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CASENOTE

In Pari Delicto Defense in Tippee-Tipper Lawsuits: *Bateman Eichler, Hill Richards, Inc. v. Berner*¹ — The common law defense of “in pari delicto”² denies recovery to plaintiffs who have participated equally with defendants in an unlawful activity.³ It is an equitable defense designed to preserve judicial integrity by preventing wrongdoers from using the courts to profit from their misdeeds.⁴ If the plaintiff’s suit will advance public policy aims, however, courts will not allow the defense.⁵

Defendants have raised the in pari delicto defense in private actions alleging violations of the federal securities laws,⁶ particularly rule 10b-5.⁷ Rule 10b-5, promulgated by the Securities and Exchange Commission (SEC) in 1942 pursuant to section 10(b) of the Securities and Exchange Act of 1934 (1934 Act),⁸ is a broad antifraud

¹ 472 U.S. 299 (1985).

² In pari delicto literally means “in equal fault.” The defense derives from the Latin expression “*in pari delicto potior est conditio possidentis (defendentis)*,” which means “[i]n a case of equal or mutual fault [between two parties] the condition of the party in possession [or defending] is the better one.” BLACK’S LAW DICTIONARY 711 (5th ed. 1979).

³ See *Holman v. Johnson*, 98 Eng. Rep. 1120, 1121 (K.B. 1775). Lord Mansfield stated that the in pari delicto defense was based on the general principle that “[n]o Court will lend its aid to a man who founds his cause of action upon an immoral or illegal act.” *Id.* See also *Handler & Sacks, The Continued Vitality of In Pari Delicto as an Antitrust Defense*, 70 GEO. L.J. 1123, 1128–31 (1982) (discussing origins of in pari delicto at common law) [hereinafter *Handler & Sacks*].

⁴ *Tarasi v. Pittsburgh Nat’l Bank*, 555 F.2d 1152, 1164 (3d Cir.) (citing *Perma Life Mufflers v. Int’l Parts*, 392 U.S. 134, 151 (1968) (Marshall, J., concurring)), *cert. denied*, 434 U.S. 965 (1977).

⁵ 3 J. POMEROY, EQUITY JURISPRUDENCE § 941 (5th ed. 1941).

⁶ See, e.g., *Wolfson v. Baker*, 623 F.2d 1074 (5th Cir. 1980), *cert. denied*, 450 U.S. 966 (1981); *Tarasi*, 555 F.2d 1152; *Malamphy v. Real-Tex Enter.*, 527 F.2d 978 (4th Cir. 1975) (per curiam); *Woolf v. S.D. Cohn & Co.*, 515 F.2d 591 (5th Cir.), *reh’g denied*, 521 F.2d 225 (1975); *James v. DuBreuil*, 500 F.2d 155 (5th Cir. 1974); *Kuehnert v. Texstar Corp.*, 412 F.2d 700 (5th Cir. 1969); *Index Fund v. Hagopian*, 609 F. Supp. 499 (S.D.N.Y. 1985); *Schick v. Steiger*, 583 F. Supp. 841 (E.D. Mich. 1984); *Kirkland v. E.F. Hutton*, 564 F. Supp. 427 (E.D. Mich. 1983); *Grumet v. Shearson/American Express*, 564 F. Supp. 336 (D.N.J. 1983); *Xaphes v. Shearson, Hayden, Stone, Inc.*, 508 F. Supp. 882 (S.D. Fla. 1981); *Moholt v. Dean Witter Reynolds*, 478 F. Supp. 451 (D.D.C. 1979); *In re Haven Indus.*, 462 F. Supp. 172 (S.D.N.Y. 1978); *Nathanson v. Weis, Voisin, Cannon, Inc.*, 325 F. Supp. 50 (S.D.N.Y. 1971).

⁷ 17 C.F.R. § 240.10b-5 (1985). Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

⁸ Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1982). Section 10(b) provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange

(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

provision designed to protect the investing public from unfair and fraudulent business practices.⁹ The SEC has used rule 10b-5 to deter insider trading of securities,¹⁰ a practice considered harmful to the securities markets.¹¹ Insider trading occurs when

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.

⁹ See, e.g., *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*, 495 F.2d 228, 235 (2d Cir. 1974); *SEC v. Texas Gulf Sulpher*, 401 F.2d 833, 858 (2d Cir. 1968), *cert. denied sub nom. Coates v. SEC*, 394 U.S. 976 (1969). Congress intended rule 10b-5 to be, in the words of one of its draftsmen, a "catch-all clause to prevent manipulative devices." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 202 (quoting Thomas G. Corcoran, Hearings on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 115 (1934)), *reh'g denied*, 425 U.S. 986 (1976). Rule 10b-5 has evolved over the years into the principal limitation on trading on the basis of material, nonpublic information. Report of the Task Force on Regulation of Insider Trading 4 (Discussion Draft 1984) (available in the St. Louis University Law School Library) [hereinafter Task Force Report]. The elements of a cause of action under rule 10b-5 generally have been held to be the following: (1) a misrepresentation, omission, or other fraudulent device; (2) in connection with the purchase or sale of securities; (3) scienter by the defendant in making the misrepresentation or omission; (4) materiality of the misrepresentation or omission; (5) justifiable reliance on the fraudulent device (except in SEC and criminal actions); and (6) damages resulting from the fraudulent device (except in SEC and criminal actions). *Id.* at 9. Although § 10(b) does not expressly create a private right of action, courts have implied private actions under rule 10b-5 since 1946. *Kardon v. Nat'l Gypsum*, 69 F. Supp. 512 (E.D. Mich. 1946). In addition, the Supreme Court repeatedly has held that an implied private right of action exists under this section. See, e.g., *Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1983).

¹⁰ See Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CALIF. L. REV. 1, 2 (1982). Insider trading refers to the purchase and sale of securities on the basis of material, nonpublic information, without disclosure of this information to the other party. See generally N. WOLFSON, R. PHILLIPS, & T. RUSSO, *REGULATION OF BROKERS, DEALERS AND SECURITIES MARKETS* ¶¶ 2.14-2.16 (1977). Section 10(b), although used by the SEC to limit insider trading, is not directed specifically at insider trading. The only provision that directly regulates trading by insiders is § 16 of the 1934 Act. 15 U.S.C. § 78p (1982). Section 16 imposes certain reporting requirements and trading restrictions upon a defined category of insiders. Task Force Report, *supra* note 9, at 52. Section 16 has limited impact on most insider trading, however, because it applies only when both purchases and sales are made within six months of each other and extends only to officers, directors, and persons who own more than 10% of a corporation's outstanding securities. *Id.* at 8 n.8. For these and other reasons, therefore, the broad antifraud language of § 10(b) has been used to limit unfair trading activity. *Id.* at 7-8 & n.8.

The SEC has several enforcement remedies available to enforce rule 10b-5 against insider trading. The most widely used remedy is the authority of the SEC to bring actions in United States district courts to enjoin violations of rule 10b-5. 15 U.S.C. § 78u(d) (1982). In addition, the SEC may transmit any evidence concerning alleged fraudulent conduct to the Attorney General, who may institute criminal proceedings. *Id.* See *infra* note 163 for a discussion of enforcement remedies available under the 1934 Act.

¹¹ See Brudney, *Insiders, Outsiders and Informational Advantages under the Federal Securities Laws*, 93 HARV. L. REV. 322, 333-39 (1979). Trading on inside information is considered harmful to the securities market because it allows insiders to manipulate market prices to their own advantage and the disadvantage of the public. See *id.* at 330-34. Moreover, insider trading permits insiders to disserve their corporation and its shareholders by manipulating corporate affairs to affect the price of the corporate stock. See *id.* at 335-36. The Senate Committee on Banking and Currency that reported out the bill that eventually became the 1934 Act stated: "[t]he bill further aims to protect the interests of the public by preventing directors, officers, and principal stockholders of a corporation, the stock of which is traded in on exchanges, from speculating in the stock on the basis of information not available to others." S. REP. NO. 792, 73d Cong., 2d Sess. 9 (1934), *reprinted in* 1

an insider,¹² in possession of material, nonpublic information¹³ concerning a corporation, "tips," recommends, or trades on that information without also disclosing the information to the public.¹⁴ Under certain circumstances, the outside recipient of the information — the "tippee"¹⁵ — also can be held in violation of rule 10b-5 if the tippee trades on the basis of the inside information without disclosing the information to the other party to the trade.¹⁶ In situations where the tippee has traded on the basis of the inside information to his or her own detriment, a tippee may try to recover his or her losses by bringing a lawsuit for fraudulent misrepresentation against the tipper.¹⁷ In such situations the tipper seeks to use the *in pari delicto* defense to bar the tippee's suit.

The federal courts have split over whether the *in pari delicto* defense bars the tippee from recovery in this situation. A majority of federal courts addressing the issue has

FEDERAL SECURITIES LAWS 716 (1983). One commentator, however, has argued that trading on inside information is not harmful to the securities market. See H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966). This commentator claims that insider trading has no discernible impact on other investors in light of the average trading volume. See *id.* at 110. Any impact this trading might have, this commentator argues, performs a useful function by preparing and properly directing the market before public announcement of the information. See also Lorie, *Insider Trading: Rule 10b-5, Disclosure, and Corporate Privacy: A Comment*, 9 J. LEGAL STUD. 819 (1980) (insider trading may enhance the efficiency of the market by making prices more accurate); Wu, *An Economist Looks at Section 16 of the Securities Exchange Act of 1934*, 68 COLUM. L. REV. 260 (1968) (insider trading activity channels additional information to the market which aids fair price determination). It has been claimed also that insider profits provide an appropriate supplement to executive compensation. See MANNE, *supra*, at 138-41. Nevertheless, the Supreme Court, Congress, and the SEC have not accepted the view that insider trading is not harmful to the securities market. See *Dirks v. SEC*, 463 U.S. 646, 659 (1983) (insiders are forbidden from personally using undisclosed corporate information to their own advantage or from giving such information to outsiders for personal gain); H.R. REP. NO. 355, 98th Cong., 1st Sess. 2, reprinted in 1984 U.S. CONG. & AD. NEWS 2274 (insider trading undermines investor confidence in the fairness and integrity of the securities market).

¹² An insider refers to an officer, director, or a controlling stockholder. *Dirks v. SEC*, 463 U.S. 646, 653 (1983) (quoting *In re Cady Roberts & Co.*, 40 S.E.C. 907, 912 (1961)). An insider also may be a corporate agent, fiduciary, or a "person in whom the sellers [of the securities] had placed their trust and confidence." *Id.* at 654 (quoting *Chiarella v. United States*, 445 U.S. 230, 232 (1980)). Under certain circumstances, outsiders may become fiduciaries of the shareholders, "such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation." *Id.* at 655 n.14.

¹³ "Material" information refers to any facts that a reasonable investor would consider important in making a decision to buy or sell a security. *TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). "Nonpublic" information refers to information not generally available to ordinary investors in the marketplace. *In re Investors Management*, 44 S.E.C. 633, 643 (1971).

¹⁴ Federal courts have interpreted rule 10b-5 as imposing an obligation on corporate insiders to disclose material inside information prior to trading or to abstain from trading. See *Texas Gulf*, 401 F.2d at 848; see also *Chiarella v. United States*, 445 U.S. 222, 226-30 (1980) (reviewing administrative and judicial development of "disclose or abstain" rule). See *infra* notes 137-60 and accompanying text for a discussion of the duty to disclose under rule 10b-5.

¹⁵ Tippees are "persons given information by insiders in breach of trust." *Ross v. Licht*, 263 F. Supp. 395, 410 (S.D.N.Y. 1967). Professor Louis Loss coined the word. 6 L. LOSS, *SECURITIES REGULATION* 3561 (2d ed. Supp. 1969).

¹⁶ See *Dirks*, 463 U.S. at 659 (tippee's duty to disclose or abstain from trading is derivative from insider's duty). See *infra* notes 92-136 and accompanying text for a discussion of cases in which courts held tippees in violation of rule 10b-5.

¹⁷ The Third Circuit has stated: "[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." *Tarasi v. Pittsburgh Nat'l Bank*, 555 F.2d 1152, 1154 (3d Cir.), cert. denied, 434 U.S. 965 (1977).

allowed the defense,¹⁸ determining that the voluntary, active participation of the tippee in the illegal trading scheme renders the tippee in pari delicto with the tipper.¹⁹ In contrast, other federal courts have disallowed the defense,²⁰ reasoning that tippees cannot be as culpable as securities professionals and corporate insiders who disseminated the inside information and initiated the fraudulent activity.²¹

In the 1985 case of *Bateman Eichler, Hill Richards, Inc. v. Berner*,²² the United States Supreme Court resolved the split among the lower federal courts. The Court disallowed the in pari delicto defense, ruling that a defendant-tipper may use the defense to bar a private damages action under the federal securities laws only where the plaintiff-tippee bears at least substantially equal responsibility for the violations he or she seeks to redress and preclusion of the suit would not interfere significantly with the effective enforcement of the securities laws.²³ The Court stated that because a tippee's duty to disclose material nonpublic information typically is derivative from the insider tipper's duty, the tippee generally cannot be said to be as culpable as a tipper.²⁴ Absent other culpable actions, the Court concluded, the tippee rarely would bear substantially equal responsibility with the tipper for the violations of rule 10b-5.²⁵ The Court reasoned that denying the defense in these situations would best protect the investing public and the national economy by permitting tippees to bring suit and expose illegal practices by corporate insiders and broker-dealers.²⁶

The plaintiffs in *Bateman Eichler* were a group of investors who purchased large quantities of over-the-counter stock²⁷ of T.O.N.M. Oil and Gas Exploration Corporation (TONM), which they eventually sold at prices substantially below their purchase price.²⁸ The investors alleged that Charles Lazzaro, a registered securities broker employed by Bateman Eichler, Hill Richards, Inc., gave them information which induced them to

¹⁸ See, e.g., *Tarasi*, 555 F.2d 1152; *Malamphy v. Real-Tex Enter.*, 527 F.2d 978 (4th Cir. 1975) (per curiam); *Woolf v. S.D. Cohn & Co.*, 515 F.2d 591 (5th Cir.), *reh'g denied*, 521 F.2d 225 (1975); *James v. DuBreuil*, 500 F.2d 155 (5th Cir. 1974); *Kuehnert v. Texstar Corp.*, 412 F.2d 700 (5th Cir. 1969); *Summerlin v. Blyth Eastman Dillon & Co.*, [1982-1983 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,197 (N.D. Ga. Mar. 23, 1983); *Grumet v. Shearson/American Express*, 564 F. Supp. 336 (D.N.J. 1983); *In re Haven Indus.*, 462 F. Supp. 172 (S.D.N.Y. 1978); *Wohl v. Blair & Co.*, 50 F.R.D. 89 (S.D.N.Y. 1970).

¹⁹ See, e.g., *Tarasi*, 555 F.2d at 1162; *James*, 500 F.2d at 159; *Kuehnert*, 412 F.2d at 703; *Grumet*, 564 F. Supp. at 339; *Haven Indus.*, 462 F. Supp. at 178.

²⁰ See, e.g., *Berner v. Lazzaro*, 730 F.2d 1319 (9th Cir. 1984), *aff'd sub nom. Bateman Eichler v. Berner*, 472 U.S. 299 (1985); *Index Fund v. Hagopian*, 609 F. Supp. 499 (S.D.N.Y. 1985); *Schick v. Steiger*, 583 F. Supp. 841 (E.D. Mich. 1984); *Kirkland v. E.F. Hutton*, 564 F. Supp. 427 (E.D. Mich. 1983); *Xaphes v. Shearson, Hayden, Stone, Inc.*, 508 F. Supp. 882 (S.D. Fla. 1981); *Moholt v. Dean Witter Reynolds*, 478 F. Supp. 451 (D.D.C. 1979); *Nathanson v. Weis, Voisin, Cannon, Inc.*, 325 F. Supp. 50 (S.D.N.Y. 1971).

²¹ See, e.g., *Berner*, 730 F.2d at 1322; *Schick*, 583 F. Supp. at 848.

²² 472 U.S. 299 (1985).

²³ *Id.* at 310-11.

²⁴ *Id.* at 313.

