SECURITIES—INSIDER TRADING—*IN PARI DELICTO* DEFENSE INAPPLICABLE IN RULE 10b-5 ACTIONS—*Bateman Eichler, Hill Richards, Inc. v. Berner*, 105 S. Ct. 2622 (1985).

The law concerning insider trading[1] under the Securities Exchange Act of 1934[2] has recently given rise to much controversy.[3] The viability of the *in pari delicto*[4] defense in relation to insider trading is one issue that has arisen under section 10(b) of the Act.[5] In particular, disputes focus on the use of the defense to bar recovery by plaintiffs because of their own unlawful conduct.[6]

---

[1] "Insider trading" is defined as the trading of stock by a corporation's officers, directors, and larger than 10% shareholders. Manne, *Insider Trading and the Administrative Process*, 35 GEO. WASH. L. REV. 473, 474 (1967). An "insider" is defined as including officers, directors, and controlling shareholders as well as "those persons who are in a special relationship with a company and privy to its internal affairs." *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961).

[2] Ch. 404, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. § 78a-78kk (1982)).

[3] *See, e.g.*, Crane, *An Analysis of Causation Under Rule 10b-5*, 9 SEC. REG. L.J. 99 (1981) (court's failure to address issue of causation as it relates to rule 10b-5); Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CALIF. L. REV. 80 (1981) (imposition of secondary liability on defendants who had not themselves expressly violated statute); Note, *Omission and Nondisclosure Under SEC Rule 10b-5: A Distinction in Search of a Difference*, 7 FORDHAM URB. L.J. 423 (1979) (defining omission and nondisclosure in relation to rule 10b-5 violations).

[4] *In pari delicto* is defined as "in equal fault." BLACK'S LAW DICTIONARY 711 (5th ed. 1979). The common law defense is derived from the Latin *in pari delicto potior est conditio defendentis* which means "in a case of equal or mutual fault . . . the position of the defending party . . . is the better one." Bateman Eichler, Hill Richards, Inc. v. Berner, 105 S. Ct. 2622, 2626 (1985). The defense is based on two premises; first, courts should not mediate among wrongdoers and second, that illegality is deterred by prohibiting an acknowledged wrongdoer from obtaining judicial relief. *Id.* at 2626-27.

[5] 15 U.S.C. § 78j(b) (1982). Section 10(b) states that:

> 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.

[6] *See, e.g.*, Berner v. Lazzaro, 730 F.2d 1319 (9th Cir. 1984), *aff'd sub nom.* Bateman Eichler, Hill Richards, Inc. v. Berner, 105 S. Ct. 2622 (1985) (defense not permitted); Tarasi v. Pittsburgh Nat'l Bank, 555 F.2d 1152 (3d Cir.), *cert. denied*, 434 U.S. 965 (1977) (defense permitted); Kuehnert v. Texstar Corp., 412 F.2d 700 (5th Cir. 1969) (defense permitted); Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50 (S.D.N.Y. 1971) (defense not permitted).

In modern years, the lower federal courts that have wrestled with the issue have reached divergent results.[7] The United States Supreme Court had not addressed the question until its recent decision in *Bateman Eichler, Hill Richards, Inc. v. Berner*.[8] In that case, the Court determined that the defense was not available to a securities professional disclosing inside information.[9]

The factual setting in *Bateman Eichler* concerned Charles Lazzaro, a registered securities broker,[10] employed by the brokerage firm of Bateman Eichler, Hill Richards, Inc. (Bateman Eichler).[11] While in the employ of Bateman Eichler, Lazzaro allegedly released false inside information to several investors in an effort to manipulate the price of T.O.N.M. Oil and Gas Exploration Corporation (TONM) stock.[12] In addition, TONM's president, Leslie Neadeau, allegedly conspired with Lazzaro in the perpetration of the fraud.[13]

In 1979, TONM, along with its subsidiary, International Gold and Diamond Exploration Corporation, Inc., entered into a series of joint venture mining agreements with six Surinamese companies pursuant to licenses granted to these companies.[14] Beginning in November of 1979, Lazzaro induced investors to purchase TONM stock by informing them that he was privy to certain material, nonpublic information received from TONM's president.[15] Lazzaro told the investors that TONM acquired options for land upon which large amounts of gold had been dis-

---

7 *See, e.g., supra* n.6.

8 105 S. Ct. 2622 (1985).

9 *Id.* at 2633.

10 A registered securities broker is someone who is registered with the Securities and Exchange Commission to act as a broker or dealer under the provisions of 15 U.S.C. § 78(a). *See* 15 U.S.C. § 78*o* (1982) (registration requirements of broker or dealer).

11 *Bateman Eichler*, 105 S. Ct. at 2624.

12 *Id.* The facts relied upon in the case are those set forth in the respondent's complaint. *Id.* Since the district court dismissed the action based on Federal Rule of Civil Procedure 12(b)(6), the complaint was construed in the respondent's favor and their allegations assumed to be true. Brief for the Securities and Exchange Commission as Amicus Curiae Supporting Respondents at 2 n.2, *Bateman Eichler*, 105 S. Ct. 2622 (1985) (No. 84-679) [hereinafter SEC Brief].

13 *Bateman Eichler*, 105 S. Ct. at 2624.

14 Joint Appendix at 8, *Bateman Eichler*, 105 S. Ct. 2622 (1985) (No. 84-679) [hereinafter Joint Appendix]. The term of the leases which were granted to the companies by the Surinam government was three years. *Id.* Surinam is a country of approximately 363,000 people. NEWSPAPER ENTERPRISE ASSOCIATION, INC., THE WORLD ALMANAC & BOOK OF FACTS 582 (1985). The country is located on the north Atlantic coast of South America and was formerly known as Dutch Guiana. *Id.*

15 Berner v. Lazzaro, 730 F.2d 1319, 1320 (9th Cir. 1984), *aff'd sub nom.* Bateman Eichler, Hill Richards, Inc. v. Berner, 105 S. Ct. 2622 (1985).

covered, that the discovery was not yet publicly known, and that it would soon be revealed.[16] Lazzaro also informed the investors of a proposed joint venture for the mining of the gold for which TONM was currently in negotiations.[17] As a result of these ventures, Lazzaro told the investors that when this information became public knowledge, the price of TONM stock would go up 10 to 15 points.[18] Lazzaro also represented that the stock, which was currently selling between $1.50 and $3 per share, might rise in value to as much as $100 per share within one year's time.[19]

In an effort to confirm Lazzaro's representations regarding his friendship with Neadeau, as well as his revelations about TONM's dealings, some of the investors contacted Neadeau.[20] Neadeau, however, would neither confirm nor deny Lazzaro's representations.[21] Neadeau's reasoning for not responding was that the information was not yet public knowledge.[22] Neadeau did say, however, that Lazzaro was very trustworthy and that he was a good man.[23]

The investors purchased TONM stock based on the premise that they, through Lazzaro, were privy to certain nonpublic information.[24] There was, however, no subsequent announcement of the joint venture by TONM as Lazzaro promised.[25] Initially after the purchases, the price of TONM stock rose to $7 per share.[26] Ultimately, however, the price of the stock fell below $1 per share in early 1981.[27]

---

16 *Bateman Eichler*, 105 S. Ct. at 2624.

17 *Id.*

18 *Id.*

19 *Id.* Lazzaro also informed the investors that all of TONM's shareholders would receive additional shares of stock of International Gold and Diamond Exploration (I.G.D.E.) for each share of TONM stock they owned without having to pay any extra money for it. *Id.* at 2624 n.3.

20 *Id.* at 2624.

21 *Id.*

22 *Id.*

23 *Id.*

24 *Id.*

25 Joint Appendix, *supra* note 14, at 12. Lazzaro attributed there being no announcement to a lack of certain required SEC filings by TONM, the death of the wife of one of the company's executives, and delays in cementing the joint venture. *Id.* at 12-13.

