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Calculating Damages In Securities Contract Breach Cases

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In January 2012, the founder and then-CEO of Gulf Keystone Petroleum Ltd. settled his divorce by agreeing to deliver 23 million shares of GKP stock to his ex-wife by the 27th of that month. Failing to deliver any shares on time, Todd Kozel instead sporadically delivered increasing quantities over the course of almost five weeks, during which time the stock soared to a record high on takeover rumors but then reversed course as the rumors were dispelled. The ensuing litigation presented a unique "damages" fact pattern for the plaintiff because the stock closed higher on each of the four delivery dates than on the breach date. Even so, in her Sept. 11, 2015, decision, Judge Nancy K. Donnellan of the Twelfth Judicial Circuit in Sarasota County, Florida, found that the delay damaged Ashley Kozel by $34,611,702.[1]

In suing to enforce her marital settlement agreement, Ms. Kozel claimed that her ex-husband's failure to timely deliver prevented her from selling millions of as-yet-undelivered shares in the high-price, high-volume market of mid-February 2012. After the court found a material breach of the settlement agreement, the court faced two questions relating to damages: the legal standard for measuring damages, and how to apply that measure of damages to the facts of the case. At trial, the parties' lawyers argued the first question and their experts opined on the second.

With respect to the legal standard for measuring damages, plaintiff's counsel Jeffrey D. Fisher and Zachary Potter argued that Kozel was harmed by having been deprived of an opportunity that she contracted for: to sell her shares during a period that turned out to be the best seller's market in the history of the stock. "Mr. Kozel took that opportunity from her. Her demands for the shares escalated as the price rose yet he ignored them and he failed to deliver most of the stock until a dramatic market decline was underway."

Defense counsel argued that, even though more than 17 million shares were not delivered until after the market turned, there was no damage because each day Mr. Kozel did deliver, the stock's closing price was higher than on the date of breach. The price rise, he contended, made Ms. Kozel "better off" on account of the breach.

To support his position, counsel for Mr. Kozel referred the court to the "general rule" for the computation of damages in contract cases, which is that damages are measured "as of the date of the breach." Under the general rule, price fluctuations during and after the breach period do not affect the nonbreaching party's recovery. Therefore, in his view, Ms. Kozel was made whole (or better) when she received stock that had a higher value that the stock she was denied on the date of breach.

Mr. Fisher countered that the general rule did not apply in this case. He explained: "Courts around the country, including in Florida, Delaware, New York and Ohio, recognize an exception to the general rule for 'delay damages' when the deliverable is a volatile security with liquidity issues, particularly if the plaintiff expressed a desire to sell that security during the delay period. That was the case here. Ms. Kozel contracted for a large delivery of stock on a date certain; the market happened to be ripe for disposal of a large volume of shares during the weeks following the promised delivery date; and Ms. Kozel repeatedly told Mr. Kozel, before and during the delay period, that she was eager to sell."

The "exception" to the general rule referenced by Mr. Fisher originated in "conversion of stock" cases, but, in Madison Fund Inc. v. Charter Co., it was recognized as an appropriate damages measure in securities-related breach of contract cases more generally.[2] Thereafter, the "exception" became broadly accepted as the appropriate legal standard in jurisdictions throughout the country for "delay damages" in breach of contract cases in which the plaintiff expressed a near-term intent to trade a security that the defendant's breach prevented him or her from trading.[3]

The Madison Fund Rule, as the exception has come to be known, measures damages using a two-prong analysis that quantifies the harm to a plaintiff when delivery of stock has been delayed in breach of a contract. The first prong, representing the per-share value of the best near-term sale opportunity that was lost due to the breach, is the "highest price" of the stock within a "reasonable period of time" following the breach. Judge Donnellan quoted Stuckey v. Online Resources Corp.[4]to explain the rationale for this prong:

> The intuition behind this rule is that the [breaching party] should bear the risk of uncertainty of the share price because the defendant's acts prevent a court from determining with any degree of certainty what the plaintiff would have done with his securities had they been freely alienable …. The injury is not the loss of a specific transaction but the loss of the ability to trade the shares as desired.

The second prong of the Madison Fund Rule, as explained by Judge Donnellan, relates to mitigation. It answers the question, "What was the per-share value of the stock in the plaintiff's hands after it was delivered on an untimely basis?" The mitigation figure is the "average price" of the shares over a "reasonable period of time" following delivery. The average price is used for mitigation because it is a "foreseeable and fair" method of computing the realizable value of the shares once delivered. By basing the second prong on average market price rather than plaintiff's sale price, the measure does not reward the defendant if the plaintiff did well on sale, nor does it penalize the defendant if the plaintiff did poorly.

The complication that arises in implementing the Madison Fund Rule, and the reason expert testimony is needed, is that the "reasonable periods" governing the first and second price prongs depend on market dynamics that are security-specific and date-specific. As defined by case law, a "reasonable period" is the time it would take to sell the plaintiff's shares beginning at a specified time (breach or delivery) without "depressing" the market for the stock. By way of example, in Ms. Kozel's case, the first "reasonable period" is the number of trading days it would have taken to dispose of 23 million shares of GKP beginning Jan. 30, 2012 (the first post-breach trading day) without depressing the market. A "reasonable period" is a period of price exposure for which the breaching party can foreseeably expect to be responsible in the event of delayed performance.

