Measuring Damages for Fraud-Based Mismanagement of a Securities Portfolio

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Measuring damages in cases of portfolio mismanagement can be a tricky job for securities litigators. Noting that the federal securities laws fail to provide any set measure of damages for fraud-based mismanagement of a portfolio, the author suggests an "alternative investment" model for these types of damages. After providing an overview of the basic measures of damages for a Section 10(b) violation, the author discusses the claims that arise from portfolio mismanagement and examines case law measuring damages for portfolio mismanagement. Finally, the author describes an "alternative investment" model and illustrates its application in this situation.

Introduction

Securities fraud comes in many forms. One "form" involves improper conduct related to managing an investor's portfolio of securities. In the now too-frequent case, an investor puts substantial capital into a portfolio of securities, allowing a broker to recommend transactions, trade securities, and generally manage the portfolio. After some period of time, the investor finds that his portfolio has lost money, or at least has not done nearly as well as was reasonably expected, given general market conditions. As it turns out, the broker traded the portfolio excessively, recommended (and possibly even acquired) securities that were not appropriate for the investor, and may have otherwise deceived the investor about

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the nature and performance of his investments. Having acted improperly, and in violation of the basic anti-fraud provisions of the securities laws, the broker is liable to the investor for the resulting harm.

But proving liability is only half the battle—to be recompensed for the harm caused, the investor must also prove his damages. Doing so is often no easy task under the federal securities laws. While the investor's typical remedy is a private suit under Section 10(b) of the Securities Exchange Act of 1934[1] and its regulatory companion Rule 10b-5,[2] there is no set measure of damages under those provisions. Furthermore, portfolio investment poses particular and often unique circumstances that bear upon measuring the investor's damages when the portfolio has been fraudulently mismanaged. Not surprisingly, given the already uncertain state of the law for measuring Section 10(b) damages, together with the nature of portfolio investment itself, the existing case law falls short of carefully measuring damages for fraudulent portfolio mismanagement.

This article presents a way to measure portfolio mismanagement damages. The fundamental goal of that measure is to compensate the defrauded investor for what he would have earned from his capital, had his capital been invested soundly and his portfolio managed properly. This means, among other necessary steps to an accurate determination, that deposits and withdrawals of capital must be accounted for carefully, that the return on securities appropriate for the investor must be considered, and that market changes over the period of the wrongdoing must be factored into determining the loss. This article describes a model for measuring portfolio mismanagement damages that includes these elements and is tailored to the nature of portfolio investment.

The first part briefly surveys the basic measures of damages for a Section 10(b) violation, noting the uncertainty that still pervades the damages issue. Part two discusses the nature of portfolio investment, describing the particularities inherent in that kind of securities activity, addressing the nature of the claims that typically arise from portfolio mismanagement, and illustrating the damages considerations that prevail in a portfolio mismanagement situation. The third part analyzes the existing cases that measure damages for portfolio mismanagement, highlighting problems in the courts' opinions.

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[1] 15 U.S.C. § 78j(b).

[2] 17 C.F.R. § 240.10b-5.

Finally, this article presents a more refined approach for measuring damages for fraudulent portfolio mismanagement—an "alternative investment" model—and illustrates application of the model itself. The ultimate goal is to offer an approach that litigants, courts, juries, and arbitrators can use to measure damages in a case of fraudulent portfolio mismanagement that is solidly based on Section 10(b) damages principles and on core financial concepts—and that also can be presented and proven reasonably simply in portfolio mismanagement litigation.

The Basic Damages Measures

Civil liability under Section 10(b), and the consequent recovery of damages, is based on an *implied* private right of action.[3] As such, neither Section 10(b) nor Rule 10b-5 specifies a measure of damages when a private plaintiff proves a violation.

Indeed, the only statutory guide for determining damages for private-right-of-action civil liability under the Securities Exchange Act of 1934 is Section 28(a). That section provides that a plaintiff suing under the Exchange Act may not recover "a total amount in excess of his *actual damages* on account of the act complained of."[4] The Supreme Court has "clearly interpreted § 28(a) as governing the measure of damages that are the permissible under § 10(b)."[5] However, Section 28(a) does not delineate the meaning of "actual damages."[6] Accordingly, the federal courts have developed damages calculations based on common law principles, primarily those from the torts of fraud, deceit, and misrepresentation.[7]

Lacking a statutory formula, the measure of damages for securi-

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[3]See e.g., Basic Inc. v. Levinson, 485 U.S. 224, 230–31 (1988); Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), cert. denied, 404 U.S. 1004 (1971); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa 1946).

[4]15 U.S.C. § 78bb(a) (emphasis added).

[5]Randall v. Loftsgaarden, 478 U.S. 647, 663 (1986) (citing Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972)).

[6]Id. at 662.

[7]See, e.g., Harris v. American Inv. Co., 523 F.2d 220, 224–25 (8th Cir. 1975), cert. denied, 423 U.S. 1054 (1976); Mitchell v. Texas Gulf Sulfur Co., 446 F.2d 90, 97 (10th Cir.), cert. denied, 404 U.S. 1004 (1971); see generally Louis Loss & Joel Seligman, *Fundamentals of Securities Regulation* at 750–51 (3d ed. 1995).

ties fraud under Section 10(b) remains unsettled and even confused.[8] Given the diversity of circumstances that arise, there is no general rule for calculating damages under Section 10(b). Essentially, an ad hoc approach, which seeks to compensate a plaintiff for his loss without burdening a defendant with unlimited liability, prevails. Nonetheless, categorizing the dominant damages measures from the caselaw clarifies the meaning of actual damages compensable for a Section 10(b) violation—as well as the kind of damages that should be recovered for fraudulent portfolio mismanagement.[9]

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[8]As one commentator has noted recently:

> The measure of recovery in a Rule 10b-5 action always has been confusing. . . . In those cases where the courts have been forced to state a measure, they have provided a bewildering mix of standards, often using the same terms, but frequently giving them radically different interpretations and doing little to resolve the inconsistencies. For those cases that made it to the end, judges seemed more partial to providing rough justice than to establishing a clean theoretical formula for recovery.

Robert B. Thompson, " 'Simplicity and Certainty' in the Measure of Recovery Under Rule 10b-5," 51 Bus. Law. 1177, 1179 (1996) (footnote omitted).

[9]The following discussion briefly summarizes important damages measures to provide a general framework for understanding and measuring damages for Section 10(b) claims grounded in fraudulent portfolio mismanagement. As noted, there have long been, and still remain, considerable uncertainties, discrepancies and confusion among the cases in measuring Section 10(b) damages (as well as even in the nomenclature courts apply to their analyses). Indeed, Professor Loss suggests that there is a general damages rule which is qualified by twelve "voracious exceptions." Loss & Seligman, supra note 7, at 1061–69. Another leading commentator similarly delineates numerous different measures of damages, often depending on the kind of transaction in issue, for Section 10(b) securities fraud. 5C Arnold S. Jacobs, *Litigation and Practice Under Rule 10b-5* § 260.03, at 11-18 to 11-187 (1998). Measuring Section 10(b) damages has, accordingly, received considerable academic attention over the years. See, e.g., Robert B. Thompson, "The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages," 37 Van. L. Rev. 349 (1984); Thomas J. Mullaney, "Theories of Measuring Damages in Security Cases and the Effects of Damages on Liability," 46 Fordham L. Rev. 277 (1977); Arnold S. Jacobs, "The Measure of Damages in Rule 10b-5 Cases," 65 Geo. L.J. 1093 (1977); Barry Reder, "Measuring Damages in 10b-5 Cases," 31 Bus. Law. 1839 (1975); Philip J. Leas, Note, "The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities," 26 Stan. L. Dev. 371 (1974); Ronald B. Lee, Comment, "The Measure of Damages Under Section 10(b) and Rule 10b-5," 46 Md. L. Rev. 1266 (1987); Tracey A. Miner, Note, "Measuring Damages In Suitability and Churning Actions Under Rule 10b-5," 25 B.C. L. Rev. 839 (1984); see also Thompson,

The "Out-Of-Pocket" Measure

The courts have often held that an "out-of-pocket" rule is the generally appropriate measure of damages for a violation of Section 10(b).[10] This rule defines actual damages as:

> [T]he difference between the contract price, or the price paid, and the real or actual value at the date of the sale, together with such outlays as are attributable to the defendant's conduct. Or in other words, the difference between the amount parted with and the value of the thing received.[11]

More specifically, for a *defrauded seller*, the out-of-pocket measure calculates damages as the fair value of the security the seller sold *minus* the fair value of the compensation he received. For a *defrauded buyer*, this measure calculates damages as the fair value

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supra note 8 (focusing on damages cap for certain Rule 10b-5 cases prescribed under 1995 amendments to securities law).

Detailed discussion of the various types of damages measures, and of the uncertainties that pervade the damages measurement issues, is not necessary for this article. It bears emphasizing, however, that overarching most of the issues concerning Section 10(b) damages, regardless of the particular formula used or its name, is whether valuation of the security in issue is determined as of the time the fraudulent transaction occurred or as of some date afterwards—that is, whether post-transaction events, such as market performance and a wrongdoer's subsequent benefits, are taken into account and, if so, how. As addressed below, this important element for calculating damages arises in portfolio mismanagement cases.

[10]See Randall v. Loftsgaarden, 478 U.S. 647, 661–62 (1986); id. at 668 (Blackmun, J., concurring) ("Normally . . . the proper measure of damages in a § 10(b) case is an investor's out-of-pocket loss. . . . "); Kronfeld v. Advest, Inc., 675 F. Supp. 1449, 1455 (S.D.N.Y. 1987) ("Generally, a plaintiff's damages in an action under Rule 10b-5 are determined by using an 'out-of-pocket' measure.") (citing cases); see also Blackie v. Barrack, 524 F.2d 891, 909 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976); Harris v. American Inv. Co., 523 F.2d 220, 225 (8th Cir. 1975), cert. denied, 423 U.S. 1054 (1976); Madigan, Inc. v. Goodman, 498 F.2d 233, 239 (7th Cir. 1974); Wolf v. Frank, 477 F.2d 467, 478 (5th Cir.), cert. denied, 414 U.S. 975 (1973); Fershtman v. Schectman, 450 F.2d 1357, 1361 (2d Cir. 1971), cert. denied, 405 U.S. 1066 (1972).

[11]Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527, 533 (10th Cir. 1962); see Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972) ("the correct measure of damages under § 28 . . . is the difference between the fair value of all that the . . . seller received and the fair value of what he would have received had there been no fraudulent conduct").

of the consideration the buyer paid for the security *minus* the fair value of the security he bought.[12]

The out-of-pocket rule is designed to make a defrauded plaintiff whole for losses without awarding him any profits he might have expected from the transaction. Thus, "[t]his measure of damages is purely compensatory, and it focuses on the plaintiff's actual loss, rather than on his potential gain."[13] Stated differently, the out-of-pocket measure permits a plaintiff to recover only for actual net losses—and net losses can never include deprivations of a potential gain.

The out-of-pocket measure of damages for a Section 10(b) violation derives from the common law remedy for deceit.[14] New York's traditional rule of damages for common law fraud is illustrative: "The basic principle underlying all rules for the measurement of damages in actions for fraud and deceit is indemnity for the actual pecuniary loss sustained as the direct result of the wrong."[15]

While the out-of-pocket measure has been used frequently, given the complexities of securities transactions, the courts have adopted numerous approaches for measuring damages in securities fraud cases which use variations of the basic fraud damages principle. As a leading authority has explained:

> Section 10(b) and Rule 10b-5 specify no damage or rescission standards, prompting the courts to take an *ad hoc* approach that often uses the common law out-of-pocket measure as an initial reference point and allows appellate courts to exercise "the

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[12]See Jacobs, supra note 9, § 260.03[c][ii], at 11–36. The general formula of out-of-pocket damages measures these values at the time of the transaction in issue. As addressed below, this temporal factor is modified for measuring damages under another often-used rule and for portfolio mismanagement.

[13]DCD Programs, Ltd. v. Leighton, 90 F.3d 1442, 1447 (9th Cir. 1996).

[14]See, e.g., Sigafus v. Porter, 179 U.S. 116 (1900); Smith v. Bolles, 132 U.S. 125 (1889); see also *Restatement of the Law of Torts 2d* § 549 (1976).

[15]Urtz v. New York Central & Hudson River R.R., 202 N.Y. 170, 174–75, 95 N.E. 711, 712 (1911); see, e.g., Dress Shirt Sales, Inc. v. Hotel Martinique Assocs., 12 N.Y.2d 339, 343, 239 N.Y.S.2d 660, 663 (1963) ("in an action for damages for fraud actual pecuniary loss must be shown"); Reno v. Bull, 226 N.Y. 546, 553, 124 N.E. 144, 146 (1919) ("The true measure of damage [in an action for deceit] is indemnity for the actual pecuniary loss sustained as the direct result of the wrong."). The New York common-law rule, however, differs from that of most jurisdictions. See, e.g., Jacobs, supra note 9, § 260.03 [c][v], at 11-66.3, n.2; n.35 below.

discretion traditionally left to the trial courts in finding damages appropriate to the facts of the case." [16]

Thus, while it is sometimes said that "[t]he traditional measure of damages in 10b-5 actions is the out-of-pocket measure,"[17] various measures are used in light of a case's particular facts and circumstances. Two of the more pertinent measures are addressed below.

The "Rescission" Measure

One important variant of the out-of-pocket measure is a rescission (or rescissory) measure of damages. The premise underlying rescission damages is that a defrauded plaintiff is entitled to rescind the improper transaction and (theoretically) obtain specific restitution of the consideration given, but that since specific restitution is impossible or impracticable under the particular circumstances, a financial equivalent is awarded instead.[18] Rescission damages usually are allowed only where plaintiff and defendant have a contractual relationship.[19]

The general formula for calculating the rescission measure of damages is essentially the same as the formula for calculating out-of-pocket damages: the Section 10(b) plaintiff can recover the difference between the price paid and the actual value. The functional distinction between the two measures is the date used for determining the actual value of the securities. If actual value is calculated as

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[16]Loss & Seligman, supra note 7, at 1060 (footnote omitted).

