
Measure of Damages for Interference with a Shareholder's Ability to Sell Stock — Part 1

In today's business climate which, for most investors, often feels more like a roller coaster ride than a smooth ascent towards financial security, the need to have complete freedom in the decision to buy and sell stock is paramount. What can an investor do, however, on those occasions where his right to freely trade his stock has been undermined, either intentionally or negligently, by the corporation in which he holds the stock, or by a transfer agent vested with the authority to timely provide stock certificates? While the causes of action available for an investor who has been harmed by the wrongful interference with his ability to sell stock vary depending upon the factual scenario involved, one common issue which arises under most any such cause of action is the appropriate measure of damages for the investor's inability to trade his stock during the period of wrongful interference. This issue is especially important in a matter involving a highly volatile stock where interference with the right to trade for even a single day could mean the difference between financial security and financial disaster.



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This issue arose in a recent case involving the improper withholding of stock certificates from an investor in a private corporation which was undergoing a merger with a large publicly traded corporation. In that case, the plaintiff had a \$50,000 investment in a private corporation. Several years later, in one of the slew of corporate takeovers and mergers occurring in 1999 and 2000, the private company was purchased by a larger corporation publicly traded on the NASDAQ stock exchange.

As a result of the merger, the plaintiff's 56,000 shares in the new corporation would be valued at several million dollars, the exact amount largely depending upon the stock price at the time the plaintiff became able to publicly sell his shares. When he learned of the merger, the plaintiff made known to the acquired company, the acquiring company and his stock broker that he wanted to sell his shares in the publicly traded company immediately upon his receipt of the stock certificates. His broker had advised him that the stock certificates were necessary to effectuate a trade, given some confusion over whether the stock carried any restrictive legends.

The closing date for the merger was February 10, 2000. At that time, the stock was trading at \$105 - \$113 per share. As of

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February 21, 2000, the transfer agent had all documents necessary from the plaintiff in order to effectuate the transfer of shares. As of that date, the share price was \$120 - \$125. On February 25, 2000, the share price reached a high of \$243.50. On March 6, 2000, the publicly traded corporation announced a secondary stock offering, which included the participation of the top executives with both the acquired company and the acquiring company. As of that date, the stock was trading at \$220. Plaintiff finally received his shares on March 9, 2000. As of that time, the stock was trading at \$190 per share. Upon receiving his stock certificates, plaintiff changed his mind and decided to immediately sell only one-half of his shares and to retain the other one-half based, in part, upon statements made by his friend, the CEO of the acquired company, indicating that the corporation was financially secure. As of the date set for trial, plaintiff still retained 28,000 shares of stock, and the market price declined to less than one dollar per share. In the legal action that was filed, plaintiff alleged that the stock certificates were wrongfully withheld, and that the delay occurred due to actions of the acquired company, the acquiring company and the transfer agent. The primary difficulty in attempting to resolve the matter arose not from a determination of liability, but rather in how to value the loss given the rapidly fluctuating stock price during the relatively short period of time of the delay. Consequently, depending upon which dates were chosen for use in measuring the delay, the plaintiff's damages ranged from \$0 to \$8,000,000. Thus, for the parties to mediate a resolution which was mutually satisfactory, a fair and equitable method of calculating the stock loss had to be determined. While this article discusses various methods used for calculating stock loss when interference occurs, additional damages may be available depending upon the specific jurisdiction and causes of action involved. Such additional damages may include damages for emotional distress, lost interest, lost dividends and legal fees as well as punitive damages.

Interestingly, California law is relatively silent on how to adequately measure damages for the wrongful interference with one's ability to trade stock. In *Wong v. Paine, Webber, Jackson & Curtis* 208 Cal. App. 2d 17 (1962), the court was confronted with a situation involving a stock broker's conversion of shares to his own use, which he was to have purchased for his client. Ultimately, the court concluded that the action was governed by California Civil Code § 3336 which read (and still reads):

"The detriment caused by the wrongful conversion of personal property is presumed to be: first — the value of the property at the time of the conversion, with the interest from that time, or, an amount sufficient to indemnify the party injured for the loss which is the natural, reasonable and proximate result of the wrongful act complained of and which a proper degree of prudence on his part would not have averted; and second — a fair compensation for the time and money properly expended in pursuit of the property."

