MITIGATION OF DAMAGES IN SECURTIES LITIGATION AND ARBITRATION

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BIOGRAPHIES

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1. Introduction

Failure to mitigate damages is a frequently asserted defense in securities litigation and arbitration. Mitigation requires the non-breaching party to act to lessen the magnitude of his economic losses unless doing so exposes him to undue risks. In many cases, the question is when is the risk "undue?"

According to one leading commentator: "almost any risk of considerable loss to the injured person if he attempts to mitigate damages should be considered undue."[1] Although determining how much risk exists in a proposed mitigating transaction or course of conduct naturally requires a case-by-case analysis, a number of cases provide useful guidance as to how courts may assess whether risks were "undue" or the potential mitigating conduct "reasonable."

A party is not, for example, required to risk large sums or engage in speculative new contracts to try to undo damage another party's breach has caused.

2. Securities Litigation Cases

In Lucente v. International Business Machines Corp.,[2] for example, a former employee sought payment for stock options and for restricted stock which his ex-employer had wrongfully withheld under a non-competition agreement. After canceling its stock options and restricted stock, IBM argued that plaintiff could have avoided most of the damages (the gains on the IBM shares) that were withheld, by buying equivalent securities in the open market when it first learned of the cancellation.

Judge McMahon disagreed:

> [M]easuring damages as the higher of the value at breach or the value at some "reasonable" intermediate date following notice of breach, implicitly takes into account Plaintiff's duty to mitigate…without requiring that the plaintiff take on additional financial risk in the hopes of avoiding some

loss…while it is true that the securities underlying these grants -- IBM common stock -- were available on the open market, Lucente was not engaged in the business of investment speculation when he signed the options grants and the restricted stock agreement. Indeed, as an IBM insider, he could not trade. It would be manifestly unjust to require one who has not speculated in the market to then go out and risk large sums of his own money on the grounds that he had a duty to mitigate. (Note omitted) (Emphasis added)).

In American General Corp. v. Continental Airlines Corp.,[3] the court held that plaintiff was not required to engage in option trading to hedge against lost profits resulting from a breach:

> Defendants have submitted elaborate schemes providing for the purchase of "put" and "call" options on Texas Air stock that they contend would have allowed American General to have "locked in" the profit it is now claiming as damages. The investment alternatives that defendants claim American General should have pursued in order to mitigate its damages are very high risk propositions. Indeed, they appear to be contrary to Texas regulations regarding the types of investments a Texas insurance company such as American General could have made … While there is a general duty to mitigate damages if it is feasible to do so, a plaintiff need not take unreasonably speculative steps to meet that duty. … American General was therefore not under a duty to engage in the put and call option scenarios set forth by defendants. (Citations omitted) (Emphasis added).

Similarly, in Matsushita Electric Corp. of America v. Gottlieb,[4] plaintiff was permitted to exercise a put option pursuant a to a settlement agreement requiring defendant to purchase 80,000 shares of stock at a pre-determined price, within 90 days. If defendant failed to do so, plaintiff would be permitted to retrieve collateral stock from an escrow agent and sell it, retaining a pre-designated sum certain. Plaintiff exercised the put, but defendant refused to purchase the stock and took steps that prevented plaintiff from obtaining the escrowed stock, thereby breaching the contract.

Defendants argued plaintiff failed to mitigate, causing its own loss, by failing to notify the escrow agent that it had exercised the put, failing to post an indemnity bond to stop defendants' transfer of shares and by failing to sell the collateral with sufficient speed to preclude loss. Judge Stewart rejected defendants' argument:

> [M]itigation … requires only a showing that plaintiff took reasonable steps to cut its losses, not that plaintiff did what the defaulting defendants would have had it do, or what in hindsight seems most effective to reduce the defaulting defendants' damages. See e.g., Carrols Equities Corp. v. Villnave, 57 A.D.2d 1044, 1045; 395 N.Y.S.2d 800, 803 (4th Dep't 1977) (duty to mitigate does not include an obligation to undertake extraordinary and costly measures), appeal denied, 42 N.Y.2d 810, 399 N.Y.S.2d 1026, 369 N.E.2d 775 (1977).) … Nor do we find that plaintiff was under an obligation to mitigate damages by taking the extraordinary and costly measure of posting an indemnity bond … Finally, plaintiff did not act negligently in selling the collateral... (Emphasis added).