[17]Jacobs, supra note 9, § 260.03[c][ii], at 11–34; see Loss & Seligman, supra note 7, at 1061.

[18]"Rescission" itself is the act of voiding a legal relationship or a transaction; it is a kind of relief for a wrong (as is damages). "Restitution" is the relief of exchanging property based on defendant's unjust enrichment. The rescission measure of damages (or "rescissional damages") is a damages formula derived from the concept of rescission/restitution. See Jacobs, supra note 9, § 260.03 [c][vi], at 11-67 to 11-69.

[19]See Huddleston v. Herman & MacLean, 640 F.2d 534, 554 (5th Cir. Unit A, Mar. 1981) ("Use of the rescissional measure is usually limited to cases involving either privity between plaintiff and defendant or some specific fiduciary duty owed by brokers to their customers."), aff'd in part, rev'd in part on other grounds, 459 U.S. 375 (1983). But see Gordon v. Burr, 506 F.2d 1080, 1083–84 (2d Cir. 1974) (actual rescission for securities fraud does not require privity); Andrew L. Merritt, "A Consistent Model of Loss Causation in Securities Fraud Litigation: Suiting the Remedy to the Wrong," 66 Tx. L. Rev. 469, 510–15 (1988) (arguing that privity should not be required for rescission damages).

of the date of the transaction, the measure of damages is out-of-pocket. If the actual value is calculated at some post-transaction date, the measure of damages can be thought of as rescissory.

It is the nature of securities trading that, at times, requires a court to use a post-transaction valuation to compensate a defrauded party fully. For example, in *Myzel v. Fields*,[20] the court recognized that the out-of-pocket theory properly measures damages in fraud and deceit cases, but that "where fungibles such as corporate stock have no ready market value and actually fluctuate in value, different measures or modified versions of the same theory become more appropriate."[21] Rescission damages can be thought to involve a constructive "tender" of the shares, or "return" of the consideration given originally, as of a post-transaction date. The most common post-transaction valuation date is the actual or constructive discovery of the fraud.[22]

The rescission measure of damages, therefore, is designed to permit a defrauded plaintiff, usually a seller, to recover subsequent accretions in value of the security traded. This measure thereby permits a plaintiff to recover lost profits. And it enables a defrauded plaintiff to shift the market risks to the defendant.

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[20]386 F.2d 718 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968).

[21]Id. at 745.

[22]See Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 651 F.2d 615, 620 (9th Cir. 1981) ("Plaintiffs' damages in a 10b-5 case are limited by what they would have realized had they acted to preserve their assets or rights when they first learned of the fraud or had reason to know of it."); Esplin v. Hirschi, 402 F.2d 94, 105 (10th Cir. 1968) ("the defrauded buyer is entitled to recover the difference between the price paid for the securities. . . and the value of the securities determined as of the time of the discovery of the fraud"), cert. denied, 394 U.S. 928 (1969). Use of a discovery-of-the-fraud date is driven by causation and mitigation principles—that is, that a defendant should not be liable for the part of a plaintiff's loss "caused by [plaintiff's] own failure, once [he] had reason to know of the wrongdoing, to take reasonable steps to avoid further harm." *Arrington*, 651 F.2d at 620. In certain circumstances, such as market transactions, discovery may be pegged to the date the *general public* knows of the fraud and has revalued the security to account for this knowledge. See Harris v. American Inv. Co., 523 F.2d 220 (8th Cir. 1975), cert. denied, 423 U.S. 1054 (1976); see also Richardson v. MacArthur, 451 F.2d 35, 43–45 (10th Cir. 1971) ("when the existence of fraud became or should have become known"). Various other post-transaction dates for valuation are possible: the date suit is filed; the date trial commences; or the date of judgment. A calculation based on the date of judgment has been characterized as "pure rescission," because this valuation "assume[s] that the plaintiff retained his stake in the issuer." Reder, supra note 9, at 1842.

In *Affiliated Ute Citizens v. United States*,[23] the Supreme Court endorsed the rescission measure of damages where the out-of-pocket measure was inadequate to compensate a defrauded plaintiff fully. The Court stated:

> In our view, the correct measure of damages under § 28 of the Act. . . is the difference between the fair value of all that the [plaintiff] received and the fair value of what he would have received had there been no fraudulent conduct. . . *except for the situation where the defendant received more than the seller's actual loss. In the latter case damages are the amount of the defendant's profit.*[24]

The *Affiliated Ute* Court therefore allowed plaintiff to recover the profits which accrued to defendant resulting from defendant's violation of Section 10(b).

A leading older case for the application of a rescissory-type measure of damages is *Janigan v. Taylor*.[25] In *Janigan*, defendant director bought plaintiff shareholders' stock after he misrepresented to plaintiffs the company's condition. Subsequent to the sale, the value of the stock greatly increased. The court permitted plaintiffs to recover the profit that accrued to defendant, even though that profit was unforeseeable. The court reasoned:

> [I]f the property is not bought from, but sold to the fraudulent party, future accretions not foreseeable at the time of the transfer even on the true facts, and hence speculative, are subject to another factor, viz., that they accrued to the fraudulent party. It may, as in the case at bar, be entirely speculative whether, had plaintiffs not sold, the series of fortunate occurrences would have happened in the same way, and to their same profit. However, there can be no speculation but that the defendant actually made the profit and, once it is found that he acquired the property by fraud, that the profit was the proximate consequence of the fraud, whether foreseeable or not. It is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them.[26]

The court, primarily for equitable reasons, thus permitted the defrauded sellers to recover the profits they might have realized but for defendant's fraud. For this reason, *Janigan* is sometimes

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[23]406 U.S. 128 (1972).

[24]Id. at 155 (citation omitted) (emphasis added).

[25]344 F.2d 781 (1st Cir.), cert. denied, 382 U.S. 879 (1965).

[26]Id. at 786.

characterized as prescribing a rescission-type measure of damages referred to as "windfall profits."[27]

Additionally, the rescission measure of damages has been expanded to permit a defrauded *buyer*, not only a defrauded seller, to recover windfall profits inuring to the other party. For example, in *Zeller v. Bogue Electric Manufacturing Corp.*,[28] the Second Circuit stated: "The reason why the remedy has been applied for the benefit of defrauded sellers but not of buyers is not any decisive legal difference but the difficulty generally confronting the defrauded buyer in showing that the fraudulent seller has in fact reaped such a profit."[29] The *Zeller* court, although noting the substantial proof problems a plaintiff must confront,[30] thereby permitted a defrauded buyer to recover profit accruing to a seller, provided that the buyer could prove such profit.

Despite numerous lower court cases, the Supreme Court has not unequivocally endorsed the rescission measure of damages. Indeed, while emphasizing that there is authority for allowing a plaintiff in some circumstances to elect either an out-of-pocket or rescissory measure of damages,[31] the Court stated that "[t]he issue whether and under what circumstances" rescissory damages are available under Section 10(b) "is an unsettled one."[32] Notwithstanding the Supreme Court's more recently stated uncertainty, the courts of appeals have long accepted the rescission measure.[33]

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[27]See, e.g., Thompson, supra note 9, at 370–72; Lee, supra note 9, at 1287.

[28]476 F.2d 795 (2d Cir.), cert. denied, 414 U.S. 908 (1973).

[29]Id. at 802 (footnote omitted).

[30]Id. at 803.

[31]Randall v. Loftsgaarden, 478 U.S. 647, 662 (1986); see DCD Programs Ltd. v. Leighton, 90 F.3d 1442, 1446 (9th Cir. 1996).

[32]*Randall*, 478 U.S. at 661.

[33]For other cases discussing or applying a rescissory measure of damages, see Stone v. Kirk, 8 F.3d 1079, 1092 (6th Cir. 1993); Arthur Young & Co. v. Reves, 937 F.2d 1310, 1335–37 (8th Cir. 1991), aff'd on other grounds, 507 U.S. 170 (1993); Bruschi v. Brown, 876 F.2d 1526, 1532 (11th Cir. 1989); Nelson v. Serwold, 576 F.2d 1332, 1338–40 (9th Cir.), cert. denied, 439 U.S. 970 (1978); Thomas v. Duralite Co., 524 F.2d 577, 586 (3d Cir. 1975); Blackie v. Barrack, 524 F.2d 891, 909 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976); Foster v. Financial Tech., Inc., 517 F.2d 1068, 1071 (9th Cir. 1975); Madigan, Inc. v. Goodman, 498 F.2d 233, 238–40 (7th Cir. 1974); Ohio Drill & Tool Co. v. Johnson, 498 F.2d 186, 190–91 (6th Cir. 1974); Levine v. Seilon, Inc., 439 F.2d 328, 334–35 (2d Cir. 1971); Baumel v. Rosen, 412 F.2d

The "Benefit-of-the-Bargain" Measure

Yet another measure of damages sometimes addressed in Section 10(b) cases is the "benefit of the bargain." By this measure, a plaintiff may recover the difference between the value of what he received and *what it was represented he would receive*.[34] It is thus a contract-like expectation measure. Until relatively recently, this measure of damages generally was disfavored in Section 10(b) cases.[35] More recently, however, cases have held that under some circumstances a securities fraud plaintiff can be entitled to recover on a benefit-of-the-bargain theory, particularly where this measure can be determined with reasonable certainty.[36]

For example, in discussing the "actual damages" limitation under Section 28(a), the Second Circuit in *Osofsky v. Zipf* stated:

> [W]e do not believe that [the section's] overall intent is to restrict the forms of nonspeculative, compensatory damages available to defrauded parties. . . . [W]e believe that the purpose of section 28(a) is to compensate civil plaintiffs for economic loss suffered as a result of wrongs committed in violation of the [Exchange] Act, whether the measure of those compensatory damages be out-of-pocket loss, the benefit of the bargain, or some other appropriate standard.[37]

The *Osofsky* court upheld benefit-of-the-bargain damages under Section 10(b) in a tender offer context. Since *Osofsky*, the Second

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571, 575 (4th Cir. 1969), cert. denied, 396 U.S. 1037 (1970); Myzel v. Fields, 386 F.2d 718, 745–49 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968); see also Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1341–46 (9th Cir. 1976) (Sneed, J., concurring); Loss & Seligman, supra note 7, at 1060–61; cf. Capital Inv., Inc. v. Bank of Sturgeon Bay, 430 F. Supp. 534, 537 (E.D. Wis. 1977), aff'd without op., 577 F.2d 745 (7th Cir. 1978).

[34]See Osofsky v. Zipf, 645 F.2d 107, 111, 114 (2d Cir. 1981).

[35]See, e.g., Levine v. Seilon, Inc., 439 F.2d 328, 334 (2d Cir. 1971) (Friendly, J.) ("a defrauded buyer of securities is entitled to recover only the excess of what he paid over the value of what he got, not . . . the difference between the value of what he got and what it was represented he would be getting"); see also Smith v. Bolles, 132 U.S. 125, 129 (1889) ("The measure of damages [for fraud is] not the difference between the contract price and the reasonable market value if the property had been as represented to be. . . . "). However, the Second Circuit in *Osofsky* noted that the benefit-of-the-bargain measure was recognized as the "preferable" damages measure in common law fraud actions. See 645 F.2d at 114.

[36]See generally Jacobs, supra note 9, § 260.03[c][v].

[37]645 F.2d at 111.

Circuit has both addressed and upheld the availability of benefit-of-the-bargain damages.[38] As noted, the key to being entitled to benefit-of-the-bargain damages is the plaintiff's ability to establish those damages with reasonable certainty.[39]

The foregoing are important, often-addressed damages measures that present the major damages issues arising from numerous variations of Section 10(b) claims. They form the backdrop for assessing damages for the portfolio mismanagement species of Section 10(b) fraud.[40]

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[38]See McMahan & Co. v. Wherehouse Entertainment, Inc., 65 F.3d 1044 (2d Cir. 1995), cert. denied, 517 U.S. 1190 (1996); Commercial Union Assurance Co. PLC v. Milken, 17 F.3d 608 (2d Cir.), cert. denied, 513 U.S. 873 (1994); Barrows v. Forest Labs., Inc., 742 F.2d 54 (2d Cir. 1984); see also Pelletier v. Stuart-James Co., 863 F.2d 1550, 1558 (11th Cir. 1989) ("[A] court may award benefit of the bargain damages under Rule 10b-5 when the circumstances require it.") (footnote omitted); Hackbart v. Holmes, 675 F.2d 1114, 1121 (10th Cir. 1982) (benefit-of-bargain damages appropriate where necessary to avoid unjust enrichment to defendant); Panos v. Island Gem Enters., Ltd., 880 F. Supp. 169, 177 (S.D.N.Y. 1995) ("although securities plaintiffs are normally restricted to an out-of-pocket recovery, when benefit-of-the-bargain damages can be measured with reasonable certainty and those damages are traceable to a defendant's fraud, courts are free to award them"). But see DCD Programs, Ltd. v. Leighton, 90 F.3d 1442, 1449 (9th Cir. 1996) (noting that "this court has never held that [benefit-of-the-bargain] damages are permissible under Rule 10b-5").

[39]See Commercial Union Assurance Co., 17 F.3d at 614 ("Benefit-of-the-bargain damages in a Rule 10b-5 action are not available unless they can be calculated with reasonable certainty.").

[40]Two other kinds of Section 10(b) damages measures, which are really variations of rescissional-type damages, are known as the "cover" measure of damages and the "*Chasins*" measure. The "cover" measure, which applies only where the plaintiff is a defrauded seller, permits recovery of the difference between the highest value a security achieves within a reasonable time after the plaintiff discovers (or should have discovered) the fraud and the value of the consideration received at the time of the transaction. See Lee, supra note 9, at 1277. The "*Chasins*" measure, named for Chasins v. Smith, Barney & Co., 438 F.2d 1167 (2d Cir. 1970), is the converse of the "cover" measure, applicable to a defrauded buyer. This measure awards the plaintiff the difference between the lowest value that the security reached within a reasonable time after the fraud was or should have been discovered and the consideration the investor paid. See id. at 1173.