²⁵ *Id.* at 314.

²⁶ *Id.* at 315.

²⁷ Stock traded "over-the-counter" refers to stock which is not traded on a stock exchange. L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 674 (1983). Common stock traded solely over-the-counter generally represents smaller and newer companies than those listed on the stock exchanges. *Id.* The over-the-counter market is a decentralized market in which broker-dealers negotiate transactions among broker-dealers and between broker-dealers and customers. *Id.* at 675-76.

²⁸ *Berner*, 730 F.2d at 1320.

purchase this stock and they subsequently incurred large trading losses.²⁹ The investors alleged that the trading losses resulted from a conspiracy by Lazzaro and Leslie Neadeau, President of TONM, to manipulate the stock price for their own personal gain.³⁰ Specifically, Lazzaro allegedly told the plaintiffs that he knew TONM's president personally and had learned the following nonpublic information: (a) vast amounts of gold had been discovered in Surinam, and TONM had options in thousands of acres in gold-producing regions of Surinam, (b) TONM was engaged in negotiations with other companies to form a joint venture for mining the Surinamese gold, and (c) when this information was made public, TONM stock would increase from \$1.50-3.00 per share to \$10-15 per share.³¹ Plaintiffs tried to confirm this information with Neadeau, but Neadeau would neither confirm nor deny the information. Instead, Neadeau allegedly stated that the information was not "public knowledge" and that Lazzaro was "very trustworthy and a good man."³² The plaintiffs purchased TONM stock in late 1979 and early 1980 for between \$1.50 and \$3.00 per share, eventually selling it at less than \$1.00 per share when the joint mining venture fell through.³³

The plaintiffs filed suit in the United States District Court for the Northern District of California, charging the defendants with violations of, inter alia, section 10(b) of the Securities and Exchange Act of 1934 and SEC rule 10b-5.³⁴ The plaintiffs alleged that Lazzaro gave them the nonpublic information about TONM stock with knowledge of its falsity and with the intention of influencing and manipulating the stock of TONM to enrich himself and Neadeau through commissions and secret profits on purchases and sales of the stock.³⁵ The district court dismissed the complaint for failure to state a claim,³⁶ accepting the defendants' argument that the plaintiffs' complaint showed that the plaintiffs were in *pari delicto* with the defendants and therefore barred from recovery.³⁷

On appeal, the United States Court of Appeals for the Ninth Circuit reversed the lower court's dismissal of the complaint.³⁸ The court held that the doctrine of *in pari delicto* does not apply where the plaintiff is less than co-equally responsible for his or her injury.³⁹ Under the facts presented in the plaintiffs' complaint, the court stated, the defrauded tippees could not be equally responsible for the injury they suffered as a result of the fraudulent scheme.⁴⁰ Moreover, the court concluded, the possible threat of private suits by injured tippees was necessary to deter tippers from knowingly passing

²⁹ *Id.*

³⁰ *Id.*

³¹ *Id.* Lazzaro also allegedly told the plaintiffs that after the announcement of the inside information, TONM shareholders automatically would receive additional stock of a TONM subsidiary without the payment of any additional monies. *Bateman Eichler*, 472 U.S. at 302 n.3.

³² *Berner*, 730 F.2d at 1320.

³³ *Id.*

³⁴ *Bateman Eichler*, 472 U.S. at 301.

³⁵ *Id.* at 303 (quoting Complaint ¶¶ 23, 30, 38). In the alternative, the plaintiffs alleged that the defendants made the representations "recklessly with wanton disregard for the truth." *Id.* at 303 n.5 (quoting Complaint ¶ 32).

³⁶ *Id.* at 304.

³⁷ *Berner*, 730 F.2d at 1320.

³⁸ *Id.*

³⁹ *Id.* at 1322.

⁴⁰ *Id.*

on false information to the investing public.⁴¹ Finally, the Ninth Circuit noted that methods were available to deter the tippee other than outright preclusion of the suit against the tipper.⁴²

In a unanimous decision,⁴³ the Supreme Court affirmed the decision of the Ninth Circuit and resolved the split among the circuits, holding that a tipper may use the in pari delicto defense to bar a tippee's action only where, as a direct result of his or her own actions, the tippee bears substantially equal responsibility for the violations he or she seeks to redress and preclusion of the suit would not interfere significantly with the enforcement of the securities laws.⁴⁴ The *Bateman Eichler* Court determined that a defendant could not use the in pari delicto defense to bar the plaintiff's suit at this stage of the litigation because, absent other culpable actions by the tippee, a tippee generally cannot be equally responsible for violations of rule 10b-5.⁴⁵ Furthermore, the Court reasoned, denying the defense in such circumstances best promotes the objectives of the securities laws.⁴⁶ The Court stressed the SEC's need to have the tippees' assistance to expose unlawful conduct of tippers and render them more easily subject to the appropriate civil, administrative, and criminal penalties.⁴⁷ Moreover, the Court agreed with the Ninth Circuit that there were other, more effective means to deter tippees.⁴⁸ Thus, the Court concluded that permitting defrauded tippees to bring suit would advance the public interest most frequently.⁴⁹ Therefore, the Court held, courts cannot apply the in pari delicto defense to bar the plaintiffs' action.⁵⁰

Bateman Eichler is important because the Supreme Court resolved the split among the circuits by allowing tippers, as defendants in private actions under the securities laws, to raise an in pari delicto defense only in very limited situations. The decision establishes a two-part test to determine whether the in pari delicto doctrine may be applied to bar a tippee's suit. In addition, the *Bateman Eichler* decision is significant because it allows a plaintiff, without regard to a fiduciary duty or special relationship with the defendant, to bring an action under rule 10b-5 for misuse of material, nonpublic information. This result contrasts with the trend of recent Supreme Court decisions to cut back on the scope of liability under rule 10b-5, thereby limiting the ability of plaintiffs to bring actions alleging abuses of inside information.⁵¹

⁴¹ *Id.* at 1323. The court concluded that securities professionals should not be permitted to shield themselves from the consequences of their fraudulent misrepresentations. *Id.* at 1323.

⁴² *Id.* at 1324 n.3. Judge Alarcon noted that the availability of suit against the tipper would not encourage tippees to increase trading; tippees face a difficult burden in succeeding in a private cause of action under rule 10b-5 because of the requirement to prove scienter, that is, to show that the tipper possessed an "intent to deceive, manipulate or defraud." *Id.* In addition, the court noted, the investor who trades on inside information may subject himself or herself to potential criminal liability and civil sanctions by the SEC. *Id.*

⁴³ *Bateman Eichler*, 472 U.S. 299 (1985). Justice Brennan wrote the opinion for the Court; Chief Justice Burger concurred in the judgment. Justice Marshall took no part in the decision.

⁴⁴ *Id.* at 310-11.

⁴⁵ *Id.* at 314.

⁴⁶ *Id.* at 315.

⁴⁷ *Id.* at 315-16.

⁴⁸ *Id.* at 318.

⁴⁹ *Id.* at 319.

⁵⁰ *Id.*

⁵¹ See, e.g., *Chiarella v. United States*, 445 U.S. 222 (1980) (only a relationship of trust and confidence and not mere possession of inside information creates duty to disclose); *Santa Fe Indus.*

This casenote examines the impact of the Supreme Court's decision in *Bateman Eichler* on the availability of the in pari delicto defense in a tippee suit under rule 10b-5. In Part I, the casenote presents an overview of the development of the in pari delicto defense in the area of federal regulatory laws and the scope of rule 10b-5 as defined by the Court. First, this casenote examines the Court's denial of the defense in the antitrust area.⁵² Next, Part I will review lower federal courts' treatment of the defense in private 10b-5 suits.⁵³ This casenote then will examine the effect of recent Supreme Court decisions defining the scope of tippee liability.⁵⁴ Finally, Part I will consider the Insider Trading Sanctions Act of 1984 — a response of the SEC and Congress to the problems of insider trading.⁵⁵

Part II of this casenote takes a closer look at the Court's decision in *Bateman Eichler*.⁵⁶ The final section analyzes the decision of the Court in *Bateman Eichler* and considers the effect the decision will have on insider trading.⁵⁷ This casenote concludes that the Court's analysis, which effectively limits the use of the in pari delicto doctrine in the federal securities area, is the correct approach to the problem of how best to deter insider trading.

I. DEVELOPMENT OF THE IN PARI DELICTO DEFENSE IN THE CONTEXT OF FEDERAL REGULATORY LAW

The statutory and judicial background of *Bateman Eichler* reflects the concern of both Congress and the courts regarding the problem of insider trading. Federal courts responded to the problem of insider trading by differing over the effectiveness of the in pari delicto defense in private actions brought under the federal securities laws. Looking to decisions in the antitrust area where the Supreme Court had rejected the defense,⁵⁸ several federal courts denied the defense to tippees, holding that corporate insiders and securities professionals should not be shielded from the consequences of their unlawful behavior.⁵⁹ In contrast, other courts upheld the in pari delicto defense, reasoning that the voluntary participation of tippees rendered them equally culpable with the defendant tippees.⁶⁰

v. Green, 430 U.S. 462 (1977) (private action under rule 10b-5 will not lie for mere breach of fiduciary duty without deception or manipulation); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (allegations of negligence insufficient to state a cause of action for damages under rule 10b-5), *reh'g denied*, 425 U.S. 986 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (only purchasers or sellers of securities have standing to sue in private action for damages under rule 10b-5), *reh'g denied*, 423 U.S. 884 (1975). See generally Gilbert, *Proving a Securities Fraud Case After the Recent Supreme Court Decisions: Will the Implied Cause of Action Survive?*, 17 SUFFOLK U.L. REV. 835 (1983) (discussing recent decisions which have made recovery in implied civil actions under the federal securities laws more difficult).

⁵² See *infra* notes 69–90 and accompanying text.

⁵³ See *infra* notes 92–136 and accompanying text.

⁵⁴ See *infra* notes 137–60 and accompanying text.

⁵⁵ See *infra* notes 161–80 and accompanying text.

⁵⁶ See *infra* notes 182–221 and accompanying text.

⁵⁷ See *infra* notes 222–284 and accompanying text.

⁵⁸ See, e.g., *Perma Life Mufflers v. International Parts Corp.*, 392 U.S. 134 (1968); *Keifer-Stewart Co. v. Joseph E. Seagram & Sons*, 340 U.S. 211 (1951).

⁵⁹ See, e.g., *Berner*, 731 F.2d at 1323; *Index Fund*, 609 F.2d at 507; *Moholt*, 478 F. Supp. at 453.

⁶⁰ See, e.g., *Tarasi*, 555 F.2d at 1162–63; *Kuehnert*, 412 F.2d at 703–05; *Grumet*, 564 F. Supp. at 341; *Haven Indus.*, 462 F. Supp. at 180.

Recent decisions by the Supreme Court in the federal securities area, however, narrowed the availability of the *in pari delicto* defense by limiting the scope of tippee liability under rule 10b-5.⁶¹ The Court rejected the theory that a tippee had a duty to disclose information or refrain from trading because of "mere possession" of inside information,⁶² holding instead that a tippee inherited only a "derivative" duty to disclose after a corporate insider had breached a fiduciary duty.⁶³ Congress reacted to this judicial narrowing of the scope of 10b-5 liability by enacting the Insider Trading Sanctions Act of 1984, which was designed to deter insider trading through increased SEC sanctions.⁶⁴ The scope of liability under the 1984 Act is broader than the judicial scope of liability under rule 10b-5, expressing congressional concern over the increasingly widespread problem of insider trading.⁶⁵ The four subsections of Part I of the casenote more closely examine this judicial and statutory background to the *Bateman Eichler* decision.

A. *In Pari Delicto in Private Antitrust Actions Under Federal Regulatory Schemes: Perma Life Mufflers v. International Parts Corp.*

The doctrine of *in pari delicto* traditionally involved purely common-law disputes between private individuals.⁶⁶ Defendants also have used this doctrine, however, in suits brought by plaintiffs under federal regulatory schemes governing commerce and finance.⁶⁷ Courts have found the doctrine difficult to apply in the latter context, however, because federal regulatory schemes generally are designed specifically to protect injured plaintiffs.⁶⁸

⁶¹ See *Dirks v. SEC*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980).

⁶² See *SEC v. Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968), *cert. denied sub nom. Coates v. SEC*, 394 U.S. 976 (1969).

⁶³ *Dirks*, 463 U.S. at 660.

⁶⁴ 15 U.S.C. § 78u(d)(2) (Supp. II 1984).

⁶⁵ See H.R. REP. NO. 355, 98th Cong., 1st Sess. 2, *reprinted in* 1984 U.S. CONG. & AD. NEWS 2274.

⁶⁶ *Woolf v. S.D. Cohn & Co.*, 521 F.2d 225, 226 (5th Cir.), *denying reh'g* to 515 F.2d 591 (1975).

⁶⁷ See, e.g., *Keifer-Stewart Co. v. Joseph E. Seagram & Sons*, 340 U.S. 211 (1951) (*in pari delicto* defense not available when plaintiff engaged in unrelated antitrust violation); *Silverberg v. Paine, Webber Jackson & Curtis, Inc.*, 710 F.2d 678 (11th Cir. 1983) (*in pari delicto* defense not available when plaintiff not shown to engage in illegal activity under federal securities laws); *Mallis v. Bankers Trust*, 615 F.2d 68 (2d Cir. 1980) (*in pari delicto* defense not available when plaintiff's alleged violations were unrelated to rule 10b-5 violations at issue); *Lawler v. Gilliam*, 569 F.2d 1283 (4th Cir. 1978) (*in pari delicto* doctrine not available in action for selling unregistered securities); *Gordon v. DuPont Glare Forgan*, 487 F.2d 1260 (5th Cir. 1973) (defense available in action for violation of stock margin rules when customer knows account is undermargined and takes no corrective action), *cert. denied*, 417 U.S. 946 (1974); *Pearlstein v. Scudder & German*, 429 F.2d 1136 (2d Cir. 1970) (*in pari delicto* defense not available when customer not equally responsible with broker for violating margin requirements); *Jewel Tea Co. v. Local Unions*, 274 F.2d 217 (7th Cir.) (*in pari delicto* defense not available when plaintiff subjected to economic coercion in antitrust violation), *cert. denied*, 362 U.S. 936 (1960); *Pennsylvania Water & Power v. Consolidated Gas & Elec. Light & Power*, 209 F.2d 131 (4th Cir. 1953) (defense of *in pari delicto* available when plaintiff voluntarily entered into illegal antitrust agreement and acted under it for seventeen years); *Serzysko v. Chase Manhattan Bank*, 290 F. Supp. 74 (S.D.N.Y. 1968) (*in pari delicto* defense bars plaintiff's recovery because of plaintiff's active deception in violation of Regulation U), *aff'd*, 409 F.2d 1360 (2d Cir.), *cert. denied*, 396 U.S. 904 (1969); *Kershaw v. Kershaw Mfg.*, 209 F. Supp. 447 (M.D. Ala. 1962) (*in pari delicto* defense applicable when plaintiff instigated illegal agreement), *aff'd per curiam*, 327 F.2d 1002 (5th Cir. 1964).

⁶⁸ *Weitzman v. Stein*, 436 F. Supp. 895, 905 (S.D.N.Y. 1977). The *Weitzman* court stated:

In the 1968 case of *Perma Life Mufflers v. International Parts Corp.*, the United States Supreme Court addressed the applicability of the in pari delicto doctrine in antitrust litigation.⁶⁹ The Court rejected the in pari delicto defense⁷⁰ in a private action brought under the Sherman and Clayton Acts.⁷¹ In separate opinions, however, five Justices agreed that the defense should be available in limited situations,⁷² such as where a plaintiff bore at least substantially equal responsibility for the violation.⁷³ Faced with the several opinions in *Perma Life*, lower courts had difficulty in determining the scope of the in pari delicto defense,⁷⁴ as well as its applicability to federal statutes outside the antitrust area.⁷⁵ In the context of federal securities laws, several courts relied heavily on the analytical framework set out by the *Perma Life* concurrences to determine the appropriateness of the in pari delicto defense,⁷⁶ while other courts sought to distinguish the *Perma Life* holding and restrict its reasoning solely to antitrust litigation.⁷⁷

In *Perma Life*, franchised operators of "Midas Muffler" shops sued the franchisor, its parent corporation, two other subsidiaries, and six officers or agents of the corporation for treble damages, claiming that certain provisions of the Midas franchise sales agree-

Over the years, this notion [equal participation in the illegal act] has proved simple enough in application in purely private disputes between private parties. However, the legislative adoption of comprehensive regulatory schemes, such as the federal securities laws, designed in part for the very purpose of aiding and protecting the injured plaintiffs, has complicated matters.

