

MEASURING DAMAGES IN SUITABILITY AND CHURNING ACTIONS UNDER RULE 10b-5

Both the churning of a customer's account and the purchasing of unsuitable securities¹ by a broker violate section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act)² and Rule 10b-5 promulgated pursuant to that statute.³ Churning occurs when a broker⁴ who exercises control over a customer's account, engages in excessive trading for the purpose of realizing increased commissions.⁵ Suitability violations occur when a broker purchases securities for a customer's account that are inconsistent with the customer's objectives and financial needs.⁶ Under Section 10(b) of the Exchange Act and Rule 10b-5, a customer may sue a broker who has churned his account or who has purchased unsuitable securities for the account to the customer's detriment. Neither Section 10(b) of the Exchange Act nor Rule 10b-5 specifies how damages in a churning or suitability suit should be calculated.⁷ Section 28(a) of the Exchange Act, however, limits a plaintiff's recovery in suits for its violation to actual damages.⁸ Given this statutory limitation, the measure of damages used in churning and suitability actions⁹ should have

¹ Although this note uses the term securities, it applies to options transactions as well. The legal standard governing claims of churning or unsuitability under Rule 10b-5 is the same for options trading and other types of securities trading. *Smith v. Sade & Co.*, [1982 Tr. Binder] Fed. Sec. L. REP. (CCH) ¶ 98,846 at 94,366 (D.D.C. October 27, 1982); § 3(10) of the Exchange Act.

² 15 U.S.C. § 78j(b) (1982).

³ The rule provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange:

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates as fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1983).

⁴ Throughout this note, the term "broker" will be used rather than "registered representative," "dealer," or "broker-dealer". This shorthand is meant to include all of these categories.

⁵ Churning occurs when a broker, exercising control over an account, initiates transactions that are excessive in light of the character of the account, in order to increase his own personal gain. *Carras v. Burns*, 516 F.2d 251, 258 (4th Cir. 1975). High turnover in the customer's account and large brokerage commissions are the hallmarks of churning. *Id.* Churning is a deceptive device made actionable under Rule 10b-5. *Id.* See also *Fey v. Walston & Co.*, 493 F.2d 1036, 1050 (7th Cir. 1974); Note, *Churning By Securities Dealers*, 80 HARV. L. REV. 869, 869 (1967) [hereinafter cited as *Churning*].

⁶ See *Clark v. John Lamula Inv., Inc.*, 583 F.2d 594, 599-600 (2d Cir. 1978); *Zaretsky v. E.F. Hutton & Co., Inc.*, 509 F. Supp. 68, 75 (S.D.N.Y. 1981).

⁷ See 15 U.S.C. § 78a *et seq.* (1982). One commentator has noted: "The basic problem with computing damages under Rule 10b-5 is that one is dealing with an implied remedy, under a rule which was drafted to provide a basis for injunctive relief." Mullaney, *Theories of Measuring Damages in Security Cases and the Effects of Damages on Liability*, 46 FORDHAM L. REV. 277, 279 (1977).

⁸ Section 28(a) of the Exchange Act, in relevant part, provides: "[N]o person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment on one or more actions, a total amount in excess of his actual damages on account of the act complained of." 15 U.S.C. § 78bb(a) (1982). Thus, the damages formula used "cannot restore a plaintiff to a better position than he would have been in if the fraud had not occurred." *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 637 F.2d 77, 85 (2d Cir. 1980). [hereinafter, "Rolf IV"]

⁹ Few actions under Rule 10b-5 go to judgment. See Mullaney, *supra* note 7, at 277-78.

the effect of placing the defrauded plaintiff in the same position that he or she would have occupied absent the fraud.¹⁰

Actual damages in churning and suitability cases are difficult to measure.¹¹ In theory, actual damages consist of the difference between the value the plaintiff's account would have had, had it been properly managed, and the value of the fraudulently mismanaged account.¹² Courts determining damages in suitability and churning cases, therefore, face the difficult task of determining the theoretical value of the well-managed account and of compensating the plaintiff accordingly.¹³

Two basic models have emerged for calculating damages in churning and suitability cases. The quasi-contractual or restitutionary model¹⁴ is used primarily in churning cases.¹⁵ Under this model, the measure of damages is the amount of commissions and interest paid by the customer to the brokerage house.¹⁶ The out of pocket or rescissory model¹⁷ is used generally in suitability cases.¹⁸ Damages awarded under this model consist of the amount of the customer's trading losses attributable to the fraud.¹⁹ A third model,

¹⁰ *Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 651 F.2d 615, 621 (9th Cir. 1981). Several general rules govern the plaintiff's recovery under Rule 10b-5. The district court is to determine the "appropriate" measure of damages in light of the facts presented. *Blackie v. Barrack*, 524 F.2d 891, 909 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976). The court's function, therefore, is "to fashion the remedy best suited to the harm." *Garnatz v. Stifel, Nicolaus & Co., Inc.*, 559 F.2d 1357, 1360 (8th Cir. 1977), *cert. denied*, 435 U.S. 951 (1978). Moreover, there must be a causal nexus between the defendant's acts and the plaintiff's loss. *See Shores v. Sklar*, 610 F.2d 235, 239 (5th Cir. 1980) (causation is an "essential element of recovery").

¹¹ In actions where liability has been found on a churning or suitability claim, no consistent measure of damages has evolved. Various commentators have noted the unsettled nature of the law on damages under Rule 10b-5. *See generally*, Rath, *Damages in Broker/Client Suits*, 15 REV. SEC. REG. 855 (1982); Brodsky, *Measuring Damages in Churning and Suitability Cases*, 6 SEC. REG. L.J. 157 (1978); Mullaney, *supra* note 7; Jacobs, *The Measure of Damages in Rule 10b-5 Cases*, 65 GEO. L.J. 1093 (1977); Note, *Rule 10b-5 Damage Computation: Application of Financial Theory to Determine Net Economic Loss*, 51 FORDHAM L. REV. 838 (1983).

¹² *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 327 (5th Cir. 1981). *See also Churning, supra* note 5, at 883.

¹³ Some of the variables inherent in determining the value of a well managed account have been listed by one commentator. *See Brodsky, supra* note 11, at 158-59.

¹⁴ *See, e.g., Hecht v. Harris, Upham & Co.*, 430 F.2d 1202, 1211-12 (9th Cir. 1970); *Kravitz v. Pressman, Frohlich & Frost, Inc.*, 447 F. Supp. 203, 216 (D. Mass. 1978); *Stevens v. Abbott, Proctor & Paine*, 288 F. Supp. 836, 849-50 (E.D. Va. 1968).

¹⁵ *See Zaretsky v. E.F. Hutton & Co., Inc.*, 509 F. Supp. 68, 73 (S.D.N.Y. 1981); *see also*, cases cited *supra* note 14.

¹⁶ *See infra* notes 32-33 and accompanying text. This measure of recovery is analogous to the remedy of restitution in contract law, where the measure of damages consists of the benefits conferred on a party who has been unjustly enriched at the expense of another. *See Restatement of Restitution* 1 (1937); 3 L. LOSS, *SECURITY REGULATION* 1794 (2d ed. 1961).

¹⁷ *See, e.g., Nye v. Blyth, Eastman Dillon & Co., Inc.*, 588 F.2d 1189, 1198 (8th Cir. 1978); *Henricksen v. Henricksen*, 640 F.2d 880, 886-87 (7th Cir. 1981).

¹⁸ *See, e.g., Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 603 (2d Cir. 1978) and cases cited *supra* note 17. Different models have been used for churning and suitability claims because the damages caused by the violations often vary. If securities suitable for the customer's account are churned, the damages consist only of the commissions and interest paid. On the other hand, where unsuitable securities are purchased, trading losses are caused by the fraud. *See Brodsky, supra* note 11, at 159.

¹⁹ *See infra* notes 55-62 and accompanying text. The pure out of pocket measure of recovery consists of the difference between the acquisition cost of a security or securities which the defendant fraudulently induced the plaintiff to purchase and the amount the plaintiff subsequently received

the loss of the bargain model, where the plaintiff recovers the profits he or she would have earned on the money had the account not been fraudulently mismanaged, has sometimes been suggested by commentators, but has rarely been adopted by courts.²⁰

Customers who allege that their accounts have been fraudulently mismanaged by their brokers often claim both that the brokers churned the account and purchased unsuitable securities. Where liability has been found on both churning and suitability claims, no single model has been adopted to calculate the plaintiff's damages. In some cases the quasi-contractual model is used,²¹ while in others the out of pocket model is deemed appropriate.²² Often courts combine the two models, thereby awarding the plaintiff both his trading losses and the amount of commissions and interest paid to the brokerage house.²³

The first part of this note will examine the traditional models of recovery used by courts in churning and suitability cases. The note suggests that neither the quasi-contractual model nor the out of pocket model accurately measures a customer's actual damages and, thus, that neither model is appropriate for use in suits between brokers and customers. This note submits that the quasi-contractual model is inappropriate because it bases recovery only upon the amount of commissions and interest paid. The potential for overcompensating the plaintiff exists with use of the quasi-contractual model when there are no trading losses in the account. The potential for undercompensating the plaintiff exists when the trading losses exceed the commissions and interest paid. The out of pocket model is similarly flawed because recovery under this model consists of the plaintiff's total amount of trading losses without regard for general market decline or other extrinsic factors which affect the value of the account. The combination method of calculating damages is an inappropriate measure because awarding both commissions paid and trading losses, which encompass some measure of the commissions paid,²⁴

when he or she sold the securities. *See* *Nye v. Blyth, Eastman Dillon & Co., Inc.*, 588 F.2d 1189, 1198 (8th Cir. 1978). The difference between the acquisition cost of a security and the amount received when the security is sold constitutes the trading profit or loss on the transaction. Trading losses in an account, therefore, consist of the aggregate of the trading profits and losses on the individual securities in the account. The trading losses in the account represent the out of pocket damages the plaintiff has suffered. *See* *Churning*, *supra* note 5, at 884-85.

²⁰ In *Steven v. Abbot, Proctor & Paine*, 288 F. Supp. 836, 849 (E.D. Va. 1968), the court dismissed the benefit of the bargain theory as being too speculative in nature, as ignoring the economic reality that properly managed accounts can lose money, and as awarding punitive damages in the guise of compensatory damages. *Id.* Use of the benefit of the bargain model, however, has been approved where defrauded sellers of securities were not paid the agreed upon price for the securities. *Osofsky v. Sipf*, 645 F.2d 107, 113 (2d Cir. 1981). The court in *Osofsky* explained that in this situation the amount of damages could readily be determined because it represented the unpaid consideration and thus was not unduly speculative. *Id.*

²¹ *See, e.g.*, *Kravitz v. Pressman, Frohlich & Frost*, 447 F. Supp. 203, 216 (D. Mass. 1978).

