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LIMITATIONS ON DEFENSES UNDER 10(b): *IN PARI DELICTO* AND UNCLEAN HANDS

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THE evolution and development of the corporate conglomerate has been the most significant factor in the growth of twentieth century American enterprise. Corporate growth has far outdistanced that of alternative forms of business. The purchase and sale of an increasing volume of corporate securities has permitted management to raise impressive quantities of capital, and has allowed numerous investors to share in the profits realized from the judicious use of their funds.

However, as the size of the American corporation has increased, management has become increasingly isolated from the individual investor. Today, the shareholder relates to the corporation primarily in terms of the return it pays for the use of his dollars. Management, on the other hand, evaluates the investor exclusively in terms of the amount of capital he is willing and able to expend.

The separate objectives entertained by management and the investor cause a stratification among investors according to their investment potentialities. Furthermore, management may wish to accord particular advantages to some investors for reasons related to the size and frequency of their investments. It might wish to accomplish this goal by disclosing special information to them, while withholding that information from other investors. The favored investor might then seek to act on the privileged information to his own benefit, but to the detriment of other shareholders, purchasers, or sellers. To allow him an inequitable economic advantage by virtue of inside information engenders distrust and stifles the exchange of securities on the open market.

Historically, there were few legal impediments to this type of activity. As late as the 1930's the only persons required to disclose information in regard to securities transactions were those owing some fiduciary duty to the other party. The general rule was that officers, directors, and majority shareholders owed no such fiduciary duty to minority shareholders except in a "special facts" situation.[1] However, following the stock market crash

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[1] Strong v. Repide, 213 U.S. 419 (1909). In *Strong* a shareholder who owned three-fourths of a corporation was held to be liable to a minority interest shareholder after

of 1929, Congress enacted federal legislation aimed at preventing dishonest and manipulative practices in securities transactions. Among the most significant post-depression measures was the Securities Exchange Act of 1934,[2] designed to require prompt disclosure of material information to investors "in order to maintain fair and honest securities markets."[3] Through the exercise of judicial creativity, the scope of Section 10(b) of the Securities Exchange Act[4] and Rule 10b-5 of the Securities Exchange Commission (SEC)[5] have been regularly expanded since their adoption. Although

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the former purchased the shares of the latter without first revealing that the government had offered to purchase the corporation's assets at a price that would greatly increase the value of its shares. The Court held that even though there would normally be no fiduciary duty in such a situation, the "special facts" in possession of the majority shareholder gave rise to a duty to disclose those facts. Accordingly, except in those situations involving "special facts" courts generally adhered to the principle that no fiduciary duty was owed by insiders in security transactions.

2 15 U.S.C. § 78 (1964). Even through section 10(b) was intended to close a gap relating to fraud in the purchase and sale of securities, there is virtually nothing in the legislative history of the Act to indicate that Congress intended that a defrauded purchaser or seller would have a private remedy. In fact, if read literally, the securities laws are so structured as to suggest that defrauded purchasers and sellers were to be restricted to the express remedies of the Act.

Despite the emphasis on the legislative history of the Act relating to markets, trading and disclosure, it would be fallacious to assume that Congress had concern only for prospective purchasers and sellers, but not for the shareholders. Examples of this concern are manifested in such areas as proxy regulation and in section 16(b) which provides for a derivative action to recover on behalf of the corporation short-selling profits realized by corporate insiders. 15 U.S.C. § 78n (1964).

3 The House Committee that reported the bill which became the 1934 Act observed that "no investor . . . can safely buy and sell securities upon exchange without having an intelligent basis for forming his judgement as to the value of the securities he buys or sells." H.R. REP. No. 1383, 73d Cong., 2d Sess. 11 (1934).

4 It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . (b) to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. 15 U.S.C. § 78j (1964).

5 17 C.F.R. § 240.10b-5 (1970). Pursuant to the authority granted, the SEC promulgated Rule 10b-5 which is expansive in its scope and provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
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> (c) To engage in any act, practice, or course of business which operates or

neither Congress nor the SEC had expressly provided private remedies for violations, the federal courts implied such a remedy.[6] Furthermore, the SEC has supported the positions of minority purchasers and sellers as amicus in the litigated cases advocating a liberal application of the rule.

