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In Pari Delicto as a Bar to Tippee's Recovery Under Rule 10b-5: The Concept of "Public Interest" in Trade Regulation Compared

John M. DeStefano

IN PARI DELICTO AS A BAR TO TIPPEE'S RECOVERY UNDER RULE 10b-5: THE CONCEPT OF "PUBLIC INTEREST" IN TRADE REGULATION COMPARED

I. *Kuehnert v. Texstar Corp.*[1]

In *Kuehnert v. Texstar Corp.* plaintiff Kuehnert sought recovery against defendants Rhame and Texstar Corporation of damages allegedly suffered as a result of defendants' violation of Rule 10b-5 of the SEC.[2] In January of 1965 Rhame, President of Texstar, gave Kuehnert, a business acquaintance, supposedly confidential corporate information. Rhame told Kuehnert that the Texaco and Humble Oil Companies had agreed with Texstar to drill two wells on Texstar land; as a result, Texstar's earnings for the fiscal year ending March 31, 1965 would be $3.30 per share and the value of the stock would increase greatly. Kuehnert relied upon this "inside" information and began purchasing Texstar stock. The drilling farmouts never materialized and Texstar did not earn the predicted $3.30. Nevertheless Kuehnert continued to buy stock in Texstar, accepting Rhame's excuses as to why earnings were not as predicted, and believing, first, that Rhame's drilling and earnings forecasts would eventually come true, and second, that this was information which the other stockholders and the public did not have. By May of 1965 Kuehnert had purchased 94,600 shares of Texstar stock, most of which he bought on margin, pledging his shares at a number of banks and businesses. In June of 1965 Rhame resigned as president of Texstar. Shortly thereafter a

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1 412 F.2d 700 (5th Cir. 1969).

2 17 C.F.R. § 240.10b-5 (1969). Rule 10b-5 was promulgated from Section 10(b) of the Securities Exchange Act of 1934 which prohibits and seeks to prevent fraud. 15 U.S.C. § 78j(b) (1964); A. Bromberg, Securities Law: Fraud—SEC Rule 10b-5 § 2.1 (1968). "The rule may be invoked whenever any person, insider or outsider, indulges in fraudulent practices, misstatements or half-truths in connection with the purchase or sale of securities." 3 L. Loss, Securities Regulation 1445 (1961). Strictly speaking, the rule only prohibits conduct and makes no provision for compensating parties injured by violations. However, the courts have consistently inferred civil liability under the rule, basing their holdings upon several different theories. See A. Bromberg, supra, § 2.4. See also Slavin v. Germantown Fire Ins. Co., 174 F.2d 799, 805 (3d Cir. 1949); Northern Trust Co. v. Essaness Theatres Corp., 103 F. Supp. 954, 964 (N.D. Ill. 1952); Osborne v. Mallory, 86 F. Supp. 869, 879 (S.D.N.Y. 1949); Kardon v. National Gypsum Co., 73 F. Supp. 798, 800 (E.D. Pa. 1947).

The full text of the rule is:

> 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 a national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (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
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> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
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> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1969).

brokerage firm returned a check for a Texstar stock purchase to Kuehnert for insufficient funds, while at the same time selling him out. Having overextended himself, Kuehnert was unable to continue purchasing Texstar stock, the price of the stock declined, and finally Kuehnert was completely sold out at a loss. Kuehnert later discovered that Rhame had deliberately misled him in an attempt to gain working control of the corporation for his own benefit. Defendant Rhame contended that, in view of Kuehnert's own attempted violation of rule 10b-5 in purchasing stock on the basis of what he believed was "inside" information that those who sold to him did not have, he should be precluded from invoking the rule to recover damages from the defendant. The District Court for the Southern District of Texas held that rule 10b-5 protects the ordinary person who buys and sells securities based upon information generally available to the investing public, and that no such protection is afforded to one who has access to or believes he has access to secret corporate information.[3] Thus the district court ruled that plaintiff had no cause of action because he was not within the class of persons to be protected under rule 10b-5. It followed alternatively, the district court reasoned, that as a bar to recovery, the defendants could validly raise the defense of *in pari delicto* against Kuehnert.[4]

