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In Pari Delicto And Unclean Hands As Defenses To Private Suit Under SEC Rule 10b-5 - Kuehnert v. Texstar Corp.

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Kuehnert v. Texstar Corp.[1]

In January of 1965 Texstar Corporation was contemplating acquisition of the Coronet Petroleum Company. The news of the merger plans was not made public until March 1965. During the period between January and March, William T. Rhame, president of Texstar, approached plaintiff Albert E. Kuehnert and urged him to join in a scheme to buy up a controlling share of Texstar's stock on the American Stock Exchange. Rhame told Kuehnert of the merger plans and, in addition, told him of secret Texstar oil drillings which would bring enormous increases in the value of company stock, as well as substantial dividends. The latter information was purportedly known only to Rhame and not to other directors or stockholders. In fact, it was completely false and Rhame intended to deceive Kuehnert.

1. 412 F.2d 700 (5th Cir. 1969). The United States District Court for the Southern District of New York relied on *Kuehnert* in Wohl v. Blair & Co., CCH FED. SEC. L. REP. ¶ 92,619 (S.D.N.Y., March 26, 1970). In *Wohl,* stockholders who had purchased stock alleged that they were fraudulently induced to do so by false representations by the defendant-broker to the effect that defendants had inside information. Plaintiffs moved to strike defendants' affirmative defenses of *in pari delicto* and unclean hands. The Court refused to strike the defenses, quoted from *Kuehnert,* and suggested a "caveat tippee" policy: "If such customers learn that they accept 'inside information' at their own risk, many may decide that it is better to reject proffers of such information and to play the game according to the laws and SEC rules enacted for their protection than to risk loss of their hard-earned capital." *Id.* at ¶ 98,780.

Relying on Rhame's "tips,"[2] Kuehnert purchased stock both before and after the March disclosures and suffered considerable losses. Thereafter, he instituted suit against both Rhame and Texstar to recover his damages.[3] The suit was brought in the United States District Court for the Southern District of Texas[4] and was based on Rule 10b–5 of the Securities and Exchange Commission.[5]

The district court granted both defendants summary judgment on the ruling that, as a matter of law, Section 10(*b*) of the Securities Exchange Act of 1934[6] and Rule 10b–5 would not sustain an action by a tippee; these provisions were not designed to protect such a person. Alternatively, the court ruled that the equitable defense of *in pari delicto*[7] barred Kuehnert's action.

On appeal to the Fifth Circuit Court of Appeals, Kuehnert admitted that he traded on inside information and therefore, as a "tippee,"[8] had a duty under Rule 10b–5 to make a disclosure to his seller. Nevertheless, he seems to have questioned whether this obligation should preclude recovery for his losses, especially for the losses resulting from post-March purchases when he only possessed untrue information. In fact, he maintained that circulation of this untrue information was prohibited by Rule 10b–5,[9] and thus there was no violation of a duty.

The fifth circuit affirmed the summary judgments on the basis of both *in pari delicto* and unclean hands,[10] holding that the application of these defenses rested in the sound discretion of the trial court. It found that Kuehnert was *in pari delicto* with Rhame prior to the

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2. Tipping has been defined as "the selective disclosure of material inside (nonpublic) information for trading or other personal purposes." A. BROMBERG, SECURITIES LAW: FRAUD — SEC RULE 10b–5 § 7.5(2) (1969) [hereinafter cited as BROMBERG].

3. Kuehnert also sued B.I. King, a later president of Texstar; but he consented early to summary judgment in King's favor. Kuehnert v. Texstar Corp., 286 F. Supp. 340, 342 (S.D. Tex. 1968). The charges against Texstar were not considered in either district or circuit court opinions.

4. 286 F. Supp. 340 (S.D. Tex. 1968).

5. Rule 10b–5, 17 C.F.R. § 240.10b–5 (1969), reads:

> 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.

6. 15 U.S.C. § 78j(b) (1964).

7. *See* text accompanying note 41 *infra.*

8. Under Rule 10b–5, a tippee might be obligated to reveal any inside information to his potential seller. For discussion of tippee liability, *see* text accompanying notes 18–32 *infra.*

9. Clause (b) of Rule 10b–5 requires not only affirmative disclosure of material information, but also prohibits circulation of false information. BROMBERG § 4.2.

10. *See* text accompanying notes 41–42 *infra.* At least one prior case has recognized that unclean hands might be available in a Rule 10b–5 action. Cartier v. Dutton, 45 F.R.D. 278 (S.D.N.Y. 1965). That decision was concerned with procedural matters, however, and did not address itself to the underlying securities law.

Bromberg has commented that the defense of *in pari delicto* should be applied where co-participants scheme to defraud a third person or where each side in a two-party transaction has made material misrepresentations in dealing with the other. BROMBERG § 11.5 n.23.

disclosures in March because both men were engaged in the same scheme to defraud investors. As to the post-merger-disclosure purchases, the court stated that the men were not *in pari delicto* because of their differing intentions;[11] but it found that Kuehnert had unclean hands in the later period. He violated securities law by *attempting* to defraud his sellers, even though the sellers were not, in fact, injured because of the falsity of the concealed information.[12]

In finding that recovery ought to be denied for losses caused by purchases both before and after March, the fifth circuit analogized to the use of unclean hands in cases under SEC proxy regulations and to the general principles barring recovery by a guilty plaintiff in other areas of law. In the antitrust area, the court reasoned, unclean hands has not always been applied because different policy principles govern; but, even there, suit by a true co-conspirator and voluntary participant may be barred.

