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Rule 10b-5-Application of the In Pari Delicto Defense in Suits Brought Against Securities Brokers by Customers Who Have Traded on Inside Information

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NOTES

Rule 10b-5—Application of the *In Pari Delicto* Defense in Suits Brought Against Securities Brokers by Customers Who Have Traded on Inside Information

I. INTRODUCTION

The *in pari delicto* defense denies recovery to an individual who participated in the wrong for which he seeks redress.[1] Although courts have applied the *in pari delicto* defense to claims arising in many substantive areas of law, the analytical foundation that courts established in contract cases remains viable. This analytical framework rests upon the premise that an individual who participates in an illegal activity should not receive judicial relief for injuries he suffered as a result of that activity. Courts, however, recognize four exceptions to that analysis which allow wrongdoers to recover for their injuries: (1) the plaintiff acted under fraud or duress; (2) the plaintiff is a member of the class of people the law seeks to protect by making the transaction illegal; (3) the plaintiff did not know that the transaction was illegal or participated in an independent wrong; (4) the denial of relief to the plaintiff is unjust or against public policy.[2] Courts consider the fourth exception to be residual in nature and often use it to promote statutory goals.

In securities law, defendants have raised *in pari delicto* as a defense to many claims, such as violations of the registration, margin, and proxy provisions and of rule 10b-5.[3] If a tippee[4] sues a tipper under rule 10b-5 to recover losses he sustained by trading securities on inside information[5] that the tipper[6] gave him, the tipper probably will assert the *in pari delicto* defense. A typical scenario begins when a broker passes inside information about a security to a client. The client buys the security, knowing that its purchase on the basis of inside information violates rule 10b-5.[7]

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1. *See* Tarasi v. Pittsburgh Nat'l Bank, 555 F.2d 1152, 1156-57 (3d Cir.), *cert. denied*, 434 U.S. 965 (1977).

2. *See infra* notes 26-39 and accompanying text.

3. *See infra* notes 63-148 and accompanying text.

4. A tippee is a person who (1) receives inside information; (2) "knows or should know that the information is nonpublic"; (3) did not receive the information in his business capacity or for a legitimate business purpose; and (4) knows or should know that he obtained the information improperly. 5 A. JACOBS, THE IMPACT OF RULE 10B-5 § 66.02 (1974).

5. Inside information consists of "nonpublic facts concerning the business of an issuer, one of its securities, or the market for its securities," that the issuer intends to be available only for a business purpose and not for the personal benefit of anyone trading in its securities. *Id.*

6. A tipper is a person who possesses material inside information and selectively discloses that information for securities trading or other personal gain. *Tarasi*, 555 F.2d at 1154 n.1; Grumet v. Shearson/American Exp., Inc., 564 F. Supp. 336, 339-41 (D.N.J. 1983).

7. 17 C.F.R. § 240.10h-5 (1983). *See infra* note 101 for text of rule 10b-5. "Rule 10b-5 has become the kernel of all antifraud actions brought either privately or by the S.E.C." Glickman, *"Tippee" Liability Under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934*, 20 U. KAN. L. REV. 47, 47 n.4 (1971).

The value of the stock declines and the investor brings suit against the broker to recoup his losses. The broker then raises the *in pari delicto* defense, contending that the court should deny recovery because the investor knowingly participated in the illegal securities purchase.

To determine whether the *in pari delicto* defense bars tippee recovery in 10b-5 cases, most courts implicitly apply the analytical framework that earlier courts derived from the application of the defense in contract cases.[8] Courts properly deny the defense and allow recovery in private 10b-5 cases when the plaintiff qualifies under one of the first three exceptions to the framework.[9] In an increasing number of cases, however, the courts must base their decisions on the fourth, residual exception because the first three exceptions do not apply.[10] The residual exception denies the *in pari delicto* defense when necessary to promote the public policies underlying rule 10b-5. Because the goals of the federal securities laws and the best way to achieve them are unsettled, the federal circuit courts disagree over whether the residual exception proscribes a 10b-5 defendant from raising the *in pari delicto* defense. One line of authority in the circuits permits the tippee to recover from the tipper those losses that he sustained while trading securities in violations of rule 10b-5.[11] These courts view the tipper as the "fountainhead" of the inside information and seek to discour-

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Rule 10b-5 requires an insider or a tippee either to disclose material inside information before trading in or recommending the purchase or sale of a security, or to abstain from trading in or recommending the security. *Tarasi*, 555 F.2d at 1161; 5 A. JACOBS, *supra* note 4, at § 66.02. In cases in which tippees sue because they lost money by trading on inside information that proved false, the courts have rejected the tippees' argument that they are not true tippees because the inside information was not material. The courts reason that no difference exists between a fraud and an attempted fraud. *Tarasi*, 555 F.2d at 1159-60; Kuehnert v. Texstar Corp., 412 F.2d 700, 704 (5th Cir. 1969). *See also* SEC v. Lund, 570 F. Supp. 1397 (C.D. Cal. 1983) (disallowing the tippee's recovery because, although the tippee breached no legal duty to those from whom he purchased the securities, he was a "temporary insider" subject to liability under 10b-5 for personally trading on nonpublic material information he received as an officer of a company with which the issuer was doing business). *But cf.* Silverberg v. Paine, Webber, Jackson & Curtis, Inc., 710 F.2d 678, 691 (11th Cir. 1983) (allowing an investor who traded on inside information to recover from his broker, the tipper, because the investor owed no duty to those from whom he purchased the securities and, therefore, did not engage in an unlawful activity).

8. *See infra* notes 96-148 and accompanying text.

9. *See infra* note 96.

10. *See, e.g.*, James v. DuBreuil, 500 F.2d 155 (5th Cir. 1974); Kuehnert v. Texstar Corp., 412 F.2d 700 (5th Cir. 1969); Nathanson v. Weis, Voisin, Cannon Inc., 325 F. Supp. 50 (S.D.N.Y. 1971). *See infra* notes 103-48 and accompanying text.

11. *See* Moholt v. Dean Witter Reynolds, Inc., 478 F. Supp. 451 (D.D.C. 1979); *Nathanson*, 325 F. Supp. 50 (S.D.N.Y. 1971).

age him from passing inside information by holding him liable for the tippee's losses.[12] Other circuit courts permit tippers to use the *in pari delicto* defense in private 10b-5 actions, reasoning that the Securities and Exchange Commission's (SEC) enforcement powers[13] provide adequate incentive to discourage the tipper from disseminating inside information.[14] These courts also fear that denying the *in pari delicto* defense would insulate tippees from the risk of loss inherent in all securities trading.[15]

This Note advocates that courts should permit tipper defendants to assert the *in pari delicto* defense in private 10b-5 cases against tippee plaintiffs unless one of the first three exceptions to the analytical framework applies. Part II of this Note discusses the purpose and application of the *in pari delicto* defense and the four situations in which courts have rejected it. Part II also illustrates how courts analyze the *in pari delicto* defense in contract, antitrust, and non-10b-5 securities cases. Part III provides a general background on the purpose of the Securities and Exchange Act of 1934 and rule 10b-5, and analyzes the current split among federal circuit courts on the application of the *in pari delicto* defense in rule 10b-5 actions. Part IV concludes that courts should leave the parties to the illegal agreements undisturbed and should not apply the residual exception to disallow the defense in 10b-5 actions. When one of the first three exceptions to the defense does apply, however, courts should continue to allow plaintiff tippees to recover against tipper defendants who have given the tippees false inside information.

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12. *Nathanson*, 325 F. Supp. at 57. *See* Kirkland v. E.F. Hutton & Co., 564 F. Supp. 427, 434 (E.D. Mich. 1983); Moholt v. Dean Witter Reynolds, Inc., 478 F. Supp. 451 (D.D.C. 1979); *In re* Haven Industries, Inc., 462 F. Supp. 172, 179 (S.D.N.Y. 1978).

13. Congress created the SEC in 1934 by enacting the Securities Exchange Act of 1934. SECURITIES AND EXCHANGE COMMISSION, THE WORK OF THE SECURITIES AND EXCHANGE COMMISSION (1980) *reprinted in* L. SODERQUIST, SECURITIES REGULATION: A PROBLEM APPROACH 4 (1982). Through the Securities Exchange Act of 1934, the SEC is given the power to investigate possible violations of the securities laws. The Commission's investigations generally arise from unusual price movements on the securities exchanges and routine inspections of broker-dealers, not from disappointed investor complaints. The SEC may then recommend that the Department of Justice prosecute the alleged violator, or the SEC may bring an injunctive action in the appropriate district court to enjoin violations of the federal securities laws. H. BLOOMENTHAL, 1980 SECURITIES LAW HANDBOOK § 24.01 (1980). *See also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (The SEC "is provided with an arsenal of flexible enforcement powers.").