In Klein v. 5B Technologies Corp.,[5] defendant failed to register certain restricted shares of stock that plaintiff received under an employment agreement. Plaintiff sued, seeking the profit he would have made on sale, had the shares been registered. Defendant argued that plaintiff should have sold shares short to mitigate, but Justice Gammerman disagreed: "[P]laintiff could not have taken any realistic steps to mitigate his damages in that such attempts would have exposed plaintiff to significant financial risk." Although defendant argued that plaintiff could have sold short to mitigate damages, testimony by both experts established plaintiff needed to be in physical possession of registered shares in order to sell short.

3. Securities Arbitration Matters.

Mitigation issues frequently arise in securities arbitrations.

The following are four examples of arbitrations in which mitigation issues played a central role in argument before the Panels. The names of the matters are not identified in respect of the privacy interests of these arbitration litigants.

Example One. In an arbitration before the National Association of Securities Dealers, Inc. ("NASD"), a Panel held that mitigation rules did not require an investor to repurchase stock which had been wrongfully liquidated to satisfy a margin maintenance call. The investor was on business overseas when the broker-dealer left a voicemail on his home phone advising him that it was issuing a maintenance margin call.

The call was based on a substantial intra-day price decline of his single stock holding and the voicemail advised that claimant's entire stock position would be liquidated if the margin call was not met by noon that day. Two hours later, the broker dealer liquidated the entire stock position.

The investor had an unblemished history of promptly complying with all prior margin calls. Claimant had paid each such call, by check, sent to the broker-dealer by mail.

By the time the investor learned of the call and liquidation, however, the market price of the stock had risen almost 50% and no liquidation would have been required. The prices was also at a point where the investor lacked the funds to re-establish his pre-liquidation share position, absent his borrowing additional funds. The stock then rose substantially in the weeks that followed.

At arbitration, the investor sought to rescind the wrongful liquidation and recover full damages for lost appreciation of the stock. The broker-dealer responded that the investor should have borrowed, if necessary, to restore his pre-liquidation share position. Specifically, the broker-dealer argued it would be unreasonable to require it to replace shares that appreciated 400% since the liquidation. The panel rejected the broker-dealer's argument and held that the investor's duty to mitigate did not require an assumption of significantly greater financial risk than had been previously undertaken. The Panel awarded rescission of the entire pre-liquidation share position at the current value.

Example Two. In another NASD arbitration, an investor's conservative stock portfolio was speculatively leveraged through a broker's use of unauthorized margin debt. The broker concealed the debt and misrepresented that the monthly statements were inaccurate due to "back office errors," and should be ignored. Instructing the investor to rely, instead, on his personal advice as to actual amounts of margin debt and net account value, the broker engaged in numerous unsuitable transactions.

The transactions resulted in substantial realized losses, and claimant incurred additional margin debt, prompting further misrepresentations by the broker, to conceal the account's deteriorating net equity.

When the investor learned what had happened, he attempted to mitigate the ongoing unsuitable risk of what had become a highly leveraged stock portfolio. He paid down the margin debt by selling a portion of what had been his long-term core holding of low cost-basis stock rather than borrow extensively. Claimant then sought both compensatory damages arising from the unauthorized trading and rescissory damages based upon the market value of the liquidated shares as of the date of arbitration and the Panel awarded claimant all the relief he sought.

The Panel, cognizant of the claimant's reasonable efforts to mitigate the risk of further damages arising from the unsuitably leveraged portfolio, awarded him not only monies lost through the unauthorized trading but, in addition, monies to compensate claimant's "opportunity cost" of having foregone the post-liquidation market appreciation of stock he was forced to liquidate to pay-down the undesired, unsuitable margin, in effect, an award of market index adjusted damages.

