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SECURITIES ACTIONS: EQUITABLE DEFENSES AND THE GOOD FAITH DEFENSE FOR "CONTROLLING PERSONS"

INTRODUCTION

When Congress passed the Securities Act of 19331 and the Securities Exchange Act of 1934,2 it did not specifically indicate what effect the statutory scheme should have upon equitable defenses formerly available in securities actions. Nonetheless, Congress seemed to have dealt with the question indirectly. Each Act includes a section manifesting a general intent to preserve prior law, providing in part: “The rights and remedies provided by this subchapter shall be in addition to any and all other rights and remedies that may exist at law or in equity.”3 In addition, each “express liability”4 section of both Acts provides that “any person . . . may [sue], either at law or in equity, in any court of competent jurisdiction . . . .”5 Moreover, the Supreme Court has observed that “the [1933] Act as a whole indicates an intention to establish a statutory right which the litigant may enforce . . . by such legal or equitable actions or procedures as would normally be available to him.”6

Notwithstanding these general references, certain inconsistencies exist. For example, both Acts specifically provide a good faith defense for “controlling persons,” without reference to the applicability of previously settled case law and the common law of agency.7 Other sections specifically incorporate certain equitable principles even though these doctrines probably would have been applied by the courts as settled law without direction from Congress.8

2. Id. §§ 78a-hh.
4. These are sections expressly providing a private cause of action, in contrast with sections under which the courts have implied such a right. See note 9 infra.
6. Deckert v. Independence Shares Corp., 311 U.S. 282, 287-88 (1940) (emphasis added). In the same vein, one jurist has noted that section 29(b) of the 1934 Act “was a legislative direction to apply common-law principles . . . enacted at a time when it seemed much more likely than it might now that courts would fail to do this without explicit legislative instruction.” Pearlstein v. Scudder & German, 429 F.2d 1136, 1149 (2d Cir. 1970), cert. denied, 401 U.S. 1013 (1971) (Friendly, J., dissenting). The Acts' language is not complex and Congress seems to have feared no confusion over the Acts' intentionally broad provisions. See H.R. Rep. No. 1838 (Conference Report), 73d Cong., 2d Sess. 30-42 (1934); H.R. Rep. No. 1383, 73d Cong., 2d Sess. 5-7 (1934); S. Rep. No. 792, 73d Cong., 2d Sess. 5-13 (1934); H.R. Rep. No. 85, 73d Cong., 1st Sess. 11-26 (1933); S. Rep. No. 47, 73d Cong., 1st Sess. 2-6 (1933).
8. One perplexing section is § 13 of the 1933 Act, 15 U.S.C. § 77m (1970), which specifically incorporates the "federal" or "equitable" tolling doctrine—providing that a plaintiff's reasonable
Although such specific incorporation of the availability of a common law doctrine may be merely an excess of caution, any failure to make such provision prompts the argument that when a statute is specific, that which is not included—e.g., other equitable principles—is deemed excluded. Due to the ambiguity of these sections, federal courts have reached inconsistent results as to whether certain equitable defenses should be permitted.

In interpreting the securities laws, the Supreme Court has repeatedly pointed to the imprecision of the Acts' language and has urged flexibility in the exercise of equitable discretion by lower courts. For example, lower courts have implied private rights of action based upon the Supreme Court's recognition that the investor protection function of some sections of the Acts could not be realized without private suits, and despite Congress' specific provision that private actions were only available under certain sections. In a similar vein, the Court has distinguished the structure and phrasing of the 1934 Act from other more precise statutes. Notwithstanding its earlier failure to discover fraud or other injury will toll the statute of limitations—a well established common law rule. Bailey v. Glover, 88 U.S. (21 Wall.) 342, 349-50 (1874); see Hochfelder v. Ernst & Ernst, 503 F.2d 1100, 1119 (7th Cir. 1974), rev'd on other grounds, 44 U.S.L.W. 4451 (U.S. Mar. 30, 1976) (No. 74-1042); Schilleci v. Guaranty Sav. Life Ins. Co., 367 F. Supp. 903, 904 (N.D. Ala. 1973); G. Clark, Equity § 306 (1954). Compounding the inconsistency, the Acts are very specific in other instances when the intent was to alter common law presumptions, e.g., concerning punitive damages, waiver, and illegality of contracts. See Securities Exchange Act of 1934 §§ 28(a), 29(a)-(b), 15 U.S.C. §§ 78bb(a), c(a)-(b) (1970).