The Fifth Circuit Court of Appeals affirmed, finding that Kuehnert, if not strictly *in pari delicto,* at least had unclean hands because of his intention to defraud his vendors by concealing what he believed to be inside information. The court decided that the objective of the securities laws, that is, the protection of the investing public, would be best promoted in the circumstances of the present case by the allowance of the defenses.[5] In so doing the court opted for the deterrent effect on tippees rather than that on insiders. The court based its decision on what it called the "guiding principle" that the degree of public interest in private SEC violations is not comparable to that in antitrust violations so as to warrant a limitation of the unclean hands and *in pari delicto* defenses as a matter of policy.[6] Thus, their application in a particular case rests with the discretion of the court.[7]

This case raises for the first time the question of allowing *in pari delicto* and unclean hands as defenses in private rule 10b-5 actions. The court here has taken a very narrow view of the public interest in private SEC suits. Its assertion that there is insufficient public interest to justify limitation of common law defenses is questionable. The purposes of the securities laws are broader than merely the protection of investors. Like private antitrust actions, private rule 10b-5 actions aid in the enforcement of the law. In the antitrust area unclean hands has been eliminated and *in pari delicto* severely restricted in order to

[3] Kuehnert v. Texstar Corp., 286 F. Supp. 340, 345 (S.D. Tex. 1968).
[4] Id.
[5] 412 F.2d at 704-05.
[6] Id. at 702.
[7] Id. at 704.

encourage private suits.[8] In support of its holding the *Kuehnert* court relied on the availability of the defenses in SEC proxy requirements cases. But those cases are not as clearcut as the court suggests. This comment will examine court treatment of the defenses in proxy cases and other SEC private actions, and will compare the public interest in SEC violations with that in antitrust violations to determine whether *Kuehnert* is consistent with promotion of the policy of the securities laws and rule 10b-5 in particular.

II. Judicial Treatment of Common Law Defenses in Private SEC Suits: Proxy Regulation, Express Civil Liability and Margin Requirements Cases

In *Gaudiosi v. Mellon*,[9] cited in *Kuehnert* in support of allowance of the defenses, equitable relief sought by plaintiff stockholder in the course of a proxy contest was barred by the defense of unclean hands. The district court held that where a candidate for director of the Pennsylvania Railroad Company in opposition to management candidates sent banks, which were the registered owners of stock in the company, telegrams in violation of SEC proxy rules, and which were intended by the candidate to induce the banks to withhold proxies and thereby deprive management candidates of votes, the plaintiff candidate had unclean hands barring equitable relief relating to the proxy contest.[10] This was an alternative holding. It is noteworthy that in its Conclusions of Law, the district court first found that defendant's conduct of the proxy contest was neither unlawful nor inequitable.[11] On appeal the lower court decision was upheld on the basis of plaintiff's unclean hands and the general equity principle that

> [p]ublic policy not only makes it obligatory for courts to deny a plaintiff relief once his "unclean hands" are established but to refuse to even hear a case under such circumstances.[12]

On the face of its opinion the court of appeals ruled out any possibility of relief for a plaintiff with unclean hands, although it may have been influenced by the district court's alternative findings concerning the defendant's conduct. More important, the court gave no consideration to whether promotion of the policy of the securities acts might dictate a different result.

Also cited in support of allowance of the defenses by the court

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[8] See Perma Life Mufflers, Inc., v. International Parts Corp., 392 U.S. 134 (1968). See also Comment, Private Antitrust Suits: The *In Pari Delicto* Defense, 10 B.C. Ind. & Com. L. Rev. 172 (1968); Comment, Limiting the Unclean Hands and *In Pari Delicto* Defenses in Anti-Trust Suits: An Additional Justification, 54 Nw. U.L. Rev. 456 (1959).

[9] 166 F. Supp. 353 (E.D. Pa. 1958), aff'd, 269 F.2d 873 (3d Cir. 1959), cert. denied, 361 U.S. 902 (1959).

[10] 166 F. Supp. at 370-71.

[11] Id. at 369-70.

[12] 269 F.2d at 882.

in *Kuehnert* is *Studebaker Corp. v. Allied Prods. Corp.*[13] In *Studebaker* the court first found no basis upon which to grant plaintiff a preliminary injunction with respect to the conduct of a corporate proxy contest. But finding that the proxy materials involved in the case were in fact misleading, though not intentionally false, the court ordered new record and meeting dates and court supervision of the contents of the new proxy materials. At this point the plaintiff objected to this form of relief, and claimed that the court had no power to fashion such relief. In reply the court *then* observed that there was a strong inference that plaintiff was in violation of the equitable doctrine of unclean hands with respect to certain efforts by the plaintiff to avoid discovery in the course of the proceedings. The substance of the court's remarks was not aimed at allowing unclean hands as a bar to plaintiff's recovery against defendant, but instead was only to demonstrate that the plaintiff's objections to the court's exercise of its equitable powers were "not well taken."[14]

