The Measure of Damages Under Section 10(b) and Rule 10b-5

Ronald B. Lee
THE MEASURE OF DAMAGES UNDER SECTION 10(b) AND RULE 10b-5

I. INTRODUCTION

The proper measure of damages for violations of the antifraud provisions of the federal securities laws has developed with a large degree of uncertainty, resulting in a multiplicity of formulations. Within the federal securities regulatory scheme created by the Securities Act of 1933 and the Securities Exchange Act of 1934, several provisions authorize private civil actions and specify a measure of damages. Certain antifraud provisions, most significantly section 10(b) of the 1934 Act, specify no precise measure of damages and thus form the basis of a judicial search for an appropriate measure of damages to effectuate the antifraud remedies. The courts have focused on section 10(b) and rule 10b-5, and, accordingly, this comment examines the measures of damages under these provisions.

Section 10(b) of the 1934 Act and rule 10b-5, promulgated as the statute's administrative counterpart by the Securities and Exchange Commission (SEC), prohibits the use of "any manipulative


2. 15 U.S.C. §§ 77a-77mm (1982) [hereinafter the 1933 Act].


or deceptive device” in the purchase or sale of securities. Plaintiffs' reliance on the broad language of rule 10b-5 has established the rule as the general authority for private civil litigation under the securities laws. While section 10(b) and rule 10b-5 fail to provide a measure of damages, however, the Supreme Court held in Affiliated Ute Citizens of Utah v. United States that section 28(a) of the 1934 Act provides the “correct measure of damages.”

Section 28(a) provides in pertinent part: “[N]o person permitted to maintain a suit for damages under the provisions of [the Exchange Act] shall recover . . . a total amount in excess of his actual damages on account of the act complained of.” Because section 28(a) fails to define the term “actual damages,” though, this provision has only broadened the search for an appropriate measure of damages under section 10(b) and rule 10b-5.

Attempting to give effect to this provision, courts have promulgated a myriad of methods to determine damages on a case by-case basis. The measures of damages most often noted include an out-of-pocket measure, a benefit-of-the-bargain measure, a “cover” measure, the Chasins measure, and a rescissory and restitutionary measure. An additional consideration arising in connection with the measurement of damages is the recovery of consequential damages. It has been argued, however, that all of these measures fail to ac-

8. 17 C.F.R. § 240.10b-5 (1986). Rule 10b-5 provides:
   It shall be unlawful for any person, directly or indirectly, by the use of any
   means or instrumentality of interstate commerce, or of the mails, or of any
   facility of any national securities exchange,
   (a) to employ any device, scheme or artifice to defraud,
   (b) to make any untrue statement of a material fact or to omit to state a
   material fact necessary in order to make the statements made, in light of the
   circumstances under which they were made, not misleading, or,
   (c) to engage in any act, practice or course of business which operates or
   would operate as a fraud or deceit upon any person in connection with the
   purchase or sale of any security.

   A federal court first found an implied private cause of action under § 10(b) and rule

   1977) (noting the “catchall” nature of § 10(b) and rule 10b-5), cert. denied, 435 U.S. 951
   (1978); D. Dobbs, supra note 4, at § 9.3.


12. 406 U.S. at 155.

13. Id.

14. See, e.g., Garnatz, 559 F.2d at 1361 n.1; Recent Development, supra note 7, at 799.

15. See infra Section II.B.

16. The Chasins measure refers to a remedy formulated in Chasins v. Smith, Barney
complish their objectives in open-market insider-trading cases.\textsuperscript{17} Another challenge to these measures rests on the case-by-case approach used by the courts, resulting in the blurring of rule 10b-5's remedies and a failure by courts to articulate any guiding principles.\textsuperscript{18}

This comment pursues several objectives. First, it outlines in greater detail the measures of damages noted above. Next, it discusses the merits of these various measures in seeking awards for damages under section 10(b) and rule 10b-5. Finally, the comment concludes that in the context of section 10(b) and rule 10b-5 the multiplicity of damages formulas is not necessarily a problem and may even be required by the complex issues raised.

II. MEASURES OF DAMAGES

A. Out-of-Pocket Damages

To give meaning to the term "actual damages" and to follow the Supreme Court's lead in \textit{Affiliated Ute Citizens},\textsuperscript{19} many courts have adopted the out-of-pocket measure as the basic measure of damages in rule 10b-5 actions.\textsuperscript{20}

The Tenth Circuit has defined a plaintiff's recovery under the out-of-pocket rule as "the difference between the contract price, or the price paid, and the real or actual value at the date of sale..."\textsuperscript{21} For example, if a defendant fraudulently induces a plaintiff to buy stock for consideration worth $60 when the fair value of the stock was only $40, then the plaintiff would recover $20 per share. The converse is true when a seller is defrauded. Thus, a seller would recover $20 per share if the stock with a fair value of $60 was sold

\begin{itemize}
  \item \textsuperscript{17} See Note, \textit{The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities}, 26 STAN. L. REV. 371, 385 (1974).
  \item \textsuperscript{18} Thompson, \textit{supra} note 1, at 350-51.
  \item \textsuperscript{19} 406 U.S. 128 (1972).
  \item \textsuperscript{20} See A. Jacobs, \textit{supra} note 1, at 11-30; Mullaney, \textit{supra} note 7, at 281.
  \item \textsuperscript{21} Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527, 533 (10th Cir. 1962). In this case the plaintiff purchased 20,000 shares of Studebaker-Packard common stock through Merrill Lynch. In subsequent litigation over claims of breach of fiduciary duty by Merrill Lynch, the court held that the measure of damages for fraud was the out-of-pocket rule. Unfortunately, the plaintiff failed to show any loss under this measure and the court denied recovery. See also Nelson v. Serwold, 576 F.2d 1332, 1338 (9th Cir.), \textit{cert. denied}, 439 U.S. 970 (1978) (articulating the out-of-pocket measure); Madigan, Inc. v. Goodman, 498 F.2d 233 (7th Cir. 1974) (same).
\end{itemize}
for consideration worth $40.\textsuperscript{22} Hence, the out-of-pocket measure focuses on the plaintiff's actual loss rather than speculating on any potential gain. Consequently, this measure bars the plaintiff's recovery of any disgorgement of the defendant's gain that may exceed the plaintiff's loss.\textsuperscript{23} Several questions arise in the application of the out-of-pocket rule.

1. \textit{Timing of Valuation}.—First, the out-of-pocket rule raises the question of the proper time to determine fair value. One response, set out in \textit{Myzel v. Fields},\textsuperscript{24} has been to determine the fair values of the security and the consideration at the time of the fraudulent transaction. Another court, in \textit{Richardson v. MacArthur},\textsuperscript{25} rejected valuation on the date of the transaction and instead advocated valuation on the date the fraud was discovered or should have been discovered. A third view, adopted in \textit{Harris v. American Investment Co.},\textsuperscript{26} values the security at a post-transaction date, to account for subsequent events such as the market reaction to the fraud.