9. The Court in J.I. Case Co. v. Borak, 377 U.S. 426 (1964), permitted a shareholder to bring an action against corporate management alleging violation of proxy solicitation provisions under Securities Exchange Act § 14(a), 15 U.S.C. § 78n(a) (1970), a section without provision for such private actions. Considerations cited by the Court were (a) that private actions are an effective way of enforcing the Acts, and (b) that federal courts have power to create federal common law. 377 U.S. at 432-34. See generally Note, The Phenomenon of Implied Private Actions Under Federal Statutes: Judicial Insight, Legislative Oversight or Legislation by the Judiciary?, 43 Fordham L. Rev. 441 (1974).


11. The Court, in Mills v. Electric Auto-Lite Co., 396 U.S. 375, 390-91 (1970), approved an award of attorneys' fees despite the absence of statutory authority, and even though Congress had provided in the 1934 Act that "no person permitted to maintain a suit for damages under the provisions of this chapter shall recover . . . a total amount in excess of his actual damages on account of the act complained of." 15 U.S.C. § 78bb(a) (1970). The Court distinguished its holding in Fleischmann Distilling Corp. v. Maier Brewing Co., 386 U.S. 714 (1967), barring such an award in a Lanham Act (15 U.S.C. §§ 1051-1127 (1970)) case. It noted that in the Lanham Act, Congress had "meticulously detailed" what remedies should be available to plaintiffs so that the refusal to augment these provisions in Fleischmann was proper. However, the Court concluded, "[b]y contrast, we cannot fairly infer from the Securities Exchange Act of 1934 a purpose to circumscribe the courts' power to grant appropriate remedies." 396 U.S. at 391 (citation omitted); cf. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975) ("It is . . . proper that we
admonition in a trademark case that if the statute in question expressly provides a remedy "other remedies should not readily be implied," the Court has found that the 1934 Act's clearly announced purpose of affording protection to the investing public requires "resolving doubts in favor of those the statute was designed to protect . . . ." Lower courts have relied upon this general emphasis on flexibility as well as their own sense of equity in determining the applicability of equitable principles formerly available to defendants in securities actions.

However, some lower courts, in ruling on the admissibility of these defenses, have relied upon a Supreme Court case that did not deal with the securities acts. In *Perma Life Mufflers, Inc. v. International Parts Corp.*, the Court held that the defense of *in pari delicto* was "not to be recognized as a defense to an antitrust action." The Court's opinion was based upon the conviction that the strong public policy in favor of competition is "best served by insuring that the private action will be an ever-present threat to deter anyone contemplating . . . violation of the antitrust laws." In addition, the Court noted in farther ranging dictum that "[w]e have often indicated the inappropriateness of invoking broad common-law barriers to relief where a private suit serves important public purposes." Reliance upon this reasoning and dictum has resulted in limitation or exclusion of equitable defenses in some securities cases.

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consider . . . policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance." [construing § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1970)].


16. Generally, a plaintiff "in equal fault" in the same transaction on which he sues is denied relief. See the definition and discussion at note 38 infra and accompanying text.

17. 392 U.S. at 140.

18. Id. at 139.

19. Id. at 138. It is noteworthy that the Court supported this broad statement by citing only two cases, both of which involved antitrust matters. Id. at 137-39. Moreover, in one of these, *Kiefer-Stewart Co. v. Joseph E. Seagram & Sons*, 340 U.S. 211, 214 (1951), plaintiff's wrongdoing consisted of a prior, unrelated conspiracy with third parties—a situation in which in pari delicto traditionally would not apply as a defense. See note 38 infra.