Judge Godbold, in his dissent, argued against any use of *in pari delicto* or unclean hands as bars to 10b–5 recovery. He saw the 10b–5 private suit as a powerful weapon against securities fraud, closely analogous to the private antitrust treble-damage action which should not be endangered in its sweeping effect by a "fastidious regard for the relative moral worth of the parties."[13]

Both majority and dissenting opinions, in several places, went beyond the narrow framework of the *Kuehnert* facts, and seemed to consider the use of unclean hands and *in pari delicto* in *all* 10b–5 suits involving trading on inside information.[14] Both agreed that answers to the question before them should be determined by what would best effectuate the securities policy of protecting the investing public.[15] The dissenting opinion emphasized deterring the tipper-insider, who begins the chain of trading on inside information; but from his concern with stopping the tipper in the *Kuehnert* situation, Judge Godbold took the unnecessary step of concluding that equitable defenses ought *never* to bar a 10b–5 action.[16] The majority emphasized deterring the use by the tippee of inside information illegally obtained from the tipper; yet the majority would leave the question of recovery to be determined on the equities of any given case and on the evaluation of the trial judge in that case as to which solution would best serve to discourage fraud.[17]

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11. Kuehnert intended to deceive traders on the American Stock Exchange, while Rhame intended only to deceive Kuehnert. 412 F.2d at 704.

12. The SEC has acted against unsuccessful and potential fraud. N. Sims Organ & Co. v. SEC, 293 F.2d 78 (2d Cir. 1961), *cert. denied*, 368 U.S. 968 (1961); Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949); Trussell v. United Underwriters, Ltd., 228 F. Supp. 757 (D. Colo. 1964).

13. 412 F.2d at 705, *quoting from* Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134, 139 (1968). *See* Note, *Applicability of Waiver, Estoppel, and Laches Defenses to Private Suits Under the Securities Act and S.E.C. Rule 10b-5: Deterrence and Equity in Balance*, 73 YALE L.J. 1477 (1964).

14. 412 F.2d at 703, 705, 706 (majority and minority opinions).

15. The court indicates that by securities policy it means the encouragement of disclosure, before trading, by the trader, of what he believes on a reasonable basis to be true, "because disclosure allows the free market to probe and evaluate his information, accepting what is true and discrediting what is false." 412 F.2d at 704.

16. *See* text accompanying notes 88–91 *infra*.

17. *See* text accompanying notes 92–94 *infra*.

LIABILITY OF TIPPERS AND TIPPEES UNDER RULE 10b–5

The reason for the *Kuehnert* court's resort to very general securities policy is that there are few, if any, other guidelines. The legislative history behind Congress' Section 10(b) and the SEC's Rule 10b–5 is scant;[18] and developments within the last decade have so increased the use of the rule[19] that there has been little chance for legislative or scholarly consideration of any problem before its appearance in an actual case.

Rule 10b–5, when it was promulgated in 1942, did not even provide for civil suit against a violator.[20] The courts found that the allowance of such a suit was necessary and implicit in the broad antifraud purpose behind the legislation.[21] Even where violators might be reached by suits expressly authorized in the 1933 and 1934 securities acts, the courts have allowed victims of fraud to proceed under the broader implied 10b–5 action.[22]

Since the SEC opinion *In re Cady, Roberts & Co.*[23] in 1961, the 10b–5 action has begun to be used in new situations, expanding its effectiveness as a weapon against various forms of trading on inside information. *Cady, Roberts* was a disciplinary proceeding instituted by the SEC against Robert Gintel, a broker who sold stock of the Curtiss-Wright Corporation for certain discretionary accounts after learning of a proposed dividend cut. He learned of the cut by way of a "tip" from one of his partners who was also a director of Curtiss-Wright. In suspending Gintel from the New York Stock Exchange for twenty days, the SEC found that Rule 10b–5 could be violated when a person traded on inside information, whether or not he was in the traditional officer-director-majority stockholder category.[24] Until

18. For discussion of legislative history, *see* BROMBERG § 2.2; 3 L. LOSS, SECURITIES REGULATION (2d ed. 1961); W. PAINTER, FEDERAL REGULATION OF INSIDER TRADING 135 (1968); Comment, *Fraud in Securities Transactions and Rule 10b–5 — A Survey of Selected Current Problems,* 46 N.C.L. REV. 599 (1968); Note, *Texas Gulf Sulphur: Its Holdings and Implications,* 22 VAND. L. REV. 359 (1969); 35 BROOKLYN L. REV. 326 (1969).

19. BROMBERG § 2.5(6).

20. SEC Release No. 3230 (May 21, 1942). The only enumerated action against a 10b–5 violator had to be initiated by the SEC itself. The Commission is authorized to bring injunctive actions in district courts when it appears that someone is engaged in or is about to engage in a violation of the securities acts or SEC rules; the Commission may also transmit evidence to the Attorney General for the institution of criminal proceedings against a violator. 15 U.S.C. § 78u(e) (1964). It can take additional action against members or officers of a national securities exchange, 15 U.S.C. § 78s (1964), or against brokers or dealers and their associates, 15 U.S.C. § 78*o*(b)(5)(D), (b)(7) (1964). It can suspend or revoke the registration of a securities association such as the National Association of Securities Dealers or suspend members of such an association. 15 U.S.C. § 78*o*-3(*l*)(1), (2)(A) (1964).

21. Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946); Comment, *Private Rights from Federal Statutes: Toward a Rational Use of Borak,* 63 NW. U.L. REV. 454 (1968); *see* J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

22. Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); Trussell v. United Underwriters, Ltd., 228 F. Supp. 757 (D. Colo. 1964); Note, *SEC Rule 10b–5 — Use of Material Inside Information in Stock Transactions — SEC Regulation of Corporate Press Releases,* 1969 WIS. L. REV. 310, 319 n.50.

23. 40 S.E.C. 907 (1961).

24. *Id.* at 912. The 1934 Securities Exchange Act had specific provisions aimed against trading by these insiders, 15 U.S.C. § 78p(b) (1964). As to the importance

Cady, Roberts the cases had not applied Rule 10b–5 beyond that group. The Commission said that its task was to identify "those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities."[25]

The expansion of liability to a 10b–5 suit was taken further in *SEC v. Texas Gulf Sulphur Co.*[26] There, lower level employees (an attorney, an engineer, and a geologist) of Texas Gulf Sulphur were found guilty of violating Rule 10b–5 when they made stock purchases on the basis of their knowledge of the extremely favorable results of drilling tests, as of then undisclosed to the public. In addition, tippers, who did not themselves trade on the basis of secret information, but who passed the information to others who traded, were also found violators.[27] *Texas Gulf Sulphur* further suggested by way of dicta that "tippees" who trade on inside information might be violating Rule 10b–5.[28]

The District Court for the Southern District of New York, in *Ross v. Licht,*[29] took the next step by allowing private recovery against three "tippees" who purchased shares of stock in the National Hospital Supply Company. The three tippees were friends of corporate insiders, and they knew of undisclosed plans for a public issue of stock. It seems that the insiders were trying to avoid 10b–5 action by making their tippees nominal purchasers (the tippees passing the stock ultimately to the insiders), and in this they were unsuccessful.[30]

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of specific congressional action against them and its relevance to questions of whether Congress intended to extend liability for nondisclosure to lower level employee traders and tippees, *see* Wiesen, *Disclosure of Inside Information-Materiality and Texas Gulf Sulphur,* 28 MD. L. REV. 189, 194–96 (1968).

25. 40 S.E.C. at 912.

26. 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1968); Weisen, *Disclosure of Inside Information-Materiality and Texas Gulf Sulphur,* 28 MD. L. REV. 189 (1968).

27. For discussion, *see* 82 HARV. L. REV. 938, 942 (1969).

28. 401 F.2d at 852–53. It has been suggested that since *Texas Gulf Sulphur,* corporations may be pressured to indemnify their directors, officers, employees, and agents. Comment, *Insider Indemnification and the Supremacy Clause: The Three Faces of Fraud,* 63 NW. U.L. REV. 523 (1968). For a discussion of the use of insurance to indemnify the corporate insider, *see* Comment, *Indemnification of the Corporate Insider: Directors' and Officers' Liability Insurance,* 54 MINN. L. REV. 667 (1970).

29. 263 F. Supp. 395 (S.D.N.Y. 1967).

30. The SEC exhibited its intention to include business associations as insiders-tippers capable of violating Rule 10b–5 when it began proceedings against Merrill, Lynch, Pierce, Fenner & Smith for giving inside information to certain investment companies and not to other clients. Also charged were the fourteen investment company-tippees. *In re* Merrill, Lynch, Pierce, Fenner & Smith, Inc., [1967–1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,596 (1968). Comment, *Texas Gulf Sulphur: Rule 10b–5 Insider Liability Expanded?,* 71 W. VA. L. REV. 218, 224 (1969); Note, *Texas Gulf Sulphur: A Vigorous Assault on Insider Trading and Misleading Press Releases,* 11 ARIZ. L. REV. 290, 296 (1969). Merrill, Lynch, Pierce, Fenner & Smith, has consented to settlement. *In re* Merrill, Lynch, Pierce, Fenner & Smith, [1967–1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,629 (1968). In continuing the proceedings against the tippees, the SEC has recommended imposition of very harsh penalties for the tippees' part in trading on inside information. Censure, permanent barring from association with brokers or dealers, and revocation of registration as investment advisors or broker-dealers were requested by the SEC. *In re* Investors' Management Co., Inc., CCH FED. SEC. L. REP. ¶ 77,752 (1969). SEC v. Glen Alden Corp., CCH FED. SEC. L. REP. ¶ 92,280 (1968), was likewise a Commission action against a corporate tipper.

