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The Measure of Damages Under the Proposed Code

ARNOLD JACOBS*

I. Introduction

In securities litigation, the measure of damages is, at least to me, equally as important as the question of liability. A defendant need not be concerned about liability in a civil case if he can win on the damage issue or can reduce the damages to a very low number. On the other hand, his position is very different if he is liable for a large amount of damages.

The pre-Code law[1] has only recently begun to develop in the area of damages.[2] While the 1934 Act[3] has been the law for 46 years, only in the last decade have courts given us some guidance on measures of damages.[4] Ironically, that guidance has not been helpful: recent litigation has produced a multitude of possible, and confusing, measures. In the present law we have—count them—more than 30 measures of damages which have been identified in rule 10b-5 cases alone.[5]

The measure of damages under the Code[6] is equally confus-

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1. Securities Act of 1933, §§ 1-26, 15 U.S.C. §§ 77a-77aa (1976); Securities Exchange Act of 1934, §§ 1-35, 15 U.S.C. §§ 78a-78kk (1976 & Supp. III 1979).

2. *See, e.g.*, J. I. Case Co. v. Borak, 377 U.S. 426 (1964), in which the Court, in implying a private cause of action for damages, stated that, "[t]he possibility of civil damages, or injunctive relief serves as a most effective weapon in the enforcement of the proxy requirements." *Id.* at 432.

3. Securities Exchange Act of 1934, §§ 1-35, 15 U.S.C. §§ 78a-78kk (1976 & Supp. III 1979).

4. *See, e.g.*, Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972), where the Court found the correct measure of damages in a rule 10b-5 action to be the difference between the fair market value of all that the seller received and the fair value of what he would have received had there been no fraud. *See also* cases collected in 5B A. JACOBS, THE IMPACT OF RULE 10B-5, § 260.03[c][ii] n. 6 (1980).

5. 5B A. JACOBS, *supra* note 4, § 260.03[c].

6. ALI FED. SEC. CODE (1978) (Proposed Official Draft). References in this speech

ing. The Code is not easy to follow. Listen to section 1708(b): "The measure of damages under section 1703(b) is computed as in section 1708(a), except that (1) sections 1703(h)(1)(B), 1708(a)(1)(A), and 1708(a)(2)(A) do not apply. . . ."[7] Or pick one of the shortest of the sections, section 1708(d): "The measure of damages under sections 1705 and 1707 is computed as in section 1708(c), read without references to offering statements or amendments and as if section 1708(c)(2) referred to section 1705 rather than section 1704."[8] The Code goes on and on.

I am sure that all of you would like me to trace carefully through each of the 30 measures of damages under the present law and compare them to provisions like those I've just read in the Code. Instead, I thought it might be better to take a specific case, an hypothetical case, in which many different measures of damages permissible under the present law are discussed and then to compare these measures to the Code approach. This example will show what I think is generally true: the measures of damages in the law today are more favorable to plaintiffs than the measures of damages the Code prescribes.

II. A Case Study

This is an hypothetical case involving a merger of two companies. The merger had taken place, and the price of the stock issued was $72 a share. This is designated as point A on the graph. A proxy statement had been disseminated in connection with the merger. The plaintiffs contended that the proxy statement should have disclosed that the chief executive officer of the

