, 815 F.2d at 440.

498. *Jordan*, 815 F.2d at 440. In the course of rejecting rescission and then reaching the issues of causation and damages, however, the court philosophizes about the nature of that relief:

A prompt demand for rescission is important in allocating risks among parties, . . . [O]nce the investor discovers the fraud, he has an ordinary investment decision to make with respect to the future — to keep (or recover) the stock in hope of gain or to disinvest. Allowing a belated election between market damages and rescission effectively allows him to do both, and therefore visits defendants with expected damages greater than the loss the investor actually suffered.

Id.

ages.⁴⁹⁹ Thus, if a seller is induced by a material misstatement to sell stock worth \$20 per share at \$10 per share, the rescissory damages received should be limited to the price-value disparity (\$10), less the market price at the time of rescission. Otherwise, the seller would be able to wait to see whether the sold stock declined in price before electing to sue for damages measured at the time of sale, thereby shifting all of the postdiscovery risk to the defendant. The seller's damages are the difference between the contract price (\$10) and the resale price a reasonable time after discovery of the fraud.⁵⁰⁰

Similarly, the defrauded buyer, who purchases worthless stock for \$10 per share, should be able to recover rescissory damages in the amount of the difference between market price at a reasonable time after the fraud is discovered and the purchase price. The buyer is encouraged to "cover" his losses by selling at the postdiscovery market price. If the buyer chooses not to resell the stock at that price and the market price continues to decline, he cannot recover from the defendant the measure of the subsequent decline. For both defrauded sellers and buyers, the court suggested that the postdiscovery decision to reinvest or divest in the stock is an independent investment decision, the risks of which cannot be passed on to the defendant.⁵⁰¹

The Seventh Circuit, however, imperfectly analogizes the Uniform Commercial Code (U.C.C.) remedy to the remedy of rescission.⁵⁰² First, the seller's remedies relied upon by the court under sections 2-706 and 2-708 are conditioned upon circumstances provided in section 2-703, not cited by the court.⁵⁰³ Those conditions all proceed from the assumption that the seller still has the goods and most assume that a breach has not yet occurred. Indeed, the resale price measure of damages in this context encourages sellers to get the best price for goods they still possess. In the securities context, however, the seller has already parted with the securities, and resale only becomes possible after discovery of the fraud or breach. Prompt election of rescission occurs prior to and differs from the decision to resell stock in a commercially reasonable manner.

499. *Id.* Comparing rescission to remedies provided under the Uniform Commercial Code, the court declares that prompt election should have the following effects:

- (1) The defrauded seller's damages will be limited to the unpaid contract price less the market price of the stock at the time of delivery; and
- (2) The defrauded buyer's damages will be limited "to the market price at the time the breach is discovered less the contract price." *Id.*

500. See U.C.C. § 2-706 (official comment 5 to section 2-706 states: "[s]ubsection (2) merely clarifies the common law rule that the time for resale is a reasonable time after the buyer's breach, by using the language 'commercially reasonable.'").

501. *Jordan*, 815 F.2d at 440.

502. See *supra* notes 497-99 and accompanying text.

503. U.C.C. § 2-703(c).

Second, and similarly, the buyer's damages under the U.C.C., which encourage him to cover by limiting his damages to the difference between the contract price and the market price at the time of discovery of the breach, presume that the buyer does not yet have some or all of the goods. Rescission, by contrast, requires the buyer first to elect to rescind the deal and then to attempt to cover. Indeed, the U.C.C. allows the buyer to recover *both* the "price,"⁵⁰⁴ which the buyer has already paid, if any, and the difference between the contract price and the cover price, suggesting that the cover measure remains separate and apart from a rescissory measure.

Third, the consequences of failing to act in a prompt manner under the U.C.C. differ from those under the doctrine of rescission. The defrauded sellers or buyers who fail to act in a commercially reasonable manner to cover or resell simply pay for their delay in an incremental reduction in their damages. By contrast, under the Seventh Circuit's view of rescission, the failure of the defrauded buyer or seller to act in a prompt fashion results not in an incremental reduction in their damages, but in a complete forfeiture of the remedy of rescission.

Finally, the U.C.C.'s measures of damages are simply not rescissory. Rather, as the Code suggests, the measures are formulas for determining damages that essentially require a plaintiff to take reasonable steps to mitigate damages. A plaintiff seller must attempt to mitigate damages by reselling goods; a plaintiff buyer must attempt to mitigate damages by covering. The failure to mitigate damages does not forfeit the remedy, but rather simply results in a reduction of the actual losses that are recoverable. Rescission, by contrast, has no inherent mitigation checks. It aims to unwind a transaction, which, because of fraud or mistake, never really took place. If, as the Seventh Circuit stated in *Jordan*, equitable requirements for the use of rescission became obsolete when law and equity merged, then nothing about rescission itself requires prompt action or mitigation.⁵⁰⁵

The lack of a precise fit between the U.C.C.'s measures of damages and rescission under the securities laws belies the Seventh Circuit's effort to limit rescissory relief to the market measure of damages. The market measure of damages measures the price-value disparity at the time of the transaction.⁵⁰⁶ Rescissory damages reflect the price-value disparity at some time after the

504. U.C.C. section 2-711(1) states: "(1) Where the seller fails to make delivery or repudiates or the buyer rightfully rejects . . . any goods involved, . . . the buyer may cancel and . . . may in addition to recovering so much of the price as has been paid . . . 'cover' . . ."

505. See *Jordan*, 815 F.2d at 440. Examples of equitable requirements include clean hands and laches. See *id.*

506. See *supra* text accompanying notes 21-23.

plaintiff discovers the fraud.⁵⁰⁷ Hypothetically, the rescissory measure would equal the market measure if the defrauded party elected to rescind the instant that the parties consummated the transaction. However, the greater the interval between the transaction date and the rescission date, the greater the chance that the rescissory measure will differ from the market measure. By requiring a prompt rescission, the Seventh Circuit seeks as much congruence between the rescissory measure and the market measure of damages as possible.⁵⁰⁸

More subtly, the court recognized that the task of calculating the fair value of stock on the transaction date before the fraud was revealed presents more problems than computing the fair value of stock on the rescission date after the fraud has been revealed to the market.⁵⁰⁹ Presumably, the market price will reflect the true value of the stock once the market is fully informed. Thus, a possible indication of the fair value of the stock on the date of the transaction is the market price of that stock once the previously concealed information has been disclosed. If the measure of rescissory damages is limited to the difference between the purchase price and the informed market price (measured a reasonable time after the market discovers the fraud), then that measure will generally be the same as the market measure, which is the difference between the purchase price and the fair value of the stock (measured by the informed market price). Requiring prompt election of rescission, therefore, ensures that rescissory and market damages will be approximately the same.