The willingness of some courts to value the security at some post-transaction time has been termed a "modified or hybrid out-of-pocket measure of damages."\textsuperscript{27} Valuation at this later date avoids speculating as to the value of a fluctuating stock or security at an earlier point in time. By waiting to value a security until the market responds to the fraud, it is believed that a more accurate value may be established. A different problem arises if a court attempts to value stock of a closely held corporation that has no ready market.

One criticism leveled at determining value at some post-trans-

\textsuperscript{22} One commentator has framed the measure in two ways:

\textit{For a defrauded seller}: The fair value of the security sold minus the fair value of the consideration received, all measured at the time of the transaction.

\textit{For a defrauded buyer}: The fair value of the consideration paid for the security minus the fair value of the security bought, all measured at the time of the transaction. A. Jacobs, \textit{supra} note 1, at 11-32.

\textsuperscript{23} By allowing the plaintiff to recover only what he or she has lost on the transaction, the plaintiff cannot recover the illegal profits the defendant might have gained on a subsequent transaction. For example, if the defendant had reaped a profit of $30 and the out-of-pocket measure only awarded $20 to the plaintiff, the defendant is not required to "disgorge" the $10 excess. \textit{See infra} Section D.5.

\textsuperscript{24} 386 F.2d 718, 745 (8th Cir. 1967), \textit{cert. denied}, 390 U.S. 951 (1968).

\textsuperscript{25} 451 F.2d 35, 43 (10th Cir. 1971).

\textsuperscript{26} 523 F.2d 220, 226-27 (8th Cir. 1975), \textit{cert. denied}, 432 U.S. 1054 (1976). In \textit{Harris} the plaintiff failed to show the actual value of his securities at the time of the transaction. On appeal the Eighth Circuit reversed the summary judgment granted the defendant and allowed the plaintiff to show value on the date of the public discovery of the fraud. In the court's view, the market adjustment for the fraud represented the true value of the security.

\textsuperscript{27} \textit{See} Thompson, \textit{supra} note 1, at 361.
action date argues that the later valuation may allow a plaintiff to recover for injury not related to the fraudulent act. 28 The value on the subsequent date may have been depressed by influences other than the fraud, such as a general market decline.

In order to prevent a plaintiff from speculating on the market value of the security and shifting the risk of a subsequent market change to the defendant, valuation should be made on the date of the fraudulent transaction. Valuation on the date of the transaction, however, should not be used if a plaintiff can establish that at the time of the transaction fraud so pervaded the market that this date would not represent an accurate date for valuation. In such cases, the courts should be willing to examine in a limited fashion subsequent market events that may provide a more accurate valuation of the security.

2. Determination of Fair Value.—The out-of-pocket measure also requires a court to select a method for determining fair value. Valuation methods include market value, capitalization of corporate earnings, and book or liquidation. 29

The use of market value to determine a security’s value involves the determination of the price of the security on a specific date when the market is “true.” The term “true” refers to a market that will accurately reflect the price of the security. A similar rationale is embodied in an efficient market theory. Under this theory, the natural operation of the security markets is deemed to produce an accurate price for a security. A market has been found not true when fraud has influenced the market and the trading public does not have the full truth for a sufficient period to allow the market to adjust. 30 An “untrue” market also exists when the people in the market are unwilling buyers and sellers. 31

The fluctuation of a security’s value on any given date creates an additional consideration in the use of market value, since a court must select the precise value to be used on that date. 32 A court may use the average price between the high and low prices of a security on the date of valuation. 33 Other corollary measures have been applied in different contexts. For example, the average of bid and

28. Id. at 362 (citing similar views).
29. Note, supra note 17, at 384.
32. See generally A. Jacobs, supra note 1, at 11-212 to -215.
asked price is used for securities traded on NASDAQ. For securities not traded on NASDAQ but on the over-the-counter markets, such as the "pink sheets," the high bid-low bid average is appropriate. Another measure suggested for a security traded on several markets is to use its value on its major market. In many cases, the relevant market will be New York because of its dominance in the American securities markets. Although the market value technique suggests relative ease in application, a problem arises when attempting to value securities of a closely held corporation that has no real market.

One acceptable method for affixing a value to a closely held corporation's securities focuses on the corporation's earnings. Under this method, a trier of fact must select a figure that reflects the future earnings of the corporation and then use an appropriate interest rate to capitalize or discount the earnings to present value. It has been suggested that future earnings should be used instead of past earnings that may be clouded by the fraud. Other variations of this method look to an earnings trend, relying on expert testimony for the price/earnings ratio of comparable companies. A similar technique uses the price of stock of companies with comparable earnings potential. Unfortunately, a lack of an earnings history by the corporation would substantially undermine the use of earnings to value the security.

A third valuation technique looks to the value of a company's assets. Specifically, this alternative rests on the corporation's net value, i.e., assets minus liabilities. This measure is not wholly determinative, as the "book value" of assets represents the historical cost of the acquisition of the assets, and therefore may not accurately reflect the corporation's value. One commentator indicates that book value would only be appropriate as a valuation method when a corporation is in formation or in liquidation as in bankruptcy. An additional difficulty with the asset valuation method arises if there is an inability to appraise the assets accurately.

34. The term "pink sheets" refers to securities listed in sheets published by the National Quotation Bureau where dealers place their bid and ask quotations. If the securities meet certain standards, they are then listed on NASDAQ. A. Jacobs, supra note 1, at 9-143.
35. Note, supra note 17, at 384.
Having reviewed these several techniques for valuation, the market value method emerges as the most practical solution, at least for publicly traded companies. The information concerning market value is easily obtainable and presents a relatively simple basis on which a factfinder may make a decision. With respect to closely held companies, an earnings valuation technique may offer the most equitable valuation of the corporation's security.

3. Consequences of the Out-of-Pocket Measure.—Several consequences flow from an application of the out-of-pocket measure of damages. Reliance on this measure of damages can directly affect whether the plaintiff can: 1) maintain the action; 2) use this measure in an insider-trading case; and 3) pursue a benefit-of-the-bargain measure of damages. An additional consideration in pursuing any measure of damages is the recovery of consequential damages.

First, if a plaintiff elects to pursue damages as measured by the out-of-pocket measure, the plaintiff must establish that a difference existed between the price paid for the security and its actual worth. Failure to establish this difference results in the dismissal of the plaintiff's suit.39 Consequently, the plaintiff's priority at the trial, aside from establishing liability, should be to establish the value of the security through reference to its market value on the date of the fraudulent transaction.

One difficulty arising from this measure of recovery in rule 10b-5 actions is the difficulty in applying it to open-market insider-trading situations. Because no privity exists between buyers and sellers, it is difficult to determine the values of the consideration paid and the securities received at the specific time of a transaction. Furthermore, due to the large number of buyers and sellers involved in these transactions, the potential exists for crippling damage awards. As a result, courts have modified the traditional measure to fit this unique situation.