26 *Bateman Eichler*, 105 S. Ct. at 2625 n.4. Some of the investors told Lazzaro that they wanted to sell their TONM stock at that time. *Id.* Lazzaro, however, informed them that he would tell them when to sell and that they should not sell yet because the price would go even higher. *Id.*

27 *Id.* at 2624-25. When the joint venture fell through in early 1981, the stock price fell. *Id.* In addition to the price of the stock falling, Lazzaro's prediction as to the issuance of additional I.G.D.E. stock for each share of TONM owned never

The investors filed suit in the United States District Court for the Northern District of California against Lazzaro, Neadeau, TONM, and Bateman Eichler.[28] The plaintiffs alleged that they suffered substantial losses as a result of the scheme to manipulate the price of TONM's stock.[29] The investors claimed that the scheme violated section 10(b) of the Securities Exchange Act of 1934,[30] as well as Securities and Exchange Commission (SEC) rule 10b-5.[31] The court dismissed the claims on the basis that the

---

materialized. Joint Appendix, *supra* note 14, at 12. In March of 1980, I.G.D.E. issued rights to purchase shares of I.G.D.E. common stock to TONM stockholders at a cost of $1.50 per share. *Id.* The rights were issued at a rate of one right for every five shares of TONM common stock owned. *Id.* TONM shareholders were never given the right to receive I.G.D.E. stock without payment. *Id.*

28 *Bateman Eichler*, 105 S. Ct. at 2624. Bateman Eichler's liability was based on § 20(a) of the Securities Exchange Act of 1934. *Id.* at 2624 n.1. That section confers joint and several liability on "[e]very person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder . . . ." 15 U.S.C. § 78t(a) (1982).

29 *Bateman Eichler*, 105 S. Ct. at 2625.

30 *See supra* note 5 for text of section 10(b).

31 *Bateman Eichler*, 105 S. Ct. at 2625. Rule 10b-5 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,
>
> (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 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.

17 C.F.R. § 240.10b-5 (1985).

The appropriate scope of rule 10b-5 as it relates to insider trading has been much discussed in recent years. Questions have arisen in view of the failure of the statutory language explicitly to consider fraud involving tippers, tippees, and securities professionals which may fall under section 10. *See* Note, *Corporate Outsider May Be Liable for Failure to Disclose or Abstain Under Rule 10b-5 Based on Employer-Employee Fiduciary Relationship*, 13 SETON HALL L. REV. 178, 182 (1982). The statutory language of rule 10b-5 places no importance on the relationship between the corporation, the violator of the statute, and those with whom they deal. *Id.* These statutory gaps were left to be filled by the courts. *Id.*

The case law involving rule 10b-5 and insider trading began to develop with the seminal case of *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961). In that case, the SEC held that a securities professional was under an obligation to disclose *material nonpublic* information or abstain from trading on it when he received inside information about a dividend from a director of the issuer. *Id.* at 912 (emphasis added). The SEC focused on:

> first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent

plaintiffs were *in pari delicto*[32] with the defendants, since, by knowingly purchasing stock on insider information, they too had violated the statutory provision under which they sought recovery.[33] Thus, the court concluded that the plaintiffs were absolutely barred from recovery.[34]

The United States Court of Appeals for the Ninth Circuit reversed the district court.[35] The Ninth Circuit acknowledged that the investors were in violation of the federal securities laws.[36] On the facts presented, however, the court discerned less than equal culpability among the parties.[37] Specifically, the court held that a tippee/investor was not as blameworthy in a securities fraud action as an insider or broker.[38] Thus, the court concluded

---

unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.

Id. This disclose-or-abstain rule was intended to prevent a corporate insider from profiting on information which was known to be unavailable to other parties. *Id.*

The *Cady, Roberts* disclose-or-abstain rule was later adopted by the Second Circuit in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied sub nom.* Coates v. SEC, 394 U.S. 976 (1969). In that case, the court expanded the disclose-or-abstain rule. *Id.* at 851-53. The rule announced by the *Texas Gulf Sulphur* court encompassed *anyone* who possessed material nonpublic information and required that they either disclose the information or abstain from trading on it while it remained nonpublic. *Id.* (emphasis added).

In subsequent years, the disclose-or-abstain rule was applied to situations involving the tipper-tippee relationship. *See, e.g.*, Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); *In re* Investors Management Co., Inc., 44 S.E.C. 633 (1971). This application of the rule is based on a belief that tippees have a duty not to profit from information that they know is confidential and know or should know came from a corporate insider. *Shapiro*, 495 F.2d at 237-38. The tippee's obligation arises from his role as a participant after the fact in the insider's breach of his fiduciary duty. *Id. Shapiro* also determined that the proper class of investors who could recover in these types of actions were those individuals who purchased securities between the time of the defendant's trading on the inside information and the time of disclosure. *Id.* at 241. *But see* Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980) (measure of damages in tipper liability case limited to tippee's profits).

See also infra notes 107-23 and accompanying text (discussing recent developments of duty to disclose).

[32] *See supra* note 4 for the definition of *in pari delicto*.

[33] *Bateman Eichler*, 105 S. Ct. at 2625.

[34] *Id.*

[35] Berner v. Lazzaro, 730 F.2d 1319, 1324 (9th Cir. 1984), *aff'd sub nom.* Bateman Eichler, Hill Richards, Inc. v. Berner, 105 S. Ct. 2622 (1985).

[36] *Id.* at 1322.

[37] *Id.*

[38] *Id.* at 1324. Relying on prior law, the Ninth Circuit found that in private antitrust suits, the *in pari delicto* defense does not apply if the facts show less than equal fault on the part of the plaintiff. *See* Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 132 (1968); Javelin Corp. v. Uniroyal, Inc., 546 F.2d 276 (9th Cir. 1976), *cert. denied*, 431 U.S. 938 (1977). It was the Ninth Circuit's opinion that the

that "the defense of *in pari delicto* is inappropriate as a sole basis for dismissal of a complaint in a private action under the federal securities laws, unless the alleged facts show that the investor is equally responsible for his injury."[39] On appeal, the Supreme Court unanimously affirmed the Ninth Circuit.[40]

Although the literal translation of *in pari delicto*[41] is equal fault, the doctrine historically has been applied in a wide assortment of situations where the party seeking equitable relief or damages has himself been involved to some degree in the same kind of wrongdoing.[42] The defense of *in pari delicto* was created at common law[43] in order to assure that wrongdoers would not benefit from their transgressions.[44] Under the doctrine, a party is precluded from recovering damages if the losses suffered are caused substantially by action that is prohibited by law.[45] Accordingly, a court will give aid to neither party and will allow the

---

same rule should apply to private actions brought under federal securities laws. *Berner*, 730 F.2d at 1321-22. The court believed that this approach would be most consistent with the full and fair disclosure requirements of the Securities Exchange Act of 1934 and its purposes of protecting investors. *Id.* at 1322 (citing U.S. v. Carman, 577 F.2d 556, 564 (9th Cir. 1978)). In the Ninth Circuit's view, this rule was determinative of the issue presented since, as the court noted, the Supreme Court had stated that a judicial sanction prohibiting a private suit by a plaintiff will not be allowed when that sanction would hinder the clear legislative intent of a statute. *Id.* Thus, the court believed that allowing Bateman Eichler to successfully raise the *in pari delicto* defense would hinder the intent of section 10 of the Act. *Id.*

In addition to being consistent with the intent of the securities laws to prohibit fraud by brokers and dealers, the court reaffirmed the principle that private suits by investors are a necessary supplement to SEC enforcement. *Id.* at 1323. Further, according to the Ninth Circuit, private actions also serve as a deterrence to fraud by exposing potential miscreants to the threat of private liability. *Id.*

The court noted that this is true even in cases in which the investor is not completely innocent himself. *Id.* The court opined that the availability of the defense would result in many 10b-5 violations remaining unexposed due to the elimination of any incentive to sue on the part of the defrauded investor. *Id.* Therefore, the Ninth Circuit held that the *in pari delicto* defense was inappropriate. *Id.* at 1324.

[39] *Id.*

[40] *Bateman Eichler*, 105 S. Ct. at 2633.