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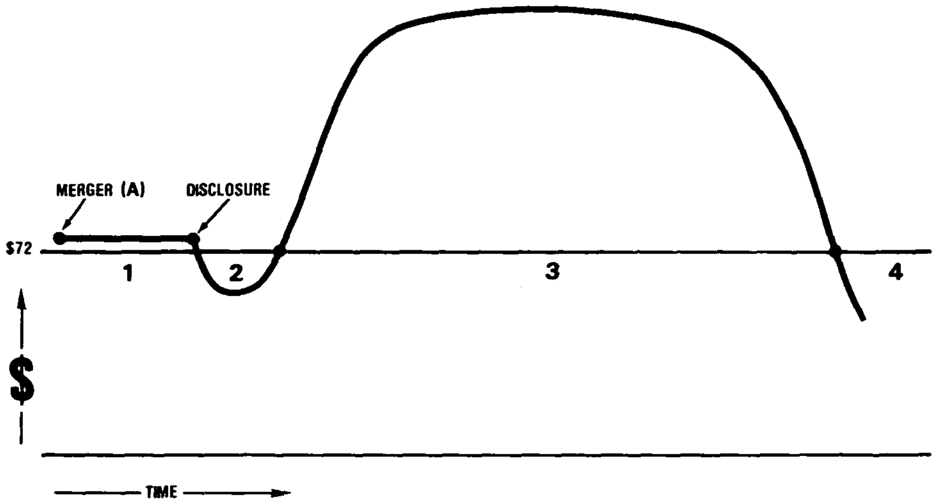
are to the 1978 proposed draft. Comparison will be made with the ALI FED. SEC. CODE (1980) (Official Draft) where the changes in the 1980 draft are significant. On Sept. 30, 1980, the Securities and Exchange Commission published, in an agency release, changes to the 1980 draft which were agreed upon by Professor Loss and the Commission. SEC Sec. Act Release No. 33-6242, 20 SEC Docket 1483 (1980) [hereinafter referred to and cited as CODE RECOMMENDATION].

7. ALI FED. SEC. CODE § 1708(b) (1978). Section 1708 has undergone substantial changes in the CODE RECOMMENDATION. CODE RECOMMENDATION, *supra* note 6, at 1499. *See* Casper, *Foreword*, 1 Pace L. Rev. 279, 286-87 (1981).

8. ALI FED. SEC. CODE § 1708(d) (1978). Section 1708(d) of the 1980 draft provides:

> (d) FOR SECTIONS 1705 AND 1707.—The measure of damages under sections 1705 and 1707 is computed as in sections 1708(a) (except as provided in section 1708(b)(1) and (2)) and section 1708(c)(2) (read as if that section referred to section 1705 rather than section 1704).



acquiring company had obtained a fair amount of business by bribing city officials in two jurisdictions. The price of the stock of the acquiring company that was issued remained relatively constant at about $72 a share through the period referred to on the graph as the Class 1 plateau. The bribes were then disclosed, and the price of the stock dipped to $60. That is the valley referred to on the graph as Class 2. After about eight weeks, the price of the stock reached $72 again and continued to climb further to $170. That is the mountain that the graph refers to as Class 3. Finally, after a two and one-half year period, the price declined below $72, Class 4 on the graph.

In short, there existed the plateau of Class 1, where people who bought the stock at the time of the merger sold it at the same price before disclosure of the adverse information; the valley of Class 2, where people sold after the disclosure of the bribe at less than $72; the mountain of Class 3, where people sold the stock at a price well above the $72 price paid at the time of merger; and the final decline of Class 4, where people either sold below $72 or still own the stock. I will use this hypothesized fact pattern to discuss liabilities under the present law and to compare them to liabilities under the Code.

III. Liability under Rule 10b-5, Section 11 and The Proposed Code

A. *Liability under Rule 10b-5*

In our hypothetical litigation, the defendants, relying on present law, argued that while there conceivably could be liability with respect to Class 2 plaintiffs, there was no liability for plaintiffs in Classes 1, 3 or 4. With respect to Class 1, defendants argued that those who bought the stock of the acquired corporation in merger at $72 and who sold at the same price in Class 1 had no claim for damages. The defendant based his argument on two principles. First, these plaintiffs incurred no loss: they bought at $72, and they sold at $72. Second, there was no causal nexus between any loss they might have sustained and the misrepresentation because the market had not yet adjusted for the misrepresentation.

The defendants lost both arguments. The court, let us imagine, held that it is possible for a Class 1 plaintiff to suffer damage in this situation where he buys and sells at the same price. The rationale of the court could have been that under present law there may be liability in either of two ways. First, there is the out-of-pocket measure under rule 10b-5.[9] The out-of-pocket measure awards defrauded purchasers the difference between what they paid for the security and its fair value on the date of the fraud. Here, the plaintiffs paid $72, but the market price would have been lower if the public had known that a percentage of the issuers' business was obtained by bribery. Second, the court could have relied on *Chasins v. Smith Barney & Co.*[10] to

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9. For a discussion of the out-of-pocket measure, *see* 5B A. JACOBS, *supra* note 4, § 260.03[c][ii] (1980).