Id.

⁶⁹ 392 U.S. 134, 135 (1968).

⁷⁰ *Id.* at 140.

⁷¹ Sherman Act § 1, 15 U.S.C. § 1 (1982) (prohibits conspiracies which unreasonably restrain trade); Clayton Act § 3, 15 U.S.C. § 14 (1982) (prohibits agreements to lessen competition). The plaintiffs alleged that the defendants entered into a conspiracy to restrain trade and lessen competition. 392 U.S. at 135. The plaintiffs also alleged price discrimination violating § 2(a) of the Clayton Act, amended by Robinson-Patman Act, 15 U.S.C. § 13 (1982).

⁷² See 392 U.S. at 146 (White, J., concurring); *id.* at 147 (Fortas, J., concurring); *id.* at 149 (Marshall, J., concurring); *id.* at 153 (Harlan, J., joined by Stewart, J., concurring in part and dissenting in part). The other Justices did not preclude the defense but stated, "[w]e need not decide . . . whether . . . truly complete involvement and participation in a monopolistic scheme could ever be a basis . . . for barring a plaintiff's cause of action . . ." *Id.* at 140 (Black, J., joined by Warren, C.J., Douglas and Brennan, JJ.) (opinion of the Court).

⁷³ See *id.* at 146 (White, J., concurring) ("I would deny recovery where a plaintiff and defendant bear substantially equal responsibility for the injury resulting to one of them . . ."); *id.* at 147 (Fortas, J., concurring) ("If the fault of the parties is reasonably within the same scale . . . then the doctrine should bar recovery."); *id.* at 149 (Marshall, J., concurring) ("I would hold that where a defendant . . . can show the plaintiff actively participated in the formation and implementation of an illegal scheme, and is substantially equally at fault, the plaintiff should be barred from imposing liability on the defendant."); *id.* at 154 (Harlan, J., joined by Stewart, J., concurring in part and dissenting in part) ("When a person suffers losses as a result of activities the law forbade him to engage in, I see no reason why the law should award him treble damages from his fellow offenders.") (emphasis in original).

⁷⁴ See, e.g., Handler & Sacks, *supra* note 3, at 1141-52 (discussing lower court interpretations of in pari delicto doctrine after *Perma Life*).

⁷⁵ *Id.* at 1143-48. See also Comment, *The Demise of In Pari Delicto in Private Actions Pursuant to Federal Regulatory Schemes*, 60 CALIF. L. REV. 572, 579-95 (1972) (discussing application of *Perma Life* to securities laws).

⁷⁶ See, e.g., *Tarasi v. Pittsburgh Nat'l Bank*, 555 F.2d 1152 (3d Cir.), *cert. denied*, 434 U.S. 965 (1977).

⁷⁷ See, e.g., *Kuehnert v. Texstar Corp.*, 412 F.2d 700 (5th Cir. 1969).

ment violated Section 1 of the Sherman Act and Section 3 of the Clayton Act.⁷⁸ The defendants contended that because the plaintiffs furthered and supported a monopolistic scheme, the *in pari delicto* doctrine should bar them from bringing suit.⁷⁹ The Supreme Court, in an opinion written by Justice Black, appeared to reject the *in pari delicto* doctrine as an antitrust defense.⁸⁰ Although the Court acknowledged that the plaintiffs may be no less "morally reprehensible" than the defendants, it nonetheless concluded that the deterrent threat posed by private actions under the antitrust laws was necessary to further the overriding public policy favoring competition.⁸¹

Despite rejecting the *in pari delicto* doctrine as a defense in antitrust actions for policy reasons, Justice Black's opinion for the Court analyzed the relative fault of the parties, concluding that even if the defense did exist, the facts in this case would not support it.⁸² The Court concluded that the plaintiffs were less responsible than the defendants for their own injuries because the plaintiffs did not actively support and further the monopolistic scheme.⁸³ Instead, the Court concluded, the plaintiffs were forced to acquiesce in the agreement solely to obtain an otherwise attractive business opportunity.⁸⁴ The Court should not use this acquiescence, the Court stated, as a ground for completely denying the right to recovery under the antitrust laws.⁸⁵

Although all of the Justices agreed with the conclusion that the plaintiffs were not equally responsible with the defendants,⁸⁶ at least five Justices stated in separate opinions that the *in pari delicto* defense still exists when a plaintiff equally and voluntarily participates in the misconduct.⁸⁷ Justices White and Marshall believed that allowing treble damage recovery to a plaintiff who actively participated in the formulation and implementation of an illegal scheme would encourage, rather than deter, violations of the antitrust laws.⁸⁸ In such a situation, these Justices agreed, a limited application of the *in*

⁷⁸ 392 U.S. at 135.

⁷⁹ *Id.* at 140.

⁸⁰ *Id.*

⁸¹ *Id.* at 139. Justice Black cited two earlier private antitrust actions where the Court did not bar the plaintiffs from recovery even though they participated in the alleged violations: *Simpson v. Union Oil*, 377 U.S. 13 (1964) (dealer whose consignment agreement was cancelled for failure to adhere to a fixed resale price could bring suit although he signed the agreement) and *Keifer-Stewart Co. v. Joseph E. Seagram & Sons*, 340 U.S. 211 (1951) (plaintiff not barred from recovery by proof he had engaged in an unrelated antitrust violation). See generally *Handler & Sacks*, *supra* note 3, at 1131-41 (discussing *in pari delicto* under antitrust laws prior to *Perma Life*).

⁸² See *Perma Life*, 392 U.S. at 138-140 (dictum).

⁸³ See *id.* at 139-40. Justice Black concluded that the plaintiffs, rather than being active participants, had the "illegal scheme . . . thrust upon them by Midas." *Id.* at 141.

⁸⁴ *Id.* at 139.

⁸⁵ *Id.* at 140.

⁸⁶ *Id.* at 147 (White, J., concurring) ("The evidence before us does not suggest that the petitioners were equal partners with respondents"); *id.* at 148 (Fortas, J., concurring) ("Clearly, petitioners here are not co-adventurers or partners"); *id.* at 149 (Marshall, J., concurring) ("[T]he record is replete with evidence . . . which indicates . . . that the petitioners did not actively seek out or support all the anticompetitive restraints embodied in the franchise."); *id.* at 156 (Harlan, J., joined by Stewart, J., concurring in part and dissenting in part) ("I would remand this case to determine whether any agreement alleged to be in restraint of trade was one for which the plaintiffs were substantially as much responsible . . . as the defendants.").

⁸⁷ See *supra* note 73 (quoting Justices' conclusions regarding situations where *in pari delicto* defense should be applied).

⁸⁸ See *Perma Life*, 392 U.S. at 146 (White, J., concurring); *id.* at 151 (Marshall, J., concurring). Justice White noted that "by insuring [the plaintiff] illegal profits if the agreement in restraint of

pari delicto defense was both proper and desirable to deter violations of the antitrust laws.⁸⁹

In summary, the Court appeared to reject the in pari delicto doctrine as a defense in antitrust actions. The concurring opinions, however, acknowledged the Justices' concern with the conflict between a wrongdoer using the courts "to profit through his own wrongdoing"⁹⁰ and the strong public interest in deterring potential violators of the antitrust laws. The lack of a clear majority holding on the appropriate role of the in pari delicto defense in antitrust actions subsequently caused confusion in federal courts which analyzed the in pari delicto defense in the context of the federal securities laws.⁹¹

B. In Pari Delicto Defense in 10b-5 Actions in Federal Courts

Innocent plaintiffs who either purchased securities from or sold them to insiders who enjoyed the benefit of special information not available to the general public ordinarily bring private rule 10b-5 suits.⁹² In a tippee suit, however, the plaintiff is a tippee who also possesses inside information that the insider-tipper has revealed.⁹³ Although lower federal courts have been uncertain of the scope of the tippee's liability under rule 10b-5, courts before 1980 generally assumed tippees were under the same affirmative duty as insiders to disclose the inside information or refrain from trading.⁹⁴ Therefore, a tippee's failure to disclose the inside information before trading placed the tippee as well as the tipper in violation of rule 10b-5.⁹⁵ Seeking to foreclose recovery in a suit against the tipper brought by the tippee, the tipper asserted the defense of in pari delicto. Federal courts looked to the several opinions in *Perma Life*, in the antitrust context, to determine the appropriateness of the defense in the context of the federal securities laws. Not surprisingly, they disagreed on whether defendants could successfully use the doctrine to bar plaintiffs' recovery in such tippee 10b-5 suits.

The first case addressing the in pari delicto doctrine in a tippee rule 10b-5 action was the 1969 case of *Kuehnert v. Texstar Corporation*, where the United States Court of Appeals for the Fifth Circuit upheld the defense.⁹⁶ The court held, over a strong dissent,⁹⁷ that the plaintiff's failure to disclose inside information before trading ren-

trade succeeds, and treble damages if it fails, it may encourage what the Act was designed to prevent." *Id.* at 146 (White, J., concurring).

⁸⁹ *Id.* at 149 (Marshall, J., concurring); *id.* at 146 (White, J., concurring).

⁹⁰ *Id.* at 152 (Marshall, J., concurring).

⁹¹ Compare, e.g., *Tarasi v. Pittsburgh Nat'l Bank*, 555 F.2d 1152 (3d Cir.) (court construed *Perma Life* as requiring an analysis of the parties' relative responsibility for the violations and the effect of the result on the enforcement of the regulatory scheme), *cert. denied*, 434 U.S. 965 (1977), with *Nathanson v. Weis, Voisin, Cannon, Inc.*, 325 F. Supp. 50 (S.D.N.Y. 1971) (court construed *Perma Life* as requiring the court to focus on what effect the result would have on protection of the investing public, notwithstanding the plaintiff's illegal conduct).

⁹² See, e.g., *Rogen v. Ilikon Corp.*, 361 F.2d 260 (1st Cir. 1966); *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963); *Ross v. Licht*, 263 F. Supp. 395 (S.D.N.Y. 1967); *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951), *aff'd*, 235 F.2d 369 (3d Cir. 1956).

⁹³ See, e.g., *Ross*, 263 F. Supp. at 410.

⁹⁴ See, e.g., *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied sub nom. Coates v. SEC*, 394 U.S. 976 (1969). See *infra* notes 137-60 and accompanying text for a discussion of Supreme Court decisions establishing the scope of tippee liability under rule 10b-5 after 1980.

⁹⁵ See *id.*

⁹⁶ 412 F.2d 700, 702 (5th Cir. 1969).

⁹⁷ *Id.* at 705 (Godbold, J., dissenting).

dered him in *pari delicto* with the defendant and barred his recovery from the insider.⁹⁸ In *Kuehnert*, the plaintiff received inside information from the President of Texstar Corporation concerning an alleged acquisition which would result in increased dividends and an increased stock value.⁹⁹ When the representation turned out to be false, the plaintiff lost his entire investment.¹⁰⁰

The Fifth Circuit reasoned that, notwithstanding the falsity of the information, the plaintiff (the tippee) believed he had a duty to disclose, yet he attempted to take wrongful advantage of his tip.¹⁰¹ Thus, the court stated, he willingly agreed to participate in an illegal scheme and accordingly, the *in pari delicto* defense barred his recovery.¹⁰² In reaching this conclusion, the *Kuehnert* court distinguished the Supreme Court's holding in *Perma Life*¹⁰³ by restricting that holding to the antitrust area.¹⁰⁴ The *Kuehnert* court noted that the degree of public interest in antitrust suits was greater than in private SEC violations between two individuals.¹⁰⁵ Furthermore, the court stated, the plaintiff actively and voluntarily participated in the wrongdoings, in contrast to an antitrust action where there may be economic duress and unequal bargaining power among parties.¹⁰⁶ Regardless of the relative fault of the parties, the court declared, the pivotal question whether to apply the *in pari delicto* defense turned on whether doing so would increase the protection of the investing public.¹⁰⁷ The court concluded that the defense should be available to defendants in 10b-5 tippee actions to provide some deterrent effect on the activities of tippees and avoid the dangers of creating an enforceable warranty for the tippees against false information.¹⁰⁸ Moreover, the Fifth Circuit observed, corporate insiders already faced substantial deterrent pressures on their conduct.¹⁰⁹

During the early 1970's, most courts followed the decision of the *Kuehnert* court and allowed the use of the *in pari delicto* defense in 10b-5 suits.¹¹⁰ In 1977, in *Tarasi v.*

⁹⁸ *Id.* at 702.

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *Id.* at 703. The plaintiff argued that because the inside information he received was false, he concealed nothing from his vendors. *Id.* The court rejected this argument, noting that regardless of whether the fraud was successful or only an attempt, "the statutory phrase 'any manipulative or deceptive device,' 15 U.S.C. § 78j(b) seems broad enough to encompass [such] conduct." *Id.* at 704.

¹⁰² *Id.* at 703.

¹⁰³ 392 U.S. 134 (1968).

¹⁰⁴ *Kuehnert*, 412 F.2d at 703.

¹⁰⁵ *Id.*

¹⁰⁶ *Id.* at 703-04.

¹⁰⁷ *Id.* at 704.

¹⁰⁸ *Id.* at 705. The court stated that if the court denied the defense to the tipper, the tippee would have "an enforceable warranty that [the] secret information is true. It is then he that will have free rein. If what he is told is false, he can recover against his informer." *Id.* In contrast, the dissent in *Kuehnert* urged that the best way to stop misuse of confidential information was to place maximum pressure on the source of the information — the tipper — to discourage the initial disclosure of the information. *Id.* at 706 (Godbold, J., dissenting).

¹⁰⁹ *Id.* at 705. The dissent argued, however, that the *in pari delicto* defense should not bar the tippees' suit because private suits under rule 10b-5 are a major weapon in attaining the objectives of the federal securities laws. *Id.* at 706 (Godbold, J., dissenting).

¹¹⁰ *Malamphy v. Real-Tex Enter.*, 527 F.2d 978 (4th Cir. 1975) (per curiam) (submission of *in pari delicto* defense to the jury is warranted against claims asserted by culpable participants); *James v. DuBreuil*, 500 F.2d 155 (5th Cir. 1974) (*in pari delicto* defense bars plaintiff's action where plaintiff had participated with defendant in fraudulent transaction with intent to violate the securities laws); *In re Haven Indus.*, 462 F. Supp. 172 (S.D.N.Y. 1978) (doctrine of *in pari delicto* bars

Pittsburgh Nat'l Bank, the United States Court of Appeals for the Third Circuit upheld the in pari delicto defense.¹¹¹ In contrast to the *Kuehnert* court, however, the Third Circuit relied on the analytical framework set out in the separate concurrences in *Perma Life* to uphold the in pari delicto defense.¹¹² The plaintiffs in *Tarasi* alleged that the defendant, an officer of the Pittsburgh National Bank, gave them inside information about a proposed merger involving clients of the bank.¹¹³ When the merger failed to materialize, the value of the plaintiffs' stock declined from eight dollars per share to one dollar per share.¹¹⁴ The *Tarasi* court interpreted the *Perma Life* concurring opinions as requiring a two-part analysis to determine the appropriateness of the in pari delicto doctrine in private suits under federal regulatory statutes.¹¹⁵ First, the court found, the plaintiffs' unlawful conduct must be active and significant before it can bar recovery, and if so, then the court must assess carefully the impact that denying recovery would have on the enforcement of statutory schemes.¹¹⁶ The court found that in a tippee-tipster situation, the plaintiffs' voluntary and willing participation in the illegal scheme differs significantly from the "passive and perhaps coerced" participation by plaintiffs in an antitrust action.¹¹⁷ The court noted that the voluntary illegal activities of the plaintiffs presented a serious threat to the investing public.¹¹⁸ Moreover, the Third Circuit observed, the plaintiffs would not have suffered any injury but for the fact they violated the securities laws by purchasing stock on the basis of inside information.¹¹⁹ The court concluded that the plaintiffs' conduct warranted application of the in pari delicto defense.¹²⁰

Turning to the policy issue of enforcement of the securities laws, the *Tarasi* court reasoned that allowing tippee recovery by eliminating the defense would result in only "incremental deterrence" of the tipper violations because the threat of tippee suits against tipsters was questionable.¹²¹ This slight deterrent effect, the court stated, would be

tippees from bringing suit under rule 10b-5); *Wohl v. Blair & Co.*, 50 F.R.D. 89 (S.D.N.Y. 1970) (court should not strike affirmative defense of in pari delicto on pretrial motion because the defense raises serious and substantial legal issues). *Cf. Woolf v. S.D. Cohn & Co.*, 515 F.2d 591 (5th Cir.) (in pari delicto defense, although not applicable on the facts of this case, is available in actions arising under the securities laws), *reh'g denied*, 521 F.2d 225 (1976). *But see Nathanson v. Weis, Voisin, Cannon, Inc.*, 325 F. Supp. 50 (S.D.N.Y. 1971) (although plaintiffs' actions violated rule 10b-5, defense of in pari delicto not available because private suits are necessary to promote the securities laws).

