by Ryon M. McCabe

Statutory Damages Under the Florida Securities and Investor Protection Act: How to Calculate and Apply Rescission Damages

This article explores a topic of frequent confusion for lawyers, judges, and arbitrators practicing securities litigation in Florida, namely, the proper calculation of damages under the Florida Securities and Investor Protection Act, commonly referred to as Ch. 517. Because the vast majority of securities claims are litigated in arbitration,[1] very little case law has developed in the area of proper damage calculations, and, at times, it seems every practitioner has a personal view of how to calculate 517 damages. This article describes the statutory formula, sets forth examples of proper damage calculations, and explores the special issues related to the "netting" of trades and the calculation of interest in multiple-transaction cases.

The Statutory Scheme

The Florida Legislature first enacted the Uniform Sale of Securities Act in 1931 in the wake of the great stock market crash of 1929.[2] Its purpose, from the outset, was to "protect investors."[3] The current version of the statute prohibits two broad categories of wrongdoing, which can be classified as "registration violations" and "antifraud violations." The registration provisions prohibit the sale of unregistered securities, the sale of securities by unregistered persons or firms, and the rendering of investment advice by unregistered investment advisors.[4]

These provisions protect investors by ensuring that investment products sold in Florida are properly registered and that all investment professionals doing business here are properly licenced and subject to ongoing regulation and potential discipline. If an unregistered product is sold in Florida, or an unregistered person or firm does business here, liability for the sale is automatic.[5]

The antifraud provisions prohibit deceptive conduct in connection with the purchase or sale of securities or the rendering of investment advice. The statute uses broad terminology to include deceptive misrepresentations, omissions, transactions, practices, and courses of conduct.[6] Although titled the "antifraud" provision, this section does not in fact require a showing of fraud, as liability can be found on proof of mere negligence.[7] Also, because the statute prohibits deceptive practices and patterns, Florida courts have interpreted it to prohibit traditional sales practice violations, such as churning and the recommendation of unsuitable investments.[8]

The result is a powerful tool for investors. An investor who proves that his or her broker made an unlawful recommendation, intentionally or negligently, can seek relief under Ch. 517 and gain the benefit of its powerful damage formula.

The Formula

The civil remedy for both registration and antifraud violations is set forth in F.S. §517.211. If the investor still owns the security, the statute allows him or her to tender the security and rescind the transaction.[9] Rescission is an equitable remedy that aims to undo a transaction. Once the investor tenders the wrongfully sold security, the seller must accept it and return to the investor the purchase price, plus statutory interest on the purchase price from the date of purchase to the present.[10]

If the investor no longer owns the security (which is more often the case), the statute sets forth a precise formula for calculating damages. These are not traditional compensatory or out-of-pocket damages, but a unique measure of statutory rescission damages. The statute provides as follows:

> (4) In an action for damages brought by a purchaser of a security or investment, the plaintiff shall recover an amount equal to the difference between:
>
> (a) The consideration paid for the security or investment, plus interest thereon at the legal rate from the date of purchase; and
>
> (b) The value of the security or investment at the time it was disposed of by the plaintiff, plus the amount of any income received on the security or investment by the plaintiff.[11]

In mathematical terms, the formula can be expressed as follows: Damages = (consideration paid + interest) - (value of security when sold + income received).

To demonstrate the formula, assume that on January 1, 2007, an unregistered broker recommends that his client invest $100,000 in an unsuitable stock, *XYZ, Inc.* Over the next year, *XYZ* pays a dividend of $500, but the stock itself plummets. On January 1, 2008, client sells the stock at a loss for $50,000. Client later brings a Ch. 517 claim and wins her case on January 1, 2009.

The damage calculation would be as follows: Client receives the return of her $100,000 purchase price, plus Florida statutory interest from January 1, 2007, to January 1, 2009. This yields $122,000.[12] The formula then subtracts the sales price client received for her stock, $50,000, plus the income she received in dividends, $500, to yield a final damage amount of $71,500. In mathematical terms: ($100,000 + $22,000) - ($50,000 + $500) = $71,500.