The Nature of Portfolio Investment and Mismanagement

The basic measures of damages often applied in Section 10(b) cases do not readily apply—without "adjustment"—to the case of fraud in the context of portfolio mismanagement. Portfolio mismanagement can involve circumstances and raise issues quite different from fraud in connection with a one-time purchase or sale of securities (the more typical situation in the cases that measure damages for securities fraud). Indeed, securities transactions involving portfolio investment present numerous unique considerations that affect the damages determination where there is fraud in connection with managing the portfolio.

The Typical Picture of Portfolio Investment

The circumstances involving investment through a securities portfolio are familiar.[41] Typically, an investor establishes a relationship with a broker. The broker should discuss with the investor the investor's goals, desires, and financial situation and needs. Two essential elements of this discussion are determining the investor's "return objectives"—the kind of investment results that the investor hopes to achieve—and his related "risk tolerance"—the level of risk that the investor is willing to accept to try to achieve that return. Put simply, the broker should know the investor's basic investment objectives and financial situation, so as to be able to recommend and purchase only securities suitable for the investor.[42] Generally, an ongoing relationship between investor and broker is established, with an expectation that the portfolio will achieve a return over time as a consequence of a planned investment program.

The investor then opens an account at the broker's firm for invest-

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[41]"Investment" is sometimes considered to be committing assets to financial securities for a long-term period. "Trading" is sometimes considered to be buying and selling of securities with a view to obtaining short-term profits. This article uses "investment" and "investing" broadly, to include securities trading, as frequently occurs in portfolio management.

[42]For example, both the New York Stock Exchange and the National Association of Securities Dealers, Inc. have adopted rules that require brokers to "know your customer," so that the broker recommends only suitable securities. NYSE Rule 405 ("Diligence as to Accounts"), reprinted in 2 New York Stock Exchange Guide (CCH) ¶ 2405 (1984); Rule 2310, NASD Manual (formerly Rules of Fair Practice of NASD, Art. III, Sec. 2).

ing and trading in securities. Sometimes the investor gives the broker discretionary trading authority—that is, the authority to trade in the investor's account (consistent with the investor's return objectives and risk tolerances) without obtaining the investor's prior consent for specific trades. With such authority, the broker generally is permitted to formulate investment strategy for the investor and then decide which specific securities to buy and sell, when to buy and sell, and in what amounts, all presumably in accord with agreed-upon objectives.

In opening the account, the investor necessarily provides capital, typically securities or cash, to purchase new securities for his account. Trading begins, generally involving both buying and selling securities. The trading is usually based on the broker's recommendations. Moreover, where the broker has discretionary trading authority, the transactions may be undertaken solely on the broker's determination.

The transactions involving the investor's portfolio generally occur over a substantial period of time. The frequency and extent of the buying and selling may vary greatly. The investor generally pays the broker commissions for the trading (and if the broker is also an investment advisor, the investor may also pay an investment advisory fee). The investor may add capital to the portfolio (i.e., he may add funds to purchase more securities, or may add new securities from outside the portfolio) and may withdraw capital (i.e., he may sell securities and take the proceeds out of the account, or may remove securities from the portfolio). The aggregate value of the investor's account will vary over time, depending on the results of the trading, general market conditions, and the addition and withdrawal of capital.

This simple description highlights various circumstances inherent in portfolio investment that can become important in measuring damages if there is fraud in managing the portfolio:

- *Numerous transactions*: securities transactions occur frequently, involving both buying and selling for the investor's account, and the consequent payment of commissions;
- *Frequent decision-making*: decisions are made constantly—typically based on the broker's initiative, his recommendation, or even his sole determination—about buying new securities for the account and selling existing securities from the account;
- *Capital changes*: the amount of capital actually invested in the portfolio often changes over time, as the investor "adds" new capital to the portfolio and "subtracts" existing capital from it;

- *Market changes*: the transactions typically occur over a period of time (often a lengthy one), during which general market conditions change; and
- *An ongoing relationship*: the investor and broker have a relationship and course of dealing that continues over time, with the investor hoping to earn a return from a planned investment program.

The confluence of these particular circumstances bears on the nature of the claims that arise in portfolio mismanagement and on a proper determination of a defrauded investor's damages.

The Common Claims Arising from Portfolio Mismanagement

The wrongdoing frequently at the core of portfolio mismanagement involves "churning" the account and trading in "unsuitable" securities. Sometimes other improper conduct, such as further misrepresentation, is also involved.

Churning

"Churning occurs when an account has been excessively traded to generate commissions in contravention to the investor's expressed investment goals."[43] A Section 10(b) violation for churning exists where an investor proves that: (1) trading in the investor's account was excessive in light of his investment objectives; (2) the broker exercised trading control for the account; and (3) the broker acted with required *scienter*—that is, an intent to defraud or with willful or reckless disregard of the investor's interests.[44] Churning is properly described as a "unified offense"—that is, it is based on a

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[43]Saxe v. E.F. Hutton & Co., 789 F.2d 105, 112 (2d Cir. 1986); see also Mihara v. Dean Witter & Co., 619 F.2d 814, 820 (9th Cir. 1980) (describing churning as "[w]hen a securities broker engages in excessive trading in disregard of his customer's investment objectives for the purpose of generating commission business"); Loss & Seligman, supra note 7, at 908–12.

[44]Hatrock v. Edward D. Jones & Co., 750 F.2d 767, 775 (9th Cir. 1984); Miley v. Oppenheimer & Co., 637 F.2d 318, 324 (5th Cir. Unit A Feb. 1981). The control necessary to establish churning does not require that the broker have "actual" control of the trading, such as where the broker is vested with discretionary trading authority; rather, "de facto" control, where the investor routinely follows the broker's recommendations, is sufficient. See *Mihara*, 619 F.2d at 821.

hindsight analysis of a broker's management of, and trading in, the account where no single transaction, or even a group of transactions, are, standing alone, improper.[45]

The courts employ various guidelines in determining whether, in a particular case, unlawful churning exists. Often churning is assessed by analyzing the "turnover rate" of an account—that is, the cost of purchases compared to the average amount invested for a given time period—in light of the client's investment objectives.[46]

Since portfolio investment often involves frequent trading, churning is a common basis of liability for mismanaging the portfolio.

The most typical damages measure for churning is characterized as a "quasi-contractual" theory, which measures damages as the amount of excess commissions (and margin interest and other costs) that the broker received as a result of the churning.[47] This quasi-contractual measure (which should be applied only in a "pure" churning case) affords restitution-like damages,[48] requiring the wrongdoing broker to return to the defrauded investor the benefits obtained from the wrongdoing.

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[45]*Miley*, 637 F.2d at 327; see Fey v. Walston & Co., 493 F.3d 1036, 1050 (7th Cir. 1974) ("The vice of churning is not to be localized within a particular transaction. It is the aggregation of transactions excessive in number and effect which constitutes the gravamen of the complaint.").

[46]See *Mihara*, 619 F.2d at 821 ("While there is no clear line of demarcation, courts and commentators have suggested that an annual turnover rate of six reflects excessive trading.").

[47]See, e.g., Nesbit v. McNeil, 896 F.2d 380, 385 (9th Cir. 1990); Shad v. Dean Witter Reynolds, Inc., 799 F.2d 525, 532 (9th Cir. 1986); Zaretsky v. E.F. Hutton & Co., 509 F. Supp. 68, 73 (S.D.N.Y. 1981); Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836, 849–50 (E.D. Va. 1968); see generally Miner, supra note 9, at 843–45. A rationale given for the quasi-contractual measure is that it is impossible to know what the value of the churned account would have been but for the wrongdoing and that, in contrast, an amount based on commissions usually can be readily determined. See id. However, highlighting the frequent uncertainty in measuring securities fraud damages, some courts have permitted more expansive damages for churning, including damages for portfolio losses. E.g., Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 906 F.2d 1206, 1217–19 (8th Cir. 1990) (investor who proved churning entitled to recover both excess commissions paid and loss of value of account); Hatrock v. Edward D. Jones & Co., 750 F.2d 767, 773–74 (9th Cir. 1984) (investor permitted to recover excessive commissions charged by broker and decline in value of portfolio resulting from fraudulent transactions); see also discussion of *Miley* at pp. 100, 103 below.

[48]See note 18 above.

Unsuitability

Another fraud-related liability basis for portfolio mismanagement derives from the "suitability doctrine." An unsuitability claim, which is a subset of the ordinary Section 10(b) fraud claim, involves a showing that a broker recommended or purchased securities for an investor knowing that they were unsuitable for the investor's needs.[49] The precise parameters of this doctrine for the purpose of establishing civil liability under the securities laws are not fully settled. However, a showing that a broker acquired unsuitable securities in conjunction with facts establishing misrepresentation or other intentionally or recklessly improper conduct is generally actionable as a Section 10(b) securities fraud claim.

Again, since portfolio investment typically involves reliance on the broker's recommendations, and frequent trading decisions over a period of time, portfolio mismanagement often involves unsuitability claims. Cases hold that the damages for unsuitability should encompass trading losses suffered as a result of acquiring the unsuitable securities.[50] This measure is essentially rescission damages, focusing on the harm suffered by the investor as a result of the broker's wrongdoing.

Other Misrepresentation

Aside from churning and unsuitability claims, there may be portfolio mismanagement because a broker otherwise misrepresents to a customer material facts in connection with the trading activity. For example, a broker or advisor may misrepresent the value of an investor's portfolio; its composition; its performance over time; circumstances related to particular trades; the risks of various securities or the account overall; research, studies or predictions about securities; and the like. Indeed, a broker engaged in churning, or

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[49]See Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1031 (2d Cir. 1993); Clark v. John Lamula Investors, Inc., 583 F.2d 594, 600–01 (2d Cir. 1978); see also Loss & Seligman, supra note 7, at 896.

[50]See, e.g., Clark v. John Lamula Investors, Inc., 583 F.2d at 603–04; Garnatz v. Stifel, Nicolaus & Co., 559 F.2d 1357, 1360–61 (8th Cir. 1977); see generally Miner, supra note 9, at 845–48; cf. *Mihara*, 619 F.2d at 826 ("While damages for churning are limited to commissions and interest, plaintiff's claim as to the suitability of the securities purchased would also encompass trading losses."); Edward Brodsky, "Measuring Damages in Churning and Suitability Cases," 6 Sec. Reg. L.J. 157, 159 (1978); (discussing different damages measures for churning and unsuitability).

knowingly recommending unsuitable securities, may also undertake to conceal that wrongdoing from the investor.

Once again, given the nature of the broker-investor relationship that underlies portfolio investment, these kinds of broker misrepresentations are sometimes implicated when the portfolio is mismanaged.[51]

When a broker engages in these types of misconduct and mismanages an investor's account, the result is that the investor's portfolio does not achieve the return that it would have achieved absent the wrongdoing. However, the usual formulations of Section 10(b) damages, whether out-of-pocket, rescission or benefit-of-the-bargain, do not—standing alone—measure damages as carefully as they should, given the unique circumstances of portfolio investment and, in particular, the common confluence of both churning and unsuitability. The circumstances inherent in portfolio investment, and the nature of wrongdoing that might arise in mismanaging the portfolio, create special considerations that should be analyzed in determining damages. Some illustrations are helpful.

Illustrations of the Damages Considerations

Assume that an investor opens an account with a broker and that the broker fraudulently mismanages the account: the broker churns the account; he recommends and causes the investor to purchase securities that the broker knows are not suitable for the investor by misrepresenting the risks of the securities and their anticipated returns; and he otherwise makes material misrepresentations to the investor in connection with purchases and sales of securities for the investor's account. The unlawful conduct continues, unbeknownst to the investor, for a substantial period of time. Now consider the following:

Scenario #1. The initial value of the securities in the investor's account is $100,000. One year later, when the broker's fraudulent

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[51]The facts that give rise to Section 10(b) claims based on churning, unsuitability and other misrepresentations of course also give rise to various other possible claims, such as common law fraud, breach of fiduciary duty, state law securities violations, and the like. In particular, where a broker has discretionary trading authority over the investor's account, a fiduciary relationship with the investor may exist; the broker's conduct then is subjected to heightened scrutiny, and misconduct gives rise to a breach of fiduciary duty claim. See Press v. Chemical Inv. Serv. Corp., 988 F. Supp. 375, 386–87 (S.D.N.Y. 1997).

conduct is first discovered, the account is worth $75,000. No capital was added or withdrawn from the account over the year. Securities that were suitable for the investor (the kind of securities the investor should have acquired) generally declined 10 percent over that one-year period.

Under a simple rescission measure of damages, the investor's damages would be $25,000—the difference between the original amount invested ($100,000) and the portfolio's value when the fraud was discovered ($75,000). The nature of the broker's wrongdoing—fraud involving numerous transactions, occurring for a year-long period—makes measuring damages by reference to the "ending" value of the portfolio wholly appropriate.[52] However, given the 10 percent market decline, the investor's portfolio would have declined to $90,000 independently from the broker's wrongdoing. Thus, a better measure of damages might be thought to be $15,000 ($90,000–$75,000). Not factoring in this independent effect on the portfolio would over-compensate the plaintiff-investor and be unfair to the defendant-broker.

Scenario #2. Suppose, however, that instead of a 10 percent decline in the market for suitable investments, that market *increased* 10 percent over the year. Thus, our hypothetical investor's account should have grown to $110,000 over the course of the year. In other words, a well-managed account—one that simply tracked the market, untainted by fraud—would have yielded $10,000 profit. The investor's damages then might fairly be calculated as $35,000 ($110,000 – $75,000), rather than a pure rescissory measure of $25,000. Not including that market appreciation would under-compensate the investor and not hold the broker liable for the investor's full economic harm.

These two scenarios illustrate a common-sense attribute of investment that is relevant to measuring damages for portfolio mismanagement. Investments, such as securities, involve a degree of risk and therefore typically change in value. An adequately-informed securities investor hopes that his investment will increase in value but recognizes (at least within the scope of proper risk disclosure) that his investment might decline in value. As such, making a securities investment entails an opportunity cost of the invested funds, which is reflected by the market for those securities. That opportunity cost,

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[52]See, e.g., the *Rolf* and *Miley* cases discussed infra.

which can be either positive or negative for the investor, should be considered in fairly assessing damages for portfolio mismanagement.

