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A New Measure of Damages for Tippee-Trading Violations Under Rule 10b-5: Elkind v. Liggett & Myers, Inc.

Of all the issues arising under section 10(b) and rule 10b-5 of the Securities Exchange Act of 1934, the subject of damages is the least formulated. The extent of liability in private actions has been particularly unsettled in the case of "tippee" trading on an impersonal market. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc. established a private right of action for all uninformed outsiders who trade during a period of tippee trading but left the measure of damages open to speculation. Because of the expansive size of this plaintiff class, concern arose over the potentially colossal liability under traditional measures of damages. In Elkind v. Liggett & Myers, Inc. the United States Court of Appeals for the Second Circuit confronted the issue and adopted a new measure of damages that places a ceiling on the otherwise potentially ruinous liability. Unlike the traditional "out-of-pocket" measure applied by the district court, the new "disgorgement" measure limits recovery to the amount the tippee gained from his wrongful trading.

3. Tipping has been defined as "the selective disclosure of material inside information." 5A A. Jacobs, The Impact of Rule 10b-5 § 162 (rev. ed. 1980). Damages are not recoverable for tipping alone. The gravamen of the violation is the tippee's trading on the basis of the tipped information while it is yet nonpublic. For this both the tipper and tippee are liable. Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 165 (1980). Elkind appears to be the first case to actually impose damages in a private action for tippee trading.
4. 495 F.2d 228 (2d Cir. 1974).
5. 635 F.2d 156 (2d Cir. 1980).
7. 635 F.2d at 172.
I. INSTANT CASE

1971 marked a record year for Liggett & Myers, Inc., with earnings of $4.22 per share. The first quarter of 1972 was equally promising with earnings of $1.00 per share (compared to $.81 in the first quarter of 1971). Release of these figures caused optimism in the financial community over Liggett's prospects and led to reports predicting that 1972 earnings would increase by about ten percent over 1971 earnings. In contrast to outward appearances and unknown to the public, second quarter earnings dropped sharply. In late June, the price of Liggett's common stock began to steadily decline. On July 17, 1972, the board of directors received preliminary data showing the first half earnings at only $1.46 per share, down from $1.82 the previous year. On the same day, one day before the earnings information was released to the public, a securities analyst questioned the company's chief financial officer about the recent decline in price of Liggett's common stock. When he asked whether there was "a good possibility" that earnings would be down, he received an affirmative "grudging" response. The Liggett officer added that this information was confidential. The analyst then sent a wire to his firm and spoke with a stockbroker from a different firm who promptly sold 1,800 shares of Liggett stock on behalf of his customers.

A class action was brought against Liggett & Myers, Inc. by Arnold B. Elkind on behalf of all purchasers of Liggett & Myers stock between the time of the wrongful tip and the subsequent

8. Liggett is a diversified company whose common stock is listed on the New York Stock Exchange. Id. at 158-59.
9. Id. at 159.
10. Id. at 160.
11. Id. at 161.
12. Interestingly, although the wire stated that because of low second-quarter earnings the first-half earnings would likely be lower than the previous year's, it did not recommend selling Liggett shares and in fact expressed optimism that the year as a whole should still show "some improvement" over the previous year's earnings, though not as much as previously forecast. Id. at n.7.
13. The opinion of the Second Circuit omits the fact that the stockbroker was from a different firm than that of the financial analyst. See 472 F. Supp. at 128. This distinction is critical in order to understand the not new but important principle that the liability of a tipper of inside information extends beyond trading by the tippee to trading by tippees of the tippee (sometimes called "remote" or "indirect" tippees). 5A A. Jacobs, supra note 3, § 167.
14. The liability of Liggett & Myers is predicated upon the trading of the stockbroker. See note 3 supra.
public disclosure.\textsuperscript{16} The district court found, and the Second Circuit affirmed, that the July 17 divulgence constituted a tip of material \textsuperscript{16} inside information, made with scienter, in violation of rule 10b-5.\textsuperscript{17} Both courts agreed that all purchasers of Liggett stock between the afternoon of July 17 and the close of the market on July 18 \textsuperscript{18} were entitled to damages. The courts, however, differed on how damages were to be measured.