In applying this statute, the court concluded that since plaintiffs could have purchased replacement stock at the time they learned of the conversion, they reasonably should have borne the burden of any loss should the stock price have declined while, conversely, they could have reaped the benefit if the stock price increased, as it did. Thus, the *Wong* court placed the burden upon the plaintiffs to take action to purchase additional stock. The result reached in *Wong* is considered by many to be flawed in several respects and, thus, has not been often followed by other jurisdictions. There are myriad reasons why this is so.

Initially, *Wong* forces an injured plaintiff to expend additional sums of money, without regard to his financial ability, in order to protect a culpable defendant from any further losses. Thus, *Wong* places substantial burdens on the innocent party for the protection of the wrongdoer. Moreover, *Wong* does not account for current market conditions where stock values fluctuate sub-

stantially on any given trading day, nor does *Wong* take into consideration what a party is to do when he ultimately expects to receive his stock certificates, but the certificates are unreasonably delayed. *Wong* also fails to allow the injured party any time to evaluate market trends before being required to purchase replacement stock. This absence of a "reasonable time" factor differentiates *Wong* from the approach utilized in many other jurisdictions. Under the rule described in *Wong*, as applied to the factual scenario described above, the plaintiff would have been forced to purchase additional shares at a cost of approximately \$8,000,000 to "protect" the culpable defendants. Thus, the general rule for damages arising from conversion as set forth in *Wong* is neither reasonable nor feasible in many situations.

Other jurisdictions have utilized alternative approaches in an effort to arrive at an equitable solution to this difficult problem. One of the oldest approaches is derived from a line of New York cases beginning with *Baker v. Drake*, 53 N.Y. 211 (1873). To pay homage to this line of cases, the rule articulated therein is referred to commonly as the "New York Rule." The New York Rule states that the damages to be awarded for conversion or other interference with stock are equal to the value of the highest price of the stock within a reasonable time after learning of the wrongful interference or conversion. Thus, in a rising market, the plaintiff would be granted a reasonable time from the date he learned of the interference to decide whether to retain or dispose of his stock. In a falling market, the New York Rule provides the plaintiff with the option of claiming the market value at the time of conversion or wrongful interference so that he is not penalized by the defendant's wrongful conduct. This is also the rule that is followed in many federal courts. (See *Schultz v. Commodity Futures Trading Commission*, 716 F.2d 136 (2d Cir. 1983).)

Thus, the New York Rule addresses many of the concerns inherent in the *Wong* decision. However, it raises a host of new potential concerns. For example, the New York Rule disregards the time between the date of conversion and the date the shareholder learns of the conversion. Therefore, the injured shareholder may be left without any remedy to take advantage of an increase in share price should it occur between the date of conversion and the date he learned of the conversion. In addition, some would argue that the reasonable time element under the New York Rule is ill defined, thus allowing for inconsistency of results between factually similar cases.

A variation of the New York Rule is utilized by several jurisdictions, including Pennsylvania, as set forth in *Fletcher v. Cobuzzi*, 510 F.Supp. 263 (W.D. Pa. 1981). Those jurisdictions provide that damages shall be calculated utilizing the highest value attained by the stock between the date of conversion and a reasonable time after notice to the plaintiff. Interestingly, the jurisdictions which apply this rule include the specific time frame excluded by the New York Rule while conversely choosing to ignore the period of time following the date the stockholder learned of the conversion. The purpose of this rule, as described by the *Fletcher* court, is to place the plaintiff in the same position as if the defendant had not interfered with the stock. This measure of damages has also been criticized. While this approach accounts for the time between the date of conversion and the date the plaintiff reasonably learned of such conversion, it still assumes that the plaintiff would have sold the stock at the highest price during that time frame. For this as well as many other reasons, most jurisdictions have rejected this variation on the New York Rule as a method for adequately assessing damages.