14. *Tarasi*, 555 F.2d at 1164; *Kuehnert*, 412 F.2d at 705; *Grumet*, 564 F. Supp. at 339.

15. *Tarasi*, 555 F.2d at 1163-64; *Kuehnert*, 412 F.2d at 705; *Grumet*, 564 F. Supp. 339.

II. THE *In Pari Delicto* DEFENSE IN NON-10B-5 CASES

In pari delicto means "of equal fault."[16] The *in pari delicto* defense arose from the equitable maxim that one who seeks equitable relief must come into court with "clean hands."[17] Courts apply the doctrine to deny relief to claimants who participated in the wrongs for which they seek recovery.[18] The courts offer three rationale for the defense. First, since both parties are "equally at fault," the courts do not want to reward one party by allowing him to profit by the illegal act.[19] Second, courts feel that denying recovery will deter future illegal conduct.[20] Finally, the *in pari delicto* defense publicly affirms the court's dissatisfaction with the plaintiff's conduct.[21]

Judicial decisions first established a framework for applying the *in pari delicto* defense in the contract setting. Since that time, courts have developed four exceptions that do not allow defendants to assert the defense. Courts apply the general contract rule and the four exception analysis to a wide range of claims, including securities and antitrust cases.

A. The Contract Cases

The *in pari delicto* defense originated in contract law. The general rule is that courts do not recognize rights arising from illegal agreements,[22] but, rather, consider the agreements void and

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16. Perma Life Mufflers v. International Parts Corp., 392 U.S. 134, 138 (1968).

17. The equitable maxim provides that courts will not intervene on behalf of a plaintiff whose prior conduct evidences bad faith or a lack of conscience. Keystone Driller Co. v. General Excavator Co., 290 U.S. 240, 244-45 (1933); 2 J. POMEROY, EQUITY JURISPRUDENCE § 397 (5th ed. 1941). Courts have distinguished between *in pari delicto* in an action at law for damages and the doctrine of "unclean hands," which denies equitable relief to a party engaging in misconduct. *See, e.g., Tarasi*, 555 F.2d at 1156-57 n.9.

18. *See* 3 J. POMEROY, EQUITY JURISPRUDENCE § 940 (5th ed. 1941).

19. *See* Zytka v. Dmochowski, 302 Mass. 63, 18 N.E.2d 332 (1938); Seitz v. Michel, 148 Minn. 80, 181 N.W. 102 (1921).

20. *See, e.g.*, Thacher Hotel, Inc. v. Economos, 160 Me. 22, 25, 197 A.2d 59, 61 (1964).

21. *See* Roberts v. Criss, 266 F. 296, 301-02 (2d Cir. 1920); Keene Syndicate v. Wichita Gas, E. L. & P. Co., 69 Kan. 284, 76 P. 834 (1904); Seitz v. Michel, 148 Minn. 80, 181 N.W. 102 (1921).

22. Standard Lumber Co. v. Butler Ice Co., 146 F. 359, 362 (3d Cir. 1906) ("The poison of the immoral consideration infects the contract as a whole, and the court below were [sic] right in refusing to lend its aid to the enforcement of any part thereof."). Ordinarily, no party may claim rights arising from an illegal contract. Priller v. Auglaize Hotel Co., 34 Ohio L. Abs. 287, 290, 36 N.E.2d 1019, 1021-22 (Ohio Ct. App. 1941). Third parties may raise the agreement's illegality when a party asserts a claim based on the agreement against them. Ingersoll v. Coal Creek Coal Co., 117 Tenn. 263, 98 S.W. 178 (1906).

leave the parties as the courts find them.[23] The rationale for the rule is twofold. First, courts should not render judgments that validate illegal acts.[24] Second, courts should discourage illegal and corrupt contracts by refusing to aid parties to illegal agreements.[25]

Courts recognize four situations in which they will not allow defendants to hide behind the *in pari delicto* defense: (1) the defendant used fraud or duress to induce the plaintiff to participate in the illegal act; (2) the plaintiff is in the class of people the law seeks to protect by making the activity illegal; (3) the plaintiff did not know that the activity was illegal or participated in an independent wrong; and (4) the denial of relief to the plaintiff would be unjust or against public policy.

1. Fraud or Duress

Courts allow the *in pari delicto* defense only when the parties are of equal fault and, therefore, will not allow its use when the defendant is guilty of inducing the plaintiff to participate in the illegal activity by fraud or duress. The fraud or duress exception frequently arises in the business context when one party to a transaction enjoys greater bargaining power than the other party.[26] Courts also commonly employ this exception when a confidential relationship exists between the two parties, thereby making the imposition of coercion or duress more likely.[27] Some courts even

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23. Sherwood & Roberts-Yakima, Inc. v. Leach, 67 Wash. 2d 630, 636-37, 409 P.2d 160, 164 (1965) (the court "leaves the parties where it finds them whether or not the situation is unequal as to the parties" in an action to recover on an illegal contract); Keene v. Harling, 36 Cal. Rptr. 98, 104-05 (1963), *vacated*, 61 Cal. 2d 318, 392 P.2d 273, 38 Cal. Rptr. 513 (1964).

24. Edwards v. Goldsboro, 141 N.C. 60, 53 S.E. 652 (1906).

25. Keene v. Harling, 36 Cal. Rptr. at 104; Edwards v. Goldsboro, 141 N.C. at 65, 53 S.E. at 653. *See also* Thacher Hotel, Inc. v. Economos, 160 Me. 22, 25, 197 A.2d 59, 61 (1964) (The court should not be concerned with its "conception of fairness between parties." The law is designed to deter people from entering into illegal contracts. It is not designed to protect either of the parties which have entered into an illegal agreement); Reagan v. Union Mut. Life Ins. Co., 189 Mass. 555, 76 N.E. 217 (1905) (A court should never sanction a contract which may endanger the public interest or which may be detrimental to the public good.) (quoting Ritter v. Mutual Life Ins. Co., 169 U.S. 139, 154 (1898)).

26. See Board of Regents v. National Collegiate Athletic Ass'n, 546 F. Supp. 1276 (W.D. Okla. 1982), *modified*, 707 F.2d 1147 (10th Cir. 1983), in which the plaintiffs alleged that the National Collegiate Athletic Association's (NCAA) control over scheduling the televising of college football games violated the Sherman Antitrust Act. The NCAA raised the *in pari delicto* defense, explaining that the plaintiffs had participated voluntarily in the challenged agreements. The court denied the defense, concluding that the NCAA had greater bargaining power than the plaintiffs in television scheduling, and that the case was a classic example of "economic coercion." *Id.* at 1324.

27. *See* National Bank & Loan Co. v. Petrie, 189 U.S. 423 (1903); Gardine v. Cottey,

presume duress or undue influence when a confidential relationship exists.[28]

2. Law Designed to Protect the Plaintiff

When the activity violates a law intended to protect a class of which the plaintiff is a member, courts generally will not allow the defendant to assert the *in pari delicto* defense. In one case, for example, the plaintiff voluntarily participated in an illegal boxing match and sued the promoter to recover for his injuries.[29] The court held that the defendant could not assert as a defense the plaintiff's violation of the boxing statute because the legislature passed the statute to protect people, like the plaintiff, who may not appreciate the consequences of their action.[30] This exception also applies when the statute that makes the activity illegal imposes a penalty upon only one party to the activity.[31]

3. Plaintiff Did Not Know of Illegality or Participated in Independent Wrong

The third exception precludes the *in pari delicto* defense when a plaintiff did not know he was engaging in an illegal activity, or when he engaged in an illegal activity independent of the wrong for which he seeks redress. Courts derive these exceptions from the premise that they should allow the *in pari delicto* defense only if the parties are of equal fault in the transaction.[32] A defendant, therefore, may not assert the defense unless the plaintiff's wrongful conduct arose from the illegal transaction with the defendant.[33] Even if both parties participated in the same illegal

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360 Mo. 681, 230 S.W.2d 731 (1950) (husband's attorney induced wife to enter void property settlement); MacRackan v. Bank of Columbus, 164 N.C. 24, 28, 80 S.E. 184, 185 (1913) (The parties are not of equal fault when one party is in a position to dictate and the other party must submit.).

28. *See* DURESS AND UNDUE INFLUENCE, §§ 29, 30 (Rev. ed. 1968).

29. Hudson v. Craft, 33 Cal. 2d 654, 204 P.2d 1 (1949).

30. *Hudson*, 33 Cal. 2d at 660, 204 P.2d at 4.

31. Prior to 1970, the federal margin statute made the extension of unauthorized credit by brokers criminal, but did not make investor acceptance of such credit illegal. Courts rarely applied the *in pari delicto* defense under this statute. *See, e.g.*, Pearlstein v. Scudder & German, 429 F.2d 1136 (2d Cir. 1970), *cert. denied*, 401 U.S. 1013 (1971).