Example Three. Claimant filed an arbitration against a broker-dealer for failing to timely exercise an investor's company-issued warrants. Respondent argued that once claimant learned of the failure, claimant had an obligation to purchase the stock at its full market price to mitigate the damage resulting from the failure to exercise the warrants should be limited to the difference between the market price of the stock at the time of the instruction to exercise and the below-market price for which the warrant entitled the investor to purchase the stock and that the investor should not be entitled to damages based on the subsequent appreciation of the shares underlying the warrants,

Claimant responded that doing so would have subjected him to higher investment risks he had anticipated. The Panel held for claimant, stating that that any effort to mitigate damages by open market purchasing of replacement shares would have exposed claimant to substantially heightened and, therefore, unreasonable risks, compared with the low risk purchase that would have attended the timely exercise of the subject warrants.

Example Four. An ERISA discretionary account manager had agreed to restructure claimant's portfolio assets, with emphasis on current income. The restructuring was to take place while claimant was on vacation but when claimant returned home, he discovered the manager had not implemented the restructuring.

During the vacation, the 9/11 World Trade Disaster occurred, equities declined and bonds appreciated. The claimants portfolio diminished in value. It was subsequently re-allocated to meet investor's previously agreed upon income objectives.

Claimant argued that given the losses his income objectives could no longer be met without allocating a far greater portion of the diminished portfolio to bonds than would have been required if the restructuring had been timely implemented. Claimant offered a market-adjusted damage analysis, running to the hearing date. Respondent argued claimant's theory should be rejected because claimant should have re-structured his own portfolio, in mitigation of damages.

The Panel found that because claimant lacked sufficient expertise to restructure his own portfolio, it would be unreasonable to require him to mitigate in that manner. In addition, claimant would have had to incur heightened risks of leverage, through borrowing, to fund the then larger and less bond-weighted portfolio to meet his pre-decline income objectives, at a time when his portfolio was larger.

Essentially, the time-differential between the date of the agreed-upon restructuring decision and its belated implementation constituted, in the Panel's view, a heightened risk that made mitigation unreasonable. Thus, the claimant's proffered market-adjusted damages, based on the bond/equity allocation differential, was found to be a valid computation of damages that could not be defeated by respondent's mitigation defense.

4. Mitigation in Commercial Contract and Other Cases

In Christman v. Maristella Compania Naviera,[6] defendant breached its contract, refusing to supply a chartered vessel unless plaintiff agreed to pay it $10,000 more than the contract price. Plaintiff refused to pay the additional sum and, instead, chartered a different vessel for $42,000 more than the initial charter and then sued to recover the $42,000. Defendant argued plaintiff failed to properly mitigate by refusing to pay the additional $10,000.

Judge Brieant held, and the Second Circuit affirmed, that plaintiff had acted reasonably in not paying the $10,000:

> It is not reasonable to expect the plaintiff to avoid harm if at the time for action it appears that the attempt may cause other serious harm. He need not enter into other risky contracts…An injured party has a duty to mitigate damages only so far as can be done by reasonable effort on his part.[7]

Judge Brieant quoted the Restatement of the Law of Contracts, Sec. 336, which states that mitigation extends to harm that the plaintiff could have avoided by "reasonable effort" without "undue risk [or] expense." As set forth in Restatement 2d Contracts, Sec. 350, Comment g "[I]t is [not] reasonable to expect [the non-breaching party] … to take steps to avoid loss if those steps may cause other serious loss. He need not, for example, make other risky contracts, incur unreasonable expense or inconvenience or disrupt his business."

Although Judge Brieant's opinion did not discuss the cost of the initial charter or the new "risk" to which plaintiff would have been subjected had he paid the $10,000, plaintiff may have feared that after paying an additional sum, defendant would have again refused to perform, or that his payment might be viewed as a novation. Thus, plaintiff was not required to mitigate by paying $10,000 to defendant even though he ended up paying four times more than he would have paid had he complied with the demand for additional compensation.

In Evra Corp. v. Swiss Bank Corp.,[8] a ship charter party sued a bank for its purported negligent failure to wire transfer an installment payment, resulting in the charter's cancellation. The bank argued the charter party had a duty to mitigate and hire a replacement vessel, at its own expense. The court found the charter party would have assumed "substantial additional risk" had it undertaken to charter a replacement vessel at the time of breach, because shipping rates were then 100% higher than when plaintiff entered the original charter.