If, however, intervening external market forces make the revelation of the concealed information on the discovery date insignificant, the rescissory measure may greatly exceed the market measure.⁵¹⁰ The Seventh Circuit responded to this possibility by redefining rescission itself. Rescission, the court declared, is an order compelling a defendant to disgorge his gains,⁵¹¹ but in the securities arena, gains and losses often match each other; the de-

507. See *supra* text accompanying notes 420-22.

508. *Jordan*, 815 F.2d at 440-42.

509. *Id.* at 442-43.

510. For example, assume a buyer purchases stock in 1985 at \$10 per share in a corporation connected to the space program. The buyer watches the stock become worthless after the shuttle disaster and then discovers an unrelated material omission which, if disclosed at the time of the purchase, would have decreased the market price for the stock in 1985 to \$7 per share. The buyer may recover, after a prompt election of rescission, the full purchase price of \$10 per share instead of the \$3 per share disparity between market price and true value at the time of the transaction. Not even a prompt rescission requirement would seem to limit rescissory damages to those market damages.

511. *Jordan*, 815 F.2d at 441.

fendant's gain is the plaintiff's loss.⁵¹² Rescission thus aims at disgorging net gains to all investors resulting from fraud, not merit.

This was the scenario in *Jordan*. When Jordan sold his stock to Duff & Phelps, Inc., all of the other investors gained because they obtained a larger share of the ultimate pot. The court concluded that the defendant (defined broadly to include its shareholders) "gained *exactly* what Jordan lost — the value of his 1.244% stake in the firm."⁵¹³ Moreover, the court found that Jordan's losses, which resulted from not taking part in the merger opportunity and from forfeiting his salary at Duff & Phelps, were matched by the defendant's gains. First, measured at the time of sale, Jordan lost the value of the merger, discounted by the probability that it would take place. He lost the value of the merger multiplied by its percentage chance of occurring, less his actual sale price. Conversely, the other investors in the firm gained the merger value, which they would otherwise have had to pay to Jordan, multiplied by that probability, and discounted by the price they actually paid for Jordan's stock. Second, Jordan's gain from the increase in his salary upon leaving Duff & Phelps is equal to Duff & Phelps' loss because the firm gave up the bargain element in his salary measured by its increase.⁵¹⁴ Hence, the firm's net profits must be discounted by Jordan's new salary and Jordan's exact same net losses must be reduced by that salary.

Even viewing rescission and out-of-pocket damages as matching net profits and losses, however, the court recognized that rescission values only those gains commencing upon the certainty of the outcome of events. Here, the merger possibility was such an event. On the contrary, the market measure values losses before the outcome becomes certain.⁵¹⁵ The court circumvented the timing disparity between the market measure and rescission by introducing into each theory a probability or a materiality factor. The likelihood that Jordan would have remained at Duff & Phelps "may be closely related to the probability that [the] deal" would have been made on beneficial terms.⁵¹⁶ The likelihood that a beneficial deal would be made, the court reasoned, would be reflected in the price that reasonable investors would be willing to pay for the stock. That price, in turn, would be reflected in any market measure of damages.

Accordingly, the probability that Jordan would have stayed at Duff & Phelps, but for the fraud, which is dependent upon the likelihood of the deal being made on beneficial terms, is a factor in the market measure of dam-

512. See Easterbrook & Fischel, *supra* note 6, at 634.

513. *Jordan*, 815 F.2d at 442.

514. *Id.*

515. *Id.*

516. *Id.*

ages. Moreover, because “Jordan must prove that he would have stayed”⁵¹⁷ to obtain rescissory damages, the effect of the merger disclosure on that decision also factors into the measure of that relief.⁵¹⁸ The court’s analysis, therefore, simply stated in the alternative, that for both market and rescissory damages, the effect of the nondisclosure on a reasonable investment decision must factor into measuring the damages. The materiality of the nondisclosure, in other words, is the proper measure of market and rescissory damages.

The Seventh Circuit, in fact, offered some guidance on how to quantify the materiality of the nondisclosure for damages purposes. First, the court decided that the plaintiff may recover the price-value disparity because information that the firm had lucrative offers may have had a substantial likelihood of inducing the “reasonable investor” to stay at the firm.⁵¹⁹ A jury could have found the nondisclosure material, thus establishing causation. But then the court indicated that the measure of damages is related to the problem of causation.⁵²⁰ The question of causation centers on probabilities; that is, the likelihood that the concealed information affected the reasonable investor by a certain amount. The court recognized that Jordan would claim that the information was material, while Duff & Phelps would adduce evidence that it would have had no effect on his investment decision given the total mix of factors weighing on it.⁵²¹ Because the truth lies somewhere in the middle, a jury verdict for one or the other based on liability would be inaccurate, introducing a “rounding error.”⁵²²

The cure to this ill, according to the court, is to collapse the issues of materiality and damages so that the jury is able to quantify more precisely the effect of the nondisclosure on the investor.⁵²³ The court suggested that an informed reasonable investor would have valued each share of stock on

517. *Id.*

518. *Id.* at 440.

519. *Id.* at 441.

520. *Id.*

521. *Id.*

522. *Id.*

523. Measuring the materiality of the nondisclosure requires quantifying: (1) the probability that the beneficial deal will occur; and (2) the probability that it would alter the investor’s decision. The former is a function of the market measure of damages because the likelihood of a good deal is reflected in a fully informed price. That likelihood can be calculated as follows:

Suppose there is one chance in three of each of the following outcomes: merger at \$50 million, LBO at \$40 million, and no deal (book value = \$2.5 million). The expected value of Duff & Phelps then is the sum of these outcomes, divided by three, or $\$92,500,000/3 = \$30,833,333$ There were 20,100 outstanding shares, making each worth \$1,534.00 in an arms’ length transaction on these assumptions.

Id. at 442-43.

the sale date at \$1,534.⁵²⁴ The fair value of the stock on the sale date is the expected value of each share because the information is so material as to affect the expectations of the reasonable investor. Furthermore, the court assumed that the likelihood that Jordan would have left the firm equals the likelihood that a good deal would be made. Without inquiring into Jordan's individual motives, the court objectively quantified the materiality of the concealed information to the reasonable investor as the difference between the price accepted and the expected value of the stock on the date of the transaction. Whether they are termed market or rescissory, damages are a quantification of the materiality of the challenged nondisclosures.

