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Securities - Plaintiff's Recovery in Private Suit Based on Violation of Federal Securities Laws Held Barred by Defenses of *In Pari Delicto* or Unclean Hands

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SECURITIES—Plaintiff's Recovery in Private Suit Based on Violation of Federal Securities Laws Held Barred by Defenses of In Pari Delicto or Unclean Hands.

Albert E. Kuehnert brought an action under section 27 of the Securities and Exchange Act of 1934[1] against Texstar Corporation and its former president William T. Rhame. Kuehnert sought damages for losses he suffered as a result of an alleged violation of section 10(b) of the Securities and Exchange Act, and Rule 10b-5 of the Securities and Exchange Commission promulgated pursuant to the Act.[2]

In January, 1965, Kuehnert was informed by Rhame, a personal friend, that Texstar was engaged in confidential negotiations with Coronet Petroleum Company, and that these negotiations would result in the acquisition by Texstar of Coronet's assets, including certain valuable oil and gas leases. Rhame further indicated that he had concluded agreements with Humble Oil and Refining Company and Texaco, Inc. which provided for these firms to take farmouts of the land acquired from Coronet for the drilling of oil and gas wells. He also told Kuehnert that Texstar would receive substantial profits from these activities resulting in a sharp rise in the price of Texstar stock, and that the earnings from the current fiscal year would be $3.00 per share.[3]

Relying on this information,[4] Kuehnert purchased 94,600 shares of Texstar stock largely on margin. Later, primarily because Rhame's alleged representations[5] concerning the "farmouts" proved untrue,

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1. 15 U.S.C. § 78a (1965).
2. 17 C.F.R. 240.10b-5 (1969). The rule provides:
"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
(1) to employ any device, scheme, or artifice to defraud.
(2) 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
(3) 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."
3. Texstar stock was registered on the American Stock Exchange and was then selling for approximately $4.25 per share.
4. Rhame had allegedly urged Kuehnert to buy large blocks of stock in the hope that they could together acquire a "working control" of the corporation. It seems possible that if Rhame did engage in the activities alleged, he may have intended to inflate the price of Texstar stock to enhance chances of the merger with Coronet. There are indications that Rhame's policies had been opposed by other members of Texstar's management.
5. Rhame denied making the representations alleged.

Kuehnert lost his entire investment.

The trial court granted summary judgment for all the defendants, holding that section 10(b) and Rule 10b-5 were intended to protect ordinary investors buying on general information, and would not support a cause of action by one dealing on the basis of confidential corporate information.[6] The court indicated alternatively, that plaintiff's recovery would be barred by the affirmative defense of *in pari delicto*.[7]

The United States Court of Appeals for the Fifth Circuit affirmed the decision, one judge dissenting. In affirming, the court of appeals relied primarily on the alternative ground suggested by the district court. They held that plaintiff's recovery was barred either by the doctrine of "unclean hands" or because he was *in pari delicto* with the defendant.[8]

Judge Godbold, in his dissenting opinion, indicated that the application of the common law defenses of *in pari delicto* and unclean hands to private actions based upon the federal securities laws was improper, particularly in the absence of authorization of these defenses by the statute. He argued that by applying these defenses the court was undermining the public policy that private actions based upon section 10(b) promote the public interest because they are an effective enforcement device to insure rigid adherence to the provisions of the Act.

The decision in *Kuehnert* seems significant primarily because it is the first instance in which a court of appeals has ruled on the applicability of the defenses of *in pari delicto* or "unclean hands" in an action arising under section 10(b) of Securities and Exchange Act of 1934. It is also significant that the court ruled on the applicability of these defenses on the basis of the facts as plaintiff believed them to be, not as they were ultimately proved at trial.[9]

Did Kuehnert's Conduct Violate Rule 10b-5

Both the district court and the court of appeals found that the plaintiff had violated Rule 10b-5 although he had made no affirmative

6. Kuehnert v. Texstar, 286 F. Supp. 340, 345 (S.D. Tex. 1968).
7. *Id.* at 345. The court did not reach the defense of Texstar that Rhame had been acting for his own interests, and not within the scope of his corporate authority.
8. Kuehnert v. Texstar, 412 F.2d 700 (5th Cir. 1969). The court did indicate, however, that, since Kuehnert himself was duped by Rhame, he was probably not *in pari delicto* as to intention with Rhame.
9. That is, the court barred Kuehnert's recovery because of his failure to disclose confidential information which had been revealed to him by Rhame, notwithstanding the fact that the information was false, and consequently Kuehnert's failure to disclose it occasioned harm to no one.

misrepresentations relating to the securities involved, and he was not an officer, director, employee, or majority shareholder of Texstar Corporation.