The district court looked to the out-of-pocket measure of damages and awarded the plaintiffs the difference between what they had paid for their stock and the "actual value" received—that is, the price at which the stock would have theoretically sold had the tip been publicly disclosed prior to the time of purchase.\textsuperscript{19} To determine the "actual value" the court looked to the post-disclosure market price:\textsuperscript{20}

[T]he price which plaintiffs would have paid for their stock in the period [between the tip and public disclosure of the tipped information] . . . can be inferred from the price which investors did pay for Liggett stock after they had absorbed the news contained in the Liggett press release of July 18.\textsuperscript{21}

\begin{itemize}
  \item 15. The plaintiff class was originally much larger. However, claims based on earlier alleged violations were dismissed by the district court and their dismissal affirmed by the circuit court. The district court determined that a tip of material inside information had occurred on July 10 and granted recovery to all plaintiffs who purchased Liggett stock between July 11 and July 18, 1972. The class was trimmed further by the Second Circuit, which reversed the finding of liability based on the alleged July 10 tip and found the only violation to be the July 17 divulgence.
  \item 16. Even though the tip did not prompt the securities analyst to advise his own firm to sell Liggett stock on behalf of its customers, the tip was found to be material. The Second Circuit correctly considered the tip's materiality, not in light of the tippee's subjective judgment of its relevance, but rather in light of the objective standard of "whether the tipped information, if divulged to the public, would have been likely to affect the decision of potential buyers and sellers." 635 F.2d at 166.
  \item 17. Id. at 168.
  \item 18. Although a press release was issued at 2:15 p.m. on July 18, the court extended the period of liability to the end of the trading day, reasoning that public disclosure was not made until the information appeared in the \textit{Wall Street Journal} early the next morning. Id. at 173.
  \item 19. 472 F. Supp. at 130-35.
  \item 20. Originally the court used a "value line" to determine the hypothetical decline in value that would have occurred had the tipped information been released at the time of the tippee trading. Id. at 129-30. Later the court filed an "Opinion Amending Findings of Fact and Conclusions of Law" in which it concluded that the value line was based on the premise that Liggett had first breached its duty in June 1972, an allegation later proved false. Without sufficient evidence to construct a value line for the shorter period of liability ultimately found, the court determined "actual value" by looking to the post-disclosure market price. Id. at 132-35.
  \item 21. Id. at 132.
\end{itemize}
Finding that it took eight trading days for the market to fully absorb the information contained in the press release, the court awarded damages based on the price of $43, the lowest closing price for Liggett stock during the eight trading days following the press release of July 18. Thus, the plaintiffs were awarded the difference between the price they paid for Liggett stock and $43, the "actual value" found by the district court. Based on the volume of trading during the period of liability, this would have amounted to a judgment of approximately $190,000.

The Second Circuit affirmed the district court's finding of liability for the July 17 tip but remanded the case for a redetermination of damages. In considering the question of damages, the court recognized three possible measures. First, the court examined the traditional out-of-pocket measure used by the district court. For several reasons, the court felt this measure was inappropriate. To begin with, the out-of-pocket measure is aimed at compensating victims of fraud for losses directly attributable to the defendant. On an impersonal market, no such fraud can be attributed to a tipper or tippee. In addition, the court reasoned, the measure often involves insurmountable proof problems in tippee-trading cases. Because the "actual value" of the stock traded during the period of liability is hypothetical, expert testimony aimed at establishing that value may be highly speculative. Use of the post-disclosure market price as alternative evidence of "actual value" during the period of nondisclosure is likewise fallible. The validity of this approach depends on the parity of the tip and the public disclosure. When the two differ, the basis of the damage calculation disappears. For example, public disclosure of the July 17 tip that there was "a good possibility" that earnings would be down would not necessarily have caused as great alarm as did the next day's press release of the disappointing preliminary earnings figures. Perhaps the most compelling reason, in the court's view, for rejecting the

22. Id. at 133.
23. The actual award was $740,000, based on the longer period of liability beginning with the July 10 tip. Id. at 135-36. The $190,000 figure is a calculation made by the author based on the estimated volume of trading during the shorter period of liability found by the Second Circuit. See id. at 136 app.
24. 635 F.2d at 170.
25. Id.
26. The court illustrates the parity problem by pointing out the difficulty of calculating how the public would have reacted to news that the Titanic was near an iceberg from how it later reacted to news that the oceanliner had struck an iceberg and sunk. Id.
out-of-pocket measure is its potential for imposing "Draco-
nian" damages that are totally out of proportion to the wrong
committed. Because the liability in tippee-trading cases often
falls ultimately on the innocent shareholders of the defendant
corporation, the court expressed reluctance to impose full out-
of-pocket damages in cases of moderate or light tippee trading
not likely to have substantially affected the market price of the
stock.