In addition to market changes, other variables come into play in determining an investor's economic loss for portfolio mismanagement. Consider the following:

Scenario #3. The investor's account opened with $100,000 and ended one year later at $75,000, but over the course of the year the investor added $15,000 to the account. Without considering market changes, it is clear that the investor's damages must be determined on more than just his initial capital invested. His loss calculation must include the $15,000 added capital, so that his damages conceptually should be $40,000 ($115,000 – $75,000). And when market changes are considered, as in Scenarios #1 and #2, the damages amounts will change further.

This illustration—involving just one capital addition—is obviously much simpler than typically occurs. As a further example, consider the following:

Scenario #4. The broker's fraud first came to light after *two* years (rather than one) and the investor's portfolio still ended at $75,000. During the first year the investor added $25,000 to his account but during the second year he withdrew $10,000. His total capital invested, now over a two-year period, therefore was still $115,000 ($100,000 + $25,000 – $10,000). Market considerations aside, damages conceptually, on a pure rescission basis, should still be $40,000 ($115,000 – $75,000). However, now include market changes in the damages determination: assume a 10 percent decrease in suitable securities the first year but a 20 percent increase the second year. The cumulative effect of these changes make the calculation more involved. On a rough conceptual basis, the investor's ending account value would be $123,000 and his damages would be $48,000.[53]

Thus, the confluence and interplay of these considerations—both

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[53]The investor added $25,000 to his account in the first year, so his total capital invested was $125,000 for that year; however, the market declined 10 percent so his account at the end of year-one would have been worth $112,500 ($125,000 – $12,500). In year-two, the investor withdrew $10,000 from his account, so that total value at end of year-two would have been $102,500 ($112,500 – $10,000); however, the market increased 20 percent that year, so his account would have been worth $123,000 ($102,500 + $20,500) at the

market conditions and net capital invested—affect the damages calculation. There can be yet other interrelated considerations:

Scenario #5. The investor systematically adds $10,000 to his account *every month.* In addition, to meet his various financial needs, he periodically withdraws capital from the account, doing so always at differing amounts and not according to a set schedule. As a result, the amount of the investor's actual invested capital changes substantially, on an irregular basis, over a two-year period. Thus, the value in the account fluctuates over the period, even aside from market changes. Significantly, it should be apparent that the effect of *market* fluctuations, as in the above scenarios, cannot even be calculated until the *actual timing* of these capital additions and withdrawals is delineated.

Finally, consider further changed circumstances relating to the "suitability" of the securities in the investor's portfolio:

Scenario #6. At the outset of their relationship, the investor tells the broker that he wants to invest in "reasonably safe, conservative" investments, where risk of loss to the portfolio will be low. Ignoring that objective, the broker recommends securities that are, in fact, very speculative and risky (doing so through purposeful misrepresentations to the investor). The investor thus opens his account with $100,000 and, as in the scenarios above, finds that one year later his account (after being churned and mismanaged) is worth $75,000. However, the market for those risky securities declined 25 percent over that one-year period. The broker therefore might assert that his wrongdoing did not "cause" the harm, since the very market the investor was in had itself declined.

The investor, however, would assert that that market is irrelevant to calculating his loss, since the securities purchased were not suitable for him. Recognition of the investor's opportunity cost under these circumstances—the return he would have earned had his capital been properly invested from day-one—should consider the appropriate market, given the investor's stated objections. In other words, if an unsuitability claim predominates and the investor's portfolio consists primarily of unsuitable securities, the investor's damages should be adjusted by the *appropriate market* for that in-

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end of year-two. Thus, given the combination of capital changes and market fluctuations, the investor's account would have been worth $123,000 absent the fraud, so his damages are $48,000 ($123,000 – $75,000).

vestor. For example (and as discussed below), in this scenario it might be appropriate to measure the investor's damages—given his investment objectives and risk tolerance—by reference to the market for corporate or government bonds rather than equities.[54]

In sum, the combination of adjustment for market changes, capital additions and withdrawals, and suitability considerations all inherent in portfolio investment complicate determining a defrauded investor's loss. Indeed, the foregoing description sets forth only a broad conceptual approach to thinking about damages in a portfolio mismanagement case, where typically numerous improper transactions occur over time; capital constantly is added or withdrawn; and market conditions which affect the portfolio's value change significantly over time.

As addressed below, a court faced with calculating damages for portfolio mismanagement should address these considerations. Nonetheless, while various courts have considered these issues to some extent, the case law is not as refined as it could be in accurately and fairly calculating damages for portfolio mismanagement.

Cases Considering a Damages Measure for Portfolio Mismanagement

Only a handful of reported cases address the measure of damages for Section 10(b) portfolio mismanagement. A review of the case-law reveals both how the courts have dealt with the damages considerations arising from portfolio mismanagement and why a more refined analysis is warranted.

Rolf

The starting point for considering the measure of damages for fraudulent mismanagement of a securities portfolio is *Rolf v. Blyth, Eastman Dillon & Co.*[55] The investor in *Rolf* sued a brokerage firm and one of its brokers for Section 10(b) and other securities law

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[54]The investor undoubtedly paid commissions to the broker in connection with the fraudulent mismanagement. These commissions are yet an additional consideration to be addressed in assessing damages. See pp. 100, 103, 119–20 below.

[55]As discussed further below, the *Rolf* case had a long and involved history which generated several Second Circuit and district court opinions. See 424 F. Supp. 1021 (S.D.N.Y. 1977) ("*Rolf I*"), aff'd in part, 570 F.2d 38 (2d Cir.)

violations arising from aiding in the fraudulent mismanagement by a financial advisor. The fraudulent mismanagement included churning and purchasing unsuitable securities, as well as other wrongdoing. The Second Circuit upheld the broker's liability for aiding and abetting and his firm's derivative liability.

While using basic concepts, *Rolf* broke new ground in stating a formula for measuring damages resulting from portfolio mismanagement. As the basic measure of damages, the Second Circuit stated:

> The proper method of determining damages is [1] to take the initial value of the portfolio, [2] adjust it by the percentage change in an appropriate index during the [unlawful activity] period, and [3] subtract the value of the portfolio at the end of the period. [56]

Measuring damages on this basis requires determining: (1) when the defendant's improper conduct began, which will give the date for calculating the initial market value of the portfolio; and (2) when the defendant's wrongdoing stopped, which will give the value of the portfolio to be subtracted under the formula.[57] The formula also requires that the portfolio's initial value be adjusted by a recognized index of value (or a combination of indices) that is representative of the stocks in the investor's portfolio, "so as to take into account the overall decline in the stock market during the period of [wrongdoing]."[58] The Second Circuit indicated (referring to its prior opinion in the case) that the market index to be used should be "representative" of the stocks in the investor's portfolio when the wrongdoing began.[59]

The Second Circuit in *Rolf* upheld the lower court's determina-

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("*Rolf II*"), cert. denied, 439 U.S. 1039 (1978), and as amended, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,525 (2d Cir. 1978), and on remand, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,919 (S.D.N.Y. 1979) ("*Rolf III*"), aff'd in part and rev'd in part, 637 F.2d 77 (2d Cir. 1980) ("*Rolf IV*"), on remand, [1981–82 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,201 (S.D.N.Y. 1981) ("*Rolf V*"), later proceeding, [1981–82 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,269 (S.D.N.Y. 1981) ("*Rolf VI*").

[56] *Rolf IV*, 637 F.2d at 84.

[57] See id. at 81, 84.

[58] Id. at 81 (footnote omitted).

[59] Id. In its first *Rolf* opinion, the Second Circuit characterized the difference between the portfolio's initial and ending values as the investor's "gross economic loss" and stated that the market adjustment should be made to the gross economic loss. *Rolf II*, 570 F.2d at 49. In its second *Rolf* opinion, the court corrected this approach, explaining that the adjustment for market change

tion of the appropriate index. The court found that the lower court acted "well within [its] discretion" in its choice of an index because most of the stocks in the plaintiff's portfolio were comparable in price to those in the index used.[60] However, the Second Circuit determined a different date for the start of the wrongdoing than the lower court had used,[61] and so the court held that the choice of the proper index—given the change in the period of wrongdoing—was still an open question for the lower court on remand.[62] As discussed further below, leaving this question open proved significant: While the index the lower court first used had declined over the then-adopted period of wrongdoing, the plaintiff (unsuccessfully) had argued for an index that had *increased* in value.[63]

The *Rolf* court also considered the possible effect on damages of withdrawals of cash and securities. The defendants argued that they should be entitled to a "credit" against the damages award for net withdrawals that the investor made during the period of wrongdoing.[64] Thus, defendants pointed to a net withdrawal (the difference of total withdrawals and total deposits) of $67,497.68 and asserted that damages should be reduced by that amount.[65] The court determined, however, that defendants would not be entitled to that credit if the wrongdoing broker played a role in the purchase of the investments from those withdrawn funds and if the value of those investments was included in the ending value of the investor's portfolio.[66] The court suggested that a credit would be appropriate if the defendants were not "tied," or responsible, for the investments related to the withdrawals and if the proceeds from the investments

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should be made to the initial value of the portfolio rather than to the gross economic loss. *Rolf IV*, 637 F.2d at 84.

[60]Id.

[61]See id. at 83–84.

[62]Id. at 84.

[63]Id. at 84 n.9. Compare *Rolf V*, [1981–82 Transfer Binder] Fed. Sec. L. Rep. at 91,414–15 (adopting the originally rejected index, which had increased, and then holding that the portfolio value should not be adjusted) with discussion at pp. 103–04, 111–12 below.

[64]637 F.2d at 85.

[65]Id. at 85–86.

[66]Id. at 85.

went outside the portfolio.[67] The Second Circuit, however, did not decide these matters, leaving them for the lower court to determine on remand.[68]

The Second Circuit's damages formula in *Rolf* was prescribed by the court's earlier opinion in the case.[69] Significantly, the Second Circuit's first *Rolf* opinion (*Rolf II*) held that in addition to damages under the portfolio comparison formula, the plaintiff was entitled to recover the commissions he paid to the defendant brokerage firm for transactions within the period of wrongdoing.[70] The Second Circuit did not comment on recovery of commissions in its second opinion (*Rolf IV*), thereby *sub silentio* leaving recovery for commissions intact. And the lower court afterwards expressly acknowledged that commissions the investor paid were part of the damages equation and then included commissions in the damages award.[71] Thus, the measure of damages prescribed in *Rolf* permitted recovery for commissions paid on transactions during the period of portfolio mismanagement—in addition to recovery of damages under the portfolio comparison formula.[72]

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[67]Id. at 86.

[68]See *Rolf IV*, 637 F.2d at 86. The Second Circuit held that the lower court on remand should determine the effect of withdrawals, and the possibility of a "credit" to defendants for the withdrawals, on a transaction-by-transaction basis. Id. The lower court did so in two later opinions. See *Rolf V*, [1981–82 Transfer Binder] Fed. Sec. L. Rep. ¶ 98,201; *Rolf VI*, [1981–82 Transfer Binder] Fed. Sec. L. Rep. ¶ 98,269. The lower court made fact-bound determinations for the various withdrawals that focused on whether withdrawn funds were used to make purchases that were part of the wrongdoing—such as being purchases of securities fraudulently recommended—and then whether the value of those purchases was within the closing value of the investor's portfolio. If so, the defendants were not entitled to a "credit" (or offset) on the damages amount—essentially because the withdrawals were part of the defendants' wrongdoing. See, e.g., *Rolf V*, [1981–82 Transfer Binder] Fed. Sec. L. Rep. at 91,415–18. See pp. 114–15 below.

[69]See *Rolf II*, 570 F.2d 38.

[70]Id. at 50.

[71]*Rolf V*, [1981–82 Transfer Binder] Fed. Sec. L. Rep. at 91,412, 91,415, 91,419; *Rolf VI*, [1981–82 Transfer Binder] Fed. Sec. L. Rep. at 91,725.

[72]The lower court originally had limited the investor's damages to *only* commissions (and margin account interest). See *Rolf I*, 424 F. Supp. at 1045. Although the lower court found the defendants liable for violation of suitability and supervision rules, and not for churning, the court derived its damages measure from the "quasi-contractual" theory adopted in churning cases.

Miley

Shortly after the Second Circuit's second *Rolf* opinion, the Fifth Circuit endorsed the *Rolf* damages measure in *Miley v. Oppenheimer and Co.*[73] The *Miley* court considered a jury verdict for a Section 10(b) plaintiff who established that the defendant broker had churned her account. The lower court permitted plaintiff to recover damages for: (1) the commissions and interest paid as a result of the excessive trading; and (2) the decline in the value of her portfolio "in excess of the average decline in the stock market during the time in which [the broker] handled her account."[74]

In addressing the excess market decline component of damages, the Fifth Circuit stated:

> It is and has been clear that, in theory, the plaintiff is entitled to recover the difference between what he would have had if the account has been handled legitimately and what he in fact had at the time the violation ended with the transfer of the account to a new broker.[75]

Thus, the court emphasized that "to approximate the trading losses caused by the broker's misconduct, it is necessary to estimate how the investor's portfolio would have fared in the absence of the . . . misconduct."[76] To do so, the court accepted the *Rolf* approach of using market indices for the pertinent period "as the indicia of how a given portfolio would have performed in the absence of the broker's misconduct.[77]

Miley addressed two other aspects of portfolio mismanagement

See id. (under this theory "the defendants are directed to return to the plaintiff all commissions earned and interest paid"; citing cases). The lower court rejected the plaintiff's claim to recover net trading losses. The court stated that "[a] more logical measure of damages is to require the defendants to return all the benefit which they received [i.e., commissions and interest]" and rejected "all other measures of damage . . . as wholly speculative." Id. The Second Circuit in its first *Rolf* opinion, of course, disagreed with the lower court's holding, finding that damages were not so speculative as to limit the plaintiff only to commissions and interest. See *Rolf II*, 570 F.2d at 487.

[73]637 F.2d 318 (5th Cir. Unit A Feb. 1981).

[74]Id. at 326.

[75]Id. at 327.

[76]Id. at 328.