In *Union Pacific R. R. v. Chicago Nw. Ry.*,[15] cited by the *Kuehnert* court as offering analogous support, the court refused to dismiss a suit for injunctive relief where defendants asserted the defense of unclean hands against the plaintiffs. The suit was brought to enjoin a proxy election on grounds of violation of SEC proxy rules, and the facts indicated that both sides in the contest may have violated proxy regulations. The court said that to dismiss the action on the basis of an unclean hands defense would work a hardship upon the rights of the public:

> To apply the maxim in this case would produce the illogic of leaving the shareholders unprotected when they have been doubly misled, stultifying the underlying purpose of the national securities laws. Where a public interest is at stake, above the interests of the parties themselves, the protection of that paramount interest overcomes the judicial reluctance to assist the wrongdoer.[16]

When defendant Northwestern asked the court for more time to pursue discovery for more evidence of unclean hands, the court refused the request and found unclean hands to be insufficient as a defense "in these circumstances even if factually established."[17] It should be noted that the court here based its decision on direct injury to the shareholders. In *Kuehnert* the court assumed there was no harm to anyone but the participants, and would undoubtedly have barred the defenses in the exercise of its discretion under circumstances similar to *Union Pacific*.

Union Pacific cited *Shinsaku Nagano v. McGrath*[18] and *A.C.*

[13] 256 F. Supp. 173 (W.D. Mich. 1966).
[14] Id. at 192.
[15] 226 F. Supp. 400 (N.D. Ill. 1964).
[16] Id. at 410.
[17] Id. at 414.
[18] 187 F.2d 753 (7th Cir. 1951).

Frost & Co. v. Coeur d' Alene Mines Corp.[19] in support of its position. The lower court in *Shinsaku Nagano* denied equitable relief to a Japanese alien resident who sought to recover shares of stock which had been seized by the Alien Property Custodian during World War II.[20] The court pointed out that plaintiff was willing to take income tax advantage of the situation which was the basis of his action. This and other similar conduct by the plaintiff led the court to conclude that the plaintiff should be denied equitable relief and "should be left in the position where his own actions have placed him."[21] The court of appeals reversed, stating:

> The [unclean hands] doctrine, which applies only to willful as distinguished from negligent misconduct, is not, however, applicable to every inconsistent act of a party but to conduct which is "unconscionable" or "morally reprehensible." An expression of public policy, the clean hands maxim is not an inexorable rule, but will be relaxed where public policy would be better served by so doing . . . ."[22]

In *A.C. Frost* the Supreme Court reversed a lower court decision which had held that plaintiff could not recover damages for breach of an option contract because the contract was "void because prohibited by law."[23] The Supreme Court assumed that the agreement involved a public offering in which securities were distributed in violation of the 1933 Act. Under such circumstances the Court observed that to deny relief because of the illegality of the contract "would probably seriously hinder rather than aid the real purpose of the statute."[24] The Court stated:

> Courts have often added a sanction to those prescribed for an offense created by statute where the circumstances fairly indicated that this would further the essential purpose of the enactment; but we think where the contrary definitely appears—actual hindrance indeed of the purpose—no such addition is permissible. The latter situation is beyond the reason which supports the doctrine now relied on.[25]

Notably, the Court included in the opinion an excerpt from the Memorandum of the SEC filed by permission of the Court in *A.C. Frost:*

> It appears to us to be entirely immaterial whether in such a case the agreement is labelled 'void' or the parties are held to be 'in pari delicto.' There, labels, as often is the case, merely state the conclusion reached, but do not aid in solu-

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19 312 U.S. 38 (1941).
20 Shinsaku Nagano v. Clark, 85 F. Supp. 368 (N.D. Ill. 1949).
21 Id. at 373.
22 187 F.2d at 759.
23 61 Idaho 21, 27, 98 P.2d 965,968 (1939).
24 312 U.S. at 43.
25 Id.

> tion of the problem. The ultimate issue is whether the result in the particular case would effectuate or frustrate the purposes of the Act.[26]

The *Kuehnert* court distinguished away the case of *Can-Am Petroleum Co. v. Beck*,[27] where contribution defenses were rejected by the court, by saying that *Can-Am* was a case of mere knowledge by the plaintiff of defendant's wrongdoing without active participation. In *Can-Am*, the plaintiff initiated an action under Section 12 of the 1933 Act[28] against defendant corporation which had made misrepresentations and thereby sold to plaintiff unregistered securities in violation of the 1933 Act.

