THE AVAILABILITY OF THE *IN PARI DELICTO* DEFENSE IN TIPPEE-TIPPER RULE 10b-5 ACTIONS AFTER *DIRKS v. SEC*

He who comes here for relief, must
draw his justice from pure fountains[1]

The defense of *in pari delicto,* which means "of equal fault,"[2] developed at common law[3] to preserve the decorum of the courts.[4] The defense has met with considerable resistance in the United States when raised in an attempt to bar actions alleging violations of federal antitrust[5] and securities[6] laws. The Supreme Court allows the *in pari*

1. Austin's Adm'x v. Winston's Ex'r, 11 Va. (1 Hen. & M.) 32, 47 (1806).

2. Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134, 135 (1968). The defense derives from the Latin expression, "*in pari delicto potior est conditio possidentis (defendentis).* In 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 (rev. 5th ed. 1977).

3. Lord Mansfield first discussed the *in pari delicto* defense in Smith v. Bromley, 99 Eng. Rep. 441 (1760) and Holman v. Johnson, 98 Eng. Rep. 1120 (1775). For nineteenth century views of the defense in state courts, see Kahn v. Walton, 46 Ohio St. 195, 207-15, 20 N.E. 203, 209-13 (1889); Starke's Ex'rs v. Littlepage, 25 Va. (4 Rand.) 368, 372-75 (1826); Austin's Adm'x v. Winston's Ex'r, 11 Va. (1 Hen. & M.) 33, 45-49 (1806).

For early Supreme Court treatments of the defense, see Second Russian Ins. Co. v. Miller, 268 U.S. 552, 562 (1925); Harriman v. Nothern Sec. Co., 197 U.S. 244, 295-98 (1905); St. Louis, V. & T.H. R.R. v. Terre Haute & I. R.R., 145 U.S. 393, 407-08 (1892); Thomas v. Richmond, 79 U.S. (12 Wall.) 349, 354-56 (1871).

For detailed reviews of *in pari delicto's* early English and American history, see Grodecki, *In Pari Delicto Potior Est Conditio Defendentis,* 71 LAW Q. REV. 254 (1955); Handler & Sacks, *The Continued Vitality of In Pari Delicto as an Anti-Trust Defense,* 70 GEO. L.J. 1123, 1128-31 (1982); Comment, *Rule 10b-5: The In Pari Delicto and Unclean Hands Defenses,* 58 CALIF. L. REV. 1149, 1162-65 (1970).

4. *See* Holman v. Johnson, 98 Eng. Rep. 1120 (1775). Lord Mansfield, although appreciative of the need to prevent courts from becoming forums for disputes grounded in illegality, clearly expressed his distaste for those who invoked the *in pari delicto* defense to shield their unlawful activities from reproach:

> The objection that a contract is immoral or illegal as between plaintiff and defendant sounds at all times very ill in the mouth of the defendant. It is not for his sake, however, that the objection is ever allowed; but is founded in general principles of policy, which the defendant has the advantage of, contrary to real justice as between him and the plaintiff; by accident, if I may so say.

Id. at 1121.

5. *See* Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134 (1968); *see generally* Handler & Sacks, *supra* note 3; Comment, *The Demise of In Pari Delicto in Private Actions Pursuant to Regulatory Schemes,* 60 CALIF. L. REV. 572 (1972).

6. Schick v. Steiger, 583 F. Supp. 841 (E.D. Mich. 1984); Kirkland v. E.F. Hutton & Co., 564 F. Supp. 427 (E.D. Mich. 1983); Xaphes v. Shearson, Hayden, Stone, Inc., 508 F. Supp. 882

delicto defense an extremely limited role in antitrust litigation.[7] The Court has yet to rule, however, on the appropriateness of the defense in actions alleging violations of the Securities and Exchange Commission's (SEC) rule 10b-5.[8] Lacking Supreme Court guidance, the lower federal courts have split over whether the *in pari delicto* defense bars "tippees" from bringing rule 10b-5 actions[9] against their "tippers."[10]

This Note suggests a contemporary analysis for determining the circumstances in which a defendant-tipper may raise the *in pari delicto* defense to bar a tippee's rule 10b-5 action. Part I of this Note reviews the Supreme Court's opinion in *Perma Life Mufflers, Inc. v. Interna-*

(S.D. Fla. 1981); Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50 (S.D.N.Y. 1971); Kulla v. E.F. Hutton & Co., 426 So. 2d 1055 (Fla. Dist. Ct. App. 1983).

7. *See* Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134 (1968); *see also infra* notes 18-25 and accompanying text (discussing *Perma Life*).

8. Rule 10b-5, promulgated by the SEC under section 10(b) of the Securities and Exchange Act, and codified as 17 C.F.R. § 240.10b-5 (Rev. Ed. 1984) provides in pertinent part:

> It shall be unlawful for any person, directly or indirectly, . . . (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.

15 U.S.C. § 78j(b), section 10(b) of the Securities Exchange Act of 1934, provides in pertinent part:

> It shall be unlawful for any person, directly or indirectly, . . . (b) To use or employ, in connection with the purchase or sale of any security . . . 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.

9. The tippees—recipients of information—usually 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.,* Grumet v. Shearson/American Express, Inc., 564 F. Supp. 326, 337 (D.N.J. 1983) (takeover failed to occur); Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50, 51 (S.D.N.Y. 1971) (anticipated favorable "merger" terms worked to tippee's detriment).

The tippee might also allege that the tipper falsely portrayed himself as an "insider." Xaphes v. Shearson, Hayden, Stone, Inc., 508 F. Supp. 882, 886 (S.D. Fla. 1981). Alternatively, the tippee may charge that the tipper intentionally failed to disclose all relevant information concerning a corporation. Kirkland v. E.F. Hutton & Co., 564 F. Supp. 427, 432 (E.D. Mich. 1983). *See also infra* note 168 (discussing differences between failure to disclose and active misrepresentation cases).

10. For courts disallowing the defense, see cases cited *supra* note 6; *see also* Mallis v. Bankers Trust Co., 615 F.2d 68 (2d Cir. 1980), *cert. denied,* 449 U.S. 1123 (1981); Lawler v. Gilliam, 569 F.2d 1283 (4th Cir. 1978). For cases allowing the defense, see Tarasi v. Pittsburgh Nat'l Bank, 555 F.2d 1152 (3d Cir.), *cert. denied,* 434 U.S. 965 (1977); Woolf v. S.D. Cohn & Co., 515 F.2d 591 (5th Cir. 1975); James v. Du Breuil, 500 F.2d 155 (5th Cir. 1974); Kuehnert v. Texstar Corp., 412 F.2d 700 (5th Cir. 1969); Grumet v. Shearson/American Express, Inc., 564 F. Supp. 336 (D.N.J. 1983); Summerlin v. Blyth Eastman Dillion & Co., [1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,197, at 95,787 (N.D. Ga. March 23, 1983); Wohl v. Blair & Co., 50 F.R.D. 89 (S.D.N.Y. 1970).

tional Parts Corp.,[11] which limited the use of the *in pari delicto* defense in antitrust law. Part II discusses the federal courts' contrasting views applicability of *in pari delicto*'s to tippee-tipper actions under rule 10b-5.[12] Part III reviews the Supreme Court's recent interpretations of the scope of the duty to disclose under rule 10b-5.[13] In part IV this Note suggests that two recent Supreme Court decisions, *Chiarella v. United States*[14] and *Dirks v. SEC*,[15] effectively rendered the *in pari delicto* defense inapplicable in most tippee suits against tippers.[16] This Note concludes that in situations where the defense potentially remains applicable, the courts will best promote the goals of the securities laws by refraining from a wholesale adoption or rejection of the *in pari delicto* bar. Instead, to achieve equity in a given case, courts should allocate loss between parties by scrutinizing their conduct under a comparative fault analysis.[17]

I. *IN PARI DELICTO* AND THE WARREN COURT

In *Perma Life Mufflers, Inc. v. International Parts Corp.*,[18] the Supreme Court considered whether the *in pari delicto* defense could bar treble damage antitrust actions.[19] The Court reversed lower court holdings that allowed the defense,[20] but the case produced a spectrum of opinions disagreeing on the circumstances in which an antitrust defendant could invoke the *in pari delicto* defense.[21] Justice Black, writ-

11. 392 U.S. 134 (1968). *See infra* notes 18-25 and accompanying text.

12. *See infra* notes 26-126 and accompanying text.

13. *See infra* notes 127-154 and accompanying text.

14. 445 U.S. 222 (1980); *see infra* notes 127-44 and accompanying text (discussing *Chiarella*).

15. 103 S. Ct. 3255 (1983); *see infra* notes 145-54 and accompanying text (discussing *Dirks*).

16. *See infra* notes 155-90 and accompanying text.

17. *See infra* notes 191-205 and accompanying text.

18. 392 U.S. 134 (1968).

19. In *Perma Life*, the plaintiffs, "Midas Muffler Shops" dealers, brought an antitrust action seeking treble damages against Midas, Inc. and its parent corporation, International Parts Corp. *Id.* at 135. The dealers alleged that the defendants conspired, via their sales agreements with the dealers, "to restrain and substantially lessen competition" in violation of the Sherman and Clayton Acts. *Id.*

20. *Id.* at 142. The lower courts maintained that the plaintiffs had voluntarily entered their sales agreements with defendants and had made "enormous profits." *Id.* at 138. Justice Black noted that the Court of Appeals had asserted that "[i]t would be difficult to visualize a case more appropriate for the application of the *pari delicto* doctrine." *Id.* (quoting Perma Life Mufflers, Inc. v. International Parts Corp., 376 F.2d 692, 699 (7th Cir. 1967)).

21. *See* 392 U.S. at 135 (majority opinion); *id.* at 142 (White, J., concurring); *id.* at 147 (Fortas, J., concurring in the result); *id.* at 148 (Marshall, J., concurring in the result); *id.* at 153 (Harlan, J., with whom Stewart, J., joins, concurring in part and dissenting in part).

ing for the Court, asserted that because of its broad scope, the *in pari delicto* defense had no place in antitrust litigation.[22] Justice Black emphasized that courts should avoid "broad common law barriers to relief" when private actions promoted "important public purposes."[23]

Five Justices, however, agreed that in certain narrowly defined circumstances, the plaintiff's culpability should serve as a defense to antitrust actions. These Justices agreed in four separate opinions that courts should bar parties who bear substantially equal fault for perpetration of an unlawful activity from pursuing actions against each other.[24] Justices Marshall, Harlan, and Stewart expressed concern that wrongdoers might reap a windfall from a treble damages award against their co-wrongdoers.[25] The divergence of opinions left lower courts uncertain whether to apply the common law *in pari delicto* defense outside the antitrust context.

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22. *Id.* at 140.