The formula is transaction-based, meaning that it must be applied to every individual "sale" or "purchase" found to be in violation of the statute.[13]

Compensatory Damages Distinguished

Note that the above calculation does not yield the same result as traditional notions of compensatory damages. Such damages would aim to compensate the investor under one of two theories: the out-of-pocket rule or the benefit-of-the-bargain rule.[14] The out-of-pocket rule would measure the client's damages based on the difference between what he or she had before the wrongful advice and what he or she had afterward, plus interest. The client's out-of-pocket damages in the above example, including interest, would be $54,945 — a lower number.[15]

The benefit-of-the-bargain rule would similarly seek to place the client in the position she would have occupied had the wrongful conduct not taken place, but it does so by taking prevailing market conditions into account. This is often referred to as the "well-managed" damage theory because it attempts to measure how much better off the client would have been had he or she been invested in a suitable portfolio of investments. Assuming a properly managed portfolio would have gained five percent annually during the relevant time period, for example, the above client's well-managed damage number would be $57,225 — still a lower number than the statutory damages.[16]

The hypothetical Ch. 517 calculation cited above is simple and straightforward. The formula gets more complicated with the addition of three factors: 1) the mandatory nature of the calculation; 2) the anti-netting rule; and 3) the calculation of interest in multiple transaction cases.

Rescission Damages Are Mandatory

First, the Ch. 517 damage formula is mandatory. Once a court or arbitration panel finds a violation of Ch. 517, rescission damages *must* be awarded — the decisionmaker cannot choose to use an alternative measure such as out-of-pocket or well-managed damages.[17] Also, common law theories such as mitigation cannot be applied to decrease or offset the Ch. 517 damage number.[18] Courts or arbitrators risk reversal or vacation of an arbitration award by rendering a judgment not based on the statutory formula.

The Anti-netting Rule

Second, because Ch. 517 is designed to deter wrongful conduct, the law does not allow a defendant to "net" damages. When a brokerage firm makes multiple unlawful sales, some of which make money and some of which lose money, the firm cannot deduct total gains from total losses to yield a net loss, as might be expected in a traditional out-of-pocket analysis.

In the seminal case on this topic, *Kane v. Shearson Lehman Hutton, Inc.*, 916 F.2d 643, 646 (11th Cir. 1990), the 11th Circuit rejected a brokerage firm's argument that it was entitled to deduct profits that had been realized from other transactions recommended by the firm. The court found "nothing in the language of §517.211 to indicate that the Florida [L]egislature intended to force victims of fraud to aggregate their profits and losses from separate transactions that happened to involve the same defendant and thus reduce their recoveries."[19] The court further reasoned that, "[i]f the methodology espoused by [Shearson] were adopted, it could serve as a license for broker-dealers to defraud their customers with impunity up to the point where losses equaled prior gains."[20] Other courts have reached similar conclusions applying federal securities laws and the Blue Sky Laws of other states.[21]

Calculation of Interest on Multiple Transactions

Third, the Ch. 517 formula increases the damage calculations for cases with multiple securities transactions. This is because the formula does not offset the interest that continues to accrue once a given security is sold. Instead, interest continues to run *on the entire purchase price* up to the date of judgment regardless of the date the security is actually sold. As a result, the investor continues to receive interest on money that may have been put to work in other investments. At times, the investor can receive multiple awards of interest on the same principle. The following example illustrates the point.

Assume that on January 1, 2007, an unregistered broker recommends that his client purchase *Stock A* for $100,000. On July 1, 2007, the broker recommends the client sell *Stock A* for $80,000 and buy *Stock B*. Six months later, on January 1, 2008, he recommends the client sell *Stock B* for $60,000 and buy *Stock C*. Six months later, on July 1, 2008, he recommends the client sell *Stock C* for $50,000. Client has invested $100,000, has bought and sold three stocks, and has only $50,000 remaining. Client files a Ch. 517 claim and wins the case on January 1, 2009.

The out-of-pocket loss in the above example would be $50,000, plus interest, for a total of $56,050.[22] The statutory damages, in contrast, would be $91,800. This is calculated by applying the statutory formula to each transaction on a stand alone basis, as follows:

A) (Purchase price of $100,000 + two years' interest of $22,000) - (sales price of $80,000) = $42,000.

B) (Purchase price of $80,000 + 18 months' interest of $13,200) - (sales price of $60,000) = $33,200.

C) (Purchase price of $60,000 + one year's interest of $6,600) - (sales price of $50,000) = $16,600.