Like rule 10b-5, Section 12, the express civil liability provision of the 1933 Act, seeks to prevent deception in securities dealings. To accomplish this object, it provides for private recovery for misrepresentation in the sale of securities by use of the mails or other means of interstate transportation or communication.[29] Defendant responded that plaintiff should be barred from recovery because she was *in pari delicto*, having participated in promoting and selling defendant's shares to others, thereby violating the same statute she sought to invoke. The court of appeals described plaintiff's activities as "both legally reckless and naive," but concluded that she had at no time had the degree of culpability attributed to the defendants.[30]

In affirming the district court's award of damages to the plaintiff, the court of appeals stressed the importance of looking at the total circumstances of the parties' association "when the public interest is involved in the enforcement of a statutory remedy."[31] The court found the principle stated in *Miller v. California Roofing Co.*[32] applicable to the federal securities acts:

> since the policy of the law designed to discourage illegal agreements comes in conflict with that policy which demands the effective enforcement of the Corporate Securities Act, the law differentiates the guilt of the parties, because refusal of relief to the less culpable would involve harmful effects wholly out of proportion to the requirements of individual punishment or the discouragement of illegal contracts.[33]

In *Can-Am*, therefore, the court recognized a sufficient degree of public interest in the enforcement of a statutory remedy under the securities acts to allow recovery by a participant in the violation. Under such circumstances the court felt it necessary to differentiate the guilt of the parties.

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[26] Id. at 44, n. 2.
[27] 331 F.2d 371 (10th Cir. 1964).
[28] 15 U.S.C. § 77*l* (1964).
[29] Id.
[30] 331 F.2d at 373.
[31] Id.
[32] 55 Cal. App.2d 136, 143-44, 130 P.2d 740, 745 (App. Div. 1942).
[33] 331 F.2d at 373.

In cases where federal margin requirements have been violated by a broker the question of allowance of common law contribution defenses frequently arises because the investor who charges the broker with the violation has in many cases himself agreed or assented to the unlawful credit terms at the time of the transaction. To prevent the excessive use of credit for purchase or carrying of securities, Section 7 of the Securities Exchange Act of 1934[34] (hereinafter the 1934 Act) authorized the board of governors of the Federal Reserve System to regulate the amount of credit that may be extended on any security registered on a national securities exchange as well as on selected over-the-counter securities. The margin provisions of the 1934 Act were adopted in response to the role that the over-extension of security credit had played in causing the depression.[35] The legislative history of the margin requirements provisions demonstrates congressional awareness of a public purpose overriding concern for the individual investor:

> Nor is the main purpose even protection of the small speculator by making it impossible for him to spread himself too thinly—although such a result will be achieved as a byproduct of the main purpose.
>
> The main purpose is to give a Government credit agency an effective method of reducing the aggregate amount of the Nation's credit resources which can be directed by speculation into the stock market and out of other more desirable uses of commerce and industry—to prevent a recurrence of the pre-crash situation where funds which would otherwise have been available at normal interest rates for uses of local commerce, industry, and agriculture, were drained by far higher rates into security loans and the New York call market.[36]

Section 7(c)[37] of the 1934 Act prohibits any broker or dealer who transacts business in securities from extending or maintaining credit on regulated securities to or for any customer in contravention of the rules and regulations of the board of governors of the Federal Reserve System. This is the provision of the Act under which customers may bring actions against brokers. If the customer was not in some way a participant in the violation, liability of the defendant broker is clear. But when the customer and broker agree in some manner to transact business in contravention of the federal margin requirements, usually on the broker's recommendation, the court must

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[34] 15 U.S.C. § 78g (1964), as amended, 15 U.S.C. § 78g (Supp. IV, 1969).

[35] The extensive liquidation of security loans has been recognized as a major cause of the depression. Note, Federal Margin Requirements as a Basis for Civil Liability, 66 Colum. L. Rev. 1462, 1464 (1966). It is the public policy of the United States to discourage and prevent the purchase of stock on extended credit. Klein v. D.R. Comenzo Co., 207 N.Y.S. 2d 739 (Mun. Ct. 1960).

[36] H.R. Rep. No. 1383, 73d Cong., 2d Sess. 8 (1934).

