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Is the Bull Market Covering Up Losses Caused by Stockbroker Misconduct?

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Calm seawater at high tide undoubtedly covers up millions of foreign objects on our beaches. Much like the camouflage a high tide offers, investors' damages resulting from their stockbroker's misconduct are often camouflaged during a bull market. The market has been going up since March 2009. The job market is improving, gross domestic product is growing, and stocks are rising. Things are just plain rosy! But, just because monthly account statements do not show a visible decline in value, that does not mean there is no trash below the high tide of the bull market.

What are "Out of Pocket" Losses?

Uninformed attorneys often think that the measure of damages for an aggrieved investor is strictly net "out of pocket" losses ("NOP"). NOP losses are calculated by taking the total amount invested and subtracting what the investor received back as income or proceeds from a sale. For example, an investor who purchases stock for $100,000, receives $5,000 income from the stock, and sells it a year later for $20,000 has sustained NOP losses of $75,000. In rising markets, such as what we are experiencing from March 2009 to the present, a broker's misconduct can be overshadowed by an increase in the portfolio which results in no NOP damages (or even a positive NOP).

It is simply incorrect that an investor's damages must default to an NOP calculation. When a broker is negligent or otherwise mismanages his client's portfolio, the client is entitled to receive the value of what the portfolio would have performed had the misconduct not occurred. The concept of being "made whole" is precisely the purpose of compensatory damages and is calculated by examining a hypothetical portfolio over the same time period. In a typical investment misconduct case, damages should be calculated by taking the initial value of the portfolio, adjusting it by a percentage change in an appropriate index during the relevant period, and subtracting the value of the portfolio at the end of the period. This calculation is called the "well-managed account" or the "benefit of the bargain."

Under the well-managed account theory, the investor's damages is the difference between what the investor would have had if the account had been handled properly and what he in fact had at the time the broker's misconduct ended. For example, a growth-oriented investor who had $100,000 invested in an S&P 500 index fund at the market peak in 2007 would have lost more than half of his portfolio by March 2009. If his broker panicked and inappropriately liquidated the portfolio to cash and stayed there for the next five years, the balance would still have been $50,000 as of the end of November 2013. Had the broker never liquidated to cash, the portfolio would have not only recouped its losses but would have grown to $136,000 by the end of 2013. In this example, the investor's well-managed damages are $86,000 ($136,000 – &50,000), as opposed to NOP damages of $50,000 ($100,000-$50,000).

Authority for Well-Managed Damages

There is no statutory authority limiting recovery to NOP damages for negligence or fraud. Instead, numerous appellate courts have provided that the well-managed account theory is the appropriate measure of damages. See, for example, *Dasler v. E.F. Hutton*, 694 F. Supp. 624 (6th Cir. 1998); *Miley v. Oppenheimer & Company*, 637 F.2d 318 (5th Cir. 1981); *Hatrock v. Edward D. Jones & Co*., 750 F.2d 767 (9th Cir. 1984).

This measure of damages was articulated by the U.S. Supreme Court in *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972), where the Court held that the proper calculation was the difference between the fair value of what the plaintiff received and the fair value of what she would have received had there been no fraud. The Fifth Circuit expanded on this theory in *Miley*, where the court held that a plaintiff in a churning and suitability case was entitled to recover the difference between the value of her account after the violation and what its value would have been absent the violation. 637 F.2d at 327. Ohio appellate courts have also upheld the award of well-managed damages when the investor had a net gain and there was no fraud alleged. *Culbertson v. J.J.B. Hilliard, W.L. Lyons*, 2012 WL 7747254 (S.D. Ohio 2012).

Calculating Well-Managed Damages

The securities industry argues that it is difficult to determine exactly how an account would have performed had there been no fraud or negligence. There are many legitimate ways of handling an account, each of which would yield a different portfolio value, and, as such, any estimate of the customer's lost investment opportunity will necessarily be imprecise. Courts have dealt with this issue time and time again. In *Miley*, for example, the court stated that "neither the difficulty of the task nor the guarantee of imprecision in results can be a basis for judicial abdication from the responsibility to set fair and reasonable damages." 637 F.2d at 327.

In *Davis*, the amount of the plaintiff's damages was based on expert witnesses' estimates, but most attempts to place the plaintiff in the same position that she would have been in if there were no fraud have involved the use of a market index. In *Roth v. Blyth Eastman Dillon & Co*., 570 F.2d 38, 49 (2d Cir. 1980), the Second Circuit held that the following steps should be taken to compute damages: 1) compute the market value of the plaintiff's portfolio when the fraud began; 2) adjust this amount by the average percentage increase or decrease of the value of the Dow Jones Industrial Average; the Standard & Poor's Index, or any other well recognized index of value or combination of indices of the national securities markets during the period of the fraud; and 3) subtract from the resulting figure the market value of the portfolio when the fraud ended.

The *Roth* court stated that the choice of an appropriate market index will depend on the circumstances of each case. For example, where a plaintiff should have been in conservative securities but for the misconduct, an index of conservative stocks would be appropriate. 570 F.2d at 49.

Investors hire financial advisors to invest their assets in accordance with their investment objectives, risk tolerances, and life circumstances. When brokers breach their duties, common sense and legal precedent dictate that the appropriate measure of damages is the difference between what investors would have had if the account had been properly managed. Therefore, all investors should carefully analyze their portfolios for improper conduct, regardless of whether their account statements reflect a loss. It very well could be the case that underneath the high tide of the bull market, the trash of unsuitable investments or other misconduct is waiting to be exposed.

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