Next, the Second Circuit examined the direct market-reper-
cussion theory of damages. This measure would allow an inno-
cent investor who bought Liggett & Myers shares at or after the
time the tippee sold Liggett shares on the basis of inside infor-
mation to recover any decline in value of his shares that is trace-
able to the tippee's wrongful trading. In the court's view, the
advantage of this measure—limitation of the plaintiff's recovery
to the amount of damage actually caused by the defendant—is
outweighed by the extremely difficult and sometimes impossible
burden of proving the extent to which a market price movement
is attributable to the tippee's conduct. Furthermore, the mea-
sure allows no recovery for the tippee's violation of his duty to
either disclose material inside information or to abstain from
trading.

Finally, the court weighed the pros and cons of the disgorgement
measure of damages. This measure was described as follows:

A third alternative is (1) to allow any uninformed investor
. . . to recover any post-purchase decline in market value of
his shares up to a reasonable time after he learns of the tipped
information or after there is a public disclosure of it but (2)
limit his recovery to the amount gained by the tippee. . . .

27. This esoteric adjective derives from the Athenian lawgiver Draco, whose code of
laws was exceedingly severe. See BLACK'S LAW DICTIONARY 443 (5th ed. 1979).
28. The claims against all individual defendants, such as the corporate officer re-
sponsible for the illegal tip, were dropped; the only party defendant brought to trial was
the corporation. 472 F. Supp. at 124.
29. 635 F.2d at 171.
30. Id.
31. Id.
32. For reasons stated in notes 62 through 64 and the accompanying text infra, the
author questions the propriety of denying the uninformed investor recovery for the de-
cline in value of his shares after he learns of the tipped information but before the infor-
mation is made public.
33. 635 F.2d at 172 (footnote added).
To illustrate, the court posed a hypothetical situation in which a tippee sells 5,000 shares of stock in X Corporation at $50 per share on the basis of inside information; before public disclosure an uninformed investor buys securities in X Corporation at $45 per share; and within a reasonable time after public disclosure the stock declines to $40 per share. Under the disgorgement measure, the uninformed purchaser would recover the difference between his purchase price ($45) and the market price within a reasonable time after public disclosure ($40), subject to a limit of $50,000, the amount the tippee gained by trading on inside information rather than on an equal information basis. If the aggregate claims of the intervening buyers exceed the tippee’s gain, “their recovery (limited to that gain) would be shared pro rata.”

In assessing the disgorgement measure, the court pointed out several advantages. Most importantly, the measure avoids the imposition of excessive, “Draconian” damages and, in most cases, results in damages awards roughly commensurate to the actual harm caused by tippee trading. Because the calculations required are simple and precise, the disgorgement measure avoids the troublesome proof problems involved in other measures. In addition, the court felt the measure would deter tippling of inside information and tippee trading.

The court also considered the disadvantages of the measure. For one, it modifies the principle that, ordinarily, liability for a rule 10b-5 violation should not depend upon gain to the wrongdoer. The measure also partially duplicates disgorgement remedies available to the SEC. In addition, the court recognized that in certain situations the measure might seem to favor the wrongdoer, as where the total claims exceed the tippee’s gain and pro rata recovery is mandated, or where, because of the modest amount of tippee trading, a class action may not be worthwhile. In contrast, the tipper and tippee may be vulnerable to heavy damages when the market price is depressed by causes unrelated to the tippee’s trading. Despite these disadvantages, “as between the various alternatives [the court was] persuaded, after weighing the pros and cons, that the disgorgement measure . . . offers the most equitable resolution of the difficult problems created

34. Id.
35. Id.
by conflicting interests.”

II. ANALYSIS
A. Policy Considerations

The Second Circuit’s decision is consistent with the remedial purpose of rule 10b-5 and is sound in terms of law and policy. The process by which the court adopted the new damages measure—weighing the pros and cons of the various alternatives in light of policy concerns—is consistent with Supreme Court guidelines. Commenting on the lack of legislative direction in the development of rule 10b-5, the Court has noted that “[i]t is therefore proper that we consider, in addition to [other] factors . . . , what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance.” Because the body of law on private actions under rule 10b-5 is largely “a judicial oak which has grown from little more than a legislative acorn,” the Supreme Court has given federal courts a broad mandate, in the context of implied civil causes of action, to fashion whatever remedies may be appropriate to effect the general remedial purpose intended by Congress. Given this broad mandate, analysis of any damages measure for tippee trading violations necessarily centers on the policies that underlie rule 10b-5.