[37] 15 U.S.C. § 78g(c) (1964).

decide whether recovery should be granted to the customer who is himself a wrongdoer.

In *Moscarelli v. Stamm*[38] the court denied plaintiff's motion for summary judgment in a margin requirement case where the broker and customer had entered agreements with each other which violated federal reserve margin rules. The courts stated that the broker was not absolutely liable under these circumstances, and that the broker's implied civil liability was subject to "the traditional tort concepts of causation and contributory negligence or analogous conduct."[39] Concluding that plaintiff's participation in the statutory violations of the margin rules presented a triable issue which could not be determined by summary judgment, the court noted that earlier decisions had held only that upon a motion for dismissal the "mere participation by the customer does not *per se* bar his recovery,"[40] and that those decisions did not adjudicate the effect of willful and active participation in such violations. The court indicated that such participation would preclude recovery.[41]

It is apparent that the cases relied upon by the *Kuehnert* court in support of its proposition that there is not a sufficient degree of public interest in private SEC violations to warrant limitation of contribution defenses as a matter of policy did not actually consider that question. Some cases under the securities acts have considered, like *Kuehnert*, whether under the facts of a particular case allowance of the defenses would promote or frustrate the policy of the Acts. In *Shinsaku Nagano* and *Moscarelli*, the courts recognized that the willfulness of plaintiff's conduct was to be considered where public policy would be best served thereby. The *Kuehnert* court suggested that mere violation of rule 10b-5 by plaintiff was sufficient to bar recovery. *Can-Am* stressed the importance of differentiating the guilt of the parties where enforcement of a statutory remedy under the federal securities acts was involved, because of the degree of public interest. The enforcement of the securities acts generally, and rule 10b-5 in particular, has much greater importance than the protection of individual investors. Even in *Kuehnert* the court recognized that its assumption that there was no harm to anyone but the participants is questionable.[42] It is suggested here that exposure of rule 10b-5 violations for purposes of enforcement carries such a public interest as to justify limitations on unclean hands and *in pari delicto* similar to those in private antitrust suits.

III. The Public Interest in Private Suits Under the Securities Acts

It was recognized by the court in *Kuehnert* that, while illegal conduct on the part of a plaintiff should generally bar recovery, in

[38] 288 F. Supp. 453 (E.D.N.Y. 1968).
[39] Id. at 459-60.
[40] Id. at 459.
[41] Id. at 460.
[42] 412 F.2d at 703, n. 5.

certain areas exceptions to this rule should be made. Such an exception has been made in the antitrust field. Severe restrictions have been placed as a matter of policy on the application of the unclean hands and *in pari delicto* defenses in private antitrust suits. The reason for this has been stated by the Supreme Court in *Perma Life Mufflers, Inc. v. International Parts Corp.*[43]

> We have often indicated the inappropriateness of invoking broad common-law barriers to relief where a private suit serves important public purposes. . . . [T]he purposes of the antitrust laws are best served by insuring that the private action will be an ever-present threat to deter anyone contemplating business behavior in violation of the antitrust laws. The plaintiff who reaps the reward of treble damages may be no less morally reprehensible than the defendant, but the law encourages his suit to further the overriding public policy in favor of competition. A more fastidious regard for the relative moral worth of the parties would only result in seriously undermining the usefulness of the private action as a bulwark of antitrust enforcement. And permitting the plaintiff to recover a windfall gain does not encourage continued violations by those in his position since they remain fully subject to civil and criminal penalties for their own illegal conduct.[44]

Private suits aid in the enforcement of the antitrust laws by exposing violations and by serving as an "ever present threat to deter anyone contemplating business behavior in violation of the antitrust laws."[45] This dual role was given added impetus by the statutory provision for recovery of treble damages by private plaintiffs.[46] The Supreme Court has termed private suits "a bulwark of antitrust enforcement."[47] The restriction of the unclean hands and *in pari delicto* defenses encourages private suits. A disenchanted co-conspirator is usually the most informed, interested and available party to expose an antitrust violation. The knowledge that allies may be potential opponents attracted by the promise of treble damages has a strong deterrent effect upon potential violators. Thus, the courts will allow even an undeserving party to benefit[48] when such a party brings an action under the antitrust laws in order to promote the broad public

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[43] 392 U.S. 134 (1968).

[44] Id. at 138-39.

[45] Id. at 139.