The court of appeals affirmed the trial court's finding that Kuehnert had an affirmative duty to disclose the confidential information he had received from Rhame to those parties from whom he purchased Texstar stock. This holding seems to be consistent with other recent 10b-5 cases. In *In Re Cady, Roberts & Co.*,[10] the S.E.C. held that a stock broker who had received confidential information from a corporate director had the same duty to disclose that information to his vendees, as the director himself would.

Ross v. Licht[11] applied the rule established in *Cady, Roberts* to hold "tippees"[12] liable for trading on the basis of confidential information without disclosing that information.

The decision in *Kuehnert* extends the trend evidenced by these decisions and seems to solidify the proposition that one who knowingly trades on the basis of information which is both confidential and material[13] has an affirmative duty to disclose that information, and failure to do so will result in a violation of Rule 10b-5.

In light of this trend, the only question as to whether Kuehnert did violate Rule 10b-5 revolves around the fact that the information he possessed was untrue, and thus resulted in no harm to the sellers with whom he dealt.[14] The question thus presented seems to be whether non-disclosure of information which was in fact untrue, though material according to the various court enunciated tests, will constitute a violation of Rule 10b-5.

The precise question thus presented does not seem to have been pre-

10. 40 SEC 907 (1961), 61-64 CCH FED. SEC. L. REP. ¶ 76, 803 (1961).
11. 263 F. Supp. 395 (S.D. N.Y. 1967).
12. Ross v. Licht seems to be the first case to have coined this phrase to denote those who, though not technically corporate insiders, have had access to confidential corporate information. The "tippees" in *Ross* were friends and relatives of directors of the corporation. The court in *Ross* indicated, alternatively, that the "tippees" were liable for aiding and abetting a violation of Section 10(b) and Rule 10b-5.
13. List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir. 1965). Only material information need be disclosed. The materiality of the statements which Kuehnert failed to disclose was not raised on appeal, however. Kuehnert v. Texstar, *supra*, note 8 at 701. The court in Ross v. Licht described a material fact as "one to which a reasonable man would attach importance in determining his choice whether to make the sale or not." 263 F. Supp., at 408.
14. The mere fact that no person suffered economic harm as a result of plaintiff's conduct, and therefore no private cause of action accrued as a result thereof, would not seem to preclude the possibility of a violation of Rule 10b-5. It is possible that such conduct could validly give rise to a proceeding by the S.E.C., and therefore result in a determination that the conduct was, in fact, illegal.

viously litigated, but the decision in *Kuehnert* appears reasonable. Kuehnert's conduct was in fact a purposeful attempt to defraud his vendors, and it was only because Kuehnert himself was being defrauded that his purpose was not fulfilled. Such conduct is precisely the type of activity that the Rule was designed to prevent, and should fall within the purview of Rule 10b-5.[15]

THE DOCTRINE OF UNCLEAN HANDS AND IN PARI DELICTO

Unclean hands is a doctrine which bars relief to a plaintiff who has acted inequitably or in bad faith in the matter in which he seeks recovery.[16] The doctrine is equitable in nature and was originally grounded in the historical concept of a court of equity as a vehicle for affirmatively enforcing the requirements of conscience and good faith.[17] Historically, it has not usually been applied in actions for damages.[18] However, prior to *Kiefer Stewart v. Seagrams*[19] one area in which the doctrine had been effectively used to preclude damage actions by plaintiffs was anti-trust treble damage litigation.[20] Private antitrust actions, like actions based on violations of section 10(b), arise as a result of alleged violations of a federal statute.[21] Consequently, the policy underlying these two categories of actions, that they provide an effective vehicle for the enforcement of the respective statutes involved,[22] is quite similar. Thus, decisions in anti-trust cases involving related issues

15. The fact situation presented here is, admittedly, a unique one. However, section (3) of the Rule would seem sufficiently broad to encompass Kuehnert's actions. It prohibits engaging 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." (Emphasis added). This section thus appears to reach even those activities which have not been successfully concluded.

16. Precision Instrument Mfg. Co. v. Automotive Maintenance Machinery Co., 324 U.S. 806, 814 (1945).

17. *Id.*

18. 30 C.J.S. *Equity* § 98 at 1038 n.1 (1965). It has been suggested that even in an equitable action the defense of unclean hands can not be applied where the transaction involves a violation of a statute if the legislative purpose would not be furthered by the application of the defense. *Id.* at 1036-37.