²² *See, e.g.*, *Nye v. Blyth, Eastman Dillon & Co., Inc.*, 588 F.2d 1189, 1198 (8th Cir. 1978).

²³ *See, e.g.*, *Henricksen v. Henricksen*, 640 F.2d 880, 884, 887 (7th Cir. 1981).

²⁴ Trading losses consist of the difference between the acquisition cost of a security and the amount received when the security is subsequently sold. Brokerage firms charge a commission on all purchases and sales they execute. The commission is automatically added to the acquisition cost of a security and is automatically subtracted from the amount received when the security is subsequently sold. *See* B. GUP., *THE BASICS OF INVESTING* 141-42 (1979) (example of security transaction confirmation showing that commission is automatically added to the price of the security). For example, if the customer purchases a security with a purchase price of \$200 and the brokerage firm charges a 5% commission for purchases and sales made on the customer's behalf, the acquisition cost of the security is \$210. If the customer subsequently sells the security for a price of \$100, the amount

overcompensates the plaintiff. The second part of the note will examine recent trends in measuring damages in churning and suitability cases, including the modified out of pocket approaches used recently in some circuits. Finally, the third part of the note will discuss the weaknesses of the various modified out of pocket models. Although the various models of recovery have been criticized by some commentators, no commentator has proposed a model which overcomes all of the defects of the prior models. This note will propose a model designed to overcome the defects in the prior models and to compensate fully, without overcompensating, the defrauded plaintiff. The proposed model takes into account all of the factors that can influence the value of an account, including market action, dividend activity, trading losses, and cash withdrawals and deposits made by the plaintiff.

I. TRADITIONAL APPROACHES TO MEASURING DAMAGES

Traditionally, damages in a churning case have been determined by the use of the quasi-contractual model of recovery, whereas damages in a suitability case have been determined by the use of the out of pocket model.²⁵ The basis for using different models in each case is related to the element of causation. The harm caused by the churning of suitable securities consists of the increased commissions, interest and taxes generated by the increased activity in the account.²⁶ The injury caused by the purchase of unsuitable securities consists of the trading losses sustained by the purchase and sale of the unsuitable securities.²⁷ Most often, however, the plaintiff customer alleges that the broker both churned the account and purchased unsuitable securities.²⁸ When the plaintiff prevails on both causes of action, neither model of recovery alone is sufficient to compensate the plaintiff fully for the harm caused by the broker.²⁹ Although recent cases have recognized the limitations of the traditional models of recovery and have developed modified models, it is necessary to understand the traditional models in order to appreciate the impact of these modifications. The traditional models of recovery not only continue to be considered as viable methods of calculating damages,³⁰ but also serve as the foundation for the modified approaches.³¹ This section will discuss the two traditional models of calculating damages and will examine the weaknesses inherent in each that precipitated the various judicial attempts at modification.

received by the customer would be \$95. The trading loss on the transaction is \$115. Trading losses, therefore, include the commissions paid on the transaction.

²⁵ See cases cited *supra* notes 15 and 18.

²⁶ Brodsky, *supra* note 11, at 159-60.

²⁷ *Id.*

²⁸ See, e.g., *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202, 1206 (9th Cir. 1970); *Fey v. Walston & Co., Inc.*, 493 F.2d 1036, 1041 (7th Cir. 1974); *Miley v. Oppenheimer & Co., Inc.*, 637 F.2d 318, 325 (5th Cir. 1981); *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38, 43 (2d Cir. 1978), *cert. denied*, 439 U.S. 1039 (1978), *award on remand appealed*, 637 F.2d 77 (2d Cir. 1980) [hereinafter cited as *Rolf II*].

²⁹ *Miley v. Oppenheimer & Co., Inc.*, 637 F.2d 318, 326 (5th Cir. 1981).

³⁰ See, e.g., *Garnatz v. Stifel, Nicolaus & Co., Inc.*, 559 F.2d 1357, 1361 (8th Cir. 1977) (out of pocket model); *Zaretsky v. E.F. Hutton & Co., Inc.*, 509 F. Supp. 68, 73 (S.D.N.Y. 1981) (quasi-contractual model); *Kravitz v. Pressman, Frohlich & Frost, Inc.*, 447 F. Supp. 203, 216 (D. Mass. 1978) (quasi-contractual model).

³¹ See *Miley*, *supra* note 28, at 327-28, discussed *infra* notes 139-56 and accompanying text.

A. The Quasi-Contractual Model: Simplicity Over Accuracy

Under the quasi-contractual model of recovery, the court allows the plaintiff customer to recover from the defendant broker or brokerage house the commissions paid, interest charged, and any fees and taxes paid on the securities transactions.³² This theory of recovery is analytically consistent with the tort claim of unjust enrichment in that it requires the broker to return to the customer the benefits derived from the broker's unlawful acts.³³

The quasi-contractual model of recovery has been used by courts for various reasons. Courts frequently reason that damages are ascertained most easily by using this method and that other models of recovery are too difficult to apply because those models depend on unduly speculative calculations.³⁴ Some courts have reasoned that the quasi-contractual model provides the most accurate measure of the plaintiff's damages and that the out of pocket and benefit of the bargain models of recovery overstate the plaintiff's loss.³⁵ Still others have reasoned that the quasi-contractual model is preferable because other models understate the plaintiff's loss.³⁶ One court even stated that commissions represent the only element of damages proximately caused by the fraudulent acts of the broker.³⁷

Some courts have reasoned that the quasi-contractual model of recovery is appropriate in situations where it is impossible to know what the value of the securities in the account would have been but for the defendant's fraud.³⁸ This reasoning is, however, little more than a rationalization. Any determination of damages entails a comparison between the theoretical value of the account had there been no fraud and the actual value of the fraudulently managed account. It is, therefore, almost always impossible to know with certainty what securities would have been in the account had there been no fraud.³⁹ This rationalization merely indicates that, as opposed to models which include the difficult and speculative calculation of the value of a theoretical, well-managed account, the quasi-contractual model results in an easily ascertainable damages award. The weakness of the quasi-contractual model of recovery, as one commentator has noted, is that,

³² See, e.g., *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202, 1211-12 (9th Cir. 1970); *Zaretsky v. E.F. Hutton & Co., Inc.*, 509 F. Supp. 68, 73 (S.D.N.Y. 1981); *Kravitz v. Pressman, Frohlich & Frost, Inc.*, 447 F. Supp. 203, 216 (D. Mass. 1978).

³³ Cf. *Speed v. Transamerica Corp.*, 135 F. Supp. 176, 186 (D. Del. 1955) *modified on other grounds and aff'd*, 235 F.2d 369 (3rd Cir. 1956) ("The injured party is entitled to require the perpetrator to disgorge gains made at the expense of the injured.").

³⁴ *Carras v. Burns*, 516 F.2d 251, 259 (4th Cir. 1975); see also *Zaretsky v. E.F. Hutton & Co., Inc.*, 509 F. Supp. at 73. In determining that the quasi-contractual model of recovery was appropriate, the *Carras* court noted: "Here, however, it is not possible to determine what the account would have been worth had there been no churning On the facts of this case, damages for churning should be limited to the ascertainable losses to the account, including commissions, service charges, and taxes attributable to trading." 516 F.2d at 259.

³⁵ E.g., *Stevens v. Abbot, Proctor & Paine*, 288 F. Supp. 836, 849-50 (E.D. Va. 1968).

³⁶ See *Kravitz v. Pressman, Frohlich & Frost, Inc.*, 447 F. Supp. 203, 216 (D. Mass. 1978).

³⁷ *Newkirk v. Hayden, Stone & Co.*, [1964-1966 Transfer Binder]FED. SEC. L. REP. (CCH) ¶ 91,621, at 95,321-22 (S.D. Cal. September 30, 1965). The *Newkirk* court also indicated that awarding damages based on adverse fluctuations in the stock would be punitive rather than deterrent "because defendants did not gain from market losses." *Id.* at 95,321. Punitive damages are not recoverable under the federal securities laws. E.g., *Byrnes v. Faulkner, Dawkins & Sullivan*, 550 F.2d 1303, 1313 (2d Cir. 1977).

³⁸ *Zaretsky v. E.F. Hutton & Co., Inc.*, 509 F. Supp. 68, 73 (S.D.N.Y. 1981). See also, *Carras v. Burns*, 516 F.2d 251, 259 (4th Cir. 1975).

³⁹ See *Churning*, *supra* note 5, at 883.

for all its simplicity, it often bears no relationship to the amount of the customer's actual damages.⁴⁰ If the value of the commissions paid as a result of the churning were the only damages suffered by the plaintiff, the theoretical amount of damages should be the difference between the commissions actually paid and those which would have been paid had the account been properly managed, rather than the total amount of commissions paid.⁴¹ Consequently, an award of the full amount of commissions paid in a churning suit may overcompensate the plaintiff.⁴²

Other justifications given for the use of the quasi-contractual model are similarly flawed. For example, the rationale that other models do not adequately compensate the plaintiff could only possibly be valid when the amount of commissions paid exceeds the trading losses in the account.⁴³ If the trading losses in the account are greater than the commissions paid, the use of the out of pocket model would result in a larger damages award for the plaintiff. Moreover, even when the commissions paid exceed the trading losses, if the broker's fraudulent conduct caused both the trading losses and the excess commissions,⁴⁴ the quasi-contractual model would undercompensate the plaintiff because it does not include compensation for trading losses.⁴⁵

The rationale that the quasi-contractual model should be used because other models of recovery overstate the plaintiff's loss⁴⁶ is similarly unconvincing. If the market value of the plaintiff's portfolio increased more than the market in general because of the broker's fraudulent trading, that is, if the plaintiff made money because of the increased trading in the account, the award of commissions would overstate the plaintiff's loss. The plaintiff would receive a windfall because he would retain the benefit of the increased trading activity in the form of greater profits or reduced losses in the account without having to incur any of the costs associated with that activity.

The total harm caused by the defendant broker's violations of the securities laws can include both excess commissions and trading losses.⁴⁷ A plaintiff customer is entitled to

⁴⁰ *Id.* at 884.

⁴¹ *Cf. Lutz v. Boas*, 39 Del. Ch. 585, 600-01, 171 A.2d 381, 391 (1961). To determine damages in such a manner, would, of course, negate the advantage of the easily ascertainable feature that is commonly associated with the quasi-contractual model of recovery. Determining the amount of commissions that would have been paid if the account were properly managed is as difficult as determining the value of the entire account in the absence of fraud.

⁴² One justification given for the award of the full amount of commissions paid is that since the damages were caused by defendant's conduct, it is reasonable to hold that the broker loses the right to retain any benefit received from his conduct. *Churning*, *supra* note 5, at 884. *Cf. Gratz v. Cloughton*, 187 F.2d 46, 51-52 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951); *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202, 1213 (9th Cir. 1970) (Powell, J., dissenting in part).