[46] 15 U.S.C. § 15 (1964). The Clayton Act also encourages private antitrust suits by permitting the use of a final judgment or decree in an antitrust suit brought by the government as prima facie evidence in an action brought by any other party against the same defendant. 15 U.S.C. § 16(a) (1964).

[47] 392 U.S. at 139.

[48] Waldron v. British Petroleum Co., 231 F. Supp. 72, 92 (S.D.N.Y. 1964); Affiliated Music Enterprises v. Sesac, Inc., 17 F.R.D. 509, 511 (S.D.N.Y. 1955); Trebuhs Realty Co. v. News Syndicate Co., 107 F. Supp. 595, 599 (S.D.N.Y. 1952).

objectives of those laws. They have determined that promotion of these objectives is more important to the public than is the comparatively small injustice which results when a wrongdoer is rewarded. The courts have supported this reasoning by finding in the lack of statutory support for the defenses and in the rejection of several alternate bills expressly allowing *in pari delicto* as a defense at the time the antitrust laws were in the process of enactment evidence of congressional intent that the defenses should not bar recovery.[49] In sum, the broad public interest in antitrust violations, as distinguished from purely personal or private injury, has led to the policy determination to limit common law defenses.

There is less support for the proposition that private SEC suits play as important a role in the enforcement of the securities acts as private suits in the antitrust area. Private rule 10b-5 suits, for example, are based upon a court implied civil liability rather than on a specific statutory provision.[50] In the 1933 and 1934 Acts Congress made no provisions to encourage private actions as attractive as is the treble damages provision of the Clayton Act, and in fact limited recovery to actual damages.[51]

Nevertheless, in *J. I. Case Co. v. Borak*,[52] a private suit brought for proxy rule violations, the Supreme Court emphasized the same "need for enforcement" policies which play such an important role in private antitrust actions. The Court stated:

> 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. The Commission advises that it examines over 2000 proxy statements annually and each of them must necessarily be expedited. Time does not permit an independent examination of the facts set out in the proxy material . . . .[53]

The Court concluded that

> it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose.[54]

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49 21 Vand. L. Rev. 1083, 1084, n. 13 (1968).

50 "In view of the general purpose of the Act, the mere omission of an express provision for civil liability is not sufficient to negative what the general law implies." Kardon v. National Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946). See also L. Loss, supra note 1, at 1757-97.

51 15 U.S.C. § 78bb(a) (1964). For a recent and extensive analysis of whether more than actual damages are recoverable under the securities acts, with a negative conclusion, see Globus v. Law Research Serv., Inc., 418 F.2d 1276 (2d Cir. 1969). But see deHaas v. Empire Petroleum Co., 302 F. Supp. 647 (D. Colo. 1969).

52 377 U.S. 426 (1964).

53 Id. at 432.

54 Id. at 433.

This statement reflects the Court's awareness of the public interest in the enforcement of the securities acts. One purpose of the securities acts is to protect individual investors.[55] But as Congress recognized, the need to regulate transactions in securities goes far beyond the need to provide protection to individual investors:

> transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto . . . .[56]

The 1934 Act, in principle an expansion of the 1933 Act, is directed toward the protection of interstate commerce, the national credit, the federal taxing power, the national banking system, and the Federal Reserve System as well as to the maintenance of fair and honest securities markets.[57] The Act recognizes that the prices of securities are susceptible to manipulation and control.[58] This in turn can give rise to excessive speculation causing unreasonable fluctuations in the market.[59] Congress embodied in the Act its recognition of the impact this process can have on the national welfare:

> National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation . . . .[60]

Thus, although there are numerous investors who directly benefit by the congressional regulation of securities transactions, non-investors also benefit because federal securities regulation is integrally related to the maintenance of nationwide economic stability.[61] And, in more immediate ways, the securities acts guard the interests of many non-investors. For example, many non-investors contribute money periodically to insurance, pension, and retirement plans. Much of this

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[55] Associated Securities Corp. v. SEC, 293 F.2d 738, 740 (10th Cir. 1961); Dolgow v. Anderson, 43 F.R.D. 472, 482 (E.D.N.Y. 1968):

> The disclosure provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 were designed to protect the small investor by preventing those "on the 'inside'" from taking "advantage of their superior knowledge to profit at the expense of the stockholders or of the investing public."

[56] 15 U.S.C. § 78b (1964).

[57] 15 U.S.C. § 78b (1964). "The great exchanges of this country upon which millions of dollars of securities are sold are affected with a public interest in the same degree as any other great utility." H.R. Rep. No. 1383, 73d Cong., 2d Sess. 15 (1934).