19. 340 U.S. 211 (1951).

20. *See* Comment, 54 NW. U.L. REV. 456 (1959).

21. The basis of the cause of action is, however, somewhat different. § 4 of the Clayton Act, 15 U.S.C. § 15 (1965), explicitly provides that private individuals shall have a cause of action for damages suffered as a result of a violation of the anti-trust laws. No such provision is applicable to violations of section 10(b). However, the courts have implied the existence of civil liability for violation of this section. Brennan v. Midwestern Life Ins. Co., 259 F. Supp. 673 (N.D. Ind. 1966); *cf.* J.I. Case v. Borak, 377 U.S. 426 (1964).

22. Perma Life Mufflers v. International Parts, 392 U.S. 134, 138 (1968); J.I. Case v. Borak, 377 U.S. 426, 432 (1964). Another policy is, of course, compensation of injured parties for the losses suffered as a result of these violations. The general purpose of the antitrust statute is the promotion of competition so as to protect the public interest; this is not dissimilar to that of the securities laws, protection of the public and investors.

can probably be afforded substantial weight in attempting to resolve similar questions in private securities litigation.[23]

The use of the defense of unclean hands in anti-trust litigation might have lent support to the propriety of its application in securities cases. However, in *Kiefer-Stewart* the United States Supreme Court held that conduct of the plaintiff which allegedly violated the Sherman Act did not preclude its recovery of treble damages because of similar but unrelated conduct by the defendant. Although the Court did not refer to the term "unclean hands" in denying recovery, it would seem that the Court effectively rejected the principle upon which the doctrine was based.[24] Thus, any previous authority derived from anti-trust cases relative to the application of "unclean hands" has been severely eroded.

The doctrine of *in pari delicto*, literally meaning of equal fault, is applied when both the plaintiff and defendant have participated in the same illegal conduct. It precludes plaintiff's recovery for any damages suffered as a result of this conduct. *Pari delicto* has traditionally been available both at law and in equity, and it has been used often in private anti-trust suits. However, its use has been somewhat limited by two recent Supreme Court cases. In *Simpson v. Union Oil Co.*[25] the Court refused to deny the plaintiff relief in a treble damage anti-trust action merely because he could have elected not to deal with a supplier, thus avoiding the necessity of entering into an illegal agreement.[26] *Simpson* has been cited as strengthening the business necessity exception to the defense of *pari delicto*.[27] Thus, although the plaintiff technically entered the agreement voluntarily, he was coerced to do so by compelling business reasons.[28]

Following *Simpson*, the Court recently decided *Perma Life Mufflers v. International Parts*.[29] In *Perma Life* the Supreme Court reversed the Court of Appeals for the Seventh Circuit which had granted a summary

23. In fact, Judge Godbold's dissent in Kuehnert was based primarily upon recent anti-trust decisions which expressed policies which he felt were equally applicable to securities litigation.

24. In *Kiefer-Stewart* the plaintiff's allegedly illegal conduct was completely unrelated to that of the defendant. Thus, since *in pari delicto* is generally applied only when the parties have jointly entered into an illegal course of dealing, it would seem that the case involves "'unclean hands". Inferentially, then, the continued viability of "unclean hands" in treble damage cases seems to be under attack in this case.

25. 377 U.S. 13 (1964).

26. Since both the plaintiff and the defendant were parties to the same agreement this case has often been interpreted as dealing with the defense of *in pari delicto*, although the Court did not use that term.

27. 57 ILL. BAR JOURNAL 413, 415 (1969).

28. That is, if he failed to agree to the illegal terms of the contract he would have been denied completely the Union Oil franchise he desired.

29. 392 U.S. 134 (1968).

judgment for the defendant on the ground that plaintiff's conduct placed it *in pari delicto* with the defendant, and thus barred its recovery.[30] Justice Black, writing the opinion of the Court,[31] appeared to reject entirely the applicability of *in pari delicto* as a defense to anti-trust violations on the basis that public policy was best served by encouraging private suits.[32] However, five members of the Court failed to concur in this opinion. Justice White agreed that the concept of *pari delicto* was not particularily useful in private anti-trust litigation, but he would replace it with the doctrine of substantial causation.[33] Justices Fortas and Marshall, while concurring in result, argued that *pari delicto* should be retained as an affirmative defense, at least in those situations where the plaintiff was an active party to the agreement and had not been subjected to coercive force on the part of the defendant.