The Seventh Circuit also suggested how that quantification can be made in subsequent rule 10b-5 actions. For example, an expert, such as an investment banker, should compute the probability that the firm in question would be sold.⁵²⁵ That price should then be reduced by the amount that the plaintiff received for his shares and any other benefits resulting from the investment decision. Ultimately, the court preferred this expert analysis to the jury's assessment of the plaintiff's subjective motivations.⁵²⁶ The court further suggested that the parties may also prefer the expert method, which attempts to quantify materiality, to the all-or-nothing character of a jury's finding.⁵²⁷

Judge Posner dissented, and particularly questioned the majority's equation of damages and materiality.⁵²⁸ After disagreeing with the majority's finding of a duty to disclose, Judge Posner argued that the question of the affect on Jordan of the concealed information, or its materiality, could not be calculated simply by an investment banker's valuation of the firm. Rather, Judge Posner believed materiality is more subjective, requiring the jury to consider numerous factors.⁵²⁹ While the dissent applauded the majority's

524. *Id.*

525. *Id.* at 443.

526. *Id.* "The computation of the expected value as of [the date of sale], rough as it is, may be more reliable than a jury's guess about whether Jordan's wife would prevail on him to quit."
Id.

527. *Id.*

528. *Id.* at 444 (Posner, J., dissenting).

529. *Id.* at 451-52. These factors include: (1) the value that Jordan would have placed on the shares if he had known what the defendant knew; (2) Jordan's attitude toward taking risks; (3) the method Jordan would have employed when trading off his estimate of the value of his shares, a value he could not have realized immediately even if he had remained with Duff & Phelps, against the higher salary he was to receive in Houston and against freedom from domestic conflict; (4) the ability of Jordan to rescind his resignation; (5) the speculation concerning whether Jordan would still have been working for Duff & Phelps two years later when the firm was reorganized; and (6) how Jordan would have reacted to the collapse of the Security Pacific deal and whether this would have precipitated his departure. *Id.*

“boldness” in “breaking with the tradition of expressing causation in either-or terms,”⁵³⁰ Judge Posner believed that the proper quantification of the materiality of the nondisclosed information was “not the probability that an investment bank would assign to Duff and Phelps’s [sic] being sold or reorganized; it is a function of the six factors that I have listed.”⁵³¹

3. *The Great Debate: Judge Easterbrook v. Judge Posner*

Thus, Judge Posner agrees with Judge Easterbrook that the proper measure of damages is a quantification of the materiality of the nondisclosure.⁵³² The judges disagree, however, on how to make that quantification. Judge Posner believes that materiality has a subjective component that requires a jury’s analysis of the total mix of information confronting the plaintiff. Judge Easterbrook, on the other hand, believes that materiality is purely objective, suggesting that the determination can be made by the court or by experts based upon the reasonable investor standard.

Because Judge Easterbrook penned the principal securities law damages decisions in the Seventh Circuit, it may be possible to predict the direction of that circuit’s law from his scholarship. In *Optimal Damages in Securities Cases*,⁵³³ Judge Easterbrook co-authored an argument for a measure of damages that approximates the “net loss” that securities fraud (a form of breach of contract) imposes on investors, divided by the probability that the activity will be detected and prosecuted with success.⁵³⁴ Net loss or net harm from securities fraud has four components: (1) the net transfer of wealth from victim to offender; (2) the total cost of accomplishing the offense, guarding against it, and litigating it; (3) the investor’s choice of the wrong investments; and (4) the choice of investment generally due consumption.⁵³⁵ When promulgating the securities laws, Congress intended to protect investors, to provide for efficient markets, and to provide for damages to deter conduct that frustrates these intentions without deterring beneficial conduct. The balance requires a measure of damages based on net harm, but, as Judge Easterbrook made clear in *Jordan*, losses and gains match each other in the securities field.

It is not surprising, therefore, that the courts, in measuring damages under rule 10b-5, have used both the out-of-pocket measure based on losses

530. *Id.*

531. *Id.*; see *supra* note 529 (factors listed).

532. See Easterbrook & Fischel, *supra* note 6, at 613.

533. *Id.* at 611.

534. *Id.* at 613-14, 618.

535. *Id.* at 622-25.

and the rescissory measure based on gains.⁵³⁶ Yet, because other net harms from securities fraud exist, such as the costs of guarding against and litigating material nondisclosures, the optimal damages in rule 10b-5 cases are not zero.⁵³⁷ Nor are optimal damages the gross transfer of wealth from investors to nondisclosers. Instead, the proper measure of damages should: (1) presume that investors' losses match other investors' net out; (2) begin with the wrongdoer's profits; (3) add damages for the cost of carrying out and thwarting the fraud; and (4) add a reserve of recovery for the costs of risk created by wrongdoing.⁵³⁸ The measure would be mechanical, fixing a percentage of the total movement of the price attributable to the omissions or misstatement.⁵³⁹ Recognizing that such a rule would only be an estimation of an "utterly unquantifiable" figure of net loss, Judge Easterbrook suggests that a statute would have to set the measure, or at least, in the meantime, expert testimony would set the measure.⁵⁴⁰

In *Jordan*, however, Judge Easterbrook stretched these theories to implement them. The court rejected any useful distinction between loss and gain in measuring damages.⁵⁴¹ The court presumed and then found that losses and gains offset each other.⁵⁴² The court then began with the defendants' profits,⁵⁴³ but did not recognize that profits should be limited to those resulting from the fraud created by the materiality of the nondisclosure. Moreover, while Judge Easterbrook stopped short of setting a mechanical rule for finding the percentage of the price causation attributable to the wrong that would precisely date net harms, he did erect and encourage probability factors for the jury's use with the help of experts in calculating the *degree* of the materiality of the defendants' misstatements or omissions. In Judge Posner's view, by breaking with the tradition of expressing materiality/causation in "either-or terms,"⁵⁴⁴ Judge Easterbrook set the stage for a reduction in damages to account more precisely for the net harm of the fraud. The proper increase of damages will continue to represent a precise quantification of the materiality of the defendant's concealments. Yet, their materiality may be measured not by their effect on the "gross movement in

536. *Id.* at 634.

537. *Id.*

538. *Id.* at 642.

539. *Id.* at 642 n.44.

540. *Id.*

541. *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429, 441-42 (7th Cir. 1987), *cert. dismissed*, 108 S. Ct. 1067 (1988).

542. *Id.* at 442.

543. *Id.*

544. *See id.* at 452 (Posner, J., dissenting).

the price of the firm's stock,"⁵⁴⁵ but by their effect on the net harm to investors and market efficiency.