An example of a judicially created modification of this measure is found in Elkind v. Liggett & Myers, Inc.40 In 1971 Liggett & Myers (Liggett) experienced a successful year. Market forecasters predicted an equally good year in 1972, and Liggett generally concurred in this assessment.41 In 1972 the Liggett directors received indications that the company would suffer a decline, and they de-

39. See generally A. Jacobs, supra note 1, at 11-36 (citing cases); Mullaney, supra note 7, at 281 (same).
40. 635 F.2d 156 (2d Cir. 1980).
41. Id. at 160.
cided to release this information to the press. Prior to the public statement, two insiders tipped some financial analysts about the announcement. These tips led to the sale of some Liggett stock. Upon discovery of the fraudulent conduct, a class of plaintiffs sued for violation of section 10(b) and rule 10b-5.

The trial court found violations of section 10(b) and rule 10b-5 and consequently held the defendants liable to all purchasers who bought in the period from the first tip to the date of public disclosure, roughly a period of six days. This measure, tied to the lowest value that the Liggett stock reached, resulted in a total recovery of approximately $740,000.42

On appeal the Second Circuit noted that the lower court had determined damages based upon a measure used for face-to-face transactions. The Court of Appeals then found that in this case the element of inducement by fraud was lacking from the transactions.43 Rejecting the lower court's measure and noting the potential for exorbitant damages, the court adopted a measure in accordance with the proposed Federal Securities Code.45 Specifically, the court structured its remedy:

(1) to allow any uninformed investor, where a reasonable investor would either have delayed his purchase or not purchased at all if he had the benefit of tipped information, to recover any post-purchase decline in market value of his shares up to a reasonable time after he learns of the tipped information or after a public disclosure of it but limit his recovery to the amount gained by the tippee as a result of his selling at the earlier date rather than delaying his sale until the parties could trade on an equal informational basis.46

By adopting this measure in the open-market insider-trading context, the Elkind court attempted to deter fraud by depriving insiders

43. Insider trading cases are no longer determined under the standards applied by the Elkind court, but rather are now determined under the standards set out in Dirks v. SEC, 463 U.S. 646 (1983). The test is whether the insider personally will benefit, directly or indirectly, from the disclosure. Absent some personal gain, the courts will find no breach of duty to shareholders, and absent any breach by the insider, there is no derivative breach by the tippee. Id. at 662.
44. 635 F.2d at 168-69.
45. See ALI FED. SEC. CODE §§ 1603, 1703(b), 1711(1) (draft 1978).
46. 635 F.2d at 172. The court hypothesized that if a tippee sold 5,000 shares at $50 per share and the security dropped to $40 within a reasonable time after disclosure, the plaintiffs would then recover losses up to a cap of $50,000 (5,000 shares multiplied by the $10 decline).
of their gain while at the same time preventing crippling damage awards. While it acknowledged some difficulties with this measure, the court nevertheless decided that the disgorgement measure represented the most equitable solution.

The disgorgement measure, however, suffers a theoretical drawback. By merely requiring defendants to disgorge illegally obtained profits, defendants incur no real penalty but rather return to their previous financial position. This result could encourage defendants to continue similar illegal conduct in the future. Consequently, Congress enacted the Insider Trading Sanctions Act, which provides for the award of treble damages.

4. The Benefit-of-the-Bargain Measure.—The benefit-of-the-bargain measure of damages differs from the out-of-pocket measure by focusing on the plaintiff's potential gain had the misrepresentation been true. As noted earlier, the out-of-pocket measure focuses on the plaintiff's actual loss. For example, if a defrauded shareholder in a tender offer sold stock that was represented to be worth $50 and that shareholder subsequently received $40 when the stock's actual value was $45, the benefit-of-the-bargain measure would award plaintiff $10 per share ($50 minus $40). On the other hand, the out-of-pocket measure would have awarded plaintiff $5 per share ($45 minus $40), based upon the actual value of the security.

Generally, the federal courts have rejected the benefit-of-the-bargain measure, due to statutory interpretation, history, and policy considerations. First, it is argued that the "actual damages" language of section 28(a) of the 1934 Act does not encompass the benefit-of-the-bargain measure because this measure arguably awards a plaintiff more than was actually lost. Next, commentators note that the federal courts' preference for the out-of-pocket measure over the benefit-of-the-bargain measure stems from the pre-Erie federal common law of damages. Finally, it has been asserted that the federal courts may object to tying the measure of damages to an

47. Difficulties with this measure include the duplication of the SEC's disgorgement proceeding and the potential for slightly larger recoveries if the market was depressed due to influences other than the fraud. Id. at 172-73.


50. See Thompson, supra note 1, at 359-60.

arbitrary representation of a security's value that is highly speculative.

Many states, however, have adopted the benefit-of-the-bargain measure in tort actions for deceit. This measure thus takes on importance if a plaintiff attempts to sue in federal court alleging both federal and state claims. Moreover, the Second Circuit adopted the benefit-of-the-bargain measure in the limited context of Osofsky v. Zipf. 52

In Osofsky defrauded shareholders of a target corporation in a successful merger sued under the 1934 Act, claiming that they were fraudulently induced to relinquish control of their company because of misrepresentations in the tender offer and the proxy solicitation materials. 53 The trial court granted summary judgment for the defendants on the ground that the plaintiffs suffered no out-of-pocket loss and, therefore, had no "actual damages" under the 1934 Act. 54

On appeal the Second Circuit reversed the lower court's decision and held:

We believe that the benefit-of-the-bargain rule should be applied under the 1934 Act to the limited situation involved in this case, where misrepresentation is made in the tender offer and proxy solicitation materials as to the consideration to be forthcoming upon an intended merger. But, of course, giving the plaintiff benefit-of-the-bargain damages is appropriate only when they can be established with reasonable certainty. 55

In reaching this result, the court first noted that the "purpose of Section 28(a) is to compensate civil plaintiffs for economic loss suffered as a result of wrongs committed in violation of the 1934 Act." 56 Based on this objective, the court refused to construe section 28(a) "to restrict the forms of nonspeculative, compensatory damages available to defrauded parties." 57 Next, the Osofsky court distinguished the cases often cited in support of the pre-Erie rejection of the benefit-of-the-bargain measure 58 by noting that the representations in those cases were highly speculative. 59 In contrast,
the plaintiffs' damages in Osofsky could be determined with certainty as the sellers did not receive the price for which they had bargained.60 Having addressed the three common obstacles mounted against the benefit-of-the-bargain measure, the Osofsky court adopted the benefit-of-the-bargain measure of damages in this special situation.

5. Consequential Damages.—Consequential damages represent costs incurred by the plaintiff that are attributable to the defendant's wrongful conduct.61 These damages play a key role in a plaintiff's recovery as they compensate the plaintiff for various expenses caused by the fraud. A plaintiff may seek consequential damages in conjunction with general, rescissory, and restitutionary damages. Further, consequential damages are available even if the plaintiff fails to prove a loss under a general measure of damages.