The district court's opinion in *Kuehnert* strongly echoed *Ross*. The court found that Kuehnert could be characterized as a tippee; and, as such, he stood in the same position as a corporate insider relative to the provisions of Section 10(b) and Rule 10b–5.[31] The circuit court, too, seemed to accept the liability of a tippee to 10b–5 suit as an established fact.[32]

UNCLEAN HANDS IN CASES UNDER SEC PROXY REGULATIONS

Several decisions have allowed unclean hands to defeat equitable actions brought for violations of Section 14(a) of the 1934 Securities Exchange Act,[33] governing fraud in the solicitation of proxies. The Third Circuit Court of Appeals found in *Gaudiosi v. Mellon*[34] that it could not entertain a Section 14(a) action brought by a plaintiff who had sought to intimidate stockholders from voting in an election for directors of the Pennsylvania Railroad. In *Studebaker Corp. v. Allied Products Corp.*,[35] the court denied Section 14(a) recovery, stating that "[t]here is . . . a strong inference that plaintiff itself conspired against equity and is in violation of the equitable doctrine of unclean hands. . . ."[36] The court exercised discretion in *not* allowing unclean hands as a defense in *Union Pacific Railroad v. Chicago and North Western Railway*.[37] In that case, both Union Pacific and North Western sought to win support of Rock Island stockholders so that they might take over Rock Island assets. Each claimed foul play by the other in proxy solicitation. The court granted plaintiff's request for a preliminary injunction against the scheduled meeting of Rock Island stockholders and ordered a new proxy solicitation. Its concern was not so much for the plaintiff as for the Rock Island shareholders. It said, "To apply the [unclean hands] maxim in this case would produce the illogic of leaving the shareholders unprotected when they have been doubly misled, stultifying the underlying purpose of the national securities laws."[38] In *Kuehnert*, the fifth circuit majority likewise reasoned that discretion might be invoked to allow recovery where, in a particular case, denying recovery would substantially affect innocent parties.[39]

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31. 286 F. Supp. at 345. But mere tippees may not be in any special relationship with a company at all. It has been suggested that holding them liable, especially beyond the "first degree tip," may be unworkable. Note, *Texas Gulf Sulphur: A Vigorous Assault on Insider Trading and Misleading Press Releases*, 11 ARIZ. L. REV. 290, 295–97 (1969). *See* text accompanying notes 86–95 *infra*.

32. 412 F.2d at 702.

33. 15 U.S.C. § 78n(a) (1964). This section prohibits fraud in the solicitation of proxies. It is broad like section 10(b) and enables the SEC to prescribe rules and regulations. There is no specifically authorized private right of action.

34. 269 F.2d 873 (3d Cir.), *cert. denied*, 361 U.S. 902 (1959).

35. 256 F. Supp. 173 (W.D. Mich. 1966).

36. *Id.* at 192.

37. 226 F. Supp. 400 (N.D. Ill. 1964).

38. *Id.* at 410.

39. *See* 412 F.2d at 704.

In Pari Delicto AND UNCLEAN HANDS IN OTHER AREAS OF THE LAW

Courts have traditionally been reluctant to aid a plaintiff who has been engaged in the same scheme as or conduct similar to that of which he complains.[40] Equity courts originated the defenses of *in pari delicto* and unclean hands to prevent such injustice. *In pari delicto* means "[i]n equal fault; equally culpable or criminal. . . ."[41] Unclean hands implies wrongdoing on the part of the complainant which has some proximate relation to the subject matter in controversy.[42] The fault of the plaintiff for unclean hands need not be equal.

Law courts have also long applied similar bars to relief in the defense of consent and in their refusal to allow recovery between joint tortfeasors.[43] As a result of the modern tendency to merge law and equity, the "equity" defenses have found their way into "legal" actions for damages.[44] Equitable defenses are usually applied on a discretionary basis. For example, it has been said that ". . . the clean hands maxim is not an inexorable rule, but will be relaxed where public policy would be better served by so doing. . . ."[45]

Among areas of the law closely analogous to securities law, there are frequent examples of the application of the unclean hands and *in pari delicto* defenses. One of these is common law fraud. In effect, a suit brought under Rule 10b–5 is only a specialized type of fraud action:[46] the plaintiff is alleging that he suffered some harm because of the defendant's fraudulent manipulation of securities.

Fraud or misrepresentation actions originated in English equity courts when law courts lacked forms to deal with such problems.[47] Therefore it is natural to find that fraud actions have been subject to those restrictions peculiar to equity. Generally one guilty of fraud himself cannot secure redress for an injury arising out of the same transaction.[48] For example, in *Goldstein v. Enoch,*[49] a California court of appeals invoked the doctrine of *in pari delicto* to prevent a minority stockholder from recovering part of the profit made when the ma-

40. *See, e.g.,* New York Football Giants, Inc. v. Los Angeles Chargers Football Club, Inc., 291 F.2d 471 (5th Cir. 1961); Ford v. Caspers, 42 F. Supp. 994 (N.D. Ill. 1941).

41. BLACK'S LAW DICTIONARY 898 (4th ed. 1951). *See* 3 J. POMEROY, EQUITY JURISPRUDENCE § 940 (5th ed. 1941); W. WAIT, 1 ACTIONS AND DEFENSES 153 (1877).

42. BLACK'S LAW DICTIONARY 1694 (4th ed. 1951); H. MCCLINTOCK, PRINCIPLES OF EQUITY § 26 (2d ed. 1948); 2 J. POMEROY, EQUITY JURISPRUDENCE § 397 (5th ed. 1941).

43. *E.g.,* Union Stock Yards v. Chicago, B. & O.R.R., 196 U.S. 217 (1905); Ford v. Ford, 143 Mass. 577, 578, 10 N.E. 474, 475 (1887); Wright v. Starr, 42 Nev. 441, 179 P. 877 (1919); Wallace v. Brende, 66 S.D. 582, 287 N.W. 328 (1939).

44. 412 F.2d at 704; 4 J. POMEROY, PRINCIPLES OF EQUITY § 1368 (2d ed. 1948).