Some courts have awarded damages based upon the highest price of the stock from the date of conversion up through the time of trial. For example, Louisiana applies this rule as enunciated in *Quealy v. Paine Webber Jackson & Curtis, Inc.*, 475 So.2d 756 (1985). *Quealy*, while recognizing the "traditional" measure of damages for conversion as set forth in cases such as

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Wong (the value of the property at the time of conversion), also recognized that such was an inadequate remedy where the chattel in question fluctuates substantially in market value. Thus, *Quealy* determined that when wrongful interference occurs, the damages should be measured by calculating the highest price between the date of such wrongful interference and the day before trial. Such method recognizes that the plaintiff should recover full value in a rising market, to compensate him for *any* potential loss. This approach has also been criticized in that, in practice, it assumes that the plaintiff would have sold his stock at the highest possible price. Supporters of this approach, however, argue that while it is unknown at what price the plaintiff would have ultimately sold his stock, he should receive all of the benefits of a rise in stock price because the decision to sell was taken out of his hands. Thus, the wrongdoer must suffer all consequences of stock price increases during the period of time in question.

Other jurisdictions advocate an approach which determines damages based upon the severity of the conduct causing the delay. In Texas, for example, with respect to chattels of fluctuating value such as stocks, some courts have determined that for simple negligence, or other unintentional interference, the stock will be valued as of the time of such wrongful act. However, in cases involving fraud, wilful wrong or gross negligence, the measure of damages has been described as the highest market value between the date of conversion and the date of filing of the suit. *Miller v. Kendall*, 804 S.W.2d 933 (1991); *Patterson v. Wizowaty*, 505 S.W.2d 425 (1974). However, even in Texas, there is a divergence of authority between the courts as to a single appropriate measure of such damages. In *Romano v. Dempsey-Tegler & Company*, 540 S.W.2d 538 (1976), the court added another factor, concluding that damages may be available for the highest intermediate value of the stock between the date of conversion and the time of trial where suit is promptly tried after filing. Iowa also follows the *Romano* approach. *Nelson v. All Am. Life & Fin. Comp.*, 889 F.2d 141 (8th Cir. 1989).

Some jurisdictions have allowed for damages to be based upon the highest value reached by the stock between the time of the wrongful interference and trial. *Ott v. Fox*, So.2d 836 (ALA.1978). Still others have based their damage calculation upon the highest value of the stock between the time of the wrongful interference and the entry of judgment. *Kaplan v. Cavicchia*, 107 N.J. Super. 201, 257 A.2d 739 (1969).

Part 2 will highlight additional recent developments in this area and their practical application.

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Measure of Damages for Interference with a Shareholder's Ability to Sell Stock — Part 2

As set forth in Part I of this article published in the last issue, courts have long struggled with the appropriate method for calculating damages for the interference with one's ability to freely trade his stock. While the varying rules for valuation each seem to have their own benefits and drawbacks, the Delaware Supreme Court recently issued a decision which arguably addresses many of those drawbacks, and provides a novel approach for calculating damages.

In *Duncan v. Theratx Inc.*, 775 A.2d 1019 (2001), the court was presented with a factual situation where shareholders of restricted unregistered stock were prevented from trading due to an improper suspension of shelf registration by the defendant corporation. Although *Duncan* was based on a cause of action for breach of contract, the court determined that the damage calculation for the restriction of the shareholders' ability to trade their stock should be made utilizing theories derived from conversion actions since "By preventing the stockholders from trading their shares, the issuers breach at least in some sense is a temporary 'conversion' of the shares." *Id.* at 1023 n. 9.



