
William K. Sanders
MEASURE OF DAMAGES FOR INSIDER TRADING: ELKIND v. LIGGETT & MYERS, INC.

Rule 10b-5 was adopted by the Securities and Exchange Commission1 to protect the investing public by promoting full disclosure of inside information.2 Under the rule, a corporate insider in possession of material inside information concerning a security has a duty to disclose such information or abstain from trading in or recommending the security.3 Breach of this duty renders the cor-

---

1 Rule 10b-5 was promulgated by the Securities and Exchange Commission pursuant to its rulemaking power under section 10(b) of the Securities and Exchange Act of 1934. 15 U.S.C. § 78j(b) (1976). 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 the 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.

17 C.F.R. § 240.10b-5 (1980).

2 Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 235 (2d Cir. 1974). The Second Circuit has stated that the purpose of rule 10b-5 is to promote full disclosure, thereby insuring that all investors are able to make informed judgments. Id. One commentator has noted that there are at least eight recognized purposes underlying the rule, but all revolve around providing investors with equal access to inside information. 5 A. S. Jacobs, The Impact of Rule 10b-5 § 6.01 at 1-132 (1980).

3 SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969). Although the Second Circuit has held that anyone in possession of material inside information is subject to the disclose or abstain standard, 401 F.2d at 848, the Supreme Court, in Chiarella v. United States, 445 U.S. 222 (1980), refused to extend the standard to a printer who, in the course of his employment, obtained information concerning a takeover bid and purchased stock in the target company. 445 U.S. at 224-25. The Chiarella Court held that "such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between the parties to a transaction." 445 U.S. at 230; accord, In re Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961). Corporate insiders have a duty to disclose by virtue of their obligation to place the shareholders' welfare above their own. 445 U.S. at 230. Tippees, by the nature of their relationship with the insider, would
poration liable to uninformed private investors\footnote{Rule 10b-5 does not specifically provide for a private right of action, but such actions consistently have been implied by the courts. The first court to recognize an implied private right of action under rule 10b-5 was Kardon v. National Gypsum Co., 73 F. Supp. 798, 800 (E.D. Pa.), \textit{modified}, 83 F. Supp. 613 (E.D. Pa. 1947). Following the lead of the lower courts, the Supreme Court also has consistently recognized an implied private right of action. E.g., Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477 (1977); Affiliated Ute Citizens v. United States, 406 U.S. 128, 154-55 (1972); Superintendent of Ins. v. Bankers Life and Cas. Co., 404 U.S. 6, 13 n.9 (1971).} who traded in the security during the period of nondisclosure.\footnote{Pursuant to rule 10b-5, the theory underlying liability in nondisclosure cases is that when an insider trades in a corporate security while in possession of material inside information, he has caused injury to uninformed investors. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 238 (2d Cir. 1974) (citing Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972)). \textit{But see} Fridrich v. Bradford, 542 F.2d 307, 318-19 (6th Cir. 1976), \textit{cert. denied}, 429 U.S. 1053 (1977) (insider trading causes no injury to persons trading on the open market).} Once liability is established, however, measurement of damages is uncertain because few courts have reached the issue.\footnote{3 A. BROMBERG, \textit{SEcurities LAW: FRAUD} § 9.1, at 225 (1977). Since far more decisions on the existence of the cause of action have been decided in favor of plaintiffs, defendants have been quick to settle upon terms which generally are unpublished. \textit{Id.}} Nonetheless, upon considering several damage standards, the United States Court of Appeals for the Second Circuit in \textit{Elkind v. Liggett & Myers, Inc.}\footnote{635 F.2d 156 (2d Cir. 1980).} recently held that uninformed purchasers may recover any post-purchase decline in the market value of their shares occurring within a reasonable time after learning of tipped information or after its public disclosure.\footnote{\textit{Id. at} 172.} The court, however, limited total recovery to the tippees' gain from any pre-disclosure trading.\footnote{\textit{Id.}}