45. Shinsaku Nagano v. McGrath, 187 F.2d 753, 759 (7th Cir. 1951).

46. Rule 10b–5 has merely eliminated some requirements for a cause of action in common law fraud, BROMBERG § 2.7(1); Note, *In Pari Delicto as a Defense for a Violation of Rule 10b–5,* 47 N.C.L. REV. 984, 987 (1969).

47. W. PROSSER, TORTS § 100, p. 701 (3d ed. 1964).

48. *See, e.g.,* Sankin v. 5410 Connecticut Ave. Corp., 281 F. Supp. 524 (D.D.C. 1968); Chohon v. Farmers & Merchants Bank, 231 Cal. App. 2d 538, 41 Cal. Rptr. 888 (Dist. Ct. App. 1964); Edwards v. Phillips Petroleum Co., 187 Kan. 656, 360 P.2d 23 (1961).

49. 57 Cal. Rptr. 19 (Ct. App. 1967).

jority stockholder bought out his minority share and then resold all the company's stock to a third person by use of a false financial statement. The court said that by seeking recovery, the plaintiff would, in effect, become a participant in the fraudulent sale to the third person.[50] A party to an illegal transaction cannot expect a court of law to enforce rights arising out of that transaction.[51]

A second area of law, in many ways comparable to securities law, is corporate breach-of-trust law. A corporate director or officer, having superior knowledge of corporate dealings and control of corporate property, is held to transact business with stockholders within a framework of fiduciary duties.[52] This principle is identical to the one behind the prohibition on insider trading: corporate insiders and others with access to information about corporate dealings are not expected to use their knowledge for personal benefit in the securities market.[53] State and federal courts have recognized equitable defenses, including *in pari delicto,* to bar recovery by stockholders suing for breach of corporate trust.[54] In *Duffy v. Omaha Merchants' Express & Transfer Co.,*[55] the plaintiff complained that certain corporate directors had accepted excessive salaries in breach of their obligations. The Supreme Court of Nebraska refused to allow recovery since the plaintiff had himself been a director at the time when high salaries had been paid. At least one commentator has written that, because of the close similarity of policies underlying corporate breach-of-trust cases and 10b–5 suits against those who trade on superior knowledge, similar defenses ought logically to apply.[56]

One possible exception to the general allowance of the unclean hands and *in pari delicto* defenses is in the antitrust field.[57] Early decisions by lower federal courts *did* allow equitable defenses to bar a privately instituted action against a violator of the Sherman Act or the Clayton Act.[58] Despite a definite congressional grant of authority for such private actions and, even more, congressional encouragement through the treble-damage provision,[59] the courts were reluctant to depart from the view that allowing recovery to a fellow violator was inequitable and unjustified.

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50. *Id.* at 23.

51. *Id.*

52. Bahlman, *Rule 10b–5: The Case For Its Full Acceptance as Federal Corporation Law,* 37 U. CIN. L. REV. 727, 746 (1968).

53. *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961).

54. *E.g.,* Liken v. Shaffer, 64 F. Supp. 432 (N.D. Iowa 1946); Gottfried v. Gottfried, 112 N.Y.S.2d 431 (Sup. Ct. 1952); Diamond v. Diamond, 107 N.Y.S.2d 508 (Sup. Ct. 1951). Maryland courts have as yet specifically allowed only acquiescence or laches as bars. The *in pari delicto* defense does not seem to have been raised in the state. *E.g.,* Matthews v. Headley Chocolate Co., 130 Md. 523, 100 A. 645 (1917).

55. 127 Neb. 273, 255 N.W. 1 (1934).

56. Bahlman, *Rule 10b–5: The Case For Its Full Acceptance as Federal Corporation Law,* 37 U. CIN. L. REV. 727, 769 (1968).

57. It has recently been suggested that labor law may present an exception comparable to antitrust law. 38 GEO. WASH. L. REV. 337, 341 (1969).

58. *E.g.,* Bishop v. American Preservers Co., 105 F. 845 (N.D. Ill. 1900).

59. 15 U.S.C. §§ 15, 26 (1964).

But beginning in 1948 with *Mandeville Island Farms, Inc. v. American Crystal Sugar Co.*,[60] and following in 1951 with *Kiefer-Stewart Co. v. Joseph E. Seagram & Sons, Inc.*,[61] the Supreme Court was thought to have established a policy of refusing to allow equitable defenses to bar the private antitrust suit.[62] In *Kiefer-Stewart*, a liquor wholesaler who had conspired with other wholesalers to fix minimum prices was suing liquor manufacturers for fixing maximum prices. The majority opinion, written by Justice Black, refused to permit the misconduct of the plaintiffs to cut off the liability of the defendants for their unlawful combination.[63] The Court probably reasoned that since private litigants have been given a significant role in furthering antitrust policy, the effectiveness of their suits should not be hindered by equitable defenses usually arising in actions involving only the interests of the immediate parties.[64] The Court may also have recognized the disenchanted co-conspirator as an ideally interested and knowledgeable complainant.[65]

Some later cases have followed *Kiefer-Stewart* and have allowed guilty plaintiffs to recover treble damages. In *Union Leader Corp. v. Newspapers of New England, Inc.*,[66] a plaintiff who had committed antitrust violations was allowed recovery against a competitor who had set secret discriminatory rates. The First Circuit Court of Appeals noted, "[i]t is now clear that a plaintiff's own antitrust violations do not bar its successful maintenance of a private antitrust action."[67] In *Simpson v. Union Oil Co.*,[68] the Supreme Court reversed the lower court's refusal to grant antitrust damages to a gasoline retailer who was injured by a "consignment" agreement to which he himself was a party.