⁴³ The quasi-contractual method of recovery allows the plaintiff to collect damages even though the account made a profit during the period of the violation. *Zaretsky v. E.F. Hutton & Co., Inc.*, 509 F. Supp. 68, 73 (S.D.N.Y. 1981).

⁴⁴ It is not always true that the only element of damages proximately caused by defendant's churning is the amount of commissions paid. As the Fifth Circuit noted: "While excessive commissions represent the sole source of gain to the broker from his misconduct, there are in fact two distinct harms (excess commissions and decline in portfolio value) which may be proximately caused by the broker's churning of an account." *Miley v. Oppenheimer & Co., Inc.*, 637 F.2d 318, 326 (5th Cir. 1981).

⁴⁵ *Id.*

⁴⁶ *See, e.g., Stevens v. Abbott, Proctor & Paine*, 288 F. Supp. 836, 849-50 (E.D. Va. 1968).

⁴⁷ *Miley v. Oppenheimer & Co., Inc.*, 637 F.2d at 326.

recover all of the actual damages proximately caused by the defendant's wrongdoing.⁴⁸ Any model of recovery used to determine compensation for plaintiffs in cases of fraud should focus, not on what the broker or brokerage house earned as a result of the fraud — as the quasi-contractual model does — but rather on the extent of damage to the customer. Although the quasi-contractual model is easy to apply, it does not accurately measure the plaintiff's actual damages because it concentrates on the amounts earned by the broker rather than the damage to the customer.

B. *The Out of Pocket Model: Defendant as Market Insurer*

Unlike the quasi-contractual model, the out of pocket or rescissory model of calculating a plaintiff's damages focuses on the economic harm done to the plaintiff customer rather than the benefit received by the defendant broker.⁴⁹ This model is used more often in suits challenging the suitability of the investment decisions made by the broker than in pure churning suits.⁵⁰ Where the suitability of a purchase is challenged, the customer is claiming that the security should not have been purchased.⁵¹ Logically, therefore, damages caused by suitability violations are not limited to commissions and interest paid, but rather consist of the total trading losses sustained on account of the unsuitable purchases.⁵² Damages under the out of pocket model of recovery, however, consist of the total decline in the value of plaintiff's account during the period of the fraud rather than only the trading losses caused by the unsuitable purchases.⁵³ This model places the customer in the position he occupied prior to the time the fraud commenced.⁵⁴

Under the out of pocket model, damages are calculated by computing the difference between the value of the plaintiff's original portfolio and the value of the portfolio at the time the fraud was, or should have been,⁵⁵ discovered.⁵⁶ The original value of the

⁴⁸ *Fey v. Walston & Co., Inc.*, 493 F.2d 1036, 1055 n.26 (7th Cir. 1974) ("damages should compensate the customer by fair approximation for the losses sustained as a proximate result of unlawful churning.").

⁴⁹ For a discussion of the out of pocket model generally, see Mullaney, *supra* note 7, at 281-83; *Churning*, *supra* note 5, at 884-85.

⁵⁰ See cases cited *supra* note 18.

⁵¹ See, e.g., *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 599-600 (2d Cir. 1978); *Garnatz v. Stifel, Nicolaus & Co., Inc.*, 559 F.2d 1357, 1360 (8th Cir. 1977).

⁵² *Brodsky*, *supra* note 11, at 159.

⁵³ *Garnatz v. Stifel, Nicolaus & Co., Inc.*, 559 F.2d 1357, 1361 (8th Cir. 1977); see also *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 604 (2d Cir. 1978). Cf. *Reeder v. Mastercraft Elec. Corp.*, 363 F. Supp. 574, 582 (S.D.N.Y. 1973). In cases of a defrauded purchaser who bought securities at an artificially high price due to the defendant's fraud, the out of pocket model gives plaintiff the difference between the price paid and the actual value at the date of sale. *Estate Counseling Service, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 303 F.2d 527, 533 (10th Cir. 1962). In the context of a defrauded purchaser who is suing the issuer or seller rather than the broker, unlike in the context of suits between brokers and customers, the out of pocket model is not synonymous with the rescissory model. *Id.*

⁵⁴ *Garnatz v. Stifel, Nicolaus & Co., Inc.*, 559 F.2d 1357, 1361 (8th Cir. 1977) ("Such a measure seeks to return the parties to the status quo ante the sale.").

⁵⁵ Courts have consistently held that damages are determined only until the time the plaintiff discovers, or reasonably should have discovered the fraud. *Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 651 F.2d 615, 620 (9th Cir. 1981); *Nye v. Blyth, Eastman Dillon & Co., Inc.*, 588 F.2d 1189, 1198 (8th Cir. 1978); *Foster v. Financial Technology, Inc.*, 517 F.2d 1068, 1072 (9th Cir. 1975). As the court in *Arrington* stated, "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." 651 F.2d at 620.

⁵⁶ *Jacobs, The Measure of Damages in Rule 10b-5 Cases*, 65 GEO. L.J. 1093, 1138 (1977).

portfolio is based on the aggregate of the market prices of the securities contained in the account (minus any debit balance) at the time the fraud commenced⁵⁷ or, where the fraud commenced upon the opening of the plaintiff's account, by the amount of the plaintiff's original investment.⁵⁸ Similarly, the value of the portfolio at the time the fraud is discovered is based on either the aggregate of the market prices of the securities in the account,⁵⁹ or, where the plaintiff closes the account upon learning of the fraud, the amount of cash returned to the plaintiff.⁶⁰ If only one security is involved, the plaintiff's total out of pocket loss is computed by taking the difference between the amount paid for the security by the customer and the amount that would have been credited to the customer had the security been sold at the time the fraud was discovered.⁶¹ Thus, the damages recovered using the out of pocket model consist not of the plaintiff's realized losses but of the losses the plaintiff would have sustained had he sold when he discovered the fraud.⁶²

The out of pocket model assumes that none of the transactions in the account were proper,⁶³ or, where only one security is involved, that no other security would have been purchased.⁶⁴ The assumptions on which this model is based ignore the fact that the plaintiff engaged the services of a brokerage house to enter into securities transactions on his behalf.⁶⁵ As a result, the out of pocket model often overstates the plaintiff's actual damages. For example, in *Clark v. John Lamula Investors, Inc.*,⁶⁶ the Second Circuit affirmed the trial court's damage award of the total amount of trading losses suffered by the plaintiff, even though the securities were sold at the bottom of a bear market.⁶⁷ The appellate court rejected the defendant's argument that the damages should be reduced to reflect the general decline the market was experiencing at that time.⁶⁸ In so doing, the court distinguished the situation where the entire account was mismanaged from a

⁵⁷ See *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, [1979 Tr. Binder] FED. SEC. L. REP. (CCH) ¶ 96,919, at 95,856 (S.D.N.Y. 1979) ("*Rolf III*").

⁵⁸ See, e.g., *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202, 1206 (9th Cir. 1970).

⁵⁹ See, e.g., *Rolf II*, 570 F.2d at 49.

⁶⁰ See, e.g., *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 327 (5th Cir. 1981).

⁶¹ See, e.g., *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 603-04 (2d Cir. 1978).

⁶² In *Costello v. Oppenheimer & Co., Inc.*, 711 F.2d 1361 (7th Cir. 1983), the district court had instructed the jury that the elements of damages which could have resulted from the wrongful conduct of the defendant were the realized losses to the account and commissions on improper transactions. *Id.* at 1373. The appellate court did not consider the appropriateness of this charge since it was not objected to at trial. *Id.* This view that plaintiff may only recover realized losses is erroneous. Plaintiffs are entitled to recover the losses they would have realized had they sold upon learning of the fraud. See *Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 651 F.2d 615, 620 (9th Cir. 1981); *Cf. Nye v. Blyth, Eastman Dillon & Co.*, 588 F.2d 1189, 1198 (8th Cir. 1978).

⁶³ *Churning*, *supra* note 5, at 884.

⁶⁴ *Id.*

⁶⁵ Upon entering the securities market, an investor assumes the risks inherent in that market and must bear the losses stemming therefrom. See *Huddleston v. Herman & Maclean*, 640 F.2d 534, 555 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds*, 103 S. Ct. 683 (1983). As the court in *Stevens v. Abbott, Proctor & Paine*, 288 F. Supp. 836, 850 (E.D. Va. 1968) stated, to ignore this reality "would be to ignore the fact that regardless of how unsophisticated and financially naive the plaintiff was, she is bound to have known that one who deals in the stock market, regardless of in how conservative a manner, stands not only the chance to have her securities appreciate in value, but likewise stands the chance that some may depreciate."

⁶⁶ 583 F.2d 594 (2d Cir. 1978).

⁶⁷ *Id.* at 599, 604.

⁶⁸ *Id.* at 603-04.

situation where the plaintiff was induced to buy one particular unsuitable security.⁶⁹ The court reasoned that where the entire account has been mismanaged and there is evidence that even a properly managed account would have declined in value because of market conditions, an offset in damages might be appropriate.⁷⁰ Where only one security is involved, however, the court reasoned that the defendants should not be permitted to avoid making the plaintiff whole merely because the plaintiff sold the unsuitable security at the bottom of a bear market.⁷¹

The distinction between fraud in connection with the entire account and fraud in connection with one security is without merit. In *Clark*, the plaintiff had engaged the services of the defendant brokerage house because she desired to invest \$100,000 and to obtain a \$1,000 per month return on her investment.⁷² An acquisition of some security or securities, therefore, was appropriate. Indeed, an acquisition was demanded by the plaintiff.⁷³ Although the plaintiff in *Clark* lost money due to the purchase of unsuitable securities, the plaintiff would probably have lost money even on securities which were suitable to her needs if she chose to sell them at the bottom of a bear market.⁷⁴ By awarding the plaintiff her entire loss on the transaction and ignoring market realities, the court allowed the plaintiff to escape the risks inherent in investing during a declining market. The court's use of the out of pocket model in *Clark* in effect made the defendant a market insurer and granted a windfall to the plaintiff. The result in *Clark* illustrates a potential problem with the use of the out of pocket model — the model overcompensates the plaintiff in situations where even a well-managed account would have lost money.

Another flaw in the pure out of pocket model of recovery is that use of this model results in no recovery to the plaintiff in situations where the plaintiff's account does not decline in value. In this situation, the plaintiff would receive no damages even though he or she paid commissions on unsuitable transactions and, if the account were a margin account,⁷⁵ also paid interest on the money used to purchase the unsuitable securities. For example, if the defendant broker fraudulently induced the plaintiff to purchase unsuitable high risk securities which did not decline in value, the plaintiff would suffer no compensable loss, according to the out of pocket theory.