20. See, e.g., *Pearlstein v. Scudder & German*, 429 F.2d 1136, 1141 (2d Cir. 1970), cert. ...
The Supreme Court has not faced squarely the question whether common law or equitable defenses may be raised in either express or implied securities actions. The Court has, however, dealt with an analogous question—the availability of equitable relief. It would seem that equitable relief in securities actions should be available upon the traditional showing of inadequate remedy at law or irreparable harm. However, the lower courts often have not adhered to these standards. Instead, they have imposed less stringent requirements in order to insure the broadest possible scope of enforcement of the securities laws. This was due in part to the Supreme Court's language in SEC v. Capital Gains Research Bureau, Inc. which held that "fraud," as used in the securities acts, was not the equivalent of common law fraud which required a plaintiff to prove both intent and injury. The Court stated that it did not think that the Acts merely codified the common law. Even if this were the case, however, the Court noted that the remedial purpose of the Acts would require that they be construed "not technically . . . but flexibly" and such a construction would lead to the same result—that the plaintiff need not show the traditional common law elements. Moreover, the Court noted that the relief sought was merely the "mild prophylactic" of injunction to compel disclosure by defendant. With that observation, the Court seemingly


21. In Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971), the Court concluded its opinion with the oblique statement: "All defenses except our ruling on § 10(b) will be open on remand." Id. at 14.


23. Kahan v. Rosenstiel, 424 F.2d 161, 173 (3d Cir.), cert. denied, 398 U.S. 950 (1970); Federal Sav. & Loan Ins. Corp. v. Fielding, 309 F. Supp. 1146, 1152-54 (D. Nev. 1969), cert. denied, 400 U.S. 1009 (1971); cf. Britt v. Cyril Bath Co., 417 F.2d 433, 436 (6th Cir. 1969). In Gordon v. Burr, 506 F.2d 1080, 1083 (2d Cir. 1974), the court of appeals reversed the trial court which had held that rescission was unavailable to a fraud victim against a defrauder not in privity and stated: "[W]e believe that the district court took too narrow a view of its powers as a court of equity . . . ." Finally, in SEC v. Management Dynamics, Inc., 515 F.2d 801, 813 (2d Cir. 1975), the court held that agency principles applied to a broker's employee in a rescission action, although refusing to intimate a view on such a case if damages had been sought.

It should be noted, however, that a statutory right to rescission is provided by, e.g., Securities Act of 1933 § 12, 15 U.S.C. § 77l (1970): a "person purchasing . . . may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security." Therefore it seems that the availability of rescission as an equitable remedy should not be as open to question as are the availability of non-statutory defenses or private injunctions.

25. Id. at 195.
26. Id. at 193.
dismissed the traditional view of injunction as an extraordinary remedy that should be limited because of its comparatively drastic effect on a defendant's activities. While the injunction in Capital Gains arguably was only a "mild" imposition on defendant, the case's broadly phrased presumption in favor of investors has often been relied upon—even to justify diluting or ignoring the Acts' clear language in certain instances in order to aid plaintiffs.27

In Rondeau v. Mosinee Paper Corp.,28 however, the Supreme Court recently addressed the issue of equitable relief in securities actions and concluded that a traditional view of equitable relief, at least in the circumstances of that case, would be more appropriate. In Mosinee, the petitioner had acquired in excess of five percent of respondent's stock but did not file a schedule 13D notice of his holdings in the time required by the Williams Act.29 The petitioner asserted that he was ignorant of the requirement but had no plan, during the period of the violation, to attempt to acquire control of Mosinee.30 The Court found that respondent suffered no harm because of petitioner's technical default, and consequently that the injunction against petitioner was improvidently granted.31 The Court reaffirmed the traditional requirement that equitable relief must be predicated upon a showing of irreparable harm to the plaintiff. It had been held frequently that some lesser showing would suffice, especially in the case of SEC actions.32