In 1971 and in the first quarter of 1972, Liggett & Myers, Inc. (Liggett) experienced record earnings.\footnote{\textit{Id. at} 159. Liggett's earnings for 1971 were $4.72 per share, up from $3.56 in 1970. Similar earnings were recorded in the first quarter of 1972. \textit{Id.}} Liggett's earnings began to falter in April of that year, however, and on July 17, 1972, poor year-to-date earnings were reported to Liggett's board of directors.\footnote{\textit{Id. at} 160. In the first six months of 1972, Liggett's earnings were $1.46 per share, down from $1.82 the previous year. \textit{Id.}} Also on July 17, Liggett's chief financial officer "grudgingly" affirmed an analyst's suggestion that Liggett's earnings were off still be liable under the \textit{Chiarella} standard. \textit{Id. at} 230 n.12. \textit{See generally} Note, \textit{Rule 10b-5 and the Duty to Disclose Market Information: It Takes A Thief}, 55 ST. JOHN'S L. REV. 93 (1980).
from the previous year.\textsuperscript{12} Pursuant to this “tip,” and prior to full public disclosure of Liggett’s earnings on July 19,\textsuperscript{13} 1800 shares of Liggett stock were sold.\textsuperscript{14}

As a result of the tip, Liggett was found liable by the District Court for the Southern District of New York for disclosure of material inside information in violation of rule 10b-5.\textsuperscript{15} Considering the measure of damages, the district court held that Liggett was liable for the out-of-pocket loss of all persons who purchased stock during the period of nondisclosure,\textsuperscript{16} that is, the difference between the price they actually paid and what the stock would have been worth had the tipped information been disclosed.\textsuperscript{17}

\textsuperscript{12} Id. at 161.

\textsuperscript{13} Id. Liggett’s board of directors issued a press release at 2:15 p.m. on July 18. Id. at 173. Published in the Wall Street Journal, the release effectively was disclosed on the following day. Id.

\textsuperscript{14} Id. at 161. Upon receiving a tip concerning faltering Liggett profits, a stock market analyst promptly wired his firm to report his findings. Id. The wire was not overly pessimistic, but recommended that shares at the current price be held and that aggressive buying be curtailed. Id. at 161 n.7. Nevertheless, 1800 shares of Liggett stock promptly were sold pursuant to the wire. Id. at 161.

\textsuperscript{15} Elkind v. Liggett & Myers, Inc., 472 F. Supp. 123, 128 (S.D.N.Y. 1977), rev’d and remanded, 635 F.2d 156 (2d Cir. 1980). Although the district court found Liggett liable for two tips, 472 F. Supp. at 128, liability for one of the tips was reversed by the Second Circuit. 635 F.2d at 158.

\textsuperscript{16} 472 F. Supp. at 129. The district court was bound to find Liggett liable to all traders during the period of nondisclosure because of the Second Circuit’s opinion in Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 236-37 (2d Cir. 1974). In Shapiro, the court stated that it would make “a mockery of the ‘disclose or abstain’ rule if we were to permit the fortuitous matching of buy and sell orders to determine whether a duty to disclose has been violated.” Id. at 236 (citation omitted). One court has suggested that at least in the case where the insiders themselves are trading, the class of plaintiffs should be limited to those trading “contemporaneously” with the defendant. Fridrich v. Bradford, 542 F.2d 307, 326 (6th Cir. 1976) (Celebrzezze, J., concurring), cert. denied, 429 U.S. 1053 (1977). In Fridrich, Judge Celebrzezze suggested that only these traders are protected by the disclose or abstain rule because it is only when the insiders are trading that the rule is violated. 542 F.2d at 326. Judge Celebrzezze agreed with the Shapiro rationale in tipping cases, however, because they involve a more widespread imbalance of information posing a much greater threat to the marketplace which could only be remedied by disclosure. Id. at 327 & n.12. But see Rapp, Fridrich v. Bradford and the Scope of Insider Trading Liability Under SEC Rule 10b-5: A Commentary, 38 Ohio St. L.J. 67, 98-100 (1977) (recommending that the Celebrzezze concurrence be adopted as a “rational limitation” on defendants’ “potentially limitless liability”); Note, Rule 10b-5 Damages: The Runaway Development of a Common Law Remedy, 28 U. Fla. L. Rev. 76, 99-100 (1975) (suggesting that class actions be discouraged by reintroducing such concepts as proximate cause and reliance in open market cases).