23. *Id.* at 138. Justice Black, joined by Chief Justice Warren, and Justices Douglas, Brennan, and White, also asserted three other grounds supporting the Court's decision to bar the *in pari delicto* defense in antitrust actions. First, Justice Black contended that the *in pari delicto* defense interfered with the public policy of promoting competition. *Id.* at 139. "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." *Id.* Justice Black also asserted that civil and criminal penalties would offset any windfall gains accruing to plaintiffs who had themselves violated the antitrust laws. *Id.* Finally, Justice Black maintained that, contrary to the opinions of the lower courts, the Midas dealers had not voluntarily participated "in any meaningful sense" in the defendant's anticompetitive activities and certainly had not "aggressively supported" the defendant's "monopolistic scheme." *Id.* at 139-40.

24. *Id.* at 146 (White, J., concurring); *id.* at 147 (Fortas, J., concurring in the result); *id.* at 149 (Marshall, J., concurring in the result); *id.* at 156 (Harlan, J., concurring in part and dissenting in part).

25. Justice Marshall did not share Justice Black's view that civil and criminal actions would deter potential plaintiffs from entering anticompetitive agreements. *See supra* note 23. Justice Marshall argued that a wholesale bar of the *in pari delicto* defense would allow parties to recover their losses in the event that their anticompetitive schemes failed, thus giving such parties "new incentive" to violate the antitrust laws. 392 U.S. at 151 (Marshall, J., concurring in the result). Justice Marshall also stressed the need to examine the equities between the parties to ensure that a party would not profit from his wrongdoing. *Id.*

Justices Harlan and Stewart agreed in principle with Justice Marshall:

> 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. . . . Even if the threat of intra-conspiracy treble damages had some deterrent effect, however, I should not think it a too "fastidious regard for the relative moral worth of the parties," . . . to decline to sanction a kind of antitrust enforcement that rests upon a principle of well-compensated dishonor among thieves.

Id. at 154 (Harlan, J., concurring in part and dissenting in part) (quoting *id.* at 139).

II. *IN PARI DELICTO* IN RULE 10b-5 ACTIONS INVOLVING TIPPERS AND TIPPEES

A. The Rule 10b-5 Setting

Rule 10b-5 tippee-tipper actions in which *in pari delicto* plays a role present a recurring fact situation. The scenario typically begins when the tipper[26] contacts his tippee.[27] The tipper induces the tippee to believe that he possesses "inside information" indicating that the value of a particular corporation's stock will rise.[28] Relying upon the tipper's representations, the tippee purchases a block of the corporation's stock.[29]

Instead of increasing in value, the purchased stock takes an unexpected turn for the worse.[30] The surprised and angry tippee sells the securities at a substantial loss.[31] Seeking recourse against the unreliable "tipper," the tippee brings an action alleging violations of rule 10b-5. The tippee usually maintains that the tipper's "tip" constituted an active misrepresentation.[32] The tipper then raises the *in pari delicto*

26. Most *in pari delicto* cases feature a stockbroker as the tipper. *See, e.g.,* Kirkland v. E.F. Hutton & Co., 564 F. Supp. 427 (E.D. Mich. 1983); Grumet v. Shearson/American Express, Inc., 564 F. Supp. 336 (D.N.J. 1983).

27. Tippees purchasing corporate stock on the basis of a "tip" usually lack any direct relationship with the corporation. Dirks v. SEC, 103 S. Ct. 3255, 3261 (1983). For a brief review of the general attributes of tippees, see Xaphes v. Shearson, Hayden, Stone, Inc., 508 F. Supp. 882, 884 n.2 (S.D. Fla. 1981).

28. The tipper most often asserts knowledge of an imminent merger or takeover. *See, e.g.,* Tarasi v. Pittsburgh Nat'l Bank, 555 F.2d 1152, 1154-56 (3d Cir.) (proposed merger), *cert. denied,* 434 U.S. 965 (1977); Xaphes v. Shearson, Hayden, Stone, Inc., 508 F. Supp. 882, 884 (S.D. Fla. 1981) (proposed takeovers).

29. The usual tippee, long on optimism and short on cash, purchases stock "on margin" through a broker. *See, e.g.,* Kuehnert v. Texstar Corp., 412 F.2d 700, 702 (5th Cir. 1969). The expectation of a quick windfall profit often persuades otherwise conservative tippees to enter speculative investments. *See, e.g.,* Tarasi v. Pittsburgh Nat'l Bank, 555 F.2d 1152, 1155 (3d Cir.) (attorney purchased quantity of three-month "call" options), *cert. denied,* 434 U.S. 965 (1977); Kirkland v. E.F. Hutton & Co., 564 F. Supp. 427, 432 (E.D. Mich. 1983) (employee of the Dictaphone Company persuaded to sell his Pitney-Bowes stock to finance purchases of stock in alleged takeover targets).

30. *See, e.g.,* Kirkland v. E.F. Hutton & Co., 564 F. Supp. 427, 432 (E.D. Mich. 1983) (purported takeover target's price plunged within two weeks of tippee's purchases); Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50, 52 (S.D.N.Y. 1971) (forecasted merger occurred, but at terms unfavorable to the tippee).

31. The tippee often unwillingly sells the shares to meet margin requirements. Grumet v. Shearson/American Express, Inc., 564 F. Supp. 336, 337 (D.N.J. 1983).

32. *Id.* The tippee often further alleges that the tipper falsely represented himself as an "insider" and that the tipper failed to disclose all the information he possessed concerning the tippee's investment. *See supra* note 9; *infra* note 168.

defense, asserting that the tippee also violated rule 10b-5 by failing to disclose the supposed "inside information" prior to trading.[33]

Since 1969 federal courts have considered the applicability of the *in pari delicto* defense to analogous fact situations in more than a dozen cases.[34] The three pairs of cases reviewed below present the federal courts' spectrum of arguments for and against acceptance of the *in pari delicto* defense.[35]

B. In Pari Delicto*: 1969-71*

In the three years following the *Perma Life* decision, two federal courts reached opposite conclusions in deciding whether a tipper-defendant could raise the *in pari delicto* defense.[36] In *Kuehnert v. Texstar Corp.*,[37] a divided Fifth Circuit[38] allowed the defense,[39] while the court

33. *See* Grumet v. Shearson/American Express, Inc., 564 F. Supp. 336, 337-38 (D.N.J. 1983); Kirkland v. E.F. Hutton & Co., 564 F. Supp. 427, 432-33 (E.D. Mich. 1983). *In pari delicto* usually is raised on a motion for summary judgment, *see* cases cited *supra*, but the tipper occasionally raises the defense on a motion to dismiss. *See* Xaphes v. Shearson, Hayden, Stone, Inc., 508 F. Supp. 882, 884 (S.D. Fla. 1981).

34. *See* E.F. Hutton & Co. v. Berns, 682 F.2d 173, 176 n.6 (8th Cir. 1982) (collecting cases); *see also* cases cited *supra* notes 6 & 10.

35. *See infra* notes 36-126 and accompanying text.

36. *See* Kuehnert v. Texstar Corp., 412 F.2d 700 (5th Cir. 1969); Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50 (S.D.N.Y. 1971); *see also infra* notes 37-73 and accompanying text. The *Kuehnert* and *Nathanson* decisions provoked substantial commentary. *See, e.g.*, Bell, *How to Bar an Uninnocent Investor—The Validity of Common Law Defenses to Private Actions Under the Securities Exchange Act of 1934*, 23 U. FLA. L. REV. 1 (1970); Jacobs, *The Impact of Securities Exchange Act Rule 10b-5 on Broker-Dealers*, 57 CORNELL L. REV. 869 (1972); Nea, *Limitations on Defenses Under 10(b): In Pari Delicto and Unclean Hands*, 5 U. RICH. L. REV. 251 (1971); Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597 (1972).

For student commentary, see Note, Pearlstein v. Scudder & German: *Implied Rights of Action for Violation of Federal Margin Requirements and the Demise of the In Pari Delicto Defense*, 66 NW. U.L. REV. 372 (1972); Comment, *In Pari Delicto as a Bar to Tippee's Recovery Under Rule 10b-5: The Concept of "Public Interest" in Trade Regulation Compared*, 11 B.C. INDUS. & COM. L. REV. 257 (1970); Comment, *Tipsters, Tippees, and the Doctrine of In Pari Delicto*, 50 B.U.L. REV. 87 (1970); Comment, *The Demise of In Pari Delicto in Private Actions Pursuant to Regulatory Schemes*, 60 CALIF. L. REV. 572 (1972); Comment, *Rule 10b-5: The In Pari Delicto and Unclean Hands Defense*, 58 CALIF. L. REV. 1149 (1970); Comment, *Securities Regulation: Doctrines of In Pari Delicto and Unclean Hands Held to Bar 10b-5 Recovery by Tippee Against Corporate Insider*, 1969 DUKE L.J. 832; Comment, *Plaintiff's Conduct as a Bar to Recovery Under the Securities Acts: In Pari Delicto*, 48 TEX. L. REV. 181 (1969).

37. 412 F.2d 700 (5th Cir. 1969).

38. Judge Aldrich of the First Circuit, sitting by designation, wrote the majority opinion joined by Judge Dyer. Judge Godbold dissented.

39. 412 F.2d at 705.

in *Nathanson v. Weis, Voisin, Cannon, Inc.*[40] held that the defendant-tipper could not assert that the plaintiff-tippee was *in pari delicto.*

In *Kuehnert,* defendant W.T. Rhame, an officer of Texstar Corporation, informed the plaintiff, Kuehnert, that Texstar would soon enter a merger that would substantially increase dividends and Texstar's market price.[41] Kuehnert purchased a block of Texstar stock,[42] but Rhame's predictions proved erroneous and Kuehnert lost his entire investment.[43] Kuehnert brought suit against Rhame and Texstar, alleging a rule 10b-5 violation.[44] In response, the defendants maintained that Kuehnert had also violated rule 10b-5 by failing to disclose material, nonpublic information prior to trading.[45]

The *Kuehnert* court held that the plaintiff had violated rule 10b-5's implied prohibition against insider trading[46] and thus stood *in pari delicto* with the defendants.[47] The court relied on the broad language "any manipulative or deceptive device" in section 10(b) of the Securities and Exchange Act (the 1934 Act)[48] to support the proposition that rule 10b-5 proscribed both successful and attempted frauds.[49] Kuehnert's intent to scheme with Rhame to defraud the investing public thus

40. 325 F. Supp. 50 (S.D.N.Y. 1971).

41. 412 F.2d at 702. Rhame, formerly president of Texstar, supposedly confided this news to Kuehnert in an attempt to persuade him to purchase a block of Texstar. Rhame hoped that Kuehnert's purchases would give him working control, thus easing Rhame's difficulty in dealing with other Texstar directors and shareholders. *Id.*

42. *Id.*

43. *Id.* Kuehnert's brokerage house liquidated his account when he failed to meet his margin calls. *Id.*

44. *Id.* at 701.