H. The Eighth Circuit

The United States Court of Appeals for the Eighth Circuit expressly traces the general out-of-pocket measure of damages in rule 10b-5 cases to the tort roots of the implied right of action.⁵⁴⁶ A defendant, under that tort model, is "liable to respond in such damages as naturally and proximately result from the fraud."⁵⁴⁷ The Eighth Circuit recognizes that the federal courts measure those damages according to the out-of-pocket rule.⁵⁴⁸ That rule allows "recovery of the difference between the actual value of the securities and their purchase price."⁵⁴⁹ The Eighth Circuit also permits recovery for consequential damages proximately resulting from the fraud.⁵⁵⁰

Calculating the disparity between the price of stock and its true value requires a determination of that value. The Eighth Circuit recognizes two dates at which the value of the stock may be determined. First, where the misstatement or omission is directed toward the plaintiff only, and not the public at large, the actual value of the securities at the time of purchase is readily ascertainable and should be used.⁵⁵¹ Alternatively, where defendant's conduct causes an artificial market price of long duration, damages are fixed not at the date of purchase, but at the date of discovery of the fraud.⁵⁵² Presumably, the market price on that date will reflect the impact of the defendant's fraud. The Eighth Circuit allows the plaintiff to establish damages on either date.

Whether value is measured on the transaction date or the postdiscovery date, however, the court determines the price-value disparity that the defendant's conduct created on the transaction date. In *Harris v. Union Electric Co.*,⁵⁵³ the court stated generally that, in a bond fraud case, the price-value disparity on the date that the bonds were issued properly measures the

545. See Easterbrook & Fischel, *supra* note 6, at 642 n.44.

546. *Garnatz v. Stifel, Nicolaus & Co.*, 559 F.2d 1357, 1360 (8th Cir. 1977), *cert. denied*, 435 U.S. 951 (1978).

547. *Id.* (quoting *Estate Counseling Serv. Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 303 F.2d 527, 533 (10th Cir. 1962)).

548. *Id.* (citing *Harris v. American Inv. Co.*, 523 F.2d 220, 224-26 (8th Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976)).

549. *Id.*

550. *Id.* (citing *D. DOBBS*, *supra* note 8, at 601-06, 615).

551. *Harris*, 523 F.2d at 226.

552. *Id.*

553. 787 F.2d 355 (8th Cir. 1986).

damages.⁵⁵⁴ That disparity represented the bonds' reduction in the value that was caused by the defendant's failure to disclose that the bonds lacked call protection.⁵⁵⁵ Yet, the court looked to the fact that the market price of the bonds had dropped when the fraud was disclosed as probative of the impact that the defendant's omission had on the initial price-value disparity.⁵⁵⁶ The value of the call protection, which the plaintiffs paid for but never received, precisely measured the damages. Accordingly, the fact that the bonds recovered and their market value eventually exceeded the plaintiffs' purchase price had no bearing on the disparity between price and value created by the defendant's conduct.⁵⁵⁷

Similarly, in those cases in which the Eighth Circuit has applied a rescissory measure of damages, it has done so in an effort to quantify the impact of the defendant's misstatement or omission on the stock's transaction price. In *Myzel v. Fields*,⁵⁵⁸ plaintiffs who were induced to sell their stock at artificially deflated prices because of defendant's failure to disclose optimistic sales figures, sought a rescissory measure of recovery.⁵⁵⁹ The Eighth Circuit approved an instruction that allowed the jury to award the plaintiffs the difference between the selling price and the "highest intermediate value" reached by the stock within a reasonable period of time after the sale.⁵⁶⁰

The instruction effectively allowed the jury to quantify the materiality of the defendant's conduct. If the omissions merely induced the plaintiffs to sell their stock at a low price, "the measure of the damages [is] the difference between what they actually received and the higher price."⁵⁶¹ If, however, the omissions were so material that their disclosure would have caused plaintiffs to retain their stock and share in the growth of the company, then

554. *Id.* at 367. The Union Electric Company issued \$70 million worth of First Mortgage Bonds in 1975. In 1978, Union Electric decided to call \$50 million of the bonds, which resulted in the bond value dropping from \$113 to \$101. The trustees refused to call the bonds without judicial approval. The litigation that ensued involved the prospectus for the bonds and an alleged violation of section 10(b). The court ruled in favor of the plaintiff bond-purchasers, finding that Union Electric had "misrepresented and omitted material facts regarding the call-protection provisions of the bond contract, and that the attempted plan to call the bonds constituted a scheme to defraud the bondholders because Union Electric knew the plan was 'contrary to and prohibited by the terms of the prospectus.'" *Id.* at 360.

555. *Id.* at 367-68.

556. *Id.* at 368.

557. *Id.* at 368 n.10, 372.

558. 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

559. *Id.* at 740.

560. *Id.* at 746. For an explanation of "higher intermediate value," see *supra* note 328 and accompanying text.

561. *Myzel*, 386 F.2d at 745.

damages are properly based on "the subsequent increases in the value of the stock over [what the jury considered] a reasonable period."⁵⁶²

In *Garnatz v. Stifel, Nicolaus & Co.*,⁵⁶³ the Eighth Circuit also recognized that the proper measure of damages in securities fraud actions is the measure that most effectively determines the materiality of the challenged conduct in each particular case. In *Garnatz*, the defendant's material misstatements and omissions induced an unsophisticated investor to enter into a bond margin account.⁵⁶⁴ Finding that the out-of-pocket rule is not a "talisman," the court concluded that this damage measure is not proper where the "gravamen" of the plaintiff's complaint is not that he bought stock at an unfair price, "but that he bought at all."⁵⁶⁵ Under those circumstances, a rescissory measure returns to the plaintiff the full purchase price less any value resulting from the fraudulent transaction.⁵⁶⁶ Accordingly, if the defendant's misstatements or omissions are so material as to induce the plaintiff to enter the market where he would not have otherwise, the measure of damages may be the full purchase price. In these cases, the full purchase price represents the materiality of the defendant's conduct.

I. The Ninth Circuit

Although the United States Court of Appeals for the Ninth Circuit ordinarily measures damages based upon the out-of-pocket rule, the court has deferred to the discretion of the lower courts' application of a rescissory measure of damages in "appropriate circumstances."⁵⁶⁷ The out-of-pocket rule measures "damages as 'the difference between the purchase price and the value of the stock at the date of purchase.'"⁵⁶⁸ The Ninth Circuit has

562. *Id.*; see also *Nye v. Blyth Eastman Dillon & Co.*, 588 F.2d 1189 (8th Cir. 1978) (permitting plaintiff investors who could not make informed investment decision because of misrepresentations to recover realized loss plus difference between market value on date of unauthorized transactions and highest market value of stock reached between the date of those sales at a reasonable period after defendants left their firm).

563. 559 F.2d 1357 (8th Cir. 1977), *cert. denied*, 435 U.S. 951 (1978).