Rule 10b-5 “is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information.” To achieve equality of information in the market, damages measures have traditionally focused on deterring conduct inconsistent with that aim and compensating victims of violations. As the scope of rule 10b-5 has expanded from face-to-face transactions to impersonal market transactions, some commentators have suggested that in the open or public market context a broad deterrent policy should predominate over the com-
pensatory policy relevant in the private market. Another recent concern of courts and commentators has been to avoid awarding colossal damages to indeterminate classes of plaintiffs to be paid in the last instance by innocent shareholders. The problem with arriving at a measure of damages consistent with the above policy considerations is that not all of the policy considerations are harmonious. For example, the deterrent element of a damages measure must sometimes be compromised in order to avoid the imposition of excessive damages. The most appropriate damages formula, then, will be the one that best balances the varying policy considerations—in other words, the one which provides an adequate amount of deterrence and justly compensates victims but which avoids the imposition of exorbitant damages ultimately payable by innocent shareholders.

B. Damages Measures Rejected by the Elkind Court

1. The out-of-pocket measure

The Second Circuit wisely rejected the out-of-pocket measure. The out-of-pocket measure awards to all members of the plaintiff class the difference between the amount they paid for their stock and the “actual value” received, i.e., the price at which the stock would have sold had there been public disclosure of the tipped information. Although this measure fully compensates the victims and more than adequately deters violators, it often does so at the expense of innocent shareholders and can lead to astronomical awards out of all proportion to the wrong


43. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 866-67 (2d Cir. 1968) (Friendly, J., concurring); 3A H. BLOOMENTHAL, supra note 41, § 9.22(1). See also Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739 (1975). Elkind is an illustration of the corporation being held liable as a tipper of inside information on an agency theory; the tip of the corporate officer is imputed to the corporation. Because the liability of tipper and tippee for the tippee’s wrongful trading is the same, the corporation’s deep pocket makes it the most logical defendant from the plaintiff’s standpoint. A damages award paid by the corporation is indirectly borne by the shareholders.
committed. In some cases the victims may be overcompensated, as where the market price of their shares is depressed by factors totally unrelated to the tippee trading or to the public disclosure of the tipped information. Where the post-disclosure market price is used to determine "actual value" during the period of nondisclosure, the wrongdoers become virtual insurers for losses sustained by anyone who happens to trade in the same stock until public disclosure is made.44

In addition to these policy reasons against the out-of-pocket measure, there are legal grounds against its application to impersonal market violations. Because the out-of-pocket measure may potentially provide for damages in excess of those caused in fact by the defendant,45 it may contravene the mandate of section 28(a) of the Securities Exchange Act of 1934 that "no person permitted to maintain a suit for damages . . . shall recover . . . a total amount in excess of his actual damages on account of the act complained of."46 The weak causal link between tippee trading on an impersonal market and the harm to intervening traders justifies a damages measure less stringent than the out-of-pocket measure. In light of the courts' tendency to relax the common law elements of fraud initially thought to be a prerequisite to liability for a rule 10b-5 violation, recovery need not depend on a strict finding of causation. This does not mean, however, that the question of causation should be ignored and full recovery allowed when the plaintiff's harm cannot logically be attributed to the defendant's wrongful act.

2. The direct market-repercussion theory

The direct market-repercussion theory of damages is a futile answer to the difficult question of causation. In theory, this measure avoids unwarranted damages awards by allowing recovery only for injuries caused by the tippee trading. However, the direct market-repercussion measure is practical only in cases of heavy tippee trading, where an actual market impact can be proven. In cases of light or moderate tippee trading, where the

44. Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977), illustrates this problem. The profit of one of the defendants, which had already been disgorged in an SEC proceeding, amounted to only $13,000. A finding of liability in a private class action under the out-of-pocket measure might have produced a damages award in excess of $7 million. Id. at 321 n.29.
45. See notes 52 through 59 and accompanying text infra.
impact on the market is likely to be negligible, the wrongdoers are protected by the difficult standard of proof. Thus, modest tippee trading would flourish. The expense of proving the extent to which a market price decline is traceable to the defendant's conduct would likely involve expert witness fees and higher attorneys fees than those in the other, more mechanical measures of damages. These increased costs would discourage private litigation where the possible award is not high enough to make a suit worthwhile. The direct market-repercussion theory fails to serve two important policy aims of rule 10b-5: it inadequately deters rule violations and undercompensates victims of such violations.

3. Other measures

Other measures of damages not considered by the Second Circuit are generally subject to the same criticisms as the out-of-pocket measure, especially in their potential for imposing "Draconian" liability. Motivated by a distaste for excessive damages, courts and commentators have suggested other methods to limit liability for open market violations. These include: increasing the stringency of the standard of proof as the size of the plaintiff class and resulting potential damages increase; legislatively abolishing private actions for open market violations and granting exclusive enforcement authority to the SEC, with damages awards financing enforcement endeavors; and recognizing existing SEC disgorgement remedies as the exclusive mode of redress.