[77]Id. The Fifth Circuit upheld a jury instruction to compute trading loss damages as follows:

damages that are important. *First*, the court noted that given the nature of churning and the "inherent uncertainties" of the stock market, it is difficult to measure accurately the loss in portfolio value proximately caused by a broker's improper trading.[78] Nonetheless, the *Miley* court stated that "neither the difficulty of the task nor the guarantee of imprecision in results can be a basis for judicial abdication from the responsibility to set fair and reasonable damages in a case."[79] In effect, the court endorsed the long-settled damages concept that a plaintiff who establishes a defendant's wrongdoing need not prove damages with precision, and that a reasonable estimate will do.

Second, the Fifth Circuit addressed the broker's argument that awarding damages for *both* commissions *and* portfolio decline constituted an impermissible double recovery. The court rejected this argument, finding that commissions and portfolio decline can be two distinct harms proximately caused by a broker's churning and that both are compensable.[80]

The Central *Rolf* and *Miley* Issues

The fundamental concept underlying the damages measure in *Rolf* and *Miley* is that an investor defrauded through portfolio mismanagement should recover the difference between what he would have had if the account had been properly managed and what he in fact did have when the wrongdoing came to light. This approach is sometimes referred to as the "well-managed account" measure of damages.[81] While the *Rolf* court characterized its measure as a "novel formula"[82] (and while aspects were indeed "novel"), the *Rolf* formula is essentially a rescission measure of

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[by finding] by a preponderance of the evidence the difference between the amount of plaintiff's original investment and dividends therefrom less any withdrawals received by Mrs. Miley and less the ending value of her account with defendants. This amount is to then be reduced by the average percentage decline in value of the Dow Jones Industrials or the Standard and Poor's Index during the relevant period of time. Id.

[78]See id. at 327–28.

[79]Id. at 327.

[80]Id. at 326–27.

[81]See, e.g., Brodsky, supra note 50, at 158, 165–66; Miner, supra note 9, at 840.

[82]*Rolf IV*, 637 F.2d at 81 n.2.

damages: it awards the defrauded investor the difference between the "price paid" for the securities (as reflected by the value of the portfolio at the start of the wrongdoing) and the actual value of the securities at a "post-transaction" date (as reflected by the value of the portfolio when the fraud is disclosed).[83]

Conceptually, a rescission measure for fraudulent portfolio mismanagement is sound; moreover, it is sensible to calculate damages by comparing the beginning and ending values of the defrauded investor's portfolio. Portfolio mismanagement—which typically involves both churning and unsuitability—generally infects the trading in the portfolio pervasively and harms the portfolio's overall return performance. A transaction-by-transaction attempt to measure the investor's loss is not feasible, given the nature of portfolio investment; nor should that level of precision be necessary, since some imprecision of the damages amount should fairly fall on the wrongdoer-defendant.

Indeed, a rescission-type measure of damages is particularly appropriate where the fraudulent mismanagement involves unsuitability (as is typically the case). Proving fraud by unsuitable recommendations means that the broker induced the investor to purchase inappropriate securities—again typically involving numerous improper purchases over a period of time. The harm to the investor relates not just to the value of the securities purchased for the portfolio but also to the fact of having bought a group of securities that the investor would not have purchased but for the wrongdoing. And the unsuitable securities often perform poorly, thereby diminishing the value of the portfolio, or at least not achieving what should have been earned. Rescission-type damages, based on a comparison of the value of the investor's original securities and of the ones he eventually ended up with, as represented by the portfolio's beginning and ending balances, is a sound way to compensate that defrauded investor. After all, had the investor not been fraudulently induced to purchase unsuitable securities, he would not have owned the securities comprising the "closing val-

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[83] The Second Circuit itself noted in its first *Rolf* opinion that "gross economic loss on a portfolio-wide basis during a relevant period of time is often referred to as a rescission measure of damages." *Rolf II*, 570 F.2d at 49 n.21 (citing authorities).

ue'' of the portfolio. He would instead have owned different securities and would presumably have earned a different return.[84]

While the broad rescission approach of *Rolf* and *Miley* is conceptually sound, measuring damages for fraudulent portfolio mismanagement should more fully consider the particular circumstances inherently involved in portfolio investment. Determining what the defrauded investor ''would have earned'' but for the fraud requires consideration of these additional circumstances. Several observations about the treatment of those circumstances in *Rolf* and *Miley* inform that determination.

First, the Second Circuit in *Rolf* addressed the effect of withdrawals from the investor's portfolio. The court determined that under certain circumstances the defendants were entitled to a ''credit'' against damages for such withdrawals. That determination was an effort to assure that the defendants were not held liable for transactions that fell outside of the investor's loss. In other words, if the investor's withdrawals were not linked to the defendants' improper conduct and if the proceeds of the withdrawals were not part of the portfolio's closing value included in the damages equation, then it was sound to exclude those withdrawals in determining damages.

The Second Circuit instructed the lower court to consider the availability of ''credits'' to the defendants on a transaction-by-transaction basis.[85] As noted, the district court subsequently did so on remand.[86] The concept underlying this approach is sound: Where equity is withdrawn from an investor's portfolio, and the defendant is not connected to the withdrawal, the investor's damages should

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[84]See, e.g., Kronfeld v. Advest, Inc., 675 F. Supp. 1449, 1456 (S.D.N.Y. 1987) (noting use of rescissory damages measure where investor is wrongfully induced to buy securities); see also In re Thomas McKinnon Sec., Inc., 191 B.R. 976, 987–88 (Bankr. S.D.N.Y. 1996) (stating that only where plaintiff asserts an unsuitability claim, or unsuitability together with churning, should courts ''recompense the plaintiff for sluggish or negative portfolio growth''); In re Drexel Burnham Lambert Group, Inc., 161 B.R. 902, 909 (Bankr. S.D.N.Y. 1993) (''The measure of damages for unsuitability claims is the plaintiff's gross economic loss, adjusted for the overall market performance.'') (citing *Rolf II*); Brodsky, supra note 50, at 159 (asserting that damages for churning and unsuitability alone are not necessarily the same and that ''trading-loss damage'' should not be assessed if there is churning without unsuitability).

[85]*Rolf IV*, 637 F.2d at 86.

[86]See p. 98 & n.68 above.

be lessened in proportion to the withdrawn equity. However, *Rolf* did not address important aspects of the withdrawal issue. As discussed in the final part, in best determining an investor's damages, it is necessary to determine the investor's actual "cash flow" involving the portfolio—including *both* the net of deposits and withdrawals and *when* during the wrongdoing period those deposits and withdrawals occurred.

Second, both *Rolf* and *Miley* allowed the investor to recover the commissions paid to the broker as part of recoverable damages. However, a portfolio's value typically is stated (such as on monthly statements) net of commissions. Where the portfolio's value is then adjusted per a market index, further analysis may be required to assure that an award of commissions does not over-compensate the investor. For example, as discussed further in part four below, if the index used for adjustment is *not* a net-of-commission rate of return, then awarding the investor both commissions and the adjusted portfolio difference would be double compensation.[87]

Third, and most importantly, a key element of measuring damages for portfolio mismanagement is "adjusting" the portfolio's value by the percentage change of an "appropriate" index. The court in *Rolf* used the index to filter out the general market decline from the loss of value in the portfolio for which the broker would be held accountable in damages. The purpose of doing so was to assure that the defendants, albeit wrongdoers, were not held responsible for the general decline in the marketplace.[88] Thus, the market adjustment in *Rolf* was used to *decrease* the investor's damages.[89]

Significantly, the Second Circuit did not directly address adjusting damages with an index that *increased* over the period in question.[90] However, the court's formulation of the damages determination was to "adjust" the initial portfolio value by the percentage

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[87]See pp. 119–20 below.

[88]See *Rolf II*, 570 F.2d at 49 n.22 ("The rescission theory of damages . . . cannot restore a plaintiff to a *better* position than he would have been in if the fraud had not occurred.") (emphasis in original).

[89]See *Rolf IV*, 637 F.2d at 84 (noting instruction to lower court "to *reduce* Rolf's gross economic loss by the percentage decline in value of some well recognized index") (emphasis added).

[90]The Second Circuit noted in its second *Rolf* opinion, but did not need to consider, that the investor argued for use of an index that actually increased over the period in question. *Rolf IV*, 637 F.2d at 84 n.9.

"change" in an appropriate index.[91] This language suggests that an upward adjustment should also be permitted in appropriate circumstances.

Nonetheless, the *Rolf* district court subsequently rejected an upward adjustment. On remand proceedings, the lower court reevaluated the appropriate index to use in light of the Second Circuit's determination of a new date for the start of the wrongdoing.[92] The district court found that the index most comparable to the investor's portfolio had increased during the period of wrongdoing. Then without any further analysis, the court held that since that index had risen, the portfolio value "need not be adjusted."[93] As addressed below, that ruling fails to capture the investor's lost opportunity costs and does not fully measure damages.

The use of a market index to adjust the investor's damages, regardless of whether the appropriate index has risen or fallen, is fundamental to measuring damages for portfolio mismanagement. Contrary to the lower court in *Rolf*, a few other district courts have accepted using an increased index.

The Pertinent Post-*Rolf/Miley* Cases

In *Winer v. Patterson*,[94] plaintiff sued his former stockbroker for churning in violation of Section 10(b). The court addressed the measure of plaintiff's damages on a partial summary judgment/*in limine* motion. Plaintiff sought to recover all commissions paid, the loss of capital in his account and "lost profits." As to lost profits, plaintiff argued that his account would have followed "the general upward trend in the stock market with an attendant profit had the account

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[91]Id.

[92]See p. 97 above. The Second Circuit held that the wrongdoing began earlier than the district court had determined. Thus, the issue on remand involved determining an index comparable to the investor's portfolio based upon the portfolio's composition at the new "start" date. See *Rolf V*, [1981–82 Transfer Binder] Fed. Sec. L. Rep. at 91,414–15.

[93]Id. at 91,415.

[94]644 F. Supp. 898 (D.N.H. 1986), modified on other grounds, 663 F. Supp. 723 (D.N.H. 1987).

not been churned."[95] Plaintiff thus proposed to measure this element of his damages by using the Dow Jones Industrial Average.[96]

The court accepted the analysis from *Miley* and subsequent cases, holding that plaintiff was entitled to recover "the difference between the value of his account after the churning and what its value would have been absent the violation.[97] This measure would allow plaintiff to recover the profits his account would have earned had it been properly managed, so long as plaintiff could meet his burden of proof at trial.[98]

The court also addressed the issue of recovery for commissions. Defendant argued that plaintiff's damages were limited to either the excessive commissions from the churning *or* actual account losses.[99] In contrast, plaintiff—relying on *Miley*—evidently argued that he was entitled "to twice recover the excess commissions paid."[100] The court made clear, however, that while the plaintiff should be made whole, he was not entitled to double recovery of excess commissions. Significantly for a careful analysis of damages for portfolio mismanagement, the court stated that the *Miley* court, in allowing recovery for both excess commissions and excess portfolio decline, "did not intend by this formula to permit a plaintiff to recover the excess commissions paid under both categories."[101]

A subsequent district court case, *Medical Associates of Hamburg, P.C. v. Advest, Inc.*,[102] dealt even more squarely with the notion of applying an increased index for measuring damages. Plaintiffs in *Medical Associates* sued their broker and his firm for alleged mismanagement of investment accounts. The parties moved for summary judgment on the measure of damages that might be

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[95]Id. at 900.

[96]Id.

[97]Id. at 900–01.

[98]Id. at 901. The court emphasized that plaintiff must establish that he would have earned profits absent the fraud and the amount of those profits. Thus the court noted that plaintiff must prove that comparing the performance of his account to the performance of the Dow Jones Industrial Average "would be an accurate measure of how his portfolio would have fared." Id.

[99]Id. at 900.

[100]Id. at 901.

[101]Id. at 901 n.4.

[102]Medical Assocs. of Hamburg, P.C. v. Advest, Inc., No. CIV-85-837E, 1989 U.S. Dist. LEXIS 11253 (W.D.N.Y. June 30, 1989).

awarded. Plaintiffs argued that the damages for mismanagement of an investment account should include both " 'raw loss' " from the diminution of the value of their accounts *and* " 'loss of investment opportunity' from the failure of the account to earn the rate of the return prevailing in the market on 'suitable risk' investments over the period in question"—a "market adjusted measure of damages."[103] Defendants asserted that plaintiff could recover only for diminution in value of the accounts.[104]

The court accepted plaintiffs' position and rejected defendants'. Quoting *Osofsky v. Zipf*,[105] the court emphasized that the Second Circuit has "taken a broad view of the actual damages limitation of section 28(a)."[106] The court held that *Rolf* supported plaintiffs' position that a market adjusted measure of damages should be used—even though *Medical Associates* involved a market in ascent rather than, as in *Rolf*, a declining market. In explaining its holding, the *Medical Associates* court stated:

> *Rolf* laid no stress on the direction of the shift of the stock market in fashioning its market adjusted damage formula, and the defendants have not advanced a reasoned basis for enabling this Court to do so. Obviously, as in *Rolf*, where the securities market is in decline over the relevant period, a decline in a plaintiff's particular portfolio is partially attributable to market forces (instead of the defendant's fraud) and the plaintiff's recovery should thus be reduced accordingly to reflect his "actual damages." *Rolf*, supra, at 84. By the same token, as in this case, where a plaintiff's portfolio declines in value notwithstanding an overall rise in the market, such plaintiff's actual injury is not limited to the simple decline in value of his securities but encompasses also damages occasioned by the failure of such securities to keep pace with the market—as they otherwise generally would have. His compensatory recovery should therefore be augmented accordingly. . . . An evenhanded application of Rolf's doctrine, irrespective of the direction of the market, accomplishes this purpose.[107]

Medical Associates thus is authority for the proposition that the

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[103]Id. at *2–*3.

[104]Id. at *3.

[105]645 F.2d 107 (2d Cir. 1981). See p. 84 above.

[106]1989 U.S. Dist. LEXIS 11253 at *3–*4.

[107]Id. at *6–*7 (citations and footnotes omitted). The *Medical Associates* court referred to *Winer* as being "the only decision directly on point with the plaintiffs' position" on this market-adjustment issue. Id. at *7–*8 & n.4. See also Miner, supra note 9, at 862 ("The same reasoning which led courts to

Rolf/Miley rescission-type measure of damages should include adjustment of the harmed portfolio by using a market index that *increased* over the period of wrongdoing.

