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Securities Regulation -- In Pari Delicto as a Defense for a Violation of Rule 10b-5

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and the first amendment right of free speech with regard to public officials. The Court held the standard to be one of actual malice, that is, knowledge that a statement is false or with reckless disregard of whether it was false or not. Of course *Heit* is distinguishable in many respects, primarily because Congress could presumably legislate a negligence standard if it so desired without running afoul of the Constitution. Absent congressional action, however, and in view of the competing policy goals—preventing fraud without interfering with the flow of corporate information—the *Sullivan* line would be an appropriate resolution of the matter. Until then, sales of corporate executives' liability insurance will probably continue to soar.[60]

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Securities Regulation—In Pari Delicto as a Defense for a Violation of Rule 10b-5

In *Kuehnert v. Texstar Corp.*,[1] the plaintiff had become acquainted through business dealings with the defendant, president of Texstar, and a personal friendship had soon developed. Over a period of five months, the defendant continuously supplied the plaintiff with inside information consisting of assurances of increased stock dividends and proposed profitable business dealings with two major oil companies. Relying primarily on this confidential information,[2] the plaintiff began buying Texstar stock on margin on the open market. None of the value-enhancing occurrences ever materialized, and the plaintiff was forced to sell his stock and suffered a large financial loss.[3] The federal district court held that the plaintiff was a tippee under Securities Exchange Commission Rule 10b-5,[4] and denied

[60] *Symposium—Rule 10b-5: Developments in the Law*, 63 Nw. U.L. Rev. 544 (1968) (suggesting that no insurance be allowed corporate executives for intentional or negligent violations of rule 10b-5).

[1] 286 F. Supp. 340 (S.D. Tex. 1968). On May 9, 1969, the United States Court of Appeals for the Fifth Circuit affirmed by a 2-1 decision. — F.2d — (1969).

[2] Apparently, another reason for Kuehnert's purchases was to help defendant retain the presidency of the company. Brief for Appellee at 5-9, Kuehnert v. Texstar Corp., — F.2d — (5th Cir. 1969).

[3] 286 F. Supp. at 342-43.

[4] 17 C.F.R. § 240.10b-5 (1968):

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
> (a) To employ any device, scheme, or artifice to defraud,
> (b) To make any untrue statement of a material fact or to omit to state a

him relief because of his knowledge that he was using inside information.[5]

When a tippee is a party to the action, he is normally the defendant. He usually receives information from an insider that is not available to the general investing public and uses this information to purchase or sell stock, either directly from a third party,[6] or indirectly on the open market.[7] The stock then increases or decreases in value as expected by the tippee, and he in turn is sued by the third party who suffered a loss because of this transaction. The instant case differs from this normal situation in at least two respects: the inside information received by Kuehnert was false, and this false information led to substantial losses, placing the tippee in the position of a plaintiff.

In holding that the plaintiff, as a tippee, could not recover under Rule 10b-5, the court stated that the Rule

> cannot be used by such a person to sustain a cause of action for fraud. It is the ordinary person that buys and sells securities based upon information generally available to the investing public who is protected by Section 78j(b) of the Act and Rule 10b-5 and not one that has access to or believes he has access to secret, material, confidential, corporate information.[8]

This language would seem to preclude recovery under the Rule by anyone that has participated in insider trading regardless of the validity of the information.[9] Yet, denying recovery to the tippee who has lost money

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> 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.

Rule 10b-5 was promulgated pursuant to section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78 (1964), which provides that

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

5 286 F. Supp. at 345.

6 *E.g.*, Ross v. Licht, 263 F. Supp. 395 (S.D.N.Y. 1967).

7 *E.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

8 286 F. Supp. at 345.

9 It was also argued that because the information was false, it would constitute a violation of the rule for the tippee to disseminate it to the general public. Brief for Appellant at 5, Kuehnert v. Texstar Corp., — F.2d — (5th Cir. 1969).

in a transaction induced by an insider is seemingly inconsistent with the trend of imposing civil liability under Rule 10b-5 whenever any false information given concerning the financial situation of a corporation results in a loss to the purchaser who relied on this information. In conjunction with potential criminal sanctions and administrative regulations, the use of Rule 10b-5 to impose civil liability[10] on insiders for violation of the Rule provides an additional deterrent to fraudulent practices in security transactions.[11] The holding in this case may thus lessen the deterrent effect of the Rule by relieving many defendant-insiders from such liability. This seems particularly true in light of the growing class of persons who may be considered "tippees."[12] Under the *Kuehnert* language, insiders could disseminate false information with relative impunity, for whatever reason, to the large class of traders who are tippees.