Dissatisfaction with the injustice of permitting a defendant who had engaged in unsuitable transactions in violation of the Exchange Act to escape liability has motivated courts, in situations where there have been no trading losses, to choose the quasi-contractual model of recovery instead of the out of pocket model.⁷⁶ By using one model of recovery when the plaintiff has trading losses and another when the plaintiff has suffered no such losses, even though each plaintiff has complained of the same wrong, courts have been inconsistent in their approach to the measurement of damages.⁷⁷ As a result, the

⁶⁹ *Id.* at 604.

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Id.* at 597.

⁷³ *Id.*

⁷⁴ Plaintiff sold her securities "two days before President Nixon resigned and close to the bottom of a bear market." *Id.* at 599.

⁷⁵ "A margin account is a trading account maintained with a brokerage firm on which the investor may borrow a percentage of the funds for the purchase of securities. The broker loans the funds at slightly above the prime rate." HIRT AND BLACK, *FUNDAMENTALS OF INVESTMENT MANAGEMENT AND STRATEGY* 481 (1983).

⁷⁶ See *Zaretsky v. E.F. Hutton & Co., Inc.* 509 F. Supp. 68, 73 (S.D.N.Y. 1981).

⁷⁷ Compare *Zaretsky*, 509 F. Supp. at 73 (quasi-contractual measure applied where plaintiff

defendant broker has the burden of paying total trading losses when those losses exist, without receiving the benefit of trading gains when such gains exist. To avoid this inequity, any model of recovery adopted for use in suits between brokers and customers should apply regardless of whether the plaintiff has made or lost money in the account.

In sum, neither the quasi-contractual model nor the out of pocket model accurately measures a plaintiff's actual damages in churning and suitability suits. Under the quasi-contractual model, damages consist of all of the commissions and interest paid by the plaintiff customer to the defendant broker.⁷⁸ The problem with this model of recovery is that it fails to focus on the harm done to the plaintiff. Rather, it concentrates on the benefit received by the defendant and, therefore, may bear little relation to the plaintiff's actual injury. In contrast to the quasi-contractual model, the out of pocket model of recovery awards the plaintiff the total trading losses sustained in the account.⁷⁹ Recovery, therefore, is theoretically related to the plaintiff customer's degree of harm. Nevertheless, this model assumes, often erroneously, that all of the trades in the account were invalid. In addition, the out of pocket model ignores the effect that market action may have had on the plaintiff's trading losses. Because the out of pocket model may compensate the plaintiff for harm not caused by the defendant, use of this model may result in a windfall to the plaintiff.

II. RECENT TRENDS IN MEASURING DAMAGES: THE MODIFIED RESCISSORY MODEL OF RECOVERY

Because the traditional quasi-contractual and out of pocket models have proved unsatisfactory in measuring damages for suitability and churning violations, courts have shown an increased willingness to develop modified models of recovery. These modified models incorporate an analysis of general market conditions in an attempt to determine the plaintiff's actual damages more accurately.⁸⁰ A modified rescissory model for calculating damages, which looks beyond the benefit received by the defendant and the trading losses sustained by the plaintiff, is becoming increasingly prevalent in both suitability and churning cases.⁸¹ Under this model, "the plaintiff is entitled to recover the difference between what he would have had if the account had been handled legitimately and what he in fact had at the time the violation ended."⁸² A modified rescissory model was first

suffered no trading losses) with *Garnatz*, 559 F.2d at 1361 (out of pocket model applied where plaintiff had suffered trading losses).

⁷⁸ See cases cited *supra* note 32.

⁷⁹ See cases cited *supra* note 53.

⁸⁰ *E.g.*, *Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 651 F.2d 615, 622 (9th Cir. 1981); *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 328 (5th Cir. 1981); *Rolf IV*, 637 F.2d at 84. This trend of including an analysis of general market conditions in an effort to determine more accurately plaintiffs' damages is apparent in 10b-5 cases involving frauds other than churning and suitability as well. *See, e.g.*, *Huddleston v. Herman & Maclean*, 640 F.2d 534, 555 (5th Cir. 1981)(claim against issuer of securities for false statements in prospectus), *aff'd in part, rev'd in part on other grounds*, 103 S. Ct. 683 (1983); *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1345 (9th Cir. 1976)(Sneed, J., concurring)(misleading financial statements); *Beissinger v. Rockwood Computer Corp.*, 529 F. Supp. 770, 788-89 (E.D. Pa. 1981)(misleading annual report); *Bonime v. Doyle*, 416 F. Supp. 1372, 1386 (S.D.N.Y. 1976), *aff'd mem.*, 556 F.2d 554 (2d Cir.), *cert. denied, sub nom. Sloane v. Bonime*, 434 U.S. 924 (1977)(market manipulation); *Black v. Riker-Maxson Corp.*, 401 F. Supp. 693, 700 (S.D.N.Y. 1975)(misrepresentations in connection with a private placement).

⁸¹ *See, e.g.*, *Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 651 F.2d 615, 621-22 (9th Cir. 1981); *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 328 (5th Cir. 1981); *Rolf II*, 570 F.2d at 49.

⁸² *Miley v. Oppenheimer & Co., Inc.*, 637 F.2d 318, 327 (5th Cir. 1981).

developed by the Second Circuit in *Rolf v. Blyth, Eastman Dillon & Co., Inc.*⁸³ The *Rolf* model awards damages in a manner that more closely approximates the plaintiff's actual damages than do the quasi-contractual and pure out of pocket models.⁸⁴

The objective of the modified rescissory model, as one court has indicated, is to measure the plaintiff's actual damages and to avoid a damages award that constitutes a windfall to either the plaintiff or the defendant.⁸⁵ Because the modified rescissory model of recovery has been used by the judiciary only in recent years,⁸⁶ however, no single formula has been uniformly accepted as a representative approach. Instead, various district and circuit courts, faced with specific factual scenarios, have developed several formulas designed to suit the particular case before the court.

This section of the note will analyze the modified rescissory approach adopted by the Second Circuit in *Rolf v. Blyth, Eastman Dillon & Co.*⁸⁷ Although the *Rolf* formula represents a step forward from the traditional approaches, this note suggests that the *Rolf* formula does not adequately measure the plaintiff's actual damages because that formula counts the commissions and interest components of the plaintiff's damages twice. Modifications of the *Rolf* formula adopted by other circuits will then be discussed. Finally, the modified rescissory model used by the Ninth Circuit in *Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,⁸⁸ will be presented and analyzed. This note suggests that the *Arrington* model, which does not count the commissions and interest components of the plaintiff's actual damages twice, but does take general market conditions into account, is an appropriate model of recovery for churning and suitability cases.

A. The Rolf Model

A modified rescissory model of recovery for churning and suitability cases was first adopted in *Rolf v. Blyth, Eastman Dillon & Co., Inc.*⁸⁹ ("*Rolf II*"). In *Rolf*,⁹⁰ the district court found that the defendant broker was liable for purchasing securities that were unsuitable for the plaintiff customer.⁹¹ The district court limited damages to the amount of commissions paid,⁹² reasoning that any other amount of damages would be too speculative.⁹³

⁸³ 570 F.2d 38 (2d Cir. 1978)(*Rolf II*), further appealed, 637 F.2d 77 (2d Cir. 1980).

⁸⁴ The modified rescissory models attempt to exclude from the damage award those declines in market forces that are caused by general market forces and that are not related to the fraud. See, e.g., *Miley v. Oppenheimer & Co., Inc.*, 637 F.2d 318, 327-28 (5th Cir. 1981); *Rolf IV*, 637 F.2d at 84.

⁸⁵ See *Miley v. Oppenheimer & Co., Inc.*, 637 F.2d 318, 327-28 (5th Cir. 1981).

⁸⁶ The Second Circuit in *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38 (2d Cir. 1978)(*Rolf II*), was the first court to adopt a modified rescissory approach. The approach has been suggested first by a commentator. *Churning*, *supra* note 5, at 885.

⁸⁷ 570 F.2d 38 (2d Cir. 1978), further appealed, 637 F.2d 77 (2d Cir. 1980).

⁸⁸ 651 F.2d 615 (9th Cir. 1981).

⁸⁹ 570 F.2d 38 (2d Cir. 1978), further appealed, 637 F.2d 77 (2d Cir. 1980).

⁹⁰ *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 424 F. Supp. 1021, 1043 (S.D.N.Y. 1977) (*Rolf I*). *Rolf* entrusted a discretionary account to Blyth, Eastman Dillon. 570 F.2d at 41. Although *Rolf*'s investment goal was to achieve substantial capital gain in an investment program emphasizing preservation and augmentation of capital, Stott, *Rolf*'s broker, in conjunction with *Rolf*'s investment advisor, Yamada, purchased highly speculative securities for *Rolf*'s account. *Id.* at 42-43. In less than a year, *Rolf*'s account had declined in value from \$1,423,000 to \$446,000. *Id.* at 42.

⁹¹ The district court also based liability on the common law claim of breach of fiduciary duty. 424 F. Supp. at 1039. The district court dismissed the plaintiff's churning claim. *Id.* at 1040.

⁹² Most courts which use the traditional approaches to the issue of damages award damages under the out of pocket model in suitability cases. See cases cited *supra* note 18.

⁹³ 424 F. Supp. at 1045.

On appeal, ("*Rolf II*") the United States Court of Appeals for the Second Circuit reversed the district court's decision on the issue of damages and remanded the case, ordering that the district court calculate damages in accordance with the following formula:⁹⁴ First, determine the market value of the plaintiff's portfolio at the time the defendant's fraud commenced; second, subtract the value of the portfolio at the time the fraud ceased, to determine "the customer's gross economic loss";⁹⁵ and finally, reduce the customer's gross economic loss by the average percentage decline in the value of a recognized index of market action,⁹⁶ or a combination of such indices, during the period of the fraud.⁹⁷

The court of appeals reasoned Rolf's portfolio would have declined in value during the bear market even in the absence of the defendant's fraud.⁹⁸ Failure to adjust the plaintiff's gross economic loss by the percentage of market decline would therefore put the plaintiff in a better position than he would have been in had the fraud not occurred, the court reasoned.⁹⁹ Such a result, the court held, would be inconsistent with the limitation of actual damages mandated by Section 28(a) of the Securities Exchange Act.¹⁰⁰ The court also held, however, without indicating its reasoning, that the customer was entitled to interest and the return of commissions paid on transactions within the period of the fraud.¹⁰¹

To illustrate the economic effect of this formula, consider the hypothetical case of Mr. Customer. Assume that Mr. Customer had a portfolio with a market value of \$200,000 when the fraud commenced and that this portfolio had declined in value to \$100,000 by the time the fraud ended. Assume further that Mr. Customer had paid \$25,000 in commissions, \$10,000 in interest and had withdrawn \$10,000 in cash for his personal use during this period. Assume also that the general market, as indicated by the appropriate index, had suffered a 10% decline during the period of the fraud. Under the *Rolf II* formula, Mr. Customer would receive \$125,000 in damages.¹⁰²

The flaws in the *Rolf II* formula are apparent from the result reached in the case of Mr. Customer. Although the intent of the formula was to reduce the plaintiff's gross economic loss by factoring in market decline so that the plaintiff would recover *less* than his full economic loss,¹⁰³ Mr. Customer, using the *Rolf II* formula, recovered *more* than his gross economic loss. The reasons for this result are three-fold. First, the plaintiff is awarded commissions and interest even though these elements are already rep-

⁹⁴ 570 F.2d at 49-50.