> The out-of-pocket measure of damages can . . . be put this way:
> *For a defrauded seller:* The fair value of the security he sold minus the fair value of the consideration he received, all measured at the time of the transaction.
> *For a defrauded buyer:* The fair value of the consideration he paid for the security minus the fair value of the security he bought, all measured at the time of the transaction.

10. Chasins v. Smith, Barney & Co., 306 F. Supp. 177 (S.D.N.Y. 1969), *aff'd*, 438 F.2d 1167 (2d Cir. 1970). Only defrauded buyers can use the *Chasins* or resale measure of damages. This measure is so named because of the important role played by the price at which a plaintiff sells or could sell the security he was fraudulently induced to buy. 5B A. JACOBS, *supra* note 4, § 260.03[c][iv].

find a second possible measure of damages available to the plaintiff — the price he paid for the security, $72, minus the lowest price the stock reached within a reasonable time after disclosure of the bribery, $60. Under that formula, damages would be $12.

With respect to Class 3 there was also a motion for summary judgment on damages; the defendants urged that no damages could be found because the plaintiffs suffered no loss. For example, a Class 3 plaintiff who paid $72 for the stock in the merger and who then sold at $102, suffered no damages at all. He actually profited $30 on his transactions. Nevertheless, summary judgment for the defendants was denied. The court could have based its opinion on the fact that persons who sold in Class 3 should have bought at $60 rather than $72. Those shareholders would then have made an additional profit of $12.

As to Class 4, the defendants argued that they had no liability for damages for two reasons. First, there could not possibly be any causal relationship between the disclosure of the bribery and the downturn in the market three years later.[11] Second, the plaintiffs had a duty to mitigate damages during the two and one-half years that the price exceeded the $72 issuance price.[12] Again, the court denied the motion for summary judgment, notwithstanding case law which conceivably imposes a duty to mitigate.[13]

These were the holdings, reached by our hypothetical court, under rule 10b-5 of the present law. The court did not reach the question of liability under another provision, section 11 of the 1933 Act, which provides a civil remedy for false or misleading

11. For an identification of three standards of causation used in determining whether remoteness limits recovery under rule 10b-5, *see* 5B A. Jacobs, *supra* note 4, § 260.03[f][ii] and cases cited therein. The most liberal standard requires only that the fraudulent act be in the chain of causation, while another requires causation-in-fact; the most stringent standard requires direct injury, proximate cause or foreseeability. *Id.*

12. *See generally* 5B A. Jacobs, *supra* note 4, § 260.03[f][iv].

13. *See* Hecht v. Harris, Upham & Co., 283 F. Supp. 417 (N.D. Cal. 1968), *aff'd on other grounds*, 430 F.2d 1202 (9th Cir. 1970). The *Hecht* court stated, "The purpose of [the securities laws] is to protect the innocent investor, as distinguished from one who loses his innocence and waits to see how his investment turns out . . . ." *Id.* at 428. *But see* Harris v. American Inv. Co., 523 F.2d 220 (8th Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976). The *Harris* court held that a plaintiff is not obligated to sell stock after discovery of fraud for the purpose of reducing damages. *Id.* at 227.

statements contained in a registration statement.[14] Because a merger is now considered a sale by the Securities and Exchange Commission,[15] issuers must file a registration statement with the Commission with respect to the securities to be issued in the merger. A defendant's exposure is thereby increased because he is now subject to both section 11 liability and rule 10b-5 liability. In short, there are two overlapping remedies and the defendant will be responsible for the greater amount.[16]

The remedy under rule 10b-5 is implied.[17] It is, therefore, not surprising to learn that no measure of damages is set forth

14. Securities Act of 1933, § 11, 15 U.S.C. § 77k (1976).

15. This change has been described by two commentators in the following manner:

> The traditional combination of two independent businesses was until 1973 exempt from the registration requirements of the 1933 Act by SA Rule 133, which proceeded on the theory that the mechanics of a shareholder vote, of corporate transfers of assets, and of receipt of securities involve "no sale" of a security. The theory ignored the reality of change, often radical change, in the investment position of the security holder who received another security. And it ignored the possibility for fraud in mergers. Rule 133 eventually sank of its own weight and was superseded by SA Rule 145, 17 C.F.R. § 230.145, requiring 1933 Act registration of securities issued in mergers unless some other exemption is applicable.