The trial judge found plaintiff's decision not to re-charter reasonable because to do otherwise would have subjected plaintiff to "undue risk." The demand that plaintiff pay double the consideration for which he bargained was held to be "undue" and not "reasonable" mitigation.

In Janowitz Bros. Venture v. 25-30 120th Street Queens Corp.,[9] the mitigation question was whether a non-breaching party could have avoided damages by completing a component of a project itself, without "unreasonable risk or expense." The Second Department found that if plaintiff had attempted to complete the project, it would have incurred an unrecoverable cost of roughly $100,000.

Because this would have "exposed [buyer] to unreasonable risk or expense," that court concluded it would have been "manifestly unreasonable" to require plaintiff to "mitigate" while incurring a substantial, "unrecoverable loss."

Koby v. U.S.[10] involved plaintiff's purchase of property at auction sale, which was later improperly voided. Plaintiff refused to participate in a second auction, to buy the same property, and sued. Defendant argued plaintiff was required to have participated in the second sale to mitigate his damages but Judge Allegra disagreed:

> While reasonable cost-avoiding steps include affirmative efforts to make substitute arrangements compensating for the lack of contract performance, such arrangements need not be entered into if they would expose the party to undue risk or significantly compromise its interests ... an injured party is not expected to 'exalt the interests of the defaulter to his own probable detriment.' … Under the circumstances, plaintiff was not required to take the economic equivalent of a Kierkegaardian leap of faith, sacrificing blindly his own interests in an effort to exalt those of the defaulting defendant. (Citations omitted) (Emphasis added).

Soren Kierkegaard was, of course, the famous progenitor of Christian existentialism who taught that Christianity's central message was that man's sense of existential "abandonment" could only be effectively addressed through a radical act of faith in God, a faith which he believed was itself contrary to both evidence and logic.

As evident from the above cases, New York courts, Federal Courts and Securities Arbitration Panels will not require a non-breaching party to a contract or securities investor to take a blind "leap of faith" or expose themselves to additional monetary harm. An injured party whose contract has been "abandoned" or who has been damaged by broker or fund manager error need not leap into risky, substitute transactions, sacrificing his own interests to attempt to save the benefit of his bargain or portfolio. Nor is plaintiff required to enter into transactions radically different from those that he or she anticipated at the time of the investment or contract. The cases and arbitrations discussed above illustrate circumstances in which courts and Panels have determined that the risks of proposed mitigating transactions were so great and/or the substitute proposed transactions or conduct so dissimilar from those originally contemplated, that the plaintiffs had no duty to mitigate in the proffered manner.

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[1] 11 Samuel Williston, A Treatise on the Law of Contracts § 1353 at 274 (3d ed.1968).

[2] 117 F. Supp.2d 336, 357 (S.D.N.Y. 2000), reconsideration granted on other grds., 146 F.Supp.2d 298 (S.D.N.Y. May 1, 2001), rev'd on other grds., 310 F.3d 243 (2d Cir. 2002).

[3] 622 A.2d 1, 11 (Del. Ch.), aff'd, 620 A.2d 856 (Del.Supr. Dec. 28, 1992).

[4] 1991 WL 152615 (S.D.N.Y. Aug. 1, 1991).

[5] N.Y.L.J. July 19, 2001, at 18, col. 2 (Sup. Ct. N.Y. Co.), appeal withdrawn, 286 A.D.2d 1007, 731 N.Y.S.2d 906 (1st Dep't 2001).

[6] 349 F. Supp. 845 (S.D.N.Y. 1971) (Brieant, J.), aff'd on opinion below, 468 F.2d 620 (2d Cir. 1972).

[7] 349 F. Supp. at 858.

[8] 522 F. Supp. 820, 833-834 (N.D.Ill. 1981), rev'd in part on other grds, 673 F.2d 951 (7th Cir.), cert. denied, 459 U.S. 1017, 103 S.Ct. 377 (1982).

[9] 75 A.D.2d 203, 212-213, 429 N.Y.S.2d 215, 221-222 (2d Dep't 1980).

[10] 2002 WL 2001230 (Fed. Cl. August 29, 2002).