45. *Id.* at 702.

46. *Id.* at 703. The court devoted only one paragraph to considering whether Kuehnert had indeed violated rule 10b-5. The court simply asserted that Kuehnert, although technically not an insider, was a "tippee," a status requiring him to disclose inside information. For support the court cited SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969). *Texas Gulf Sulphur* no longer represents a valid precedent for determining when a tippee's duty to disclose arises. *See* Dirks v. SEC, 103 S. Ct. 3255 (1983); *see also infra* notes 145-54 and accompanying text (discussing *Dirks*).

47. 412 F.2d at 704. The court rejected Kuehnert's argument that because he had traded on incorrect inside information, his purchases did not defraud any third parties and thus his actions did not violate rule 10b-5. *Id.*

48. *See supra* note 8.

49. 412 F.2d at 704. The court buttressed its argument with the assertion that the related equitable notion of "unclean hands" traditionally looked to the parties' intent as a basis for barring their actions. *Id.* The court apparently had no qualms about relying on equitable principles to bolster its argument for allowing the common law *in pari delicto* defense.

operated to bar his action even though it was he who was defrauded.[50]

Although the court established that the tippee-tipper action provided a proper context to apply *in pari delicto,*[51] it added that the public policy of protecting investors might preclude the use of the defense.[52] The court perceived that two competing policy considerations were at issue. Allowing the defense would fail to deter tippers from misrepresenting that they possess inside information.[53] Denying tippers the defense, in contrast, would in effect give tippees an "enforceable warranty" that their tipped "inside information" was true.[54]

Balancing these considerations, the court held that public policy favored the use of the *in pari delicto* defense in actions brought by tippees against tippers.[55] First, the court maintained that the threat of third party private suits and SEC enforcement actions adequately deterred tippers from violating rule 10b-5.[56] In addition, the court noted that although tippees and tippers present relatively equal threats to the in-

50. *Id.* The court noted that Kuehnert's losses were directly related to his own attempted fraud. Disclosure prior to trading would have apprised him of Rhame's untruthfulness and deterred him from trading. *Id.*

51. In this respect, the court distinguished the antitrust situation in *Perma Life* on three grounds. First, the court asserted that private actions alleging violations of the securities laws did not promote the public interest in the same way as the treble damage antitrust provision. In the securities context, the court argued, the principal question in a suit involves only an accounting among joint conspirators. *Id.* at 703; *cf. Perma Life Mufflers, Inc. v. International Parts Corp.,* 392 U.S. 134, 139 (1968) (private action is an "ever-present threat" to deter anticompetitive behavior). Second, the court noted that Kuehnert was an active participant in a scheme to defraud the investing public. 412 F.2d at 703; *see also Perma Life Mufflers,* 392 U.S. at 149 (Marshall, J., concurring in the result) (defendant in antitrust action should be able to assert *in pari delicto* when he can show that plaintiff actively participated in the illegal scheme). Finally, the court found that Kuehnert acted entirely voluntarily in dealing with Rhames. 412 F.2d at 704.

52. 412 F.2d at 704-05.

53. *Id.* at 705.

54. *Id. Cf.* Pearlstein v. Scudder & German, 429 F.2d 1136, 1148 (2d Cir. 1970), (Friendly, J., dissenting), *cert. denied,* 401 U.S. 1013 (1971). In *Pearlstein,* after the majority denied the *in pari delicto* defense to a broker who had extended a client credit in violation of the margin requirements of the Federal Reserve System's Regulation T, Judge Friendly asserted that "[a]ny deterrent effect of threatened liability on the broker may well be more than offset by the inducement to violations inherent in the prospect of a free ride for the customer, who, under the majority's view, is placed in the enviable position of 'heads-I-win tails-you-lose.' " *Id.* He added that the majority decision "shocks the conscience and wars with common sense." *Id.* at 1145.

55. *Id.*

56. 412 F.2d at 705. The court cited the Second Circuit's broad, all-encompassing view of the duty of disclosure promulgated in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969). *See supra* notes 23 & 25 (discussing contrasting views of the deterrence effect of private suits and agency enforcement actions in the antitrust field as expressed in the Supreme Court's *Perma Life* decision).

vesting public, tippees are less visible to potential third party litigants, and thus less likely to be sued for a rule 10b-5 violation.[57] Finally, the court asserted that the fear of financial loss would deter tippees from trading on inside information.[58]

In *Nathanson v. Weis, Voisin, Cannon, Inc.*,[59] the plaintiffs, acting on a "merger" tip from the defendant broker-dealers,[60] purchased a substantial amount of TST Industries securities.[61] Although the merger took place, its terms were disadvantageous to the plaintiffs, who took a substantial loss.[62] The plaintiffs filed suit, alleging that the defendants' misrepresentations constituted a rule 10b-5 violation and common law fraud.[63] On the defendants' motion for summary judgment,[64] the court held that despite the plaintiffs' violation of rule 10b-5, the *in pari delicto* defense did not bar plaintiffs' rule 10b-5 action.[65]

The *Nathanson* court initially determined that under rule 10b-5 the

57. 412 F.2d at 705.

58. *Id.*; *see also* Wohl v. Blair & Co., 50 F.R.D. 89, 93 (S.D.N.Y. 1970) (advocating a policy of "caveat tippee").

Judge Godbold, dissenting in *Kuehnert*, disagreed with the majority on two points. First, he asserted that the majority incorrectly characterized the private suit as less important for enforcing the securities laws than the treble damages actions in antitrust litigation. 412 F.2d at 706 & n.2 (Godbold, J., dissenting). He also suggested that courts could best serve the purposes of the securities laws by seeking to deter tippers. According to Judge Godbold, focusing on the tipper would deter the most knowledgeable of the parties, whose disclosure was "the first step in the chain of dissemination." *Id.*

59. 325 F. Supp. 50 (S.D.N.Y. 1971).

60. Defendants were unquestionably "insiders." Most of the defendant's officers and directors also were officers and directors of both merging corporations. *Id.* at 51 & n.1.

61. *Id.* at 51.

62. *Id.* at 51-52. The Nathansons bought TST when its market price listed at $8 per share and Elgin (the other merging corporation) listed at $17 per share. The Nathansons made their purchases with the understanding that the merger would entitle holders of TST shares to one share of Elgin in exchange for one share of TST. *Id.* at 51. Under the terms of the actual merger, holders of TST shares received one share of Elgin in exchange for every two and one-half shares of TST. *Id.* at 52.

63. *Id.* at 51. Plaintiff's rule 10b-5 action and its common law fraud counterpart are similar actions. In both instances the plaintiff alleges that the defendants actively misrepresented a material fact. The fraud lies between the parties in such situations. The defendants' fraud, grounded in an active misrepresentation, must be distinguished from the rule 10b-5 violation in which plaintiffs allegedly act *in pari delicto* with defendants. The latter fraud arises from the parties' failure to disclose material, nonpublic information prior to trading (or instigating trading) and operates as a fraud against the public. For a general discussion of the current relation between fraud, rule 10b-5 and the *in pari delicto* defense, see *infra* notes 155-205 and accompanying text.

64. 325 F. Supp. at 52. The defendants alleged that the plaintiffs acted *in pari delicto* by failing to disclose material, nonpublic information prior to trading. *Id.*

65. *Id.* at 53.

plaintiffs, as tippees, had a duty to disclose material, nonpublic information prior to trading.[66] The court rejected the plaintiffs' contention that trading on the basis of false information did not constitute fraud against the public. The court reasoned that plaintiffs' failure to disclose seemingly material, nonpublic information constituted a potential fraud and thus a violation of rule 10b-5.[67]

Although the court found the plaintiffs in violation of rule 10b-5, it asserted that if the plaintiffs' suit promoted public policy, the defendants could not raise the *in pari delicto* defense.[68] The *Nathanson* court's view of public policy in the tippee-tipper context contrasted sharply with the *Kuehnert* court's conclusions.[69] The *Nathanson* court asserted that both private suits under the securities laws and treble damage actions in antitrust litigation served "as a means not only of redressing a private wrong, but also of protecting the public interest."[70] After examining the relative fault of the parties, the court maintained that in the "usual situation"[71] the tipper presented a greater threat than the tippee to the policies underlying the securities laws.[72] The court concluded that denying the tipper the *in pari delicto* shield would most effectively protect the investing public.[73]

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66. *Id. See supra* note 46 (same approach followed in *Kuehnert*). The *Nathanson* court contended that in the 1934 Act Congress had intended to protect investors, insure fairness in the secondary securities markets, and promote equal access to material information. 325 F. Supp. at 53 (citing SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969)). *Cf.* Dirks v. SEC, 103 S. Ct. 3255, 3265 (1983) ("a purpose of the securities laws was to eliminate 'use of inside information for personal advantage' ") (quoting Cady, Roberts & Co., 40 S.E.C. 907, 912 n.15 (1961)).

67. 325 F. Supp. at 55. *Accord* Kuehnert v. Texstar Corp., 412 F.2d 700, 704 (5th Cir. 1969). For a discussion of the effect of recent Supreme Court decisions on the *Nathanson* and *Kuehnert* courts' reasoning concerning potential fraud as a violation of rule 10b-5, see *infra* notes 170-83 and accompanying text.

68. 325 F. Supp. at 55-56. *Accord* Kuehnert v. Texstar Corp., 412 F.2d 700, 704 (5th Cir. 1969).

69. *See supra* notes 51-58 and accompanying text.

70. 325 F. Supp. at 54. *See also id.* at 56 n.30 ("In both situations, private litigation serves to deter violations and to encourage injured parties to expose violators to the public.") (quoting 5 GA. L. REV. 166, 177 (1970)). *But see supra* notes 56-57 and accompanying text (discussing the *Kuehnert* court's view).

71. 325 F. Supp. at 57. The court possibly contemplated that in some situations, the tippee, if "sophisticated," might present a potential threat to the investing public equivalent to that of the usual tipper. *See* Kirkland v. E.F. Hutton & Co., 564 F. Supp. 427, 435 (E.D. Mich. 1983). For further discussion, see *infra* notes 193-95 and accompanying text.

72. 325 F. Supp. at 57.