C. Causation and Damages Measures

Other approaches center on limiting the scope of compensable harm. For example, one commentator advocates reintroducing the requirement of establishing proximate cause and reliance in class actions, which would cause questions affecting individual

47. For a general discussion of the various measures possible for a rule 10b-5 violation, see Jacobs, note 2 supra; Note, The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities, 26 Stan. L. Rev. 371 (1974).
members to predominate over questions common to the class, thus defeating the class action under the Federal Rules of Civil Procedure.\textsuperscript{61} The Sixth Circuit's reliance on causation in \textit{Fridrich v. Bradford}\textsuperscript{52} has reduced the plaintiff class to an extent which makes a class action nearly impossible. In \textit{Fridrich} the court held that the defendants' act of trading on the basis of inside information was not "causally connected" with any loss by the plaintiffs, who traded on an impersonal market and whose decision to buy or sell was unaffected by the wrongful act of defendants. This view of causation is at odds with the Second Circuit's view in \textit{Shapiro v. Merrill Lynch}.\textsuperscript{53} The Sixth Circuit disagreed with the Second Circuit's interpretation of the "causation in fact" language of \textit{Affiliated Ute Citizens v. United States},\textsuperscript{54} which reads as follows:

Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.\textsuperscript{55}

The Second Circuit in \textit{Shapiro} expanded the application of this language from the face-to-face transaction in \textit{Affiliated Ute Citizens} to open-market nondisclosure violations as well. The Sixth Circuit, however, read the language narrowly and limited its application to the circumstances of \textit{Affiliated Ute Citizens}, where the plaintiffs' harm came as a result of a deliberate scheme by the defendants to induce the plaintiffs to sell their stock while the defendants withheld material facts that would have influenced the plaintiffs' decision to sell.

\textit{Elkind} follows \textit{Shapiro} and takes an even more relaxed view of causation. Indeed, the \textit{Elkind} court did not even separately consider whether there was causation but indicated that materiality and scienter are the only essential elements of liability for tippee trading. It is safe to say that the Second Circuit views causation as existing whenever the tip is material (reason-

\textsuperscript{52} 542 F.2d 307 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977).
\textsuperscript{53} 495 F.2d 228 (2d Cir. 1974).
\textsuperscript{54} 406 U.S. 128 (1972).
\textsuperscript{55} Id. at 153-54 (citations omitted).
ably likely to affect the decision of potential buyers and sellers).

The difference of position between the two circuits results from their different postures toward the role of causation. The causation found to exist in Shapiro is actually nothing more than causation of the fact of injury to the plaintiffs. Fridrich, on the other hand, is concerned with the extent of the plaintiffs' injury actually caused by the defendant's act. As the Sixth Circuit correctly points out, the duty of an insider or tippee to disclose is not an absolute one, but an alternative one to either "disclose or abstain." It is the act of trading, not the failure to disclose, that violates rule 10b-5. Because the defendant's trading on an impersonal market does not alter the plaintiff's expectations or in any way influence the plaintiff's trading decision, the defendant's trading cannot be said to be the cause in fact of the plaintiff's injury; the plaintiff's injury (decline in value of his shares) would have been the same had the defendant abstained from trading and publicly released the inside information at a later date. It cannot accurately be said that, but for the defendant's act, the plaintiff would not have suffered a decline in the value of his shares. The Sixth Circuit, in Fridrich, correctly determines that insider trading is not necessarily the cause of the decline in value of the plaintiff's shares and ends its inquiry with a finding of no causation.

What Fridrich fails to recognize—and what Shapiro and Elkind only implicitly recognize—is that the plaintiff has been harmed in the sense that his statutory right to trade on an equal information basis has been violated and that the defendant's illegal trading on the basis of inside information is the cause of the plaintiff's harm in this sense. Granted, the harm suffered by the violation of this intangible right does not necessarily equal the decline in value of the plaintiff's shares. For this reason, the out-of-pocket measure of damages bears no logical relation to

56. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968); 5A A. Jacobs, supra note 3, § 165.01; 5 id. § 166.02(c).