32. Graham v. Dean, 144 Tex. 61, 188 S.W.2d 372 (1945); Oakes v. Guarantee Ins. Co., 573 S.W.2d 899, 902 (Tex. Civ. App. 1978); Western Nat'l Bank, Denton v. King, 547 S.W.2d 734 (Tex. Civ. App. 1977).

33. In Phenix Ins. Co. v. Clay, 101 Ga. 331, 28 S.E. 853 (1897), a landlord knowingly and unlawfully leased an apartment to a prostitute. When the premises burned down, the landlord's insurance company tried to avoid payment by asserting that the landlord used

transaction, the defendant must show that the plaintiff was aware of its illegality.[34]

4. Residual: Public Policy and Statutory Goals

If the first three exceptions are not available, courts often use a fourth, residual exception when they feel obliged to deny the *in pari delicto* defense to promote public policy and statutory goals. Courts using the fourth exception attempt to ascertain the legislative intent behind the violated statute and the most appropriate manner of promoting the statute's goals.[35] Statutes, however, often have many goals[36] and courts, therefore, often face the difficult task of choosing between those goals in particular cases to determine whether the denial of the *in pari delicto* defense is in the public's best interest.[37] Likewise, although courts readily agree that they should use the *in pari delicto* defense and this fourth exception to deter future illegal conduct,[38] courts often find it difficult in particular factual settings to determine whether denying the defense will deter or encourage future violations.[39]

B. Antitrust

Courts generally deny the *in pari delicto* defense in antitrust actions, implicitly applying the *in pari delicto* contract analysis.

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the premises illegally. The court denied the defense, finding that the illegal activity was independent of the insurance contract. *See also* Kiefer-Stewart Co. v. Joseph E. Seagram & Sons, Inc., 340 U.S. 211 (1951) (independent violations of the same act do not support the *in pari delicto* defense).

34. *See, e.g., Oakes*, 573 S.W.2d at 902 (although contract between insurance company and agent was void due to agent's violations of state law, agent could not raise the *in pari delicto* defense because the insurance company was unaware of the violations); Roylex, Inc. v. Avco Community Developers, Inc., 559 S.W.2d 833, 838 (Tex. Civ. App. 1977) (allowing plaintiff to recover because he was unaware of facts making the transaction illegal); *King*, 547 S.W.2d 734 (parties not at equal fault when only one party knew of illegality).

35. *See, e.g.*, Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134, 138-39 (1968); Palmer v. Thomson & McKinnon Auchincloss, Inc., 427 F. Supp. 915, 920 (D. Conn. 1977).

36. *See, e.g.*, Pearlstein v. Scudder & German, 429 F.2d 1136 (2d Cir. 1970), *cert. denied*, 401 U.S. 1013 (1971) (majority felt margin laws protected investors, while dissent believed margin statutes regulated nation's credit).

37. *See, e.g.*, Kuehnert v. Texstar Corp., 412 F.2d 700, 704-05 (5th Cir. 1969); *infra* notes 118-34 and accompanying text.

38. *See, e.g.*, Tarasi v. Pittsburgh Nat'l Bank, 555 F.2d 1152, 1163 (3d Cir.), *cert. denied*, 434 U.S. 965 (1977).

39. *See, e.g., Kuehnert*, 412 F.2d at 705, 706 (the majority found that allowing the *in pari delicto* defense best deters illegal conduct, while the dissent contended that denying the defense would discourage illegal behavior).

The United States Supreme Court rejected the defense in *Perma Life Mufflers, Inc. v. International Parts Corp.*,[40] an antitrust case on which courts frequently rely to deny use of *in pari delicto* in other substantive legal areas.[41]

The petitioners in *Perma Life*, former Midas Muffler dealers, contended that Midas restrained and substantially lessened competition in violation of the Sherman Act[42] and the Clayton Act[43] by requiring each Midas dealer to sign an allegedly abusive sales agreement. The sales agreements barred the dealers from purchasing from other sources of supply, prohibited them from selling outside their designated territory,[44] and required them to sell Midas products at fixed retail prices.[45] The petitioners challenged the agreements despite their enthusiastic attempts to acquire additional Midas franchises with full knowledge of the provisions of the agreement, and despite the enormous profits which they made as Midas dealers.[46] The United States Court of Appeals for the Seventh Circuit held that the *in pari delicto* defense barred petitioners' claims.[47] The Supreme Court reversed in an opinion that relied on the rationale underlying the exceptions to the defense which courts developed in contract law, although the Court did not adopt expressly the contract framework.

Justice Black's majority opinion implicitly applied the first contract exception, emphasizing the parties' unequal bargaining power as a ground for rejecting the *in pari delicto* defense.[48] He

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40. 392 U.S. 134 (1968).

41. *See, e.g.*, Pearlstein v. Scudder & German, 429 F.2d 1136, 1141 (2d Cir. 1970) (violation of SEC margin requirements), *cert. denied*, 401 U.S. 1013 (1971); Moholt v. Dean Witter Reynolds, Inc., 478 F. Supp. 451, 452 (D.D.C. 1979) (insider trading); Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50, 56 (S.D.N.Y. 1971) (insider trading).

42. 15 U.S.C. §§ 1-7 (1982). Petitioners alleged a violation of § 1 of the Sherman Act, which prohibits "contract[s] . . . in restraint of trade." *Id.* § 1.

43. 15 U.S.C. §§ 12-27 (1982). Petitioners alleged a violation of § 14 of the Clayton Act, which prohibits sale of goods contracts that substantially lessen trade by providing that the purchaser may not deal in the goods of the seller's competitors. *Id.* § 14.

44. Justice Marshall suggested that this provision might actually benefit the plaintiffs by restricting competition between franchisees. *Perma Life*, 392 U.S. at 149 (Marshall, J., concurring).

45. *Id.* at 136-37.

46. *Id.* at 138.

47. Perma Life Mufflers, Inc. v. International Parts Corp., 376 F.2d 692 (7th Cir. 1967), *reversed*, 392 U.S. 134 (1968). The court stated that it would be difficult to find a case which was more suitable to the application of the *in pari delicto* defense. *Id.* at 699. Each of the plaintiffs voluntarily entered into each of the franchise agreements and each of the plaintiffs had the right to abandon his agreement. *Id.* The plaintiffs, moreover, sought damages because they were denied additional franchises. *Id.*

48. *Perma Life*, 392 U.S. at 140-41.

noted that even though the dealers sought the Midas franchises enthusiastically, they did not seek actively each clause in the sales agreements.[49] The majority felt that the petitioners accepted many of the agreements' restraints solely "to obtain an otherwise attractive business opportunity."[50] In his concurring opinion, Justice White agreed that the plaintiffs did not enter the agreements voluntarily.[51] He found that the defendant had used its market power and leverage to "thrust" the agreements upon the plaintiffs.[52]

The *Perma Life* Court also implicitly applied the second contract exception to deny the *in pari delicto* defense, finding that the petitioners were members of the class that Congress sought to protect when it enacted the antitrust laws.[53] Justice Fortas, concurring with the majority, explained that Congress designed the antitrust laws to protect individuals from unfair business agreements when the agreements are the only feasible way the individual may conduct business.[54]

The *Perma Life* majority also implicitly applied the fourth, residual contract exception, which seeks to promote public policy and statutory goals, and concluded that denying the defense would serve antitrust policies more efficiently.[55] The Court indicated that the antitrust laws do not reflect a congressional intent to recognize

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49. *Id.* at 139.

50. *Id.* Some commentators have criticized the Court for finding that the plaintiffs entered into the agreements involuntarily merely because some of the clauses were not in their best interest. *See, e.g.*, Comment, *Antitrust—Franchise Agreement* — In Pari Delicto *Held not a Defense in an Action by Franchisee Against Franchisor*, 14 N.Y.L.F. 658, 665 (1968) ("Four franchisees are allowed to collect treble damages, notwithstanding the fact that they voluntarily and knowingly enter the program, expand and profit in the program . . . , and provide to the consumer a quality muffler accompanied by an extraordinary warranty."). The agreements did not require the plaintiffs to pay a franchise fee, which may suggest that the plaintiffs willingly agreed to the restrictions. Indeed, most contracts contain clauses that are desirable to one party but not to the other. Taken to its logical conclusion, Justice Black's assertion would leave gifts as the only truly voluntary transactions.

51. *Perma Life*, 392 U.S. at 143 (White, J., concurring).