\textsuperscript{17} 472 F. Supp. at 129. The district court used two different methods to determine the value of stock purchased by plaintiffs. In its initial opinion, the court used the value line method. Id. See notes 36-37 and accompanying text infra. The court later amended its opinion because the value line originally constructed by the plaintiffs was based on an alleged
On appeal, the Second Circuit affirmed Liggett's liability for the tip, but rejected the district court's out-of-pocket measure of damages.\(^\text{18}\) Out-of-pocket damages are inappropriate when tippees merely trade on inside information, the court reasoned, since such conduct does not amount to a fraud perpetrated directly upon the plaintiff.\(^\text{19}\) Moreover, the court recognized that the out-of-pocket formula could expose defendants to damages "out of all proportion to the wrong committed."\(^\text{20}\) The Elkind court also noted the difficulty of establishing one element of the out-of-pocket equation—the "value" that the stock would have had assuming full disclosure of the tipped information.\(^\text{21}\) Indeed, the court rejected two methods other courts have used to make this determination.\(^\text{22}\) The use of expert testimony to construct a "value line" was considered by the court to be "hypothetical" and "speculative."\(^\text{23}\) The alternative use of an actual post-disclosure market price as a nunc pro tunc indicator of pre-disclosure value also was rejected because it assumed "parity" between the content of the tip and public disclosure.\(^\text{24}\)

An alternative measure of recovery noted by the Elkind court would permit uninformed investors to recover any erosion in the market price of the stock which directly resulted from the tippees' wrongful conduct.\(^\text{25}\) Although this "causation-in-fact" approach has the advantage of limiting recovery to the damage actually caused by the defendant's activities, it was rejected by the Second Circuit because it imposes an impossible burden on plaintiffs to prove when, and the extent to which the integrity of the market breach of duty to disclose for which the court did not find the defendant liable. 472 F. Supp. at 131. In its amended opinion, the court relied upon the cover method used by the Tenth Circuit in Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 105 (10th Cir.), cert. denied, 404 U.S. 1004 (1971). The cover method consists of the difference between the purchase price and the lowest market price within a reasonable period after the investor should have become apprised of the facts. 472 F. Supp. at 132; see notes 40-41 and accompanying text infra.

\(^{18}\) 635 F.2d at 157.

\(^{19}\) Id. at 170. But see Harris v. American Inv. Co., 523 F.2d 220, 225-26 (8th Cir. 1975), cert. denied, 423 U.S. 1054 (1976).

\(^{20}\) 635 F.2d at 170.

\(^{21}\) Id.; see note 35 and accompanying text infra.

\(^{22}\) 635 F.2d at 170; see notes 36-39 and accompanying text infra.

\(^{23}\) 635 F.2d at 170.

\(^{24}\) Id. The Elkind court was skeptical whether the market would react similarly to disclosed information at two different times even in cases where there was parity between the content of the tip and the disclosure. Id.

\(^{25}\) 635 F.2d at 171.
was affected by the tippees’ conduct. Furthermore, the court stated, such an erosion in price could be considered an injury to the plaintiffs as shareholders, not purchasers, thus barring recovery under rule 10b-5.

Recognizing that all damage measures are somewhat imperfect, the Second Circuit held that successful private 10b-5 plaintiffs properly could recover any post-purchase decline in the market value of their shares, but limited such recovery to no more than the defendant’s gain. The court noted several advantages associated with this “disgorgement” approach. By making tippers and tippees liable for the amount gained as a result of their misconduct, the court noted that disgorgement would deter further insider trading while barring windfall recoveries. Additionally, the court stated that disgorgement avoids problems of proof since plaintiffs merely would have to establish the purchase price of their securities; the market price of the securities at a reasonable time after public disclosure, or after the plaintiffs learned of the tipped information, whichever occurred first; and the fact that reasonable persons would not have paid the purchase price had the tipped information been disclosed. Finally, the court concluded that in most cases the damages recoverable under a disgorgement standard would correspond to the injury caused by the tippees’ illegal conduct.