57. The implied private right of action to recover for a rule 10b-5 violation is grounded in tort. The seminal decision in this area was Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). The rationale for judicially implying a private civil remedy was found in the Restatement of Torts § 286 (1934), which recognized the disregard of the command of a statute as a wrongful act and a tort. Kardon also cited Texas & Pac. Ry. v. Rigsby, 241 U.S. 33, 39 (1916), which recognized the right to recover damages where the violation of a statute results in damage to one for whose protection the statute was enacted.
tippee trading violations in an impersonal market. But the defendant has violated the rule, and the plaintiff has been harmed by the defendant's conduct (though not necessarily to the full extent of his monetary loss). For this reason, the *Fridrich* court's denial of recovery is incorrect. In keeping with the federal courts' broad powers to fashion remedies to effect the remedial purpose of rule 10b-5, some remedy ought to be provided. Because the extent to which the plaintiff's loss was actually caused by the defendant is usually impossible to ascertain, the remedy should be so fashioned that the policy objectives of deterrence and disclosure predominate over the compensatory concerns relevant in face-to-face transactions.

**D. The Damages Measure Adopted by the Elkind Court: The Disgorgement Measure**

Damages awards under the disgorgement measure are equal to the aggregate of plaintiff losses limited by the tippee's gain. The mechanics of this measure entail a two-part calculation. The first part is to determine the loss of each member of the plaintiff class. In the case of an injured buyer this amount consists of the difference between the purchase price and the depressed market value of the buyer's shares within a reasonable time after public disclosure. The court in the instant case indicated in dictum that it would limit recovery to interim traders who learn of the tipped information before public disclosure: "[The plaintiff is entitled] to recover any post-purchase decline..."

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58. Perhaps the *Elkind* court was recognizing this fact when it criticized the out-of-pocket measure as inappropriate in open market violations because "it is directed toward compensating a person for losses directly traceable to the defendant's fraud upon him. No such fraud or inducement may be attributed to a tipper or tippee trading on an impersonal market." 635 F.2d at 170 (emphasis added).

59. See note 39 supra.

60. The word "loss" is intentionally used to avoid the connotation of causation associated with the word "damages."

61. An injured *seller* (where the tippee buys on inside information) would recover the difference between the price at which he sold and the higher fair market value of his shares within a reasonable time after public disclosure. ALI Fed. Sec. Code §§ 1708(b), 1708(a)(2)(B) (Proposed Official Draft 1978). Note: Although the 1980 bound volume of the ALI Federal Securities Code is now in circulation, this Case Note cites to the 1978 Proposed Official Draft referred to by the *Elkind* court. The content of all sections cited is the same in the two editions except for a few minor changes in wording. The 1980 Code represents the final product of the American Law Institute. For a detailed discussion of the proposed Federal Securities Code, see 33 U. MIAMI L. REV. 1425-648 (1979) (symposium issue).
in market value of his shares up to a reasonable time after he learns of the tipped information or after there is public disclosure of it." Denying recovery for the market price decline occurring after an interim investor learns of the tipped information but before public disclosure encourages the investor to immediately sell—in violation of rule 10b-5. A better rule would be to eliminate the "after he learns of the tipped information" language and allow all uninformed purchasers to recover the post-purchase decline in value up to a reasonable time after public disclosure, including those who learn of the tipped information prior to public disclosure—provided they do not trade until after public disclosure.

The second part of the disgorgement measure calculation is to determine the amount of the tippee's gain, which acts as an upper limit of liability. This amount consists of the difference between the price obtained by selling on the basis of inside information and the market price of the same number of shares after public disclosure of the tipped information.

What the disgorgement measure amounts to is a potentially full "rescissory measure" of damages for each individual plain-
tiff, with the aggregate liability of the defendant limited to the amount of the tippee's gain. This quasi-equitable remedy would be accepted as an appropriate measure of liability if it is consistent with the policy objectives of rule 10b-5.

The effectiveness of a damages formula's contribution to the overall objective of equality of information in market trading depends largely on its deterrent effect. The court in *Elkind* considered the deterrent effect of the disgorgement measure in one sentence: "To the extent that it makes the tipper and tippees liable up to the amount gained by their misconduct, it should deter tipping of inside information and tippee-trading." Although this important policy objective deserved more consideration by the court, the seemingly hasty conclusion is sound. The potential liability of a tipper of inside information—the amount gained not only by his direct tippee but also by all remote tippees—will usually far outweigh any benefit to be derived from the wrongful tip. The sufficiency of the deterrent effect on tippees is a closer question. Admittedly, the tippee stands to lose only what he has gained from his illegal trading. However, the deterrent effect on tippees is not nearly as important as that on the tipper, who is the fountainhead of the stream of inside information. Usually tippees will not even be made parties to the suit, making the measure of damages applicable to them irrele-

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67. Because of the lack of a definite causal link between the wrongful act and the measure of liability, the disgorgement measure might more accurately be thought of as a quasi-equitable remedy rather than as a measure of damages. The object of the measure is to afford the monetary equivalent of rescission up to the amount of the wrongdoer's gain.