DEVELOPMENT OF TIPPER-TIPPEE LIABILITY

Section 10(b) of the Act, and Rule 10b-5[7] sought to deter that expand-

would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

[6] Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). While neither 10(b) nor 10b-5 expressly provides for a private remedy for violation, the federal courts have provided such a remedy. Four years after the adoption of 10b-5 it was held in *Kardon* that a person harmed by a violation of the Rule had an implied federal right of action for damages. Since *Kardon*, each of the federal circuits either directly or by implication has recognized a private right of action to enforce Rule 10b-5. *See* Janigan v. Taylor, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); A. T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967); McClure v. Borne Chem. Co., 292 F.2d 824 (3d Cir. 1961); Beury v. Beury, 222 F.2d 464 (4th Cir. 1955); Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961); Texas Continental Life Ins. Co. v. Dunne, 307 F.2d 242 (6th Cir. 1962); Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963); Greater Iowa Corp. v. McLendon, 378 F.2d 783 (8th Cir. 1967); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Doelle v. Ireco Chemicals Co., 391 F.2d 6 (10th Cir. 1968).

In case after case, barriers to the scope of Rule 10b-5 have either been sharply limited or have disappeared entirely. While not involving 10(b), in the first case to reach the Supreme Court under the 1934 Act, it was held that a shareholder could assert the corporation's right for the violation of 14(a) and that "federal courts have the power to grant all necessary remedial relief." The thrust of the federal decisions is toward providing civil redress to a defrauded claimant. Furthermore, 10b-5 claimants have not been subjected to rigid adherence to the common law elements of fraud; and courts to varying degrees, have modified or abandoned such traditional requirements as privity, scienter and reliance. *See* J. I. Case Co. v. Boark, 377 U.S. 426, 435 (1964); Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970); Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540 (2d Cir. 1967); Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Errion v. Connell, 236 F.2d 447 (9th Cir. 1956); Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); Reynolds v. Texas Gulf Sulphur Co., 309 F. Supp. 548 (D. Utah 1970); Drake v. Thor Power Tool Co., 282 F. Supp. 94 (N.D. Ill. 1967); Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967); Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673 (N.D. Ind. 1966); Lorenz v. Watson, 258 F. Supp. 724 (E.D. Pa. 1966); Miller v. Bargain City, U.S.A., Inc., 229 F. Supp. 33 (E.D. Pa. 1964); Cooper v. North Jersey Trust Co., 226 F. Supp. 972 (S.D.N.Y. 1964); New Park Mining Co., v. Cranmer, 225 F. Supp. 261 (S.D.N.Y. 1963); Pettit v. American Stock Exch., 217 F. Supp. 21 (S.D.N.Y. 1963); Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962); Texas Continental Life Ins. Co. v. Bankers Bond Co., 187 F. Supp. 14 (W.D. Ky. 1960), *rev'd on other grounds, sub nom.* Texas Continental Life Ins. Co. v. Dunne, 307 F.2d 242 (6th Cir. 1962); H. L. Green Co. v. Childree, 185 F. Supp. 95 (S.D.N.Y. 1960); Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951).

[7] 17 C.F.R. § 240.10b-5 (1970).

ing category of deceptive practices falling within its broad definition of fraud "in connection with the purchase or sale of any security." Paramount among the forbidden fraudulent practices is a corporate insider's failure to disclose material facts in connection with his sale or purchase. However, the concept of the corporate insider is no longer limited to the "traditional" insiders—officers, directors and major shareholders. It now encompasses those select purchasers and sellers who receive advance material information from inside sources—"tippees."[8]

Tipping is defined as "the selective disclosure of material inside (non-public) information for trading or other personal purposes."[9] The first indication that a "tippee" would be liable for a violation of 10b-5 was advanced in a disciplinary proceeding by the SEC. In *In re Cady, Roberts,*[10] a partner in a brokerage house, who was advised by a fellow employee on the board of directors that his corporation was planning to reduce its dividend, was held to be an insider, and therefore under a duty to disclose this information before trading in the corporation's stock because his was a relationship giving access to material facts.