27. One example is the interpretation of sections in both Acts that appear to forbid any award in excess of "actual damages." See Securities Exchange Act of 1934 § 28(a), 15 U.S.C. § 78bb(a) (1970); Securities Act of 1933 §§ 11(e), (g), 12, 15 U.S.C. §§ 77k(e), (g), 77i (1970). Some cases have refused to hold that such language bars the availability of punitive damages through the assertion of a pendent state claim. See Young v. Taylor, 466 F.2d 1329, 1337 (10th Cir. 1972); In re Caesars Palace Sec. Litigation, 360 F. Supp. 366, 394 (S.D.N.Y 1973); Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 444-45 (N.D. Cal. 1968) (dictum), modified on other grounds, 430 F.2d 1202 (9th Cir. 1970). Contra, Schaefer v. First Nat'l Bank, 326 F. Supp. 1186, 1193 (N.D. Ill. 1970), appeal dismissed, 465 F.2d 234 (7th Cir. 1972). Similarly, the Supreme Court in Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970), affirmed an award of attorneys' fees as permissible in the trial court's discretion, although the Acts only authorized such awards in actions under certain sections. See Securities Exchange Act of 1934 § 18(a), 15 U.S.C. § 78r(a) (1970). See also Young v. Taylor, supra, at 1337 (attorneys' fees available through pendent state law claim). The Supreme Court has also sanctioned the application of a liberal common law measure of general damages, ruling that a defrauded seller's damages should be the difference between the price received and the actual value "except for the situation where the defendant received more than the seller's actual loss. In the latter case damages are the amount of the defendant's profit." Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972); see SEC v. Shapiro, 494 F.2d 1301, 1309 (2d Cir. 1974); Rochez Bros. v. Rhoades, 491 F.2d 402, 416-17 (3d Cir. 1974); Janigan v. Taylor, 344 F.2d 781, 786-87 (1st Cir.), cert. denied, 382 U.S. 879 (1965).

30. 422 U.S. at 55 & n.4, 60-62.
31. Id. at 57-61.
The language of Mosinee thus discounts somewhat the statutory presumption in favor of securities plaintiffs. The holding, however, may be circumscribed by the evident impatience of the Supreme Court with suits brought on the basis of technical violations and a growing sensitivity of the courts to the fact that tender offers, like that contemplated by petitioner, may be unjustly and irreparably harmed by the premature granting of injunctions. Furthermore, Mosinee may be distinguished by the Court's repeated stress upon petitioner's good faith which seemingly provided him a defense based on equity when the statute did not.

SEC actions for injunctions are governed by 15 U.S.C. §§ 77t(b), 78u(e) (1970), each providing in essence: "Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation. . . it may in its discretion, bring an action. . . to enjoin. . . and upon a proper showing. . . injunction. . . shall be granted. . . ." One interpretation of this language is that "a proper showing" is made when "it shall appear to the Commission," i.e., a prima facie case. SEC v. Management Dynamics, Inc., 515 F.2d 801, 808 (2d Cir. 1975) (the SEC injunction is a "creation of statute" not subject to prior standards); SEC v. Torr, 87 F.2d 446, 450 (2d Cir. 1937) (dictum); SEC v. Jones, 85 F.2d 17 (2d Cir. 1936) (per curiam); cf. Blue Chip Stamps v. Manor Drug Stores, 492 F.2d 136, 140 n.10 (9th Cir. 1974) (en banc), rev'd on other grounds, 421 U.S. 723 (1975) ("Private parties may maintain an action to enjoin anticipated or continuing violations of § 10(b) and Rule 10b-5 though they could not sue for damages."); Kahan v. Rosenstiel, 424 F.2d 161, 174 (3d Cir.), cert. denied, 398 U.S. 950 (1970); Note, The Purchaser-Seller Limitation to SEC Rule 10b-5, 53 Cornell L. Rev. 684, 694-97 (1968).