---

26 Id.
27 Id. (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952)). The Blue Chip Court held that shareholders who suffer losses in the value of their investment due to corporate insider activity concerning the purchase or sale of securities are barred from being plaintiffs in a rule 10b-5 action. 421 U.S. at 738. It is submitted that the Elkind plaintiffs, as purchasers during the period of nondisclosure, would be entitled to recovery under the causation-in-fact approach because it is merely a method of measuring loss and does not establish standing to sue. The Elkind court did not consider this to be a problem in defining disgorgement, a measure which uses a similar formulation. 635 F.2d at 172.
28 635 F.2d at 172.
29 Id.
30 Id. In holding that recovery should be based on the price of the security after the plaintiff learned of the inside information or after its public disclosure, whichever occurred first, it is submitted that the Elkind court reverses what should be the correct holding. Recovery should be based on the price when there is public disclosure or when the plaintiff discovers the information, whichever is later. ALI FED. SEC. CODE § 1703 (h)(1) (1980); 6 L. LOSS, SECURITIES REGULATION 1630 (2d ed. 1961); RESTATEMENT (SECOND) OF TORTS § 549, Comment c (1977). The only way a person could learn of the undisclosed information before public release probably would be through a tip. In such instances, the parties could subject themselves to possible liability if they tried to trade their shares.
31 635 F.2d at 172. The court stated that when tippees sell only a few shares, the likeli-
It is submitted that the disgorgement standard of damages used by the Second Circuit, while uniquely limiting liability, is similar in many respects to other damage measures. In adopting disgorgement, however, the Elkind court improperly may have dismissed such other measures. Additionally, because disgorgement focuses primarily on a defendant's gain rather than on a plaintiff's loss, it ignores the compensatory purpose of implied private 10b-5 actions and diminishes their deterrent effect. Nevertheless, by employing a disgorgement standard, the Second Circuit has addressed a troublesome element of other damage measures: the imposition of excessive liability upon defendants.

OTHER MEASURES OF RULE 10B-5 DAMAGES

When determining damages for rule 10b-5 violations involving insider trading in the open market, courts have relied on either the out-of-pocket or cover measures of damages. The out-of-pocket award is measured by the difference between the value of the thing bought, sold, or exchanged, and its purchase price. Borrowed from the common-law tort concept of fraudulent misrepresentation, the measure entitles a defrauded plaintiff to recover the actual loss sustained as a result of the defendants' wrongful conduct. In cases of fraudulent face-to-face transactions, the actual hood of substantial injury to uninformed outsiders is small. On the contrary, when tippees sell large amounts of stock realizing substantial profits, the likelihood of injury is large. This position is contrary to the causation-in-fact principle upon which liability for nondisclosure is based. See Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972).


value of the property can be determined by its market value on the date of the transaction.\textsuperscript{34} In the open market situation, however, the market price of a security will not reflect its actual value because the effect of undisclosed information will not be accounted for.\textsuperscript{35} Therefore, courts have fashioned two methods of calculating actual value. One method is to construct a value line showing the price the stock would have sold for on each day of the tipping period had the tipped information been disclosed.\textsuperscript{36} This involves the determination and elimination of various market and firm-specific factors unrelated to the tip in order to isolate the change in price attributable solely to the fraudulent activity.\textsuperscript{37} The second method uses the market price on the date the fraud is discovered as an indicator of the actual value of the stock on the day of the plaintiff's purchase.\textsuperscript{38} One court employing this nunc pro tunc approach stated that on such a date the market will reflect the true value of the stock unaffected by the defendant's fraud.\textsuperscript{39}


\textsuperscript{36} E.g., Huddleston v. Herman & MacLean, 640 F.2d 534, 556 (6th Cir. 1981); Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1344 (9th Cir. 1976) (Sneed, J., concurring).


The Elkind court rejected the value line as "hypothetical" and "speculative." In so doing, the court seemingly failed to consider the validity of the use of expert testimony to determine damages in other contexts. In wrongful death cases, for example, experts consistently have been called upon to determine both the decedent's life expectancy, through actuarial tables, and potential earnings, through the use of many intangible figures such as job performance and inflation. E.g., Perry v. Allegheny Airlines, Inc., 489 F.2d 1349, 1351 (2d Cir. 1974); Huddell v. Levin, 395 F. Supp. 64, 83 (D.N.J. 1975), vacated on other grounds, 537 F.2d 726 (3d Cir. 1976). Moreover, the use of expert testimony to determine potential corporate profits is an accepted practice in breach of contract for sale cases. E.g., Autowest, Inc. v. Peugeot, Inc., 494 F.2d 556, 555-56 (2d Cir. 1970); Liberman v. Nagel, 316 F.2d 214, 223 (6th Cir. 1963). It is submitted that the determination of the actual value of a security, which involves a similar analysis, is no more hypothetical and speculative, and could have been used in the Elkind case.