73. *Id.* The court discounted the *Kuehnert* court's fears of giving a "windfall" or "enforceable warranty" to the tippee. " 'In our view the danger of permitting a windfall to an unscrupulous

C. In Pari Delicto*: 1977-1981*

Federal courts reevaluated the *in pari delicto* defense almost a decade after the *Kuehnert-Nathanson* division in *Tarasi v. Pittsburgh National Bank*[74] and *Xaphes v. Shearson, Hayden, Stone, Inc.*[75] In *Tarasi,* the plaintiffs[76] purchased a block of stock and several call options after receiving a confidential "merger" tip from defendant Mialki, a bank officer.[77] The merger failed to materialize and the plaintiffs sustained a $22,000 loss.[78] Plaintiffs filed suit alleging that the defendants' affirmative misrepresentations constituted a violation of rule 10b-5.[79] The Third Circuit Court of Appeals affirmed the district court's grant of summary judgment, holding that the doctrine of *in pari delicto* barred the plaintiffs' action.[80]

After finding that the plaintiffs had violated rule 10b-5,[81] the court

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investor is outweighed by the salutary policy effect which the threat of private suits for compensatory damages can have upon brokers and dealers above and beyond the threats of governmental action by the Securities and Exchange Commission.' ") *Id.* (quoting Pearlstein v. Scudder & German, 429 F.2d 1136, 1141 (2d Cir. 1970), *cert. denied,* 401 U.S. 1013 (1971)).

74. 555 F.2d 1152 (3d Cir.), *cert. denied,* 434 U.S. 965 (1977).

75. 508 F. Supp. 882 (S.D. Fla. 1981).

76. The plaintiffs were a used car salesman Mr. Tarasi, his aunt, and an attorney George Sampas. Sampas' decision to purchase call options instead of common stock evidences his relative sophistication in comparison with the average tippee. 555 F.2d at 1154-55.

77. *Id.* at 1154. Mialki advised plaintiffs that a certain Meridian Industries would soon enter a merger and probably "double in value." *Id.*

78. *Id.* at 1154-56. Plaintiffs' stock plunged from a value of $8 per share to $1 per share and plaintiff Sampas' options expired worthless. *Id.* at 1156.

79. *Id.*

80. *Id.* at 1164.

81. *Id.* at 1161. The court assumed that plaintiffs' role as "tippees" automatically gave them the obligation to disclose inside information prior to trading. This view followed the broad views of rule 10b-5's coverage expressed in Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974) and SEC v. Texas Gulf Sulphur Co., 401 F.2d 228 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969). *See infra* note 143 (noting the confusion which resulted after the Supreme Court's decision in Chiarella v. United States, 445 U.S. 222 (1980), in determining when tippees had a duty to disclose). For a discussion of *Chiarella,* see *infra* notes 132-43 and accompanying text.

For a post-*Chiarella* treatment of this issue in the *in pari delicto* context, see Xaphes v. Shearson, Hayden, Stone, Inc., 508 F. Supp. 882 (S.D. Fla. 1981); Kulla v. E.F. Hutton & Co., 426 So. 2d 1055 (Fla. Dist. Ct. App. 1983). *See also infra* notes 88-96 and accompanying text (discussion of *Xaphes*). *But see* Grumet v. Shearson/American Express, Inc., 564 F. Supp. 336 (D.N.J. 1983).

The Supreme Court finally identified the source of tippees' duty to disclose in Dirks v. SEC, 103 S. Ct. 3255 (1983). *See infra* notes 145-54 and accompanying text. For a discussion of *Dirks'* impact on the *in pari delicto* defense's use in actions between tippees and tippers, see *infra* notes 157-90 and accompanying text.

held that the parties were equally at fault,[82] and concluded that a proper basis existed for invoking the *in pari delicto* defense.[83] The court then considered the competing public policy considerations to determine whether allowing the *in pari delicto* defense would promote the purposes of the securities laws. Three factors led the court to allow the defense. First, allowing tippers to use the defense would deter many tippee violations of rule 10b-5.[84] Second, the court stressed the importance of preserving "the integrity of the courts and preventing wrongdoers from profiting from their misdeeds."[85] Finally, the court argued that the common law *in pari delicto* defense was more appropriate in the context of a rule 10b-5 cause of action, which is judicially created,[86] than in statutorily created actions such as the antitrust treble damages provision.[87]

In *Xaphes v. Shearson, Hayden, Stone, Inc.*,[88] the Southern District of Florida considered the effect on the *in pari delicto* doctrine of the Supreme Court's decision in *Chiarella v. United States*,[89] which held that a trader does not incur a duty to disclose prior to trading unless he

82. 555 F.2d at 1162. The *Tarasi* court reached its determination that the parties were of "substantially equal fault" by focusing on the extent to which the parties' acts ultimately contributed to plaintiffs' loss. The court asserted that the conclusion in *Nathanson* that the parties were not substantially equal at fault resulted from that court's placing too much emphasis on "enforcement considerations" and not enough emphasis on the causative element of plaintiff's loss. 555 F.2d at 1162 & n.50.

The court noted that the tippee-tipper context did not present a situation where the parties were coconspirators and truly *in pari delicto*. *Id.* at 1162 & n.47. *See also* Malamphy v. Real-Tex Enter., 527 F.2d 978 (4th Cir. 1975) (*in pari delicto* properly invoked to deny experienced real estate brokers recovery of investments in fraudulent real estate venture when they had willingly entered the scheme to defraud the public); James v. Du Breuil, 500 F.2d 155 (5th Cir. 1974) (plaintiffs held *in pari delicto* with defendant and denied recovery where plaintiffs violated federal regulations by loaning stock to defendant insider in order to become part of an "organizer's trust" to gain greater profits on merger).

83. 555 F.2d at 1162.

84. *Id.* at 1163. The court also asserted that barring the *in pari delicto* defense undoubtedly would increase the number of tippee actions against tippers. The court emphasized that many tippee actions would still fail because of tippees' difficulty proving that their tippers had acted with the requisite *scienter*. *Id.* *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); *see also infra* note 198 (examining rule 10b-5's scienter requirement).

85. 555 F.2d at 1164. *See also supra* note 4 (discussing early history of *in pari delicto*).

86. *See* Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947) (recognizing an implied private cause of action under rule 10b-5); *cf.* J.I. Case Co. v. Borak, 377 U.S. 426 (1964) (recognizing implied cause of action under section 14(a)).

87. 555 F.2d at 1164.

88. 508 F. Supp. 882 (S.D. Fla. 1981).

89. 445 U.S. 22 (1980).

has a fiduciary relationship with corporate shareholders.[90] In *Xaphes,* the plaintiff brought suit, alleging that he sustained heavy losses in the stock market after making several purchases in reliance on defendant's supposed "inside information."[91] The plaintiff charged that the defendant's broker made intentional misrepresentations and falsely represented himself as an "insider."[92]

The court found that the plaintiff had not acted *in pari delicto* with defendants in violating rule 10b-5.[93] The court maintained that the plaintiff lacked a duty to disclose inside information because he was not a tippee of an "insider."[94] To hold the plaintiffs *in pari delicto,* the defendants had to establish that the broker had a duty to disclose. The court held that if the defendants could not meet this burden, then the plaintiff's "mere possession" of inside information did not impose on him a duty to disclose.[95] Without a finding that plaintiff had violated rule 10b-5 the defendants could not raise the *in pari delicto* defense, which only applies when a plaintiff has committed a legal wrong.[96]

D. In Pari Delicto*: the Spring of 1983*

In the early part of 1983, four courts reconsidered the role of *in pari*

90. *Id.* at 230. For a discussion of *Chiarella,* see *infra* notes 132-44 and accompanying text.

91. 508 F. Supp. at 884. Defendant's broker-employee allegedly maintained that he knew of several imminent takeovers. *Id.*

92. *Id.* at 886.

93. *Id.* at 887.

94. *Id.* at 886.

95. *Id.* For a recent case reaching the same conclusion, see Kulla v. E.F. Hutton & Co., 426 So. 2d 1055 (Fla. Dist. Ct. App. 1983). *Kulla* and *Xaphes* each involved defendants who were not clearly insiders and who, at the time of their motion to dismiss, had not yet demonstrated their insider status. The *Kulla* court asserted that before *in pari delicto* could bar a plaintiff's action, the defendant must establish that plaintiff was in fact a wrongdoer. *Id.* at 1058. Relying on *Chiarella,* the court contended that plaintiff could not violate rule 10b-5 unless the defendant-tippers first established their own insider status, which would impose on them the responsibility to disclose their inside information or abstain from trading on it. *Id.* The court reversed and remanded for a finding of whether defendants met these tests. *Id.* at 1060.

96. 508 F. Supp. at 886. The court also asserted that the plaintiff had no duty to disclose false inside information. The court reasoned that *Chiarella* imposed no duty to disclose any information that is not material, inside information. *Id.* The court's rationale is unpersuasive, however, because it fails to address the question whether the plaintiff's actions constituted an attempted fraud in violation of rule 10b-5. *Compare* Grumet v. Shearson/American Express, Inc., 564 F. Supp. 336, 340 (D.N.J. 1983) (agreeing with *Kuehnert* that rule 10b-5 proscribes both attempted frauds and successful ones) *with infra* notes 169-83 and accompanying text (asserting that the failure to satisfy the *Dirks* framework for determining a tippee's duty to disclose effectively prevents a plaintiff from committing an actionable attempted fraud).

delicto in tippee-tipper actions.[97] A review of these cases reveals that prior to the Supreme Court's decision in *Dirks v. SEC*[98] the *Kuehnert-Nathanson* and *Tarasi-Xaphes* splits persisted between the federal courts.[99]

In *Grumet v. Shearson/American Express, Inc.*,[100] a New Jersey federal court approved the use of the *in pari delicto* defense. In *Grumet*, a Shearson broker, Travis, induced the plaintiffs to buy stock in the target company of a supposed takeover bid by claiming to have inside information.[101] When the takeover failed to occur, the target company's stock plummeted in price, causing the plaintiff a substantial loss.[102] The plaintiff brought suit alleging that the defendant violated rule 10b-5 by making affirmative misrepresentations or by recklessly passing false information to the plaintiff.[103] The court held that despite Travis' questionable "insider" status, public policy barred plaintiff's claim.[104]

Relying on *Xaphes*,[105] the plaintiff argued that Travis was not an "insider," and that Travis had not received inside information from an insider.[106] The court rejected *Xaphes'* reasoning[107] and instead followed *Cady, Roberts & Co.*,[108] an SEC enforcement action cited with approval in *Chiarella*.[109] In *Cady, Roberts*, the SEC ruled that the de-

97. Grumet v. Shearson/American Express, Inc., 564 F. Supp. 336 (D.N.J. 1983); Kirkland v. E.F. Hutton & Co., 564 F. Supp. 427 (E.D. Mich. 1983); Summerlin v. Blyth Eastman Dillon & Co., [1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,197, at 95,787 (N.D. Ga. March 23, 1983); Kulla v. E.F. Hutton & Co., 426 So. 2d 1055 (Fla. Dist. Ct. App. 1983).

98. 103 S. Ct. 3255 (1983).

99. *Kulla* essentially followed *Xaphes*. 426 So. 2d at 1057-60. *See supra* note 95. *Summerlin*, in contrast, asserted that *Kuehnert's* reasoning applied with "equal force" and accordingly granted defendants' motion for summary judgment. [1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,197, 95,793. For a discussion of *Grumet* and *Kirkland*, see *infra* notes 100-26 and accompanying text.