[41] *See supra* note 4 for a definition of *in pari delicto*. A correlative principle to *in pari delicto* is the equitable doctrine of "unclean hands" which states that "he who comes into equity must come with clean hands." McCLINTOCK, PRINCIPLES OF EQUITY 59 (2d ed. 1948). The unclean hands defense, however, was inapplicable in the *Bateman Eichler* case since only legal (monetary) damages were sought. *See id.*

[42] *See, e.g.*, Perma Life Mufflers v. Int'l Parts Corp., 392 U.S. 134, 138 (1968).

[43] Historically, the purpose of the doctrine was to protect the court's integrity where it was asked to choose between two wrongdoers. Nea, *Limitations on Defenses Under 10(b): In Pari Delicto and Unclean Hands*, 5 U. RICH. L. REV. 251, 257 (1971).

[44] *See, e.g.*, Tarasi v. Pittsburgh Nat'l Bank, 555 F.2d 1152, 1156 (3d Cir.), *cert. denied*, 434 U.S. 965 (1977).

[45] *Id.* at 1157.

losses to remain as they are.[46] There is, however, an important public policy limitation to the foregoing rule.[47] Courts may allow a party who is *in pari delicto* to sue for relief if the court determines that public policy will be advanced by allowing the party to recover.[48]

Although the Supreme Court never considered the applicability of the *in pari delicto* defense as a bar to private rights of action under the federal securities laws,[49] the Court had been presented with that issue involving a private antitrust action plaintiff in its 1968 decision in *Perma Life Mufflers, Inc. v. International Parts Corp.*[50] In *Perma Life*, the petitioners, former dealers and operators of "Midas Muffler Shops," alleged that Midas restrained and substantially lessened competition through their sales agreements with the dealers in violation of the Sherman and Clayton Acts.[51] The petitioners, however, subscribed to the agreements and profited despite the contested restrictions.[52] The Court ruled that the defense was inapplicable in the instant case because of the overriding public interest to be served.[53] Writing the opinion of the Court, Justice Black set forth the proposition that the threat of treble damage suits acted as a strong deterrent to antitrust violations.[54] Justice Black also reaffirmed the Court's unwillingness to invoke "broad common-law barriers to relief

---

46 *See, e.g.*, 3 J. POMEROY, A TREATISE ON EQUITY JURISPRUDENCE §§ 940-41 (5th ed. 1941).

47 *See id.* § 941.

48 *Id.* A second limitation on the common law defense is that a court can only look to the conduct related to the transaction before it. *Id.* The court may not prohibit recovery based on a plaintiff's actions in a separate setting. *See* Tarasi v. Pittsburgh Nat'l Bank, 555 F.2d 1152, 1157 (3d Cir.), *cert. denied*, 434 U.S. 965 (1977).

49 The first case to hold that there is an implied private right of action under rule 10b-5 was Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). A majority of the circuits now recognize the private right of action. *See* 3 L. Loss, SECURITIES REGULATION 1763-64 (2d ed. 1961 & Supp. 1969). The Supreme Court has also recognized the private right of action. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 388-89 (1983).

50 392 U.S. 134 (1968).

51 *Id.* at 135.

52 *Id.* at 138. Although the petitioners accepted the terms of the agreements as presented, they repeatedly objected to the restraints as harmful to their welfare. *Id.* at 139. The Supreme Court determined that this conduct eliminated any blameworthiness on the part of the petitioners since they did not actively promote the respondents' scheme. *Id.*

53 *Id.*

54 *Id.* at 139.

where a private suit serves important public purposes."[55] Accordingly, Justice Black believed that the doctrine of *in pari delicto* should not be recognzied as a valid defense in antitrust actions.[56]

The approach of the lower federal courts that have considered the applicability of the defense in securities laws cases has been either to distinguish *Perma Life* so as to allow the defense[57] or to use the holding as the basis for disallowing it.[58] For exam-

---

55 *Id.* at 138. Justice Black suggested that, if the petitioners actively participated in the illegal scheme, the defense may be allowed. *Id.* at 141.

56 *Id.* at 140. The Court felt no need to decide whether a plaintiff who was completely involved with and participated in the monopolistic scheme could be barred from bringing an action. *Id.* The Court found that the dealers had relatively little bargaining power in this case and that they had not acted voluntarily in their actions. *Id.* at 140-41.

In four separate opinions, five Justices agreed that in some narrowly defined circumstances the plaintiff's own conduct could serve as a basis for defense in antitrust actions. In his concurrence, Justice White explained that the defense is inapplicable if the plaintiff is *substantially equally responsible* for his injury. *Id.* at 146 (White, J., concurring) (emphasis added). Justice Fortas agreed that the defense is barred if responsibility for the injury is equal. *Id.* at 147 (Fortas, J., concurring). Justice Marshall indicated that the defense would be allowable only if the private antitrust defendant proved "that the plaintiff actively participated in the formation and implementation of an illegal scheme, and is substantially equally at fault. . . ." *Id.* at 149 (Marshall, J., concurring). Justices Harlan and Stewart, who concurred in part and dissented in part, disagreed with the majority's definition of *in pari delicto*. *Id.* at 153 (Harlan & Stewart, JJ., concurring in part and dissenting in part). Justices Harlan and Stewart would have remanded the case for a determination of whether the plaintiffs voluntarily cooperated with the defendants to violate the law. *Id.*

57 For cases allowing the *in pari delicto* defense, see, *e.g.*, Wolfson v. Baker, 623 F.2d 1074 (5th Cir. 1980), *cert. denied*, 450 U.S. 966 (1981) (broker who failed to advise investor that his holdings were large enough to require registration and that sale of his holdings would be illegal could successfully use *in pari delicto* defense to bar investor's recovery against him under securities laws); Tarasi v. Pittsburgh Nat'l Bank, 555 F.2d 1152 (3d Cir.), *cert. denied*, 434 U.S. 965 (1977) (rule 10b-5 claim by investor against tipper who provided investor with false inside information barred by *in pari delicto* defense); Malamphy v. Real-Tex Enter., Inc., 527 F.2d 978 (4th Cir. 1975) (*in pari delicto* used to deny recovery to experienced real estate brokers who voluntarily entered into a scheme to defraud the general public); James v. DuBreuil, 500 F.2d 155 (5th Cir. 1974) (*Kuehnert* rule of allowing *in pari delicto* defense applies to transactions effectuated in public market); Kuehnert v. Texstar Corp., 412 F.2d 700 (5th Cir. 1969) (defense applicable in rule 10b-5 claim against corporate insider who gave false tip to an investor who bought stock on open market); Grumet v. Shearson/American Express, Inc., 564 F. Supp. 336 (D.N.J. 1983) (defense of *in pari delicto* could be used to bar recovery by investor against broker where broker's inside information turned out to be false even though broker was not true insider).

58 For cases disallowing the defense, see, *e.g.*, Berner v. Lazzaro, 730 F.2d 1319 (9th Cir. 1984), *aff'd sub nom.* Bateman Eichler, Hill Richards, Inc. v. Berner, 105 S. Ct. 2622 (1985) (defense of *in pari delicto* inappropriate as basis for dismissal of alleged 10b-5 violation where tippee is not of equal fault with broker-tipper); Mallis v. Bankers Trust Co., 615 F.2d 68 (2d Cir. 1980), *cert. denied*, 449 U.S. 1123 (1981) (defense of *in pari delicto* not appropriate in rule 10b-5 tipper-tippee action when

ple, in 1969, in *Kuehnert v. Texstar Corp.*,[59] the Fifth Circuit Court of Appeals was faced with the issue of deciding whether the *in pari delicto* defense could serve to bar a duped tippee[60] from recovering against his tipper under section 10(b) of the 1934 Act.[61] In that case, the president of Texstar Corporation, Rhame, told his friend Kuehnert of a pending merger between Texstar and Coronet Petroleum Company.[62] Rhame additionally told Kuehnert of some secret discoveries on a highly favorable "farmout"[63] by Texstar from which high dividends and an increase in stock value were expected.[64] The "farmout" representations were not accurate and, as a result, Kuehnert lost all of his investment.[65] Both parties claimed rule 10b-5 violations.[66]

In affirming the district court's summary judgment for the defendant, the Fifth Circuit held that the plaintiff's own illegal conduct barred his recovery.[67] The court acknowledged that,

---

plaintiff's wrongdoing was not equal to defendant's and when plaintiff's alleged wrongdoings were not sufficiently related to statutory violations or objectives under rule 10b-5); Lawler v. Gilliam, 569 F.2d 1283 (4th Cir. 1978) (defense disallowed when parties not mutually at fault and when regulatory objectives would be interfered with if defense was allowed); Xaphes v. Shearson, Hayden, Stone, Inc., 508 F. Supp. 882 (S.D. Fla. 1981) (defense does not apply to noninsider broker because his customer not a tippee having duty to disclose); Moholt v. Dean Witter Reynolds, Inc., 478 F. Supp. 451 (D.D.C. 1979) (*in pari delicto* not valid defense by broker in quasi-fiduciary position relative to plaintiff-investor and who is not equally at fault with his duped investor); Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50 (S.D.N.Y. 1971) (*in pari delicto* not available in rule 10b-5 claim by investor against broker-insider who gave out false information).