The imposition of civil liability under 10b-5 requires three elements in order to establish a right of recovery, all of which seem to be present in this case: 1) a purchase by the plaintiff, 2) reliance on misleading statements made by the defendant, and 3) a financial loss suffered through this purchase.[13] It seems clear, then, that Kuehnert would have been allowed to recover, absent the defense permitted by the court. The reason for denying recovery was unclear, but the court did use the doctrine of in pari delicto[14] as an alternative holding.[15] Although the doctrine was mentioned only briefly in the opinion, its rationale permeates the entire decision. For example, the court stated that "the tippee such as Kuehnert must be painted with the same brush and the same color as the insider from whom the tippee receives his information,"[16] and that "Rule 10b-5 [was]

[10] The first instance in which civil liability was imposed under Rule 10b-5 was Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). There have, apparently, been no subsequent decisions rejecting this innovation, and it has met with overwhelming acceptance. Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 676 (N.D. Ind. 1966). *See also* Ruder, *Corporate Disclosures Required by the Federal Securities Laws: The Codification Implications of Texas Gulf Sulphur*, 61 Nw. U.L. Rev. 872 (1967).

[11] See Fratt v. Robinson, 203 F.2d 627, 632 (9th Cir. 1953): "[N]othing . . . would tend more . . . to deter fraudulent practices in security transactions . . . than the right of defrauded sellers or buyers . . . to seek redress in damages in federal courts."

[12] *See* A. Bromberg, Securities Law: Fraud § 4.4, at 76 & n.33.1 (1967).

[13] Posner, *Developments in Federal Securities Regulation*, 22 Bus. Law. 645, 654 (1967).

[14] For different applications of this doctrine, *compare* Hall v. Corcoran, 107 Mass. 251 (1871), *with* Whelden v. Chappel, 8 R.I. 230 (1865).

[15] "Alternatively, the defense of in pari delicto asserted by the defendants is good as against Kuehnert, although because of the above holding no further discussion of that doctrine and its applicability here is necessary." 286 F. Supp. at 345.

[16] *Id.*

not intended to be and cannot be used by such a person to sustain a cause of action for fraud."[17] These passages seem to reiterate the policy of the in pari delicto doctrine—that someone who is at fault will be precluded from recovery from another party at fault, even if the other party may be more blameworthy.[18]

In using this language, the court may have felt that if the plaintiff himself were found to be a violator of the Rule, denying him recovery might be an effective deterrent to people who find themselves in the position of the tippee in the future. Since there could be no possibility of recovery from anyone in the event the insider information was incorrect, the tippee would theoretically refrain from trading on any inside information. Another possibility left open by the court's language is that a balancing test could be used to determine whether a particular tippee would be allowed to recover based on the comparative guilt in each individual case. But the judicial imposition of civil liability under the Rule has eliminated the necessity of proving all the required elements[19] of common law fraud,[20] and it is arguable that to preserve the overall deterrent effect of permitting civil recovery under Rule 10b-5, the Rule should also preclude the equitable defense of in pari delicto under any circumstances.

Traditionally the concepts inherent in in pari delicto were used in litigation involving private parties, where public regulation was not involved. When private litigants have been given a significant role in furthering public aims, as is evidenced by the civil remedy in connection with criminal sanctions for a violation of the Securities Exchange Act, sound arguments exist for limiting the scope of equitable defenses.[21] An illustrative analogy[22] is found in recent antitrust litigation.[23] The Supreme Court of the United States eliminated the doctrine of in pari delicto as a

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[17] *Id.*

[18] See, *e.g.*, Note, *In Pari Delicto and Consent as Defenses in Private Antitrust Suits*, 78 HARV. L. REV. 1241 (1965).

[19] The common law elements of fraud are: (1) a false representatation, (2) of a material fact, (3) made with knowledge of its falsity, and (4) with intent to deceive, (5) which representation is relied upon by plaintiff, (6) resulting in damage to him. W. PROSSER, LAW OF TORTS §§ 100, 104, at 700, 736 (3d ed. 1964).

[20] *E.g.*, Speed v. Transamerica Corp., 99 F. Supp. 808, 831 (D. Del. 1951).

[21] *Cf.* Note, *In Pari Delicto and Consent as Defenses in Private Antitrust Suits*, 78 HARV. L. REV. 1241, 1241-42 (1965).