In *Ross v. Licht,*[11] five directors, officers and large shareholders joined with friends to purchase the outstanding stock of the corporation and then issue new shares to the public at a higher price. The three friends—"tippees"—were held liable along with the others as insiders. The court gave considerable attention to the close relationship between the "tippees" and the managers of the corporation as well as the fact that the "tippees" actively participated in the scheme that was withheld from the shareholders. While the court based its holding primarily on breach of trust, it remarked that the mere fact that the "tippees" were given information would be sufficient to create liability for trading on it.

Recent occurrences have imposed liability on the "tipper" as well as on the "tippee." The SEC found that the brokerage firm of Merrill Lynch,

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[8] *See* SEC v. Texas Gulf Sulfur Co., 401 F.2d 833 (2d Cir. 1968); A. BROMBERG, SECURITIES LAW: FRAUD–SEC RULE 10b-5, 180-81 (1968); Kennedy & Wander, *Texas Gulf Sulfur, A Most Unusual Case,* 20 BUS. LAW 1057, 1064-65 (1965). *See generally* Mosser v. Darrow, 341 U.S. 267 (1951).

[9] A. BROMBERG, SECURITIES LAW: FRAUD–SEC RULE 10b-5, § 7.5(2), at 190.7 (1967).

[10] *In re* Cady, Roberts, 40 S.E.C. 907 (1961). The Commission stated that

> [a]nalytically, the obligation of insiders rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. *Id.* at 912.

[11] 263 F. Supp. 395 (S.D.N.Y. 1967).

Pierce, Fenner and Smith, while underwriting a new issue for Douglas Aircraft, had violated 10b-5 by tipping material information (a drop in earnings) to several favored institutional customers, while concealing the information from other customers.[12] However, the first holding that explicitly regarded tipping as a violation of 10b-5 was *SEC v. Texas Gulf Sulfur*.[13] Six "tippees" purchased stock prior to the official announcement of the now famous ore discovery. The court imposed vicarious responsibility on the "tipper" for the trades of the "tippees".[14] The court gave no express reason for its holding that tipping constitutes a violation. However, this result is implicit in the court's condemnation of inside trading, its lengthy discussion of "connection" and materiality, its policy emphasis of equal access of all investors to material information,[15] and its purpose of elimination of informational unequalities in the market.[16] While the "tippees" were not made defendants in *Texas Gulf Sulfur* and no concrete rules were enunciated with respect to their conduct, the court clearly indicated that their conduct was as equally "reprehensible"[17] as that of the "tippers."

While the trend is toward placing the "tipper" and "tippee" within the ambit of 10b-5, it is always essential that all of the fundamental requirements of the Rule must be met before there can be any recovery. Furthermore, it should be obvious that not all information received constitutes a tip of the type that falls within the scope of the Rule. On one hand, there could be a valid corporate purpose surrounding the disclosure of information; while, on the other, the information so disclosed could be of such a general nature as not to be considered material. It would appear that trading by the "tippee" would be necessary under the reasoning of *Texas Gulf Sulphur*.[18] This should not be the standard as the giving of the tips can create a virtual unending chain of subsequent "tippees." The "relationship giving access" test to material undisclosed information as suggested in *Cady, Roberts*[19] appears to be the best criteria at this time for deducing

[12] *In re* Merrill Lynch, Pierce, Fenner & Smith, SEC Securities Exchange Act Release No. 8459 (Nov. 25, 1968).
[13] 401 F.2d 833 (2d Cir. 1968).
[14] *Id.* at 856 n. 23.
[15] *Id.* at 848, 849.
[16] *Id.* at 858.
[17] *Id.* at 853.
[18] *Id.* at 850-852 and 858. However, in SEC v. Glen Alden Corp., CCH, SECURITIES L. REP., ¶ 92,280 (S.D.N.Y. Aug. 7, 1968), a consent injunction was issued preventing the dissemination of information to "any selected persons."
[19] 40 S.E.C. 907 (1961).

liability, as it provides a clearer and more easily construed standard for deterring such conduct.