59 412 F.2d 700 (5th Cir. 1969).

60 A "tipper" is a person who has possession of "material inside information" and who makes selective disclosure of such information for trading or other personal purposes. *See, e.g.*, 3 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD & COMMODITIES FRAUD 190.7 (1985). The tipper must also have a duty not to disclose the information. Dirks v. SEC, 463 U.S. 646 (1983). A "tippee" is one who receives such information from a "tipper". *Id.* "Materiality" is defined as whether "there is a *substantial likelihood* that a reasonable shareholder *would* consider [an omitted fact] important in deciding how to vote." TSC Indus. Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (emphasis added). *See also infra* notes 117- 23 and accompanying text for a discussion of the duties required of tipper and tippee.

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

62 *Id.* at 702.

63 "Farmout" is defined as "[t]o let for a term at a stated rental. To turn over for performance or care. To exhaust farm land by continuous raising of a single crop." BLACK'S LAW DICTIONARY 546 (5th ed. 1979).

64 *Kuehnert*, 412 F.2d at 702.

65 *Id.*

66 *Id.* at 701. Kuehnert sued Rhame alleging that he had violated rule 10b-5. *Id.* Rhame, in turn, claimed that Kuehnert had violated rule 10b-5 since he failed to disclose the material, nonpublic information before he traded on it. *Id.* at 702.

67 *Id.* at 703.

while certain areas of law give rise to exceptions to this general rule,[68] the guiding principle for application of the *in pari delicto* defense is one of policy.[69] In the Fifth Circuit's view, the public interest of accounting among joint conspirators was not sufficient justification to bar the defense in securities actions.[70] In a direct response to the Supreme Court's holding in *Perma Life*, the *Kuehnert* court felt that the public interest in private actions under the federal securities laws was not comparable to the public interest of treble damage in antitrust actions.[71] The court further distinguished the instant case from *Perma Life*; in *Kuehnert*, the plaintiff-tippee's actions were entirely voluntary and no form of duress could be alleged, whereas the same could not be said in *Perma Life*.[72] In fact, Kuehnert was an active participant in the wrongdoing.[73]

In holding that Kuehnert's status as a tippee made the defense of *in pari delicto* available to Rhame, the Fifth Circuit articulated that the application of the defense lies with the discretion of the court and is based upon policy.[74] The court, in balancing the potential harm to investors presented by the countervailing arguments, determined that the danger of allowing tippees to recover was clearly superior.[75] The court agreed with Kuehnert that allowing the defense would leave little incentive for a tipper not to intentionally release false information.[76] Nevertheless, the court reasoned that disallowance of the defense would in effect give the tippee an enforceable warranty that the material, nonpublic in-

---

68 *See, e.g.*, Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134 (1968) (*in pari delicto* defense does not apply in antitrust law).

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

70 *Id.* at 703.

71 *Id.*

72 *Id.* at 703-04. *See also supra* note 52.

73 *Kuehnert*, 412 F.2d at 703-04.

74 *Id.* at 704. The court rejected Kuehnert's claim that he did not violate rule 10b-5. *Id.* Kuehnert's claim was based on the fact that the "inside information" he traded on was false. *Id.* at 703-04. The court felt that "the statutory phrase 'any manipulative or deceptive device' " in the 1934 Act was broad enough to include conduct irrespective of its result. *Id.* at 704. Thus, the court felt that Kuehnert's intent was important and the degree of success of his scheme was irrelevant. *Id.* at 704. The *Bateman Eichler* Court expressed no view on the plaintiff-investors' liability since it was not addressed below. *Bateman Eichler*, 105 S. Ct. at 2630 n.21. The Court merely assumed that the respondents' activities rendered them at fault. *Id.*

75 *Kuehnert*, 412 F.2d at 705. According to the court, the question was "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.* at 704.

76 *Id.* at 705.

formation he received was true.[77] The court concluded its analysis by observing that allowing the defense in other antifraud sections of the securities laws has not limited the effective enforcement of those provisions.[78] Furthermore, the court noted that tippees presented virtually the same threat to investors as did insiders themselves and, as such, should be discouraged from acting inappropriately.[79]

Eight years later, the Court of Appeals for the Third Circuit in *Tarasi v. Pittsburgh Nat'l Bank*[80] also held that a private defendant in a 10b-5 action could successfully claim the defense of *in pari delicto*.[81] In *Tarasi*, a group of disappointed investors brought suit against their banker because they lost money after buying stock on the basis of his inside information.[82] The court distinguished the case at bar from the Supreme Court's decision in *Perma Life* by noting that the plaintiffs' conduct here were voluntary.[83] The court noted that the plaintiffs' conduct contributed significantly to their losses and posed a great threat to the investing public.[84] The court, however, also observed that *Perma Life* left open the possible applicability of the defense if the plaintiff's unlawful conduct was found to be active and significant.[85] The court agreed that denying the defense would deter tippers who deliberately passed false information, but questioned its effect on tippers who believed that their information was true.[86] The court questioned whether the threat of tippee suits would deter potential tippers because proof of scienter is a prerequisite to recovery in a private 10b-5 action.[87] In addition, because of the rarity of tippee suits, the court concluded that the best solution would be to rely on potential SEC penalities to deter tippers.[88] The court posited that the best way to deter tippees was by making the de-

---

77 *Id.*

78 *Id.* The court cites as an example the area of proxy regulation. *Id.*

79 *Id.*

80 555 F.2d 1152 (3d Cir. 1977).

81 *Id.* at 1164.

82 *Id.* at 1154.

83 *Id.* at 1162.

84 *Id.* at 1163.

85 *Id.* at 1158.

86 *Id.* at 1163. The court's doubt presumably arose because the plaintiff would have to demonstrate that the tipper knowingly gave out false inside information concerning the transaction in question.

87 *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). The Court defined "scienter" as the "mental state embracing intent to deceive, manipulate, or defraud." *Id.* at 193 n.12.

88 *Tarasi*, 555 F.2d at 1164.

fense of *in pari delicto* available to defendant-tippers.[89]

In 1971, the District Court for the Southern District of New York faced the same issue as the *Kuehnert* and *Tarasi* courts in *Nathanson v. Weis, Voisin, Cannon, Inc.*[90] The *Nathanson* court, however, reached the opposite result.[91] In *Nathanson*, the plaintiffs received material inside information concerning a merger from representatives of the defendant.[92] In reliance on this "tip," the plaintiffs purchased stock.[93] When the information proved false, the plaintiffs lost rather than made money and brought suit against the securities broker.[94] In his analysis, Judge Weinfeld reviewed the reasoning earlier courts used in determining whether to permit the *in pari delicto* defense.[95] Judge Weinfeld determined that the public policy considerations of protecting the investing public and effective enforcement of the securities acts' antifraud provisions were accomplished by discouraging insiders from releasing inside information to a preferred group.[96] The *Nathanson* court cited the Supreme Court's holding in *Perma Life* as indicative of the unavailability of the *in pari delicto* defense in securities violations cases.[97] The court observed that the underlying policies of private enforcement of the securities acts and the antitrust

---

89 *Id.* In 1983, the District Court of New Jersey was faced with the same issue as the *Tarasi* court in Grumet v. Shearson/American Express, Inc., 564 F. Supp. 336 (D.N.J. 1983). The *Grumet* court held that the defense of *in pari delicto* was available to a broker whose inside information proved to be false and caused substantial losses to an investor although the broker may not truly have been an "insider" within the meaning of the securities laws. *Id.* at 341. The *Grumet* court relied on *Tarasi* and *Kuehnert* as the basis for its decision. *Id.* at 338-40.