Courts have awarded consequential damages in a wide variety of forms. For example, in Madigan, Inc. v. Goodman62 the plaintiffs were allowed to seek consequential damages incurred in attempting to save an insurance company that they had purchased. Case law establishes that consequential damages may also include such items as: dividends on stock that the plaintiff was fraudulently induced to sell;63 dividends on stock the plaintiff would have bought that were instead taken by defendants;64 capital gains tax;65 brokerage fees paid in connection with the fraudulent transaction;66 and the plaintiff's expenses incurred with the purchase on the market of shares the plaintiff was fraudulently induced to sell.67 Although conse-

60. Id. at 114.
62. 498 F.2d 233 (7th Cir. 1974). To recover consequential damages, the plaintiff must show the causal relationship between the expenditures and the fraud with a great amount of certainty. Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795 (2d Cir.), cert. denied, 414 U.S. 908 (1973). Further, a court has included in consequential damages a loss due to a market decline when it was shown that the plaintiff's decision to enter the market was a "natural, proximate, and foreseeable consequence of defendant's fraud." Garnatz v. Stifel, Nicolaus & Co., 559 F.2d 1357, 1361 (8th Cir. 1977), cert. denied, 435 U.S. 95 (1978) (holding that the plaintiff's aversion to risk would have prevented participation in a risky investment program).
63. Glick v. Campagna, 613 F.2d 31, 36 (3d Cir. 1979).
measures encompass many items, courts do deny recovery of some expenses incident to the fraud. For example, a New York court has denied as consequential damages expenses incurred with an SEC enforcement suit, the cost of an audit committee, and the loss of income flowing from improper payments.  

Despite the wide availability of consequential damages, courts generally impose two restrictions on the award of consequential damages. First, a claimant must establish that the expenses were the proximate result of the fraud. Second, a court will deny consequential damages if they duplicate the plaintiff’s recovery from some other measure of damages. Generally, the award of consequential damages in connection with the use of the out-of-pocket measure or restitution will not result in duplication of damages.  

B. The Cover Measure

The “cover” measure of damages allows a defrauded seller to recover the difference between the highest value a security achieves within a reasonable period after the plaintiff discovers or should have discovered the fraud and the value of the consideration at the time of the transaction. For example, if a defrauded seller sold stock worth $60 for $40 and the stock reached a value of $80 within a reasonable time after discovery, the seller could recover $40 ($80 minus $40) per share. The cover measure theorizes that disclosure of the fraud would have allowed the plaintiff to reduce the damages. Thus, disclosure may have permitted the plaintiff to repurchase the stock before it reached its maximum market value. Alternatively, the plaintiff may have waited to sell the stock at a higher price.

1. Mitchell v. Texas Gulf Sulphur.—The leading case addressing this measure of damages is Mitchell v. Texas Gulf Sulphur Co. In Mitchell defendant Texas Gulf Sulphur, which had made a valuable ore discovery, released a press statement denying rumors of the find. Later, the company made a second statement acknowledging the discovery. Unfortunately for Mitchell and others, investors sold

---

69. D. Dobbs, supra note 4, at § 9.3.
70. The term “cover” derives from the measure of damages for conversion. See Mulvaney, supra note 7, at 285. One commentator notes that the conversion analogy is “less than perfect” because with over-the-counter and listed securities, the defendant never gains control of the securities. A. Jacobs, supra note 1, at 11-39.
71. Recent Development, supra note 7, at 805.
72. 446 F.2d 90 (10th Cir.), cert. denied, 404 U.S. 1004 (1971).
their stock in reliance upon the first press release. The Tenth Circuit stated:

We believe the measure of damages used should award the reasonable investor the amount it would have taken him to invest in the TGS market within a reasonable period of time after he became informed of the [corrective] April 16 release . . . and its import to investment, a reasonable time lapse may be allowed to expire to permit the investor to decide whether or not he would reinvest and take advantage of a spiraling market . . . . The award proposed would permit one to 'cover' by reinvestment and suffer neither loss nor forced sale.

The damages then should be based on the highest value of TGS stock between Monday April 20 and a reasonable time thereafter. The court opted for the cover remedy as opposed to rescission for two reasons. First, rescission would have been improper because there were no direct dealings and no privity between the parties. Consequently, there was no contract to be rescinded and the parties could not be returned to the status quo ante. Second, there was no unjust enrichment accruing to the defendants that could be awarded to the plaintiffs. The actual application of the cover measure raises several other issues.

2. Timing of Valuation.—When applying the cover measure, a court must first establish the time for determining the value of both the consideration and the security. In most cases the court will determine the value of the consideration as of the date of the fraudulent sale. As noted in the context of the out-of-pocket measure, valuation on this date prevents unfair plaintiff speculation on a subsequent market change, a concern that runs throughout all the damage measures discussed in connection with rule 10b-5. Proposed dates of valuing the security, however, have varied considerably. The various times suggested include: the date of the violation; a reasonable time after discovery of the fraud; the date of suit; and the date of judgment.74

73. Id. at 105.
In considering these various dates, valuation on the date of the fraudulent transaction presents several advantages. First, valuation on this date minimizes any opportunity for plaintiff speculation. Second, this rule offers relative ease in application, since a factfinder may look to a specific date and compare the price at which the plaintiff sold the stock with the highest market price that the stock reached on this date. Consequently, courts should measure the value of both the security and the consideration on the date of the fraudulent transaction to determine the plaintiff's recovery under the cover measure of damages.

3. Additional Considerations.—Other issues arise in connection with the operation of the cover measure of damages, including: the facts that the plaintiff must discover; the timing of the discovery of the fraud; and the meaning of a reasonable time. These concerns resemble considerations often discussed in a contract action in conjunction with a due diligence requirement or an obligation to mitigate damages. In a contract damages situation a plaintiff must undertake action to either bring suit promptly or prevent an increase in the injuries sustained by the breach. This policy reflects a judicial concern for avoiding the imposition of an award that is not commensurate with the injury caused by the defendant. A similar concern is reflected in the courts' approach to awarding damages under the cover measure. Generally, the timing and the facts necessary to determine when the seller discovered or should have discovered the fraud should correspond with those that would commence the running of the statute of limitations.\(^7\)\(^5\) A reasonable time has been found to range from one day to two months,\(^7\)\(^6\) but the courts can formulate no hard and fast rule as to a reasonable time, since the time needed by different investors to reach a reinvestment decision will vary.