Another district court case, *Dasler v. E.F. Hutton & Co.*,[108] also dealt with these damages measurement issues in an analogous context. The *Dasler* plaintiffs sued a brokerage firm and its brokers for wrongdoing as the investment manager of a profit-sharing plan governed by the Employee Retirement Income Security Act of 1974 (ERISA). As the plan's administrators, plaintiffs asserted claims against defendants for breach of fiduciary duty under ERISA and for violation of Section 10(b) arising from defendants' excessive trading in the securities held by the plan's account.[109] After trial, the court found that defendants had traded the plan's account excessively and had thereby breached their fiduciary duty owed to plaintiffs. While the court evidently adopted a measure of damages only for the ERISA violation, there was a finding of a Section 10(b) violation, and the court both cited *Miley* and followed the *Rolf/Miley* formula. Thus the court's opinion is instructive for considering damages for Section 10(b) portfolio mismanagement generally.[110]

In measuring the plan's losses, the *Dasler* court held that the plan's actual earnings under the broker's management during the period of wrongdoing must be compared "with those earnings which would have been reasonable had the plan's account not been excessively traded."[111] The court accepted that the result of that comparison should then be adjusted for market factors: "The plan's loss is properly measured by the difference between the plan's actual performance during the period of excessive trading and that amount

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include market decline in the damages analysis . . . mandates the inclusion of market appreciation in the damages analysis during a period of market appreciation as well.") (cited in *Medical Associates*).

[108]694 F. Supp. 624 (D. Minn. 1988).

[109]Id. at 626.

[110]*Dasler* was tried before both a jury and the court. The jury was the factfinder on plaintiffs' Section 10(b) claim, and the court was the factfinder on plaintiffs' ERISA claim (with the jury then sitting in an advisory capacity on that claim). Id. at 627. The jury determined that defendants had churned the plan's account in violation of Section 10(b). Id. at 628 n.6. That jury determination resolved an issue common to plaintiffs' ERISA claim, so the court was required to render judgment on the ERISA claim consistent with the jury's fact determination. Id. at 627–28.

[111]Id. at 634 (citing Donovan v. Bierwirth, 754 F.2d 1049, 1056 (2d Cir. 1985)).

it would have earned during this period as measured and adjusted by the movement of an appropriate index reflecting the stock market.''[112] The court ruled that the Standard & Poor's 500 Corporate Index was the appropriate index to use because ''[n]early all of the stocks purchased in the plan [were] among those included in the S&P.''[113]

The court's opinion included an appendix showing its actual damages calculation.[114] That appendix shows that the court's calculation included *both* an upward adjustment and a downward one based on the S & P index—since the S & P had both decreased and increased during the period of wrongdoing.[115] The court did not discuss, or differentiate between, making an adjustment to the portfolio value depending on whether the market index had increased or decreased. Instead, the court simply adjusted the calculation downward for the period when the S & P had fallen and upward for the period when the S & P had risen.[116]

The *Dasler* court also included in its damages calculation an amount for new contributions to the plan account made during the period of wrongdoing. Treating those contributions like new ''capital,'' the court thus included them for the purpose of determining the adjusted closing value of the plan's account.[117] In addition to the portfolio valuation comparison, the court awarded plaintiffs the amount of commissions paid to defendants.[118]

The court's calculations thus encapsulated various components for calculating damages for portfolio mismanagement: the court used the *Rolf* formula, included capital additions, adjusted the

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[112]Id.

[113]Id. at 631, 634.

[114]Id. at 635.

[115]Id. at 631 n.9.

[116]The court found that the S&P rose 26 percent, from 107.94 to 135.76, during one year of the period of wrongdoing and noted that the S&P rose 21 percent over the entire 17-month period of wrongdoing. Id. at 631, 631 n.9, 635.

[117]Id. at 635.

[118]Id. at 634.

portfolio value both upwards and downwards according to a market index, and awarded commissions as part of damages.[119]

Although other cases have language and rulings following the *Rolf/Miley* lead, the reported caselaw does not further elaborate or develop a more detailed measure of damages for portfolio mismanagement. A more comprehensive model to guide the courts—and which the litigants in portfolio mismanagement cases should present to the courts—is warranted.[120]

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[119]Cf. Donovan v. Bierwirth, 754 F.2d 1049, 1056 (2d Cir. 1985) (measure of damages for breach of fiduciary duty under ERISA, as related to improper securities transactions, "requires a comparison of what the [ERISA] Plan actually earned on the [securities] investment with what the Plan would have earned had the funds been available for other Plan purposes. . . . In determining what the Plan would have earned . . . , the district court should presume that the funds would have been treated like other funds being invested during the same period in proper transactions.").

[120]For other pertinent cases, see Hatrock v. Edward D. Jones & Co., 750 F.2d 767, 774 (9th Cir. 1984) (in Section 10(b) case involving churning, court endorsed *Miley* formulation of determining decline in portfolio value by difference between what investor would have had if account had been handled properly and what investor in fact had when wrongdoing ended); Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 651 F.2d 615, 620–21 (9th Cir. 1981) (section 10(b) case involving broker's misrepresentations concerning risks and predicted performance of five stocks, where no churning involved; court upheld damages based on difference between value of stocks purchased because of the fraud as of the date plaintiffs knew or should have known of the fraud and value of the stock plaintiff would have owned had there been no fraud); Kronfeld v. Advest, Inc., 675 F. Supp. 1449, 1456 (S.D.N.Y. 1987) (fraud alleged was that defendants selected risky bond investments and misrepresented them as safe ones; court held that "[c]orrect application of the *Rolf* formula presumably would mean reducing plaintiffs' gross economic loss by some overall measure of the bond market, perhaps by performance of bonds of the sort plaintiffs purportedly sought to purchase"); Levine v. Futransky, 636 F. Supp. 899, 900 (N.D. Ill. 1986) (plaintiffs alleged that over five-year period, defendant-investment advisor invested plaintiffs' portfolio in risky investments instead of in conservative ones as plaintiffs had instructed; court held that "[p]laintiffs may be entitled to recover the difference between the loss incurred on the sale of the speculative securities and the greater amount plaintiffs would have received had they not been defrauded and the more conservative securities had been bought and sold"); Sullivan v. Chase Inv. Servs., Inc., 79 F.R.D. 246, 262–64 (N.D. Cal. 1978) (plaintiffs alleged that defendants fraudulently marketed investment advisory services to numerous clients who eventually lost money; court held that representative index consisting of securities suitable for each type of investor should be constructed, and damages should then be measured as the difference between the performance of the client's actual portfolio and of the foregoing index during the damage period);

An "Alternative Investment" Model

While *Rolf* and its progeny provide a method for measuring damages for fraudulent portfolio mismanagement, that method has significant deficiencies. A more refined approach—one that better accounts for the particular circumstances arising in portfolio investment and better determines the investor's loss for mismanagement—should be used.

Most fundamentally, the core of the *Rolf/Miley* method should be re-worked. The *Rolf/Miley* approach measures damages by adjusting the initial value of the investor's portfolio by an index meant to account for market changes over the period of the wrongdoing, and then decreasing that adjusted portfolio value by the portfolio's actual ending value. A better approach has a different focus: how much capital, and when, did the investor invest in the portfolio during the period of the fraudulent mismanagement, and how much would that capital have earned if it had been invested and managed properly. This approach can be thought of as an "Alternative Investment" Model for calculating portfolio mismanagement damages.

The Components of the Model

The principle components which must be determined for this Model are:

- The *time period* covering the fraudulent mismanagement, which leads to the portfolio's value when the mismanagement began and ended;
- The *actual cash flow* of the portfolio over the period of

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see also Abrahamson v. Fleschner, 568 F.2d 862, 878–79 (2d Cir. 1977) (fraud consisted of investment partnership's failure to inform limited partners that large percentage of portfolio was invested in unregistered securities as opposed to safe securities; for claim under Investment Advisers Act of 1940, "[t]he proper measure of damages then would be that part of net losses incurred on unregistered securities after the point when the defendants' representations became fraudulent which stems from the portion of those investments inconsistent with defendants' representations"), cert. denied, 436 U.S. 905 (1978); see also Twomey v. Mitchum, Jones & Templeton, Inc., 262 Cal. App. 2d 690, 730–33, 69 Cal. Rptr. 222, 249–51 (Cal. Ct. App. 1968) (in churning and unsuitability case, court measured investor's damages by using difference of value of securities originally turned over to broker and subsequently returned to investor, *less* withdrawn funds and *plus* "amount which would have been earned" on securities).

mismanagement, which leads to the net capital invested in the portfolio; and

- The *appropriate alternative investment*, which leads to the rate of return on that investment.

The Model uses these components to determine how much the investor would have earned on his invested capital from the appropriate alternative investment over the period of the mismanagement; the difference of that return and the actual portfolio value at the end of the period is the investor's damages.

Importantly, the Model is a pragmatic approach to addressing damages proof in fraudulent portfolio mismanagement cases. It is designed for litigants and their lawyers, and for judges, juries and arbitrators. Advanced financial theories have sometimes been suggested for measuring damages in securities fraud cases.[121] But overly sophisticated financial theories are not easily presented by litigants and not readily understood and adopted by courts.[122] While the Model presented here typically will require some expert proof, a virtue of the Model—which is very important in any litigated matter—is that it can be presented reasonably simply.

The Model also addresses and accounts for key damages issues, as considered in the cases, that emerge from portfolio mismanagement. As described below, the Model thus deals with the effect of withdrawals and deposits, as well as with recovery for commissions.

Most importantly, the Model deals with the important consideration of market change—whether downward or upward movement—and the related concept of a defrauded investor's lost opportunity costs. When a broker fraudulently mismanages the

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[121]See generally Edward S. Adams & David E. Runkle, "Solving a Profound Flaw in Fraud-on-the-Market Theory: Utilizing a Derivative of Arbitrage Pricing Theory to Measure Rule 10b-5 Damages," 145 U. Pa. L. Rev. 1097 (1997); Bradford Cornell & R. Gregory Morgan, "Using Finance Theory to Measure Damages in Fraud on the Market Cases," 37 U.C.L.A. L. Rev. 883 (1990); Daniel R. Fischel, "Use of Modern Finance Theory in Securities Fraud Cases," 38 Bus. Law. 1 (1982); Jared T. Finkelstein, Note, "Rule 10b-5 Damages Computation: Application of Financial Theory To Determine Net Economic Loss," 51 Fordham L. Rev. 838 (1983).

[122]See, e.g., Basic, Inc. v. Levinson, 485 U.S. 224, 252 (1988) (White, J., concurring in part and dissenting in part) (noting that "[c]onfusion and contradiction in court rulings are inevitable when traditional legal analysis is replaced with economic theorization by the federal courts").

investor's portfolio, the critical damages determination is the amount the portfolio *would have earned* had there been no wrongdoing—essentially, permitting recovery for any "profits" from his invested capital that the investor might have earned if his portfolio had been managed properly, or diminishing recovery for any losses that would have been sustained regardless of the fraud. A damages measure that considers lost opportunity costs is consistent with the basic rescission measure of damages, with sometimes-available benefit-of-the-bargain damages, and with the theory of recovery underlying the *Rolf/Miley* approach. Indeed, a defrauded investor may be damaged even if there is some *increase* in the portfolio's value over the period of the wrongdoing, where the relevant market increased proportionately more.[123] By using the return on an appropriate alternative investment, the Model captures both market changes and the investor's lost opportunity costs.[124]

The components of the Model are described further below.

The Time Period

The Model follows the *Rolf/Miley* rescission approach in requir-

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[123]In *Rolf*, the Second Circuit used a market index adjustment, where the market had declined, to lower damages, since loss from general market decline is not attributable to the defendant's wrongdoing. However, the converse is not true for portfolio mismanagement in an ascending market. When the relevant market rises but, due to fraudulent mismanagement, the investor's capital is not invested in suitable securities, the lost market profit *is* attributable to the defendant's wrongdoing.

[124]As authoritative commentators have noted regarding the courts' market indices adjustment approach: "By calculating portfolio value net of the market [i.e., by use of an index] a plaintiff can be awarded damages even when the value of the portfolio increases." Loss & Seligman, supra note 7, at 1063.

Moreover, capturing the investor's lost opportunity costs is particularly appropriate because churning is frequently involved in fraudulent portfolio mismanagement. Churning does not involve the sale of overvalued securities; rather, the harm arises from the excess trading itself. Thus, the cases hold that even where a churned account realizes a net value, the investor is entitled to recover the profits that would have been realized had the account not been churned. See, e.g., Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 906 F.2d 1206, 1217–19 (8th Cir. 1990) ("Churning is not excused by the fact that the account realizes a new profit."); Nesbit v. McNeil, 896 F.2d 380, 385–86 (9th Cir. 1990) (investors entitled to recover excess commissions despite portfolio gain; court rejected defendants' claim for "offset").

See generally Merritt, supra note 19, at 522–30 (noting use of market adjustments for measuring damages in section 10(b) cases based on churning and unsuitability, and differentiating those cases from other section 10(b) cases).

ing a determination of the start and end dates of the fraudulent mismanagement. While the Model uses this determination differently than the *Rolf/Miley* formula, those dates are still the bookends for the damages calculation. The reason is straightforward: The broker should only be liable for the investor's losses that occur as a result of the broker's misconduct, which is circumscribed temporally.

The Model's calculation of damages starts when the wrongdoing itself started. A portfolio mismanagement case involves an on-going relationship between broker and investor, and the fraud might start at various time during the relationship. The wrongdoing could begin at day one—when the investor opens the account—if, for example, the broker knowingly recommends, and therefore induces the investor to purchase, unsuitable securities. Or the account might be opened in a perfectly proper way, but then down the road the broker recommends unsuitable securities, makes misrepresentations to the investor about the portfolio's performance, deceives the investor about the nature of particular securities, and the like. Or, similarly, the broker at a certain point in time might begin churning the account. The investor's substantive proof on the Section 10(b) claim should show when in the course of the broker's conduct the actual fraudulent mismanagement began.[125]

The Model requires that the portfolio's value be determined when the misconduct began. That value, which is analogous to the purchase or sale amount in the more typical securities case involving a one-time transaction, is the starting amount for the Model's alternative investment calculation.