90 325 F. Supp. 50 (S.D.N.Y. 1971).

91 *See id.* at 53.

92 *Id.* at 51.

93 *Id.* Relying on the defendant's claim that one share of TST stock would be exchanged for one share of Elgin stock in the merger, the plaintiffs purchased TST stock. *Id.* When the merger was completed, the actual ratio of exchange was one share of Elgin stock for every two and one-half shares of TST stock. *Id.* at 52.

94 *Id.* at 51-52.

95 *Id.* at 52. In particular, Judge Weinfeld examined the *Kuehnert* case which allowed the defense, and Wohl v. Blair & Co., 50 F.R.D. 89 (S.D.N.Y. 1970), which denied it. *Id.* at 52.

96 *Nathanson*, 325 F. Supp. at 53-54. The court reiterated the well-documented opinion that the chief policy of Congress underlying the 1934 Act was "to prevent inequitable and unfair practices and to insure fairness in securities transactions." *Id.* at 53 (quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied sub nom.* Coates v. SEC, 394 U.S. 976 (1969)). The court also noted that the actualization of "[r]ule 10b-5 'is based in policy on the justifiable expectation of the securities marketplace that all investors . . . have relatively equal access to material information . . . .' " *Id.* at 53-54.

97 *Nathanson*, 325 F.2d at 56.

laws were quite similar.[98]

It was the view of the *Nathanson* court that the insider presented a potentially greater risk to the investing public than the non-insider.[99] The court concluded that an insider serves as the nucleus of the confidential information, while a tippee may have only innocently received the information and thereby presents only a minimal potential for harm.[100] The court noted that the most effective way of restricting the use of material inside information while it was unavailable to the investing public was by making the defense of *in pari delicto* unavailable to the insider.[101] In the court's view, denying the defense would serve as an effective deterrent to selective disclosure of material inside information.[102]

In 1981, in *Xaphes v. Shearson, Hayden, Stone, Inc.*,[103] the Southern District of Florida was also asked to consider the applicability of the *in pari delicto* defense in a securities laws case.[104] In *Xaphes*, the defendant broker induced the plaintiff to purchase various stocks of companies that were allegedly subject to takeover bids.[105] This inside information proved false as no takeovers occurred thereby leaving the plaintiffs without their anticipated profits.[106] In its decision whether to permit the *in pari delicto* defense, the *Xaphes* court considered the Supreme Court's 1980 decision in *Chiarella v. United States*[107] and its effect on the

---

98 *Id.* at 56 n.30.

99 *Id.* at 57.

100 *Id.* This interpretation is no longer valid in view of the decision in Dirks v. SEC, 463 U.S. 646 (1983), in which the Supreme Court held that a tippee is someone with a duty to disclose. *See infra* notes 117-23 and accompanying text.

101 *Nathanson*, 325 F.2d at 57.

102 *Id.* at 57-58.

103 508 F. Supp. 882 (S.D. Fla. 1981).

104 *See id.* at 884.

105 *Id.* The defendant was a brokerage firm whose agent allegedly convinced the plaintiff to start a margin account with them. *Id.* The plaintiff transferred his "blue chip" stocks to the account. *Id.* Subsequently, the defendant's agent convinced the plaintiff to sell some of these stocks and to buy others about which the agent claimed to have inside information. *Id.* This claim proved to be false and the plaintiff lost money. *Id.*

106 *Id.*

107 445 U.S. 222 (1980). The law relating to insider trading under rule 10b-5 was changed drastically by the Supreme Court in its decision in Chiarella v. United States. *See generally* Note, *The Availability of the In Pari Delicto Defense in Tippee-Tipper Rule 10b-5 Actions After Dirks v. SEC*, 62 WASH. U.L.Q. 519, 535-36 (1984). (discussing impact of *Chiarella* and *Dirks* on availability of *in pari delicto* defense). In *Chiarella*, the Supreme Court reversed Vincent Chiarella's rule 10b-5 conviction. *Chiarella*, 445 U.S. at 236-37. Chiarella worked for a financial printer who was hired by corporations to print documents to be used for tender offers and other acquisitions.

issue at hand.[108] In *Chiarella*, the Supreme Court held that rule 10b-5 liability was based on a duty to disclose nonpublic information, which duty arose from fiduciary relationships between the parties.[109] Mindful of this holding, the *Xaphes* court determined that since Philip Xaphes did not breach the duty established in *Chiarella* as he was not a tippee, there could be no finding that his actions constituted equivalent fault to that of the defendant.[110] The court distinguished the facts in *Xaphes* from those of *Kuehnert*.[111] In *Kuehnert*, the defendant was a corporate insider who gave out false information about the corporation's stock.[112] Therefore, the plaintiffs were actual tippees since they received their information from insiders who had a duty to disclose.[113] Conversely, in *Xaphes*, the plaintiff was held not to be a tippee because the nonpublic information was not disseminated by an insider.[114] According to the *Xaphes* court, it is only when a plaintiff breaches some duty to disclose, thereby becoming a blameworthy party, that the defense of *in pari delicto* arises.[115] Furthermore, according to the *Xaphes* court, the public policy considerations favored placing liability upon the defendant who

---

Id. at 224. The names of the target companies were not given to the printing company until immediately prior to the public announcement of the acquisition. *Id.* Chiarella deciphered the names of the target companies from information contained in the material to be printed and bought shares in the target companies based on this information. *Id.* He later sold the shares at a profit and was convicted based on the law at the time which established liability for *anyone* who traded while in the possession of material nonpublic information. *Id.* at 224-25. (emphasis added). The Supreme Court reversed the conviction and required that liability under rule 10b-5 be based on "a duty to disclose [material nonpublic information] arising from a relationship of trust and confidence between parties to a transaction." *Id.* at 230. The Court did not consider Chiarella's possible liability under a "misappropriation" theory since the theory was never submitted to the jury at trial. *Id.* at 235-37. Misappropriation theory liability would have been based on Chiarella's breach of duty to the acquiring corporation when he traded upon information obtained as an employee of a financial printer retained by the corporation. *Id.* According to the Court, the use of confidential information does not constitute fraud under section 10(b) when the person using the information is not a corporate insider and is not acting in a position of trust and confidence toward the sellers of the securities. *Id.* at 230-33. The Court felt that application of any other rule would create a general duty among "all participants in market transactions to forego actions based on material, nonpublic information." *Id.* at 233.

108 *Xaphes*, 508 F. Supp. at 886.

109 *Chiarella*, 445 U.S. at 232-35.

110 *Xaphes*, 508 F. Supp. at 886.

111 *Id.* at 885.

112 *See supra* notes 59-79 and accompanying text.

113 *Xaphes*, 508 F. Supp. at 886.

114 *Id.* at 885.