Recently, however, there has been well-reasoned questioning of the scope of the *Kiefer-Stewart* line of cases.[69] Did they really hold that *in pari delicto* cannot bar recovery in an antitrust suit? The questioning, developed especially in *Pennsylvania Water & Power Co. v. Consolidated Gas Electric Light & Power Co.*[70] and in *Perma Life*

60. 334 U.S. 219 (1948). In that case, the Supreme Court refused to apply a bar in a sugar grower's suit against price-fixing by a refiner with whom he had illegally contracted to sell his entire crop.

61. 340 U.S. 211 (1951).

62. Note, *In Pari Delicto and Consent as Defenses in Private Antitrust Suits*, 78 HARV. L. REV. 1241, 1244 (1965).

63. 340 U.S. at 214. *Kiefer-Stewart* was followed almost immediately by Moore v. Mead Service Co., 340 U.S. 944 (1951), *remanding* 184 F.2d 338 (10th Cir. 1950). The lower court had refused to allow plaintiff to recover against bakers who had entered into an agreement to reduce prices because plaintiff had previously agreed with retailers to have them buy only from him. In remanding, the Supreme Court referred the tenth circuit to *Kiefer-Stewart*.

64. Note, *In Pari Delicto and Consent as Defenses in Private Antitrust Suits*, 78 HARV. L. REV. 1241, 1242 (1965).

65. *Id.*

66. 284 F.2d 582 (1st Cir. 1960).

67. *Id.* at 586.

68. 377 U.S. 13 (1964).

69. Note, *In Pari Delicto and Consent as Defenses in Private Antitrust Suits*, 78 HARV. L. REV. 1241, 1243 (1965).

70. 209 F.2d 131 (4th Cir. 1953).

Mufflers, Inc. v. International Parts Corp.,[71] centers around a distinction between equitable defenses. Whereas unclean hands merely implies that the complainant has been guilty of some relevant misconduct himself, *in pari delicto* literally means that the plaintiff's fault is *equal* to the defendant's.[72] It might narrowly be held to indicate that the plaintiff and the defendant were involved in the same illegal scheme, for equally reprehensible reasons, and with a similarly fraudulent intent. When one does make these distinctions, he can, as do the courts in *Pennsylvania Water* and *Perma Life*, see that *Kiefer-Stewart* and its companion cases may be explained without completely discarding the true defense of *in pari delicto*. In *Mandeville* and *Simpson*, the plaintiffs were "little men," involved in antitrust schemes initiated by "big business" influences. There was some quantum of economic coercion involved in their participation.[73] The reason the Supreme Court allowed them to recover could have been recognition of a coercion exception to *in pari delicto*, rather than refusal to recognize true "equal fault" as a defense. The plaintiffs in *Moore v. Mead Service Co.*[74] and *Kiefer-Stewart* were both guilty of antitrust violations, but neither was involved in the same monopolistic scheme of which he complained. In *Union Leader*, the plaintiff's own illegal discriminatory rate setting was in retaliation for defendant's and was done in desperation to maintain a legally gained competitive position. The first circuit said,

> To the extent that a party has merely sought to offset the other's illegal acts it has not acted with a wrongful intention, nor should its conduct result in public injury. In such a case there would be no reason to encourage recovery by the original offender, and every reason not to.[75]

After making the distinctions between defenses, the *Pennsylvania Water* court recognized *in pari delicto* as a defense to a treble-damage antitrust action where plaintiff and defendant were involved in the same illegal conspiracy. It was convinced that the Supreme Court in *Kiefer-Stewart* was not overruling the allowance of *in pari delicto*, firmly established in pre-*Kiefer* cases.[76]

The Supreme Court itself distinguished between defenses when considering *Perma Life*.[77] In that case the plaintiffs were retail dealers who operated "Midas Muffler Shops" under agreements with defendant,

71. 392 U.S. 134 (1968). *See* Crest Auto Supplies, Inc. v. Ero Mfg. Co., 246 F. Supp. 224 (N.D. Ill. 1965); Rayco Mfg. Co. v. Dunn, 234 F. Supp. 593 (N.D. Ill. 1964).

72. *See* text accompanying notes 40–42 *supra*.

73. *Compare* the *Perma Life* (note 71 *supra*) argument that coercion is involved in franchise agreements *with* those in *Simpson* (note 68 *supra*), *Rayco*, and *Crest* (both cited at note 71 *supra*). All of the lower court cases had viewed franchise agreements as consensual.

74. 340 U.S. 944 (1951). *See* note 63 *supra*.

75. 284 F.2d at 586–87.

76. 209 F.2d at 133–34. The pre-*Kiefer* cases had recognized equitable defenses. *See* note 58 *supra* and accompanying text.

77. Premier Elect. Constr. Co. v. Miller-Davis Co., 292 F. Supp. 213, 218–19 (N.D. Ill. 1968); Note, *The Supreme Court's Rejection of In Pari Delicto as a Defense*, 3 VALPARAISO U.L. REV. 234, *passim* (1969).