100. 564 F. Supp. 336 (D.N.J. 1983).

101. 564 F. Supp. at 337. The defendant's broker allegedly informed the plaintiff that he received his "inside information" from a director of the "target's" board of directors. *Id.*

102. *Id.*

103. *Id.* Federal courts unanimously have agreed that a showing of "recklessness" on the defendant's part will meet rule 10b-5's scienter requirement. For further explanation and a collection of the approving courts, see *infra* note 198.

104. 564 F. Supp. at 341.

105. *See supra* notes 88-96 and accompanying text.

106. 564 F. Supp. at 339-40.

107. *Id.* at 340.

108. 40 S.E.C. 907 (1961).

109. 445 U.S. 222, 227 n.8 (1980).

fendant's broker violated rule 10b-5 when, without disclosing, he instituted trading in several discretionary accounts after receiving corporate inside information.[110] The court reasoned that Travis, like the broker in *Cady, Roberts,* violated rule 10b-5 by failing to disclose, although he was not an actual insider.[111]

The court concluded that the plaintiff's conduct constituted a violation of rule 10b-5 because the rule "extended to attempted as well as consummated frauds."[112] The court reiterated *Kuehnert's* assertion that section 10(b)'s reference to "any manipulative or deceptive device" prohibited attempted frauds.[113] Finally, the court further buttressed its argument with the contention that plaintiff's conduct fell within rule 10b-5(c)'s prohibition of any practice that "would operate" as a fraud

110. Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961). *Cady, Roberts* laid the framework for modern analysis of rule 10b-5's duty to disclose. In *Cady, Roberts,* the SEC clarified rule 10b-5's scope, holding that the rule extended to fraudulent actions beyond the usual shareholder-officer face-to-face trading context, and to nontraditional insiders. *Id.* at 914. The Commission held that an obligation to disclose material, nonpublic information prior to trading arises when a relationship exists that gives the informant direct or indirect access to corporate information intended solely to fulfill a corporate purpose and not to benefit anyone personally. *Id.* at 912. The Commission justified its holding by noting "the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing." *Id.*

The Second Circuit seized upon *Cady, Roberts'* "inherent unfairness" language to assert that "anyone" in possession of inside information had the duty to disclose prior to trading. SEC v. Texas Gulf Sulphur Co., 401 F.2d 883, 848 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969). In 1980 the Supreme Court repudiated the *Texas Gulf Sulphur* reasoning. In *Chiarella v. United States,* 445 U.S. 222 (1980), the Court premised the duty to disclose on the existence of a fiduciary relationship, thus crystallizing *Cady, Roberts'* requirement that a special relationship must exist between the trader and the corporation. *Id.* at 226-28. *Accord* Dirks v. SEC, 103 S. Ct. 3255, 3260 (1983); *id.* at 3270 n.8 (Blackmun, J., dissenting).

111. 564 F. Supp. at 340. The court also rejected the plaintiff's attempt to distinguish *Cady, Roberts. Id.* The plaintiff alleged that, unlike the broker in *Cady, Roberts,* Travis did not have a link to the target company's board of directors. *Id.* Relying on Justice Blackmun's dissent in *Chiarella,* the court held that the concept of an insider was flexible and could encompass Travis.

The court expressed extremely questionable judgment in relying on Justice Blackmun's dissent. The *Chiarella* majority opinion strongly presented the opposite argument, asserting that only a very select group of "insiders"—those with a fiduciary relationship to corporate shareholders—had a duty to disclose under rule 10b-5. Chiarella v. United States, 445 U.S. 222, 234 (1980). In fact, the majority directly took issue with Justice Blackmun's "flexible insider" principle, characterizing it as "not substantially different" from the rejected *Texas Gulf Sulphur* approach, *see supra* note 110, and criticizing it for its propensity to "raise questions whether either criminal or civil defendants would be given fair notice that they have engaged in illegal activity." *Id.* at 235 n.20.

112. 564 F. Supp. at 340 (quoting Tarasi v. Pittsburgh Nat'l Bank, 555 F.2d 1152, 1159-60 (3d Cir.), *cert. denied,* 434 U.S. 965 (1977)).

113. 564 F. Supp. at 340. *See also supra* text accompanying notes 48-49.

or deceit.[114] Thus, application of the *in pari delicto* defense was appropriate.

In *Kirkland v. E.F. Hutton & Co.*,[115] the court followed the *Nathanson* court and denied the tipper the *in pari delicto* defense.[116] The *Kirkland* plaintiff lost $75,000 in the market[117] after a sharp decline in the price of Trans World Corporation (TWC) stock, which the plaintiff had purchased in reliance on a "tip" from defendant's broker.[118] The plaintiff charged that Hutton and its broker intentionally failed to disclose to the plaintiff "potentially discouraging information" concerning TWC stock, thus persuading him to make his purchases.[119]

The court asserted that a defendant could raise the *in pari delicto* defense only when the parties were "relatively equal in fault,"[120] the plaintiff had acted voluntarily,[121] and the defense would promote public policy.[122] Rejecting the majority view, the court argued that in the usual tipper-tippee situation, the parties are not equally at fault.[123] The court acknowledged that tippers usually know it is illegal to trade on the basis of inside information.[124] The court argued that tippees, in contrast, vary greatly in their knowledge of the rules governing the purchase and sale of securities.[125] The court emphasized that tippees,

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114. 564 F. Supp. at 340. The *Grumet* court's "attempted fraud" arguments probably are no longer valid. *See infra* notes 169-83 and accompanying text. After laying the legal framework for the *in pari delicto* defense, the court held that allowing the defense would promote public policy. The court's rationale closely followed that delineated in *Kuehnert* and *Tarasi*. 564 F. Supp. at 341. *See supra* notes 51-58 & 84-87 and accompanying texts.

115. 564 F. Supp. 427 (E.D. Mich. 1983).

116. *Id.* at 434.

117. *Id.* at 431.

118. *Id.* at 432. The broker allegedly maintained that TWC was an imminent takeover target. *Id.*

119. *Id. Kirkland* differs from other tipper-tippee cases in that plaintiff did not allege that the defendant tippers made affirmative misrepresentations, but rather that the defendants persuaded plaintiff to make his purchases by failing to disclose all the relevant information they possessed. *See infra* note 168.

120. 564 F. Supp. at 435-36. *See supra* text accompanying note 24.

121. 564 F. Supp. at 435-36. *See supra* note 23.

122. 564 F. Supp. at 435-36. *See supra* notes 51-58 & 68-73 and accompanying text.

123. 564 F. Supp. at 435-36. *Cf.* Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134, 151, 153 (1968) (Marshall, J., concurring in the result) (asserting that the Court should give great emphasis "to the equities as between the parties" and adopt a "respective-fault" approach for determining when parties are *in pari delicto*).

124. 564 F. Supp. at 435 ("the 'tipper,' who possessed information by virtue of an inside position with the corporation and who passes it along to a 'tippee,' is . . . almost always in a position to understand the obligations attendant to the confidential information").

125. *Id.*

who often lack sophistication about the market, are less culpable than their knowledgeable tippers for nondisclosure violations.[126]

III. The Supreme Court and the Duty to Disclose

In *Chiarella v. United States*[127] and *Dirks v. SEC*,[128] the Supreme Court established the circumstances in which tippers and tippees incur a duty to disclose material, nonpublic information prior to trading under rule 10b-5.[129] The *Chiarella* and *Dirks* decisions undermine the legal basis for the *in pari delicto* defense in most tipper-tippee cases,[130] and cast serious doubt on the defense's availability in the few remaining cases in which considerations of public policy control.[131]

In *Chiarella* the Supreme Court determined the circumstances that impose upon a trader a duty under rule 10b-5 to disclose material, nonpublic information prior to trading.[132] Vincent Chiarella, a printer, learned the identities of takeover targets through his employment with a company engaged in printing corporate announcements.[133] Before an SEC investigation exposed his activities, Chiarella realized a $30,000 profit from purchases and sales made immediately before and after four corporate takeovers and one merger.[134] Chiarella was convicted of seventeen counts of violating rule 10b-5[135] and his conviction

126. *Id.* The Court thus denied summary judgment, holding that issues of material fact remained with respect to the relative fault of the parties and the scienter requirement. *Id.* at 437. *See infra* notes 198 (discussing the scienter requirement); *see also infra* notes 191-205 (discussing tippee and tipper sophistication).

127. 445 U.S. 222 (1980).

128. 103 S. Ct. 3255 (1983).

129. *See infra* text accompanying notes 139 & 151-54.

130. *See infra* notes 157-83 and accompanying text.

131. *See infra* notes 184-90 and accompanying text.

132. For commentary on the *Chiarella* decision, see Brudney, *Insiders, Outsiders, & Informational Advantages Under the Federal Securities Laws*, 93 Harv. L. Rev. 322 (1979); Dooley, *Enforcement of Insider Trading Restrictions*, 66 Va. L. Rev. 1 (1980); Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 Sup. Ct. Rev. 309; Heller, Chiarella, *SEC Rule 14e-3 and* Dirks: *"Fairness" versus Economic Theory*, 37 Bus. Law. 517 (1982); Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement*, 70 Calif. L. Rev. 1 (1982). For a review of disclosure law as it stood between *Texas Gulf Sulphur* and *Chiarella*, see Fleischer, Mundheim & Murphy, *An Initial Inquiry Into the Responsibility to Disclose Market Information*, 121 U. Pa. L. Rev. 798 (1973).

133. 445 U.S. at 224.

134. *Id.* at 224 & n.1.

135. *Id.* at 225. The Securities Exchange Act (section 32(a)) provides for criminal penalties for willful violations of the Act. 15 U.S.C. § 78ff(a). *See* 445 U.S. at 225 n.3.

was affirmed on appeal.[136] The Supreme Court granted certiorari,[137] reversed,[138] and held that a duty to disclose material, nonpublic information prior to trading does not arise under rule 10b-5 if the trader does not stand in a fiduciary relationship to corporate shareholders.[139]

Chiarella's "fiduciary relationship" requirement sharply limited the duty of disclosure[140] in most instances to traditionally recognized insiders such as corporate directors, officers, and high level employees.[141] The Court failed to clarify, however, the circumstances in which tippees of insiders incur a duty to disclose prior to trading.[142] The Court's failure in this respect left open the question of when a tippee suing his tipper for fraudulent misrepresentation under rule 10b-5 also violates rule 10b-5—an issue of significance for the *in pari delicto* defense.[143] The source of tippee liability remained in doubt until the Court confronted the issue in *Dirks v. SEC.*[144]

In *Dirks,* Ronald Secrist, a former officer of Equity Funding Corporation of America (EFCA), sought out Raymond Dirks, a noted investment analyst, in an effort to expose a massive fraud within EFCA.[145] Dirks subsequently played a major role in exposing the EFCA fraud.[146]

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136. 588 F.2d 1358 (2d Cir. 1978).