Criticism of the cover measure centers upon the perceived simplistic treatment of the investor population in *Mitchell v. Texas Gulf Sulphur*. Specifically, it has been argued that courts should not use an objective approach, looking to the investment decision of a reasonable investor\(^7\)\(^7\) as is suggested by the language of *Mitchell*.\(^7\)\(^8\) Instead, courts have been urged to use a more subjective approach

\(^7\)\(^5\) A. Jacobs, *supra* note 1, at 11-43.
\(^7\)\(^6\) See Nye, 588 F.2d at 1198 (two months); Baumel, 412 F.2d at 576 (one day); see generally A. Jacobs, *supra* note 1, at 11-43 (citing additional cases).
\(^7\)\(^7\) A. Jacobs, *supra* note 1, at 11-45.
\(^7\)\(^8\) 446 F.2d 90, 105 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971).
tailored to the investors involved. Arguably, by considering each investor subjectively, a court may more accurately affix a value to the security.

Thus, the cover measure can only be invoked by a defrauded seller to recover the difference between the consideration paid and the highest value reached by the security within a reasonable time after the transaction. In addition, the defrauded seller may invoke the measure despite an inability to prove an out-of-pocket loss. The measure may also be invoked if the seller has not “covered” or finds it impossible to cover the loss.

C. The Chasins Measure

The converse of the cover measure is the Chasins measure, which provides a measure of damages for a defrauded buyer. Derived from Chasins v. Smith, Barney & Co., this measure awards a defrauded plaintiff the value of the consideration paid minus the lowest value the security reaches within a reasonable time after the fraud is discovered or should have been discovered. For example, if the plaintiff bought stock at $45 when its value was $40 and then sold the stock at $35 within a reasonable time, the Chasins measure would award the plaintiff $10 per share ($45 minus $35). The Chasins measure also differs from the out-of-pocket measure, which would award the plaintiff $5 per share under these facts ($45 minus $40).

In Chasins Smith, Barney failed to reveal to Chasins that it was “making a market” in securities that it induced Chasins to purchase. Justifying its award, the court stated: “Such a measurement is justified where, as here, the evil is not the price at which

79. See Note, supra note 17, at 379 (dividing investors into two categories: long-term investors and short-term investors); accord A. Jacobs, supra note 1, at 11-45 (enumerating factors: the seller’s sophistication; the type of fraud; the market conditions; the plaintiff’s contacts with a broker; the market reaction time; and the size of plaintiff’s investment).
80. Id.
81. A plaintiff may not be able to cover, for example, when he or she has sold a block of stock so large that it would be impossible or impracticable to reinvest.
83. Various times for valuation of the security have been suggested besides the date of the plaintiff’s discovery of the fraud or the date when the plaintiff should have discovered it. Other times include: the date suit was initiated; during trial; and the end of a reasonable time. See A. Jacobs, supra note 1, at 11-54.
84. “Making a market” has been defined by SEC rule 17-a9(f)(1), 17 C.F.R. § 240.17a-9(f) (1986), as involving “a dealer who, with respect to a particular security, holds himself out as being willing to buy and sell for his own account on a continuous basis otherwise than on a national securities exchange.”
Chasins bought but the fact of being induced to buy and invest for some future growth in these stocks without disclosure of Smith, Barney's interest; the damages granted were proper under the circumstances.85

1. Application of the Chasins Measure.—As with the cover measure, the Chasins measure raises questions concerning the degree and timing of a plaintiff's knowledge of the fraud, and the limits of "a reasonable time."86 With respect to the extent of a plaintiff's discovery of the fraud and its timing, knowledge sufficient to commence the running of the statute of limitations has been a suggested standard.87 As to the definition of a reasonable time, a court will make this determination on a case-by-case basis.

2. Criticisms of the Chasins Measure.—Certain criticisms have been leveled at the Chasins measure of damages. One commentator stresses the "unworkability of exploring the subjective determinations of the plaintiff investor."88 Another view suggests that "Chasins should not be read as establishing a form of investor's insurance for those persons who purchase in reliance on a misstatement or as a result of a material omission."89

Thus, the Chasins measure of damages applies only to a defrauded buyer. A plaintiff may seek damages under this measure: when the plaintiff's injury does not stem directly from the price paid; when there is no evidence of the security's fair value and the out-of-pocket measure is, therefore, inappropriate; or, when a broker-dealer violates rule 10b-5.90

D. Rescission, Restitution, and Windfall Profits91

Instead of awarding some measure of damages at law to a de-
frauded plaintiff, courts may fashion an equitable form of relief by allowing a plaintiff to rescind the transaction and seek specific restitution. If specific restitution is impracticable or impossible, a court may grant the plaintiff rescissory damages. Further, in some instances, courts have used unjust enrichment principles to award the plaintiff the gains that the defendant derived from the fraudulent conduct.

1. Rescission.—In granting a rescissory remedy a court attempts to return the plaintiff and the defendant to the *status quo ante*. The availability of rescission in rule 10b-5 actions derives from several sources. First, section 29(b) of the 1934 Act, which renders any contract in violation of the Act voidable, provides one theoretical basis. Further, if a plaintiff can establish a violation of rule 10b-5, or any violation of the 1934 Act, section 29(b) protects the interests of an innocent party to a fraudulent transaction based on a contract and in violation of the 1934 Act. Specifically, instead of being void, as the statutory language might suggest, the contract is voidable at the election of the injured party, thereby preserving a plaintiff’s right to rescind. As a result, while scant attention has been directed towards this provision, section 29(b) represents a powerful tool for the protection of defrauded investors.

Section 12(2) of the 1933 Act also expressly provides for rescission. This section allows a buyer to sue for rescission when the offeror or seller of the security has included any untrue statement in any prospectus or oral communication made to the buyer through any means or instrument of interstate commerce or the mails. The use of a rescissory remedy, therefore, is well established in securities litigation.

Another basis for the right of rescission derives from the courts’

defendant’s return to the plaintiff, and the plaintiff’s similar return to the defendant, of the property received in the transaction. Recovery of rescissory damages occurs when a defendant is unable to accomplish specific restitution.

94. See generally A. Jacobs, supra note 1, at 11-64 (arguing that the “actual damages” language of § 28(a) includes rescission and restitution).
96. Id. at 8.
97. See id. at 3-4.
ability to fashion appropriate equitable remedies. Some uncertainty exists, however, as to whether a plaintiff can obtain rescission when an adequate remedy exists under a measure of damages at law. Moreover, a rescissory remedy permits a plaintiff to shift the risk of a declining market to the defendant and thereby reap a benefit beyond the extent of the fraud. This has encouraged courts to impose several constraints upon this remedy.

The most basic requirement imposed on a plaintiff seeking rescission is that there must be a contractual relationship with a defendant. The privity requirement, therefore, renders rescission unavailable in cases involving insider trading on the exchanges or in the over-the-counter markets.