564. *Id.* at 1359. The bond margin account in *Garnatz* allowed the investor to purchase bonds through a broker on margin, or with money effectively borrowed from the broker. Because the investor's bond purchases were highly leveraged, small fluctuations in the market price of the bonds resulted in disproportionately large fluctuations in the investor's account equity. Accordingly, such accounts carry tremendous risk.

565. *Id.* at 1360 (citing *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970)). See also *supra* text accompanying notes 272-89.

566. *Garnatz*, 559 F.2d. at 1361.

567. *Blackie v. Barrack*, 524 F.2d 891, 908-09 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976). See also *Wool v. Tandem Computers Inc.*, 818 F.2d 1433, 1436 (9th Cir. 1987); *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1341-46 (9th Cir. 1976) (Sneed, J., concurring in part).

568. *Wool*, 818 F.2d at 1437 (citing *Green*, 541 F.2d at 1344 (Sneed, J., concurring)).

concluded that the out-of-pocket measure is the only measure available to a plaintiff injured by market transactions in an actively traded stock.⁵⁶⁹ In *Green v. Occidental Petroleum Corp.*,⁵⁷⁰ Judge Sneed reasoned that because plaintiffs who do not deal face to face with the defendants in open market transactions provide no direct pecuniary benefit to the defendants, those plaintiffs may recover only what they lost and not what the defendants gained.⁵⁷¹ Accordingly, Judge Sneed concluded that, in the open market context, the rescissory measure of damages is generally improper.⁵⁷²

Rescission is proper, however, when it approximates the materiality of the alleged misstatements or omissions.⁵⁷³ Rescission contemplates placing the injured party in the position that party occupied before being induced by the wrongful conduct to enter the transaction. Pure rescission requires an exchange between the parties of the entire purchase price and the stock purchased. When the purchaser no longer possesses the stock, however, the defendant must return its monetary equivalent. Under the rescission model, the monetary equivalent of the stock must be determined on the date that the purchaser was under a duty to return the stock.⁵⁷⁴ That duty arises on the date of discovery of the fraud and extends to a reasonable time after discovery. The rescissory measure of damages, therefore, is the difference between the transaction price and the stock's value within a reasonable time after discovery of the fraud. That measure does not work in the open market setting, however, because the defendant never received any consideration. More significantly, the Ninth Circuit rejects the rescissory measure of relief in typical open market cases because the disparity between the transaction price and the post-discovery value of the stock does not reflect the losses precisely caused by the defendant's misstatements or omissions.

Rescissory damages, however, work "justly" when a material misstatement or omission induces the plaintiff to sell his stock to the defendant. The plaintiff may recover the spread between transaction price and postdiscovery value only where that spread has a "necessary relationship to the amount needed" to return the plaintiff to the position he would have occupied absent the misstatement or omission.⁵⁷⁵ Rescission is also available where the plaintiff-buyer retains his stock until the date of disclosure. In that instance, the plaintiff is entitled to the return of his purchase price reduced by the

569. *Id.*

570. 541 F.2d 1335 (9th Cir. 1976).

571. *Id.* at 1341-42 (Sneed, J., concurring).

572. *Id.* at 1342.

573. *See, e.g., Nelson v. Serwold*, 576 F.2d 1332, 1338-40 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978).

574. *Green*, 541 F.2d at 1342.

575. *Id.*

value of the stock, if any, on the date of disclosure. This measure is proper because it quantifies the shift in market risks directly caused by the defendant's fraud.⁵⁷⁶ Even in the open market setting, rescissory damages are available where the corporate defendant makes material misstatements or omissions when repurchasing its own shares or making a public offering.⁵⁷⁷ In those situations, the corporation receives a benefit from the plaintiff caused by its material misstatements or omissions.⁵⁷⁸ Finally, a plaintiff may recover her entire purchase price in cases such as bond fraud where the defendant's misstatement or omission does not alter the price of the stock, but the misstatement or omission alters the decision to invest.⁵⁷⁹

Whether the district court in its discretion applies a rescissory or a tort measure, it must calculate the disparity between transaction price and the stock's value. The increase or decrease in the market price of stock after disclosure of the material misstatement or omission is "circumstantial evidence" of the true value of the stock on the date of the transaction.⁵⁸⁰ But the market price after a corrective disclosure is not conclusive evidence of the value of the stock on the transaction date. The corrective disclosure may not be complete. In addition, the prolonged nature of some frauds introduces external market variables that affect the amount of market reaction following disclosure.⁵⁸¹ Therefore, the Ninth Circuit allows the jury to assign a value to the stock along a timeline based upon an "appropriate mix" of "various methods," including expert testimony regarding capitalization of earnings.⁵⁸² The jury, in analyzing the mix of evidence, attempts to determine the price-value disparity reflected in the materiality of the defendant's misrepresentations.⁵⁸³

The Ninth Circuit further demonstrated that recovery of damages rests upon the quantification of the materiality of the defendant's conduct through the case of "in-and-out" plaintiffs. "In-and-out" plaintiffs purchase stock after the material misstatements or omissions, but resell the stock *before* disclosure. In that situation, the plaintiff who purchases stock worth \$10 per share at an inflated market price of \$20 and then resells the stock at an inflated market price of \$20 per share seemingly does not suffer any

576. *Id.* at 1343.

577. *Id.* at 1341-42 nn.1-2.

578. *Id.*

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

580. *Id.* at 909 n.25.

581. *Id.*

582. *Id.*

583. *Id.*

losses.⁵⁸⁴ Even if the market price of the stock declines before resale to \$15 per share, that pre-disclosure decline must be attributable to external market forces unrelated to the defendant's misstatements.⁵⁸⁵ Accordingly, it would appear that these in-and-out traders have suffered no out-of-pocket losses. Nonetheless, the Ninth Circuit has held that the in-and-out plaintiff may recover under the out-of-pocket rule even in the absence of corrective disclosures.⁵⁸⁶

For in-and-out traders, the price-value disparity must be measured both at the time of purchase and at the time of resale.⁵⁸⁷ If the plaintiff purchases stock worth \$10 per share at an inflated market price of \$20 per share, that plaintiff has suffered out-of-pocket losses at the date of purchase of \$10 per share. If external market forces cause the market price to decline to \$15 per share, then the plaintiff has suffered, on the date of resale, losses of \$5 per share. The price-value disparity on the date of the transaction is \$10 per share. The price-value disparity on the date of resale is only \$5 per share. The Ninth Circuit holds that the in-and-out trader is entitled to recover the amount of the original price-value disparity that is not recouped in the market place, or \$5 per share.⁵⁸⁸

Moreover, the in-and-out trader may recover damages even where his resale price *exceeds* the original purchase price. Whatever market gains the plaintiff recovered are unrelated to the defendant's conduct. Therefore, the plaintiff is still entitled to recover the price-value disparity created by the defendant's wrongdoing.⁵⁸⁹ Although the court justifies the recovery of damages in those cases under the out-of-pocket rule, which measures the price-value disparity at the transaction date, the plaintiffs have not suffered out-of-pocket losses. Instead, the court employs the out-of-pocket device as a method of placing a "cost" on the defendant's misrepresentations in an effort to quantify their materiality.⁵⁹⁰ Even where the defendant's misstatements have not resulted in out-of-pocket trading losses, plaintiffs may recover because the defendant's misstatements were material. Damages are recoverable to the extent that the defendant's misstatements or omissions create a disparity between the price at which a reasonable investor would trade stock and the stock's real value.