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After considering and rejecting other methods of calculation utilized previously, the *Duncan* court determined that the value for the interference with the right to freely trade stock should be the difference between the highest intermediate price of the shares during a reasonable time at the beginning of the restricted period and the average market price of the shares during a reasonable period after the restrictions were lifted. *Id.* at 1029. (emphasis added). Importantly, this rule applies regardless of whether the shareholder sells or retains any or all of his stock upon the conclusion of the interference. Rather, the measure is designed to compensate the stockholder for his lost expectation interest during the period of the delay, without placing upon the defendant the risk of subsequent share price changes if the shareholder elects to retain his shares of stock after the interference has been eliminated.

The *Duncan* Approach

Furthermore, the *Duncan* approach has the added feature of allowing the trier of fact to determine what constitutes a "reasonable time" and a "reasonable period" so that damage calculations can be made on a case by case basis based upon the particular fact pattern involved, as opposed to the application of a mathematical formula without regard to either aggravating or mitigating factors which may affect both the shareholder's ability to trade, and his decision regarding the disposition of his stock once he regains his trading rights.

To illustrate the *Duncan* rule and its application in this context, I will apply it to the case scenario as set forth above. Initially, it is important to remember that two different calculations should be determined: (1) the highest intermediate price of the shares during a reasonable time at the beginning of the restricted period and (2) the average market price of the shares during a reasonable period after the restrictions were lifted. It is the differ-

ence between these two figures which provides the damage calculation.

Under our factual scenario above, the beginning of the restricted period would be the time, as determined by the trier of fact, when the plaintiff should have, without interference, received his stock certificates and had the free ability to trade his shares. The trier of fact would then determine a reasonable time from that period forward, and take the highest share price during that period. Thus, if the transfer agent had all of the documents necessary to effectuate the transfer as of February 21, 2000, and the transfer of shares occurred within three days thereafter, and the trier of fact determined a reasonable time to be anywhere from one to ten days, the highest share price during that time would have been \$243.50 per share on February 25, 2000. In *Duncan*, the trier of fact determined ten days to be a reasonable time.

Shareholders Can Recover Some Increases in Share Price

It is important to note that the *Duncan* analysis utilizes the highest intermediate price during this reasonable time, as it provides a rough approximation of what the stockholders would have received absent the restrictions. It accomplishes this by allowing the shareholders to recover some of the increases in the share price during the restricted period without assuming that the stockholders would have sold at the highest possible share price during that same restricted period.

The second or "offset" number would be the average market price of the shares during a reasonable period after the interference concludes. This figure is to reasonably approximate the value of the shares after the interference ends, while allowing the shareholder time to make a reasonable investment decision thereafter. In the example set forth above, plaintiff received his shares on March 9, 2000. Thus, once the trier of fact determines a reasonable period of time thereafter that the plaintiff should have made the decision to either retain or sell his shares, a calculation would be made to determine the average price of the stock during that time period. Once again, if a ten day period is utilized to determine a "reasonable time," the average market price was approximately \$145. Thus, pursuant to the *Duncan* analysis, and making certain assumptions as to reasonable time periods, plaintiff's total loss would be approximately \$4.6 million. Once again, this is without regard to the fact that plaintiff sold one-half of his shares and still retains the other one-half.

As the *Duncan* court explained:

"The intuition behind this rule is that the issuer defendant should bear the risk of uncertainty in the share price because the defendant's acts prevent the court from determining with any degree of certainty what the plaintiff would have done with his securities had they been freely alienable. But the issuer should not bear the risk of all subsequent share price increases because it is impossible to know whether and when the stockholders actually would have sold their shares during the restricted period." *Id.* at 1023.

Thus, the method of calculating damages set forth in *Duncan* provides the value of the opportunity lost as a result of the wrongful interference.

Clearly, California courts have failed to address, in large measure, an appropriate method of calculating damages for the lost opportunity to trade stock when a wrongful withholding or interference occurs. The *Wong* decision clearly did not envision the rapid fluctuation in market price which is prevalent in today's fast paced global markets. Some of the other methods set forth above may provide some guidance in wrestling with this issue in the future.

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