68. 635 F.2d at 172.

69. See note 13 supra.

70. In most cases, the tipper derives an intangible benefit only, such as the goodwill of the tippee. The only benefit Liggett & Myers was found to have obtained from its wrongful tip was the maintenance of "a good relationship" with the analyst tippee. 472 F. Supp. at 194.
vant. Moreover, the arguably weak deterrent effect of the disgorgement measure on both tippers and tippees could be heightened by prejudgment interest at a rate sufficient to make the eventual liability exceed the benefit attained. In addition, the deterrent effect of the disgorgement measure is augmented by the prospects of duplicate disgorgement remedies available to the SEC and the possibility of criminal liability.

Perhaps the major disadvantage of the disgorgement measure is that the ceiling of the tippee’s gain reduces the measure’s deterrent effect on light tippee trading. Since the origination of a private suit depends upon the likelihood of a recovery substantial enough to make the costs of litigation an acceptable risk, minor tipping violations will likely pass unchecked by private litigants. Although such violations are subject to SEC proceedings and criminal sanctions, the limited policing capabilities of the SEC make the unlikelihood of deterrence from private suits a valid concern. The Supreme Court has indicated the importance of private litigation as “a necessary supplement to Commission action” in enforcing the securities laws. However, the converse—holding tipper and tippee liable for full out-of-pocket losses of interim investors regardless of the amount of shares traded by the tippee—seems even less desirable.

Another apparent disadvantage to the disgorgement measure is that it does not fully compensate plaintiffs when their aggregate claim exceeds the tippee’s gain. However, because of the tenuous causal link between the wrong and the injury, full compensation may be inappropriate. Instead of granting full recovery, the disgorgement measure attempts to grant recovery “roughly commensurate to the actual harm caused by the tippee’s wrongful conduct.”

In a case where the tippee sold only a few shares, for instance, the likelihood of his conduct causing any substantial injury to

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71. Prejudgment interest has generally but not invariably been allowed on damages for rule 10b-5 violations. 3A H. Bloomenthal, supra note 41, § 9.22[4].
74. 635 F.2d at 172.
intervening investors buying without benefit of his confidential information would be small. If, on the other hand, the tippee sold large amounts of stock, realizing substantial profits, the likelihood of injury to intervening uninformed purchasers would be greater and the amount of potential recovery thereby proportionately enlarged.\textsuperscript{76}

The court admits that “under some market conditions such as where the market price is depressed by wholly unrelated causes, the tippee might be vulnerable to heavy damages, permitting some plaintiffs to recover undeserved windfalls.”\textsuperscript{76} But even in this situation, liability is limited to the tippee’s gain. Furthermore, since the measure is premised on the idea that the actual cause of depressed market prices is difficult and sometimes impossible to ascertain, the measure takes into account the “likelihood” of the harm being caused by the tippee trading by correlating the potential liability to the volume of tippee trading. In this manner the measure approximates the actual harm caused and avoids “windfall recoveries of exorbitant amounts bearing no relation to the seriousness of the misconduct.”\textsuperscript{77}

Because of the conflicting interests involved in the various policy considerations that must be considered in choosing a damages formula, it is impractical to search for the perfect formula. Instead, courts should do as the Elkind court did and choose the formula that on balance best achieves the policy aims of deterring violators and compensating victims but avoiding the imposition of exorbitant damages bearing no relation to the wrong committed. Of all the measures suggested in the legal literature on this subject, the disgorgement measure strikes the best balance among these policy aims.

\textbf{E. The Scope of the Elkind Decision}

Even if one accepts the proposition that \textit{Elkind v. Liggett & Myers, Inc.} is sound when limited to its facts, the broad question remains of defining the reach of the court’s decision. For example, should the disgorgement measure apply to a corporate insider who trades on his own account while withholding material inside information? Although the court did not expressly indicate that the new measure was to apply to cases of insider

\textsuperscript{75} Id.
\textsuperscript{76} Id. at 172-73.
\textsuperscript{77} Id. at 172.
trading, such an intention may be inferred. The ALI Federal Securities Code, relied on by the court, imposes the disgorgement measure on corporate insiders who trade on their own account.\(^7\) The consensus of opinion favors the same measure of damages for corporate insiders as for tippers and tippees.\(^7\)