An opposing interpretation which appears more plausible from the face of the statute is that the injunction may be sought when it "appears to the Commission" but should only be granted "upon a proper showing," i.e., the showing of irreparable harm usually required "at law or in equity in a court of competent jurisdiction." See, e.g., Fenstermacher v. Philadelphia Nat'l Bank, 493 F.2d 333, 340 (3d Cir. 1974); Ozark Air Lines, Inc. v. Cox, 326 F. Supp. 1113, 1117-18 (E.D. Mo. 1971). The formulation of this traditional rule outside the realm of securities cases is found in Beacon Theatres, Inc. v. Westover, 359 U.S. 500, 506-07 (1959); United States v. W.T. Grant Co., 345 U.S. 629, 633 (1953).

Recent cases have dismissed such claims more frequently. See, e.g., Simon v. New Haven Board & Carton Co., 516 F.2d 303, 306 (2d Cir. 1975) (dictum); Daley v. Capitol Bank & Trust Co., 506 F.2d 1375 (5th Cir. 1974); cf. Stirling v. Chemical Bank, 382 F. Supp. 1146, 1152 (S.D.N.Y. 1974), aff'd, 516 F.2d 1396 (2d Cir. 1975) (complaint failed to state a cause of action where it alleged defendant failed to file schedule 13D but contained no allegation of harm to plaintiff). It is noteworthy that the Court has suggested in a rule 10b-5 case that if it ruled in favor of the plaintiffs the effect might be "to encourage nuisance or 'strike' suits." Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740 (1975). A presumption against plaintiffs in derivative suits gives rise to the latter expression. Hence to compare such cases to any section 10(b) action is to progress far from mechanical presumptions favoring securities plaintiffs.
Apart from the *Mosinee* analogy, federal courts today must draw from an inconsistent body of precedent in ruling on the availability of defenses in securities actions. This Comment will analyze decisions reached by the lower courts facing this question to determine whether they are in accord with apparent congressional intent. In addition, consideration will be given to the non-statutory equitable defenses relating to plaintiffs' participation in violations (*in pari delicto*, unclean hands and illegality), to plaintiffs' acquiescence in violations (laches, estoppel and waiver), and to the statutory defense of good faith for "controlling persons."

I. DEFENSE OF PLAINTIFFS' PARTICIPATION

A. In Pari Delicto and Unclean Hands

The Court's statement in *Perma Life* that the defense of *in pari delicto* is "not to be recognized as a defense to an antitrust action" need not be taken literally in view of the opinion as a whole. The defense properly comes into play only when fault is found to be relatively equal, and the Court in *Perma*

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respondent made this 'a particularly inappropriate occasion to fashion equitable relief . . . ." 422 U.S. at 56. Indeed, Judge Pell, dissenting from the Seventh Circuit majority opinion, had written: "We are . . . confronting the matter of remedy and indeed whether any remedy is . . . needed." 500 F.2d 1011, 1018 (7th Cir. 1974). Similarly, while the Court has emphasized the literal provisions of § 16(b) of the 1934 Act, 15 U.S.C. § 78p(b) (1970) (see Blau v. Lehman, 368 U.S. 403, 409-14 (1962); cf. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 734 (1975) (dictum)), it has also held that insiders' short-swing profits under the section are not necessarily violations, despite the section's apparent strict liability, if the defendant insider in fact lacked the potential for "speculative abuse." In such a case, no real harm could have been suffered by plaintiffs. Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 594-95 (1973); cf. Provident Secs. Co. v. Foremost-McKesson, Inc., 506 F.2d 601, 604 (1974), aff'd, 96 S. Ct. 508 (1976). 37. 392 U.S. at 140.