¹¹¹ 555 F.2d 1152, 1162 (3d Cir.), *cert. denied*, 434 U.S. 965 (1977).

¹¹² *Id.* at 1161-62.

¹¹³ *Id.* at 1154-56. The plaintiffs alleged that they purchased stock of Meridian Industries on information given to them by the defendant concerning a proposed merger between Meridian Industries and Paragon Plastics. Specifically, the defendant allegedly told the plaintiffs that the common stock of Meridian, which was then selling at eight dollars per share, would double in price because of the planned merger. *Id.* at 1154.

¹¹⁴ *Id.* at 1154, 1156.

¹¹⁵ *Id.* at 1158-59.

¹¹⁶ *Id.*

¹¹⁷ *Id.* at 1161-62.

¹¹⁸ *Id.* at 1162.

¹¹⁹ *Id.*

¹²⁰ *Id.*

¹²¹ *Id.* at 1163. The court noted that because tippees would have to show scienter as a prerequisite to recovery under rule 10b-5, it was uncertain whether the threat of tippee suits would forestall tipsters from spreading inside information. *Id.*

outweighed by the increase in tippee trading that would result from creating a warranty for tippees by eliminating the defense.¹²² Moreover, the court observed, the possibility of SEC and criminal actions and private suits by non-tippee purchasers and sellers already discouraged tippees from releasing inside information.¹²³ Finally, the Third Circuit concluded that where enforcement concerns are equally balanced, the court may consider the traditional rationale for imposing the *in pari delicto* defense — that wrongdoers should not be permitted to profit through their own wrongdoings.¹²⁴

In contrast to the decisions upholding the *in pari delicto* defense by the *Kuehnert* and *Tarasi* courts, the United States Federal District Court for the Southern District of New York denied the *in pari delicto* defense, holding that the defense was not available to the defendant against tippees who claimed damages from reliance on false inside information.¹²⁵ In *Nathanson v. Weis, Voisin, Cannon Inc.*, the court focused on the effect that allowance or disallowance of the defense would have on protecting the investing public, rather than on the relative fault of the parties.¹²⁶ The plaintiffs in *Nathanson* purchased stock of TST Industries based on a merger "tip" they received from the defendant, a brokerage firm that owned controlling shares in the merging corporations.¹²⁷ The merger took place, but the terms were different from those that the defendant had represented to the plaintiffs, who took a substantial loss.¹²⁸ In denying the defense, the court asserted that the insider or broker-dealer, as the source of the confidential information, presented a greater potential threat than the tippee to undermining the statutory protection intended for the public investor because he or she was in a position to disclose information selectively.¹²⁹ The most effective way to discourage dissemination of inside information, the district court reasoned, was to place maximum pressure on tippees by making the *in pari delicto* defense unavailable to them.¹³⁰

Federal courts which disallowed the defense after *Nathanson* generally focused on the relative fault of the parties, concluding that in tippee-tipper situations the parties were not equally at fault. In one case the court found the facts were unclear as to whether the plaintiff understood and knowingly engaged in the illegal act of using inside information.¹³¹ Another court held that investors could not be as culpable as brokers because brokers are "quasi-fiduciaries" and should be held to a high degree of "trustworthiness and fair dealing."¹³²

¹²² *Id.*

¹²³ *Id.* at 1164.

¹²⁴ *Id.*

¹²⁵ *Nathanson v. Weis, Voisin, Cannon, Inc.*, 325 F. Supp. 50, 53 (S.D.N.Y. 1971).

¹²⁶ *Id.* at 52-53.

¹²⁷ *Id.* at 51.

¹²⁸ *Id.* at 52. The plaintiffs alleged that the defendant made false and misleading statements regarding the exchange ratio at the time of the merger and knew the exchange ratio would not be as stated when he induced plaintiffs to buy TST Industries common stock. *Id.* at 51.

¹²⁹ *Id.* at 57.

¹³⁰ *Id.* at 57-58.

¹³¹ *Kirkland v. E.F. Hutton*, 564 F. Supp. 427, 436-37 (E.D. Mich. 1983).

¹³² *Moholt v. Dean Witter Reynolds*, 478 F. Supp. 451, 453 (D.D.C. 1979). See also *Berner v. Lazzaro*, 730 F.2d 1319, 1322 (9th Cir. 1984) (tippees could not have been as equally responsible for their injuries as securities professionals who initiated fraudulent scheme), *aff'd sub nom. Bateman Eichler v. Berner*, 472 U.S. 299 (1985); *Index Fund v. Hagopian*, 609 F. Supp. 499, 506-07

Other federal courts continued to allow the *in pari delicto* defense, concluding that the tippee generally was a voluntary, active, and essential participant in the illegal activity.¹³³ These courts focused on the effect that denial of the defense would have on the enforcement of the securities laws and protection of the investing public.¹³⁴ In one case, the court noted that eliminating the defense would remove the most effective deterrent of a tippee's use of the information.¹³⁵ Similarly, another court concluded that permitting the tippee to bring suit actually would encourage improper use of inside information.¹³⁶

In summary, lower federal courts had trouble determining the scope of the *Perma Life* decision and analogizing the fault of the tippees and tipplers in a 10b-5 suit to the fault of the parties in an antitrust violation. The courts' speculations on the potential effects that the *in pari delicto* defense would have on the enforcement of the securities laws widened the split among the federal courts as to the proper role of the doctrine in rule 10b-5 actions.

C. The Duty to Disclose Under Rule 10b-5

In addition to the confusion resulting from application of the *Perma Life* opinions, the changing scope of the insider's duty to disclose inside information and its effect on the tippee's duty to disclose added to the difficulty in applying the *in pari delicto* defense in 10b-5 suits. Prior to 1980, courts assumed that tippees were under the same duty to disclose material nonpublic information prior to trading as traditional insiders. Courts applied the "disclose or refrain" rule, holding that a tippee violated rule 10b-5 when the tippee possessed material, nonpublic information that the tippee knew or should have known came from a corporate insider and the tippee failed to refrain from trading or

(D.C.N.Y. 1985) (although plaintiffs' agent allegedly accepted a bribe, plaintiffs were not as culpable as defendants who induced plaintiffs to buy worthless securities).

Courts also disallowed the *in pari delicto* defense in some cases as a result of the narrowed scope of the insider's duty to disclose and the uncertainty over the source of the tippee's duty to disclose. *See Schick v. Steiger*, 583 F. Supp. 841 (E.D. Mich. 1984) (*in pari delicto* defense not available when tippee not shown to violate rule 10b-5 in the absence of a duty to disclose inside information or refrain from trading); *Xaphes v. Shearson, Hayden, Stone, Inc.*, 508 F. Supp. 882 (S.D. Fla. 1981) (*in pari delicto* defense not available because the plaintiff could not be characterized as a tippee in violation of rule 10b-5 in the absence of any facts establishing the defendant as an insider); *Kulla v. E.F. Hutton*, 426 So. 2d 1055 (Fla. Dist. Ct. App. 1983) (tippee did not violate rule 10b-5 in a situation where the tipper was not shown to be a corporate insider and hence, the *in pari delicto* defense did not preclude the tippee from pursuing a legal remedy against the tipper). *But see Grumet v. Shearson/American Express*, 564 F. Supp. 336 (D.N.J. 1983) (*in pari delicto* defense should be available, regardless of whether the tipper is an insider, to discourage improper use of inside information by tippees). *See infra* notes 137-60 and accompanying text discussing the duty to disclose under rule 10b-5.

¹³³ *See, e.g.*, *Summerlin v. Blyth, Eastman Dillon & Co.*, [1982-1983 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,197 at 95,793 (N.D. Ga. Mar. 23, 1983).

¹³⁴ *See, e.g.*, *Wolfson v. Baker*, 623 F.2d 1074 (5th Cir. 1980), *cert. denied*, 450 U.S. 966 (1981); *Summerlin*, [1982-1983 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,197 (N.D. Ga. Mar. 23, 1983); *Grumet*, 564 F. Supp. 336 (D.N.J. 1983); *In re Haven Indus.*, 462 F. Supp. 172 (S.D.N.Y. 1978).

¹³⁵ *Haven Indus.*, 462 F. Supp. at 180.

¹³⁶ *Grumet*, 564 F. Supp. at 341.

disclose the information before trading.¹³⁷ The tippee's violation of rule 10b-5 gave the tipper the opportunity to raise the *in pari delicto* defense and claim the tippee was substantially equally at fault for the alleged damages and, therefore, should be barred from recovery.¹³⁸

In the 1980 decision of *Chiarella v. United States*, however, the United States Supreme Court narrowed the scope of an insider's duty to disclose material, nonpublic information prior to trading.¹³⁹ As a result, the scope of a tippee's duty to disclose under rule 10b-5 also narrowed,¹⁴⁰ making it more difficult to find a tippee in violation of rule 10b-5. This narrowed scope of tippee liability, in turn, limited the situations where a tipper could assert the *in pari delicto* doctrine as a defense to bar the tippee's private damages action.¹⁴¹

In *Chiarella*, the Court rejected the theory that a duty to disclose under section 10(b) arose from mere possession of nonpublic information.¹⁴² Instead, the Court concluded that a duty to disclose arose when one party was entitled to know the inside information held by the other party because of a fiduciary or other similar relationship between them.¹⁴³ Accordingly, the Court reasoned, a trader in stock has no duty to reveal inside information to a prospective vendor if the trader is neither an insider nor a fiduciary.¹⁴⁴ The *Chiarella* Court addressed the issue of tippee liability briefly in a footnote, where it

¹³⁷ See, e.g., *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied sub nom. Coates v. SEC*, 394 U.S. 976 (1969). In *Texas Gulf*, the court concluded that the duty to disclose inside information prior to trading was "also applicable to one possessing the information who may not strictly be termed an 'insider.'" *Id.* The first extension of rule 10b-5 liability to persons not usually considered insiders occurred in *In re Cady Roberts & Co.*, 40 S.E.C. 907 (1961). In *Cady*, the SEC held that the duty to disclose material nonpublic information arose from the existence of a relationship affording access to inside information intended to be available only for corporate purposes and the unfairness of allowing a person in a special relationship to the insider to take advantage of this information by trading without disclosure. *Id.* at 912. See also *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*, 495 F.2d 228, 236-38 (2d Cir. 1974) (Second Circuit imposed duty on tippees to disclose material inside information before trading); *In re Investors Management Co., Inc.*, 44 S.E.C. 633, 641 (1971) (SEC held that a duty is imposed on a tippee when the following elements exist: (a) The tippee possesses information which is material and nonpublic; (b) the tippee knew or had reason to know that the tipper selectively revealed or otherwise improperly disclosed the information; and (c) the information was a factor in the tippee decision to trade).

¹³⁸ See, e.g., *Kuehnert v. Textstar Corp.*, 412 F.2d 700 (5th Cir. 1969).

¹³⁹ 445 U.S. 222, 233-35 (1980).

¹⁴⁰ In the absence of guidance from the Supreme Court, lower courts assumed that the scope of a tippee's duty to disclose under rule 10b-5 was the same as an insider-tipper's duty to disclose, and thus the tippee's duty to disclose narrowed with the narrowing of the insider's duty to disclose. See *supra* note 137 and accompanying text.

¹⁴¹ See *supra* note 132 and accompanying text for rule 10b-5 cases where courts refused to apply the *in pari delicto* defense due to the narrowed scope of tippee liability after *Chiarella*.

¹⁴² 445 U.S. at 235.

¹⁴³ *Id.* at 228.

¹⁴⁴ *Id.* at 229. In *Chiarella*, the defendant worked for a New York financial printer who printed corporate takeover bid announcements. *Id.* at 224. *Chiarella* was able to gather information before the final printing of the takeover bids, use this information to purchase shares of the target companies' stock before the information was released, and later sell the stock for large profits once the information became public. *Id.* The Court held that *Chiarella* had no duty to reveal this information because he had no special relationship with the selling shareholders: "[h]e was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence." *Id.* at 232.

noted that a tippee's obligation has been viewed as arising from his or her role after the fact in a tipper's breach of a fiduciary duty.¹⁴⁵

The Supreme Court relied in part on this observation of the nature of tippee liability under rule 10b-5 in its decision three years later in *Dirks v. SEC*.¹⁴⁶ The *Dirks* Court held that tippees assume a fiduciary duty to disclose or refrain only when there has been a showing that the insider tipper has breached their own duty by deriving a personal benefit from the disclosure and the tippees know or should know that the breach occurred.¹⁴⁷ Thus, the Court concluded, a tippee's duty to disclose or abstain "is derivative from that of the insider's duty."¹⁴⁸

In *Dirks*, Ronald Secrist, a former officer of Equity Funding Corporation of America (EFCA), gave information to Raymond Dirks, a noted investment analyst, alleging a massive fraud at EFCA and urging Dirks to expose it.¹⁴⁹ Prior to exposing the fraud, however, Dirks discussed the information with several clients who had large holdings in EFCA. The clients subsequently sold approximately \$16 million in EFCA stock, thereby causing a rapid and dramatic drop in the market value of the EFCA stock.¹⁵⁰ In an administrative hearing, the SEC found Dirks guilty of aiding and abetting violations of rule 10b-5.¹⁵¹

The Supreme Court reversed Dirks' conviction.¹⁵² The Court held that Dirks, as a tippee of material inside information, had no duty to abstain from using the inside information because the insider tipper from whom he received the information had not breached his duties to shareholders.¹⁵³ The Court emphasized the requirement of a specific relationship between the shareholders and the individual trading on the information.¹⁵⁴ The Court rejected the theory that a tippee "inherits" a fiduciary duty to the shareholders whenever the tippee receives inside information.¹⁵⁵ The Court stated that

¹⁴⁵ *Id.* at 230 n.12.

¹⁴⁶ 463 U.S. 646 (1983).

¹⁴⁷ *Id.* at 660.

¹⁴⁸ *Id.* at 659.

¹⁴⁹ *Id.* at 648-49.

¹⁵⁰ *Id.* at 649-50.

¹⁵¹ *Id.* at 650-51. An administrative law judge found Dirks guilty of aiding and abetting violations of rule 10b-5. See *In re Dirks*, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,812 at 83,941 (Jan. 22, 1981). Upon appeal, the SEC reduced the sanction imposed on Dirks from a 60-day suspension to censure, in light of his role in exposing the massive fraud at EFCA. See *id.* at 83,950. Dirks sought review in the Court of Appeals for the District of Columbia. *Dirks*, 463 U.S. at 652. The court entered judgment against Dirks based on the reasons stated by the SEC in its opinion. *Id.*

¹⁵² *Id.*

¹⁵³ *Id.* at 667. The Court held that Secrist and other EFCA employees did not violate their fiduciary duty to the shareholders because they revealed the information in order to expose the fraud and not to benefit monetarily or personally. *Id.* at 666-67. The dissent argued, however, that adding a special motivational requirement to the insider's fiduciary duty was not justified, because the shareholder's injury caused by the dissemination of inside information by the insider remains the same regardless of the insider's motivation. *Id.* at 673 (Blackmun, J., dissenting). By adding this improper purpose requirement to the insider's fiduciary duty, the dissent argued, the Court limited the investing public's protection under § 10(b). *Id.* at 667-68 (Blackmun, J., dissenting).