The end point of the mismanagement must also be determined. Consistent with the basic rescission measure, the end point under the Model is when the wrongdoing is discovered (or, at least when it reasonably should have been discovered).[126] The Model's alternative investment calculation stops at that end point. It is appropriate to end the calculation at that point because once the wrongdoing is disclosed, the investor can make new investment decisions, and the broker should not be held liable for subsequent losses.

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[125]Obviously, even if mismanagement is proven, when it began can be in issue. For example, in *Rolf* the Second Circuit held that the wrongdoing started earlier than the lower court had determined. See p. 97 above.

[126]See p. 81 and note 22 above. Similar to the starting point, when the investor discovered, or should have discovered, the wrongdoing can also be hotly contested.

The portfolio's value as of that end date also must be determined. Generally, that value will be readily determined from the portfolio's account statements. Valuing the portfolio at that point is akin to a constructive "sale" of all the securities in the portfolio. However, as set forth below, the Model uses this end-date value differently than it is used under the *Rolf/Miley* approach.

The Cash Flow

A critical factor in calculating damages for portfolio mismanagement—and one that the cases do not adequately address—is the investor's cash flow and the amount of capital the investor contributed to the portfolio. Indeed, when the investor contributed and withdrew capital from the account is very important to the Model's calculation.

The portfolio's actual cash flow for the period of the wrongdoing must be reconstructed. Beginning at the start of the wrongdoing and ending at discovery of the fraud, an accounting must be made showing all new capital contributed to the portfolio and all existing capital withdrawn from the portfolio. In effect, all transactions constituting deposits to and withdrawals from the portfolio must be itemized—a tracking of the portfolio's "money in, money out." The accounting must show specifically *when* capital is added or withdrawn. The total amount, consisting of the original starting capital plus all additions and minus all withdrawals of capital, is the investor's "net capital invested."

This accounting usually can be prepared by reviewing the portfolio's monthly account statements. Those statements will show when new capital is contributed to the portfolio and when existing capital is withdrawn from it.

Timing of the additions and withdrawals is a key to the Model. For example, if the period of mismanagement lasted two years, new capital added in month two will have a more significant effect on an investor's damages than new capital added in month twenty-two of that period. Thus, the actual date of the deposit or withdrawal transaction should be determined as part of the net capital invested accounting. As evident from the discussion above, however, the existing caselaw does not adequately address the importance of this timing aspect of the net capital invested.

Furthermore, in determining net capital invested, it is important to ascertain the source of the "new" capital and the destination of the "old" capital. For capital to be deemed added to the portfolio, it must originate from outside of the portfolio itself. For example,

often an investor's portfolio at a brokerage firm will consist of numerous accounts, all handled by the same broker. And often transactions will occur between those accounts, such as selling securities from one account to purchase securities for another. An ''intra-portfolio'' capital transaction or transfer is not new capital being added to the portfolio. In contrast, a clear example of new capital is when the investor, believing that his portfolio is performing well, uses new income to buy additional securities for the portfolio.

Withdrawals must be analyzed similarly. A ''withdrawal'' from one account that is actually a ''transfer'' to another account within the mismanaged portfolio is not a reduction of capital. For example, if the proceeds of selling securities from one account within the portfolio are used to buy securities for another portfolio account, capital has not been withdrawn. The portfolio's net capital invested is affected only if the withdrawn capital goes to a destination outside of the mismanaged portfolio itself.

This distinction is important. In a portfolio mismanagement case, a broker's churning may involve numerous transactions among accounts held in the portfolio. The necessary accounting must examine the transactions to determine whether they are actually deposits or withdrawals involving the portfolio's capital.[127]

Simply put, only capital added to the portfolio originating from an external source—one outside of the portfolio itself—is an increase of net capital invested. Similarly, only capital withdrawn from the portfolio that goes to a destination outside of the mismanaged portfolio (such as the investor's bank account, or a securities account handled by a different brokerage house) is a reduction of capital. If capital stays within the mismanaged portfolio, there is no effect on the net capital invested amount or the Model's calculation.

The Alternative Investment

The alternative investment component of the damages Model provides the investment return that the investor would have earned

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[127]The Model's capital component is reflected in the ''credits'' determination that concerned the *Rolf* courts. See p. 97–98 above. The approach in *Rolf*, focusing on whether withdrawals were used to purchase securities within the ambit of the wrongdoing and whether those securities were then included in the mismanaged portfolio's closing value, is basically sound and consonant with the Model. However, as described above, a more particularized accounting of withdrawals is appropriate and affords a better damages measure.

if his capital had been invested properly. This component is analogous to the market index used in the cases, but it is more refined than that index, and it works differently.

The Model requires that the investor establish the *appropriate* alternative investment. This is an important determination (and, again, one not adequately addressed in the cases). The best way of thinking about this issue is by focusing on the investor's *risk tolerance* and *return objective* in establishing the portfolio. The Model's alternative investment should be an investment instrument that most closely matches the investor's risk tolerance and return objective. That investment is, in fact, the kind of instrument that was suitable for the investor—the instrument that the investor would have invested in, if his capital had been invested in accord with his desires.

Selecting the appropriate alternative investment is a fact determination. Inquiry should focus on: (1) the investor's statements to the broker, in starting the relationship and opening the portfolio, about the risk he was willing to accept and the return he hoped to achieve; (2) the documents, if any, that might have been prepared or completed reflecting these risk and return considerations; (3) the investor's course of dealings and communications with the broker after opening the portfolio; (4) the investor's past investment history; and (5) the kind of investment that would be consistent with the investor's financial needs and circumstances. Fundamentally, determining the correct alternative investment is a question of intent: What kind of investment program was appropriate—or suitable—for the investor given his stated desires and financial situation. In making this determination for the Model, an "investor profile" can be established—an identification of the characteristics of the investor's risk tolerance and return objective.

It is critically important that this investor profile assemble competent and compelling proof to show the nature of the securities that the investor would have acquired had his capital been invested properly. Absent such proof, the Model will be subject to challenge on the basis that the damages determined are "speculative"—that is, that the determination turns on the return from an alternative investment and that it is "impossible" to ascertain how the investor's capital would have been invested but for the broker's

wrongdoing. However, sufficient detailed proof on the alternative investment can overcome that kind of speculative-damages claim.[128]

To select the appropriate alternative investment, the investor's profile should be matched with the investment attributes of a particular investment, principally its risk and return characteristics. A variety of instruments is possible for the alternative investment. The range, from conservative to risky, includes money market investments, short-term government bills and notes, medium- and long-term government bonds, corporate bonds (in various grades), equity securities (which can also be further categorized by price, quality, and the like), and even commodities. Information on the historical return performance of all classes of investments is readily available. Indeed, the market indices used in the cases are simply compilations of the returns for these various classes of securities. Similarly, the risk on particular instruments is analyzed and quantified, so that relevant risk assessment information can also be obtained. For example, standard deviation analysis affords a statistical measure of an investment's volatility and, therefore, provides a measure of risk.

An investment instrument with an historical performance and a recognized risk that matches the investor's profile should be selected. Expert proof may be necessary to show the comparability between the investor's profile and the investment's attributes. The

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[128]In Resolution Trust Corp. v. Commonwealth Fed. Sav. & Loan Ass'n v. Stroock & Stroock & Lavan, 853 F. Supp. 1422 (S.D. Fla. 1994), the plaintiff brought common law claims against the defendant law firm, asserting that the law firm's improper advice caused a bank to purchase junk bonds which resulted in losses to the bank. The court noted that the bank "in an absolute sense, actually made money on the junk bonds." Id. at 1424. The plaintiff, however, argued that the return on these bonds was a loss because but for the law firm's negligence, the bank would have invested in other investments that would have provided a return greater than the returns from the junk bonds. Id. Deciding the case under Florida law governing recovery for lost profits, the court ruled that the plaintiff's damages theory was speculative, finding that the evidence did not show that the bank would have bought the alternative investment put forth in the plaintiff's theory. The court therefore granted summary judgment for the defendant law firm. Id. at 1425–26, 1429. See also Messer v. E.F. Hutton & Co., 833 F.2d 909 (11th Cir. 1987), modified on other grounds, 847 F.2d 673 (11th Cir. 1988). As noted, however, where properly proven, a finder of fact should be able to determine an appropriate alternative investment, removing any speculation as to damages.

proper alternative investment is the one whose investment attributes most closely match the investor's profile.[129]

In selecting the alternative investment, it is important not to limit the inquiry to the composition of the investor's mismanaged portfolio. Because suitability claims are so pervasive in fraudulent portfolio mismanagement, the investor's actual portfolio may not match his risk tolerance and return objective—that is, due to unsuitability, the securities purchased might not possess the investment characterizations that the investor wanted. The correct inquiry focuses on how the investor's capital would have been invested if his desires had been followed. A *suitable* investment must be ascertained—one whose investment attributes match the investor's desires. Once again, cases that indiscriminately assume that the investor's actual portfolio determines the comparable investment do not properly assess damages.[130]

Selecting the appropriate alternative investment determines the

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[129]The determination of matching the investor profile to the investment's attributes can be objective, subjective, or both. For example, an investor might state that he wants to achieve a certain percentage return and is willing to experience a certain percentage risk. In this circumstance, the risk/return analysis becomes fairly objective. More commonly, however, an investor states general risk/return objectives—that he has "conservative" or "aggressive" return goals, is willing to accept "moderate" or "speculative" risk, and the like. The alternative investment in these circumstances is more subjective, but fair and reasonable determinations can readily be made and proven. Furthermore, portfolio investment frequently is much more complicated than the scenario described here, involving different kinds of accounts and diversification of risk (with consequent return tradeoffs) as part of a comprehensive investment strategy. For example, a managed portfolio often will consist of a variety of instruments, such as stocks, bonds (and very different kinds of both) and money market funds, which are purchased as part of a careful plan by which fluctuations is one asset class cancel out fluctuations in another. Those considerations, as well as the particulars of proof matching the investor profile to alternative investment attributes (which are, of course, very specific to an individual case), are beyond the scope of this article. The central point is that under this Model for measuring fraudulent portfolio mismanagement damages, a type of investment instrument whose attributes match the investor's investment intent should be determined and that evidence can be presented to do so.

[130]See Frank H. Easterbrook & Daniel R. Fischel, "Optimal Damages in Securities Cases," 52 U. Chi. L. Rev. 611, 648–51 (1985). In considering damages for brokers' misconduct arising from portfolio mismanagement, Judge Easterbrook and Professor Fischel note that where a broker buys risky stocks for an investor's portfolio when the investor really wanted a safe portfolio, "[i]nstead of comparing the client's portfolio against a similarly

rate of return used in the Model. As noted, various sources give the historical performance on classes of investments. For example, if it is determined that corporate bonds—a moderately conservative investment—were the suitable securities for the investor, the rates for various grades of these bonds are available on an annual, monthly, and weekly basis. The same is generally true for other investment classes.

It is also important that the alternative investment rate be comparable to the method of the investor's portfolio valuation. For example, often a portfolio investment strategy includes reinvestment in the portfolio of all dividends paid on the securities held in the portfolio. If so, the value of the portfolio's account set forth in the account statements will include the reinvested dividends. The alternative investment rate used should be one that similarly includes a total return (capital change plus any reinvested dividends) on the alternative investment. Significantly, some of the commonly used market indices may not include dividend reinvestment.

An important issue also related to the alternative investment rate concerns commissions. As discussed above, *Rolf*, *Miley* and the subsequent portfolio mismanagement cases permitted the defrauded investor to recover as part of a damages award an amount for commissions, in addition to recovering for loss related to the portfolio's value. Permitting recovery for commissions that an investor paid in

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risky portfolio, the court should compare the client's portfolio against how the target risk classification would have done.'' Id. at 650. For example, they note that in *Rolf* the broker improperly put the investor into very high-risk stocks, and they argue that the Second Circuit erred in *Rolf IV* by adjusting damages using a higher-risk index because it supposedly was comparable to the portfolio. Id. at 650 n.64. Judge Easterbrook and Professor Fischel posit that the best measure of damages in broker misconduct cases compensates for the excess risk produced by the brokers' investment choices. Thus, ''[t]he court could compute the extent to which the portfolio the broker put together was riskier than an appropriate target portfolio and *award compensation that depends on how far a well-chosen portfolio would be expected to outperform the excessively risky one*.'' Id. at 651 (footnote omitted; emphasis added). By focusing on the appropriate alternative investment, the Model described here accomplishes that measure of damages. See also Merritt, supra note 19, at 531 (arguing that in calculating damages for securities fraud, plaintiff should recover ''for all their losses if the defendants' misrepresentations induced them to accept a package of risks that they would not have chosen otherwise''); Brodsky, supra note 50, at 159 (''aggrieved customers [should] be permitted to compare the actual performance of their account with the performance of a hypothetical account that would have been suitable for the customer and was not churned'').

connection with unlawful securities transactions is sound, since those commissions are harm to the investor and an improper benefit for the broker. However, as noted above, there must be careful analysis in measuring damages to assure that the defrauded investor recovers for commissions but is not awarded a double recovery for them. The Model does so.

The account value typically stated on brokerage statements is an amount net of commissions—that is, a month-end or year-end account value that reflects a deduction for the commissions paid for the trading in the account. Market rates of return for various classes of securities (as used in the Model's alternative investment formula) typically report total yield on the securities that do *not* subtract for commissions (or transaction costs). Under the Model, the portfolio's net-of-commissions closing value is subtracted from the total return amount earned on the alternative investment. That difference thereby captures the commission amount as part of the investor's loss.

Since commissions are included in the loss determined under the Model, a separate award for commissions, as was permitted in several of the cases, is unwarranted, since it would afford the investor double recovery. In applying the Model to a particular case, it is therefore important to determine that the portfolio's closing value is net of commissions and that the alternative investment's rate is, in contrast, a total return. In this way, using the alternative investment under the Model provides a damages measurement that (without need for other proof) includes commissions.