52. *Id.* Justice White provided the following list of considerations for determining whether the parties to an illegal agreement are equally at fault:

> [T]he relative responsibility for originating, negotiating, and implementing the scheme; . . . who might reasonably have been expected to benefit from the provision or conduct making the scheme illegal . . . ; . . . whether one party attempted to terminate the arrangement and encountered resistance or counter-measures from the other; [and] who ultimately profited or suffered from the arrangement.

Id. at 146-47.

53. *Id.* at 139 ("the law encourages his suit").

54. *Id.* at 148 (Fortas, J., concurring) (quoting Ring v. Spina, 148 F.2d 647, 653 (2d Cir. 1945)).

55. *Perma Life*, 392 U.S. at 138-39.

the *in pari delicto* defense in treble damage antitrust actions.[56] The Court noted that by providing successful plaintiffs with treble damage awards, Congress insured that private suits would be an ever-present deterrent to anyone contemplating business behavior in contravention of antitrust law.[57] The *Perma Life* Court felt that even if the plaintiff was as "morally reprehensible" as the defendant, the plaintiff should recover treble damages to "further the overriding public policy in favor of competition."[58]

Although the Supreme Court in *Perma Life* denied the application of the *in pari delicto* defense in an antitrust action, it explicitly did not circumscribe the defense's viability in other settings.[59] Moreover, Justice Fortas, concurring, emphasized that courts should not allow plaintiffs in antitrust actions to recover damages for any clause that the plaintiff initially desired and originated.[60] The separate concurring opinions of Justices White and Marshall expressed the view that if the defendant proved that the plaintiff participated in the formulation of the entire agreement by negotiating each clause, the plaintiff should not recover.[61] Occasionally, courts improperly rely on *Perma Life* for the broad proposition that defendants may not raise the *in pari delicto* defense in any setting.[62] The Court based its denial of the *in pari delicto* defense in *Perma Life*, however, on the narrow grounds of the unequal bargaining power of the parties, the statute's specific purpose of protecting the plaintiff's class, and the statute's unique treble damage provision.

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56. *Id.* at 138.

57. *Id.* at 139.

58. *Id.*

59. *Id.* at 140.

60. *Id.* at 148.

61. *Id.* at 146, 150.

62. The Court in *Perma Life* broadly stated that "the doctrine of *in pari delicto* . . . is not to be recognized as a defense to an antitrust action." *Perma Life*, 392 U.S. at 140. Some courts have used this broad statement to generally deny the *in pari delicto* defense. *See, e.g.*, American Soc'y of Mechanical Eng'rs, Inc. v. Hydrolevel Corp., 456 U.S. 556 (1982); Mallis v. Bankers Trust Co., 615 F.2d 68 (2d Cir. 1980) (Supreme Court has not displayed much enthusiasm for the *in pari delicto* defense to claims for violation of federal statutes); Adolph Coors Co. v. A & S Wholesalers, Inc., 561 F.2d 807 (10th Cir. 1977) (trial court concluding that the *in pari delicto* defense has been consistently rejected in the antitrust context).

C. Securities

1. Sales of Unregistered Securities

Courts also have considered the availability of the *in pari delicto* defense in actions arising from sales of unregistered securities. The Securities Act of 1933[63] contains registration provisions[64] which protect investors by insuring that adequate, accurate information about securities is available to the general public.[65] Courts generally do not recognize the *in pari delicto* defense in cases of registration violations.

When the average investor conducts securities transactions, he generally is exempt from the registration requirements of the 1933 Act.[66] The investor, however, will lose his registration exemption and be subject to civil liability if he buys unregistered securities with a "view towards distribution."[67] Despite this illegality, courts have been reluctant to hold those investors *in pari delicto* with the parties who sold them the unregistered securities. In *Can-Am Petroleum Co. v. Beck*,[68] an investor purchased unregistered securities from the Can-Am Company and later sued the company for securities registration violations when the securities declined in value. The company raised the *in pari delicto* defense, contending that the plaintiff also violated the 1933 Act by actively selling the unregistered securities to other investors.[69] The United States Court of Appeals for the Tenth Circuit disallowed the defense, finding that the plaintiff had not violated the 1933 Act because she

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63. 15 U.S.C. § 77a (1982).

64. A detailed examination of the registration requirements of the 1933 Act exceeds the scope of this Note. Generally, however, § 5(c) of the 1933 Act makes it unlawful for any person to offer or sell a security unless the issuer has filed a registration statement for the transaction. *See* 15 U.S.C. § 77e(c) (1982). If, however, either the security or the transaction qualifies for an exemption under §§ 3 or 4, the security is not subject to the 1933 Act's registration provisions. *See* 15 U.S.C. § 77d (1982). *See generally* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 297-440 (1983) (examination of the exemptions available under §§ 3 and 4).

65. *See* SEC Securities Act Release No. 3844 (Oct. 8, 1957) ("A basic purpose of the Securities Act of 1933 . . . is to require the dissemination of adequate and accurate information concerning issuers and their securities in connection with the offer and sale of securities to the puhlic.").

66. Section 4(1) of the 1933 Act exempts transactions by persons other than issuers, underwriters, and dealers. *See* 15 U.S.C. § 77d(1) (1982). The typical investor does not fall within the definitions of issuer, underwriter, or dealer in § 2(4), (11) or (12) of the 1933 Act. *See* 15 U.S.C. § 77b(4), (11), (12) (1982). *See generally*, L. Loss, *supra* note 64, at 400-01.

67. In this situation the investor qualifies as an underwriter, thereby losing his § 4(1) exemption. *See* L. Loss, *supra* note 64, at 400.

68. 331 F.2d 371 (10th Cir. 1964).

69. *Id.* at 374.

did not participate in the entire distribution scheme, but had made only isolated sales.[70] In a similar case,[71] a court found that, although the plaintiff had sold unregistered securities illegally, public policy considerations permitted him to recover from the parties who sold him the unregistered securities.[72]

2. Margin Violations

When courts consider whether to permit a defendant to raise the *in pari delicto* defense in a margin violation case, they confront a statutory scheme similar to rule 10b-5. Congress enacted the federal margin statutes primarily to prevent a recurrence of the stock market crash of 1929[73] by combating the common desire of investors to speculate unwisely on credit.[74] Section 7(c) of the Securities Exchange Act of 1934[75] empowers the Federal Reserve Board to regulate the amount of credit that securities purchasers may receive.[76] Pursuant to this authority, the Board has enacted several regulations to restrict brokers, dealers,[77] and banks[78] from

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70. *Id.*

71. Lawler v. Gilliam, 569 F.2d 1283 (4th Cir. 1978).

72. *Id.* at 1293-94. The *Lawler* court stated that private suits were essential to the effective enforcement of the registration requirements. *Id.* at 1293.

73. Although they disagree about the purposes of the margin requirements, *see* L. Loss, *supra* note 64, at 718-19, currently most courts believe that the statutes serve a credit regulatory function. *See, e.g.*, Gilman v. Federal Deposit Ins. Corp., 660 F.2d 688, 692 (6th Cir. 1981). The House report on H.R. 9323 supports this view:

> The main purpose [of the margin provisions] is to give a government credit agency an effective method of reducing the aggregate amount of the nation's credit resources which can be directed by speculation in the stock market and out of other more desirable uses of commerce and industry—to prevent a recurrence of the pre-crash situation where funds which would otherwise be available at normal interest rates for uses of local commerce, industry and agriculture were drained by far higher rates into security loans and the New York call market.

H.R. REP. No. 1383, 73d Cong., 2d Sess. 8 (1934), *quoted in* Avery v. Merrill Lynch, Pierce, Fenner & Smith, 328 F. Supp. 677, 678-79 (D.D.C. 1971).

74. Pearlstein v. Scudder & German, 429 F.2d 1136, 1141 (2d Cir. 1970), *cert. denied* 401 U.S. 1013 (1971).

75. 15 U.S.C. § 78g(c) (1982).

76. Section 7(c) provides in relevant part:

> It shall be unlawful for any member of a national securities exchange or any broker or dealer, directly or indirectly, to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer—(1) on any security (other than an exempted security), in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System shall prescribe under . . . this section[.]

Id.

77. Regulation T, 12 C.F.R. § 220.4(c)(2) (1983), promulgated pursuant to 15 U.S.C. § 78g(a) (1982), governs broker and dealer credit extensions. It reads in relevant part:

> In case a customer purchases a security (other than an exempted security) in the special cash account and does not make full cash payment for the security within 7

extending excessive credit to investors.