To discourage plaintiffs from shifting the risk of a market decline to the defendant, courts require a plaintiff to file suit for rescission promptly after notice of the fraud. Baumel v. Rosen offers a classic example. In Baumel the plaintiffs sold their shares in a closely held company to several insiders. These plaintiffs subsequently witnessed the public sale of their former company for a significant profit to the defendants. The plaintiffs, however, waited three years to bring their suit for rescission. On appeal the Fourth Circuit denied the claim for rescission because of the protracted delay between the discovery of the fraud and the suit. Baumel, therefore, illustrates the two major constraints placed on the remedy of rescission: the existence of a contract and a prompt suit. Again, these considerations are analogous to the requirements of due diligence

99. One court has noted: "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 . . . ." Huddleston v. Herman & MacLean, 640 F.2d 534, 554 (5th Cir. 1981) (quoting R. Jennings & H. Marsh, Securities Regulation: Cases and Materials 1085 (4th ed. 1977)), modified on other grounds, 459 U.S. 375 (1983). Additional support is drawn from the Supreme Court's approval of rescission and restitution in Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 155 (1972) (citing with approval cases supporting this remedy).


101. The plaintiff reaps a benefit by waiting to see whether the market will rise or fall before selecting a remedy. If the market falls, the plaintiff will rescind and return a depreciated security and receive in return the plaintiff's undepreciated consideration that the buyer used to purchase the security. See Thompson, supra note 1, at 369.

102. A contract is not necessarily required in the § 12(2) context in which the basic requirement is the use of an untrue statement in a prospectus or oral communication.

103. Huddleston, 640 F.2d at 554: "Use of the rescissional measure is usually limited to cases involving either privity between plaintiff and defendant or some specific fiduciary duty owed by brokers to their customers."


105. Id. at 574-75.
and mitigation of damages. In many cases, rescission fails to provide adequate relief and it becomes necessary to consider restitution as well.

2. *Restitution.*—Restitution differs from monetary damages and rescission in a number of ways. First, the measure of restitution is the amount by which the defendant was unjustly enriched.\(^{106}\) Thus, restitution and damages rest on two different premises. While restitution focuses on the defendant’s gain, damages focus on compensating the plaintiff for any loss. In addition, restitution differs from rescission by not imposing a privity requirement.

These distinctions may suggest that restitution does not constitute “actual damages” as required by section 28(a) of the 1934 Act;\(^{107}\) this argument fails, however, in light of the Supreme Court’s approval of a restitutionary recovery in *Affiliated Ute Citizens of Utah v. United States.*\(^{108}\) Specifically, the Court cited with approval *Janigan v. Taylor*,\(^{109}\) which required a defendant to return all the profits he had gained on a subsequent resale of the stock. The Supreme Court’s apparent approval of this measure indicated that such a large recovery not normally associated with the term “actual damages” was an appropriate measure under rule 10b-5.

Several consequences flow from an election of specific restitution.\(^{110}\) First, the security’s value does not need to be determined, because specific restitution results in an exchange of the security for the purchase price. Plaintiffs will only pursue specific restitution when the value of what they gave up in the transaction exceeds the value of what they received. Further, specific restitution may be had even if the defendant no longer possesses the shares obtained from the plaintiff. The defendant effectuates specific restitution in this situation by tendering equivalent shares or purchasing shares to return to the plaintiff. Specific restitution represents only one form of restitution. When the defendant cannot effect specific restitution, the plaintiff may seek rescissory damages.

3. *Rescissory Damages.*—To accomplish the same goal as specific restitution, rescissory damages equal the value that the plaintiff gave

\(^{106}\) Nelson v. Serwold, 576 F.2d 1332, 1338 (9th Cir.) (“the recent trend looks to defendant’s profits rather than to plaintiff’s losses in measuring damages”), *cert. denied*, 439 U.S. 970 (1978).


\(^{109}\) 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

\(^{110}\) See generally A. Jacobs, supra note 1, at 11-75 (discussing specific restitution).
up minus the value received in the transaction.\textsuperscript{111} Due to the potential for plaintiff speculation, the plaintiff must assert the claim promptly. In addition, a court may mitigate any substantial harshness to the defendant resulting from this remedy by reducing the plaintiff's recovery to reflect the amount by which defendant's efforts increased the value of the security.\textsuperscript{112} A somewhat different issue has arisen in deciding whether a defendant can offset the amount to be tendered to the plaintiff in a rescission action by the tax benefits the plaintiff receives from the investment.

4. Randall v. Loftsgaarden.—In its only securities decision in 1986, the Supreme Court answered the foregoing question. In Randall v. Loftsgaarden\textsuperscript{113} plaintiffs purchased limited partnership interests in a motel project marketed as a "tax shelter."\textsuperscript{114} When the venture experienced financial difficulty, the plaintiffs brought suit under section 12(2) of the 1933 Act\textsuperscript{115} for prospectus fraud and section 10(b) of the 1934 Act for material misrepresentations made by Loftsgaarden concerning the project's financing, leasing arrangements, and compensation structure.\textsuperscript{116} The Eighth Circuit had sustained Loftsgaarden's liability under section 12(2) and section 10(b), and had ordered the award of rescissory damages reduced by the tax benefits received by the plaintiffs.\textsuperscript{117} Due to a conflict in the circuits over the issue,\textsuperscript{118} the Supreme Court granted certiorari.

In resolving this question, the Court first held that the language of section 12(2), requiring an offset for "income received," could not include tax benefits. The Court reasoned that the statute's plain meaning did not include tax benefits within the term "income."\textsuperscript{119} Further, the Court noted that the legislative history of section 12(2) failed to establish any congressional intent to treat tax benefits as


\textsuperscript{112} See Thompson, supra note 1, at 372 (noting the difficulty in procuring this protection for a defendant).

\textsuperscript{113} 106 S. Ct. 3143 (1986), aff'g Austin v. Loftsgaarden, 675 F.2d 168 (8th Cir. 1982).

\textsuperscript{114} The attraction of this investment was the ability of each individual limited partner to claim deductible partnership losses greatly in excess of the funds invested. These losses would then be used to offset other income.


\textsuperscript{116} 106 S. Ct. at 3147.

\textsuperscript{117} Austin, 675 F.2d at 181.

\textsuperscript{118} See Burgess v. Premier Corp., 727 F.2d 826, 838 (9th Cir. 1984) (refusing to reduce damages by tax benefits received).