\textsuperscript{38} E.g., Harris v. American Inv. Co., 523 F.2d 220, 226 (8th Cir. 1975), cert. denied, 423 U.S. 1054 (1976); Richardson v. MacArthur, 451 F.2d 35, 43-44 (10th Cir. 1971); 3 A. Bromberg, supra note 6, § 9.1, at 228; Restatement (Second) of Torts § 549, Comment c (1977).

An alternate measure of damages has been referred to as the "cover" measure. Simply stated, this measure awards the defrauded purchaser the difference between his purchase price and the lowest price of the security within a reasonable time after the investor should have become aware of the true facts. The purpose of this award is to fix a date at which time a reasonable investor should become aware of his loss and be in a position to prevent further losses.

In defining disgorgement, the Elkind court retained several principles of both the out-of-pocket and cover measures. Thus, the Elkind disgorgement formula allows recovery for any post-purchase decline in the market price of a security within a reasonable time after full disclosure of tipped information. In this respect, disgorgement is similar to both the cover and out-of-pocket nunc pro tunc formulas. All three approaches set plaintiff's recovery at the difference between the price paid for securities and the price of such securities at some period after disclosure. The period after disclosure within which a price is to be selected and the criteria for determining such post-disclosure price, however, vary among the three approaches. With respect to determining a post-disclosure period, both the cover and disgorgement measures allow

It is suggested that although the Elkind court properly rejected the nunc pro tunc method of determining damages, it disregarded the principal deficiency with this approach. By failing to account for the numerous market variables, other than the tip, which could affect the price of the stocks during the period of nondisclosure, the nunc pro tunc valuation approach places the entire risk of loss in market price during this period on the defendants—a risk which the defendants neither caused nor assumed. Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1343 (9th Cir. 1976) (Sneed, J., concurring); Bonime v. Doyle, 416 F. Supp. 1372, 1385 (S.D.N.Y. 1976), aff'd, 556 F.2d 554 (2d Cir. 1977). The Elkind court noted that under disgorgement the defendants would assume the risk that "the market price may reflect disclosure of information more adverse than the tip and other adverse market conditions." 635 F.2d at 173 n.29.


41 Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 105 (10th Cir), cert. denied, 404 U.S. 1004 (1971); Esplin v. Hirschi, 402 F.2d 94, 104 (10th Cir. 1968), cert. denied, 394 U.S. 928 (1969). Upon learning of a fraud, the extent of the plaintiff's loss caused by the defendant becomes known to him. Therefore, any further loss would not be attributable to the wrongful conduct of the defendant. 446 F.2d at 105; 402 F.2d at 104-05.

42 635 F.2d at 172.

recovery for any post-purchase decline within a reasonable time after disclosure. The out-of-pocket nunc pro tunc measure, on the other hand, sets a price immediately upon disclosure. With respect to setting a post-disclosure price, both the out-of-pocket nunc pro tunc and disgorgement methods use the market price at the time disclosure is deemed to have occurred, whereas the cover measure uses the lowest market price within the post-disclosure period. Because of such differences, the recovery obtainable under these measures is inconsistent. For example, on July 17, the day of the tip in Elkind, Liggett stock closed at 55 1/4 on the New York Stock Exchange. Additionally, the price on July 19, the day of disclosure, was 46 3/4. Under the out-of-pocket nunc pro tunc measure, the award would be based on the difference between these prices. Because the tipped information was effectively, hence reasonably, disseminated on the same day as the public disclosure, the Elkind court also used a disclosure price of 46 3/4. The district court, ostensibly employing the cover award, however, used 43, the lowest price within 8 days after disclosure. The court considered such a period sufficient for a reasonable investor to become aware of the information. Although the actual difference which resulted in Elkind was insignificant, such would not necessa-