137. 441 U.S. 942 (1979).

138. 445 U.S. at 237.

139. *Id.* at 230, 232.

140. *Chiarella* represents a rejection of the Second Circuit's assertion in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969), that "anyone in possession of material inside information must either disclose it to the investing public, or . . . must abstain from trading in or recommending the securities concerned while such information remains undisclosed." *Id.* at 848. *See* Chiarella v. United States, 445 U.S. 222, 231 (1980).

141. *See* Langevoort, *supra* note 132, at 20. Professor Langevoort correctly points out that *Chiarella's* rationale probably extended the duty of disclosure to certain other persons who usually stand in a special "relationship of trust and confidence" to a corporation. *Id.* The Supreme Court later gave credence to Langevoort's assertion. Dirks v. SEC, 103 S. Ct. 3255, 3261 n.14 (1983). *See infra* notes 153-54 and accompanying text.

142. The Court merely stated in a footnote that "[t]he tippee's obligation has been viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty." 445 U.S. at 230 n.12.

143. Some understandable confusion resulted from the *Chiarella* Court's citation in its footnote on tippee liability to Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974). After *Chiarella's* emphasis on the link between the duty to disclose and a fiduciary relationship, *Shapiro* represented seemingly weak precedent because it relied on the *Texas Gulf Sulphur* view that the duty to disclose arose in "anyone" in "mere possession" of inside information. 495 F.2d at 237.

144. 103 S. Ct. 3255 (1983).

145. *Id.* at 3258.

146. *Id.* at 3259 n.8, 3263 n.18.

Prior to disclosure of the fraud, however, Dirks tipped several institutional clients who liquidated approximately $16,000,000 in EFCA holdings, a sell-off that caused a rapid, dramatic drop in EFCA's market value.[147]

In an SEC enforcement action, Dirks was found guilty of aiding and abetting violations of rule 10b-5.[148] After granting certiorari[149] the Supreme Court reversed the conviction,[150] holding that the duty of a tippee to disclose or abstain from trading on inside information derives from the fiduciary duty the insider-tipper owes the corporation's shareholders;[151] where the insider does not tip for the purpose of securing a personal gain, the tippee does not breach his derivative duty by trading.[152] The Court also asserted that certain individuals outside the circle of traditional corporate insiders directly incur a duty of disclosure.[153] The Court maintained that "under certain circumstances" professionals enjoying a "special confidential relationship" with the conduct of a corporation's business directly acquire a fiduciary responsibility and independently possess a duty to disclose.[154]

147. *Id.* at 3258-59.

148. Boston Co. Inst'l Investors, Inc., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,705, 80,816 (S.D.N.Y. 1978). The administrative law judge suspended Dirks from association with any registered broker for sixty days. *Id.* The administrative law judge also censured four institutions that had traded large blocks of EFCA subsequent to receiving tips from Dirks and prior to the fraud's public exposure. *Id.* at 80,867.

Dirks appealed to the SEC, *In re* Dirks, 21 S.E.C. Docket 1401, 1412 (1981), which reduced Dirks' sanction to censure, and to the Court of Appeal for the District of Columbia, Dirks v. SEC, 681 F.2d 824 (D.C. Cir. 1982), which affirmed the conviction.

149. 103 S. Ct. 371 (1982).

150. 103 S. Ct. 3255, 3268 (1983).

151. *Id.* at 3264 (1983).

152. *Id.* at 3265-66. Justice Powell, writing for the Court, stated that the proper test for establishing a fiduciary breach of duty requires an inquiry into whether the tipping insider secured a direct or indirect personal gain. *Id.* Justice Powell asserted that this test focused on "objective criteria" such as "pecuniary gain or a reputational benefit that will translate into future earnings." *Id.* (citing Cady, Roberts & Co., 40 S.E.C. 907, 912 n.15 and Brudney, *supra* note 132, at 348). Justice Powell maintained that Secrist tipped for the commendable purpose of exposing the EFCA fraud and thus failed to breach his fiduciary duty. *Id.* at 3267 & n.27.

153. *Id.* at 3261 n.14. For a discussion of the significance of this footnote, see Note, Dirks v. SEC's *Footnote Fourteen: Horizontal and Vertical Reach,* 62 WASH. U.L.Q. 477 (1984).

154. 103 S. Ct. at 3261 n.14. Two post-*Dirks* courts have considered the scope of footnote fourteen. *See* Moss v. Morgan Stanley Inc., 719 F.2d 5, 15 (2d Cir. 1983) (holding that employees of an investment banking form retained by an aggressor in a takeover fight did not owe a duty to disclose pursuant to footnote fourteen); SEC v. Lund, 570 F. Supp. 1397, 1403 (C.D. Cal. 1983) (close friend and business associate of corporate director owed a duty to disclose under footnote fourteen as a "temporary insider").

IV. ANALYSIS AND APPLICATION

Successful invocation of the *in pari delicto* defense depends on the satisfaction of two conditions. First, the defendant must establish that the plaintiff participated in a wrongful act with the defendant. The parties' fault must be mutual, simultaneous, and relatively equal.[155] Second, the court must decide that allowing the *in pari delicto* defense will promote applicable public policy.[156]

After *Dirks*, defendants face considerable obstacles proving that plaintiff-tippees violated rule 10b-5. A tippee lacks a duty to disclose unless his tipper possesses a duty to disclose.[157] The tipper must demonstrate that he is an insider or that he received "inside information" under the proper circumstances from an insider. A tipper satisfies this first requirement in one of three ways. First, a tipper qualifies as an insider with a duty to disclose if he occupies a corporate position giving him a fiduciary relationship with corporate shareholders.[158] Such positions typically include a corporation's directors, officers, and "upper echelon" employees.[159] Alternatively, the defendant qualifies as an insider if he occupies a "special relationship" with a corporation.[160] Those potentially in such a relationship include attorneys, underwriters, and accountants.[161] Finally, the tipper also possesses a duty to disclose if he receives material, nonpublic information from a recognized "insider" who "tipped" the tipper for the purpose of securing a personal gain.[162]

If the tipper demonstrates that he possesses a duty to disclose, he then must show that he "tipped" the plaintiff-tippee for the improper

155. *See, e.g.*, Tarasi v. Pittsburgh Nat'l Bank, 555 F.2d 1152, 1157 (3d Cir.), *cert. denied*, 434 U.S. 965 (1977); Grumet v. Shearson/American Express, Inc., 564 F. Supp. 336, 339 (D.N.J. 1983); Kirkland v. E.F. Hutton & Co., 564 F. Supp. 427, 435 (E.D. Mich. 1983); Xaphes v. Shearson, Hayden, Stone, Inc., 508 F. Supp. 882, 885 (S.D. Fla. 1981).

156. *See, e.g.*, cases cited *supra* note 155.

157. *See supra* text accompanying notes 151-52.

158. *See supra* text accompanying note 141.

159. *See* Brudney, *supra* note 132, at 343-47; Langevoort, *supra* note 132, at 18-24.

160. *See supra* notes 153-54 and accompanying text.

161. *See* Langevoort, *supra* note 132, at 20-21. The Supreme Court did not give an exclusive list of those who qualify as "special" fiduciaries. The Court referred to "consultant(s) working for a corporation," language that probably includes, under the right circumstances, engineers, market analysts, university professors, public relations firms, and marketing-advertising agencies. *See* Dirks v. SEC, 103 S. Ct. 3255, 3261 n.14 (1983).

162. *See supra* note 152 and accompanying text.

purpose of securing a personal benefit.[163] If a tipper meets these legal requirements, his tippee derivatively possesses a duty to disclose prior to trading.[164] The tippee's failure to disclose thus constitutes a breach of his duty and renders the parties "in pari delicto."[165]

163. *Id.* The tipper should find it easier to satisfy the "improper purpose" test than the preliminary "fiduciary" test. Whereas the "fiduciary" requirement clearly limits the number of individuals with a duty to disclose, the insider easily can meet the "improper purpose" test. For instance, brokers who are also corporate officers or directors tip for the improper purpose of securing a personal gain when they tip for the purpose of receiving commissions or to cultivate future dealings with their clients. *Id. See also supra* note 41 and accompanying text (tipper in *Kuehnert* tipped to induce his tippee-friend to make sizeable purchases, which when added to his own holdings, would give him working control of his corporation).

164. *See supra* text accompanying note 152. The *Dirks* Court also contended that a tippee only assumes a derivative fiduciary duty to corporate shareholders if, in receiving a tip, he "knows or should know that there has been a breach" by the insider-tipper. 103 S. Ct. at 3264. *Accord In re* Investors Management Co., 44 S.E.C. 633, 651 (Comm'r Smith, concurring in the result).

165. *See supra* text accompanying note 155. Note that the tipper still must convince the court that the invocation of the *in pari delicto* defense will promote public policy. *See infra* notes 184-205 and accompanying text.

The Eastern District of Michigan recently reached an arguably improper result in considering whether tippees in a 10b-5 action had a duty to disclose. *See* Schick v. Steiger, 583 F. Supp. 841 (E.D. Mich. 1984). In *Schick* the defendant, an insurance broker, received a tip regarding a potential takeover from a close friend who was a member of the founding family of the target corporation. *Id.* at 843. The defendant immediately purchased a large quantity of stock in the target corporation. He then tipped numerous investors who also purchased significant amounts of the target corporation's stock in reliance on the defendant's supposed inside information. *Id.* The tippees bought and sold stock in the target corporation over a six month period. Although some of the tippees realized gains from their trading, many incurred losses, especially after the "target" corporation's stock dropped in price when the takeover failed to materialize. *Id.* The plaintiffs subsequently brought a 10b-5 action against the defendant, who moved for summary judgment, alleging that the plaintiff-tippees had acted *in pari delicto* with him in violating rule 10b-5 by trading on supposed material, nonpublic information. The court denied the defendant's motion for summary judgment, *id.* at 848, holding that the tippees did not acquire a duty to disclose and consequently could not have acted *in pari delicto* with the defendant in violating rule 10b-5.

The court in *Schick* considered the impact of Dirks v. SEC, 103 S. Ct. 3255 (1983), on the availability of the *in pari delicto* defense. 583 F. Supp. at 846-48. *Compare* Berner v. Lazzaro, 730 F.2d 1319 (9th Cir. 1984) (court failed to consider whether *Dirks* had altered the analysis for determining the appropriateness of the *in pari delicto* defense); Silverberg v. Paine, Webber, Jackson & Curtis, Inc., 710 F.2d 678 (11th Cir. 1983) (same). The *Schick* court, however, considered the facts of the case not in their true light, but as the plaintiffs had thought them to be, asserting erroneously, *see infra* notes 177-83 and accompanying text, that "there is no difference in substance between a successful fraud and an attempt." 583 F. Supp. at 847 (citing Kuehnert v. Texstar Corp., 412 F.2d 700, 704 (5th Cir. 1969)).