\textsuperscript{119} 106 S. Ct. at 3150.
"income received." In the context of rescission, Justice O'Connor, writing for the majority, construed the term "consideration" to include only the money or property given by the investor.\textsuperscript{120}

Next, Justice O'Connor considered whether section 28(a) affected the Court's conclusion that rescissory damages should not be offset by tax benefits.\textsuperscript{121} First, the Court refused to limit section 12(2)’s rescissory remedy by a restrictive reading of section 28(a)’s "actual damages" requirement. With respect to plaintiffs' section 10(b) claim, the Court again rejected a restrictive reading of section 28(a) that would limit the plaintiffs' recovery to their net economic harm. The Court reasoned that any beneficial position in which the plaintiffs find themselves derives more from operation of the Internal Revenue Code than from an unduly generous award of rescissory damages. Consistent with these principles, the Court noted that plaintiffs in the future would not be able to speculate by delaying their suit and continuing to reap their tax benefits.\textsuperscript{122}

In a brief partial concurrence, Justice Blackmun agreed with the Court's conclusion as to section 12(2) but asserted that tax benefits should be taken into account in rule 10b-5 actions for out-of-pocket damages.\textsuperscript{123} Justice Blackmun argued that tax benefits represent part of the value that the plaintiffs bargained for in such a tax shelter limited partnership. Consequently, if a rule 10b-5 violation occurred with respect to these tax benefits, then the value of the tax benefits should affect the determination of damages under an out-of-pocket measure.\textsuperscript{124}

Finally, Justice Brennan in dissent argued that tax benefits should be taken into account in section 12(2) rescissory awards.\textsuperscript{125} Justice Brennan based his argument on common law and equitable principles relating to rescission, and concluded that the bargained-for tax benefits are part of what the investors receive for their consideration. For this reason, an amount representing these benefits should offset what the defendant must return to the plaintiff in rescission. Using a broad construction of the term "income," Justice Brennan concluded that the plaintiffs' award should be offset by the tax benefits received in both section 12(2) and section 10(b)

\textsuperscript{120} Id. at 3151.
\textsuperscript{121} Id. at 3152.
\textsuperscript{122} Id. at 3155 (citing Baumel v. Rosen, 412 F.2d 571, 574-75 (4th Cir. 1969)).
\textsuperscript{123} Id. at 3155-57 (Blackmun, J., concurring).
\textsuperscript{124} Id. at 3156.
\textsuperscript{125} Id. at 3157 (Brennan, J., dissenting).
actions.\textsuperscript{126}

Justice Brennan's dissent raises several interesting points. First, the Court's strong reliance on an Internal Revenue Code definition of income does not commend itself as strongly as the Court suggests. There are many definitions of income, some narrower than others. Further, the Internal Revenue Service does not consider its basic definition of income, found in section 61 of the Internal Revenue Code, to be exhaustive. Justice Brennan's broader definition of income, therefore, may be more relevant, since real estate limited partnerships and their attendant tax benefits have achieved a degree of prominence that did not exist when the securities laws were enacted. Justice Brennan's reliance on common law and equitable principles of rescission in the absence of any express statutory command suggests a sound basis for the conclusion that tax benefits should offset rescissory awards under rule 10b-5. To return the parties truly to the \textit{status quo ante}, each party must return the bargained-for consideration, which includes the tax benefits accompanying a limited partnership real estate investment. While such a course might create administrative difficulties in calculating each investor's tax benefits, this course more accurately reflects the principles of rescission. Finally, allowing recovery of these tax benefits would accomplish "true" compensation and greater deterrence, two goals of the securities laws.

5. \textit{Windfall Profits}.—The final form of relief, closely related to rescission and restitution, is windfall profits. Under the windfall profits measure of recovery, a defrauded seller recovers the profits made by a defendant on a resale of the securities fraudulently obtained from the plaintiff. Resting on an unjust enrichment theory, the seminal case in this area is \textit{Janigan v. Taylor}.\textsuperscript{127}

In \textit{Janigan} the plaintiffs sold their stock to their corporation's president for roughly $40,000. Later, the president sold the stock for $700,000. In fashioning an award, the court upheld the plaintiffs' recovery of the defendant's net profit on the resale.\textsuperscript{128} The court noted that "[i]t is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them."\textsuperscript{129} By awarding the plaintiffs the defendant's gains, the court achieved two goals of the securities laws, compensation and

\textsuperscript{126} Id. at 3158-59.
\textsuperscript{127} 344 F.2d 781 (1st Cir.), \textit{cert. denied}, 382 U.S. 879 (1965).
\textsuperscript{128} Id. at 786.
\textsuperscript{129} Id.
deterrence.\textsuperscript{130} Furthermore, the \textit{Janigan} court noted that the defendant would not have to return any profits that were directly attributable to his own personal efforts.\textsuperscript{131}

Another case illustrates the difficulty encountered by a defendant seeking to establish that personal efforts increased the profits. In \textit{Rochez Brothers v. Rhoades}\textsuperscript{132} Rhoades purchased Rochez stock and later sold the company for a large gain. Although the court noted Rochez' business timidity and his depreciating effect on the company, the Third Circuit still denied the entrepreneurial Rhoades any reduction under the \textit{Janigan} exception.\textsuperscript{133}

The windfall profits measure as expressed in \textit{Janigan} received additional modification in \textit{SEC v. MacDonald}.\textsuperscript{134} In \textit{MacDonald} the defendant, chairman of a faltering investment trust, bought stock in the trust because he knew the trust was about to enter into a favorable lease.\textsuperscript{135} Suit was brought under rule 10b-5, and the trial court required the defendant to disgorge the profits that he realized on the resale of the stock.\textsuperscript{136} The First Circuit reversed the lower court's measure of restitution. The appellate court held that the defendant must disgorge an amount representing the increased value of the shares at a reasonable time after public dissemination of the information.\textsuperscript{137} In addition, the court found that no conduct by the defendant led to an increase in the value of the shares; consequently, the defendant failed to qualify for the \textit{Janigan} exception.\textsuperscript{138}

The focus by the \textit{MacDonald} court on the causal link between the plaintiff's injuries and the defendant's misrepresentation effectively limits the total disgorgement measure established in \textit{Janigan}. The \textit{MacDonald} limitation reflects a recurring concern of courts in this area. In formulating damages, the courts have attempted to prevent plaintiffs from speculating on the market by waiting to sue and allowing damages possibly to increase. The \textit{MacDonald} decision "caps" the disgorgement measure of recovery by allowing a plaintiff to recover only the appreciation in the value of the stock up to a

\begin{itemize}
  \item \textsuperscript{130} See Nelson v. Serwold, 576 F.2d 1332, 1339 (9th Cir.), cert. denied, 439 U.S. 970 (1978) (allowing defendant to profit would undermine the deterrent effect of the 1934 Act).
  \item \textsuperscript{131} 344 F.2d at 787.
  \item \textsuperscript{132} 491 F.2d 402 (3d Cir. 1973).
  \item \textsuperscript{133} \textit{Id}.
  \item \textsuperscript{134} 699 F.2d 47 (1st Cir. 1983).
  \item \textsuperscript{135} \textit{Id}. at 48.
  \item \textsuperscript{136} \textit{Id}.
  \item \textsuperscript{137} \textit{Id}. at 52.
  \item \textsuperscript{138} \textit{Id}.
\end{itemize}
fixed point in time. The MacDonald measure, as a result, avoids imposing exorbitant damage awards by shifting the risk of a market change to the defendant for only a reasonable period. The risk of any subsequent change in the market then shifts back to the plaintiff.