44 See 635 F.2d at 172 (disgorgement); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 105 (10th Cir.), cert. denied, 404 U.S. 1004 (1971) (cover).
45 See note 38 and accompanying text supra.
47 635 F.2d at 173.
48 Id.
49 Id. In the initial decision in the district court, wherein a value line method was applied, see notes 36-37 and accompanying text supra, the actual value of stock purchased by plaintiffs was found to be $41. 472 F. Supp. at 129. This finding had to be rejected, however, because it was based on counts for which the court subsequently found no liability. Id. at 131.
50 635 F.2d at 173. Although the price differential obtained under the out-of-pocket or disgorgement tests may be identical, it bears repeating that the total damages recoverable probably will differ. Thus, under the out-of-pocket formula, damages will be calculated by multiplying the price differential times the number of shares purchased by the plaintiffs. Under the disgorgement formula, however, damages will be determined by multiplying the price differential times the number of shares traded by the defendants.
51 472 F. Supp. at 133.
52 Id. In Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), cert. denied, 404 U.S. 1004 (1971), the Tenth Circuit allowed 9 trading days as a reasonable time to discover the fraud, overruling the 17 days allowed by the district court. 446 F.2d at 105.
rily be true in all instances. Indeed, in cases where tipped information is not quickly publicized, or where the stock market experiences substantial fluctuation after disclosure, the difference could be considerable. Therefore, it is submitted that, if a post-disclosure price is to be used, selection of an average price within a reasonable period after disclosure may be the most equitable solution.

PURPOSES OF PRIVATE IMPLIED RULE 10B-5 ACTIONS

It is submitted that the Elkind disgorgement measure disregards the compensatory purpose and undermines the deterrent value of private 10b-5 causes of action. Typically, when courts have implied a cause of action for violation of a statute, the purpose of such implication has been to compensate those persons injured by the behavior in derogation of the statute. To the extent that the Elkind disgorgement measure lessens the relationship between the plaintiffs' loss and the damages imposed, however, it ignores any compensatory objective. Since, as in Elkind, disgorgement while possibly being a deterrent, but see notes 56-59 and accompanying text infra, generally will be insufficient to compensate those injured by the defendants' misconduct. See Rapp, supra note 16, at 91-92; Note, Rule 10b-5 Damages: The Runaway Development of a Common Law Remedy, 28 U. Fla. L. Rev. 76, 79 (1975). Rule 10b-5 could not have real significance as a protective device without a private right of enforcement which is compensatory in nature. Rapp, supra note 16, at 91.

53 Under the facts in Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), cert. denied, 404 U.S. 1004 (1971), the difference which would result from the use of alternative damage valuation measures is significant. The average price of the stock on the date the public became aware of the disclosure was $42.75. Using the highest price during the reasonable reinvestment period, however, the Tenth Circuit based its recovery on a price of $59 per share. See Note, Securities Regulation — Damages for SEC Rule 10b-5 Violations — The Measure of Damages Caused by False and Misleading Statements is the Difference Between the Plaintiff's Selling Price and the Highest Daily Price Attained During a Reasonable Reinvestment Period, Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir. 1971), 49 Tex. L. Rev. 1141, 1144-45 nn.15-17 (1971).


55 Dooley, supra note 32, at 21-22. In the Dooley article, written before the Second Circuit's opinion in Elkind, the author indicated that the circuit's opinion in Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974), left open the possibility that a "court would be free to find that defendants' violation had caused one kind of injury (the open market purchasers investment losses) and to award damages based on a wholly unrelated theory (forfeiture of profits)." Dooley, supra note 32, at 21-22. In Shapiro the court stated that gain is an element to be considered in determining the appropriate relief. 495 F.2d at 242. Cf. Coffee v. Permian Corp., 474 F.2d 1040, 1043 (5th Cir.), cert. denied, 412 U.S. 920 (1973) (gain may be considered in determining liability).