¹⁵⁴ *Id.* at 655. The Court also noted that "[u]nder certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for a corporation, these outsiders may become fiduciaries of the shareholders." *Id.* at 655 n.14.

¹⁵⁵ *Id.* at 655-56.

this theory of tippee liability was based on the erroneous idea that the antifraud provisions require equal information among all traders.¹⁵⁶ A legal duty to disclose information, the Court reasoned, arose from the relationship of the parties and not merely from a person's ability to acquire information because of his or her position in the market.¹⁵⁷

Dirks made it more difficult to find a tippee in violation of rule 10b-5. The duty to disclose does not attach to a tippee unless the insider tipper has breached a fiduciary duty to shareholders by disclosing information to the tippee for reasons of personal benefit and the tippee knew or should have known the breach occurred.¹⁵⁸ Only if these conditions are met does a tippee violate rule 10b-5 by trading on the basis of inside information without disclosure. Thus, after *Dirks*, it became more difficult for the defendant-tipper to show that the plaintiff-tippee also violated the same statutory provisions under which the plaintiff sought recovery.¹⁵⁹ Moreover, even if the plaintiff also violated the statutory provision, it became more difficult for the defendant to show that the plaintiff's fault was equal to the defendant's fault, because the tippee's duty to disclose arose only after the fact of the insider's breach of fiduciary duties.¹⁶⁰ The *Dirks* decision thus appeared to limit the effectiveness of the in pari delicto doctrine as a defense available to tippees in actions brought against them by tippees.

D. Legislative Response to Insider Trading — The Insider Trading Sanctions Act of 1984

Despite the SEC's increased enforcement efforts,¹⁶¹ insider trading continued to increase during the late 1970's and early 1980's, exacerbated by the increased activity in

¹⁵⁶ *Id.* at 657.

¹⁵⁷ *Id.* at 657-58. The Court acknowledged that "[d]epending on the circumstances, . . . one's trading on material nonpublic information is behavior which may fall below ethical standards of conduct." *Id.* at 661 n.21. Nevertheless, the Court emphasized that in a statutory area of law such as securities regulation, there are significant distinctions between legal obligations and ethical ideals. *Id.*

¹⁵⁸ *Id.* at 660-62.

¹⁵⁹ The common-law defense of in pari delicto is available only where a plaintiff participated equally with the defendant in the specific illegal behavior that is the subject of the plaintiff's suit. See *supra* notes 2 and 3 discussing the in pari delicto defense.

¹⁶⁰ See *Dirks*, 463 U.S. at 659-60. See also 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, 538-43 (1984) (discussing difficulties tippees face in proving tippees violated rule 10b-5 after *Dirks*) [hereinafter Note, *Availability of Defense*]. The Court's decisions in *Chiarella* and *Dirks* also restrict the ability of a non-tippee plaintiff to bring suit under rule 10b-5. A non-tippee plaintiff has no cause of action against a party who traded on the basis of material nonpublic information in the absence of a duty to disclose to the plaintiff. The Supreme Court imposed a duty to disclose on corporate insiders and other persons who are in a relationship of trust and confidence with the issuer or seller of the securities. See *Dirks*, 463 U.S. at 655; *Chiarella*, 445 U.S. at 228. See also *Moss v. Morgan Stanley Inc.*, 719 F.2d 5, 15 (2d Cir. 1983) (quoting *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983)) (plaintiffs could not maintain cause of action where defendants owed no duty of disclosure to the plaintiff), *cert. denied sub nom. Moss v. Newman*, 465 U.S. 1025 (1984). Moreover, under *Dirks*, the insider or fiduciary must disclose the inside information for the improper purpose of personal gain before the Court considers the duty breached. *Dirks*, 463 U.S. at 662.

¹⁶¹ See Memorandum of the Securities and Exchange Commission in Support of the Insider Trading Sanctions Act of 1982, H.R. REP. NO. 355, 98th Cong., 1st Sess. 21 (1983) (SEC has brought over fifty insider trading cases since 1978, compared to forty cases brought between 1942 and 1978) [hereinafter SEC Memorandum]. As of Feb. 1984, the SEC had brought over 120 enforcement actions alleging violations of the insider trading proscriptions. Lynch, *The Insider Trading Sanctions Act: New Remedies for the SEC*, 31 FED. BAR NEWS & J. 166 (1984). The SEC brought more cases

mergers and tender offers, the growth of the options market, and the increased volume of trading in the securities market generally.¹⁶² By 1984, the SEC felt strongly that the enforcement remedies available under the 1934 Act¹⁶³ were inadequate to deter insider trading.¹⁶⁴ In an attempt to respond to the increasingly widespread problem of insider trading,¹⁶⁵ the SEC proposed legislation in 1982 to increase the remedies available for violations of the 1934 Act.¹⁶⁶ Congress enacted the SEC's proposal in 1984 as the Insider Trading Sanctions Act¹⁶⁷ (1984 Act).

The 1984 Act authorizes the SEC to seek civil penalties of up to three times the amount of profit gained, or loss avoided, by a person who violated the federal securities laws by purchasing or selling a security while in possession of material nonpublic information.¹⁶⁸ Courts also may impose this penalty upon tippers who aid and abet violations

during the four years preceeding 1983 than in all the previous years combined. H.R. REP. NO. 355, 98th Cong., 1st Sess. 5, reprinted in 1984 U.S. CONG. & AD. NEWS 2274 [hereinafter HOUSE REPORT].

¹⁶² HOUSE REPORT, *supra* note 161, at 5; see generally Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1 (1980) (discussing incidence of insider trading and effectiveness of enforcement remedies).

¹⁶³ See 15 U.S.C. § 78u(d) (1982) (SEC can seek injunctions against violations); *id.* at § 780-3(h) (SEC can discipline broker-dealers who violate 1934 Act); *id.* at § 78u(a) (SEC can investigate insider trading violations and publish findings). The 1934 Act subjects violators to possible criminal fines of up to \$10,000 and maximum five-year prison terms for "willful" violations of the 1934 Act. See *id.* at § 78ff(a) (criminal penalties). The SEC also can request that the court order certain equitable remedies such as disgorgement of the illegal profits. See, e.g., SEC v. Blatt, 583 F.2d 1325, 1335 (5th Cir. 1978) (disgorgement deprives wrongdoer of ill-gotten gains); SEC v. Commonwealth Chem. Sec., 574 F.2d 90, 102 (2d Cir. 1978) (disgorgement is a method of forcing defendant to surrender unjust enrichment).

¹⁶⁴ SEC Memorandum, *supra* note 161, at 24. The SEC considers the injunctive remedy inadequate to deter insider trading because it merely requires the defendant to comply with the law, and as such, presents no significant hardship. *Id.* The SEC also considers the disgorgement of illegal profits inadequate because it simply restores a defendant to his or her original position without extracting a penalty for his or her illegal behavior. *Id.* In addition, the SEC considers the \$10,000 criminal fine inadequate because the effects of inflation have diminished its deterrent impact. *Id.* at 26. See SEC v. Randolph, 564 F. Supp. 137 (N.D. Cal. 1983) (court acknowledges inadequacy of SEC remedies to deter insider trading), *rev'd on other grounds*, [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,576 (9th Cir. June 29, 1984).

¹⁶⁵ HOUSE REPORT, *supra* note 161, at 5. See generally Dooley, *supra* note 162 (discussing effectiveness of enforcement efforts in regulating insider trading).

¹⁶⁶ HOUSE REPORT, *supra* note 161, at 8.

¹⁶⁷ 15 U.S.C. § 78u(d)(2) (Supp. II 1984). President Reagan signed the Act into law on August 10, 1984. The House Report, as amended by Senator D'Amato's floor remarks and as further amended by floor comments of Representatives Dingell and Broyhill, is the only comprehensive source of the legislative history. See 130 CONG. REC. S.8912-14 (daily ed. June 29, 1984) (statement of Sen. D'Amato); 130 CONG. REC. H.7756-60 (daily ed. July 25, 1984) (statements of Reps. Dingell and Broyhill). Neither the Senate Banking Committee nor the Senate-House conference prepared a report. For commentary on the Act, see Brodsky, *Insider Trading and the Insider Trading Sanctions Act of 1984: New Wine into New Bottles?*, 41 WASH. & LEE L. REV. 921, 922 (1984); Freeman, *The Insider Trading Sanctions Bill — A Neglected Opportunity*, 4 PACE L. REV. 221 (1984); Langevoort, *The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*, 37 VAND. L. REV. 1273 (1984); Lynch, *The Insider Trading Sanctions Act: New Remedies for the SEC*, 31 FED. BAR NEWS & J. 166 (1984); Stevenson, Jr., *The Insider Trading Sanctions Act: Some Unfinished Business Ahead*, Nat'l L.J., Oct. 15, 1984, at 18, col. 1.

¹⁶⁸ 15 U.S.C. § 78u(2)(A)(Supp. II 1984). The 1984 Act leaves the actual amount of the civil penalty to the discretion of the courts, in light of the facts and circumstances of the case. HOUSE REPORT, *supra* note 161, at 8-9.

by communicating nonpublic information.¹⁶⁹ In addition, the 1984 Act increases the maximum criminal fine for "willful" violations of the 1934 Act from \$10,000 to \$100,000.¹⁷⁰

Congress intended this expansive scope of liability under the 1984 Act as a response to the recent judicial decisions,¹⁷¹ such as *Chiarella*¹⁷² and *Dirks*,¹⁷³ that restricted the scope of liability for rule 10b-5 violations.¹⁷⁴ The 1984 Act is internally inconsistent, however, as it appears to both adopt and abandon the existing judicial approach. On the one hand, the House Report rejected the call for a definition of insider trading clearly indicating those persons and activities subject to liability under the 1984 Act.¹⁷⁵ The House Report noted instead that the law with respect to insider trading was sufficiently well developed to provide adequate guidance.¹⁷⁶ On the other hand, however, the language of the 1984 Act departs from the restrictive judicial approach to rule 10b-5 liability in several ways. First, the House Report makes no reference to the *Chiarella* requirement that a fiduciary duty or special relationship with the issuer must exist before the court can find a violation of the federal securities laws.¹⁷⁷ Moreover, in response to concern over the *Dirks* decision and its possible adverse effect on the SEC's ability to pursue insider trading cases, the House Report indicates that the *Dirks* case involved "unique facts" and should be "narrowly construed" by the courts so that it does not adversely affect the SEC's insider trading program.¹⁷⁸ Thus, while the House Report appears to adopt the existing restrictive judicial approach to rule 10b-5 liability, the language of the 1984 Act is broadly written to give the SEC added flexibility to reach a wide range of abuses.¹⁷⁹

In sum, the straightforward purpose of the 1984 Act was to curb insider trading by increasing the risks run by persons who engage in this activity. The language of the

¹⁶⁹ HOUSE REPORT, *supra* note 161, at 9.

¹⁷⁰ *Id.* at 12.

¹⁷¹ See, e.g., *Chiarella v. United States*, 445 U.S. 222 (1980) (only a relationship of trust and confidence and not mere possession of inside information creates duty to disclose); *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977) (private action under rule 10b-5 will not lie for mere breach of fiduciary duty without deception or manipulation); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (allegations of negligence insufficient to state a cause of action for damages under rule 10b-5), *reh'g denied*, 425 U.S. 986 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (only purchasers or sellers of securities have standing to sue in private action for damages under rule 10b-5), *reh'g denied*, 423 U.S. 884 (1975).

¹⁷² 445 U.S. 222 (1980).

¹⁷³ 464 U.S. 646 (1983).

¹⁷⁴ See *supra* notes 139-60 and accompanying text for a discussion of the Court's restriction of the scope of liability for rule 10b-5 violations.

¹⁷⁵ HOUSE REPORT, *supra* note 161, at 13-14.

¹⁷⁶ *Id.* at 13.

¹⁷⁷ See *supra* notes 139-45 and accompanying text for a discussion of the duty to disclose under *Chiarella*. The House Report cited underwriters, investment analysts, lawyers, accountants, financial printers, government officials, and other persons who learn of material inside information as persons subject to liability under the Act without regard to their relationship to the issuer. HOUSE REPORT, *supra* note 161, at 4.

¹⁷⁸ HOUSE REPORT, *supra* note 161, at 14-15. Because the Act did not include a definition of insider trading, the House Report noted that judicial interpretations of *Dirks* could affect the ability of the SEC to bring actions alleging violations of rule 10b-5. The House Committee therefore directed the SEC to monitor the effects of *Dirks* on the SEC's insider trading program for at least two years. *Id.* at 15.

¹⁷⁹ See *id.* at 8, 13.

legislation, however, does not fit within the judicial guidelines on the scope of liability under rule 10b-5.¹⁸⁰ Thus, in *Bateman Eichler v. Berner*,¹⁸¹ the Court was faced with reconciling the language of the 1984 Act and the need for additional deterrence to insider trading, with the judicially narrowed scope of 10b-5 liability and the conflicting lower court decisions on the availability of the in pari delicto defense in the tippee-tipper context.

II. THE *BATEMAN EICHLER* DECISION — A CLOSER LOOK

In *Bateman Eichler v. Berner*,¹⁸² the Supreme Court, in a unanimous opinion written by Justice Brennan, affirmed the ruling of the Ninth Circuit¹⁸³ by holding that the in pari delicto defense could not serve as a basis to bar the plaintiff's complaint in an action brought under the federal securities laws.¹⁸⁴ The Court also defined the limits of the in pari delicto defense in securities cases.¹⁸⁵

The Court began its analysis by discussing the traditional scope of the common-law defense of in pari delicto.¹⁸⁶ The defense is grounded on the premise that courts should not be used to mediate disputes among wrongdoers, the Court stated.¹⁸⁷ In addition, the Court noted, denial of judicial relief to wrongdoers may act as an effective deterrent to illegal behavior.¹⁸⁸ The Court pointed out, however, that the classic formulation of the in pari delicto defense limited its application only to situations where plaintiffs truly bore at least substantially equal responsibility for their injury.¹⁸⁹ The reason for this limitation, the Court explained, is the possibility of an "inequality of condition" between the parties that creates different degrees in their guilt.¹⁹⁰ Furthermore, the Court stated, even where plaintiffs are substantially equally at fault, public policy considerations may preclude the use of the defense.¹⁹¹

After identifying the common-law scope of the in pari delicto defense, the Court next examined the precedential value of the *Perma Life*¹⁹² decision, which had denied the use of the defense in private antitrust actions.¹⁹³ Anticipating that the *Perma Life* two-step inquiry would not permit the use of the in pari delicto defense, the defendants attempted to distinguish *Perma Life* and restrict its holding only to antitrust violations.¹⁹⁴ The defendants argued that although the antitrust laws expressly provided for private

¹⁸⁰ See Brodsky, *supra* note 167, at 938-40.

¹⁸¹ 472 U.S. 299 (1985).

¹⁸² *Id.*

¹⁸³ *Berner v. Lazzaro*, 730 F.2d 1319 (9th Cir. 1984).

¹⁸⁴ *Bateman Eichler*, 472 U.S. at 314.

¹⁸⁵ *Id.* at 310-11.

¹⁸⁶ *Id.* at 306-07.

¹⁸⁷ *Id.* at 306.

¹⁸⁸ *Id.*

¹⁸⁹ *Id.* at 306-07.

¹⁹⁰ *Id.* at 307. The Court noted that the parties may not be equally at fault because of "an 'inequality of condition' between the parties, . . . or a 'confidential relationship between th[em].'" *Id.* (quoting 3 J. POMEROY, EQUITY JURISPRUDENCE § 942a, at 741 (5th ed. 1941)).

¹⁹¹ *Id.* The Court noted that the defense frequently was precluded in order to promote public interests. *Id.*

¹⁹² 392 U.S. 134 (1968). See *supra* notes 69-90 and accompanying text for a discussion of *Perma Life*.