DEFENSES OF TIPPER TO TIPPEE

In sharp contrast to what appears to be the basic trend of extending the penalties for the misuse of inside information is a recent fifth circuit decision that appears to detract from some of the previous decisions regarding "tippers" and "tippees." The decision in *Kuehnert v. Texstar Corporation*[20] raises some fundamental questions as to the allocation of responsibilities in carrying out the objectives of 10b-5.

The *Texstar* case presented the unusual situation of a "tippee" seeking to recover losses he had sustained as the result of relying on faulty inside information supplied to him by a "tipper." The plaintiff through various dealings with the corporation became friendly with its president. During the course of this friendship, the president disclosed certain information that caused the plaintiff to purchase a large number of Texstar shares.

Specifically, the officer revealed that his corporation was planning a merger and indicated that Texstar's stock would increase in value as a result of certain "secret" discoveries that had not been announced. He also told the plaintiff that as president he was having trouble with some of the other directors and stockholders, and that it was to his advantage to keep the information secret while he, and hopefully the plaintiff, bought enough Texstar stock to acquire control of the company.

Acting upon this information, Kuehnert purchased on margin a large number of Texstar shares on the open market without disclosing the information that he had obtained from the president. Later the price declined, and the representations proved to be false. After the plaintiff's margin position had been sold out at a substantial loss, he sued his "tipper" and others under 10b-5 to recover his losses.

The court held that Kuehnert, as a "tippee" who traded on nonpublic information, was precluded from recovery under the statute and the Rule because he was *in pari delicto* and had unclean hands. The court observed that the two doctrines were based upon public policy and their application rested within the discretion of the court.[21]

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[20] 412 F.2d 700 (5th Cir. 1969).

[21] *Id.* at 704. At least one court in a 10b-5 action has refused in its discretion to allow the defense of unclean hands because "it would have further complicated the issues in an already complicated case." Texas Continental Life Ins. Co. v. Dunne, 307 F.2d 242,

In an historical sense, the doctrine of *in pari delicto* had been used to protect the sanctity of the court where it has been called upon to decide between two wrongdoers[22] and "the doctrine has been applied correctly or incorrectly in a wide variety of situations."[23] The status of the defense of *in pari delicto* is uncertain in actions under blue sky laws[24] and Section 12 of the 1933 Act.[25] However, courts have not hesitated to apply it in proxy cases,[26] but have refused to do so in antitrust litigation.[27] The related defenses of waiver, estoppel, and laches have been held specifically applicable to 10b-5 actions.[28] The fifth circuit has previously recognized that *in pari delicto* may constitute a defense under 10b-5, but refused to allow such defense where the only fault attributable to the corporate plaintiff

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250 (6th Cir. 1962). *See also* Wohl v. Blair & Co., 50 F.R.D. 89 (S.D.N.Y. 1970) (motion to strike defenses of *in pari delicto* and unclean hands in 10b-5 action denied in discretion of trial court).

[22] McCLINTOCK, PRINCIPLES OF EQUITY § 26 (2d ed. 1948).

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

[24] Reilly v. Clyne, 27 Ariz. 432, 234 P. 35 (1925); Taormina v. Antelope Mining Corp., 110 Cal. App. 2d 314, 242 P.2d 665 (Dist. Ct. App. 1952); Randall v. California Land Buyers' Syndicate, 217 Cal. 594, 20 P.2d 331 (1933); Schvaneveldt v. Noy-Burn Milling & Processing Corp., 10 Utah 2d 1, 347 P.2d 553 (1959). In extreme cases recovery has been denied. *See* Miller v. California Roofing Co., 55 Cal. App. 2d 136, 130 P.2d 740 (Dist. Ct. App. 1942).

[25] The defense of *in pari delicto* may be applicable to causes of action by an underwriter. *See* Slack v. Stiner, 358 F.2d 65, 67-68, 70 (5th Cir. 1966); Can-Am Petroleum Co. v. Beck, 331 F.2d 371 (10th Cir. 1964); Fox v. Glickman Corp., 253 F. Supp. 1005, 1011-12 (S.D.N.Y. 1966); Belhumeur v. Dawson, 229 F. Supp. 78, 86-87 (D. Mont. 1964); Athas v. Day, 186 F. Supp. 385, 389 (D. Colo. 1960).