A + B + C = $91,800

As the number of transactions increase, the statutory number becomes even greater. The reason, again, is that the formula allows the investor to continue to collect interest on each transaction up to the time of judgment, even though the money for that transaction may have been put to work in other investments.

Florida's statute is one of only three in the country to employ this version of the formula.[23] Since Florida's adoption of the Uniform Sale of Securities Act in 1931, the National Conference of Commissioners on Uniform State Laws has adopted three subsequent versions of the act — in 1956, 1985, and 2002. All three versions contain different damage formulas, which include an offset for interest accruing after a security is sold.[24] Florida has declined to adopt any of these damage formulas.

Among the three states that currently employ Florida's version of the formula, only one reported case has emerged to address the issue of interest calculation. In *Kugler v. Southmark Realty Partners, III*, 723 N.E.2d 710 (Ill. App. Ct. 1999), investors in limited partnerships sued a series of unregistered brokers who sold the investments. The court entered summary judgment against the brokers on liability. As to damages, an issue arose regarding the calculation of interest for two investors who sold their investments prior to judgment. The investors argued they were entitled, under the plain reading of the statute, to continue to collect interest on the full purchase price all the way through judgment, even though they had sold their investment earlier. The brokers disagreed, arguing this would give the investors a windfall, and that, once the investment was sold, interest should only accrue on the actual loss, not the full purchase price.

The court sided with the investor, noting that the language of the statute was "clear and unambiguous."[25] Under the Illinois statute, therefore, interest continues to run on the entire purchase price, even after the security is sold.

The language of Florida's damage formula is equally clear and unambiguous, and it should be applied in the same way. By declining three opportunities to change the formula, Florida has opted to maintain a damage calculation that makes the consequences of wrongdoing very high for investment professionals doing business in this state. There are sound policy reasons for doing so, including Florida's large elderly population and the significant amount of retirement assets located here. The formula is also consistent with Ch. 517's underlying goal of protecting investors — a goal that recent market events and scandals demonstrate still needs to be pursued more than 70 years after the statute was first enacted.[26]

Conclusion

According to the Florida Division of Securities, in 2008, more than 266,000 brokers and investment advisors held active licenses in Florida.[27] Given this number and recent events in the stock market, Florida's lawyers, judges, and arbitrators will likely have ample opportunity in upcoming years to work through the intricacies of Ch. 517's damage formula. The author hopes the formula will be applied more consistently and in conformity with the statute's plain language, the existing case law, and the underlying goals and purposes of Ch. 517.❑

[1] In 1987, the Supreme Court upheld the use of mandatory arbitration clauses in contracts between investors and brokerage firms. *See Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987). As a result, virtually all Ch. 517 claims against brokerage firms are now arbitrated before the Financial Industry Regulatory Authority (FINRA).

[2] *See* Laws of Florida, Ch. 14889 (1931).

[3] *See Rudd v. State*, 386 So. 2d 1216, 1218 (Fla. 5th D.C.A. 1980).

[4] Fla. Stat. §§517.07, 517.021 (2008).

[5] *See Skurnick v. Ainsworth*, 591 So. 2d 904, 906 (Fla. 1991).

[6] Fla. Stat. §517.301 (2008).

[7] *See Grippo v. Perazzo*, 357 F.3d 1218, 1222 (11th Cir. 2004) (recognizing that Fla. Stat. §517.301's scienter requirement can be satisfied with a showing of "mere negligence").

[8] *See Newsom v. Dean Witter Reynolds, Inc.*, 558 So. 2d 1076, 1077 (Fla. 1st D.C.A. 1990) ("Contrary to appellee's argument, an unsuitable trading violation of Section 517.301(1), Florida Statutes, is not merely technical. Just like churning, it is statutory fraud.").

[9] Fla. Stat. §517.211 (2008).

[10] *Id.*

[11] *Id.*

[12] Florida's statutory interest rate was 11 percent in 2007 and 2008. *See* Fla. Stat. §55.03 (2008).

[13] *See* Fla. Stat. §517.211 (2008).

[14] *See Laney v. American Equity Investment Life Ins. Co.*, 243 F. Supp. 2d 1347, 1354-55

(M.D. Fla. 2003) (discussing out-of-pocket and benefit-of-the-bargain damages).