Synthesizing the various opinions in *Perma Life* is rather difficult but seems to yield the impression that where the plaintiff has actively and purposefully engaged in conduct leading to the furtherance of the illegal act, he will be denied recovery. This was the interpretation of *Perma Life* advanced by the court in the recent case of *Premier Electric Co. v. Miller-Davis.*[34] There the court denied recovery to the plaintiff in a treble damage suit because of his participation in an alleged bid-rigging scheme. In applying *Perma Life* to that case, the court said:

> Thus, in each of the five opinions in the case, the door was left open for a limited application of a defense of illegality in civil antitrust actions. The distinctions drawn throughout the various opinions are particularly relevant here. Premier is not a mere participant or unwilling victim of the transaction out of which the case arose. Rather, Premier was an originating, moving, active and aggressive party to the illegal bidrigging scheme. There is no indication that the Supreme Court sought to protect a plaintiff so

30. Perma Life Mufflers v. International Parts Corp., 376 F.2d 692 (7th Cir. 1967).

31. Only three members of the Court concurred in this opinion. Justices White, Fortas, and Marshall wrote separate concurring opinions, and Justice Harlan dissented in an opinion in which Justice Stewart concurred.

32. Although it is not clear even under the authority of Justice Black's opinion that the plaintiff's conduct will never bar his recovery, for he stated:

> "We need not decide, however, whether such truly complete involvement and participation in a monopolistic scheme could ever be a basis, wholly apart from the idea of *pari delicto*, for barring a plaintiff's cause of action." Perma Life, *supra* note 28, at 140.

33. Thus, the plaintiff could not recover unless the defendant's conduct had been a substantial cause of his injury. In those instances in which the plaintiff had not been coerced into accepting the illegal agreement, but was an active co-conspirator, this element would not be present and recovery would be barred. It seems this concept is still close to the concept of *pari delicto* accepted by some of the other members of the Court.

34. 1969 CCH TRADE CASES Par. 72, 710.

intensely involved in an illegal restrain on trade.[35]

In light of recent developments it appears that the Court has rejected the theory that any wrongdoing on the part of a plaintiff in relation to the matter being litigated will bar his recovery. However, they seem to have retained a limited version of *in pari delicto* as a defense to private antitrust litigation.

In analyzing the plaintiff's conduct in *Kuehnert*, it seems clear that he could correctly be described as having "unclean hands", as he attempted to perpetrate a fraud upon his vendors. It is less clear whether he could be accurately characterized as being *in pari delicto* with the defendant. If Kuehnert's conduct is analyzed from his subjective point of view,[36] he actively engaged in illegal conduct in concert with Rhame. Indeed, if Kuehnert's stock purchase had resulted in economic loss to his vendors, Rhame would seem to have been jointly and severally liable to those parties for aiding and abetting Kuehnert's 10b-5 violation.[37] Moreover, Rhame's violation of Section 10(b) and Rule 10b-5 seems to arise primarily because of Kuehnert's transactions, for without them, the purchase and sale which is a prerequisite to finding a 10b-5 violation would not have been present.[38]

However, even if a plaintiff's conduct is deemed to have established "unclean hands" or *pari delicto*, the question still remains as to whether it should bar the maintenance of a private damage action.

Should Unclean Hands or In Pari Delicto Bar Recovery in a Private Action Under Section 10(b)

Section 10(b) of the Securities Exchange Act does not explicitly provide a private cause of action for damages resulting from a violation of its terms. The right to maintain such an action, however, has been implied judicially.[39] It might be argued that because the cause of ac-

35. Premier, *supra* note 34, at 86,540. The court seemed to recognize that what was being applied was a test of substantial illegality, whatever its name, when it said ". . . (W)e sanction the defense of illegality, call it *in pari delicto* if you will, in these circumstances. . . ." *Id.*

36. The court seems to have done this, although it recognized that Kuehnert and Rhame could not technically "be seen as *in pari delicto* even as to intentions." Kuehnert, *supra*, note 8, at 704. Thus, since Kuehnert and Rhame had different subjective intentions (Rhame's apparently being to defraud Kuehnert) it could be argued that they were not engaged in the same conduct, and that *in pari delicto* would not apply.

37. *Cf.* Pettit v. American Stock Exchange, 217 F. Supp. 21 (S.D.N.Y. 1963); Anderson v. Dupont, 291 F. Supp. 705 (D. Minn. 1968).