The *in pari delicto* doctrine, at least on the basis of the buyer's knowledge of a violation of Section 12, is so foreign to the purpose of the section that there is hardly a trace of it in the cases. *See* Rosenberg v. Hano, 121 F.2d 818, 822 (3d Cir. 1941); 3 L. Loss, SECURITIES REGULATION, 1694 (1961).

[26] Studebaker Corp. v. Allied Products Corp., 256 F. Supp. 173, 192 (W.D. Mich. 1966); Gaudiosi v. Franklin, 166 F. Supp. 353 (E.D. Pa. 1958), *aff'd and dismissed in part, sub nom.* Gaudiosi v. Mellon, 269 F.2d 873 (3d Cir.), *cert. denied,* 361 U.S. 902 (1959). *Cf.* Union Pacific R.R. v. Chicago & N.W. Ry., 226 F. Supp. 400 (N.D. Ill. 1964) (inequitable to apply doctrine of unclean hands because of peculiar factual situation).

[27] Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134 (1968); Kiefer-Stewart Co. v. Joseph E. Seagram & Sons, 340 U.S. 211 (1951). *Cf.* Union Leader Corp. v. Newspapers of New England, Inc., 284 F.2d 582, 586-87 (1st Cir. 1960), *cert. denied,* 365 U.S. 833 (1961).

[28] Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962). *See also* Marth v. Industrial Incomes, Inc., 290 F. Supp. 755, 758 (S.D.N.Y. 1968); Hecht v. Harris, Upham, & Co., 283 F. Supp. 417, 428 (N.D. Cal. 1968); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bocock, 247 F. Supp. 373, 377-78 (S.D. Tex. 1965); 6 L. Loss, SECURITIES REGULATION, 3888-90 (Supp. 1969).

was the issuance of stock in violation of the registration requirements of the 1933 Act.[29]

In determining whether it should apply the doctrine of *in pari delicto,* the court in *Texstar* noted that its main problem was the fact that because Kuehnert knew nothing, he had nothing to conceal, and did not defraud those from whom he purchased.[30] The court then resolved this dilemma by reasoning that there was no difference in substance between a successful fraud and an attempt because the statutory phrase "any manipulative or deceptive device"[31] was broad enough to cover both situations. This conclusion was supported by citing situations where the SEC had been successful in enjoining a potential fraud as well as prosecuting a fraud that failed.[32]

In his dissent Judge Godbold observed that neither the statute nor the Rule provide for the imposition of the doctrine in private 10b-5 litigation and indicated that it will hinder the private suit as an effective weapon under 10b-5.[33] Making reference to *Perma Life Mufflers, Inc. v. International Parts Corporation,*[34] he argued that in the antitrust field, the doctrine had lost much of its vitality.

In *Perma Life,* a group of franchisees, who operated Midas Muffler Shops, brought an action under the Sherman[35] and Clayton[36] Acts against their former franchisor. The plaintiffs alleged that the franchise agreement requiring that all parts be purchased exclusively from the parent unlawfully restrained and impeded competition.[37] The defendant argued that the plaintiffs were *in pari delicto* and, therefore, not entitled to maintain their suit because each had eagerly and voluntarily sought out and profited from the very franchises that they were now claiming to be unlawful.

The United States Supreme Court reversed the circuit court and held that even though the plaintiffs were not without fault, the doctrine had no place in antitrust litigation because of the overriding public policy of pro-

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29 Hooper v. Mountain States Securities Corp., 282 F.2d 195 (5th Cir. 1960), *cert. denied,* 365 U.S. 814 (1961).

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

31 15 U.S.C. § 78(j) (b) (1964).

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

33 *Id.* at 705.

34 392 U.S. 134 (1968).

35 15 U.S.C. § 1 (1964).

36 15 U.S.C. §§ 13-14 (1964).