The margin statutes originally made it illegal for brokers to extend excessive credit, but did not subject the customers to liability for accepting the credit.[79] As a result, most courts refused to allow a broker to raise the *in pari delicto* defense when an investor sued to recover losses that he sustained while trading on unauthorized credit.[80] The courts reasoned that it was unfair to apply the defense against an investor who had not engaged in illegal conduct.[81] Some courts also reasoned that Congress enacted the margin laws to protect investors and, therefore, plaintiff investors came within the second exception to the *in pari delicto* defense.[82]

In 1970 Congress amended the margin statutes to make acceptance by investors of unlawful credit extensions illegal.[83] Since this statutory change, the majority of courts have held that investors no longer have a private cause of action against their brokers under section 7.[84] These courts emphasize that the legislative intent behind the 1970 amendments to section 7 is to tighten control on national credit policy by holding investors as well as lenders

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days after the date on which the security is so purchased, the creditor shall, except as provided in paragraphs (c)(3) through (7) of this section, promptly cancel or otherwise liquidate the transaction or the unsettled portion thereof.

78. Regulation U, 12 C.F.R. § 221.3(t) (1983), controls bank credit extensions.

79. *See Pearlstein*, 429 F.2d at 1141. 15 U.S.C. § 78g(c) states:

It shall be unlawful for any member of a national securities exchange or any broker or dealer, directly or indirectly, to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer . . .

(1) on any security (other than an exempted security), in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System shall prescribe under subsections (a) and (b) of this section[.]

80. *See, e.g., Pearlstein*, 429 F.2d at 1136; *Avery*, 328 F. Supp. at 677; Zatz v. Hertz, Neumark & Warner, 262 F. Supp. 928 (S.D.N.Y. 1966). *But see* Serzysko v. Chase Manhattan Bank, 290 F. Supp. 74 (S.D.N.Y. 1968), *aff'd*, 409 F.2d 1360 (2d Cir.), *cert. denied*, 396 U.S. 904 (1969). (allowing the *in pari delicto* defense in a margin violation case because bank did not know that the borrower used the money to purchase securities).

81. *See, e.g., Avery*, 328 F. Supp. at 680.

82. *See, e.g., Zatz*, 262 F. Supp. at 930-31. Indeed, the Senate Banking & Currency Committee Report provides that one purpose of the margin provision is "to protect the margin purchaser by making it impossible for him to buy securities on too thin a margin." STOCK EXCHANGE PRACTICES, REPORT OF SENATE COMM. ON BANKING AND CURRENCY, S. REP. No. 1455, 73d Cong., 2d Sess. 17 (1934). See *supra* notes 29-31 and accompanying text for a discussion of the second exception to the *in pari delicto* defense.

83. 15 U.S.C. § 78g(f) (1983) makes it unlawful for any person to obtain an extension of credit that violates the margin statutes.

84. *See, e.g.*, Gilman v. Federal Deposit Ins. Corp., 660 F.2d 688 (6th Cir. 1981); Gutter v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 644 F.2d 1194 (6th Cir. 1981), *cert. denied*, 455 U.S. 909 (1982); Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 603 F.2d 1073 (4th Cir. 1979); Utah State Univ. v. Bear, Stearns & Co., 549 F.2d 164 (10th Cir.), *cert. denied*, 434 U.S. 890 (1977).

accountable.[85] These courts, therefore, hold that an investor who has violated section 7 has no cause of action under section 7 against the lender.[86] A few courts, however, emphasize that an ancillary purpose of the margin statutes is to protect private investors.[87] These courts permit a good faith investor who unknowingly has violated section 7(c) to maintain an action against his broker, but allow the broker to assert the *in pari delicto* defense.[88] No courts permit a party who knowingly has violated the margin statutes to maintain an action against his broker, dealer, or banker for a margin infraction. This result is in sharp contrast to rule 10b-5 cases, in which courts often permit a party who has violated the rule to maintain a 10b-5 action.[89]

3. Proxy Violations

The SEC designed the proxy provisions in Securities Exchange Act Rule 14(a)[90] to ensure complete and accurate disclosure during proxy solicitations.[91] Courts generally have recognized the availability of the *in pari delicto* defense in proxy violation cases. In *Chris-Craft Industries, Inc.* v. *Independent Stockholders Committee*,[92] a group of disgruntled shareholders engaged in a proxy fight with the company management in an attempt to gain control of the corporation. Management brought an action against the shareholders alleging federal proxy violations. The United States District Court for the District of Delaware found that both sides

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85. *See, e.g., Stern*, 603 F.2d at 1084.

86. *Id.* The courts rely on the test outlined in Cort v. Ash, 422 U.S. 66 (1975), to determine whether a private cause of action will exist for the plaintiff. *Gilman*, 660 F.2d at 692. In the typical margin violation case the courts will not recognize a private cause of action because the plaintiff/borrower is not one "for whose *especial* benefit the statute was enacted" and Congress did not intend to provide a remedy for borrowers. *See Gilman*, 660 F.2d at 692-93 (quoting Cort v. Ash, 422 U.S. at 78 with emphasis in original); *Gutter*, 644 F.2d at 119; *Stern*, 603 F.2d at 1081; *Utah State Univ.*, 549 F.2d at 169-70.

87. *See, e.g.*, Palmer v. Thomson & McKinnon Auchincloss, Inc., 427 F. Supp. 915, 921 (D. Conn. 1977).

88. *Id.* at 921-22.

89. *See infra* notes 103-17 and accompanying text. Courts have denied the *in pari delicto* defense when a corporation sues its former officers or directors for perpetrating a fraud against the corporation. *See* Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961); Rosen v. Dick, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,786, at 96,602 (S.D.N.Y. Sept. 3, 1974). The courts reason that the defendant was guilty of fraud (exception 1), or that the corporation was not a knowing party to the fraud (exception 3). *See Hooper*, 282 F.2d at 208.

90. 15 U.S.C. § 78n (1982).

91. *See* L. Loss, *supra* note 64, at 512-18.

92. 354 F. Supp. 895 (D. Del. 1973).

willfully had violated rule 14(a) and the court, therefore, refused to grant relief to either party.[93] The shareholders contended that the court should grant them relief because management's misconduct was more severe than the shareholder's violations.[94] The court rejected this argument, stating that when both parties willfully violate federal securities laws, the court will not weigh the severity of one party's misconduct against the other's, but will deny relief and leave the parties as the court finds them.[95]

III. APPLICATION OF THE *In Pari Delicto* DEFENSE IN 10B-5 CASES

A. The Goals of Rule 10b-5

Courts implicitly apply the *in pari delicto* analysis when a tippee sues a tipper under rule 10b-5 to recover for a decline in the value of securities that he purchased pursuant to the tipper's inside information. In many of these 10b-5 actions, one of the first three exceptions to the *in pari delicto* defense applies and the courts prohibit the tippers from raising the defense.[96] Frequently, however, the first three exceptions are inapplicable and the court must determine whether the residual exception requires the court to deny the defense. Because the residual exception seeks to advance statutory goals, the policies underlying rule 10b-5 are of crucial importance in that determination.

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93. The *Chris-Craft* court found management guilty of making false and material misstatements in violation of rule 14a-9 and the shareholders guilty of violating rule 14a-11(c), which requires disclosure of the names of participants in the proxy solicitation.

94. *Chris-Craft*, 354 F. Supp. at 922.

95. *Id.* Other courts have relied on a similar doctrine, the doctrine of unclean hands, to deny relief in proxy violation suits. *See, e.g.*, King v. Edwards, 559 F. Supp. 75, 88 (N.D. Ga. 1982) ("The [unclean hands] doctrine is applicable in a private lawsuit for the violation of proxy regulations where the party seeking relief is also guilty of wrongdoing in the proxy contest."); Blanchette v. Providence & Worcester Co., 428 F. Supp. 347, 357 (D. Del. 1977) (The court recognized the application of the unclean hands doctrine in those cases where the one seeking relief is "guilty of a violation involving the transaction in litigation."); Aster v. BP Oil Corp., 412 F. Supp. 179, 190 (M.D. Pa. 1976) ("Except in extraordinary circumstances, a party seeking equitable remedies who has not acted in 'good faith' will be denied relief.") (citations omitted), *aff'd without an opinion*, 549 F.2d 794 (3rd Cir. 1977).

96. *See, e.g.*, Berner v. Lazzaro, No. 83-1972 (9th Cir. Feb. 15, 1984) (securities professionals and corporate officers who engaged in fraud not allowed to invoke *in pari delicto* defense to escape liability to their tippees); Pearlstein v. Scudder & German, 429 F.2d 1136, 1141 (2d Cir. 1970) (*in pari delicto* does not apply when violated margin statute imposed penalty only upon creditor), *cert. denied*, 401 U.S. 1013 (1971); Ring v. Spina, 148 F.2d 647, 652 (2d Cir. 1945) (when party acts under duress of another, the parties are not *in pari delicto*); Moholt v. Dean Witter Reynolds, Inc., 478 F. Supp. 451, 453 (D.D.C. 1979) ("[B]roker . . . cannot be said to be equally at fault with his receptive but duped investors . . . ."); Weitzman v. Stein, 436 F. Supp. 895, 906 (S.D.N.Y. 1977) (lack of knowledge).