⁹⁵ *Id.* at 49.

⁹⁶ The court left it to the district court to select the appropriate market index, or combination of indices, given the nature of Rolf's account. In addition, the court also indicated that the market decline could be determined by the use of expert opinion. *Id.* at 49 n.22.

⁹⁷ *Id.* at 49.

⁹⁸ *Id.* at 49 n.22.

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *Id.* at 50. The court in *Rolf II* also held that Rolf's damages must be reduced by the amount he received in settlement of his claims against other defendants. *Id.* at 49-50. This holding is in keeping with section 28(a) of the Securities and Exchange Act of 1934 which limits the amount of plaintiff's recovery, "in one or more actions" to his or her actual damages. 15 U.S.C. § 78bb(a) (1982), quoted *supra* note 8.

¹⁰² This figure was calculated as follows: \$200,000 (the market value of the portfolio at the time the fraud commenced) minus \$100,000 (the value of the portfolio when the fraud was discovered) minus \$10,000 (market decline) plus \$25,000 (commissions) plus \$10,000 (interest) equals \$125,000.

¹⁰³ See 570 F.2d at 49.

resented.¹⁰⁴ When a security is purchased, brokerage commissions are automatically added to the cost of the security.¹⁰⁵ The sum of the purchase price and the commissions paid represents the acquisition cost of the security to the customer.¹⁰⁶ The opening value of the account, therefore, includes the amounts paid in commissions. When a security is sold, brokerage commissions are automatically subtracted from the sale proceeds.¹⁰⁷ The difference between the sale proceeds and the commissions charged represents the amount the customer receives when the security is sold.¹⁰⁸ The ending value of the account, therefore, also includes amounts paid as commissions. Similarly, the interest charged by the brokerage house on margin accounts is automatically added to the customer's debit balance on a monthly basis.¹⁰⁹ Because the values of the original and ending portfolios are determined by subtracting the debit balance from the market value of the portfolio, interest paid to the brokerage house is also factored into the plaintiff's gross economic loss in *Rolf II*.¹¹⁰ Adding commissions and interest charges as separate components of the damages calculation, therefore, compensates the plaintiff twice for the same harm suffered.¹¹¹ This result could be avoided by not including commissions and interest as separate factors in the damages formula or by determining the beginning and ending values of the portfolio net of commissions and interest and factoring out the commissions charged on securities transactions that occurred during the period of the fraud. No evidence that commissions and interest were factored out of the beginning and ending values of the portfolio was offered in *Rolf II*.¹¹²

The second flaw in the *Rolf II* formula, as commentators have noted, is that the percentage decline of the market is derived from the plaintiff's gross economic loss rather than from the value of the original portfolio.¹¹³ Because market forces operate on the plaintiff's entire portfolio, the percentage decline should be computed by using the figure that represents the amount the plaintiff invested in the market.¹¹⁴ This figure is the value of the original portfolio, not the gross economic loss figure.

The third flaw in the *Rolf II* formula is that the defendant is not given credit for cash withdrawn from the account and used for the plaintiff's personal purposes. When a customer withdraws money from a brokerage account, the value of the account is reduced by the amount withdrawn. Because the decline in value is not caused by the defendant, the defendant should not be held responsible for this decline.¹¹⁵ As the Second Circuit subsequently recognized when the *Rolf* case was again before it, the losses suffered by the plaintiff should be offset by the benefits received by the plaintiff.¹¹⁶

¹⁰⁴ See *Arrington v. Merrill Lynch, Pierce, Fenner & Smith*, 651 F.2d 615, 621 (9th Cir. 1981).

¹⁰⁵ See GUP, *THE BASICS OF INVESTING*, 142 (1979) [hereinafter cited as GUP], see also, *supra* note 24.

¹⁰⁶ See GUP, *supra* note 104, at 142.

¹⁰⁷ See *Id.*

¹⁰⁸ See *Id.*

¹⁰⁹ See *Id.* at 138.

¹¹⁰ See *Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 651 F.2d 615, 621 (9th Cir. 1981) (loss measurement already includes interest).

¹¹¹ *Id.*

¹¹² See *Rolf II*, 570 F.2d at 48-50.

¹¹³ This was pointed out by two case comments. See 83 DICK. L. REV. 175, 181 (1978); 66 GEO.L.J. 1551, 1570-71 (1978).

¹¹⁴ 83 DICK. L. REV. at 181; 66 GEO.L.J. at 1570-71.

¹¹⁵ See cases cited *supra* note 10.

¹¹⁶ *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 637 F.2d 77, 85-6 (2d Cir. 1980). (*Rolf IV*).

The Second Circuit refined the *Rolf II* model when the damage award granted by the district court on remand ("*Rolf III*") was subsequently appealed.¹¹⁷ On this appeal, ("*Rolf IV*") Rolf claimed that the court below erroneously computed his damages by reducing his damage award by the amount received in settlement from certain defendants without taking into account the value of the stock surrendered by him in connection with that settlement.¹¹⁸ Rolf also claimed that he was entitled to prejudgment interest.¹¹⁹ The defendants also appealed the district court's damage award, claiming that the lower court erroneously declined to grant them credit for the net withdrawals of cash and securities Rolf had made from his account during the period of the fraud.¹²⁰

Recognizing that the damages formula articulated in *Rolf II* overstated the plaintiff's actual damages¹²¹ by reducing the plaintiff's gross economic loss, rather than the original value of the portfolio, by the percentage of market decline, the Second Circuit in *Rolf IV* revised its damages formula. In *Rolf IV*, the court held that the original value of the plaintiff's portfolio, rather than the plaintiff's gross economic loss, should be reduced by the percentage decline in the general market.¹²² The court in *Rolf IV* set forth the following formula for calculating damages: First, determine the value of the plaintiff's portfolio when the fraud commenced; then adjust that value by the percentage change in the appropriate market indicator, given the nature of the plaintiff's portfolio,¹²³ during the period of the fraud; and finally, subtract from this adjusted figure the value of the stock portfolio at the time the fraud ended.¹²⁴

In *Rolf IV*, the Second Circuit Court of Appeals modified its *Rolf II* model by holding that the original value of the plaintiff's portfolio, rather than the plaintiff's gross economic loss, should be reduced by the percentage of market decline. The court reasoned that reducing the plaintiff's economic loss by the percentage of market decline would allow the plaintiff too great a recovery.¹²⁵ Recognizing that had there been no fraud the market action would have affected the total value of the portfolio,¹²⁶ the court held that the value of the original portfolio is the appropriate figure to be reduced by the percentage of market decline.¹²⁷ The court did not modify its position taken in *Rolf II* that commissions and interest paid to the broker should be returned to the plaintiff; indeed, this issue was not presented on appeal.¹²⁸ The court did, however, recognize that any award to the plaintiff should be reduced by any withdrawals of cash or securities made for the customer's personal use.¹²⁹

¹¹⁷ *Id.* at 84-85.

¹¹⁸ *Id.* at 80.

¹¹⁹ *Id.*

¹²⁰ *Id.*

¹²¹ *Id.* at 84.

¹²² *Id.*

¹²³ In *Rolf IV*, the plaintiff argued that the district court erred in using the Standard & Poor's Low Priced Index. 637 F.2d at 84. The Second Circuit held that the choice of market index was well within the discretion of the district court, given the nature of the plaintiff's portfolio. *Id.*

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ The issue of which figure should have been reduced by the percentage of market decline was also not presented as an issue on appeal. Rather, two law review case comments drew this to the attention of the court. 637 F.2d at 84. See *supra* note 112.

¹²⁹ 637 F.2d at 86. The court also held that it was error not to award prejudgment interest in the absence of any showing of unfairness to the defendant. *Id.* at 87. An award of pre-judgment interest is a matter of judicial discretion. *Blau v. Lehman*, 368 U.S. 403, 414 (1962).

To illustrate the effect of the *Rolf IV* damages formula, consider again the hypothetical case of Mr. Customer. Under the *Rolf II* formula, Mr. Customer would have received \$125,000 in damages.¹³⁰ Under the *Rolf IV* formula, Mr. Customer would receive \$105,000 in damages.¹³¹

Although the *Rolf IV* damages formula more realistically portrays the plaintiff's actual damages than did the *Rolf II* formula, it still overcompensates the plaintiff by counting commissions and interest twice.¹³² Despite this flaw, the theory of damages reflected in the *Rolf IV* damages analysis, which recognizes that extrinsic factors can cause a decline in the value of the plaintiff's account,¹³³ is a logically sound and commendable approach to the measurement of actual damages in churning and suitability actions because it more accurately measures a plaintiff's actual damages than do the traditional quasi-contractual and out of pocket models.

B. Variations on Rolf

Following the example set by the Second Circuit in *Rolf II*,¹³⁴ other district and circuit courts have adopted damages formulae that award the plaintiff less than his or her gross economic loss. These damages formulae indicate that courts have recognized that compensating the defrauded customer for the full amount of trading losses sustained and commissions paid results in a windfall to the plaintiff.¹³⁵ Commentators likewise have suggested alternate approaches to the damages problem that would reflect more accurately the customer's actual damages.¹³⁶ The methods of calculation vary and sometimes remain unstated,¹³⁷ nevertheless their goal is the same — to compensate the plaintiff for all the losses stemming from defendant's fraud and to avoid making the defendants, in effect, market insurers.¹³⁸

¹³⁰ See *supra* notes 94-102 and accompanying text.

¹³¹ This figure was calculated as follows: \$200,000 (original portfolio value) minus \$20,000 (percent of market decline) minus \$100,000 (ending value of portfolio) plus \$10,000 (interest) minus \$10,000 (cash withdrawn by the plaintiff) plus \$25,000 (commissions) equals \$105,000.

¹³² See *supra* notes 104-111 and accompanying text.

¹³³ 637 F.2d at 84.

¹³⁴ 570 F.2d 38 (2d Cir. 1978).

¹³⁵ See *infra* notes 142-146 and accompanying text discussing the damages formula adopted by the Fifth Circuit in *Miley v. Oppenheimer & Co., Inc.*, 637 F.2d 318, 327-28 (5th Cir. 1981) and notes 169-171 *infra* discussing the damages formula adopted by the Ninth Circuit in *Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 651 F.2d 615, 621-22 (9th Cir. 1981).