37 Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134, 135 (1968).

moting competition.[38] The rationale employed by the Court condemning the invocation of broad common law barriers to relief where a private suit serves important public purposes seemed finally to answer the question of whether this doctrine that had arisen in private suits should be interpreted narrowly in order to advance public policy.[39] It is unfortunate that the court in *Texstar* did not select this logical approach because the doctrine of *in pari delicto* is based upon a number of technical and often differing standards[40] that will only add confusion to and impede the orderly growth and development of standards designed to insure fair and honest security markets.

It is equally disturbing to note that the court in *Texstar* also based its rejection of Kuenhert's claim by equating his "impure heart" to having unclean hands.[41] Prior to *Texstar*, there had been only a very limited recognition of the defense of unclean hands in 10(b) and 10b-5 actions.[42] The maxim had been allowed as a defense to a shareholder's derivative suit involving proxy solicitation. In *Gaudiosi v. Franklin*,[43] the third circuit qualified the use of the unclean hands defense by observing that the court "is not bound by formula or restrained by any limitation that tends to

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38 *In pari delicto* has lost such limited vitality as it previously had in the antitrust area. In rejecting *in pari delicto* in that field, the Supreme Court said:

> We have often indicated the inappropriateness of invoking broad common-law barriers to relief where a private suit serves important public purposes . . . . Both Simpson [v. Union Oil Co., 377 U.S. 13 (1962)] and Kiefer-Steward [Co. v. Seagram & Sons, 340 U.S. 211 (1951)] were premised on a recognition that the purposes of the antitrust laws are best served by insuring that the private action will be an ever-present threat to deter anyone contemplating business behavior in violation of the antitrust laws. The plaintiff who reaps the reward of treble damages may be no less morally reprehensible than the defendant, but the law encourages his suit to further the overriding public policy in favor of competition. A more fastidious regard for the relative moral worth of the parties would only result in seriously undermining the usefulness of the private action as a bulwark of antitrust enforcement. And permitting the plaintiff to recover a windfall gain does not encourage continued violations by those in his position since they remain fully subject to civil and criminal penalties for their own legal conduct.

Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134, 138-39 (1968).

39 *See, e.g.*, Kiefer-Stewart Co. v. Seagram & Sons, Inc., 340 U.S. 211 (1951); Florida East Coast Ry. v. Brotherhood of Locomotive Engineers, 362 F.2d 482 (5th Cir. 1966).

40 Kuehnert v. Texstar Corp., 417 F.2d 700, 706 (5th Cir. 1969) (dissenting opinion).

41 *Id.* at 703.

42 *See* Cartier v. Dutton, 45 F.R.D. 218 (S.D.N.Y. 1969) (defense of unclean hands allowed to be pleaded in an action to rescind a sale of stock); Texas Continental Life Ins. Co. v. Dunne, 307 F.2d 242 (6th Cir. 1962) (trial court did not abuse discretion in refusing to hear matters relaing to defense of unclean hands).

43 166 F. Supp. 353 (E.D. Pa. 1958), *aff'd and dismissed in part, sub nom.* Gaudiosi v. Mellon, 269 F.2d 873 (3d Cir.), *cert. denied*, 361 U.S. 902 (1959).

trammel the free and just exercise of discretion."[44] More significantly, the tenth circuit in a case involving the 1933 Securities Act, has held that "an investor does not waive or lose the shelter of the act because he becomes to some extent involved in the illegality of the security sales."[45]

Virtually any violation of a statute can cause a claimant's hands to be "unclean,"[46] but the maxim had been limited to the requirement that the unclean hands arise out of the same transaction as the action in litigation.[47] Courts have refused to apply the doctrine where it would cause a result counter to public policy or result in injustice.[48] For example, one court was especially critical of this equitable defense with respect to proxy solicitations:

> To apply the maxim in this case would produce the illogic of leaving the shareholders unprotected when they have been doubly mislead, stultifying the underlying purpose of the national securities law. Where a public interest is at stake, above the interests of the parties themselves, the protection of that paramount interest overcomes the judicial reluctance to assist a wrongdoer.[49]

The *Texstar* court further based its denial of relief upon a fear that "[i]f a tippee can sue he has, in effect, an enforceable warranty that secret information is true."[50] The majority reasoned that by denying a "tippee" the right of recovery against a "tipper," the "tippee" will be discouraged from trading because he must bear the burden of any loss that would be sustained if the information were false.[51] However, from a practical standpoint this type of discouragement will have little effect upon a "tippee" who, presumably, is a speculator willing to assume certain risks before making his initial investment. If this is his only discouragement, the "downside" risk in acting upon a tip would almost always justify the taking of the risk.