115 *Id.* at 886.

effectuated the fraud.[116]

In 1983, in *Dirks v. SEC*,[117] although the Supreme Court did not address the *in pari delicto* defense, the Court both reasserted and clarified its *Chiarella* decision.[118] In *Dirks*, the Court reversed the lower court's holding that a broker who released nonpublic information though not trading on it was in violation of the securities laws.[119] The Court reaffirmed *Chiarella* and confirmed that the duty to disclose material nonpublic information is based on the existence of a fiduciary relationship between the parties to a transaction.[120] In *Dirks*, the Supreme Court defined the parameters of the fiduciary relationship respecting tippees.[121] In the Court's view, a tippee has a duty to disclose material nonpublic information or abstain from trading on it only when he knows or should know that his insider has breached his fiduciary duty by disclosing the information.[122] Thus, the tippee's duty to disclose is derived from the insider's duty.[123]

It was against this backdrop of conflicting decisions and interpretations that the Supreme Court was presented with the *Bateman Eichler* case. Justice Brennan, writing for a unanimous Court, began the opinion in *Bateman Eichler* by giving a brief history of the common law defense of *in pari delicto*.[124] Citing the Court's holding in *Perma Life*, Justice Brennan re-emphasized the sentiment that it is inappropriate to use broad common law defenses as barriers to relief because a private action provides a valuable public service.[125] The Court disagreed with the defendants' argument that the principles espoused in *Perma Life* supporting the unavailability of the *in pari delicto* defense were inapplicable in the case at bar.[126] In particular, the Court noted

---

116 *Id.* at 886-87.

117 463 U.S. 646 (1983).

118 *See id.* at 657-58.

119 *Id.* at 652.

120 *Id.* at 654-55.

121 *See id.* at 659-64.

122 *Id.* at 660-61.

123 *Id.*

124 *Bateman Eichler*, 105 S. Ct. at 2626. *See also supra* notes 43-48 and accompanying text.

125 *Bateman Eichler*, 105 S. Ct. at 2627.

126 *Id.* at 2628. The basis of this contention by the defendants was that *Perma Life* was an antitrust case and that Congress had expressly provided for private rights of action under the antitrust laws. *Id.* Conversely, however, private rights of action under securities laws were implied by the courts and not expressly provided for by Congress. *Id.* As such, the defendants asserted that a broader application of the defense of *in pari delicto* should be supported in securities actions. *Id.*

that there is nothing in the *Perma Life* decision which suggests that it is only when Congress *expressly* provides for private remedies that public policy implications should dictate.[127] The Court, therefore, opined that it could fairly apply the full force of its holding in *Perma Life* to an implied private cause of action under the securities laws.[128] Accordingly, the Court held that the plaintiff in private securities actions may only be barred by the *in pari delicto* defense when the plaintiff is at least "substantially equally responsible" for the injury for which he seeks reparation, such injury being a direct consequence of his own actions.[129] Furthermore, the Court concluded that preclusion of the defense would advance the proficient execution of the securities laws.[130]

In analyzing the apportionment of fault among Bateman Eichler, Lazzaro, and Neadeau, the Court disagreed with the defendants' contention that the plaintiffs' fault was substantially equal to their own. The Court determined that since the plaintiffs had acted voluntarily[131] in trading on the inside information, they were culpable parties under rule 10b-5.[132] The Court relied on its holding in *Dirks v. SEC*[133] as the basis for rejecting this contention.[134] It was the opinion of the Court that a person whose culpability is derived solely from another party could not be said to be as guilty as the other party.[135]

The Court also relied on *Dirks* to opine that an insider commits a potentially wider range of violations than does a tippee.[136]

---

127 *Id.* In addition, the historical application of the common law defense required that public policy implications be considered in applying the doctrine. *Id.*

128 *Id.* at 2629.

129 *Id.*

130 *Id.*

131 This is a distinction lower courts have made. *See, e.g.*, Tarasi v. Pittsburgh Nat'l Bank, 555 F.2d 1152, 1161 (3d Cir.), *cert. denied*, 434 U.S. 965 (1977); Kuehnert v. Texstar Corp., 412 F.2d 700, 704 (5th Cir. 1969).

132 *Bateman Eichler*, 105 S. Ct. at 2630. Rule 10b-5 was promulgated pursuant to section 10(b) of the Securities Exchange Act of 1934. *See supra* note 31 for text of rule 10b-5. The Act was passed in an effort to protect "the investing public and the national economy through the promotion of a 'high standard of business ethics . . . in every facet of the securities industry.' " *Bateman Eichler*, 105 S. Ct. at 2631 (quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186-87 (1968)).

133 463 U.S. 646 (1983). *See also supra* notes 117- 23 and accompanying text.

134 *Bateman Eichler*, 105 S. Ct. at 2630.

135 *Id.*

136 *Id.* This was based on a belief that a tippee who trades on inside information is often guilty of fraud against the shareholders. *Id.* This is a violation for which responsibility is shared by the tipper. *Id.* In addition, frequently the insider also has breached his fiduciary duty toward the issuing company himself. *Id.* The tipper who intentionally gives false material inside information to a tippee also has com-

Due to the possible scope of the tipper's violations, the Court reasoned that a tippee cannot properly be classified as someone of substantially equal fault with a tipper, unless there is some other action by the tippee which outweighs the insiders' violations.[137] According to the *Bateman Eichler* Court, the facts did not support any claim of such action by the tippees.[138] The Court determined that Lazzaro and Neadeau initiated the conduct which resulted in the rule 10b-5 violation by the plaintiffs.[139] This, according to the Court, made the defendants far more culpable than the plaintiffs.[140] Therefore, the Court concluded that the plaintiffs' fault could not be considered equal to the insiders'.[141]

The Court next dealt with the general effect of the *in pari delicto* defense on the objectives of the federal securities laws.[142] The Court began with the premise that barring private actions by allowing the defense would result in many frauds going undetected by the SEC.[143] The Court opined that the defense of *in pari delicto* would remove the incentive for defrauded investors to bring private suits against the defrauding tipper and, as a result, would take away one of the chief methods that the SEC has of detecting such frauds.[144]

The Court then discussed the policy ramifications of the *in pari delicto* defense.[145] The Court concluded that it was more important in terms of deterrence for the insider- tipper, rather than the tippee, to be discouraged from acting illegally.[146] According

---

mitted fraud against the tippee. *Id.* Such fraud is even more serious when the tipper is a securities broker who has a fiduciary duty toward his clients. *Id.*

137 *Id.* The Securities Industry Association, who submitted an amicus curiae brief, contended that the defense of *in pari delicto* should bar recovery against a defendant brokerage firm whose liability was based on its status as a "controlling person" over the defrauding party. *Id.* at 2631 n.25. This claim was based on the fact that, due to this status, the brokerage firm's liability was vicarious. *Id.* The Court expressed no opinion on this contention since neither the defendant nor the Ninth Circuit had raised the issue previously. *Id.*

138 *Id.*

139 *Id.* In reviewing this case on appeal, the Supreme Court accepted the facts as they were presented in the complaint as being true since the district court dismissed the case based on the pleadings. *Id.*

140 *Id.*

141 *Id.*

142 *See id.*

143 *Id.* This issue was raised by the SEC in its amicus brief. *See* SEC Brief, *supra* note 12, at 25.

144 *Bateman Eichler*, 105 S. Ct. at 2631-32.

145 *See id.* at 2632.

146 *Id.*

to the Court, the rationale behind this objective is that the insider is the "fountainhead" of the inside information; if, therefore, the insider is inhibited from releasing such information, a 10b-5 violation may be averted.[147] The Court also reasoned that an insider is more likely to have the benefit of counsel than the investor and, as such, is more likely to know that his conduct is wrong.[148] As a result of these public policy factors, the Court concluded that the defense of *in pari delicto* was inappropriate in actions such as the one before it.[149]

In the final part of the opinion, Justice Brennan addressed one of the key reasons emphasized by lower courts allowing the defense.[150] This was the so-called "enforceable warranty."[151] Under this doctrine, if the tip received proves accurate, the tippee acquires illegal profits and therefore has no reason to sue.[152] Conversely, if the tip proves incorrect, the tippee sues the tipper for the money lost.[153] The Court was not persuaded by the enforceable warranty theory for two reasons.[154] First, a tippee would only be able to recover if the insider acted with scienter.[155] Therefore, according to the Court, only when a tippee has been deliberately defrauded will he be able to recover.[156] Secondly, the tippee would be subject to substantial civil and criminal penalties under the Insider Trading Sanctions Act of 1984[157] and, as such, would not be free of liability for his actions.[158] The Court concluded that because the public interest was best protected by denying the defense, *in pari delicto* did not bar the investors from

147 *Id.* (citing Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50, 57-58 (S.D.N.Y. 1971)).