¹³⁶ Note, *Rule 10b-5 Damage Computation: Application of Financial Theory to Determine Net Economic Loss*, 51 *FORDHAM L. REV.* 838, 864-6 (1983); Rath, *Damages in Broker/Client Suits*, 15 *REV. SEC. REG.* 855, 858 (1982); Brodsky, *supra* note 11, at 165-66.

¹³⁷ See, e.g., *Mihara v. Dean Witter & Co., Inc.*, 619 F.2d 814, 826 (9th Cir. 1980). In *Mihara*, liability was found on both churning and suitability grounds. *Id.* at 817. Mihara's account reflected trading losses of \$46,464 and commission and interest expenses of \$18,000. *Id.* at 818, 826. The jury awarded the plaintiff \$24,600 in actual damages. *Id.* at 826. The appellate court indicated that the jury award represented half of all commissions and interest paid and half of the trading losses in the account. *Id.* This award was held to be reasonable and not excessive. *Id.* Although the plaintiff recovered only a portion of his trading losses, it is unclear what rationale led to the specific amount awarded.

¹³⁸ See, e.g., *Miley v. Oppenheimer & Co., Inc.*, 637 F.2d 318, 327 (5th Cir. 1981). By taking into account such factors as market action and by excluding losses on securities purchased at the initiative of the plaintiff, courts are attempting to exclude from the damages award losses not caused by the defendant's fraudulent conduct. *Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 651 F.2d 615, 621-22 (9th Cir. 1981). This effort is in accord with 10b-5 cases which employ a proximate cause

The Fifth Circuit's decision in *Miley v. Oppenheimer & Co., Inc.*¹³⁹ illustrates the use of another modified rescissory method of calculating the plaintiff's actual damages. In *Miley*, a jury found that the defendants were liable for churning the plaintiff's account.¹⁴⁰ The defendants appealed the finding of liability and the damages award.¹⁴¹ The Fifth Circuit affirmed both the finding of liability and the measure of damages used by the district court.¹⁴² Noting that churning could cause both excess commissions to be paid and trading losses to be sustained,¹⁴³ the Fifth Circuit held that a damages formula should encompass both commissions and trading losses.¹⁴⁴ The court rejected the defendant's argument that the award of both commissions and trading losses resulted in double recovery for the plaintiff.¹⁴⁵ The real problem in calculating damages, the court found, was accurately measuring the amount of trading losses caused by the excessive trading and unsuitable transactions.¹⁴⁶ Finding that the district court had used an appropriate method of calculating damages, the Fifth Circuit approved the district court's jury instructions on the measure of damages. Under the *Miley* approach to the measurement of damages, the actual damages sustained are calculated using the following formula: First, determine the amount of the plaintiff's original investment and the resulting dividends; then, subtract any withdrawals from the account made by the plaintiff; next, subtract the ending value of the plaintiff's account; and, finally, reduce this amount by the average percentage decline in the value of the Dow Jones Industrial or Standard and Poor's index during the relevant period of time.¹⁴⁷ In addition, the court held that the plaintiff's interest and commission expenses were properly added to this figure¹⁴⁸ to arrive at the total amount of the plaintiff's actual damages.¹⁴⁹

In *Miley*, the court reasoned that because the defendant's fraud may have caused the plaintiff both to pay excess commissions and to sustain trading losses, the victimized

test for determining the damages award. See *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981) *aff'd in part, rev'd in part on other grounds*, 103 S.Ct. 683 (1983); *Oleck v. Fischer* [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,898 at 95,702 (S.D.N.Y. June 8, 1979), *aff'd on other grounds*, 623 F.2d 791, 795 n.8 (2d Cir. 1980).

¹³⁹ 637 F.2d 327 (5th Cir. 1981).

¹⁴⁰ *Id.* at 325.

¹⁴¹ *Id.*

¹⁴² *Id.*

¹⁴³ *Id.* at 326.

¹⁴⁴ *Id.*

¹⁴⁵ *Id.*

¹⁴⁶ *Id.* at 327. The court's award of damages for the trading losses due to unsuitable transactions even though only churning was alleged by the plaintiff indicates that the court assumed that once churning was established, unsuitable transactions must have been made. While the two violations often occur in conjunction, unsuitable purchases do not inevitably flow from churning activity. See *Hecht v. Harris, Upham & Co., Inc.*, 430 F.2d 1202, 1212 (9th Cir. 1970).

¹⁴⁷ 637 F.2d at 328.

¹⁴⁸ *Id.* at 326.

¹⁴⁹ The jury also awarded plaintiff \$100,000 in punitive damages for her state law claim of breach of fiduciary duty. *Id.* at 329. Section 28(a) of the Exchange Act, *see supra* note 8, has been held to bar the award of punitive damages under Rule 10b-5. *See, e.g.,* *Byrnes v. Faulkner, Dawkins & Sullivan*, 550 F.2d 1303, 1313 (2d Cir. 1977); *see generally* *Hirsch & Lewis, Punitive Damage Awards Under the Federal Securities Acts*, 47 NOTRE DAME LAW. 72 (1971). Punitive damages may be awarded, however, under a state law claim which is pendent to a Rule 10b-5 claim. *E.g.,* *Coffee v. Permian Corp.*, 474 F.2d 1040, 1044 (5th Cir. 1973) ("It is well established that exemplary damages may be awarded if allowable under state law when a state law violation is joined with the 10b-5 complaint."), *cert. denied*, 412 U.S. 920 (1973); *see generally*, Comment, *Punitive Damages and the Federal Securities Act: Recovery Via Pendent Jurisdiction*, 47 Miss. L. J. 743 (1976).

investor should be compensated for both harms.¹⁵⁰ The court recognized, however, that to award full out of pocket recovery to the investor would disregard the ordinary hazards of the marketplace and, consequently, would exact too high a penalty from the defendants.¹⁵¹ Its task in assessing damages, the court reasoned, was to estimate how the investor's portfolio would have fared in the absence of the defendant's misconduct.¹⁵² Adjusting the plaintiff's loss by an appropriate indicator of market decline, the court found, was a logical method of estimation.¹⁵³

The model approved by the Fifth Circuit for calculating the plaintiff's actual damages in *Miley* is similar to the model employed by the Second Circuit in *Rolf II*.¹⁵⁴ Both models adjust the plaintiff's gross economic loss by the percentage of market decline during the period in which the fraud took place.¹⁵⁵ In *Miley*, however, the court also included the element of dividends in its damages analysis.¹⁵⁶ In determining the value of the plaintiff's original portfolio,¹⁵⁷ the district court instructed the jury to add dividends received from the original portfolio to the value of the securities held.¹⁵⁸ The *Miley* court affirmed this instruction on appeal without discussing the element of dividends.¹⁵⁹ By including dividends in the analysis, the district court and the Fifth Circuit presumably recognized that dividends affect the value of a securities portfolio.¹⁶⁰ Under the approach to damages calculation approved by the court in *Miley*, defendants are credited for the dividends generated by the account. By adding the amount of dividends that the plaintiff would have received from her original investment to the value of the plaintiff's original portfolio, however, the district court insured that the defendants were credited only with dividends received in excess of those that would have been received even had there been no fraud. For example, if the plaintiff owned one security which generated \$100 in dividends and the defendant broker purchased an unsuitable security which generated \$50 in dividends, the \$50 in dividends received from the unsuitable security would be credited to the defendants to offset the trading losses sustained on the transaction under the *Miley* formula. Under the *Miley* formula, therefore, defendants are credited with the dividends that the plaintiff received as a result of the defendant's actions.

To illustrate the effect of the damages formula affirmed in *Miley*, consider again the hypothetical case of Mr. Customer. In addition to beginning with a portfolio valued at

¹⁵⁰ 637 F.2d at 326.

¹⁵¹ *Id.* at 327.

¹⁵² *Id.* at 328.

¹⁵³ *Id.*

¹⁵⁴ Compare *Miley*, 637 F.2d at 328 with *Rolf II*, 570 F.2d at 49-50.

¹⁵⁵ *Miley*, 637 F.2d at 328; *Rolf II*, 570 F.2d at 49-50.

¹⁵⁶ 637 F.2d at 328.

¹⁵⁷ This is analogous to the first step in the *Rolf* formula. See *supra* note 94 and accompanying text.

¹⁵⁸ 637 F.2d at 328.

¹⁵⁹ *Id.*

¹⁶⁰ Because dividends are received by the brokerage houses and are credited to the customer's account, they add to the value of the customer's account. The defendant should not have the benefit of these dividends that would be received on the original portfolio in the absence of the defendant's conduct. By adding the value of these dividends to the value of the plaintiff's original portfolio, the defendant is only given credit for the dividends which would not have been received in the absence of fraud. Because the value of the original portfolio is the starting point for the determination of damages, inflating that value by the amount of dividends that would be received on the original security portfolio offsets the increased value to the ending portfolio value by this amount. See *Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 651 F.2d 615, 621 (9th Cir. 1981).

\$200,000 assume that this portfolio would have generated \$15,000 in dividends if left intact during the period of the fraud. Assume further that during the period of the fraud Mr. Customer actually received \$20,000 in dividends, which were credited to his account. Under the *Rolf II* model, Mr. Customer would have received \$125,000 in damages.¹⁶¹ Under the *Rolf IV* model, Mr. Customer would have received \$105,000 in damages.¹⁶² Under the *Miley* formula, Mr. Customer would receive \$128,500 in damages.¹⁶³ Thus, under the *Miley* formula, Mr. Customer would receive more than he would under either the *Rolf II* or *Rolf IV* models and more than the total amount of trading losses in the account, despite the reduction for market decline and the credit of excess dividends to the defendant. This result occurs because the plaintiff's gross economic loss, rather than the value of the original portfolio, is reduced by the market decline.

A comparison of the results reached under the *Miley* formula with those reached under the *Rolf II* and *Rolf IV* models highlights the weaknesses of the *Miley* approach to the measurement of damages in churning and suitability actions. Although the inclusion of dividends adds to the accuracy of the damages award,¹⁶⁴ the *Miley* formula is beset with the same weaknesses that the *Rolf II* formula had and which led the Second Circuit to revise its original formula in *Rolf IV*.¹⁶⁵ First, the original value of the plaintiff's account, not the value after it had been reduced by the plaintiff's withdrawals and the ending value of the account, should be reduced by the percentage decline in the appropriate market index.¹⁶⁶ Second, commissions and interest should not be counted twice.¹⁶⁷ Despite its flaws, the *Miley* model does represent a valid attempt to reduce the amount awarded in damages from the plaintiff's gross economic loss. In addition, the *Miley* model, unlike its predecessors, recognizes that the element of dividends should be taken into account in any damages formula used in a churning or suitability suit.¹⁶⁸

C. The Arrington Model

The Ninth Circuit's decision in *Arrington v. Merrill Lynch, Pierce, Fenner & Smith Inc.*,¹⁶⁹ represents another attempt by the judiciary to overcome the problems of the traditional quasi-contractual and out of pocket models of recovery. In *Arrington*, the plaintiffs, at their own initiative, opened a brokerage account with the defendants and invested \$280,000 in Western Airlines securities.¹⁷⁰ The defendant broker, without explaining the risks, suggested to the plaintiffs that they open a margin account and purchase on the margin additional securities which he recommended to them.¹⁷¹ The plaintiffs followed

¹⁶¹ See *supra* note 102 and accompanying text.