584. See, e.g., *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1345 (9th Cir. 1976) (Sneed, J., concurring).

585. *Id.*

586. *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1437 (9th Cir. 1987).

587. *Id.* at 1438 n.4.

588. See *id.* (providing a comparable example); *Green*, 541 F.2d at 1345-46.

589. *Green*, 541 F.2d at 1346.

590. *Id.*

J. The Tenth Circuit

The United States Court of Appeals for the Tenth Circuit embraces the out-of-pocket rule as the customary measure of damages in a rule 10b-5 case.⁵⁹¹ Yet the circuit also recognizes an exception to that measure where disgorging the defendant's profits is necessary to prevent unjust enrichment.⁵⁹² The court's citation in *Hackbart v. Holmes*⁵⁹³ to *Affiliated Ute Citizens v. United States*⁵⁹⁴ indicates its acceptance of a measure of damages based on the defendant's profits caused by the wrong, where that measure exceeds out-of-pocket losses.⁵⁹⁵ In the Tenth Circuit, defrauded purchasers and sellers of securities may recover the amount of the defendant's profits attributable to the defendant's material misstatements or omissions.⁵⁹⁶

Moreover, the Tenth Circuit allows a plaintiff to elect rescissory damages. In *Esplin v. Hirschi*,⁵⁹⁷ the court held that a defrauded buyer is entitled to recover the difference between the price paid for the securities and the value of the securities determined on the date of the discovery of the fraud.⁵⁹⁸ Similarly, in *Richardson v. MacArthur*,⁵⁹⁹ the Tenth Circuit concluded that rescissory damages should reflect the disparity between the purchase price and the stock's value at the time the plaintiff would seek rescission, within a reasonable time after discovery of the fraud.⁶⁰⁰

Finally, in *Mitchell v. Texas Gulf Sulphur*,⁶⁰¹ the Tenth Circuit established a "cover" measure of damages for a defrauded seller. Here, plaintiffs sold their Texas Gulf Sulphur (TGS) stock after defendant Texas Gulf Sulphur falsely denied rumors of a major ore discovery, but before it issued a corrective disclosure admitting the find.⁶⁰² After cautioning that its standard of recovery was fashioned for "unprecedented circumstances," the court declared:

We believe the measure of damages used should award the reasonable investor the amount it would have taken him to invest in

591. *Hackbart v. Holmes*, 675 F.2d 1114, 1121 (10th Cir. 1982) (citing *Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 303 F.2d 527, 533 (10th Cir. 1962)).

592. *Hackbart*, 675 F.2d at 1122 (citing *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972)).

593. 675 F.2d 1114 (10th Cir. 1982).

594. 406 U.S. 128 (1972).

595. *Hackbart*, 675 F.2d at 1122; see also *Affiliated Ute*, 406 U.S. at 155.

596. *Hackbart*, 675 F.2d at 1122.

597. 402 F.2d 94 (10th Cir. 1968), cert. denied, 394 U.S. 928 (1969).

598. *Id.* at 104-05.

599. 451 F.2d 35 (10th Cir. 1971) (stock purchaser sued a corporation to recover losses due to alleged fraud by corporation's employee who sold the stock).

600. *Id.* at 43-44.

601. 446 F.2d 90 (10th Cir.), cert. denied, 404 U.S. 1004 (1971).

602. *Id.* at 95-96.

the TGS market within a reasonable period of time after he became informed of the [fraud] The award proposed would permit one to 'cover' by reinvestment and suffer neither loss nor forced sale.

The damages then should be based on the highest value of TGS stock between [disclosure] and a reasonable time thereafter.⁶⁰³

According to the court, the unprecedented circumstance that justified this unique remedy was the unavailability of a restitutionary remedy: no privity existed between the parties, and the defendants were not unjustly enriched.⁶⁰⁴

The real basis for the cover measure in *Mitchell*, however, was its capacity to reflect the disparity between the plaintiffs' sale price and the real value of TGS stock. The price at which the plaintiffs could have reinvested in TGS after disclosure represented the market's informed judgment of the actual value of TGS. The disparity between that informed price and the uninformed market price accepted by the plaintiffs, according to the court, approximated the value of the concealed information.⁶⁰⁵ The nondisclosure of the ore discovery was so material that, if a reasonable investor had known about the information, he would have retained his TGS stock and sold at the highest post-disclosure value.⁶⁰⁶ The cover measure of damages has utility, therefore, in quantifying the materiality of misstatements or omissions that induce a plaintiff to forfeit entirely all profits reasonably determinable. In the Tenth Circuit, the cover measure, like rescission, disgorgement, and out-of-pocket relief, is a tool that trial courts may use to approximate the materiality of the defendant's misstatements or omissions.

K. *The Eleventh Circuit*

The United States Court of Appeals for the Eleventh Circuit presumes that the proper measure of damages in a rule 10b-5 case is "the difference between the purchase price paid for the security and the value the security would have had absent the misstatements [or] omissions."⁶⁰⁷ Under this out-of-pocket rule, the price-value disparity is determined as of the date of the transaction.⁶⁰⁸ In calculating the fair value of securities at the time of

603. *Id.* at 105.

604. *Id.*

605. *See id.*

606. *Id.*

607. *Alna Capital Assocs. v. Wagner*, 758 F.2d 562, 566 (11th Cir. 1985) (citing *Huddleston v. Herman & MacLean*, 640 F.2d 534, 555-56 (5th Cir. 1981), *aff'd in relevant part*, 459 U.S. 375 (1983)).