The major difficulty with the *Texstar* reasoning is that it bypasses the primary purpose of the Act and Rule in dealing with insiders—to protect

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44 Gaudiosi v. Mellon, 269 F.2d 873, 881 (3d Cir. 1959).

45 Can-Am Petroleum Co. v. Beck, 331 F.2d 371 (10th Cir. 1964).

46 *See* McClintock, Principles of Equity 59, 62 (2d ed. 1948).

47 National Surety Corp. v. Allen-Codell Co., 70 F. Supp. 189 (E.D. Ky. 1947); Ohio Oil Co. v. Sharp, 135 F.2d 303 (10th Cir. 1943).

48 *See* McCullough Tool Co. v. Well Surveys Inc., 395 F.2d 230 (10th Cir. 1968); Leo Feist, Inc. v. Young, 138 F.2d 972 (7th Cir. 1943).

49 Union Pacific R.R. v. Chicago & Northwestern Ry., 226 F. Supp. 400, 410 (N.D. Ill. 1964).

50 Kuehnert v. Texstar Corp., 412 F.2d 700, 705 (5th Cir. 1969).

51 *Id.*

the public by discouraging the private dissemination of material inside information. As pointed out by Judge Godbold, the basic premise of the majority in *Texstar* is that the degree of public interest in private SEC actions does not compare to that in antitrust litigation. However, the Supreme Court in *J.I. Case Co. v. Borok,*[52] while discussing proxy requirements stated:

> Private enforcement of the proxy rules provides a necessary supplement to commission action. As in anti-trust treble damage litigation, the possibility of civil damages or injuctive relief serves as a most effective weapon in the enforcement of proxy requirements.[53]

The defenses of unclean hands and *in pari delicto* should be inapplicable to both private SEC actions (proxy or 10b-5) and antitrust litigation, not just the latter, because of the equivalent overriding public interest element present in both areas.

CONCLUSION

Imposing liability upon the insider-"tipper" would not be contrary to the overall goal of preserving "fair and honest markets"[54] while "protecting the ordinary purchaser and seller of securities."[55] As the Court in *Perma Life* observed, "the plaintiff who reaps the reward of treble damages may be no less morally reprehensible than the defendant, but the law encourages his suit to further the overriding public policy in favor of competition."[56] Furthermore, in light of the court's language in *Texas Gulf Sulphur,* the "tippee" will himself gain no windfall by recovering from his "tipper" because he will likely be liable to the other parties in the transaction.[57] In addition, the difficulty of deciding the application of *in pari delicto* based upon "badness" makes impossible the creation of an orderly or consistent body of law on the subject.[58] Finally, litigation among reprehensible parties serves to expose their misconduct and render such conduct more susceptible to appropriate civil, administrative, and criminal penalties.[59]

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[52] 377 U.S. 426 (1964).
[53] *Id.* at 432.
[54] 15 U.S.C. § 78(b) (1964).
[55] Cochran v. Channing Corp., 211 F. Supp. 239, 243 (S.D.N.Y. 1962).
[56] Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134, 139 (1968).
[57] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 853 (2d Cir. 1968).
[58] Kuehnert v. Texstar Corp., 412 F.2d 700, 706 n.3 (5th Cir. 1969) (dissenting opinion).
[59] *Id.*

The end result in *Texstar* is that the initial loss is placed upon the "tippee" rather than on the "tipper" where the burden should rest. The insider who misuses material inside information is the person who should be punished and discouraged. Policy would better be served by placing the initial loss on the insider and thereby discourage him from tipping at all.