[15] Out-of pocket damages are calculated as follows: (purchase price of $100,000) - (sale price of $50,000 + dividends of $500) + (statutory prejudgment interest from January 1, 2008, to January 1, 2009, of $5,445) = $54,945.

[16] Well-managed damages are calculated in two steps. Step 1: (purchase price of $100,000 + five percent gain for year one) - (sale proceeds of $50,000 + dividend of $500) = $54,500. Step 2: ($54,500 + five percent gain for year two) = final damages of $57,225.

[17] *See Scheurenbrand v. Wood Gundy Corp.*, 8 F.3d 1547, 1552 (11th Cir. 1993) (noting that once jury reaches a decision on Ch. 517 liability, it is "obliged to return the amount of compensation fixed by the statute").

[18] *See Randall v. Loftsgaarden*, 478 U.S. 647 (1986) (no offsets allowed to damages under §12(2) of the federal Securities Act of 1933); *Odmark v. Westside Bancorporation*, 1988 WL 108288 * 2 (W.D. Wash. 1988) (no mitigation allowed under Washington Securities Act).

[19] *Kane v. Shearson Lehman Hutton, Inc.*, 916 F.2d 643, 646 (11th Cir. 1990).

[20] *Id.*

[21] *See Nesbit v. McNeil*, 896 F.2d 380, 385-86 (9th Cir. 1990) ("gains in portfolio will not offset losses"); *Davis v. Merrill Lynch*, 906 F.2d 1206, 1218 (8th Cir. 1990); *Levine v. Futransky*, 636 F. Supp. 899, 900 (N.D. Ill. 1986).

[22] The loss on sales of securities is $50,000. The total interest is $6,050, calculated as follows. Stock A: (purchase price of $100,000 – sales price of $80,000) = $20,000 loss. Eighteen months of interest at 11 percent = $3,300. Stock B: (purchase price of $80,000 – sales price of $60,000) = $20,000 loss. Twelve months of interest at 11 percent = $2,200. Stock C: (purchase price of $60,000 – sales price of $50,000) = $10,000 loss. Six months of interest at 11 percent = $550.

[23] The other two states are Illinois and Texas. *See* 815 Ill. Comp. Stat. 5/12 (West 2008); Texas Securities Act §33 (West 2008); *see also* Long, Blue Sky Law, §9.15 n.10 (West 2008).

[24] The 1956 act, for example, which is currently in force in many states, allows an investor to recover the following: "[T]he consideration paid for the security, together with interest at (x) percent per year from the date of payment, costs, and reasonable attorneys' fees, less the amount of any income received on the security, upon the tender of the security and any income received on it, or for damages if he no longer owns the security. Damages are the amount that would be recoverable upon a tender less the value of the security when the buyer disposed of it *and interest at six (x) percent per year from the date of disposition.*" (Emphasis added.)

The final sentence is the key because, in mathematical terms, it creates an offset to prevent a plaintiff from continuing to recover interest on money that has been recouped through a sale of the security. The plaintiff continues to recover interest only on the loss, not the entire purchase price.

[25] *Kugler*, 723 N.E.2d at 716. The court noted its own disagreement with the statute, but recognized its duty to follow the statute regardless of its own opinion on how damages should be calculated. *Id.*

[26] In 2008 and 2009, several nationwide Ponzi schemes were exposed involving Florida victims, including those run by Bernard Madoff, Allen Stanford, and Arthur Nadel. The stock market also experienced a historic crash, with Florida investors losing billions, many of whom were exposed to unsuitable investments, churning, and other brokerage firm wrongdoing.

[27] *See* Florida Office of Financial Regulation, *Office of Financial Regulation Securities Firms, Branches and Agents Statistics*, www.flofr.com/securities/Forms/firmagtbostats.pdf.

***Ryon M. McCabe** is a partner with McCabe Rabin, P.A., in West Palm Beach. He is board certified in business litigation and represents investors in securities and investment-related disputes. Mr. McCabe thanks Sean Kelly of Kelly & Associates, LLC, for providing the investment calculations used for this article.*

This column is submitted on behalf of the Business Law Section, Louis T. M. Conti, chair, and Melanie E. Damian and Peter F. Valori, editors.