Section 10(b) of the Securities Exchange Act of 1934[97] prohibits any person who buys or sells securities from using deceptive or manipulative devices that contravene SEC rules whose purpose is to protect the investing public.[98] Although the congressional intent behind the adoption of section 10(b) is unclear,[99] the provision expressly empowers the SEC to adopt rules that protect investors and promote the public interest.[100] Pursuant to this broad authority the SEC adopted rule 10b-5 to prevent fraud by any person in the purchase or sale of securities.[101] Courts have advanced several policies in support of rule 10b-5, including: the protection of investors; assurance of fairness in securities trading; deterrence of secur-

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97. 15 U.S.C. § 78j(b) (1983).

98. *Id.* Section 10(b) states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id.

99. Scant legislative history accompanies the enactment of § 10. The House Report states:

> The House bill . . . and the Senate amendment contain similar provisions regulating the use of manipulative devices, except that the Senate amendment contains a provision prohibiting the use or employment in connection with the purchase or sale of any security of any manipulative or deceptive device or contrivance "which the Commission may declare to be detrimental to the interests of investors." The substitute includes this provision of the Senate amendment with the modification that it is made unlawful to use or employ any such device or contrivance "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

H.R. REP. No. 1838, 73d Cong., 2d Sess. 32-33 (1934). *See generally* 5 A. JACOBS, *supra* note 4, at § 5.01 (legislative background to § 10(b)).

100. 15 U.S.C. § 78j(b) (1983); see *supra* note 98 for the relevant text of the provision.

101. 17 C.F.R. § 240.10b-5 (1983). Rule 10b-5 provides:

> It shall be unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id. Prior to the enactment of rule 10b-5 the securities statutes prohibited fraud only in the sale of securities. *See* Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a)(1982). The SEC was powerless to punish fraud in connection with the purchase of securities.

ities violations; compensation for victims; and disclosure of information relevant to securities transactions.[102] Courts seek to promote these rule 10b-5 goals when they determine whether to apply the residual exception to the *in pari delicto* defense.

B. 10b-5 Cases Denying the In Pari Delicto *Defense*

Several courts have prohibited tipper defendants from raising the *in pari delicto* defense in private 10b-5 cases.[103] In *Nathanson v. Weis, Voisin, Cannon, Inc.*,[104] the United States District Court for the Southern District of New York discussed several of the judicial rationale that deny use of the defense in rule 10b-5 cases. The defendant in *Nathanson*, a securities brokerage firm, persuaded the plaintiffs to purchase securities of the target company in a merger agreement by informing them that the target company planned to exchange its stock valued at eight dollars per share for stock valued at seventeen dollars per share.[105] The plaintiffs suffered a substantial loss when the merger took place at a much lower exchange rate than they expected.[106] Plaintiffs brought suit charging defendants with several federal securities law violations,[107] and claiming damages under rule 10b-5. The defendants raised the *in pari delicto* defense, arguing that the plaintiffs should not recover because they violated rule 10b-5 by purchasing securities on the basis of material inside information.[108] The court denied the *in pari delicto* defense because allowing the plaintiffs to recover would serve more effectively the policies underlying rule 10b-5.[109]

The *Nathanson* court implicitly applied the residual exception

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102. *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 847-48, 855, 858, 860 (2d Cir. 1968), *cert. denied sub nom.* Coates v. SEC, 394 U.S. 976 (1969). *See generally* 5 A. JACOBS, *supra* note 4, at §§ 6.01-.09 (outlining eight policies behind rule 10b-5).

103. *See, e.g.*, Moholt v. Dean Witter Reynolds, Inc., 478 F. Supp. 451 (D.D.C. 1979); Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50 (S.D.N.Y. 1971). The Supreme Court consistently has affirmed the right of individuals to bring private suits under rule 10b-5 and § 10(b) of the Securities Exchange Act of 1934. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 196 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 729-30 (1975); Affiliated Ute Citizens v. United States, 406 U.S. 128, 150-54 (1972); Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971).

104. 325 F. Supp. 50 (S.D.N.Y. 1971).

105. *Id.* at 51.

106. *Id.* at 52.

107. *Id.* at 51. In addition to rule 10b-5, plaintiffs charged the defendants with violating §§ 12 and 17 of the Securities Act of 1933 and § 10b of the Securities Exchange Act of 1934.

108. 325 F. Supp. at 52.

109. *Id.* at 53.

to the *in pari delicto* defense, explaining that the securities laws not only prevent fraud, manipulation, and deception, but also seek to compel insiders to adhere to their duty of publicly disclosing material inside information before trading upon it.[110] The court supported its holding with several express rationale. First, the court noted that courts have disallowed the *in pari delicto* defense in antitrust cases, such as *Perma Life*.[111] The court conceded, however, that significant differences exist between the antitrust statutes, which clearly manifest congressional intent to secure private enforcement by providing treble damage awards, and rule 10b-5, which does not contain an analogous provision.[112]

Second, the *Nathanson* court found that the broker—the tipper—and the investors—the tippees—were not equally at fault because the broker's misconduct presented a greater potential threat to the investing public.[113] Although the court recognized that the tippees were in a position to take advantage of innocent investors, it felt that the broker posed a much greater threat to the public because he was the "fountainhead" of the confidential information.[114]

Third, the court reasoned that denying the defense would encourage tippee suits and, thereby, deter brokers from passing inside information.[115] The court conceded that allowing tippees to recover might indemnify them against trading losses,[116] but felt that the threat of private suits was a beneficial supplement to the SEC's enforcement powers.[117]

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110. *Id.* at 53-54.

111. *Id.* at 56; see *supra* notes 40-61 and accompanying text for a discussion of the *Perma Life* decision.

112. 325 F. Supp. at 56. The court offered no rationale for its reliance on *Perma Life* notwithstanding these differences. In a footnote, however, the court argued that the securities laws are similar to the antitrust laws in that both have similar policies underlying the private enforcement of the statutes. *Id.* at 56 n.30. *But see Kuehnert*, 412 F.2d at 703 ("In private SEC violations [sic] the degree of public interest is not comparable to that made apparent by the triple damage provision; we see no sufficient public interest when the only question is one of accounting between joint conspirators.")

113. 325 F. Supp. at 57; *see Moholt*, 478 F. Supp. at 453 ("The broker-dealer as tipper presents a greater threat than the customer-tippee to the integrity of the regulatory framework that prohibits trading on material inside information.").

114. 325 F. Supp. at 57.

115. *Id.* at 56-57.

116. *Id.* at 55 n.26.

117. *Id.* at 57 (citing Pearlstein v. Scudder & German, 429 F.2d 1136, 1141 (2d Cir. 1970), *cert. denied*, 401 U.S. 1013 (1971)).

C. *10b-5 Cases Allowing the* In Pari Delicto *Defense*

Several courts have held that allowing the *in pari delicto* defense in private 10b-5 cases better promotes the goals of rule 10b-5. In *Kuehnert v. Texstar Corp.*,[118] for example, the defendant tipper persuaded the plaintiff tippee to purchase stock on the basis of inside information. The inside information proved false and the plaintiff sued the tipper to recover his investment. The United States Court of Appeals for the Fifth Circuit implicitly applied an *in pari delicto* analysis,[119] held that plaintiff's 10b-5 violations put him *in pari delicto* with the defendant, and barred recovery.

The *Kuehnert* majority recognized the general rule that a plaintiff's illegal conduct should preclude recovery.[120] The court then considered several of the traditional exceptions justifying denial of the *in pari delicto* defense and rejected them based on the facts in the case. The majority found irrelevant evidence that defendant originated the illegal scheme, and concluded that plaintiff was equally at fault because he willingly entered into an illegal activity that was potentially profitable for both parties.[121] The court noted that plaintiff's voluntary participation in the transactions prevented him from claiming that defendant coerced him with economic duress or that plaintiff had mere knowledge of the illegality of the scheme and did not participate actively.[122]

The *Kuehnert* court finally based its holding on the residual exception to the *in pari delicto* defense,[123] stating that availability of the defense lies in the court's discretion.[124] The court noted that the plaintiff sought to defraud innocent investors—the class of people Congress intended to protect by enacting rule 10b-

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118. 412 F.2d 700 (5th Cir. 1969).

119. *Id.* at 703. The court stated that "[t]he guiding principle [in determining whether to allow recovery] is one of policy."

Courts claim to apply only a two part test. To satisfy the two part test the plaintiff must be substantially equal in fault with the defendant and the application of the defense cannot adversely affect the enforcement of the statutory scheme. Grumet v. Shearson/American Exp., Inc., 564 F. Supp. 336, 339 (D.N.J. 1983).