[22] The following analogy has been drawn between these two fields. "Private enforcement of the proxy rules provides a necessary supplement to Commission action. As in antitrust treble damage litigation, the possibility of civil damages or injunctive relief serves as a most effective weapon in the enforcement of the proxy requirements." J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964).

[23] Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134 (1968).

defense to a civil action for an antitrust violation under both Section 1 of the Sherman Act[24] and Section 3 of the Clayton Act.[25] The court concluded that the public policy of permitting civil recovery as an additional deterrent for a violation of the antitrust laws was paramount to the equitable doctrine of in pari delicto.

It would appear also that the overriding interest of maintaining the integrity of the securities exchange can probably be best achieved by preventing fraud at its source. Admittedly, an individual plaintiff may be allowed to recover when his actions have been just as blameworthy as the defendant's, but the limited number of situations in which the plaintiff might be equally blameworthy would not seem to justify the administrative costs and burdens of allowing the defendant to prove that the equities are in his favor in a particular case.

Permitting equitable defenses also appears inconsistent with developing trends of 10b-5 enforcement, and in fact with the purpose of the Rule itself, which was designed in large part to protect the integrity of stock transactions[26] by deterring the misconduct of insiders.[27] Judicial attempts to eliminate misconduct by facilitating recovery for a violation of the Rule are evidenced by the steady liberalizing of its requirements: the common law elements of fraud do not have to be proved,[28] the requirement of privity has been emasculated,[29] and the concept of who may qualify as an "insider" subject to the Rule is expanding.[30] These trends all serve to discourage securities fraud, and allowing equitable defenses for the initiator of the false information could serve to weaken any such deterrent effect. Further, by holding that the Rule was not intended to protect one "that has access to or believes he has access to secret, material, confidential, corporate information,"[31] the court arguably reads out that part of the Rule that states that "[i]t shall be unlawful for any person . . . to make any untrue statement . . . in connection with the purchase or

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[24] 15 U.S.C. § 1 (1964).
[25] 15 U.S.C. § 14 (1964).
[26] Pettit v. American Stock Exch., 217 F. Supp. 21, 28 (S.D.N.Y. 1963).
[27] List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir. 1965).
[28] Posner, *Developments in Federal Securities Regulation*, 22 Bus. Law. 645, 654 (1967).
[29] Ruder, *Corporate Disclosures Required by the Federal Securities Laws: The Codification Implications of Texas Gulf Sulphur*, 61 Nw. U.L. Rev. 872, 892-96 (1967).
[30] *E.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).
[31] 286 F. Supp. at 345.

sale of any security."[32] It seems unlikely that the court could have intended to weaken so substantially such a significant part of the Rule, but at least insofar as the civil remedy is concerned the effect of its language could have this result.

In denying the plaintiff the use of the Rule in this case, the court does not employ all the potential deterrent force it has available. All the court requires in order to bar a plaintiff from recovery under the Rule is that he believe that he is using some secret information.[33] A different result in this case would have the effect of reducing the number of initial false statements, and recovery would not be dependent on the later actions of the one who received the information. The subsequent action by the plaintiff does not lessen the evil of giving false statements in the first place, and should not relieve the defendant of any liability, either civil or criminal. In short, the subjective intent of the tippee should not lessen the responsibility of an instigator who has clearly violated the Act himself.

ALEXANDER P. SANDS, III

Torts—Liability of Builder-Vendor's Lender for Failure to Protect Vendee against Defective Home

In *Connor v. Great Western Savings and Loan Association*,[1] the California Supreme Court held that a lender who provided financing for a subdeveloper had a duty to purchasers to exercise reasonable care to prevent the builder from constructing and selling defective houses. The subdeveloper was inexperienced and undercapitalized, and its lender retained substantial control over the subdevelopment planning almost to the point of being an entrepreneur without sharing attendant risks. *Connor* is a decision without precedent,[2] and it pioneers a new area in a field that was already in a great state of flux—tort liability in the home-building in-

[32] 17 C.F.R. § 240.10b-5 (1968).
[33] 286 F. Supp. at 345.

[1] — Cal. 2d —, 447 P.2d 609, 73 Cal. Rptr. 369 (1968) (Traynor, C.J., in a 4-3 decision).
[2] The intermediate appellate court did reach almost the same result, however, in holding that Great Western owed purchasers of housing built by the subdeveloper a duty "at least to the extent of protecting these persons from gross structural hazards." Connor v. Conejo Valley Dev. Co., 253 Cal. App. 2d —, —, 61 Cal. Rptr. 333, 344 (Dist. Ct. App. 1967).