38. Birnbaum v. Newport Steel Co., 193 F.2d 461 (2d Cir. 1952).

39. *See* note 20, *supra*. One rationale that has been advanced to support the finding is that a violation of a statute which enunciates the legislative purpose of protecting certain rights gives rise to a cause of action in tort for the violation of the statutory duty thus created.

tion is derived from a statutory duty, any affirmative defense which might conflict with the underlying Congressional purpose should not be available.[40] However, the Ninth Circuit Court of Appeals in *Royal Air v. Smith* has held that because private actions arising under section 10(b) had originally been judicially implied, common law defenses should be available.[41] Notwithstanding the *Smith* decision, it would seem unwise to apply an affirmative defense to an action based upon a violation of a statutory duty where that application would severaly undermine the basic policy of the statute.

In *Kuehnert*, the court indicated that application of the defenses of unclean hands or *in pari delicto* rested within the discretion of the court, and should be governed by the underlying policy of the securities laws.[42]

In determining how to best effectuate the policy of the act, the court indicated that it was extremely important to discourage a "tippee" from trading on the basis of confidential information. If such a party were allowed to recover from his "tippor" he would have, in effect, "an enforceable warranty that secret information is true."[43] If the information is false he could recover from the insider, and if it is true he will probably have profitted from the stock transaction itself.[44]

Against this consideration, the court weighed the fact that to deny Kuehnert recovery would fail to discourage Rhame's conduct. It determined that the overall policy of the act would best be served by denying Kuehnert recovery, notwithstanding the fact that Rhame was the original cause of the disclosure of the confidential information.

This decision does not seem unreasonable in light of the fact that an insider, such as Rhame, remains open to action by the Securities Exchange Commission, would be jointly liable with the "tippee" for any

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40. *See* note 18, *supra*.

41. 312 F.2d 210 (9th Cir. 1962). The defenses involved were those of waiver and estoppel.

42. Kuehnert, *supra* note 8, at 704. The basic policy of the Act is, of course, protection of the investing public.

43. *Id.* at 705.

44. The tippee would, of course, be liable to those he dealt with, but this liability might never be discovered. The court in Royal Air v. Smith, *supra* note 41, at 213-214, in discussing an analogous problem, said:

> The purpose of the Securities Exchange Act is to protect the innocent investor, not one who loses his innocence and then waits to see how his investment turns out before he decides to invoke the provisions of the Act."

This introduces a very interesting question which was not treated by the Court of Appeals in Kuehnert, but which represented the primary rationale for the District Court decision. The District Court held that section 10(b)was intended to protect general investors, not those acting on the basis of confidential information, and would not support a cause of action by a "tippee." There is little authority on this question, but the theory, if it has any validity at all, adds weight to the policy considerations tending to indicate recovery should be denied to a "tippee".

harm occasioned by the "tippee's" transactions and is primarily liable for any damages resulting from his own purchases or sales.[45]

CONCLUSION

The fact situation presented in *Kuehnert v. Texstar* is admittedly an unique one. In this regard the court's decision to view the plaintiff's conduct from the standpoint of his subjective belief, without regard to the objective validity of the information he possessed, seems reasonable in light of the broad protective purposes of section 10(b).

The court's broad application of "unclean hands" or *in pari delicto* as a defense to a private 10b-5 action may be unwise.[46] The policy considerations involved, while varying to some degree, are similar to those contained in the application of these defenses in private anti-trust actions.[47] As previously indicated the United States Supreme Court has apparently rejected unclean hands as a defense to these actions.[48] However, it does seem that a limited version of *pari delicto*, possibly in the form of a substantial illegality test, is still viable in the anti-trust cases.[49] It is submitted that application of a similar test would be preferable to the broad holding of the court of appeals in *Kuehnert*. In any case, it seems clear that some of the questions raised by this decision, like many others in the field of securities law generally, are badly in need of clarification by the Supreme Court.

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45. Even if unclean hands or *pari delicto* is applied to private 10b-5 actions, they would, of course, have no effect on a proceeding by the S.E.C. Moreover, Rhame would seem jointly liable with Kuehnert for aiding and abetting a 10b-5 violation. *See* note 36, *supra* and accompanying text. The strongest policy argument against the action taken by the Kuehnert court may be that by allowing the action Rhame's conduct is publicized and that by discouraging "tipping" at its initial source, among corporate officials, indirect effects of the initial disclosure will be prevented.

46. Partcularly where, as here, the court indicated that application of the defenses rests within the discretion of the court. It would seem that if the plaintiff's conduct justifies a denial of recovery in one instance, similar conduct should be treated in the same manner.

47. Actually, the policy of private enforcement seems stronger in anti-trust cases because private actions are explicitly sanctioned by section 4 of the Clayton Act, and treble damages are allowed.

48. *See* note 24, *supra.*

49. *See* notes 32-34, *supra,* and accompanying text.