120. *Kuehnert*, 412 F.2d at 703.

121. *Id.*

122. *Id.* at 703-04. Other courts require the plaintiff's active participation to deny the defense in 10b-5 cases. *See, e.g.*, James v. DuBreuil, 500 F.2d 155, 159 (5th Cir. 1974); Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 378 F. Supp. 112, 138 (S.D.N.Y. 1974), *aff'd in part and rev'd in part*, 540 F.2d 27 (2nd Cir. 1976).

123. *Kuehnert*, 412 F.2d at 704.

124. *Id.* The court stated that the "question must be one of policy: which decision will have the better consequences in promoting the objective of the securities laws by increasing the protection to be afforded the investing public." *Id.*

5[125]—and rejected plaintiff's argument that, because the deal failed, they did not harm any innocent investors.[126] The court found no substantive difference between a successful and an attempted fraud,[127] and reasoned that the plaintiff had a statutory duty to disclose inside information before trading on it, and that the plaintiff contributed to his loss by failing to fulfill that obligation.[128] The majority also feared that if it denied the defense then the tipper would receive an enforceable warranty against securities trading losses when trading on inside information.[129] Such a warranty would ensure that an investor could not lose money as a tippee because he could recover his loss from the tipper if the inside information proves false, and normally would realize a gain in the market if the inside information is true. In addition, although most tippees theoretically are liable under rule 10b-5,[130] the difficulty of tracing them often affords tippees practical immunity from liability.[131] The court also found denial of the defense necessary to deter tippees from trading on inside information because the illegal transactions of both tippers and tippees threaten the investing public.[132] The majority conceded that denying the defense would reduce the deterrence against becoming a tipper, but noted that SEC enforcement powers already provide a sufficient disincentive to potential tippers contemplating passing inside information.[133] The *Kuehnert* majority concluded that its role was not to serve as a referee between guilty parties and, therefore, that it should let the plaintiff's loss lie where it fell.[134]

A dissenting opinion in *Kuehnert* noted that neither the SEC rules nor the securities statutes provide for the *in pari delicto* doctrine in private 10b-5 actions.[135] The dissent also relied on *Perma Life*[136] for the proposition that the *in pari delicto* defense had lost

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125. *Id.*; *see* Tarasi v. Pittsburgh Nat'l Bank, 555 F.2d 1152, 1162 (3rd Cir.), *cert. denied*, 434 U.S. 965 (1977).

126. *Kuehnert*, 412 F.2d at 704.

127. *Id.*

128. *Id.* at 704; *see Tarasi*, 555 F.2d at 1162.

129. *Kuehnert*, 412 F.2d at 705; *see Tarasi*, 555 F.2d at 1163-64; *In re* Haven Indus., Inc., 462 F. Supp. 172, 179-80 (S.D.N.Y. 1978) (quoting *Kuehnert*, 412 F.2d at 705).

130. *See supra* note 7.

131. *Kuehnert*, 412 F.2d at 705; *see* In re Haven, 462 F. Supp. at 180.

132. *Kuehnert*, 412 F.2d at 705.

133. *Id.* at 705; *see Tarasi*, 555 F.2d at 1164; In re Haven, 462 F. Supp. at 180. For a discussion of the SEC's enforcement powers, see *supra* note 13.

134. *Kuehnert*, 412 F.2d at 705.

135. *Id.* (Godbold, J., dissenting).

136. 392 U.S. 134 (1968); *see supra* notes 39-60 and accompanying text.

viability in other legal areas.[137] The dissent's principal disagreement with the majority, however, was that private tippee suits would provide needed deterrence against tippers who represent the first step in the dissemination of inside information.[138]

In *Tarasi v. Pittsburgh National Bank*,[139] the United States Court of Appeals for the Third Circuit also held that the defendant in a private 10b-5 case could assert the *in pari delicto* defense.[140] The court noted that the investor plaintiff's conduct was active and voluntary, obviating the *Perma Life* Court's[141] concern that denying the use of the defense against plaintiffs whose participation was active or coerced would be unfair.[142] Like the *Kuehnert* majority, the *Tarasi* court relied on the residual exception to allow the defense. The court stated that the plaintiff's illegal actions not only had contributed significantly to his losses, but that they also presented a serious threat to the investing public.[143] The court acknowledged that denying the defense would deter tippers who deliberately pass false information,[144] but questioned the deterrent effect on tippers who believe their inside information is true.[145] Because proof of scienter is a prerequisite to recovery in a private 10b-5 suit,[146] the court doubted whether the threat of tippee suits would deter potential tippers.[147] Moreover, because tippee suits are relatively rare, the court felt that the optimum solution would be to rely on potential SEC penalties to dissuade tippers and to provide tippees with a disincentive to trade on inside information by denying them a cause of action against their tippers.[148]

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137. *Kuehnert*, 412 F.2d at 705.

138. *Id.* at 706.

139. 555 F.2d 1152 (3d Cir. 1977).

140. In *Tarasi*, a group of disappointed investors sued their banker because they lost money after purchasing securities on the basis of the banker's inside information.

141. 392 U.S. 134 (1968); *see supra* notes 47-53 and accompanying text.

142. *Tarasi*, 555 F.2d at 1162.

143. *Id.*

144. *Id.* at 1163.

145. *Id.*

146. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). "There is no indication that Congress intended anyone to be made liable . . . unless he acted other than in good faith." *Id.* at 206.

147. *Tarasi*, 555 F.2d at 1163. The court's doubt presumably arose because the plaintiff would have to demonstrate that the tipper knowingly gave out false information concerning the transaction in question.

148. *Id.* at 1163-64.

IV. ANALYSIS

In many recent 10b-5 cases, courts have not allowed defendants to raise the *in pari delicto* defense. In several of these cases, courts properly have denied the *in pari delicto* defense on the ground that one or more of the first three exceptions to the defense was available.[149] Although courts have had difficulty determining whether to apply one of the first three exceptions to deny the defense, the goals underlying the defense and its exceptions are relatively clear.

When the first three exceptions are not available, however, courts must rely on the fourth, residual exception to the defense[150] to determine whether a tippee may recoup his losses from a tipper. Courts employ the residual exception to deny the *in pari delicto* defense when the interests of public policy and statutory goals so dictate. Given the divergence of opinion concerning the goals of 10b-5 and the best method to promote those goals, courts disagree on whether to employ the residual exception to allow a tippee, who has engaged knowingly in illegal behavior, to recover from his tipper.

The *Nathanson* court[151] most effectively articulated the judicial rationale that preclude defendants from asserting the *in pari delicto* defense in private 10b-5 actions. Although the *Nathanson* court recognized that significant differences exist between antitrust and rule 10b-5 cases, the court relied on the Supreme Court's decision in *Perma Life*[152] to deny the defense in a private 10b-5 action.[153] Other courts have relied on *Perma Life* in 10b-5 cases to an even greater extent than did the *Nathanson* court,[154] even though a close examination of the *Perma Life* holding reveals almost no support for an analogy between antitrust and 10b-5 legal principles. As the *Nathanson* court noted, the Supreme Court based its *Perma Life* holding on the unequal bargaining power of the parties.[155] The plaintiffs in *Nathanson*, however, voluntarily pur-

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149. *See supra* note 96. See *supra* notes 22-34 and accompanying text for a discussion of the first three exceptions to the *in pari delicto* defense.

150. See *supra* notes 35-38 and accompanying text for a discussion of the fourth, residual exception to the *in pari delicto* defense.

151. Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50 (S.D.N.Y. 1971); *see supra* notes 104-17 and accompanying text.

152. Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134 (1968); *see supra* notes 39-60 and accompanying text.

153. *Nathanson*, 325 F. Supp. at 56.

154. *See supra* note 61 and accompanying text.

155. *Nathanson*, 325 F. Supp. at 56; *see* Perma Life Mufflers, Inc. v. International

chased the securities in violation of the securities laws.[156] Indeed, economic duress is unlikely to be an element in a 10b-5 insider trading action because the plaintiff probably cannot establish a credible claim that the tipper coerced him into entering the illegal securities transaction.[157] The *Nathanson* court also recognized that the antitrust laws differ substantially from rule 10b-5 because they provide for a private treble damage action, a provision which clearly manifests a congressional intent to secure private enforcement of antitrust law.[158] In contrast, section 10(b) of the 1934 Act does not indicate that Congress intended to provide guilty parties with a private cause of action under the statute.[159] The *Nathanson* court also reasoned that courts more effectively could promote the fundamental purpose of rule 10b-5—ensuring "that all investors . . . have relatively equal access to material information" [160] —by allowing tippees to recover from tippers. The court viewed the tipper as the greater potential threat to public investors because he was the fountainhead of the inside information.[161] To protect investors, the *Nathanson* court advocated stopping inside information at its source by providing tippees with an incentive to sue tippers.[162]

Courts that allow the *in pari delicto* defense in private 10b-5 cases, such as the Fifth Circuit in *Kuehnert*,[163] agree that courts should employ rule 10b-5 to prevent insider trading,[164] but contend that allowing the defendant to assert the defense is the most effective way to curb the flow of inside information. The *Kuehnert* court's approach is more persuasive than *Nathanson* and its prog-

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Parts Corp., 392 U.S. 134, 139-41 (1968).