After recognizing that the defendant had a "close relationship" with his insider-tipper, 583 F. Supp. at 847, the court contended that the defendant derivatively had acquired a duty to disclose because his tipper had tipped him in order to confer a "friendly gift"—an improper purpose for tipping according to the Court in *Dirks*. *Id.* The court might also have concluded that the defendant acquired a duty to disclose pursuant to footnote fourteen of *Dirks* because of his confidential

The effect *Chiarella* and *Dirks* have on the availability of the *in pari delicto* defense appears most visibly in the context of suits brought by investor-tippees against their brokers.[166] If the broker fails to demonstrate that he possesses a duty to disclose, his dutiless tippee's failure to disclose indisputably does not constitute a violation of rule 10b-5.[167] The tippee's failure to commit a wrongful act in such situations renders inapplicable the *in pari delicto* defense. Neither the tipper nor the tippee commits a fraud against the public. Only the tipper's fraud against the tippee remains.[168]

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relationship with the insider-tipper. *See* SEC v. Lund, 570 F. Supp. 1397, 1403 (C.D. Cal. 1983); *supra* note 154.

The court then, however, deviated from the proper mode of analysis and found that the plaintiff-tippees had not acquired derivatively a duty from the *original* insider. 583 F. Supp. at 847-48. The court reached an incorrect conclusion because it failed to address whether or not the tippees derivatively had acquired a duty to disclose from their tipper—the defendant. The defendant, who either derivatively or directly had acquired a duty to disclose from his insider-tipper, clearly tipped the plaintiffs for the improper purpose of securing a personal gain. The defendant hoped that his tippees' purchases would drive up the price of the "target" stock that he had purchased earlier. The defendant, then, tipped to secure an improper pecuniary gain. *See* Dirks v. SEC, 103 S. Ct. 3255, 3266 (1983) (recognizing pecuniary gain as an improper purpose for tipping); *supra* notes 152 & 163 and accompanying texts. Furthermore, the plaintiffs knew that they had received the supposed inside information as a result of tips from an insider to the defendant and from the defendant to themselves. Both tips constituted a breach of the respective tipper's fiduciary duty. 583 F. Supp. at 843. The plaintiffs, thus, should have been recognized as having a duty to disclose.

In *Schick*, then, because both the plaintiffs and the defendant breached their respective fiduciary duties, the legal basis existed for the application of the *in pari delicto* defense.

166. Such actions constitute the majority of reported tippee-tipper cases. In recognition of this fact, one court took judicial notice of brokers' tendency to intimate to their clients that they have inside information. Moholt v. Dean Witter Reynolds, Inc., 478 F. Supp. 451 (D.N.J. 1979).

167. *See supra* notes 157-62 and accompanying text; *see also* Silverberg v. Paine, Webber, Jackson & Curtis, Inc., 710 F.2d 678 (11th Cir. 1983). In *Silverberg* the court correctly denied defendants the use of the *in pari delicto* defense when defendant Paine, Webber's broker, who was not an insider, frauduently induced the plaintiff to make large purchases of Posi-Seal, Inc. *Id.* at 691. The court did not, however, consider whether the plaintiff, as a tippee, possessed a duty to disclose. Judge Tuttle merely asserted that the plaintiff's purchases of Posi-Seal stock were "indistinguishable" from the printer's purchases in *Chiarella*. *Id.* A complete analysis of the *in pari delicto* problem would have focused on the broker's noninsider status and his consequential lack of a duty to disclose. Because the broker had no duty to disclose, his tippees had no derivative duty to disclose prior to trading and thus did not violate rule 10b-5 by failing to disclose their reputed "inside information."

168. The tipper's lack of a duty to disclose will, in some circumstances, also operate to deprive the plaintiff of his entire cause of action. If the tippee's action alleges that the defendant-tipper failed to disclose potentially discouraging information (as opposed to allegations that the tipper made an active misrepresentation), the tippee will have to demonstrate that the tipper breached a duty to disclose material, nonpublic information to the tippee. *See supra* note 119 and accompanying text. In such cases, therefore, the tipper's lack of a duty to disclose not only prevents imposition of the *in pari delicto* defense, but also deprives the plaintiff of the ability to satisfy two

Defendants typically assert that tippees' unsuccessful frauds nonetheless are covered by section 10(b)'s references to "any manipulative or deceptive device"[169] or rule 10b-5's reference to any practice "which operates or would operate as a fraud."[170] Prior to *Chiarella* and *Dirks,* uncertainty as to the source of tippee liability[171] contributed to the courts' willingness to accept this argument.[172] Federal courts accepted the "attempted fraud" arguments because they deemed "mere possession" of inside information sufficient to raise a duty to disclose prior to trading.[173] When the tipped "inside information" turned out to be false or when the tipper was not a real "insider," it was merely factually impossible for the tipper to harm the investing public.[174] The *Kuehnert* court thus correctly asserted in 1969 that "[t]he absence of actual harm to his vendors, as far as Kuehnert was concerned, was a *pure fortuity.*"[175] The courts properly interpreted tippees' behavior as actionable "attempts" to violate rule 10b-5. Tippees could not raise factual impossibility as a defense to a charge of attempt.[176]

In the mid-1970's, however, the Supreme Court began to narrow the scope of rule 10b-5.[177] The Court's emphasis on the need to find fraud

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crucial elements of a rule 10b-5 action alleging failure to disclose: defendant's duty to disclose and his breach of that duty.

Federal courts also are likely to decline to exercise pendent jurisdiction over such a plaintiff's possible common law tort claims. *See* Grumet v. Shearson/American Express, Inc., 564 F. Supp. 336, 338 (D.N.J. 1983); *In re* Haven Industries, Inc., 462 F. Supp. 172, 182 (S.D.N.Y. 1978).

169. *See supra* note 8.

170. *Id.*

171. *See supra* notes 142-43 and accompanying text.

172. *See, e.g.,* Kuehnert v. Texstar Corp., 412 F.2d 700, 704 (5th Cir. 1969); Grumet v. Shearson/American Express, Inc., 564 F. Supp. 336, 340 (D.N.J. 1983); Moholt v. Dean Witter Reynolds, Inc., 478 F. Supp. 451, 452 (D.D.C. 1979); *In re* Haven Industries, Inc., 462 F. Supp. 172, 178 (S.D.N.Y. 1978); Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50, 55 (S.D.N.Y. 1971).

173. *See supra* note 56. In the 1960's and early 1970's, decisions giving a broad interpretation to rule 10b-5's coverage fit within the Supreme Court's mandate that the lower federal courts should interpret the terms of the 1934 Act "not technically and restrictively, but flexibly to effectuate its remedial purposes." Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972); Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971).

174. *See infra* note 176.

175. Kuehnert v. Texstar Corp., 412 F.2d 700, 704 (5th Cir. 1969) (emphasis added).

176. W. LAFAVE & A. SCOTT, HANDBOOK ON CRIMINAL LAW 440 (1972). "Factual impossibility" occurs when "what the defendant intends to accomplish is proscribed by the criminal law, but he is unable to bring about that result because of some circumstances unknown to him when he engaged in the attempt." *Id.*

177. *See* Blue Chips Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (establishing that a plaintiff lacks standing to assert a rule 10b-5 action if he is not a purchaser or seller of the security in question); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (holding that negligence does not

in rule 10b-5 actions,[178] together with its concentration on defining the "duty" aspect of the fraud,[179] rendered obsolete the "attempted fraud" rationale. *Chiarella* and *Dirks* settled the law governing the duty of disclosure of a tippee and his insider-tipper.[180] After *Dirks,* if a tipper-insider lacks a duty to disclose, or tips for a "proper" purpose,[181] it is legally impossible for the tippee to violate rule 10b-5 by failing to disclose prior to trading. Unlike factual impossibility, the law recognizes legal impossibility as an absolute defense to a prosecution for an attempt.[182] Rule 10b-5, therefore, does not now cover tippees' attempted frauds.[183]

The issue remains, however, whether the *in pari delicto* defense survives *Chiarella-Dirks* in situations where the tipper is the requisite type of insider and tips for the improper purpose of securing a personal gain. In this circumstance, both the tipper and tippee have committed a fraud against the investing public, thus establishing the legal foundation for applying the defense. The court then must decide whether application of the defense will promote public policy.[184]

Until recently courts asserted that "protecting the investing public" was the preeminent public policy behind the securities laws.[185] After *Chiarella and Dirks,* however, the Supreme Court arguably views rule 10b-5's primary purpose as to prevent fraudulent gains by fiduciaries,

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meet rule 10b-5's scienter requirement); Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977) (narrowing the definition of fraud under rule 10b-5 to those actions clearly involving "manipulation and deceit"); *see also supra* notes 127-54 and accompanying text (reviewing *Chiarella* and *Dirks'* narrowing of the scope of rule 10b-5's duty of disclosure).

178. Santa Fe Industries, Inc. v. Green, 420 U.S. 462, 472-74 (1977) (asserting that a mere breach "of fiduciary duty in connection with a securities transaction" without conduct involving manipulation and deceit does not constitute rule 10b-5 fraud).

179. *See supra* notes 127-54 and accompanying text (reviewing *Chiarella* and *Dirks*).

180. *See supra* notes 139 & 151-52 and accompanying text.

181. *See* Dirks v. SEC, 103 S. Ct. 3255, 3267 n.27 (1983) (exposing corporate fraud is a proper purpose for tipping).

182. *See* W. LAFAVE & A. SCOTT, *supra* note 176, at 442 (asserting that "[t]he reason for not convicting him has nothing to do with the failure of the enterprise, but rather with the absence of any prohibition of the conduct whether completed or not") (quoting Hughes, *One Further Footnote on Attempting the Impossible,* 42 N.Y.U.L. REV. 1005, 1006 n.1 (1967)). *See supra* note 177 (describing conditions for factual impossibility).

183. *Cf.* Kuehnert v. Texstar Corp., 412 F.2d 700, 704 (5th Cir. 1969) (no "difference in substance between a successful fraud and an attempt").

184. *See supra* text accompanying notes 155-56.