¹⁶² See *supra* note 131 and accompanying text.

¹⁶³ This figure was calculated as follows: \$215,000 (original value of portfolio and dividends) minus \$10,000 (cash withdrawals) minus \$100,000 (ending portfolio value) minus \$11,500 (percentage of market decline) plus \$25,000 (commissions) plus \$10,000 (interest) equals \$128,500.

¹⁶⁴ *Id.*

¹⁶⁵ See *Rolf IV*, 637 F.2d at 84-86.

¹⁶⁶ *Id.* at 84.

¹⁶⁷ See *Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 651 F.2d 615, 622 (9th Cir. 1981).

¹⁶⁸ *Miley*, 637 F.2d at 328.

¹⁶⁹ 651 F.2d 615 (9th Cir. 1981).

¹⁷⁰ *Id.* at 618.

¹⁷¹ *Id.* Although *Arrington* was decided as a misrepresentation and omission case rather than as suitability or churning case, the gravamen of plaintiffs' claim was that they were fraudulently induced to purchase speculative securities on the margin, activities which were unsuitable for them. *Id.* at 617, 619. Thus, the analysis is conceptually similar to a case alleging unsuitability.

this advice.¹⁷² At their own initiative and without any advice by the defendant broker, the plaintiffs also purchased an additional thousand shares of Western Airlines securities on the margin.¹⁷³ The plaintiffs suffered a substantial loss on their investments in Western Airlines securities as a result of the stock market "crash" of 1974.¹⁷⁴ Upon realizing the extent of their loss, they instituted suit against the defendant broker and brokerage firm.¹⁷⁵ The defendants were found liable for fraudulently inducing the plaintiffs to convert their cash account into a margin account and to invest in speculative securities without informing them of the risks inherent in such transactions.¹⁷⁶

The district court determined the plaintiffs' damages by imputing a sale of the margin stocks on the date that the plaintiffs should have discovered the fraud.¹⁷⁷ From this figure, the court subtracted the amount the plaintiffs would have received had they sold their margin securities from their margin balance on that date.¹⁷⁸ The court further reduced this amount by that portion of the margin debt attributed to the unsolicited purchase of one thousand shares of Western Airlines.¹⁷⁹ The method of calculating damages used by the district court is represented by the following formula: First, determine the margin debt at the time the fraud was, or should have been, discovered; then, subtract the value of the margin stock at the time of the discovery of the fraud; and finally, subtract the price of any margin security for which the defendants were not responsible.¹⁸⁰

By focusing only on the speculative margin stock the defendants fraudulently induced the plaintiffs to purchase rather than on the entire portfolio, the court was able to factor out the market decline of the original portfolio without the need of a market indicator.¹⁸¹ Because the only securities purchased as a result of the defendant's fraud were still in the account when the fraud was discovered, the court was able to determine

¹⁷² *Id.* at 618.

¹⁷³ *Id.*

¹⁷⁴ *Id.* at 617.

¹⁷⁵ *Id.* at 619.

¹⁷⁶ *Id.* at 617.

¹⁷⁷ *Id.* at 620. The district court determined that the plaintiffs should have discovered the fraud on the date that they received their first margin call. *Id.* at 620. On appeal, the plaintiffs argued that choosing this date as the damages cut off date was erroneous because the defendants perpetrated their fraud after this date. *Id.* In rejecting this argument, the court noted that ordinary mitigation principles are applicable in 10b-5 cases and held that, "Plaintiff's 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." *Id.*

¹⁷⁸ *Id.* at 621.

¹⁷⁹ *Id.* The method employed in *Arrington* is similar to the approach taken by the Seventh Circuit in *Fey v. Walston & Co.*, 493 F.2d 1036 (7th Cir. 1974). In *Fey*, the court distinguished between trading losses on stock purchases initiated by the customer and those initiated by the broker. The Seventh Circuit held that since the losses on the transactions the customer initiated occurred independently of the broker's conduct, these transactions could not be "lumped in for the jury's consideration without at least affording some guide by which they can be eliminated from consideration upon a determination that, indeed, the defendants had nothing to do with them." *Id.* at 1055.

¹⁸⁰ *Arrington*, 651 F.2d at 621.

¹⁸¹ Since the court was able to determine with precision what securities would have been in plaintiff's account if there had been no fraud, the decline in the value of plaintiff's account attributable directly to market depreciation was easily ascertainable. Where it is impossible to know in what condition the plaintiff's portfolio would have been had there been no fraud, a court must use a market indicator to approximate the impact market depreciation has on the account. *See Rolf H.*, 570 F.2d at 49 n.22.

the exact amount of the losses attributable to the defendants' actions. The court determined the plaintiffs' actual damages by focusing only on the speculative margin stocks in the account rather than on the entire portfolio. Having determined what the exact nature of the account would have been had there been no fraud, the court could then compare the value of the properly managed account with its actual value to arrive at the actual damages caused by the defendants' fraud.¹⁸²

On appeal, the plaintiffs argued that they were entitled to recover all of the losses in their account, with no deduction for the losses attributable to general market decline.¹⁸³ The Ninth Circuit rejected this argument, reasoning that had there been no fraud, the plaintiffs would have owned all of the securities in their account that they purchased at their own initiative.¹⁸⁴ The decline in the market value of these securities was, therefore, not caused by the defendants, according to the court.¹⁸⁵ The damages caused by the defendants acts consisted only of the difference between what the plaintiffs would have had if they had purchased only the securities bought at their own initiative and what they in fact had in their account.¹⁸⁶

The Ninth Circuit affirmed the appropriateness of the theory of damages used by the district court, finding error only in the district court's treatment of the dividend activity in the plaintiffs' account.¹⁸⁷ Like the *Rolf* models,¹⁸⁸ the district court's model of damages did not make any special provision for the treatment of dividends. Finding that this omission was error, the Ninth Circuit held that the plaintiffs were entitled to credit for the cash dividends paid on the original stocks and applied against the margin debt.¹⁸⁹ This treatment of dividend activity is analytically consistent with the treatment of dividends in the formula used by the court in *Miley*.¹⁹⁰ The dividends attributable to the plaintiffs' original portfolio are credited to the plaintiffs' original account value.¹⁹¹ The defendants, therefore, receive credit for only the dividends received as a result of the additional activity in the account.¹⁹²

In *Arrington*, the Ninth Circuit rejected the plaintiffs' argument that they were entitled to the return of interest paid in addition to the trading losses associated with the fraudulently purchased margin stock.¹⁹³ The court reasoned that "plaintiffs' formula would compensate them twice for the interest accrued on the margin debt, since these charges were simply added to the debt . . . and are already included in the [plaintiffs'] 'losses'."¹⁹⁴ Similarly, although the *Arrington* court did not address the element of commissions, the commissions paid by the plaintiff were not added to the trading loss figure.¹⁹⁵

¹⁸² Because the exact amount of damages could be calculated, it was not necessary for the court to use a market indicator to estimate the decline in value of the plaintiff's portfolio not caused by the defendant's fraud.

¹⁸³ 651 F.2d at 620.

¹⁸⁴ *Id.* at 621.

¹⁸⁵ *Id.*

¹⁸⁶ *Id.*

¹⁸⁷ *Id.*

¹⁸⁸ See *supra* notes 94-97 and notes 123-24 and accompanying text.

¹⁸⁹ 651 F.2d at 621.

¹⁹⁰ 637 F.2d at 328.

¹⁹¹ 651 F.2d at 621.

¹⁹² See *supra*, note 160.

¹⁹³ 651 F.2d at 622.

¹⁹⁴ *Id.*

¹⁹⁵ *Id.* Commission charges, like interest expenses, are charged against the account and are incorporated in the reduced ending value of the account. See *supra* note 24.

The hypothetical case of Mr. Customer illustrates the effect of the *Arrington* model of calculating damages. Continue to assume that the original value of Mr. Customer's portfolio is \$200,000 and that he received \$15,000 in dividends on the securities in this portfolio. Assume also that the ending value of his portfolio is \$100,000, consisting of \$200,000 of margin debt, \$120,000 in the value of margined securities, and \$180,000 in the value of the original portfolio. Assume further that Mr. Customer actually received \$20,000 in dividends, that he withdrew \$10,000 in cash for his own use, and that his account generated \$25,000 in commissions and \$10,000 in interest. In contrast to the *Rolf IV* model, under which Mr. Customer would receive \$105,000 in damages,¹⁹⁶ and the *Miley* model, under which Mr. Customer would receive \$128,500 in damages,¹⁹⁷ under the *Arrington* model Mr. Customer would receive \$85,000 in damages.¹⁹⁸

The *Arrington* model has several advantages over both the traditional models of recovery and the modified models developed by the Second Circuit in *Rolf II*¹⁹⁹ and *Rolf IV*²⁰⁰ and the Fifth Circuit in *Miley*.²⁰¹ First, in the hypothetical case of Mr. Customer, the *Arrington* model is the only formula under which Mr. Customer would receive less than his total out of pocket loss, a result the *Rolf* and *Miley* courts reasoned was necessary to prevent the plaintiff from receiving a windfall.²⁰² The *Arrington* approach is the only modified rescissory model to compensate the plaintiff for only that portion of his losses proximately caused by the defendant's conduct and not for losses caused by other factors such as market decline. Second, by recognizing that commissions and interest charges are debited to the account and are reflected in the reduced ending balance of the account, and by refusing to add commission and interest charges to the trading loss figure, the *Arrington* model avoids counting commissions and interest twice.²⁰³ The *Arrington* model logically accounts for all items affecting a customer's account, including dividends, market decline,²⁰⁴ commissions, interest and cash withdrawals. It is, therefore, a logically sound approach to determining the plaintiff's actual damages. As such, it should serve as a model for courts faced with suits between customers and brokers in the future.

III. A PROPOSED MODEL

The goal of any model for calculating damages in a suit for churning or suitability violations is to place the defrauded customer in the same position he would have occupied had there been no fraud.²⁰⁵ Given the complex nature of the average brokerage ac-

¹⁹⁶ See *supra* note 131 and accompanying text.

¹⁹⁷ See *supra* note 163 and accompanying text.

¹⁹⁸ This figure was calculated as follows: \$200,000 (margin debt) minus \$120,000 (ending value of marginal securities) plus \$15,000 (dividends received on original portfolio) minus \$10,000 (cash withdrawals) equals \$85,000.

¹⁹⁹ 570 F.2d 38 (2d Cir. 1978).

²⁰⁰ 637 F.2d 77 (2d Cir. 1980).