156. *Nathanson*, 325 F. Supp. at 56.

157. Tarasi v. Pittsburgh Nat'l Bank, 555 F.2d 1152, 1162 (3d Cir.), *cert. denied*, 434 U.S. 965 (1977).

158. *Nathanson*, 325 F. Supp. at 56.

159. The courts, however, have implied a private cause of action under rule 10b-5. *See supra* note 103. Although innocent investor suits are an important 10b-5 enforcement device, a much more troublesome situation arises when a party guilty of violating rule 10b-5 brings suit.

160. *Nathanson*, 325 F. Supp. at 53-54 (quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969)).

161. *Nathanson*, 325 F. Supp. at 57.

162. *Id.* at 57-58. The *Nathanson* court also relied on Pearlstein v. Scudder & German, 429 F.2d 1136 (2d Cir. 1970), *cert. denied*, 401 U.S. 1013 (1971), for the proposition that the threat of private suits provides an important supplement to SEC actions. *Nathanson*, 325 F. Supp. at 57.

163. Kuehnert v. Texstar Corp., 412 F.2d 700 (5th Cir. 1970); *see supra* notes 118-38 and accompanying text.

164. *Kuehnert*, 412 F.2d at 704.

eny. The *Kuehnert* majority reasoned that if it authorized tippee suits, it would grant tippees an enforceable warranty against losses they incur while trading on inside information.[165] Congress enacted section 10(b) of the 1934 Act to protect innocent investors, not to create windfalls for parties who have violated the securities laws. Moreover, the threat of SEC criminal and civil proceedings, and potential harm to professional reputations, already provide tippers with a substantial disincentive to disseminate inside information.[166] In contrast, as the *Kuehnert* court recognized, the difficulty of tracing tippees makes the threat to the tippee of 10b-5 liability remote.[167]

The *Kuehnert* position also finds strong support in the analysis of the *in pari delicto* defense in the margin and proxy violation cases.[168] Rule 10b-5 makes it illegal for an insider to pass inside information and requires anyone who obtains inside information either to disclose that knowledge to the public or to refrain from trading on it.[169] Similarly, the margin statutes hold both the creditor and the debtor liable for trading on excessive credit.[170] Most courts deny borrowers a private cause of action under the margin statutes because they have violated the statute under which they seek to recover,[171] just as tippees have violated rule 10b-5. Because the margin laws regulate borrowers, the courts reason that legislatures did not enact the margin statutes for the "especial benefit" of borrowers.[172] Similarly, because the securities laws regulate tippees, the courts should reason that legislatures did not enact the laws governing securities trading for the especial benefit of tippees. In addition, courts deny relief in proxy violation cases to parties who have violated the statute under which they seek redress.[173]

A bill passed by the United States House of Representatives and pending in the United States Senate lends additional support to the *Kuehnert* court's holding that tippees may not recover in private 10b-5 actions against tippers. House Bill 559 would increase the penalties imposed on persons who trade or cause other persons to trade on inside information relating to upcoming tender

165. *Id.* at 705.
166. *See supra* note 133 and accompanying text.
167. *See supra* notes 7, 131 and accompanying text.
168. *See supra* notes 72-95 and accompanying text.
169. *See supra* notes 97-101 and accompanying text.
170. *See supra* notes 73-88 and accompanying text.
171. *See supra* notes 83-88 and accompanying text.
172. *See supra* note 86.
173. *See supra* notes 89-95 and accompanying text.

offers.[174] One variation of the bill would require persons violating the statute to forfeit to the United States Treasury three times the amount of their gain or the loss they avoided by trading on inside information.[175] Although the bill would not apply to cases in which tippees suffer trading losses and sue their tippers,[176] courts may refer to the bill, if Congress passes it, as evidence of congressional intent when applying the residual exception in 10b-5 cases. The increased penalty on the tippee that the bill proposes supports the position that rule 10b-5 seeks to protect innocent investors; it is not designed to insure parties violating the rule against trading losses.[177]

Courts, therefore, should not use the residual exception to permit plaintiffs to recover in 10b-5 tipper-tippee cases, but should leave the parties as they find them. Although it is uncertain whether permitting or denying the defense more successfully will deter insider trading, the policy considerations that the *Kuehnert* court advanced militate strongly against allowing the tippee to obtain judicial relief. Courts long have recognized that allowing a guilty party to recover is resorting to a fiction—a fiction that courts should perpetuate in tipper-tippee 10b-5 cases only when doing so will further the public policies underlying any of the first

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174. H.R. 559, 98th Cong., 1st Sess. (1983).

175. H.R. 559, 98th Cong., 1st Sess. § (f) (1983) provides:

> Any person violating this section shall forfeit the amount of his gain [or the loss avoided] and shall pay the amount [or two or three times the amount] into the Treasury of the United States upon order of a United States District Court in an action commenced by the Commission under Section 21(a).

The bracketed parts are alternative provisions in the bill.

176. The damage provision, *supra* note 175, applies only if the tippee realized a gain or avoided a loss by trading on the inside information. The bill does not apply if the tippee sustained a loss from insider trading.

177. Because the statute imposes treble damages on tippers, some courts may attempt improperly to analogize the bill to antitrust cases such as *Perma Life*. Courts in antitrust cases have denied the defense on the ground that the treble damage provision seeks to encourage private causes of action, and thus courts should construe strictly impediments to private suits. An analogy between the proposed bill and the antitrust statute is inapposite for two reasons. First, several justices on the *Perma Life* Court recognized that when parties are equally responsible for antitrust violations courts should apply the *in pari delicto* defense to deny recovery. In the tipper-tippee situation both parties generally bear equal responsibility for the potential harm to the investing public and thus courts should not deprive the tipper of the benefit of the defense. The tipper obtains and passes the inside information to the tippee who has an advantage over other investors when he trades on the inside information. Second, the United States Treasury receives the damages under the proposed bill, as opposed to an antitrust action in which the plaintiff receives the treble damage award. The different damage recipients undercut any contention that Congress designed House Bill 559 to provide tippees with an incentive to bring private 10b-5 suits against tippers.

three exceptions to the *in pari delicto* defense. Because the policies underlying rule 10b-5 are unclear, however, courts should not rely on the residual exception to the defense to allow tippees to recover. Judicial disagreement concerning the goals of 10b-5 is indicative of the fact that this area of the law is too unsettled to justify allowing guilty tippees to recover. The first three exceptions, however, serve clearly defined public policies and courts, therefore, should continue to rely on them to permit guilty tippees to recover in those extremely rare situations in which the exceptions apply.

V. Conclusion

The *in pari delicto* defense first arose in contract disputes. Defendants since have asserted the defense in a wide variety of situations. From this wide application, the courts have developed four exceptions to the defense's application.

Federal circuit courts disagree over whether to allow the defense to bar the recovery of a tippee against his tipper in a private 10b-5 suit, or to disallow the defense and permit recovery under the defense's fourth, residual exception. The courts that deny the defense reason that holding the tipper liable to his tippee for passing on inside information more effectively advances the goals of section 10 of the Securities and Exchange Act of 1934 and rule 10b-5. These courts reason that imposing liability on tippers will deter them from disseminating inside information, and thereby reduce the amount of trading on inside information. The courts improperly analogize the 10b-5 cases to the antitrust cases, which have allowed guilty plaintiffs to recover.

On the other hand, the courts that allow the *in pari delicto* defense have concluded that denying relief to a guilty tippee more efficiently advances the goals underlying section 10 and rule 10b-5. These courts reason that denying tippees recovery eliminates the warranty against loss that allowing recovery would grant tippees.

Because the courts disagree over whether allowing the defense better effectuates the underlying policies of section 10 and rule 10b-5, the courts should grant the defense. Permitting a guilty party to recover is resorting to a fiction. Courts should resort to such fictions only when it clearly serves the underlying policies of the statute. In addition, actions that tippees bring against tippers under rule 10b-5 are analogous to cases involving margin violations and proxy regulation violations. Decisions in both margin violation and proxy regulation violation cases have recoguized the *in pari*

delicto defense and denied recovery to guilty plaintiffs. For these two reasons, all courts should recognize the *in pari delicto* defense in tippee suits against tippers under rule 10b-5.

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