¹⁹³ *Bateman Eichler*, 472 U.S. at 308 (citing *Perma Life*, 392 U.S. at 140).

¹⁹⁴ *Id.* at 309.

actions — thereby encouraging private enforcement of the antitrust laws — Congress did not provide for a private action under section 10(b) of the 1934 Act.¹⁹⁵ The defendants argued that Congress intended a broader application of common-law defenses to bar private actions under rule 10b-5.¹⁹⁶ The Court, however, concluded that it could apply the views expressed in the concurring opinions of *Perma Life* to implied private actions under the federal securities laws.¹⁹⁷ The Court disagreed with the defendants' interpretation of congressional intent, noting that public policy considerations are not limited to situations where Congress expressly provides for private remedies.¹⁹⁸ In any event, the Court noted, the *in pari delicto* doctrine itself required a careful consideration of public policy concerns before the defendants could use the defense to bar the plaintiff's suit.¹⁹⁹ The Court also rejected the defendants' argument that the securities laws, by providing a savings provision,²⁰⁰ supported a broader scope for equitable defenses.²⁰¹ The Court noted that courts always have construed equitable defenses narrowly in the context of the federal securities laws, because Congress intended these laws to rectify the deficiencies of the available common-law protections in the securities area.²⁰² Accordingly, the Court adopted a two-part inquiry derived from *Perma Life* for determining when a defendant may use the *in pari delicto* defense in securities actions: the court will bar the plaintiff's recovery only if "(1) as a direct result of his own actions, the plaintiff bears at least substantially equal responsibility for the violations he seeks to redress, and (2) preclusion of the suit would not significantly interfere with the effective enforcement of the securities laws and protection of the investing public."²⁰³

After formulating the two-part inquiry to determine if the *in pari delicto* defense is available to the defendant, the Court discussed each of the two elements in greater detail. The Court first addressed the circumstances when, under the first requirement, a plaintiff, as a direct result of his or her own actions, bears substantially equal responsibility for the violations he or she seeks to redress. Proceeding on the assumption that the plaintiffs in this case had violated section 10(b) and rule 10b-5,²⁰⁴ the Court concluded that a tippee cannot be characterized as being of substantially equal culpability as a tipper.²⁰⁵ In the context of insider trading, the Court stated, the recent decision in *Dirks*

¹⁹⁵ *Id.* Courts imply private actions under rule 10b-5 from § 10(b). *Id.* (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975)).

¹⁹⁶ *Id.*

¹⁹⁷ *Id.* at 310.

¹⁹⁸ *Id.*

¹⁹⁹ *Id.*

²⁰⁰ 15 U.S.C. § 78bb(a) (1982). Section 28(a) of the 1934 Act provides in relevant part: "[t]he rights and remedies provided. . . shall be in addition to any and all other rights and remedies that may exist at law or in equity." *Id.*

²⁰¹ *Bateman Eichler*, 472 U.S. at 309.

²⁰² *Id.* at 310. The Court noted that it consistently has maintained that "common law doctrines are sometimes of 'questionable pertinence' in applying the securities laws." *Id.* (citing *Herman & MacLean v. Huddleston*, 459 U.S. 375, 388-89 (1983)).

²⁰³ *Id.* at 310-11.

²⁰⁴ *Id.* at 311. The Court acknowledged, however, the inappropriateness of resolving the question of the plaintiffs' fault solely on the basis of the allegations set forth in the complaint. *Id.* at 311 n.21. The Court noted that it was unclear both as to whether the plaintiffs acquired a duty to disclose and as to the nature of the information on which the plaintiffs traded. *Id.*

²⁰⁵ *Id.* at 314.

v. SEC²⁰⁶ made it clear that a tippee's duty to disclose material nonpublic information was derivative from the insider's duty and arises only after the fact of the insider's breach of fiduciary duties.²⁰⁷ Thus, the Court concluded, because a tippee's duty is solely derivative, the tippee cannot be as culpable as one whose breach of duty gave rise to that liability in the first place.²⁰⁸ Furthermore, the Court reasoned, a tipper who selectively discloses material nonpublic information commits a potentially broader range of violations than does a tippee who trades on the basis of that information.²⁰⁹ While a tippee may be guilty of fraud against individual shareholders, a tipper may be guilty not only of fraud against the individual shareholders, but also of fraud against the issuer itself and perhaps against the tippee by intentionally conveying false or materially incomplete information to the tippee.²¹⁰ Therefore, the Court concluded, the allegations in the complaint that the defendants masterminded this scheme to manipulate the market in TONM stock for their own personal benefit and used the purchasing plaintiffs as unwitting dupes to inflate the price of TONM stock, if true, rendered the broker-dealer and corporate insider far more culpable than the investors.²¹¹

The Court next examined the second inquiry: whether denying the *in pari delicto* defense best promoted the objectives of the securities laws. The Court concluded that permitting defrauded tippees to bring suit and expose illegal practices by corporate insiders and broker-dealers would advance the public interest best.²¹² The Court first noted that barring private actions in tippee-tipper cases would result in a number of alleged fraudulent practices going undetected because of the difficulty in detecting false tipping.²¹³ Moreover, the Court stated, the SEC is more likely to maximize deterrence of insider trading by bringing enforcement pressures to bear upon the sources of such information — corporate insiders and broker-dealers — because they are more likely to be advised by counsel and be better informed on the allowable limits of their conduct than are ordinary investors.²¹⁴

Finally, the Court considered the argument, relied upon by some lower federal courts which have allowed the *in pari delicto* defense,²¹⁵ that denial of the defense would create an enforceable warranty for tippees.²¹⁶ By denying the defense, lower courts posited, if the inside information were correct, the tippee would reap illegal profits; if the information were false, the tippee could sue his or her tipper for recovery.²¹⁷ The

²⁰⁶ 463 U.S. 646 (1983). See *supra* notes 146–60 and accompanying text for a discussion of the *Dirks* case.

²⁰⁷ *Bateman Eichler*, 472 U.S. at 313 (citing *Dirks v. SEC*, 463 U.S. 646, 654–64 (1983)). The Court also noted that the tippee may be liable if he or she otherwise obtains the information illegally or misappropriates it. *Id.* at 313 n.22.

²⁰⁸ *Id.* at 313.

²⁰⁹ *Id.*

²¹⁰ *Id.* at 313–14.

²¹¹ *Id.* at 314.

²¹² *Id.* at 319.

²¹³ *Id.* at 315. The Court noted that the SEC had advised the Court that the SEC has insufficient resources to ensure that false tipping does not occur or is consistently discovered without the aid of exposure by tippee lawsuits. *Id.* (citing Brief for SEC as Amicus Curiae at 25).

²¹⁴ *Id.* at 316–17.

²¹⁵ See, e.g., *Kuehnert v. Texstar Corp.*, 412 F.2d 700, 705 (5th Cir. 1969).

²¹⁶ *Bateman Eichler*, 472 U.S. at 317–18.

²¹⁷ See, e.g., *Kuehnert v. Texstar Corp.*, 412 F.2d 700, 705 (5th Cir. 1969).

Bateman Eichler Court characterized this theory as overstated for failing to consider other significant factors which deterred tippee trading and avoided the danger of creating an enforceable warranty.²¹⁸ First, the Court observed, tippees who bring suit against their tippers to recover damages expose themselves to the threat of substantial civil and criminal penalties under both rule 10b-5 of the 1934 Act and sections 2 and 3 of the Insider Trading Sanctions Act of 1984.²¹⁹ Second, tippees cannot bring a private cause of action under rule 10b-5 in the absence of showing that the defendants acted with scienter, that is, an intent to deceive, manipulate, or defraud.²²⁰ Thus, only in cases where tippers have defrauded tippees deliberately can tippees maintain a private suit for recovery. Therefore, the Court concluded, given the deterrent pressures already facing tippees, allowing defrauded tippees to bring suit would more effectively expose the illegal conduct of corporate insiders and broker-dealers and advance the public interest.²²¹

III. CRITIQUE OF *BATEMAN EICHLER*

The *Bateman Eichler* Court faced the difficulty of reconciling the traditional equitable principles disfavoring recovery by wrongdoers with both the scope of rule 10b-5 liability and the public policy considerations promoting fairness to and protection of the investing public. The lower court decisions had divided on the appropriate role of the *in pari delicto* defense in achieving these goals.²²² The *Bateman Eichler* Court concluded that denial of the defense would best promote the objectives of the securities laws, although the Court did not reject the defense in all situations.²²³

This section of the casenote analyzes the *Bateman Eichler* decision in two subsections. First, this section examines the Supreme Court's reasoning in adopting the already established antitrust test to determine the appropriateness of the *in pari delicto* defense in actions arising under the federal securities laws. This section suggests that the Court correctly analogized actions under the two regulatory schemes. This examination also demonstrates, however, that although the Court's ruling allows for the possibility of the *in pari delicto* defense, the Court's analysis of the two requirements necessary to use the doctrine limits a successful assertion of the defense by the defendant in a tippee-tipper suit.

The second subsection analyzes the impact that denial of the *in pari delicto* defense will have on the practice of insider trading. Unavailability of the defense to the tipper should deter insider trading activity because the tipper will face the additional threat of private suit by tippees. By not eliminating the defense completely, however, the Court's decision also should deter tippees who instigate fraudulent schemes because these tippees will not be assured of recovery against their tippers. Thus, the Court's narrowly drawn

²¹⁸ *Bateman Eichler*, 472 U.S. at 318.

²¹⁹ *Id.* at 318 & n.32. The Insider Trading Sanctions Act imposes severe civil sanctions, as well as criminal fines of up to \$100,000, on persons who have illegally used inside information. *Id.* See *supra* notes 161-80 and accompanying text for a discussion of the Insider Trading Sanctions Act.

²²⁰ *Id.* at 318. Scienter refers to a mental state embracing an intent to deceive, manipulate, or defraud. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, *reh'g denied*, 425 U.S. 986 (1976).

²²¹ *Bateman Eichler*, 472 U.S. at 319.

²²² See *supra* notes 92-136 and accompanying text for a discussion of the lower court decisions in tippee-tipper suits.

²²³ *Bateman Eichler*, 472 U.S. at 317.

scope of the in pari delicto doctrine in the securities area is the better approach to deterrence of insider trading.

A. *Analysis of the Supreme Court's Reasoning in Bateman Eichler*

1. Analogy to Antitrust Actions

The *Bateman Eichler* Court stated that a tippee's own actions may bar a private damages action brought under the federal securities laws only when the plaintiff-tippee, as a direct result of the tippee's own actions, bears substantially equal responsibility for the violations the tippee seeks to redress and preclusion of the suit will not interfere significantly with the effective enforcement of the securities laws and protection of the investing public.²²⁴ The Court derived this two-part test directly from the majority and concurring opinions of *Perma Life*, which considered the validity of the in pari delicto defense in antitrust litigation.²²⁵ Indeed, the *Bateman Eichler* Court expressly stated that "the views expressed in *Perma Life* apply with full force to implied causes of action under the federal securities laws."²²⁶

The *Bateman Eichler* Court was correct in applying *Perma Life* because the distinctions between the antitrust and securities laws, emphasized by some lower federal courts allowing the in pari delicto defense,²²⁷ are insignificant. One unimportant distinction arises because the antitrust laws specifically provide for private actions,²²⁸ while private actions under the federal securities laws are implied by the courts.²²⁹ Yet this express versus implied private right of action is a distinction without substance. Private actions under both the antitrust and the securities laws function as deterrents to business behavior in violation of the laws.²³⁰ While Congress did not provide expressly for private actions, private actions are consistent with the public policy purposes of the securities

²²⁴ *Id.* at 310-11.

²²⁵ The Court in *Perma Life* emphasized the narrow construction which courts should place on common-law defenses to federal regulations. 392 U.S. 134, 138 (1968). The two-part test does allow, however, for a limited application of the defense as recognized by the Justices writing in separate concurring opinions in *Perma Life*. See *supra* notes 87-89 and accompanying text.

²²⁶ *Bateman Eichler*, 472 U.S. at 310.

²²⁷ See, e.g., *Kuehnert v. Texstar Corp.*, 412 F.2d 700, 703-04 (5th Cir. 1969) (significant differences exist between antitrust laws and federal securities laws). See also Comment, *Availability of An In Pari Delicto Defense in Rule 10b-5 Tippee Suits*, 77 COLUM. L. REV. 1084, 1091 n.41 (1977) [hereinafter Comment, *Tippee Suits*].

²²⁸ 15 U.S.C. § 15 (1982). Section 15(a) provides in relevant part: "[e]xcept as provided in subsection (b) of the section, any person who shall be injured in his business or property by reason of anything forbidden in the antitrust laws may sue therefor in any district court of the United States . . ." *Id.*

²²⁹ See, e.g., *Kardon v. Nat'l Gypsum*, 69 F. Supp. 512 (E.D. Pa. 1946) (implied private action recognized under rule 10b-5); *Superintendent of Ins. v. Bankers Life and Cas.*, 404 U.S. 6 (1971) (Supreme Court recognizes private right of action implied under section 10(b)).

²³⁰ See *Perma Life*, 392 U.S. at 139 (private actions under antitrust laws necessary to further the public policy favoring competition); *Herman & MacLean v. Huddleston*, 459 U.S. 375, 386-87 (1983) (private actions under rule 10b-5 necessary to further the broad remedial purposes of the securities laws against fraud). See MacIntyre, *The Role of the Private Litigant in Antitrust Enforcement*, 7 ANTITRUST BULL. 113, 113-14 (1962) (private actions under antitrust laws reflect legislative intent to supplement government enforcement).

statutes — including protecting investors and providing for a fair and honest market.²⁵¹ Moreover, the Supreme Court and the SEC have emphasized the necessary and effective function that private actions play in achieving these objectives and supplementing government enforcement.²⁵² The distinction between an express or implied private action, therefore, is not significant in light of the common function that private actions play in promoting the objectives of the federal regulations.

One court also has used the treble damage provision available to antitrust plaintiffs,²⁵³ without a similar remedy provided in the securities laws,²⁵⁴ to distinguish the antitrust statutes from the federal securities laws.²⁵⁵ The Fifth Circuit in *Kuehnert* suggested that this distinction reflects Congress's intent to encourage private plaintiffs to bring suits under the antitrust laws, but not under the federal securities laws.²⁵⁶ This argument, however, fails to account for at least part of the motivation behind the treble damage provision: its punitive nature acts as an increased deterrent against repetition of the offense and as a warning to other potential violators, thus minimizing the potential plaintiff's risk of retribution from a defendant who is often dealing in the same market.²⁵⁷ The plaintiff in a private securities action, not facing this same risk, needs no additional incentive to bring suit. Thus, lack of a treble damage provision in the securities laws is not sufficient to distinguish the securities laws from the antitrust statutes.

Distinguishing *Perma Life* from securities litigation on public policy grounds is equally unpersuasive. The Fifth Circuit in *Kuehnert* reasoned that the degree of public interest in private SEC violations is not comparable to the interest in antitrust violations and therefore, public policy considerations favoring the private suit are not sufficient to outweigh the need to prevent wrongdoers from benefitting from their illegal conduct.²⁵⁸ This argument, however, assumes that the public does not benefit from denying the in pari delicto defense and thereby exposing the defendant's illegal behavior. A tippee's exposure of the tipper's behavior informs both the SEC and other investors of the alleged illegal behavior, thereby leading to sanctioning the tipper and consequently, deterring other potential violators. The private action under the securities laws thus helps to create a fair and honest securities market, an interest comparable to the public's interest in fair and open competition under the antitrust laws.

In summary, the lower courts' attempts to dismiss the relevance of the *Perma Life* antitrust decision to the securities laws are unpersuasive. Both the antitrust and the

²⁵¹ Eight policies have been cited as underlying rule 10b-5: (1) maintaining free securities markets; (2) equalizing access to information; (3) insuring equal bargaining strength; (4) providing for disclosure; (5) protecting investors; (6) assuring fairness; (7) building investor confidence; and (8) deterring violations while compensating victims. Note, *The Tips are for the Taking: The Supreme Court Limits Third Party Liability in Dirks v. SEC*, 12 PEPPERDINE L. REV. 93, 96 n.15 (1984) (citing 5 A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5 §§ 6.01-.09 (2d rev. ed. 1984)).