²⁰¹ 637 F.2d 318 (5th Cir. 1981).

²⁰² *Rolf II*, 570 F.2d at 49 n.22; *Miley v. Oppenheimer & Co., Inc.*, 637 F.2d at 328.

²⁰³ 651 F.2d at 622.

²⁰⁴ Although *Arrington* did not explicitly deal with the factor of general market decline, comparing the value of the plaintiff's account as it would have been without the defendant's fraud with the value of the account as it actually existed, the *Arrington* court effectively factored in the market decline on the plaintiff's original portfolio without the need for the use of a market indicator. See 651 F.2d at 621.

²⁰⁵ *Id.*

count,²⁰⁶ any damages formula used must take into account more than commissions paid or trading losses sustained. The traditional quasi-contractual model, which focuses only on commissions and interest paid,²⁰⁷ and the traditional out of pocket model, which takes into account only trading losses sustained,²⁰⁸ are ill-suited to most suits between customers and brokers because they do not take into account many of the factors that influence the value of a securities account. A more complex model for measuring damages, which incorporates as many of the variables that affect a customer's account as possible, should be used in these suits. This section will first discuss the contributions made to the analysis of damages by the recent modified rescissory approaches adopted by various circuits. Next, a proposed model, which incorporates many of the contributions made by these recent approaches, will be suggested. This note submits that this proposed model is more consistent with the goal of measuring the plaintiff's actual damages than previous models because it incorporates many of the variables affecting the value of the account without counting any single component of the plaintiff's damages twice. Because this model incorporates most of the variables that may affect the value of a customer's portfolio, it applies to most of the factual situations likely to arise in the context of any suit between a customer and a broker.

The first court to go beyond the traditional models of recovery was the Second Circuit in *Rolf II*.²⁰⁹ In *Rolf II*, the court recognized that market action affects the value of an account regardless of the fraudulent acts of the defendant.²¹⁰ Market action, the court held, should, therefore, be incorporated into the damages formula used.²¹¹ The court in *Rolf II* reasoned that reducing the original value of the plaintiff's account by the percentage of market decline would reflect more accurately the value of the account absent the fraud than would the traditional approach of using only the original value of the account.²¹² Subsequently, the Second Circuit in *Rolf IV*, recognized that any award to the plaintiff should be reduced by any withdrawals of cash or securities made for the customer's own use.²¹³ The *Rolf II* and *Rolf IV* decisions added two elements to the traditional models of recovery that are properly incorporated into any damages formula — market action and withdrawals made by the customer for personal consumption.²¹⁴

In *Miley*,²¹⁵ the Fifth Circuit incorporated the element of dividends into the calculation of the damages caused by the defendant's fraudulent acts. The *Miley* court held that the dividends received from the securities in the original portfolio should be added to the value of the original portfolio.²¹⁶ As the *Miley* court recognized, all dividends received in an account are credited to the account and, consequently, affect its ending value.²¹⁷ By adding the amount of dividends that would have been received from the securities in the

²⁰⁶ Commissions, interest, dividends, cash withdrawals and deposits, as well as market action all affect the value of a brokerage account.

²⁰⁷ See, *supra* notes 32-33 and accompanying text.

²⁰⁸ See, *supra* notes 53-54 and accompanying text.

²⁰⁹ 570 F.2d 38. See *supra* notes 89-133 and accompanying text.

²¹⁰ *Id.* at 49.

²¹¹ *Id.*

²¹² *Id.* at 49 n.22.

²¹³ 637 F.2d at 86.

²¹⁴ *Id.* at 84-86.

²¹⁵ 637 F.2d 318 (5th Cir. 1981).

²¹⁶ *Id.* at 328.

²¹⁷ *Id.*

original portfolio to the value of the original portfolio, the court insured that the damages formula credits the defendant with only the dividends received in excess of those that would have been received in the absence of the defendant's fraud. The *Miley* court contributed the additional element of dividend activity to the analysis of the measure of damages in suits between customers and brokers.²¹⁸

In *Arrington*,²¹⁹ the Ninth Circuit added another dimension to the damages analysis by recognizing that fees charged by the brokerage house, such as interest, are routinely debited to the plaintiff's account.²²⁰ The *Arrington* court reasoned that because these fees are debited to the account, they are reflected in the reduced ending value of the account and should not be a separate item of the plaintiff's damages.²²¹ Before the *Arrington* decision, courts added fees charged by the brokerage house, such as commissions and interest, to the difference between the value of the original and ending values of the account to arrive at the ultimate damages figure.²²² By recognizing the need to avoid counting fees charged by the brokerage house twice in measuring damages, the *Arrington* court contributed another necessary feature to the damage analysis in suits between customer and brokers.

Accepting the reasoning of the Second Circuit in *Rolf*,²²³ the Fifth Circuit in *Miley*,²²⁴ and the Ninth Circuit in *Arrington*,²²⁵ that any damages formula used in a suit between a broker and customer should incorporate the following elements: the original value of the account, the value of the account on the date the fraud was, or should have been discovered, market action, dividend activity, and cash withdrawals and deposits made by the customer. With these elements in mind, the following formula is suggested for calculating damages in suits between customers and brokers: First, determine the value of the portfolio at the time the fraud commenced; then, add the amount of dividends which either were received, or would have been received, in the account on the securities in the original portfolio; next, reduce this value by the percentage decline or increase this figure by the value of percentage increase, using the appropriate market indicator, given the nature of the plaintiff's portfolio; next, subtract the value of the plaintiff's portfolio at the time the fraud was, or should have been, discovered; then, subtract any withdrawals of cash or securities from the account made by the plaintiff; and finally, add any deposits of cash or securities to the account made by the plaintiff.

This proposed model is designed to cover the vast majority of suits between customers and brokers for churning, suitability, or both. The goal of this model is to return the customer to the position that he would have been in had there been no fraud. By adjusting the plaintiff's out of pocket loss by the percentage decline in the market in general and by refusing to add commissions and interest to the adjusted trading loss figure, this formula is designed to compensate the plaintiff fully and to avoid having defendants reap the profits of their fraud. The proposed model accomplishes this goal without overcompensating the plaintiff and without making the defendants, in effect, market insurers.

²¹⁸ *Id.*

²¹⁹ 651 F.2d 615 (9th Cir. 1981).

²²⁰ *Id.* at 622.

²²¹ *Id.*

²²² *See, e.g.*, 637 F.2d at 326.

²²³ 570 F.2d 38 (2d Cir. 1978); 637 F.2d 77 (2d Cir. 1980).

²²⁴ 637 F.2d 318 (5th Cir. 1981).

²²⁵ 651 F.2d 615 (9th Cir. 1981).

Application of this proposed formula is intended to extend beyond the traditional factual setting of a decline in value of the customer's account during a period of market decline. If the market rose during the period of the fraud, for example, the value of the customer's original account would be increased by the percentage of market appreciation. Use of the proposed formula in a period of market appreciation recognizes that in the absence of fraud, the value of the original portfolio would increase during a period of market appreciation just as the value of the original account would decrease during a period of general market decline. Because no case has been presented where the market rose during the period of the fraud, no court has explicitly recognized the need to factor in market appreciation in a damages formula. The same reasoning which led courts to include market decline in the damages analysis, however, mandates the inclusion of market appreciation in the damages analysis during a period of market appreciation as well. Only when the general market has remained steady during the period of the fraud should market action be excluded from the damages analysis. A steady market would indicate that the value of the original portfolio would also have remained steady in the absence of the defendant's fraud, and, therefore, no adjustment to that value is necessary.

The plaintiff customer should be compensated for the actual harm caused by the defendant's acts rather than out of pocket loss sustained by the plaintiff. The proposed model is designed to achieve this result. Under the proposed model, if the defendant's acts did not cause the loss, for example, if the total decline in the value of the account were due to market action, the plaintiff would recover nothing even though there was a loss in the value of his account. Such a result is correct because the decline in value was caused by market activity and not by the defendant's actions. The proposed model, however, does permit a plaintiff to recover damages even if his or her account has not declined in value. For example, if the plaintiff's original portfolio consisted of high-yield securities and the defendant had fraudulently induced the plaintiff to purchase low-yield securities, the plaintiff would receive the lost dividends even if the account had not declined in value.

The proposed model, which incorporates the contributions to the calculation of damages made by the Second Circuit in *Rolf*,²²⁶ the Fifth Circuit in *Miley*,²²⁷ and the Ninth Circuit in *Arrington*,²²⁸ is an appropriate model of damages for most suits between customers and brokers. Under the proposed model, the plaintiff is compensated for the actual harm caused by the defendant's fraud, whether that harm is in the form of trading losses, lost dividends, or, during a period of market appreciation, lost participation in the appreciation. The defendant, however, is not held liable for harm not caused by his or her acts, such as loss due to market decline. Similarly, under the proposed model, the defendant is not charged for the same harm, such as commissions and interest, more than once. The proposed model, therefore, represents a logical approach to the calculation of damages in a churning or suitability case.

CONCLUSION

A review of the churning and suitability cases that have gone to judgment indicates that damages in these cases are not easily computed.²²⁹ Decisions in this area are the

²²⁶ 570 F.2d 38 (2d Cir. 1978); 637 F.2d 77 (2d Cir. 1980).

²²⁷ 637 F.2d 318 (5th Cir. 1981).

²²⁸ 651 F.2d 615 (9th Cir. 1981).

²²⁹ See *Miley v. Oppenheimer & Co., Inc.*, 637 F.2d 318, 327 (5th Cir. 1981)(in which the Fifth Circuit noted that the real problem with compensating the victimized investor is "the difficulty in

subject of varying and sometimes conflicting legal analysis.²³⁰ Recently, however, courts have begun to appreciate the number of factors that must be taken into account in computing a fair measure of damages and have attempted to devise models which look to more than a customer's trading losses and a broker's commissions. Undoubtedly, plaintiffs will continue to argue for the model of recovery which results in the greatest recovery, usually the pure rescissory model, and defendants will continue to argue for the model of recovery which results in the least amount of damages, usually the pure quasi-contractual model. Trial courts today, however, may be more inclined to adopt an established modified rescissory model of recovery that incorporates extrinsic factors, such as market action, or to devise a model of their own. The model proposed by this note incorporates market action, dividend activity, cash withdrawals and deposits, as well as the traditional elements of commissions and trading losses in its calculation of the actual damages sustained. The proposed model is a viable alternative to the traditional and modified formulae previously approved by courts because it corrects some of the flaws in the previous models and attempts to avoid a windfall for either party from the damages award.

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accurately measuring the loss in portfolio value proximately caused by the excessive trading and unsuitable transactions.").

²³⁰ See *Fey v. Walston & Co., Inc.*, 493 F.2d 1036, 1055 n.26 (1974)(in which the Seventh Circuit noted that, "the law in this area remains largely uncharted.")