III. Analysis

Having outlined the operation of these measures, the merits of their application to several situations will now be considered through the use of two hypotheticals. The first hypothetical applies those measures of damages generally available to a defrauded buyer: an out-of-pocket measure; a benefit-of-the-bargain measure; the Chasins measure; a rescissory measure; a specific restitution measure; and a windfall profits measure. The second hypothetical considers those measures of damages generally available to a defrauded seller: an out-of-pocket measure; a benefit-of-the-bargain measure; a cover measure; a rescissional measure; a specific restitution measure; and a windfall profits measure. In any given case all of these measures may not be available. Further, as consequential damages involve relatively separate concerns, they are not included in these examples.

1. Recovery By A Defrauded Buyer.—With respect to a defrauded buyer, consider the following facts: The defendant misrepresented to the buyer that Corporation X's stock was worth $200 per share. This led the buyer to purchase X stock for consideration worth $150 when in reality the stock was worth only $100 per share on the date of the fraudulent transaction. Within a reasonable time thereafter the X stock declined in value to $50 per share.

Under the out-of-pocket measure, the defrauded buyer would recover $50 ($150 minus $100) per share. This figure represents the consideration paid minus the actual value of the security on the date of the transaction. The date of the transaction should act as the reference point unless the market is so pervaded by fraud that the value on this date is inaccurate. In addition, these figures represent the market value of the shares. If the plaintiff purchased stock of a closely held corporation, a different valuation technique should be used.

With the benefit-of-the-bargain measure, the plaintiff would recover $100 ($200 minus $100) per share. This measure focuses not on what the buyer actually paid but on what the buyer would have received had the stock been worth its represented value. Generally, federal courts have rejected this measure except in special situations
such as tender offers, in which this measure overcomes the judicial hurdles outlined previously.

Looking to the Chasins measure, the buyer would recover $100 ($150 minus $50) per share, reflecting the difference between the consideration paid and the lowest value that the stock reached within a reasonable time. Use of this measure under these facts thus results in a greater recovery than under the out-of-pocket measure. While this may not always be the case,\(^\text{139}\) this situation reveals that the Chasins measure may hold some advantages for the plaintiff in certain situations. Resort to the Chasins measure would prove advantageous when this measure in fact exceeds the out-of-pocket measure; when the fair value of the stock cannot be determined, thereby precluding use of the out-of-pocket measure; and when the fraud, while not going directly to the price nevertheless led to a decline in the stock value, and the buyer could not establish out-of-pocket damages on the date of the transaction.

Under a rescissory measure, an additional fact should be added. For the purpose of this example, assume that the buyer resold the X stock for $75 and therefore could not tender the shares and accomplish specific restitution. This measure awards the buyer $75 ($150 minus $75) per share, as the defendant returns the $150 and the buyer returns the amount reaped from the stock. Because of the potential for a buyer to speculate by waiting until the value of the X stock declined further, courts resort to principles related to due diligence and mitigation of damages and require a plaintiff to sue promptly.

In a suit for specific restitution, a buyer still owning the X shares would tender the shares and the defendant would return the $150 consideration. Recovery under this rule requires the prior existence of a contract between the parties. This remedy, therefore, may not be available in every situation. Further, the buyer would only want to pursue this measure if the value of what was given up in the transaction exceeded the value of what was received.

Finally, a recovery of windfall profits does not arise under these facts as the defendant derives no excess profit from the transaction. These facts reflect a limitation in the application of this measure. When the defendant reaps no profits from the transaction, the buyer must resort to some other measure. In addition, if the defendant

\(^{139}\) Out-of-pocket damages would exceed the Chasins measure if the lowest value of the stock within a reasonable time after the transaction does not descend below the actual value of the stock on the date of the fraudulent transaction.
realized profits, the buyer’s recovery would be limited by the cap established in *MacDonald*.

2. *Recovery by a Defrauded Seller.*—To consider the measures of damages available to a defrauded seller, assume the following facts: The defendant’s misrepresentations lead the seller to sell the stock in X Corporation for $100 when the actual value was $150. The defendant’s false statement referred to the value of X stock at $75 per share. Within a reasonable time after the transaction, the X stock reached a value of $175. The defendant later realized a profit of $100 per share when the stock was sold for $200 per share.

Under these facts, the defrauded seller would recover $50 ($150 minus $100) per share with the out-of-pocket measure. This measure awards the plaintiff the difference between the amount realized on the sale of the X stock and the value of the stock on the date of the transaction.

The benefit-of-the-bargain measure would award plaintiff $75 ($150 minus $75) per share in an attempt to give the plaintiff what the plaintiff might have received had the sale not been fraudulent. The availability of this measure is somewhat limited, however, for in tender offers the plaintiff might not be able to recover this generous measure of damages.

The defrauded seller would recover $75 ($175 minus $100) per share under the cover measure. The cover measure focuses on the value that the stock reached in a reasonable time after the transaction and in effect awards the plaintiff the amount it would have taken to reenter the market and repurchase X stock. The cover measure is available only to a defrauded seller. A defrauded buyer, therefore, must resort to the *Chasins* measure to match the limits of this measure of damages.

If the defendant had disposed of the stock, a rescissory measure of damages would be available to the defrauded seller. Assume that at the time the defendant must tender the value of the disposed shares their value is $210 per share. In accord with this remedy, the plaintiff recovers $110 ($210 minus $100) per share as each party tenders the value received from the transaction. Of course, the plaintiff will only desire to pursue this measure when the value of the stock appreciates above the value the plaintiff received for the stock.

Under a specific restitution recovery, the plaintiff will tender the $100 consideration and the defendant will tender the X shares. One obvious benefit to this measure is that there are no real valua-
tion problems since each party returns that which was received. The plaintiff may not wish to seek this remedy when the stock's value has declined. Further, if the defendant has sold the shares, specific restitution may not be available and the plaintiff must look to some other damage formulation.

Finally, under a windfall profits measure of damages, the plaintiff would recover $100 ($200 minus $100) per share, to reflect the profits that the defendant realized on the subsequent sale. If this transaction occurred in a public market, the MacDonald limitation would allow the plaintiff to recover the defendant's profits only up to an amount representing the increased value of the shares at a reasonable time after the public discovers the fraud. Consequently, if the X stock did not appreciate greatly in value within a reasonable time after the transaction, the plaintiff may want to pursue recovery under a measure of damages that would yield a larger recovery.

IV. Conclusion

The objective of this comment has been to illustrate some of the difficulties and complexities that courts encounter in formulating damage awards under rule 10b-5. As is probably inherent in dealing with the issues raised in this area, a great deal of confusion exists. Courts will continue to struggle with these concepts, and they must strive to make clear the bases of their decisions in order to guide practitioners. No uniform measure exists, nor should courts attempt to create one. Instead, courts must continue to balance the desire to compensate the plaintiff against the risk of imposing severe hardship on the defendant. In using the measures discussed, courts ultimately must apply them to promote fairness.

RONALD B. LEE

140. The MacDonald limitation concerns a public market situation and not a private transaction.