2 A. Bromberg & L. Lowenfels, Securities Fraud & Commodities Fraud, § 6.5 (114) (1979) (citations omitted).

16. Securities Exchange Act of 1934, § 28(a), 15 U.S.C. 78bb(a) (1976). Section 28(a) of the 1934 Act provides:

> The rights and remedies provided by this chapter [the 1934 Act] shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of.
>
> Section 28 (a) . . . precludes recovery under 10b-5 if the plaintiff already obtained damages under a Securities Act express or implied remedy. Thus, a complainant can recover under 10b-5 the amount, if any, by which his actual damages exceed the compensation he received under his 1933 Act claim. The situation is less clear if a plaintiff seeks damages under both Acts in one suit, or if he recovers actual damages under 10b-5 and in a later suit seeks damages under a 1933 Act provision. In either case, he should be able to recover the full measure of damages specified in a 1933 Act express remedy minus his 10b-5 recovery [footnote omitted].

5B A. Jacobs, *supra* note 4, § 260.03[h]. Also *see, e.g.*, Beecher v. Able, 435 F. Supp. 397 (S.D.N.Y. 1975). The court held that there was no possibility of a double recovery which would prevent prosecution of a § 10(b) claim when no judgment had been entered on the successful § 11 claim. *Id.* at 412-13.

17. *See, e.g.*, Superintendent of Ins. of N.Y. v. Bankers Life and Cas. Co., 404 U.S. 6 (1971). In *Bankers Life*, the Court stated that, "It is now established that a private right of action is implied under § 10(b)." *Id.* at 13 n. 9 (citations omitted).

in the rule. Unlike rule 10b-5, section 11(e) of the 1933 Act provides an express remedy.[18] That measure is almost as complicated as some of the measures of damages in the Code. In the case we have been discussing, which is mapped on the graph, there was no section 11 claim because at the time of the merger the Commission did not require a registration statement. But, to continue our hypothetical, let us assume they did, and examine the liability that the defendant issuer would have had under section 11.

B. *Liability under Section 11*

Section 11(e) provides three alternative measures of damages.[19] The first measure is the price paid for the security, $72, minus the value of the security at the time suit was brought. If suit were brought at the lowest level, $60, then under this formula plaintiffs would have had damages of $72 minus $60, or $12.

The second measure is the price paid, $72, minus the price at which such securities were disposed of in the market before suit. That means that all the people in Class 1 would be entitled to no damages since they disposed of their securities before suit at $72. That is, their measure of damages would be the price paid, $72, minus the price at which they sold before suit, $72 — nothing.

The third measure, available if the damages are less than those calculated under the first alternative, is the price paid for the stock, $72, minus the price at which such securities were disposed of after suit but before judgment. If we use this third method, the damages are less than $12. This means that anybody who sold in Class 3 would have no damages under this meausre, and anyone who sold in Class 4 could have as much as $12 worth of damages.

C. *Liability Under Rule 10b-5 Compared with Section 11*

Now let us compare liabilities under rule 10b-5. Based on the court's opinion in the case we have been hypothesizing,

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18. Securities Act of 1933, § 11(e), 15 U.S.C. § 77k(e) (1976).
19. *Id.*

under rule 10b-5, defendants have a $12 liability for Class 1, a $12 liability for Class 3, and a $12 liability for Class 4. Under section 11, if it were applicable to the particular facts of this case, the issuer would have no liability for Class 1, no liability for Class 3, and as much as $12 liability for Class 4. But, because of the overlap of remedies, the issuer would be liable for $12 per share to Class 1, Class 3, and Class 4.