Midas, Inc. They complained of certain provisions in their contracts which restricted their right to deal in products other than defendant's. Justice Black's majority opinion reasoned that plaintiffs could recover antitrust damages because "their participation was not voluntary in any meaningful sense."[78] In other words, they were economically coerced. Black failed to make a definitional distinction between *in pari delicto* and broader unclean hands, but he did suggest that "truly complete involvement and participation" might bar recovery.[79] Each of the four justices who wrote separate opinions seemed to agree that there was a difference between a guilty plaintiff whose suit would nevertheless be allowed and a true co-conspirator whose suit might be barred.[80]

The conclusion would seem to be that a true "equal fault" will probably now be a good defense to suits under the Clayton Act treble-damage provision. Even in antitrust, where Congress unquestionably set up the private action as an instrument against monopolistic practices, the courts have not abandoned their concern with fairness. Wherever they can find some small advantage in the plaintiff's position, they will allow him to make his treble recovery because Congress has decided that it needs the help of private citizens in uncovering and acting against trade restraints. But where a plaintiff is attacking exactly the conduct in which he himself is unrepentingly engaged,[81] the scales of justice, despite the strain, will not tip.[82]

In Section 10(b) and Rule 10b–5, no specific private right of action has been given by Congress or by the SEC, much less one encouraged by treble damages.[83] Reasons are not readily available in the legislative history.[84] One might speculate that Congress did not feel that securities fraud endangered as large a segment of the national population as did monopolistic practices. Perhaps it felt that the injured party in a securities fraud case did not need as great an incentive to bring suit as one harmed by an illegal restraint of trade, because he was likely to be closer to and more aware of the identities of his defrauders. In any case, this failure cannot be overlooked. It would seem to justify denying recovery where courts find that both plaintiff and defendant are guilty of misconduct. Congress did not indicate that the guilty plaintiff's suit was needed to effectuate its securities

78. 392 U.S. at 139.

79. *Id.* at 140. Justice Black also wrote the opinion of the Court in *Kiefer-Stewart.* This may explain his desire to discard the defense labeled *in pari delicto,* while upholding the denial of relief where fault is equal.

80. 392 U.S. at 143 (separate opinion of Justice White), 147 (separate opinion of Justice Fortas), 149 (separate opinion of Justice Marshall), 153 (separate opinion of Justice Harlan).

81. Damages may be recoverable if a plaintiff has withdrawn from participation in the scheme. *E.g.,* Victor Talking Mach. Co. v. Kemeny, 271 F. 810 (3d Cir. 1921).

82. One reason given for allowing a plaintiff to recover in spite of an equitable defense raised by the defendant is that the court may exercise its "discretion" in allowing any such defense. *See* note 45 *supra* and accompanying text. If antitrust cases now agree in allowing only true *in pari delicto* to bar recovery, is this discretion not going to be bound up in the determination as to whether the fault of the plaintiff and defendant is *equal*? Where the court feels that recovery is not in the interests of justice, is it not likely to make fine fault distinctions?

83. *See* note 20 *supra.*

84. *See* note 18 *supra.*

plan. There were remedies against the defendant which could be set in motion by the Securities and Exchange Commission,[85] and these were originally regarded as adequate. Therefore, it is easier for a court to concern itself with justice between the parties. It can deny recovery, not only when plaintiff and defendant are precisely *in pari delicto,* but when plaintiff presents himself with any unclean hands.

CONCLUSION

The three varying points of view presented by the *Kuehnert* opinions need to be examined critically. First, the district court opinion that Section 10(b) and Rule 10b–5 were not designed to protect a tippee[86] is too facile and short-sighted. Certainly recovery by a tippee may indirectly aid the ordinary investor if it serves to deter leaks of inside information. Suit *against* a tippee has only been recognized as permissible since *Texas Gulf Sulphur* in 1968. Congress and the SEC, if they have reflected at all on the possibility of tippee suits against tippers, have not made their opinions public.

The circuit court opinions acknowledge the lack of legislative direction and try to reason whether allowing or disallowing equitable defenses will result in cutting off more trading on inside information in the securities markets.[87] Judge Godbold's dissent suggests that the best way to stop misuse of confidential information is to discourage the "insider-tipster" from making the initial disclosure.[88] Insiders are a smaller, more identifiable group; they are more likely to be advised by counsel of the allowable limits of their conduct. On the other hand, tippees are a larger class, difficult to trace; they are less likely to know that action on inside information is prohibited. In fact, the tippee may be no more than "the unsophisticated odd-lot purchaser" who buys a few shares on "confidential" data given to him over the telephone by his broker.[89] The tippee who collects damages remains liable to those

85. *See* note 20 *supra.* It may be significant that despite the growth of private action in the securities field, Congress has not indicated a shift in its position as to the importance of this kind of suit by making it statutory or by allowing multiple damages.

86. 286 F. Supp. at 345.

87. In the remand decision of SEC v. Texas Gulf Sulphur, CCH FED. SEC. L. REP. ¶ 92,572 (S.D.N.Y. 1970), the court was considering the appropriateness of utilizing ancillary relief to the injunctions granted over the objection by the defendants that the SEC was limited to the statutory remedies. In fashioning new remedies, *see* note 93 *infra,* on the basis of § 27 of the 1934 Act, the court was exercising its inherent equity power to devise remedies best able to effectuate the purposes of the 1934 Act. *Id.* at ¶ 98,594. The court *quoted* from Mills v. Electric Auto-Lite Co., CCH FED. SEC. L. REP. ¶ 92,556, 98,536–37 (U.S. Sup. Ct. 1970):

> In selecting a remedy the lower courts should exercise "the sound discretion which guides the determinations of courts of equity," keeping in mind the role of equity as "the instrument for nice adjustment and reconciliation between the public interest and private needs as well as between competing private claims."