185. *See, e.g.,* Kuehnert v. Texstar Corp., 412 F.2d 700, 704 (5th Cir. 1969); Summerlin v. Blyth Eastman Dillon & Co., [1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,197, at 95,793 (N.D. Ga. March 28, 1983).

and not to protect the investing public.[186] In *Dirks* the Court identified the issue whether the *tipper* "tipped" to secure personal benefit as the key to determining tippee liability.[187] The Court's focus on the tipper's actions, and its decision to make the tippee's liability completely dependent upon the tipper's actions,[188] suggest that the Court views the tipper as the "greater threat" to the investing public.[189] Thus, if confronted with the issue, the Court probably would choose to bar a tipper from invoking the *in pari delicto* defense.[190]

Acceptance of this conclusion[191] leaves the question whether a wholesale foreclosure of the *in pari delicto* defense promotes public policy.[192] The apparent unfairness of giving tippees an "enforceable warranty"[193] and of treating all tippees in the same manner,[194] casts doubt on the wisdom of denying defendants the *in pari delicto* defense. The courts recognize that not all tippees possess the same sophistication.[195]

In view of this unfairness, courts seeking to promote the public policies of protecting investors and preventing fraudulent personal gain should reject a defendant's assertion of *in pari delicto* as an absolute

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186. *Compare* Dirks v. SEC, 103 S. Ct. 3255, 3265 (1983) (emphasizing the Court's determination to prevent fraud through the utilization of the improper purpose test: " 'It is important in this type of case to focus on policing insiders and what they do.' ") (quoting Investors Management Co., 44 S.E.C. 633, 648 (1971) (Commissioner Smith, concurring in the result)) *with id.* at 3271 (Blackmun, J., dissenting) (bemoaning the absence of protection for investors: "It makes no difference to the shareholder whether the corporate insider gained or intended to gain personally from the transaction; the shareholder still has lost because of the insider's misuse of non-public information.").

187. *See supra* note 152 and accompanying text.

188. *See supra* note 167 and accompanying text.

189. *Accord* Kirkland v. E.F. Hutton & Co., 564 F. Supp. 427, 434-46 (E.D. Mich. 1983); Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50, 57 (S.D.N.Y. 1971).

190. *Accord* Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50, 57 (S.D.N.Y. 1971); *see also supra* notes 68-73 and accompanying text (discussing *Nathanson* court's view of public policy).

191. *See supra* notes 152-53 and accompanying text.

192. *See, e.g.*, Perma Life Mufflers v. International Parts Corp., 392 U.S. 134, 143 (1968) (White, J., concurring):

> I also agree that the *in pari delicto* defense in its historic formulation is not a useful concept for sorting out those situations in which the plaintiff might be barred because of his own conduct from those in which he may have been a party to an illegal venture but is still entitled to damages from other participants.

Id.

193. *See supra* note 54 and accompanying text.

194. *See supra* text accompanying notes 125-26.

195. *Id.* Investment analysts and elderly widows, for example, do not deserve the same manner of treatment.

defense to a tippee's rule 10b-5 action. The courts can best promote public policy by adopting a comparative fault approach in tippee-tipper actions.[196] Such an approach provides tippees damages in accordance with the circumstances peculiar to each case.[197]

Under the comparative fault approach, the tippee still must demonstrate that the tipper made affirmative misrepresentations or engaged in reckless conduct in violation of rule 10b-5.[198] The fact-finder then should consider the following factors to formulate an equitable award of damages:[199] the tippee's sophistication; the tipper's conduct; who in-

196. Gustafson v. Benda, 661 S.W.2d 11 (Mo. 1983) (en banc). Thirty-two states have adopted comparative negligence or comparative fault by statute and nine (including Missouri) have done so by judicial decision. *Id.* at 11 n.9. Although courts do not usually invoke comparative fault to determine damages in intentional tort actions, the drafters of the Uniform Comparative Fault Act noted that in appropriate cases, the courts are not precluded from applying comparative fault. UNIFORM COMPARATIVE FAULT ACT § 1 comment on conduct covered (1977). Tipper-Tippee actions pursuant to rule 10b-5 are such "appropriate cases." Courts generally hesitate to pursue a comparative fault analysis when presented with intentional torts (i.e., battery, assault) because these torts involve passive plaintiffs in no way responsible for their harm. In contrast, tippee-tipper actions, where the tipper is the requisite insider and tips for an improper purpose, do not present the equivalent of the passive plaintiff in battery-assault actions. In the tipper-tippee context the case-to-case disparity of tippee fault justifies the use of comparative fault.

197. *See supra* note 196.

198. The Supreme Court clearly has stated that a showing of negligence alone on the defendant's part will not satisfy the scienter requirement for a rule 10b-5 action. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 215 (1976). The Court expressly reserved the question, however, whether a showing of recklessness satisfies the scienter requirement:

> [T]he term "scienter" refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5.

Id. at 194 n.12. *See also* Aaron v. SEC, 446 U.S. 680, 686 n.5 (1980). Since *Hochfelder* the Circuit Courts have unanimously agreed that a showing of recklessness will satisfy the scienter requirement. *See* Dirks v. SEC, 681 F.2d 824, 844 n.27 (D.D.C. 1982), *rev'd on other grounds,* 103 S. Ct. 3255 (1983); Hackbart v. Holmes, 675 F.2d 1114, 1117 (10th Cir. 1982); G.A. Thompson & Co. v. Partridge, 636 F.2d 945, 961 n.32 (5th Cir. 1981); McLean v. Alexander, 599 F.2d 1190, 1197 (3d Cir. 1979); Mansbach v. Prescott, Ball & Truben, 598 F.2d 1017, 1024 (6th Cir. 1979); Nelson v. Serwold, 576 F.2d 1132, 1337-38 (9th Cir.), *cert. denied,* 439 U.S. 970 (1978); Rolf v. Blyth Eastman Dillon & Co., 570 F.2d 38, 44-47 (2d Cir.), *cert. denied,* 439 U.S. 1039 (1978); Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1044 (7th Cir.), *cert. denied,* 434 U.S. 875 (1977).

199. *See* Fischer, *Products Liability—Applicability of Comparative Negligence,* 43 MO. L. REV. 431 (1978). Professor Fischer suggests the consideration of the following factors for determining the parties' relative fault:

> 1. The magnitude of the harm threatened by the conduct; the more dangerous the conduct, the more culpable the party is likely to be.
> 2. The extent to which the harm was foreseeable. In this regard inadvertent conduct is less culpable than the deliberate creation of a risk of harm. The diminished capacity of the party or the presence of an emergency are also factors which lessen culpability.

itiated the fraudulent activity; the conduct of the parties after the tippee's initial purchases; the conduct of the parties prior to the tippee's purchases; and whether the tippee actually became a co-conspirator[200] in the fraudulent venture.[201]

Where the legal foundation for the *in pari delicto* defense exists,[202] adoption of a comparative fault approach to tippee-tipper conflicts will promote public policy. The comparative fault approach helps prevent the fraud of both tippees and tippers. A comparative fault analysis creates the prospect of an award of damages against the tipper who widely and indiscriminately tips customers who invest heavily. The prospect of irretrievable loss also should deter sophisticated tippees from acting on "inside information."[203] The comparative fault approach thus ultimately deters tippers and sophisticated tippees, the parties presenting the greatest "threat" to the investing public.[204]

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3. Balanced against the foregoing factors is the value of the interest the party was protecting by his conduct. Less culpability is involved in taking an unreasonable risk to achieve a worthy objective than to achieve an unworthy one. However, this factor must be considered in light of the alternative means available to the party to protect his interests.

Id. at 438.

200. *See supra* note 82.

201. The comparative fault approach focuses on the equities between the parties, ensuring that wrongdoers will not recover damages to the extent that they are at fault. Perma Life Mufflers v. International Parts Corp., 392 U.S. 134, 151 (1968) (Marshall, J., concurring in the result).

202. *See supra* notes 157-65 and accompanying text. A comparative fault analysis is inappropriate when the legal foundation for the *in pari delicto* defense does *not* exist. In such cases the tippee is entitled to an unencumbered measure of damages because he has not engaged in any wrongdoing.

203. *See supra* note 58 and accompanying text.

204. A recent case illustrates the need for a comparative fault approach when a defendant in a rule 10b-5 action properly raises the *in pari delicto* defense. In Berner v. Lazzaro, 730 F.2d 1319 (9th Cir. 1984) a broker dealer and the president of a small corporation schemed to defraud investors by spreading false rumors concerning the future of the president's corporation. *Id.* at 1320. Ten investors brought suit, alleging that the broker and corporate president's actions constituted a violation of rule 10b-5. The investors admitted that they had made their purchases on the basis of alleged inside information received from the defendants. *Id.* at 1320. The trial court granted the defendants' motion to dismiss on the grounds that the plaintiffs unlawfully had acted *in pari delicto* with the defendants in violating rule 10b-5. *Id.* The appellate court reversed, asserting simply that the allegations of the complaint would demonstrate, if true, that the plaintiffs were not "equally responsible" for their injuries. *Id.* at 1322, 1324. The court reached its decision without alluding to the duty to disclose and without considering either *Chiarella* or *Dirks*.

In *Berner* the plaintiffs clearly had violated rule 10b-5. They had received material, nonpublic information from a broker who, due to his working relationship with a corporate president, occupied the status of a special insider as the Supreme Court envisioned in footnote 14 of *Dirks*. *See supra* notes 154 & 160 and accompanying texts. The broker tipped the plaintiffs for the wrongful purpose of securing a personal gain (commissions on the trades). *See supra* note 152 and accom-

The adoption of a comparative fault methodology also will eliminate an anomaly in tipper-tippee disputes. All tippers who make active misrepresentations will be held accountable for their acts regardless of whether they are fiduciary-insiders.[205] A tippee's action will no longer fail on the "mere fortuity" that the tipper turns out to be a true insider.[206] Uniformity in the application of the law will prevail in tippee-tipper actions.

Matthew D. Menghini

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panying text. The plaintiffs, knowing of the defendant's breach, consequently possessed a derivative duty to disclose prior to trading. *See supra* notes 151 and accompanying text. The defendants thus had the proper legal foundation for raising the *in pari delicto* defense.

These facts warrant an inquiry into the relevant sophistication of the individual investors to avoid an inequitable result. The *in pari delicto* defense would bar the actions of those sophisticated investors who actively sought to violate the securities laws and who were at least equally as reprehensible as the defendants. Those unsophisticated investors, who were in fact "dupes," would be allowed to press their claims against the defendants. The *Berner* court's preoccupation with finding that the defrauded investors were "equally responsible" for their injuries suggested that, after properly applying a duty to disclose analysis in future *in pari delicto* cases, the court might be willing to conduct a comparative fault analysis to determine which investor's claims should be allowed to proceed in the interests of equity and justice.

205. Tippers lacking a *Chiarella* duty of disclosure cannot raise the *in pari delicto* defense. *See supra* notes 166-68 and accompanying text. Tippers who do have a duty to disclose will face the comparative fault damages award. *See supra* notes 195-203 and accompanying text.

206. *See* Grumet v. Shearson/American Express, Inc., 564 F. Supp. 336, 341 (D.N.J. 1983).