Disgorgement, while possibly being a deterrent, but see notes 56-59 and accompanying text infra, generally will be insufficient to compensate those injured by the defendants' misconduct. See Rapp, supra note 16, at 91-92; Note, Rule 10b-5 Damages: The Runaway Development of a Common Law Remedy, 28 U. Fla. L. Rev. 76, 79 (1975). Rule 10b-5 could not have real significance as a protective device without a private right of enforcement which is compensatory in nature. Rapp, supra note 16, at 91.
ment may result in damages grossly inadequate to compensate plaintiffs, the effect will be to render such actions unattractive to potential plaintiffs. Moreover, since gain has not been considered a prerequisite to liability, it is inconsistent to consider it a prerequisite to recovery. Indeed, the practical effect is that, without gain, a finding of liability would become a Pyrrhic victory. The real inquiry, therefore, should focus upon the damages incurred by the plaintiff.

Although the Elkind court suggested that the disgorgement measure would be an effective deterrent to insider trading, it is submitted that its deterrent effect is questionable because it fails to promote two principal means of deterrence: the likelihood of incurring liability and the threat of severe punishment once liability is imposed. The likelihood of incurring liability merely on the strength of private implied 10b-5 actions had been minimal even before disgorgement due to the difficulty and expense involved in proving liability. Disgorgement, of course, does not ameliorate these problems. Moreover, because the threat of severe punishment is lessened by the damage-limiting aspect of disgorgement, it is submitted that disgorgement will not serve to restrain insider trading.

---


67 635 F.2d at 172. The Securities and Exchange Commission consistently has maintained that disgorgement is an effective deterrent to insider trading. Ellsworth, Disgorgement in Securities Fraud Actions Brought By the SEC, 1977 DUKE L.J. 641, 649. Ellsworth suggests, however, that the Commission's position in this respect may be based on its desire to "dispel the notion" that the Commission is bringing the action to redress private investors. Id.


70 See Dooley, supra note 32, at 22-26.


1981]

INSIDER TRADING

THE ADVANTAGES OF LIMITING LIABILITY

Viewed in the context of the current trend in 10b-5 jurisprudence, the Elkind disgorgement measure may represent a welcome middle ground between the purposes of the rule and the effect of implied private actions. The potential effect of the expansion of civil liability to the area of insider trading in the open market is massive liability. Such an effect has led courts and commentators to devise methods which would limit a defendant's liability. Indeed, one court, reasoning that insider trading would not injure persons buying and selling on the open market, absolved the defendants in a case factually indistinguishable from Elkind. By shielding defendants from excessive liability, the Second Circuit's disgorgement measure is a less drastic attempt to limit plaintiff recoveries. Furthermore, it appears that excessive liability is responsible, in part, for the recent trend by the Supreme Court to curtail the expansion of private rights of action under rule 10b-5 and circumscribe the rights of plaintiffs. No attempt has yet been

61 "[T]he possibility that damages may be dramatic in amount may be the most important factor in determining whether liability should be imposed at all.” Ruder, Texas Gulf Sulphur — The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases, 63 Nw. U.L. Rev. 423, 427 (1968). See note 62 and accompanying text infra.

62 Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977). The Sixth Circuit held that insider trading on the open market does not cause injury to other persons. 542 F.2d at 323. The court held that the causation-in-fact test defined by the Supreme Court in Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972), was limited to cases where the defendants' conduct directly induced the plaintiffs to trade. 542 F.2d at 320. The motivating factor behind this decision seems to be the court's unwillingness to impose unlimited damages on the defendants. Id. at 320-21.