Therefore, the application of discretionary equitable defenses to effectuate securities policy is a proper consideration for the court in *Kuehnert.*

88. The dissent sees the "flow" of inside information as the greatest threat to an informed securities market. 412 F.2d at 706; *see* 1969 DUKE L.J. 832, 839–40; *see* Note, *In Pari Delicto as a Defense for a Violation of Rule 10b–5,* 47 N.C.L. REV. 984 (1969).

89. 412 F.2d at 706. Tippees, in fact, may come in a "bewildering variety of forms." BROMBERG § 7.5(6)(a). There are numerous factors which must be considered in deciding just how "guilty" or "sophisticated" or "fraudulent" any tippee may be.

with whom he trades, so that recovery is not a virtual windfall. These arguments have some validity. But Judge Godbold has fallen into a trap when he concludes from them that equitable defenses ought never to be applied in any 10b–5 litigation.

Texas Gulf Sulphur suggested that a tipper should be liable for damages to those who trade with his tippee.[90] The tipper, in such a case, might seek indemnification or contribution from the tippee; and the tippee would probably raise *in pari delicto* as a defense.[91] The circuit court majority's solution would allow the court to look at what the tipper and tippee had done, at the circumstances surrounding their action, and at the results of that action. The court could do what seemed most equitable between the parties and what seemed most likely to discourage trading on inside information in similar cases. The result of Judge Godbold's failure to recognize *in pari delicto* would be to allow contribution in any such case, even where the tippee was his "unsophisticated odd-lot purchaser."

The majority concludes that the better policy choice is to remain flexible and leave upon persons believing themselves tippees the restraint arising from fear of irretrievable loss should they act upon a tip which proves to have been untrue.[92] Tippees who, when they trade, present the same threat to their buyers or sellers as insiders themselves, should not be granted an "enforceable warranty"[93] that the secret in-

For a discussion of some of these factors, *see* BROMBERG § 7.5(6)(a) and Note, *Texas Gulf Sulphur: Its Holdings and Implications,* 22 VAND. L. REV. 359, 378 (1969). Some tippees may be so close to their insider sources as to be virtually indistinguishable as far as tracing and awareness of guilt are concerned.

90. 401 F.2d at 856 n.23. On remand to determine the appropriate remedies to be given the SEC against the defendants, the district court has held that Coates and Darke, both tippers, must pay to Texas Gulf Sulphur the profits gained from their use of inside information. Included in these profits are profits made by the tippees of Darke and Coates. SEC v. Texas Gulf Sulphur, CCH FED. SEC. L. REP. ¶ 92,572, 98,595–97 (S.D.N.Y. 1970). However, the court made a distinction between the tippees who bought on Darke's recommendation, and the tippees who purchased on the recommendation of Darke's tippee. The profits made by these "second degree" tippees were not included in the amount Darke had to pay, as the court felt that limiting the damages to the profits of the "first degree" tippees was a sufficient deterrent to trading on inside information. *Id.* at ¶ 98,597.

The SEC did not proceed against the tippees who in turn became tippers; they kept their profits. This may indicate that the SEC believes the best way to stop the use of inside information is to stop it where it starts. Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding,* 51 VA. L. REV. 1271, 1283 (1965). Yet in a recent action, the SEC has asked for extremely harsh penalties against tippees. *See* note 30 *supra.*

91. Note, *Texas Gulf Sulphur: A Vigorous Assault on Insider Trading and Misleading Press Releases,* 11 ARIZ. L. REV. 290, 297 (1969). Section 11(f) of the 1933 Securities Act gives specific contribution rights between persons involved in making a fraudulent registration statement. 15 U.S.C. § 77K(f) (1964). But where a § 10(b) tipper-defendant sought to join another by third-party procedure, the court required him first to show that he was not *in pari delicto.* Handel-Maatschappij H. Albert De Bary & Co. v. Faradyne Electronics Corp., 37 F.R.D. 357 (S.D.N.Y. 1964); *see* 82 HARV. L. REV. 938, 943 (1969).

92. The majority sees the "use" of inside information as more easily prevented than its "flow." 412 F.2d at 705. The tippee is the party who acquires the immediate benefit, and if he can provide recovery, it is logical to hold him before his tipper. BROMBERG § 7.5(4); 1969 DUKE L.J. 832, 840; 82 HARV. L. REV. 938, 943 (1969). *See also* BROMBERG § 7.5(3)(b).

93. In varying situations a hard and fast rule on allowing or disallowing equitable defenses would cause injustice. The majority's choice of wording "leav[ing] . . . the

formation they receive is true. If given such a warranty, they may be able to sue insiders when information turns out to be false, yet escape liability when it is true because of the difficulties in tracing tippees.[94]

The definitive interpretation of Rule 10b–5 has not yet been enunciated. The development of rational extensions and limitations on liability is still to come. The flexibility of the prevailing *Kuehnert* opinion, which allows courts to seek the best method for discouraging securities manipulation, is laudable.

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restraint arising from the fear of . . . loss" and "enforceable warranty" — contrasts the merits of flexibility as a deterrent to the likelihood of such injustice. 412 F.2d at 705.

94. *Id.*