Ms. Kozel hired Marcia Kramer Mayer, a financial economist at NERA Economic Consulting, as her damages expert. Mayer conducted an econometric analysis to determine the length of each "reasonable period." Building on the academic event study and market microstructure literatures, she estimated a regression equation to explain GKP's historical daily price performance as a function of two variables: the performance of an index of London-traded oil and gas stocks, and the net direction of executed orders in GKP. She found that, holding constant index performance, the lopsidedness of volume as between buyer-initiated trades and seller-initiated trades was a statistically significant predictor of GKP's daily return. Mayer used her model to determine the maximum number of additional GKP shares that could have been sold each day without, in expectation, depressing the stock's closing price by more than a specified percentage.

Based on this model, Mayer found that Ms. Kozel could have sold the GKP shares due her at a rate of 4 percent, 8 percent or 13 percent of the stock's daily London volume without depressing closing price by more than an expected 1 percent, 2 percent or 3 percent, respectively. From these sale rates and the stock's daily volume, Mayer determined how many trading days it would have taken Ms. Kozel to dispose of her shares at the relevant times.

Once she delineated the reasonable periods, Mayer found the highest price in the immediate post-breach period for the first prong of the Madison Fund analysis and the average price in the post-delivery period for the second prong. Multiplying the applicable share count by the price drop from one prong to the next, she calculated Ms. Kozel's damages. Mayer testified at trial that, if the court adopted the "reasonable periods" consistent with a 2 percent price impact constraint (achieved by selling 8 percent of the daily volume), Ms. Kozel's Madison Fund damages were $34,611,702.

Mr. Kozel also offered expert testimony regarding the Madison Fund "reasonable periods" but of a completely different sort. Rather than analyze data, Mr. Kozel's expert testified on the basis of his knowledge and experience as a broker in London. Mr. Kozel's expert claimed that, had he been given Ms. Kozel's 23 million shares to sell, he could have disposed of them within hours if not minutes using any number of strategies, including block trades and "dark pools," without depressing price more than trivially.

Had the court given full weight to this testimony, it would have concluded that Ms. Kozel had no damages. Ms. Kozel's counsel argued that such "pure opinion" testimony, with no known error rate and based entirely on "rules of thumb," was not entitled to any weight in Florida given the state's adoption of the Daubert standards for admission of expert testimony.[5] The court agreed and gave no weight to Mr. Kozel's expert's testimony. In contrast, the court deemed Mayer's testimony to be "credible, relevant, and reliable."

After applying the Madison Fund Rule, a measure of damages that it described as "objective," the court addressed the "subjective" measure advocated by Mr. Kozel (who made arguments in the alternative as to why, in his view, Ms. Kozel's damages were zero). Mr. Kozel contended that, to establish damage, Ms. Kozel needed to establish that she wanted to "sell at a particular date and at a particular price," but that there was no such evidence. Ms. Kozel responded that she was not required to place "imaginary" orders during the breach period and that there was ample evidence of her desire to sell during that period, including, importantly, a telephone call to Mr. Kozel the day before the stock price peaked. The court agreed with Ms. Kozel and held that, even measured subjectively, Ms. Kozel sustained damages of $31,606,588. To arrive at this figure, the court computed the value of Ms. Kozel's undelivered shares on the day she demanded them by phone by multiplying the number of missing shares by the closing price of the stock. The court then reduced this figure using the “mitigation” analysis from the Madison Fund Rule, i.e., the court multiplied the share count by the average price that Ms. Kozel could have achieved by selling her shares after Mr. Kozel’s untimely deliveries using a sale rate that would not depress the market by more than 2 percent. Under the unique facts of the case, the objective and subjective measures yielded roughly the same result.

The decision joins a long line of authority developed in multiple states over the last 38 years that provides a predictable and objective method to compute damages for delayed delivery of stock, particularly when the claim involves many shares relative to market volume.

—By Jeffrey D. Fisher and Zachary R. Potter, Fisher & Bendeck PL, and Marcia Kramer Mayer, NERA Economic Consulting

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DISCLOSURE: Jeffrey Fisher and Zachary Potter represented Ashley Kozel in the case discussed, and Marcia Kramer Mayer was hired as her damages expert.

[1] Kozel v. Kozel, No. 2010-DR-008976-NC,2015 WL 5446389 (Fla. Cir. Ct. Sept. 11, 2015).

[2] Madison Fund Inc. v. Charter Co., 427 F. Supp. 597 (S.D.N.Y. 1977) (applying Florida law).

[3] See Duncan v. Theratx Inc., 775 A. 2d 1019 (Del. 2001) (adopting Madison Fund Rule); Lindon v. Dalton Hotel Corp., 49 So. 3d 299 (Fla. 5th DCA 2010) (citing Madison Fund); Katz Deli of Aventura Inc. v. Waterways Plaza LLC, 38 Fla. L. Weekly D2511 (Fla. 3d DCA Nov. 27, 2013) (citing Madison Fund); Cole v. Am. Capital Partners Ltd. Inc., 394 Fed. Appx. 544, 546 (11th Cir. 2010) (affirming the district court’s holding that Madison Fund is a proper statement of Florida law); Stuckey v. Online Res. Corp., 909 F. Supp. 2d 912 (S.D. Ohio 2012) (adopting Madison Fund Rule).

[4] Stuckey,909 F. Supp. 2d at 930.

[5] Daubert v. Merrell Dow Pharmaceuticals Inc., 509 U.S. 579 (1993)