[58] 15 U.S.C. § 78b(3) (1964).

[59] 15 U.S.C. § 78b (1964).

[60] 15 U.S.C. § 78b(4) (1964).

[61] Loomis, The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940, 28 Geo. Wash. L. Rev. 214, 216-17 (1959).

money is then invested for the ultimate benefit of those who pay the premiums.[62] In addition, securities are frequently used as collateral in loan transactions where it is important to the interests of the securing parties that the values of the securities are fairly and honestly determined.[63] Under these circumstances unchecked violations of the securities acts may affect the ability of insurance companies to meet their obligations and may threaten the soundness of the banking system.

Attainment of the purposes of the Acts was sought by adoption of a policy of full and fair disclosure in securities transactions.[64] Section 10(b), with its corresponding rules, is an important part of that policy designed to prevent manipulative and deceptive devices.[65] The thrust of rule 10b-5 goes to the protection of such fraud as is accomplished by false statements, a failure to correct a misleading impression, or not stating anything at all when there is a duty to speak.[66] Thus, enforcement of rule 10b-5 serves "important public purposes."[67] Enforcement of the provisions of the securities acts is the responsibility of the SEC. Its activities are both regulatory and disciplinary in nature but, because of limitations of personnel and financial support, the SEC's investigatory and remedial activities are restricted:

> Because of budgetary limitations, and alternative demands on available manpower, the Commission cannot fully investigate or take action in every case of possible violation.[68]

Private rule 10b-5 suits are, therefore, an important supplement to administrative action,[69] and encouragement of such suits increases the effectiveness of the rule.

The *Kuehnert* court felt that the decision in *SEC v. Texas Gulf Sulphur Co.*[70] already provided a substantial deterrent to insiders; thus, it reasoned that it was now desireable to provide a similar deterrent to tippees. This reasoning fails to take into account one of the most important objectives of the policy of encouraging private suits among guilty parties by the limitation of common law defenses, that

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62 In 1954, the book value of private non-insured pension funds was $11 billion; 10 years later it was over $46 billion. It has been estimated that net receipts will amount to $6 billion annually by 1970 and $8 billion by 1980. Mundheim & Henderson, Applicability of the Federal Securities Laws to Pension and Profit-Sharing Plans, 29 Law & Contemp. Prob. 795, 796 (1964). For a discussion of how pension funds and other institutional investors utilize the securities markets, see SEC Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 2, at 837-70 (1963).

63 See 15 U.S.C. § 78b(3) (1964).

64 Sowards, The Federal Securities Act, 11 Business Organizations § 1.02 (1969).

65 See note 1 supra.

66 See note 1 supra.

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

68 Excerpt from SEC amicus curiae brief as quoted in Dolgow v. Anderson, 43 F.R.D. 472, 483 (E.D.N.Y. 1968). See also Cary, Administrative Agencies and the Securities and Exchange Commission, 20 Law & Contemp. Prob. 653-54 (1964).

69 J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964).

70 SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

is, the *exposure* of violators. The maintenance of the principles of full disclosure and honest dealing in connection with the purchase or sale of securities is too important to allow fraudulent activity to go undetected. *Texas Gulf Sulphur* was concerned with standards of conduct but did not bear on the question of exposure. As one writer has noted:

> [I]t seems contrary to common sense to believe that episodes like those in *Cady, Roberts* and *Texas Gulf Sulphur* are as rare as their legal outcroppings.[71]

The limitation of common law defenses would make rule 10b-5 more effective by increasing exposure of violations, and the greater likelihood of exposure would act as a greater deterrent. The circumstances in *Kuehnert* demonstrate this. The court admitted that by refusing the dupe-tippee a remedy against the insider, the insider has "free rein."[72] He can distribute false and misleading information to certain investors with impunity, fearing neither possible liability to the dupe-tippees nor exposure. Without the self-interest in the prospect of recovering their losses, the dupe-tippees are unlikely to risk SEC and criminal sanctions by exposing the insider who defrauded them. Thus, such fraudulent activity will often remain undiscovered. Without fear of exposure by those he uses, an insider can lead others unsophisticated in securities dealings into fraudulent schemes intended for manipulative purposes. Despite this, the *Kuehnert* court felt it should not allow a tippee to recover because this would, in effect, give him "an enforceable warranty" against an insider that secret information is true. This kind of injustice should be overlooked when exposure of statutory violations is so important to the public interest. This "warranty" may make it less risky for a tippee, but an insider, knowing the recourse the misled tippee would have against him, is far less likely to give the tippee such an opportunity. Deterring violations of SEC regulations at their source, at the insider level, would be far more effective. Insiders are more likely to have access to informed counsel and to be aware of the rules prohibiting misuse of corporate confidential information for personal gain. And, as noted in the dissenting opinion to *Kuehnert*, when violations occur, exposure through private suits renders all guilty parties "more easily subject to appropriate civil, administrative, and criminal penalties."[73]