148 *Id.*

149 *Id.*

150 *See id.* at 2632-33.

151 *Id.*

152 *Id.*

153 *Id.*

154 *Id.* at 2633.

155 *Id. See also supra* note 87 for definition of scienter.

156 *Bateman Eichler*, 105 S. Ct. at 2633.

157 Pub. L. No. 98-376, § 1, 98 Stat. 1264 (codified as amended at 15 U.S.C. § 78u(d)(2)(A). (Supp. 1985)). Under the Act, the amount of the civil penalty that may be imposed is "determined by the court in light of the facts and circumstances" of each case. 15 U.S.C. § 78u(d)(2)(A). The penalty, however, may "not exceed three times the profit gained or loss avoided as a result of such unlawful purchase or sale" in violation of rule 10b-5. *Id.* The Act also provides for a criminal sanction of not more than $100,000. 15 U.S.C. § 78ff(a) (Supp. 1985). Prior to passage of the Act, the maximum criminal penalty was $10,000. *Id.*

158 *Bateman Eichler*, 105 S. Ct. at 2633 n.32.

recovering against the insiders in *Bateman Eichler*.[159]

In reaching this conclusion, the Supreme Court applied the correct standard of law by stating that the defense of *in pari delicto* would only be allowed in cases in which the plaintiff is of substantially equal fault with the defendant.[160] The Court, however, erred in avoiding certain issues, as well as by its convoluted analysis of others. In appraising the Court's holding both in terms of the case at bar and in terms of the broad implications it creates, the decision is problematic at best.

The first difficulty created by the Court is in its express holding that the defense will only be allowed in cases in which the plaintiff, by his own actions, "bears at least substantially equal responsibility for the violations he seeks to redress."[161] The trouble created by this standard is that it is unclear. By deciding to hear this case, the Court had before it the opportunity to elucidate what constitutes "substantial equal responsibility," and to elaborate the factors to be considered in determining if equal fault exists. Prior to the Court's decision in *Bateman Eichler*, it was universally held that the standard to be used in cases of this kind was "substantial equal responsibility."[162] The difficulty in those cases, however, arose when courts were asked to determine if the requisite fault existed on the part of the plaintiffs.[163] By failing to set precise guidelines to answer this question, the Court's decision in *Bateman Eichler* is rendered virtually useless as authority in all but identical factual settings.

At various points of its opinion, however, the Court appears to be proffering a formula. For example, the Court, relying on *Dirks*, stated that a tippee's duty is derivative from the tipper-insider.[164] The Court maintained "that a person whose liability is solely derivative can[not] be said to be as culpable as one whose breach of duty gave rise to that liability in the first place."[165] It appears from this statement that the Court is attempting to preclude the defense from ever being raised in the tipper-tippee

---

159 *Id.* at 2633.

160 *Id.* at 2630-31. *See also* Brief of Petitioner at 43, Bateman Eichler, Hill Richards, Inc. v. Berner, 105 S.Ct. 2622 (1985)(No. 84-679)[hereinafter Brief of Petitioner]; SEC Brief, *supra* note 12 at 16.

161 *Bateman Eichler*, 105 S. Ct. at 2629.

162 *See, e.g.*, Tarasi v. Pittsburgh Nat'l Bank, 555 F.2d 1152, 1157 (3d Cir. 1977); Kuehnert v. Texstar Corp., 412 F.2d 700, 704 (5th Cir. 1969); Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50, 57 (S.D.N.Y. 1971).

163 *See, e.g., supra* note 162.

164 *Bateman Eichler*, 105 S. Ct. at 2630.

165 *Id.*

context since a tippee's duty is always derivative.[166] This is inconsistent with the Court's pronounced view that the defense is valid if the "plaintiff bears at least substantially equal responsibility for the violations."[167] The Court then stated that the insider commits a possibly wider range of violations than does his tippee.[168] Therefore, absent other actions by the tippee which could increase his culpability and outweigh the insiders' violations, the tippee cannot be of substantially equal fault with the tipper.[169] Once again the Court seems to be leaving open the availability of the defense, a theme which is inconsistent with its prior expressed view that a tippee cannot be as culpable as his tipper since his duty is derivative.

One of the possible readings of this disparity is that the Court foresees situations in which the tippee's conduct outweighs the insiders' culpable conduct by a great margin.[170] Such a situation would be difficult to imagine. Any such scenario would almost certainly leave the tipper without one of the elements necessary for a 10b-5 violation and, therefore, neither the tipper nor the tippee would be liable since no duty would have been breached by the insider. The decision thereby virtually renders moot the issue of the availability of the defense in the tipper-tippee context.

A correlative problem in *Bateman Eichler* is created by the Court's inconsistent application of the facts. This is significant because it permitted some of the law which the Court espoused to produce seemingly incorrect results. One example of this difficulty is found in the Court's weighing of the relative culpabilities of the parties. The complaint suggested rather strongly that much of the information that Lazzaro disseminated was true.[171] Later in its opinion, the Court appeared to recognize the allegation that Lazzaro "masterminded this scheme to manipulate the

166 This interpretation is based on the theory that if a tippee's duty is derivative, and that a tippee is therefore never as culpable as the insider/tipper, the Court's substantially equal fault standard effectively precludes the application of the defense in future cases.

167 *Bateman Eichler*, 105 S. Ct. at 2629.

168 *See supra* note 157 and accompanying text for an explanation of these violations.

169 *Bateman Eichler*, 105 S. Ct. at 2630-31.

170 This conclusion is based upon the court's judgment that "a person whose liability is solely derivative can[not] be said to be as culpable." *Id.* at 2630. Since the term "substantial equal responsibility" implies a degree of culpability somewhat less than equal, the Court's statement does not totally preclude a finding of culpability on the part of the plaintiff, but does make it much more difficult.

171 *Id.* at 2629 n.21.

market."[172] However, by ultimately accepting the facts as detailed in the complaint, the Court tacitly acknowledged that much of the information that Lazzaro conveyed to the plaintiffs was true and was, therefore, a factor reducing Lazzaro's culpability. This consideration would have been important when the Court weighed Lazzaro's culpability against that of the plaintiff-tippees. The Court, however, never considered this factor when making its analysis.

In addition, the Court failed to take other important facts into consideration. For example, the plaintiffs stated that they were told, and therefore believed, that gold exploration had been performed in Surinam for more than 100 years.[173] The complaint also stated that, in reality, Surinam's highest gold production was in 1908 and that it had declined steadily since that time.[174] These representations as to the length of time that gold had been mined in Surinam were not inaccurate. The plaintiffs made no claim that Lazzaro misrepresented to them the amount of gold that was mined in Surinam. More importantly, the plaintiffs as investors could easily have researched the history of Surinam's gold production.[175] The significance of this point is that when weighing the culpability of the parties, the plaintiff-tippees' reasonableness in relying on the information should certainly have been a factor considered by the Court. The investors in the instant case could easily have investigated the validity of some of Lazzaro's claims, but they failed to do so. As a result, the Court should have increased the plaintiffs' culpability. Moreover, this increased culpability would have been more significant had the Court juxtaposed it with a proper reduction of Lazzaro's fault.[176]

Another problem with the *Bateman Eichler* holding is the Court's disregard of Bateman Eichler's argument concerning the differences between the applicability of the *in pari delicto* defense

---

172 *Id.* at 2631.

173 *See* Joint Appendix, *supra* note 14, at 9.

174 *Id.*

175 *See, e.g.*, NEWSPAPER ENTERPRISE ASSOCIATION, INC., THE WORLD ALMANAC & BOOK OF FACTS 582 (1985).