608. *Alna Capital Assocs. v. Wagner*, 532 F. Supp. 591, 603 (S.D. Fla. 1982), *aff'd in part and rev'd in part*, 758 F.2d 562 (11th Cir. 1985).

the transaction in *Alna Capital Assocs. v. Wagner*, the court began with the purchase price and then reduced that price, in accordance with expert testimony, to account for the likely reduction in market price attributable to each misstatement or omission.⁶⁰⁹ Although the fair value calculation rested on a number of factors, the Eleventh Circuit expressly held that the valuation process must reflect the premium over market price running to buyers of a controlling interest in the corporation.⁶¹⁰ The calculation results in a measurement of the disparity created by the defendant's conduct between market price and true value. The court quantified the materiality of the misstatements or omissions.⁶¹¹

The Eleventh Circuit has recognized, but not affirmatively accepted, the rescissory alternative to out-of-pocket damages in rule 10b-5 cases. In *Silverberg v. Paine, Webber, Jackson & Curtis, Inc.*,⁶¹² the court declined to reach the issue of the propriety of the lower court's rescission instruction in a rule 10b-5 case.⁶¹³ The circuit court found that the jury's verdict was independently supported by pendent state law theories.⁶¹⁴

While the Eleventh Circuit declined to pass on the merits of this instruction in a rule 10b-5 case, it did remark: "[W]e do not mean to imply that the measure of damages in the instant case was necessarily improper Various federal courts have recognized the appropriateness of this measure in certain situations."⁶¹⁵ Moreover, the court took "special note" of the United States Supreme Court's admonition of the federal courts to use their discretion in federal securities actions to create relief that will remedy the harm done.⁶¹⁶ Accordingly, the Eleventh Circuit at least acknowledged the

609. *Alna Capital*, 758 F.2d. at 566.

610. *Id.* at 566-67.

611. *Id.*

612. 710 F.2d 678 (11th Cir. 1983).

613. *Id.* at 687 n.15. The trial court instructed the jury that in computing an award for damages, it could include "the difference between the purchase price paid for the . . . stock . . . and the price at which such stock was or could have been sold by the plaintiff when he learned of the alleged fraud." *Id.* at 685. Because the instruction was proper as to a common law fraud count, the court declined to address its propriety under a rule 10b-5 claim. *Id.* at 685-86.

614. *Id.* at 685. The lower court instructed the jury that:

If you find for the plaintiff, you should determine and write on the verdict form, in dollars, the total amount of loss or damage which the greater weight of the evidence shows he sustained as the result of the incident complained of. Those elements which you should consider in arriving at the amount of money damages which will constitute fair and adequate compensation for the loss or damage allegedly incurred include *the difference between the purchase price paid for the . . . stock . . . and the price at which such stock was or could have been sold by the plaintiff when he learned of the alleged fraud*

Id.

615. *Id.* at 687 n.15.

616. *Id.* (citing *J.I. Case v. Borak*, 377 U.S. 426, 433-34 (1964)).

case law suggesting that "rescission may be an available remedy in some actions under the federal securities law."⁶¹⁷

If courts awarded rescission under rule 10b-5 in the Eleventh Circuit, however, the measure of the plaintiff's recovery would be limited to the losses proximately caused by the defendant's conduct. Because rescission endeavors to unwind the transaction, the plaintiff generally may recover his purchase price without having to show losses caused by the defendant's fraud.⁶¹⁸ Nonetheless, the Eleventh Circuit has held that even where the plaintiff seeks a rescissory remedy under rule 10b-5, he must demonstrate that the defendant's material misstatements or omissions proximately caused his losses.⁶¹⁹ The proximate cause element, according to the court, prevents rule 10b-5 from becoming a system of investor insurance.⁶²⁰ Under the rescissory measure, therefore, a plaintiff may recover the difference between the transaction price and the postdiscovery value of the stock, provided that the defendant's conduct caused the disparity. Rescission, like the out-of-pocket measure, becomes the portion of the price-value disparity created by the defendant's misstatements or omissions. Rescission is likewise proper only to the extent that it quantifies the materiality of those misstatements or omissions.

L. *The District of Columbia Circuit*

The law regarding damages for rule 10b-5 violations within the District of Columbia Circuit emanates from the National Student Marketing Securities Litigation.⁶²¹ After the SEC established that the former president and counsel of a merged corporation had failed to disclose material information in an unsigned comfort letter before consummating a merger,⁶²² several private actions were pursued that eventually resulted in a structured settlement. In the context of litigation over the administration of the settlement, the district court had occasion to address the proper measure of damages.

The United States District Court for the District of Columbia has suggested that "securities law damage" guidelines require that a plaintiff recover the difference between the price paid and the fair market value of the stock traded.⁶²³ Fair market value represents the price which a willing

617. *Rousseff v. E.F. Hutton Co.*, 843 F.2d 1326, 1328 (11th Cir. 1988).

618. *See, e.g., Randall v. Loftsgaarden*, 478 U.S. 647 (1986); *see also supra* text accompanying notes 77-152.

619. *Rousseff*, 843 F.2d at 1329.

620. *Id.*

621. *See SEC v. National Student Mktg.*, 457 F. Supp. 682 (D.D.C. 1978).

622. *Id.*

623. *See In re National Student Mktg. Litig.*, 598 F. Supp. 575, 582 (D.D.C. 1984).

buyer would pay a willing seller when neither is under any compulsion and both are reasonably informed as to the relevant facts.⁶²⁴ In an active market, that fair market value requires an analysis of market price and factors external to the fraud. Absent an active market, the fair market value of stock must be determined "based on an assessment of all available evidence of value."⁶²⁵ Moreover, it is proper to discount the value of stock to reflect its lack of marketability.⁶²⁶

While suggesting that the out-of-pocket measure is the rule in securities fraud actions, the district court has also recognized rescissory relief,⁶²⁷ although the court has placed limits on its availability. Observing that rescission is an equitable remedy, the court has concluded that it must be asserted "promptly" after discovery of the fraud.⁶²⁸ Hence, a plaintiff must elect rescission a reasonable time after discovery of the fraud.⁶²⁹ What constitutes a reasonable time in seeking rescission depends on the circumstances of each case. The court has declared, however, that "[t]he key inquiry is whether the rescinder acted with due diligence in asserting the equitable remedy."⁶³⁰

While both out-of-pocket damages based on a plaintiff's losses and rescission based on a defendant's gain are available in the District of Columbia Circuit, the courts have placed market valuation limits on the former, and equitable limits on the latter, which restrict recovery to price swings created by defendant's material misstatements or omissions. The goal is to quantify those material misstatements or omissions.

IV. CONCLUSION

The United States Supreme Court and the federal circuit courts agree that the out-of-pocket rule represents the traditional measure of damages under rule 10b-5. The plaintiff-seller under the rule may recover the difference between the price received for the stock and its fair value, measured at the time of the transaction. Defrauded buyers of securities may also pursue this measure of recovery. Courts borrow the out-of-pocket measure from tort law

624. *Id.* at 582.