The Model uses the alternative investment's rate of return to calculate the total return that the investor would have earned on the net capital invested. This amount is determined by a formula that computes the investor's gain or loss at the alternative investment rate on the on-going capital invested over the period of the wrongdoing. This calculates the total return that the investor would have earned on the net capital invested from the alternative investment. As illustrated below, the Model thus captures the interplay between the investor's capital invested, including both changes in the amount and timing considerations, and the rate of return from the alternative investment, which also typically changes over time.

Significantly, the Model uses a "time series" for the alternative investment by which the alternative investment rate changes over time. This is important to the damages calculation. For example, if the period of wrongdoing lasted two years, and it is determined that a certain class of equity securities was the proper alternative investment, the return on that class of securities likely changed during that

period. Those securities might have had a significant return the first year but might not have performed as well, or might even have had negative return, the second year. Due to several interrelated considerations, it is important to use the securities' actual return rates for incremental intervals comprising the period of the wrongdoing. First, the amount earned on the alternative investment depends on the alternative investment's rate of return; second, that amount also depends on the amount of capital invested at a particular time; and third, the total (or cumulative) amount earned on the alternative investment—an amount key to the Model—is a result of the time value of money arising from the interplay of the net capital invested and the alternative investment rate of return. The interplay of these considerations is evident in the illustrations below.[131]

Despite the significance of changing rates, the cases which adopt a market index typically use a "blended" rate—*one rate* for the whole period of wrongdoing. Doing so measures damages more imprecisely than need be and might produce a damages amount that is unfair to either the defrauded investor or the culpable broker.

Finally, the Model subtracts the value of the portfolio as of the end date of the wrongdoing period from the return on the alternative investment as of that date. That difference is the investor's damages.

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[131]The incremental period used for a given case depends on the particular circumstances. For example, consideration should be given to whether the investor had a long-term or short-term investment plan and history; the nature and reliability of the data available for the selected alternative investment; the frequency of trading in the portfolio; and the duration of the wrongdoing. The application of the Model illustrated below uses one-year incremental periods for the rate of return on the alternative investment. In most cases, a one-year incremental period is a sensible rule of thumb and affords a reliable damages measure.

Illustrations of the Model

The following exhibit illustrates how the damages calculation works:

Exhibit 1

Loss Calculation

Net Capital Invested				Return On Net Capital Invested From Alternative Investment*		
Deposit (Withdrawal)	Date	Account	Cumulative Net Capital Invested	Yield	Gain	Cumulative Value
150,000	01/01/88	No. 1	150,000	10.7%	0	150,000
0	12/31/88	year end-	150,000	10.7%	16,285	166,285
25,000	06/21/89	No.2	175,000	16.2%	12,367	203,651
0	12/31/89	-year end-	175,000	16.2%	17,070	220,722
100,000	11/30/90	No. 1	275,000	6.8%	13,892	334,613
0	12/31/90	-year end-	275,000	6.8%	1,901	336,514
(50,000)	06/29/91	No. 1	225,000	19.9%	31,965	318,479
0	12/31/91	-year end-	225,000	19.9%	31,132	349,611
(30,000)	10/02/92	No. 1	195,000	9.4%	24,929	344,540
0	12/31/92	-year end-	195,000	9.4%	7,826	352,366
50,000	02/18/93	No. 2	245,000	13.2%	5,997	408,363
25,000	05/19/93	No. 1	270,000	13.2%	12,856	446,219
25,000	07/19/93	No. 1	295,000	13.2%	9,474	480,693
150,000	11/22/93	No. 1	445,000	13.2%	21,319	652,012
0	12/31/93	-year end-	445,000	13.2%	8,817	660,829
(65,000)	02/23/94	No. 1	380,000	-5.8%	(5,896)	589,933
40,000	10/19/94	No. 1	420,000	-5.8%	(22,849)	607,084
0	12/31/94	year end-	420,000	-5.8%	(7,311)	599,773
0	01/31/95	-year end-	420,000	27.2%	12,555	612,328
(30,000)	05/01/95	No. 1	390,000	27.2%	37,960	620,288
110,000	09/01/95	No. 2	500,000	27.2%	53,143	783,431
0	12/31/95	-year end-	500,000	27.2%	65,984	849,416
$500,000						
			Alternative Investment Value Dec. 31, 1995			$849,416
			Actual Value Dec. 31, 1995			($495,000)
					Loss	$354,416

* Alternative investment is corporate bonds (long-term high-grade, Aa-rated and better)

The hypothetical defrauded investor here opened his portfolio on January 1, 1988, starting with $150,000 as his initial capital invested. He opened two accounts for the portfolio (designated accounts "No. 1" and "No. 2"). The wrongdoing came to light several years later, on December 31, 1995. During that period, the investor made eight deposits in varying amounts (ranging from $25,000 to $150,000) and four withdrawals (ranging from $30,000 to $65,000). The investor's net capital invested was $500,000. The exhibit shows the date each deposit and withdrawal was made, the affected account, and the cumulative amount of the capital invested as the deposits and withdrawals occur and at each year-end. Any transfers or transactions between the investor's two accounts within

the portfolio are not shown as part of the cash flow, since they do not affect the capital invested amount.

In this hypothetical scenario, the determination was made that the suitable instrument for the investor—the alternative investment—was a long-term high-grade corporate bond. That investment is reasonably safe and secure, being less risky (and therefore generally yielding less) than equity securities. But it is riskier (and typically produces higher return) than money market instruments and government securities. Of course, use of the Model in litigation depends on the investor's evidence: To prove damages under this calculation, the investor will need to show that corporate bonds were comparable to, and matched, his investment objectives.

The exhibit shows the "yield," or rate of return, on the corporate bond, on an annual basis. The data used is a time series at one-year increments.[132] The yield ranges from a high of 27.2 percent (late in the wrongdoing period, for 1995) to a low of -5.8 percent (for the prior year, 1994). The yields used in the exhibit are actual historical data, derived from a widely used, authoritative source.[133]

The exhibit shows the on-going gain from the alternative investment, calculated as of the date of each deposit to and withdrawal from the capital invested and at year-end.[134] The final column shows the on-going cumulative value of the alternative investment (consisting of the capital invested plus the return from the alternative investment). Under this exhibit, the alternative investment's total value at the end of the wrongdoing period was $849,416.

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[132]That period is used in the illustration because the wrongdoing occurred over a several year period, the hypothetical investor (given the long investment period) had a long-term investment horizon, and the one-year period afforded very accurate rate-of-return data. Depending on the particulars in a given case, the incremental period used for the rate of return could be shortened (such as using monthly rates).

[133]The data source is *Stocks, Bonds, Bills and Inflation 1996 Yearbook*, prepared and published by Ibbotson Associates. Ibbotson Associates has collected and organized voluminous data on rates of return on various investment instruments from 1926 to the present, providing a history of returns in capital markets over that long period. The Ibbotson study is widely accepted and deemed very reliable.

[134]The formula for determining the amount of alternative investment gain is, in substance, the alternative investment's existing cumulative value multiplied by the annual yield percentage, as determined for the precise number of days from the last transaction or year end, *less* that existing cumulative value; or [cumulative value] $\times$ (1 + [yield]) ^ (([time period]) $\div$ 360) $-$ [cumulative value].

Thus, the hypothetical investor invested a total of $500,000 over an eight-year period (1988–95). Had the portfolio been managed properly, the investor should have had $849,416 on December 31, 1995. Under the exhibit, the actual value of his mismanaged portfolio was only $495,000. His damages are the difference between what he should have had and what he really had ($849,416 − $495,000), or $354,416.[135]

This exhibit can be used to show the importance of the timing of deposits and withdrawals. Consider that instead of investing $110,000 on September 1, 1995 (as in Exhibit 1), the investor invested that amount much earlier, on September 1, 1989. As Exhibit 2 shows, although the investor at the end of the day had still invested $500,000 in the portfolio, his damages—due to the time value of money—are now greater:

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[135]This spreadsheet for the Model "automatically" accounts for dividends and commissions. Dividends earned on the investor's accounts were, as shown per the account statements, reinvested in the accounts. Similarly, the yield percentages used are total return figures. Thus, there is an "apples-to-apples" comparison to account for the value of dividends. As for commissions, the commissions that the investor paid were, as again set forth in the account statements, regularly charged to his accounts, so that the ending balance of his portfolio is reduced by the costs of commissions he paid for the fraudulent securities trading (i.e., the portfolio balance is "net of commissions"). The yield percentages used are *not* net of commissions (i.e., they are total return figures that do not subtract for any transaction costs). Thus, the Model captures as damages the amount paid for commissions.

Exhibit 2

Loss Calculation (Illustration-2)

Net Capital Invested				Return On Net Capital Invested From Alternative Investment*		
Deposit (Withdrawal)	Date	Account	Cumulative Net Capital Invested	Yield	Gain	Cumulative Value
150,000	01/01/88	No. 1	150,000	10.7%	0	150,000
0	12/31/88	-year end-	150,000	10.7%	16,285	166,285
25,000	06/21/89	No.2	175,000	16.2%	12,367	203,651
110,000	09/01/89	No. 1	285,000	16.2%	6,208	319,859
0	12/31/89	-year end-	285,000	16.2%	16,556	336,415
100,000	11/30/90	No. 1	385,000	6.8%	21,173	457,588
0	12/31/90	-year end-	385,000	6.8%	2,600	460,188
(50,000)	06/29/91	No. 1	335,000	19.9%	43,713	453,901
0	12/31/91	-year end-	335,000	19.9%	44,370	498,270
(30,000)	10/02/92	No. 1	305,000	9.4%	35,529	503,800
0	12/31/92	-year end-	305,000	9.4%	11,443	515,243
50,000	02/18/93	No. 2	355,000	13.2%	8,769	574,012
25,000	05/19/93	No. 1	380,000	13.2%	18,071	617,083
25,000	07/19/93	No. 1	405,000	13.2%	13,101	655,184
150,000	11/22/93	No. 1	555,000	13.2%	29,058	834,242
0	12/31/93	-year end-	555,000	13.2%	11,281	845,523
(65,000)	02/23/94	No. 1	490,000	-5.6%	(7,544)	772,979
40,000	10/19/94	No. 1	530,000	-5.6%	(29,939)	783,040
0	12/31/94	-year end-	530,000	-5.6%	(9,430)	773,610
0	01/31/95	-year end-	530,000	27.2%	16,194	789,805
(30,000)	05/01/95	No. 1	500,000	27.2%	48,963	808,767
0	12/31/95	-year end-	500,000	27.2%	143,245	952,012
$500,000						
			Alternative Investment Value Dec. 31, 1995			$952,012
			Actual Value Dec. 31, 1995			($495,000)
					Loss	$457,012

* Alternative investment is corporate bonds (long-term high-grade, Aa-rated and better)

Thus, if the investor had invested his $110,000 six years earlier, his portfolio would have been worth $952,012 and his damages would be $457,012. In assessing damages for portfolio mismanagement, it is critically important to capture the timing of deposits and withdrawals.

These exhibits highlight several other important points in considering portfolio mismanagement damages. For example, an investor can suffer damages even if the value of his portfolio appreciates. In the first exhibit, the investor who invested $500,000 would still be damaged if the mismanaged portfolio had increased to, say, $750,000. That investor might have earned $250,000 over the eight-year period, but had the portfolio been properly managed, and had his capital been invested in investments appropriate for him, he would have earned almost $100,000 more (i.e., $849,416). A portfolio subjected to fraud can earn money, but if it did not keep

pace with the appropriate market, the investor is nonetheless damaged.[136]

The exhibits also show how the well-managed portfolio is subject to both upward and downward market changes. The hypothetical investor's portfolio here usually increased in value annually, but in one year (1994) it suffered a negative return (−5.8 percent). Even the well-managed portfolio would have incurred a loss that year. The Model takes both ascending and declining market conditions into account.

Finally, it should be readily apparent from the exhibits that the Model easily adapts to calculating damages based on other rates of return and using other alternative investments. For example, should the determination be made to use a blended rate of return (which generally affords a less precise measure of damages), the calculation can be easily changed.[137] Similarly, if a determination is made to use a different alternative investment, or another market index, that computation can readily be made.

It bears emphasizing that the foregoing exhibits are greatly simplified examples of what occurs in the real world. In a case of portfolio mismanagement, many more withdrawals and deposits, among various accounts within the managed portfolio, typically occur. But while the analysis in an actual case may be more factually involved, the underlying concepts of the Model and the resulting damages calculations are the same—and they can be presented at trial simply and straightforwardly.

Conclusion

The harm that results from securities fraud infecting portfolio mismanagement needs to be measured differently from the harm

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[136]Cf. Redstone v. Goldman, Sachs & Co., 583 F. Supp. 74, 75–76 (D. Mass. 1984) (court rejected defendants' argument that plaintiffs suffered no compensable loss where the portfolio appreciated in value after the wrongful transactions, since plaintiffs could show that they were "seeking realization of their reasonably certain expectations").

[137]The blended rate for the corporate bond alternative investment from 1988 to 1995 was 11.8 percent. If that rate were used as the yield to determine the hypothetical investor's loss in these illustrations, there is only a small effect on the damages amount. In other situations, however, depending on how much is invested, when it is invested, and the period of wrongdoing, using a blended return instead of annual (or other incremental) returns could have a more significant effect.

arising in other Section 10(b) cases, using a method that accounts for the particularities of portfolio investment. It is important to recognize that the "Alternative Investment" Model described here is not a measure of damages designed solely for a defrauded investor. Rather, brokers and brokerage firms can also use the Model to fend off excessive damages claims presented by defrauded investors. The same considerations that drive using the Model for a plaintiff's damages case may warrant a defendant presenting the Model in appropriate circumstances as well. Thus, a defendant confronting liability for fraudulent portfolio mismanagement may want to show the effects of market changes, particularly where the relevant market declined; an "investor profile" and the appropriate alternative investment that the investor should have acquired; the appropriate index or rate of return on that alternative investment; the timing of the investor's actual cash flow and an accurate accounting of the investor's net capital invested; single, not double, recovery for commissions and dividends; and the proper time period of the fraudulent mismanagement. In short, the Model described here enables both plaintiffs and defendants in portfolio mismanagement cases—and, hopefully, courts and arbitrators who must decide their cases—to measure portfolio mismanagement damages as fairly as possible.