176 By being forced to weigh relative culpabilities, the Court interposed state common law fraud provisions into its analysis of the use of the *in pari delicto* defense in rule 10b-5 cases. This weighing of culpabilities, however, is in opposition to the determination of liability under the rule. A party is liable under rule 10b-5 if all of the elements of a violation are present. *See supra* note 5 for text of rule. Nowhere in rule 10b-5 is there a provision for weighing culpabilities. Accordingly, measurements of degrees of fault are irrelevant. Thus, the *Bateman Eichler* Court has interjected common law principles into the federal securities laws. Such action should have included a complete and fair analysis of all factors impinging on culpability.

in securities regulation cases as opposed to antitrust actions. Bateman Eichler contended that there were crucial differences between the federal antitrust laws and federal securities laws which made the analogies to *Perma Life* improper.[177] According to the defendants, the critical distinction between the two statutes was that there is an express private right of action in the antitrust statutes, while the private right of action under federal securities laws has only been implied by the courts.[178] While the Court was correct in stating that nothing in *Perma Life* implied that public policy considerations should govern only when Congress has expressly provided for private remedies,[179] the Court failed to address the true value of the defendants' argument. One of the critical considerations that the Court made when considering the public policy implications was whether allowing the defense was consistent with the intent behind the federal securities laws.[180] Since Congress expressly provided for a private right of action in the antitrust laws, it is obvious that the legislature felt that such a right was important for proper enforcement of the federal antitrust laws. By contrast, Congress's failure to expressly provide for a private cause of action in securities laws cases may imply that the legislature did not feel that such a right was as important for enforcement of the securities laws. The *Bateman Eichler* Court failed to address this distinction when drawing analogies between the antitrust and securities laws except to state that whether the right was expressed or implied was irrelevant.[181] If, however, the private right of action is the best way to promote the objectives of the federal securities laws,[182] the Court has failed to answer the question why Congress did not expressly provide for such a right.[183]

---

177 Brief of Petitioner, *supra* note 160, at 31.

178 *Id.* at 32.

179 *Bateman Eichler*, 105 S. Ct. at 2628.

180 *Id.* at 2631.

181 *Id.* at 2628-29.

182 It is worth noting that *Bateman Eichler* appears to end a line of cases which has restricted the private right of action under rule 10b-5. *See, e.g.*, Chiarella v. United States, 445 U.S. 222 (1980) (recognizing that parties must have fiduciary duty to company before disclosure of information is violation); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (making scienter element of 10b-5 violation); TSC Industries v. Northway, Inc., 426 U.S. 438 (1976) (defining materiality and requiring that disclosed information be material to constitute violation). Conversely, the *Bateman Eichler* Court chose to encourage rather than restrict private rights of action.

183 The Court also failed to address why the development of the private right was left to judicial interpretation.

Another criticism of the *Bateman Eichler* holding concerns the Court's affirmation of the policy of protecting the investing public which underlies the federal securities laws. A close reading of the Court's opinion reveals that many of the points raised by the Court under the veil of public policy are tenuous at best. One problem arises from the Court's declaration that the best way to stop information leaks is to cut off the source of the information.[184] While it is true that if there is no one to release material inside information to a tippee, the antifraud goals of the securities laws will be furthered; likewise, if no one takes the information and trades on it, the same goals will be met. It is for that reason that both the "tipper" and "tippee" are held liable for violations of rule 10b-5. The fact that the tippee's duty is derivative is irrelevant. Both the tippee and tipper are liable to defrauded investors when a 10b-5 violation is found.

It is also important to note that disallowing the defense will not prevent insiders from distributing inside information. At the very most, it will keep insiders from disseminating intentionally false information. The value of protecting tippees in such situations is disputable since the tippee has also violated the securities laws.[185]

Furthermore, the *Bateman Eichler* Court reasoned under the public policy rubric that if it allowed the defense of *in pari delicto*, then the SEC would lose a valuable tool used in uncovering 10b-5 violations.[186] Congress, however, has not considered the private suit an important enough tool to express the right in legislation.[187] Nevertheless, in order to buttress its argument, the Court noted that the Insider Trading Sanctions Act of 1984[188]

---

184 *Bateman Eichler*, 105 S. Ct. at 2632.

185 For the sake of analogy, the *Bateman Eichler* Court's analysis may be compared to its possible applications in other legal fields. For example, in the criminal law context, it is difficult, if not impossible, to imagine a court mediating a dispute between an illegal drug dealer and his buyer. This would be true even in cases in which the dealer or buyer cheated the other. Likewise, in the area of contract law, a court will allow the parties to an illegal contract to stand where it finds them. The court will not mediate between wrongdoers. *See also supra* notes 41-46 and accompanying text.

186 *Bateman Eichler*, 105 S. Ct. at 2631.

187 In fact, the validity of the court's argument is rendered somewhat suspect by the facts of the instant case. The investors brought suit against Bateman Eichler and Lazzaro only after learning of an SEC investigation against Lazzaro for possible fraud. *See* Joint Appendix, *supra* note 14, at 14. While this fact is not determinative, it certainly diminishes the validity of the converse argument made by the SEC and by the Court.

188 15 U.S.C. § 78u(d)(2)(A) (Supp. 1985). *See also supra* note 157 for discussion of Act's penalties.

imposes civil and criminal penalties on the investor-tippee.[189] The logic behind this argument is that the tippee should be allowed to recover from the insider, and that such a theory does not give the tippee an "enforceable warranty" since he is still subject to civil and criminal penalties under the Act.

This logic is clearly erroneous. If the penalties that the tippee is subject to under the Insider Trading Sanctions Act of 1984 are less than his anticipated recovery from the suit, then the Act serves as no deterrent to a tippee who traded on inside information and lost. If on the other hand, the penalties are equal to or greater than his anticipated recovery, then no critically thinking tippee would bring the suit since he would have nothing to gain from it, and much to lose. These comments, therefore, defeat the Court's and the SEC's goal of having 10b-5 violations brought into the public view through tippee suits.

Finally, there is a problem with the Court's argument that tippers are more likely than the normal investor to have the advice of counsel, and therefore are more likely to know what conduct is allowable.[190] The error with this logic is that rule 10b-5 does not require the trader to actually know that trading on inside information is a violation of the rule.[191] Therefore, the "unknowing tippee"—one who does not know that trading on inside information is a violation of the rule—is just as guilty as the "knowing tipper" as long as the elements of a 10b-5 violation are present. In addition, it is unlikely that a small investor would be able to command the time and resources necessary to bring a 10b-5 suit. Therefore, the plaintiffs in 10b-5 actions are usually larger investors who are just as likely to have the benefit of counsel as is the insider.

It is suggested that the substantially equal fault standard espoused by the *Bateman Eichler* Court be clearly defined as meaning equal culpability. In cases in which the tippee is at least equally responsible for his losses, he should be barred from recovering from his tipper. In spite of *Dirks*, it is still possible to foresee a situation in which such equal culpability exists. For example, a sophisticated investor may approach a corporate officer and initiate a scheme whereby the investor/tippee receives material nonpublic information. In this case, the tippee is as culpable as the insider because the tippee originated the fraudulent plan.

---

189 *Bateman Eichler*, 105 S. Ct. at 2633 n.31.

190 *Id.* at 2632.

191 *See supra* note 5 for text of rule 10b-5.

Some of the factors which courts should consider in weighing the relative culpabilities of the parties include the sophistication of the tippee/investor, the experience and knowledge of the insider, which of the parties initiated the plan to release the information, and the prior dealings and relationships between the insider and the tippee. If weighing is unworkable because of the inherent subjective nature of these factors, the defense should be barred. This alternative is clearly more in line with the intent of the securities laws to promote fairness in securities transactions. This purpose is better served by a total ban on the *in pari delicto* defense than by its haphazard and inconsistent application.

In conclusion, after considering the foregoing problems associated with the *Bateman Eichler* decision, it becomes clear that the Court did not accomplish its objective. The Court, in attempting to resolve the issue of whether the defense of *in pari delicto* is applicable in rule 10b-5 actions created more questions than it answered. More importantly, the Court's failure to set guidelines for future courts to follow in analyzing the applicability of the *in pari delicto* defense leaves unresolved the issue of the appropriate use of the defense in rule 10b-5 actions.

Eric S. Mandelbaum