625. *Id.* A variety of factors should be considered, including the value of comparable companies, the value of intangible assets such as managerial skill, capitalized future earnings and the bid and asking prices for the stock. In assessing the value of these factors, the court should appoint a special master or weigh expert testimony. *Id.*

626. *Id.* at 582-83.

627. *In re National Student Mktg. Litig.*, 445 F. Supp. 157, 163 (D.D.C. 1978).

628. *Id.* Promptness is particularly essential given the speculative nature of securities. *See also supra* notes 407-423 and accompanying text.

629. *In re National Students*, 445 F. Supp. at 163.

630. *Id.* at 164.

which endeavors to make the plaintiff whole by returning to the plaintiff the losses proximately caused by the defendant's fraud.

Calculating the disparity between the price paid for stock and its true, real, or fair value presents difficulties for the courts. A court must first define the consideration paid for stock. It then must ascertain the fair value of the stock as of the date of the transaction. Fair value represents the market price that the stock would have fetched in a fully informed market. Because securities fraud presumes a materially misinformed market, the determination of fair value requires an analysis of the materiality of the information withheld at the time of the transaction. In some cases, the best evidence of the materiality of the information will be the market price of the stock within a reasonable time after the disclosure. In others, the materiality is best gauged by the resale price. Expert testimony and special masters are used to measure that materiality. Courts also employ an appropriate market index so that the damages do not include losses caused by external market forces. The courts seek, by this inquiry, to ascertain the disparity created by a defendant's omission or misstatement between price paid and fair value. Out-of-pocket damages, as used by the lower federal courts, quantify the materiality of that omission or misstatement.

The courts also concur that a defrauded buyer or seller of securities may elect to recover as damages the amount of the defendant's profit directly attributable to his material misstatements or omissions where that amount exceeds the plaintiff's out-of-pocket losses. Such profits, however, must be a proximate consequence of the fraud and not due to any special efforts on the defendant's part. Courts have analogized this measure of recovery to the disgorgement of a defendant's unjust enrichment. Courts have also called this recovery a rescissory measure of damages because it seeks to return both parties to their pretransaction status. The measure is justified by section 29(a) of the Securities and Exchange Act of 1934, which allows the avoidance of contracts entered into in violation of rule 10b-5, and by the analogy between securities fraud and breach of contract. Critics have noted that this measure, which creates excessive damage awards and allows a plaintiff to speculate at a defendant's expense about stock even after the plaintiff becomes aware of the fraud, leaves the plaintiff secure in knowing that he can always recover the purchase price. These criticisms have led the courts to place creative limits on the disgorgement and rescission remedies. The limits, which are borrowed from tort law causation concepts, do not permit a plaintiff to recover a defendant's profits not caused by the fraud. Moreover, courts require a plaintiff to deduct from the rescissory awards any value received as a result of the fraud. These limitations alone have generated criticism because they impose legal concepts on equitable recovery.

Nonetheless, the federal courts generally approve, and may continually move in the direction of encouraging, a profit-based measure of damages under rule 10b-5. Whether considered rescission or disgorgement, this measure attempts to return to a plaintiff that portion of a defendant's profits caused by the defendant's misstatements or omissions. Courts, as well as testifying experts, have used a number of devices to arrive at this figure. A court will award a plaintiff the full purchase price when the defendant has induced the plaintiff to enter the market in the first place; that is, where the omissions or misstatements are so material that they induced an investment rather than a price. The difference between the purchase price and the plaintiff-buyer's resale price, a reasonable time after discovery of the fraud, will be used when the defendant concealed facts so material that a reasonable investor could have deduced from them that the resale price was much lower than the potential fruits of an unrealized speculation. Conversely, the disparity between purchase price and the plaintiff-seller's cost of covering by repurchasing the stock a reasonable time after discovery of the fraud will be used when the misstatements and omissions induced the plaintiff to forfeit the repurchase opportunity. The resale measure and the cover measure both limit rescissory recovery to a measure of the materiality of the challenged misstatements or omissions. Not surprisingly, they have been analogized to the Uniform Commercial Code's damage provisions which foster beneficial postbreach commercial activity by limiting damages to a measure of the precise wrong.

The judicial use of equitable limits on rescissory relief creates the same effect. Although privity is no longer required for rescission, promptness and diligence remain a requirement. Requiring the plaintiff to make a prompt election of rescission mitigates the damages to the price-value disparity. If rescission is prompt, that disparity can be determined at a date close to the transaction date, or better still, at a date that reflects a fully informed market price. Under the labels of the resale measure, the cover measure, or equitable limits on rescission, courts fashion relief that quantifies the materiality of the defendant's omissions or misstatements. Therefore, while courts state generally that the out-of-pocket measure or rescissory measure of damages are viable alternatives, they have applied those measures as a tool to a single end: quantifying materiality. Because reasonable investors do not base investment decisions on speculation, the benefit-of-the-bargain measure has been widely rejected as a proxy for the materiality of the challenged concealments. In the rare case where that measure has been used, the court has made clear that the misrepresentation involved affected a fixed term of the "benefit" of the plaintiff's bargain. Where, in the unusual case, the misstatement is so material that it affects a benefit that a reasonable investor consid-

ered significant, the benefit-of-the-bargain measure may be a useful tool in gauging the materiality of the misstatement.

Erratic in theory but consistent in practice, the lower federal courts have followed the Supreme Court's implicitly suggested yardstick for damages: the materiality of the defendant's nondisclosures or misstatements. The plaintiff may recover damages that quantify the materiality of the challenged conduct in a rule 10b-5 action.

That measure of recovery based on materiality is consistent with the precise goals of section 10(b) and rule 10b-5. Because a rule 10b-5 violation is predicated upon a material misstatement or omission, damages that are also predicated on that misstatement or omission necessarily fit the violation. Furthermore, because the measure of damages can never exceed the amount by which the defendant's conduct caused the plaintiff's harm, the measure will rarely result in a windfall. Because, on the other hand, the measure of damages rests upon the precise misstatement or omission made by the defendant, that measure deters precisely the conduct targeted by section 10(b) and rule 10b-5.

Finally, a measure of damages based upon the quantification of the materiality of the defendant's misstatement or omission affords the district courts both wide discretion and clear guidance in measuring damages. A court's goal in calculating damages is clear: determine the degree, if any, to which the defendant's misstatement or omission created a disparity between the transaction price and the value of the securities at the time of the transaction. The court, however, maintains wide discretion in selecting the best method to achieve that goal.