63 Lowenfels, Recent Supreme Court Decisions Under The Federal Securities Laws: The Pendulum Swings, 65 Geo. L. Rev. 891, 892 (1977). In four recent cases, the Supreme Court, relying solely on the language and legislative history of section 10b and rule 10b-5, has severely curtailed the use of rule 10b-5 as a private remedy. In Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), the Court held that an action under rule 10b-5 does not lie in the absence of scienter on the part of the defendant. Id. at 193. This case overruled earlier circuit court cases which had held that negligence was sufficient. E.g., White v. Abrams, 495 F.2d 724, 730 (9th Cir. 1974); Myzel v. Fields, 386 F.2d 718, 734-35 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968); Kohler v. Kohler Co., 319 F.2d 634, 637 (7th Cir. 1963). In Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), the Court held that offerees who were discouraged from purchasing securities by an overly pessimistic prospectus had no standing to bring an action under rule 10b-5. Id. at 727, 751-52. Instead, the Court held, the plaintiff class was limited to purchasers and sellers. Id. at 749; see note 26 and accompanying text supra. In Sante Fe Indus., Inc. v. Green, 430 U.S. 462 (1977), the Court narrowed further the construction of rule 10b-5, holding that fraudulent conduct alone, absent a misrepresentation or nondisclosure, is insufficient to maintain a cause of action under the rule. Id. at 470-72. Lastly, in Chiarella v. United States, 445 U.S. 222 (1980), the Court held that the disclose or abstain rule does not apply absent a fiduciary
made to eliminate implied private 10b-5 actions on the basis of excessive imposition of damages. Nevertheless, the Court's view of implied causes of action generally has narrowed, allowing them only when a specific intent on the part of Congress to create such a remedy can be discerned.\(^4\) Since such evidence of intent is scarce with respect to rule 10b-5,\(^5\) disgorgement properly removes the irritant of "draconian" damages, an irritant which might otherwise prompt the Supreme Court to dismiss the private 10b-5 cause of action.

**Conclusion**

Prior to adopting a disgorgement measure of damages, the relationship between the parties. \textit{Id.} at 233-35.

Taken together, these cases may represent the beginning of the end of the private right of action under rule 10b-5, "a judicial oak which has grown from little more than a legislative acorn," 421 U.S. at 737, because the Court may soon begin to look at the legislative intent of the rule itself to see if a cause of action was ever intended. See notes 64-65 and accompanying text infra.

\(^4\) Touche Ross & Co. v. Redington, 442 U.S. 560, 575-76 (1979). In Cort v. Ash, 422 U.S. 66, 78 (1975), the Court outlined a four-part test to be used to determine whether a cause of action could be implied from a statute:

- First, is the plaintiff 'one of a class for whose especial benefit the statute was enacted?' . . . Second, is there any indication of legislative intent . . . to create such a remedy or to deny one? . . . Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy? . . . [F]inally, is the cause of action one traditionally relegated to state law . . . so that it would be inappropriate to infer a cause of action based solely on federal law? \textit{Id.} (emphasis in original) (citations omitted).

Recently in Touche Ross, however, the Court narrowed this test, stating that all \textit{Cort} factors were not necessarily to be given equal weight. 442 U.S. at 575. Instead, the "central inquiry" must be "whether Congress intended to create, either expressly or by implication, a private cause of action." \textit{Id.} The Court suggested that the other three elements of the \textit{Cort} test were relevant to the issue of intent. \textit{Id.} at 575-76. See generally Note, \textit{The Suitability Rule: Should a Private Right of Action Exist?} 55 \textit{St. John's L. Rev.} 493 (1981). Although it seemed doubtful that civil liability under rule 10b-5 would be able to withstand this analysis, recently in Wachovia Bank & Trust Co. v. National Student Marketing Corp., 650 F.2d 342 (D.C. Cir. 1981), the court applied the \textit{Cort} test and concluded that an implied cause of action did exist. \textit{Id.} at 351-54. The court, however, did not find that Congress specifically intended to create such a remedy. \textit{Id.} at 352. Instead, the court based its decision on the fact that there was no indication that Congress "meant" to deny one. \textit{Id.} at 352. This is contrary to recent pronouncements by the Supreme Court on this subject. Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 24 (1979) ("[t]he dispositive question remains whether Congress intended to create any such [private] remedy").

\(^5\) The Supreme Court has stated that rule 10b-5 "does not by its terms create an express civil remedy for its violation, and there is no indication that Congress, or the commission . . . contemplated such a remedy." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 196 (1976); Ruder, \textit{Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?}, 57 \textit{Nw. U. L. Rev.} 627, 642-43 (1963).
Elkind court carefully considered the practical consequences of other damage measures used by the courts to assess private plaintiff recoveries under rule 10b-5. Nonetheless, it is suggested that the court improperly focused upon the excessive damages potentially wrought by implied private 10b-5 causes of action. Predicated upon such a focus, disgorgement ultimately may harm the investing public because it eliminates much of the incentive for private 10b-5 actions, thereby removing the most serious threat to insiders contemplating the misuse of inside information.

William K. Sanders