²⁵² See, e.g., *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (private enforcement of SEC rules provides a necessary supplement to SEC action), *reh'g denied*, 423 U.S. 884 (1975).

²⁵³ 15 U.S.C. § 15(a) (1982).

²⁵⁴ 15 U.S.C. § 78bb(a) (1982) provides in relevant part: "[n]o person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of."

²⁵⁵ See, e.g., *Kuehnert*, 412 F.2d at 703.

²⁵⁶ *Id.*

²⁵⁷ See Comment, *The Demise of In Pari Delicto in Private Actions Pursuant to Regulatory Schemes*, 60 CALIF. L. REV. 572, 573 n.6 (1972).

²⁵⁸ *Kuehnert*, 412 F.2d at 703.

securities laws are designed to prohibit unfair business practices and protect injured plaintiffs from such illegal conduct. Accordingly, because the distinctions between these two regulatory schemes are unimportant, the Court properly adapted the standards for applying the in pari delicto defense in antitrust litigation to the tippee-tipper situation in *Bateman Eichler*.

2. Substantially Equal Responsibility Requirement

The holding in *Bateman Eichler* appears to allow a tipper to assert successfully the in pari delicto defense if the tipper can meet both requirements of the two-part test. The first step of the two-part test requires that the tippee, as a direct result of his or her own actions, bear substantially equal responsibility for the violations he or she seeks to redress.²³⁹ The Court's reasoning, however, makes it nearly impossible for the defendant-tipper ever to show that the plaintiff-tippee's violation of rule 10b-5 is substantially equal to his or her own violation. Moreover, the Court failed to suggest what "other culpable actions"²⁴⁰ could render the tippee substantially equally responsible for the injuries and allow the tipper to assert successfully the in pari delicto doctrine.

The *Bateman Eichler* Court concluded that in the context of insider trading, the derivative nature of the tippee's liability under rule 10b-5 rendered the tippee less culpable than the tipper.²⁴¹ The tippee's liability is considered derivative in light of the Court's decision in *Dirks v. SEC*, where the Court made it clear that a tippee acquired a duty to disclose only if the insider breached a fiduciary duty to shareholders by disclosing the inside information and the tippee knew or should have known of the breach.²⁴² Thus, in any consideration of the relative fault of the parties in a tippee-tipper case based on breach of duty, the fault of the tipper always would outweigh the fault of the tippee, without regard to the specific facts of the case.

The Court was too quick to conclude, however, that a tippee could not bear equal responsibility for the 10b-5 violation. Nothing in *Dirks* indicated that breach of duty by

²³⁹ *Bateman Eichler*, 472 U.S. at 310-11.

²⁴⁰ *Id.* at 314.

²⁴¹ *Id.* at 313. The Court also noted in a footnote, however, that a tippee may be liable, apart from the derivative liability theory, if he or she otherwise "misappropriate[s] or illegally obtain[s] the information." *Id.* at 313 n.22. Justice Stevens' concurrence and Chief Justice Burger's dissent in *Chiarella* suggested the "misappropriation" theories of rule 10b-5. 445 U.S. 222 (1980) (Stevens, J., concurring and Burger, C.J., dissenting).

Justice Stevens suggested that the tippee's breach of duty arose not from a failure to disclose material nonpublic information to the other trader, but from a breach of duty owed to the source of the information. *Id.* at 238 (Stevens, J., concurring). In the usual tippee-tipper suit, however, the tipper is generally the party in the fiduciary relationship with the source of the information, thus breach of duty only would establish a derivative chain of liability for the tippee.

Chief Justice Burger suggested that there is a duty to disclose information which a trader acquires through an illegal act, regardless of the fiduciary relationship of the parties. *Id.* at 240 (Burger, C.J., dissenting). This theory, however, leads to a broader application of the "disclose or refrain" rule, a result which is contradictory to the current restrictive approach of the Court in this area. Neither misappropriation theory, therefore, appears to be useful to the tipper to prove the "substantially equal responsibility" element necessary for the application of the in pari delicto defense. In any event, the Court has not expressly adopted either theory as a basis for tippee liability. See generally Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CALIF. L. REV. 1, 44-52 (1982) (discussing misappropriation theories).

²⁴² 463 U.S. 646, 660 (1983).

the tippee caused less serious injury or harm to shareholders than the selective disclosure of the inside information by the tipper. Indeed, the *Dirks* Court stated that the "transactions of those who knowingly participate with the fiduciary in such a breach [using inside information for personal advantage] are 'as forbidden' as transactions . . . [by the fiduciary] himself."²⁴³ Moreover, by focusing on the nature of the duty imposed upon the parties, the Court overlooked the fact that in the tippee-tipper context, although the parties commit separate violations of the securities laws,²⁴⁴ both parties must commit violations to create the harm to the innocent shareholders and result in the injury suffered by the complaining tippee. By summarily concluding that tippees are less culpable than tippers because of the derivative nature of their duty, the Court failed to compare properly the tippee's and tipper's responsibility for the 10b-5 violation.

The Court did note briefly the potentially broader range of violations which a tipper might commit, including breach of duty towards the issuer and the shareholders by disclosing selectively insider information and fraud against the tippee if that information is false.²⁴⁵ The Court correctly pointed out that these violations, absent any other violations by the tippee other than trading on the inside information, would render a tipper more culpable than a tippee.²⁴⁶ The Court was incorrect, however, in giving these

²⁴³ *Id.* at 659 (quoting *Mosser v. Darrow*, 341 U.S. 267, 272 (1951)).

²⁴⁴ The plaintiffs' violation consists of trading on the basis of inside information. The defendants' violation consists of tipping the inside information. See Comment, *Tippee Suits*, *supra* note 227, at 1094-95.

²⁴⁵ *Bateman Eichler*, 472 U.S. at 313-14. The tippees contended that because they could not inherit a duty to disclose false information, it was legally impossible for the tippees to violate rule 10b-5 by failing to disclose before trading. *Id.* at 311 n.21 (emphasis added). The *Bateman Eichler* Court did not address the issue of the duty to disclose false information but noted that lower federal courts supported the theory that the tippee's unsuccessful fraud was a violation under rule 10b-5's reference to any practice which "would operate" as a fraud. *Id.* In any event, resolution of this issue would not aid the tipper in successfully asserting the in pari delicto defense. If the tippees do not inherit a duty to disclose false information, failure to disclose does not violate rule 10b-5 and the in pari delicto defense is not applicable. If the tippees do inherit a duty to disclose false information under rule 10b-5, the *Bateman Eichler* Court already has concluded that the derivative nature of this liability renders the tippee less culpable than the tipper and thus, the tipper cannot use the in pari delicto defense to bar the tippee's action.

²⁴⁶ *Id.* at 314. The Securities Industry Association, in its amicus brief, argued that liability of the tipper — the brokerage firm, Bateman Eichler, Hill Richards, Inc. — could not possibly equal or exceed the fault of the plaintiffs, because the brokerage firm played only a "vicarious" role as "controlling person" of the defrauding tipper. See Brief of Securities Industry Association, Amicus Curiae in Support of Petitioner at 23, *Bateman Eichler*, 472 U.S. 299 (1985) [hereinafter SIA Brief]. The Court expressed no views on the issue of whether the in pari delicto defense should bar recovery against an employer who acts only as the "controlling person" of the defrauding tipper, noting that the issue was not raised by the Ninth Circuit or before the *Bateman Eichler* Court. *Bateman Eichler*, 472 U.S. at 314 n.25. The difficulty in resolving the issue of the availability of the in pari delicto defense to employers as controlling persons results from a lack of judicial agreement over the scope of controlling person liability. Section 20(a) of the 1934 Act imposes controlling person liability unless the controlling person "acted in good faith and did not directly or indirectly induce the acts constituting the violation or cause of action." 15 U.S.C. § 78t(a) (1982). The SEC's position, however, endorsed by a majority of the courts, is that the common-law doctrine of respondeat superior makes employers liable for the acts of their employees without the limitation of the good faith defense provided by section 20(a). See, e.g., *Marbury Management v. Kohn*, 629 F.2d 705, 716 (2d Cir.) (where respondeat superior principles are applied, the good faith defense afforded by section 20(a) is unavailable), *cert. denied sub nom. Wood Walker & Co. v. Marbury Management*, 449 U.S. 1011 (1980). Other courts, in contrast, have held that section 20(a) was the

potential additional violations the weight of a finding of actual violations by the tipper. Rather than comparing the potential securities violations by the tipper with the actual violations of the tippee, the Court should have held that both parties' actual violations would be the basis for assessing relative culpability for determining the availability of the *in pari delicto* defense.

The *Bateman Eichler* Court attempted to leave open the possibility of the *in pari delicto* defense by declaring that there may be other culpable actions by a tippee which could outweigh the potential violations of the tipper and render the tippee substantially equally responsible as the tipper.²⁴⁷ It is unlikely, however, that a tipper could show, on a motion to dismiss, other culpable actions to bar the plaintiff's suit because the court must accept as true the allegations set forth in the tippee's complaint.²⁴⁸ It is unlikely that the tippee would allege actions which a court might consider sufficiently culpable to result in dismissal of the lawsuit.

Furthermore, because the *Bateman Eichler* Court failed to suggest what other actions would be sufficient to find a tippee *in pari delicto* with the tipper, the defense may not be successful at a later stage in the litigation. In its amicus brief, the SEC noted that a tippee may have substantially equal or greater fault than the tipper-defendant where the tippee-plaintiff was involved in an actual conspiracy with the tipper to misuse the information for their mutual benefit or where the tippee-plaintiff instigated the tipper's violation of law.²⁴⁹ The Court did not adopt these suggestions, however. As a result, the Court gives no guidance as to the nature of "other culpable actions" by the tippee that the tipper would need to prove in order to use the *in pari delicto* defense at another stage in the litigation.

3. Promotion of the Securities Laws

The tipper may bar the tippee's action only if he or she satisfies both parts of the two-part test. Under the second part of the test, preclusion of the suit must not interfere significantly with the enforcement of the securities laws.²⁵⁰ In *Bateman Eichler*, the Court concluded that denying the *in pari delicto* defense and thus allowing the suit to proceed would best protect the investing public and the national economy.²⁵¹ The Court based its conclusion on several factors, including the need for private actions in the securities area to expose and deter fraudulent practices.²⁵² In addition, the Court reasoned that

exclusive source of liability. *See, e.g.*, *Christoffel v. E.F. Hutton*, 588 F.2d 665, 667 (9th Cir. 1978) (the controlling person provision of the 1934 Act supplants vicarious liability of employer under respondeat superior doctrine). The Supreme Court has not addressed the question of whether the common-law doctrine remains available under the securities laws. The Court would need to resolve this issue before it could determine the relative culpability of employers.

²⁴⁷ *Bateman Eichler*, 472 U.S. at 314.

²⁴⁸ *Berner*, 730 F.2d at 1320.

²⁴⁹ Brief for the SEC as Amicus Curiae Supporting Respondents at 5, *Bateman Eichler*, 472 U.S. 299 (1985) [hereinafter SEC Brief]. Section 1725(d) of the Federal Securities Code of the American Law Institute would recognize the defense of *in pari delicto* in specified circumstances, after considering the deterrent effect of the particular type of liability, the financial and legal sophistication of the parties, and the parties' relative responsibility for the loss incurred. FED. SEC. CODE § 1725(d) (1980).

²⁵⁰ *Bateman Eichler*, 472 U.S. at 311.

²⁵¹ *Id.* at 315.

²⁵² *Id.* at 315-16.

deterrent pressures aimed at a smaller, identifiable group of tippers would be more effective than measures aimed at the potentially larger group of tippees.²⁵³ Moreover, other deterrent measures were available which would serve to curb tippee trading other than preclusion of the tippee's suit against the tipper.²⁵⁴ In light of the Court's reasoning, the tipper would rarely, if ever, be able to show that denial of the tippee-plaintiff's suit through the *in pari delicto* defense would not interfere significantly with the enforcement of the securities laws.

The Court's conclusion that denial of the tippee's suit would interfere with the effective enforcement of the securities laws was based in large measure on the SEC's assertion in its amicus brief that it could not prosecute false tipping effectively without the exposure of the practice provided by private actions brought by tippees.²⁵⁵ The *Bateman Eichler* Court endorsed this argument, noting that litigation between guilty parties serves an important function of exposing unlawful conduct that might otherwise go undetected and unremedied.²⁵⁶ This reasoning is questionable, however, in at least two respects. First, it is inconsistent with the trend in recent Supreme Court decisions to restrict the scope of 10b-5 liability and increase the burden on plaintiffs bringing actions under this rule.²⁵⁷ For example, under the Court's decision in *Chiarella*, an innocent investor who enters into a transaction with a party who is misusing or has misappropriated confidential information has no cause of action against that party in the absence of a duty to disclose to the innocent investor.²⁵⁸ Yet in *Bateman Eichler*, the Court has

²⁵³ *Id.* at 317 & n.29. The Court cited in a footnote a 1977 article by a student commentator, who suggested that deterrent pressures aimed exclusively at tippees, even if proportionately as successful as measures aimed at tippers, still would leave a number of violations undeterred because of the large class of tippees. *Id.* at 317 n.29 (citing Comment, *Availability of An In Pari Delicto Defense in Rule 10b-5 Tippee Suits*, 77 COLUM. L. REV. 1084, 1096-97 (1977)). This student commentator also noted that, aside from a tipper's greater responsiveness to deterrent pressures, both parties' potential risks support an even stronger argument for allowing tippee recovery. See Comment, *Tippee Suits*, *supra* note 227, at 1097. The commentator observed that while the tippee can regulate the amount of risk incurred in trading on inside information, the tipper, in contrast, has no control over the extent of the tippee's potential losses from trading. *Id.* at 1097 & n.91. This resulting uncertainty, the commentator suggested, in itself would have a deterrent value. *Id.* at 1097.

²⁵⁴ *Bateman Eichler*, 472 U.S. at 318 & n.32.

²⁵⁵ *Id.* at 315. See SEC Brief, *supra* note 249, at 5.

²⁵⁶ *Bateman Eichler*, 472 U.S. at 315-16 (citing *Kuehnert v. Texstar Corp.*, 412 F.2d 700, 706 n.3 (5th Cir. 1969) (Godbold, J., dissenting)). Judge Godbold, dissenting in *Kuehnert*, noted that "litigation among guilty parties serves to expose their unlawful conduct and render them more easily subject to the appropriate civil, administrative and criminal penalties." *Kuehnert*, 412 F.2d at 706 n.3 (Godbold, J., dissenting).

²⁵⁷ See *supra* notes 139-60, 171 and accompanying text discussing the Court's decisions narrowing the scope of liability under rule 10b-5.

²⁵⁸ *Chiarella*, 445 U.S. at 235. See, e.g., *Moss v. Morgan Stanley Inc.*, 719 F.2d 5 (2d Cir. 1983), *cert. denied sub nom. Moss v. Newman*, 465 U.S. 1025 (1984). In *Moss*, an employee of an investment banking firm retained to evaluate a tender offer and a stockbroker who learned of the tender offer were not traditional corporate insiders. *Id.* at 15. Therefore, they owed no duty of disclosure to the shareholders who unwittingly sold stock of the target company prior to the announcement of the tender offer. *Id.* In contrast, if the defendants had "tipped" this confidential information, their tippees could maintain an action against them in the event of a trading loss without the bar of the *in pari delicto* defense. See Romano, *Is 'Berner' What Insider Protection Is All About?*, *Legal Times*, July 1, 1985, at 33, col. 1, reprinted in, L.A. Daily J., at 4, col. 1 (discussing *Bateman Eichler* decision in light of recent rule 10b-5 cases).

endorsed a lawsuit by someone who admittedly tried to trade on inside information. Thus, the innocent investor could not sue the tippee, who is trying to trade on inside information, but the tippee could sue his or her tipper. Although both situations involve the misuse of inside information, the Court's decision allows only the plaintiff who has participated in that misuse, not the innocent plaintiff, to sue for recovery. The Court does not explain the apparent contradiction between these two situations, although one possible explanation is that the distinction follows recent cases which indicate that the Court views the primary purpose of rule 10b-5 as the prevention of fraudulent gains by fiduciaries, rather than as a broad provision for the protection of the investing public.²⁵⁹ This does not explain, however, why the Court appears to regard the tipping of false information as an illegal practice to be exposed and sanctioned, yet regards the misuse of inside information as insufficient to maintain a private cause of action unless the innocent investor establishes the insider's requisite duty to the investor.²⁶⁰

A second inconsistency arises from the Court's endorsement of private actions by tippees as a necessary enforcement tool and the Court's subsequent observation that other measures are available to discourage suits by tippees against their tippers.²⁶¹ In response to an argument that denial of the *in pari delicto* defense would increase tippee trading because of the availability of recovery against the tipper, the Court pointed out that an effective deterrent against tippee trading and tippee lawsuits was the tippee's exposure to the threat of substantial civil and criminal penalties under rule 10b-5 and the Insider Trading Sanctions Act.²⁶² Thus, the Court concluded that the *in pari delicto* defense should be denied to encourage private suits by tippees, yet noted that if the tippees brought such actions, they would expose themselves to substantial penalties. This inconsistency undercuts the Court's assertion that denying the *in pari delicto* defense in order to encourage private actions best serves the securities laws.