D. *Liability Under the Code*

The Code simplifies all this in the sense that it does not permit overlapping remedies.[20] I will spare you the details, but by tracing through sections 1703[21] and 1705[22] of the Code, you eventually conclude that this situation would be governed by section 1704.[23] Section 1704 imposes liability for false offering statements and would, therefore, apply to this case. Section 1704(h) says the measure of damages is as stated in section 1708(c). Section 1708(c) says the measure of damages under section 1704 (which is the provision we are talking about) is computed as in section 1708(a), except as provided in sections 1708(b)(1) and (2) and 38 other exceptions.[24]

When you cut through it all, the Code really says that the issuer (as distinguished from other persons who could be liable) would be liable for the amount the plaintiff paid plus interest ($72 plus interest) minus the value of the security received, valued as of the end of a reasonable period after the true facts became known. We are positing that the security went down to $60 after a reasonable time. So the issuer's liability under the Code is $72 minus $60, less any returns,[25] plus interest. There is no

20. ALI FED. SEC. CODE § 1722(f) (1978). This section provides:

(f) [Remedies noncumulative.] No person or class may recover, through satisfaction of judgment in one or more actions, more than the greater of the amount recoverable (1) in whatever action created by or based on a violation of this Code (as defined in section 225) yields the greatest such amount, or (2) in any other action.

21. *Id.* § 1703.

22. *Id.* § 1705.

23. *Id.* § 1704.

24. *Id.* § 1708. For a discussion of changes in this section made by the CODE RECOMMENDATION, *see* Casper, *supra* note 7, at 286-87.

25. "Returns" means dividends or distributions that the plaintiff received on the security.

concept in the Code of dividing the plaintiffs up among classes. This measure of recovery applies to everybody. No matter when a stockholder of the disappearing merger partner sold stock that he got in the merger, he would be entitled, in this example, to $12.

The Code sets up certain limits with respect to liability. Many of these are derived from section 11(e) of the 1933 Act, because section 1708(c) and section 1704 are basically the analogues of section 11 of the 1933 Act. These limits do not apply to the fact pattern we have been discussing. For instance, there are limits on the liability of any particular defendant relating to the amount of securities that he sold.[26] This is designed for statutory underwriters. Another limit, found in section 1708, which again derives from section 11(e), is that the price from which you subtract to get your damages, the minuend, cannot exceed the offering price.[27] This has great significance in a fluctuating market where plaintiffs are buying and selling in that market subsequent to the merger. It is of no importance, however, in a merger with respect to the people who purchased in the merger. A final limit in section 1708 is that an underwriter is not liable for any greater portion of the offering than his portion.[28] This has great practical importance in public offerings, but none in a merger.

Finally, I will touch on some other novel aspects of the Code's provisions which limit damages. Under section 11 of the 1933 Act, there are no limits like those I am about to describe. The Code, in section 1708(c)(2), incorporates some limit on the measure of damages for false offering circulars.[29] Recall that "offering circulars" is the Code's name for registration statements. For each defendant, the Code restricts the measure of damages under the false offering circulars section to the greatest of the following three items: One hundred thousand dollars, 1% of the gross revenues of the defendant (up to $1,000,000), or the defendant's profit. These limits do not apply if the plaintiff proves that the misrepresentation was made with knowledge by the

26. ALI FED. SEC. CODE § 1708 (1978).
27. *Id.*
28. *Id.*
29. *Id.* § 1708(c)(2).

particular defendant, whatever knowledge means, nor do they apply with respect to the registrant to the extent that an offering statement covers the distribution by or for the account or benefit of the issuer, which is, of course, our case in the merger. These limits, \$100,000, 1% up to \$1,000,000, and the profit ceiling, under the Code's parallel to section 11, are innovations in the law, but do not apply in a merger.

IV. Summary

What we've learned from all of this very technical detail is that the Code contains a precise and specific measure of damages for each type of violation. The result is that damages are limited in the Code in two ways. First, the multiple measures of damages which formerly permitted overlapping remedies and which gave a plaintiff the maximum possible recovery would no longer be available. Second, the inclusion of precise definitions of the damage remedies in the Code eliminates judicial flexibility. Courts would be unable to award what they believe to be just damages unless that amount can be calculated from the measures found in the Code.