With the degree of public interest involved in the enforcement of rule 10b-5 through private suits, the *Can-Am* principle that in cases under Section 12 of the 1933 Act it is necessary to differentiate the guilt of the parties[74] ought to be equally applicable in rule 10b-5 cases. As in *Moscarelli*, mere participation by a plaintiff should not per se bar his recovery. Although decisions in these and other securities acts

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[71] Schotland, Unsafe at Any Price: A Reply to Manne, *Insider Trading and the Stock Market*, 53 Va. L. Rev. 1425, 1474 (1967).

[72] 412 F.2d at 705.

[73] Id. at 706, n.3.

[74] 331 F.2d at 373.

cases have been based on facts in particular cases, these principles should be applicable in all rule 10b-5 cases. This is supported by the growing importance of private suits under rule 10b-5.[75] Violations of the rule can bring liability whether or not willfully committed. The *Kuehnert* decision would apparently bar recovery by any tippee, whether he acted willfully or was merely unknowledgeable about the rule's prohibition against the use of inside information. The court denied recovery to Kuehnert without discussion of the willfulness of his conduct. Aside from that consideration, Kuehnert was an unknowing part of a larger scheme by Rhame to gain working control of Texstar. Rhame's use of Kuehnert for this purpose constituted a breach of trust to other Texstar stockholders. Nevertheless, the court made no attempt to differentiate the degree of guilt of the parties.

Apart from the question of whether *in pari delicto* should bar recovery by a true co-conspirator or a party with equal guilt,[76] unclean hands at least should not be a sufficient defense. It is true that the actions of a dupe-tippee may be so predicated upon purely personal interests and motives that allowing recovery may seem unjust. And though one of the objectives of rule 10b-5 is to protect the ordinary person who buys and sells securities, it is also the implicit purpose of the rule, as evidenced by its inclusion in a legislative act specifically adopted to protect significant national and public interests, to safeguard both the investing and non-investing public in many different ways. Protection of individuals and protection of the public in general are not mutually exclusive courses of action.

Conclusion

The decision in *Kuehnert* that the unclean hands of a dupe-tippee should bar his recovery of losses under rule 10b-5 against the insider who defrauded him tends to lessen, rather than enhance, the effectiveness of that rule. It is likely that many violations of rule 10b-5 go undiscovered. Particularly in circumstances like those in *Kuehnert,* the bar of unclean hands closes the most likely avenue of exposure. A strong deterrent to similar schemes is thereby lost.

The policy of full disclosure which rule 10b-5 is intended to effect is an important underpinning of securities regulation. The regulation of the securities markets is vital to the maintenance of national economic stability. This, in fact, is the basis of federal legislative jurisdiction.[77] With such a public interest in the enforcement of rule 10b-5, judicial policy should be directed towards promoting enforcement. Private suits aid enforcement significantly and their role is increasing. Keeping bars to such suits at a minimum as a matter of policy best serves the public interest. This policy is in keeping with the principles laid down by the Supreme Court that "broad common law barriers to relief [are inappropriate] when a private suit serves

[75] Kuehnert v. Texstar, 412 F.2d 700, 706, n.2 (5th Cir 1969).
[76] Id. at n.3.
[77] 15 U.S.C. § 78b (1964).

important public purposes,"[78] and that the courts should "be alert to provide such remedies as are necessary to make effective the congressional purpose."[79] The public interest in the exposure of rule 10b-5 violations should be sufficient to overcome any judicial reluctance to reward a wrongdoer. No rule 10b-5 suit is only a question of "accounting between joint conspirators."[80]

JOHN M. DESTEFANO

[78] Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134, 138 (1968).
[79] J. I. Case Co. v. Borak, 377 U.S. 426, 433 (1964).
[80] Kuehnert v. Texstar Corp., 412 F.2d 700, 703 (5th Cir. 1969).