In summary, the Court's analysis of the second step of the *in pari delicto* test imposes a heavy burden on tippers who attempt to show that denial of the tippee lawsuit does not harm the policy aims of the securities laws. The Court has endorsed private actions by tippees as necessary aids to the declining SEC enforcement resources, especially in light of the growing size and complexity of the securities market.²⁶³ Thus, given the Court's support for this private enforcement remedy, it is virtually impossible for the tipper to show that preclusion of the tippee suit would not interfere with promoting the goals of the securities laws.

²⁵⁹ See, e.g., *Dirks*, 463 U.S. 646 (1983). In *Dirks*, the Court stated that not all breaches of fiduciary duty in connection with securities transactions violate rule 10b-5; breaches must involve actual manipulation or deception. *Id.* at 654. The *Dirks* dissent noted: "[t]he Court today takes still another step to limit the protection provided investors by Section 10(b) of the Securities Exchange Act of 1934." *Id.* at 667-68 (Blackmun, J., dissenting). See also *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977) (narrowing the definition of fraud under rule 10b-5 to those actions clearly involving "manipulation and deceit"); Note, *Availability of Defense*, *supra* note 160, at 542-49 (concluding that Supreme Court views rule 10b-5's purpose as preventing fraudulent gains by fiduciaries).

²⁶⁰ See Romano, *supra* note 258, at 4, col. 1.

²⁶¹ *Bateman Eichler*, 472 U.S. at 315, 318 & n.32. The Court noted these other factors included the requirement of proving that the defendant acted with scienter and the threat of civil and criminal sanctions under the 1934 Act and the Insider Trading Sanctions Act. *Id.* at 318.

²⁶² *Id.* at 318 & n.32.

²⁶³ *Id.* at 315 (quoting H.R. REP. NO. 355, 98th Cong., 1st Sess. 6 (1983)).

B. Effectiveness of the Bateman Eichler Decision in Deterring Insider Trading

Despite the Court's holding in *Bateman Eichler* that the in pari delicto defense may be available to bar the tippee's suit if the tipper satisfies the two-part test, the analysis above leads to the conclusion that the defense is unavailable to the defendant-tipper. If the defense is in fact unavailable to the tipper, two questions arise. First, does denial of the in pari delicto defense effecuate the objectives of rule 10b-5?²⁶⁴ If so, should courts reject the in pari delicto defense entirely in the securities law context?

Denial of the in pari delicto defense does effecuate the objectives of rule 10b-5 because it allows private actions by tippees to become an actual threat to tippers by removing the most significant obstacle barring tippee lawsuits. In *Bateman Eichler*, the Court denied the in pari delicto defense and placed narrow limits on its use based on the premise that the threat of private suit by tippees would deter tippers from initiating fraudulent schemes through disseminating false information. For this premise to be valid, however, there must be an actual threat of private suit by the tippee. The Court pointed out that although tippees no longer would face the possibility of dismissal by the in pari delicto doctrine, other factors discouraging tippee suits still would exist, however, such as the scienter requirement and the potential for civil and criminal sanctions on the tippee's own behavior.²⁶⁵ Thus, denying to tippers the use of the in pari delicto defense only effecuates the deterrent objectives of rule 10b-5 if, despite these additional factors, more tippees bring actions against their tippers.

Closer examination of these factors reveals that they do not present a significant obstacle to tippee suits. Tippees will bring suit against their tippers only if they trade on the tipped information to their detriment. A detrimental result may occur if the inside information given to the tippee is intentionally false, materially misleading, or deceptive by virtue of exaggeration. In these cases, it may be relatively easy for the plaintiff to prove the elements of scienter, because the tipper knowingly intended to deceive the tippee.²⁶⁶ Because most of the tippee-tipper lawsuits raised in the past fifteen years have alleged some element of fraud or deceit by the tipper,²⁶⁷ this requirement of scienter does not appear sufficiently burdensome to discourage tippees from bringing suit.

The civil and criminal sanctions provided by the Insider Trading Sanctions Act also fail to provide a significant disincentive to deter private actions by tippees. As noted previously, the *Bateman Eichler* Court cited the potential threat of sanctions under the 1984 Act as an effective deterrent to tippee lawsuits.²⁶⁸ The Court's reliance on the effectiveness of the 1984 Act against tippee lawsuits, however, is unsound. First, the

²⁶⁴ See *supra* note 231 for a discussion of the policies underlying rule 10b-5.

²⁶⁵ *Bateman Eichler*, 472 U.S. at 318 & n.32.

²⁶⁶ Scienter is an element of a rule 10b-5 action. *Aaron v. SEC*, 446 U.S. 680, 691 (1980). The scienter element is satisfied for an insider-tipper when he or she knowingly discloses information that he or she knows is material and nonpublic to one who might be reasonably expected to use it to his or her advantage. *Elkind v. Liggett & Myers*, 635 F.2d 156, 167 (2d Cir. 1980).

²⁶⁷ In most cases, the tippees accuse the tippers of actively misrepresenting that they have inside information about imminent events that will affect the market price of a particular corporation's stock. See, e.g., *Tarasi*, 555 F.2d at 1153 (merger failed to occur). The tippee also may allege that the tipper failed to disclose all relevant information concerning a corporation. See, e.g., *Kirkland v. E.F. Hutton*, 564 F. Supp. 427, 432 (E.D. Mich. 1983) (tipper did not reveal potentially discouraging information about investment to tippee).

²⁶⁸ See *supra* notes 218-20 and accompanying text.

legislative history of the 1984 Act indicates that Congress primarily aimed the 1984 Act at corporate insiders and tippees.²⁶⁹ In addition, because the civil penalty provision in the 1984 Act measures the penalty in terms of the profits realized or losses avoided by trading in a security while in possession of material, nonpublic information,²⁷⁰ the penalty provision may not apply to a defrauded tippee who has lost money by trading on the inside information.²⁷¹

Uncertainty over the scope of tippee liability under the 1984 Act in light of the Court's decision in *Dirks*²⁷² also may render the Act ineffective against tippees. Congress's failure to define "insider trading"²⁷³ and identify clearly those persons and activities subject to the 1984 Act creates confusion as to the 1984 Act's applicability to tippees. The 1984 Act sanctions anyone who trades "while in possession of" material nonpublic information.²⁷⁴ Under the *Dirks* standard, in contrast, a tippee does not violate rule 10b-5 by merely possessing inside information while trading; instead, the tipper must breach a fiduciary duty to shareholders of which the tippee knew or should have known before the tippee acquires a duty to disclose or abstain.²⁷⁵ Because the House Report expressly states that Congress did not intend the 1984 Act to change the underlying case law of insider trading,²⁷⁶ it appears the narrow construction given tippee liability in *Dirks* limits the 1984 Act. Apparently, the House Committee which reported on the 1984 Act recognized the potential impact that judicial interpretation of the *Dirks* decision might have in limiting the effectiveness of the Act, because the Committee directed the SEC to monitor the effects of *Dirks* on the SEC's insider trading program for at least two years.²⁷⁷ Thus, despite the broad scope of liability indicated in the "mere possession" language of the 1984 Act and the stated intention of Congress to provide the SEC with

²⁶⁹ HOUSE REPORT, *supra* note 161, at 9. The House Report noted that the penalty would be imposed on "persons who aid and abet violations by communicating ('tipping') material nonpublic information" because these persons are "most directly culpable in a violation." *Id.* To date, the SEC has used the sanctions available under the Act in only one enforcement action in a traditional insider trading case. SEC v. Ablan, [1984-1985 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,847 (S.D.N.Y. Nov. 27, 1984).

²⁷⁰ HOUSE REPORT, *supra* note 161, at 8.

²⁷¹ See Note, *Rule 10b-5 — Application of the In Pari Delicto Defense in Suits Brought Against Securities Brokers by Customers who have Traded on Inside Information*, 37 VAND. L. REV. 557, 582 n.176 (1984).

²⁷² 463 U.S. 646 (1983). See *supra* notes 146-60 and accompanying text for a discussion of the scope of tippee liability under *Dirks*.

²⁷³ HOUSE REPORT, *supra* note 161, at 13. Congress specifically declined to define "insider trading" to avoid creating "new ambiguities." *Id.* at 13.

²⁷⁴ *Id.* at 9.

²⁷⁵ *Dirks*, 463 U.S. at 660.

²⁷⁶ HOUSE REPORT, *supra* note 161, at 13. The American Bar Association's Task Force on Insider Trading Regulation, preparing a lengthy analysis in 1984 of the existing federal statutory regulation of insider trading, concluded that Congress should not have left to further case-by-case development the basic policy question of what uses of inside information were unlawful, but instead should have provided a statutory definition of what trading activity on the basis of inside information was prohibited. Report of the Task Force on Regulation of Insider Trading at 4 (Discussion Draft 1984) (available in the St. Louis University Law School Library). The Task Force concluded that the case law development under rule 10b-5 was confused and did not warn predictably what conduct may be unlawful; thus, it provided an uncertain statutory basis for the penalty provisions of the Insider Trading Sanctions Act. *Id.* at 4-5.

²⁷⁷ HOUSE REPORT, *supra* note 161, at 15.

an additional enforcement tool,²⁷⁸ the restrictive scope of tippee liability under *Dirks* limits the 1984 Act's effectiveness against tippees.

Thus, given the minimal impact which the scienter requirement and the Insider Trading Sanctions Act have on discouraging tippees from bringing private actions, the importance of the decision in *Bateman Eichler* becomes apparent. Denial of the in pari delicto defense removes the most significant obstacle barring tippee lawsuits, thus allowing private actions by tippees to become an actual threat to deter tippers from disclosing false or misleading information. This threat is particularly important in light of the recent Supreme Court decisions which have imposed a heavy burden of proof upon plaintiffs in rule 10b-5 insider trading cases,²⁷⁹ reducing the threat of private suit by non-tippee plaintiffs. The Court's restrictive approach to 10b-5 liability has diminished the force of rule 10b-5 as an effective weapon against insider trading.²⁸⁰ In *Bateman Eichler*, however, the Court in effect added an implied private action for damages by a tippee as a weapon to deter insider trading, a weapon which also aids SEC enforcement efforts by exposing the illegal practices of tippers. Thus, after *Bateman Eichler*, tippers face a triple threat: actual threat of action by defrauded tippees, increased threat of SEC sanctions, and increased severity of sanctions under the Insider Trading Sanctions Act.

The Court should not eliminate the in pari delicto defense completely, however, because of the possible increase in tippee trading which might result from providing tippees with the potential ability to recover losses from their tippers. The Court failed to address adequately the argument that denial of the in pari delicto defense would increase tippee trading by creating an enforceable warranty for tippees.²⁸¹ As noted above, the scienter requirement and the Insider Trading Sanctions Act are not effective to deter tippee trading.

For this reason, the Court's decision not to eliminate completely the in pari delicto defense is important. Although the Court did not identify the situations where the relative culpabilities of the parties merit a "different mix of deterrent incentives,"²⁸² the possibility that the Court would allow the in pari delicto defense, and thus deny the tippee suit, theoretically exists. Even though the Court did not adopt the suggestion, the SEC, in its amicus brief, noted that courts should apply the defense to bar claims where the plaintiff has instigated the scheme or actually was involved in the conspiracy to misuse the information.²⁸³ Even this slight possibility of the availability of the in pari delicto defense should serve to deter some tippee trading.

²⁷⁸ See *id.* at 8.

²⁷⁹ See cases cited *supra* note 51. See generally Gilbert, *Proving a Securities Fraud Case After the Recent Supreme Court Decisions: Will the Implied Cause of Action Survive?*, 17 SUFFOLK U.L. REV. 835 (1983) (discussing recent decisions which have made recovery in implied civil actions under the federal securities laws more difficult).

²⁸⁰ See Note, *Dirks v. SEC: The Supreme Court Establishes the Standard for Tippee Liability Under Rule 10B-5*, 36 BAYLOR L. REV. 217, 238 (1984).

²⁸¹ *Bateman Eichler*, 472 U.S. at 317-18.

²⁸² *Id.* at 317.

²⁸³ SEC Brief, *supra* note 249, at 5. One student commentator has suggested a comparative fault approach would deter both tippees and tippers. See 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, 544 (1984). Under this approach, courts should consider such factors as the tippee's sophistication, the tipper's conduct, who initiated the fraudulent activity, the conduct of the parties before and after the tippee's initial trading, and whether the tippee actually became a co-conspirator in the fraudulent scheme. *Id.* at 544-55.

Furthermore, there are several possible reasons why unavailability of the in pari delicto defense should not increase significantly tippee trading. First, a relationship of trust and confidence established with the tipper, rather than the ability to recover from the tipper in the event of a loss, usually motivates the tippee in part to trade on the inside information.²⁸⁴ Second, the 1984 Act still may be effective against successful tippees, depending on future interpretations of *Dirks*. In addition, if denying the in pari delicto defense to tippers effectively discourages tippers from disseminating inside information, denial of the defense should reduce the volume of tippee trading.

In sum, the Court's analysis of the standard to be applied to the in pari delicto doctrine in 10b-5 actions deters insider trading. Allowing the private action to proceed in tippee-tipper 10b-5 suits will provide a deterrent effect on the activities of tippers and thus, promote the goals of the federal securities laws. Furthermore, the possibility that courts will apply the in pari delicto defense to deny tippee recovery in situations where the tippee is as culpable as the tipper in violating the securities laws minimizes the danger of increased tippee trading.

CONCLUSION

The Supreme Court's decision in *Bateman Eichler v. Berner* provides the courts with a two-part test to evaluate the availability of the in pari delicto defense to implied private damages actions under the federal securities laws. In applying this test, the Court found that, upon the defendant-tippers' motion to dismiss the complaint, the defendants could not bar the plaintiffs' action by the in pari delicto defense. Despite the apparent availability of the in pari delicto doctrine to defendants, the Court's analysis effectively eliminated the doctrine as a bar to defrauded tippees' claims under rule 10b-5.

This result seems to contrast with recent decisions in the insider trading area which have made it more difficult for plaintiffs to sue under rule 10b-5. Yet, while it may seem contradictory that a tippee, admittedly in violation of the securities law, can maintain an action under rule 10b-5 where an innocent investor might be unable to do so, this result, nevertheless, is the better approach to achieving the goals of the securities laws in the context of a tippee-tipper lawsuit. Denial of the in pari delicto defense exposes tippers to the potential threat of suit by tippees, in addition to the existing threat of SEC prosecution and increased sanctions under the Insider Trading Sanctions Act. This increased pressure on tippers should deter disclosure of material, nonpublic information by tippers and accordingly, decrease the volume of insider trading. Thus, the narrow limits the *Bateman Eichler* Court has placed on the availability of the in pari delicto doctrine in the context of the federal securities laws best promote one of the goals of the federal securities laws — to protect the investing public — and specifically, the goal of rule 10b-5 — to prohibit fraudulent practices by market participants.

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²⁸⁴ See Comment, *Tippee Suits*, *supra* note 227, at 1097.