Basically, the same policy considerations involved in tippee-trading cases apply to insider-trading cases. Perhaps the only difference lies in the level of deterrence desired. It might be argued that under the disgorgement measure a tipper of inside information stands to lose much more than he gains by tipping and that the disgorgement measure thus adequately deters the evils of tipping at the source. In contrast, a corporate insider who trades on his own account stands to lose only what he has gained by his wrongful act and thus is not adequately deterred. However, the need to deter insider trading is not as great as the need to deter tipping of inside information. "Tipping because it involves a more widespread imbalance of information presents an even greater threat to the integrity of the marketplace than simple insider trading."\(^8\) Moreover, the deterrent effect of the disgorgement measure is augmented by other factors: In addition to SEC proceedings, criminal liability, and the prejudgment interest mentioned above, an insider may be liable for short-swing profits under section 16(b) and may suffer unfavorable tax consequences.\(^9\) The possible availability of state law remedies serves as an additional deterrent to insider trading.\(^9\)

Another question remaining after Elkind is the rigidity with which the disgorgement measure should apply to impersonal market violations.\(^9\) Should it be applied exclusively, in all cases,

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\(^7\) ALI FED. SEC. CODE §§ 1603, 1703(b) (Proposed Official Draft 1978).
\(^8\) E.g., Jacobs, supra note 2, at 1130 n.211.
\(^10\) The gain experienced by the insider on his wrongful trading presumably will have been taken in a prior year as a capital gain. Based on analogy to the tax consequences in a section 16(b) situation, the liability may have to be reported as a capital loss. Unless the insider has "capital gains in the current or carried-forward year against which to offset such capital [loss], the loss may be of limited value to [him]. I.R.C. § 1211(b)." 3A H. BLOOMENTHAL, supra note 41, § 9.22[5] n.475.
\(^12\) The term "impersonal market violation" embraces trading on inside information
or should the ceiling of the tippee’s gain be removed in certain instances to allow full rescissory or out-of-pocket damages? For example, where the difficult burden of proof is overcome and the damages actually caused by the defendant’s violation are proved to be more or less than the amount provided by the disgorgement measure, should the court abandon the disgorgement measure and award actual damages? Should egregious violations such as the selling of nonpublic inside information justify a more stringent measure of damages? The court seemed to embrace the disgorgement measure unreservedly and to reject the out-of-pocket measure and the direct market-repercussion theory generally. However, these questions may need to be answered on a case-by-case basis by reexamining the policy objectives of rule 10b-5 and balancing two competing interests: (1) the convenience of the precise, workable formula of the disgorgement measure, and (2) the desirability of fixing liability so that it is commensurate with the wrong done and the damage actually caused thereby. In most cases, the disgorgement measure will satisfy both interests. In order to achieve some level of certainty and uniformity in a very unsettled area of the law, courts should adopt the disgorgement measure as the general rule in private actions for impersonal market violations and deviate therefrom only in rare instances.

III. CONCLUSION

In Elkind v. Liggett & Myers, Inc. the Second Circuit was faced with the difficult task of choosing a damages formula for tippee-trading violations under rule 10b-5. This Case Note has attempted to establish that the formula adopted, the disgorgement measure, is the best alternative because it strikes the best balance among the relevant policy considerations and seems most compatible with the theory of causation in impersonal market transactions. It is not suggested that the disgorgement

84. The ALI Federal Securities Code allows the disgorgement measure to be “reduced to the extent . . . that the defendant proves that the violation did not cause the loss.” ALI Fed. Sec. Code § 1708(b)(2) (Proposed Official Draft 1978). In the situation of an injured buyer who sells his stock before public disclosure of the tipped information, this section may limit recovery to the amount of decline in value up to the time of sale (or a pro rata portion thereof where the total claims exceed the tippee’s gain). The ALI Code also allows the awarding of consequential damages and costs without regard to the limit of the tippee’s gain. ALI Fed. Sec. Code §§ 1708(b)(0), 1723(a), 1723(d) (Proposed Official Draft 1978).
measure is perfect. In the future, courts that confront situations similar to that presented before the Elkind court may wish to explore variations of or alternatives to the disgorgement measure. For example, if it is felt that the disgorgement measure does not adequately deter tippers of inside information, courts might impose exemplary damages on top of the regular damages recoverable under the disgorgement measure. Or, courts may wish to exercise their broad remedial powers by maintaining a flexible approach and applying a more stringent measure of damages for particularly serious violations. The legislatures, state and national, may wish to explore other avenues such as the establishment of a double- or treble-disgorgement formula. Until these and other avenues and variations have been further explored, the Elkind decision remains as persuasive authority in favor of the disgorgement measure of damages.

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