38. Comment, The Demise of In Pari Delicto in Private Actions Pursuant to Regulatory Schemes, 60 Calif. L. Rev. 572, 577 (1972). In pari delicto ("in equal fault") is generally used interchangeably with "unclean hands" to denote unfair or inequitable, although not necessarily illegal, conduct by an applicant for equitable relief. Many courts require that the conduct occur in the same transaction from which the applicant's right arises. Such conduct will cause a court of equity to deny the requested relief. 2 J. Pomeroy, Equity Jurisprudence § 403 (5th ed. 1941) [hereinafter cited as Pomeroy]; see D. Dobbs, Remedies § 2.4, at 45-46 (1973) [hereinafter cited as Dobbs]. The defense also is available in actions at law involving illegal transactions, depending upon the parties' relationship, the seriousness and relevance of plaintiff's wrong, and enforcement considerations. 6A A. Corbin, Contracts §§ 1535, 1536, at 821-26 & n.23 (1962) [hereinafter cited as Corbin]. Furthermore, it is said that where the fault is truly equal, no recovery even at law is permitted. In pari delicto, however, often appears as an "exception" or a qualifier to "unclean hands." Where one party is not equally culpable and some important public policy—particularly one announced by statute—is advanced by permitting that party to have relief, then even a court of equity may ignore his improper conduct. 6A Corbin, supra, § 1540 at 833-35; 2 Pomeroy, supra, § 403, at 137; 14 S. Williston, Contracts § 1631A, at 46-47 (3d ed. 1972); see 6A Corbin § 1465, at 557. The basis of the Perma Life decision fits precisely within the last exception; "public policy in favor of competition" is so strong that the moral worth of plaintiffs is disregarded—especially since the private antitrust action is a "bulwark of antitrust enforcement." 392 U.S. at 139.
Life found that the plaintiff franchisees who brought suit to nullify the franchises had been coerced into antitrust violations by their franchisor. As the plurality opinion noted, the illegal agreement was virtually a contract of adhesion, not negotiated or chosen by the plaintiffs but rather "thrust upon" them, and their intent in signing was not equivalent to defendant's anticompetitive purpose. Hence, had the Court cast its opinion in terms of the precise application of the traditional in pari delicto rule, it would not have reached a different result. Indeed, the doctrine mandates that plaintiffs in Perma Life have relief for two reasons: their degree of fault and participation were less than defendant's, and secondly, they had been more nearly equal, the strong public policy favoring private actions as part of the regulatory scheme might still, in this case, override an in pari delicto defense. Finally, the Perma Life Court added the caveat: "We need not decide... whether... truly complete involvement and participation... could ever be a basis, wholly apart from the idea of in pari delicto, for barring a plaintiff's cause of action, for in the present case [such a] picture... is utterly refuted by the record." The Court has yet to elaborate on the meaning of "complete involvement and participation." However, this statement of the Court, as well as statements in the concurring opinions, manifest a recognition that a plaintiff who shares substantially equal fault may be barred. Consequently, Perma Life should not foreclose a defendant's assertion of in pari delicto in a securities action where the fault is nearly equal, notwithstanding the public policy favoring private enforcement. While determining equality of fault may be difficult, the fair results which the defense produces justify its continued availability.

39. 392 U.S. at 139-42.
40. See note 38 supra.
41. 392 U.S. at 140. In addition, the Court stated that "we cannot accept the Court of Appeals' idea that courts have power to undermine the antitrust acts by denying recovery to injured parties merely because they have participated to the extent of utilizing illegal arrangements formulated and carried out by others." Id. at 139.
42. Id. at 143-44, 147 (White, J., concurring); id. at 147 (Fortas, J., concurring); id. at 148-51 (Marshall, J., concurring); id. at 153-56 (Harlan & Stewart, JJ., concurring in part & dissenting in part).
43. Indeed, despite the Perma Life decision, some courts have concluded that the defense remains available in antitrust cases. See Note, Rethinking In Pari Delicto: An Antitrust Policy Analysis, 3 Fla. St. L. Rev. 360, 361-62, 369-72 (1975).
44. "[T]he amorphous quality of 'equal fault' renders uniform application impossible." Comment, The Demise of In Pari Delicto in Private Actions Pursuant to Regulatory Schemes, 60 Calif. L. Rev. 572, 576 (1972). The only general rule that may be stated is that a plaintiff's mere knowledge of defendant's securities violations without more is never a bar—at least absent circumstances amounting to laches or estoppel. See A.C. Frost & Co. v. Cœur d'Alene Mines Corp., 312 U.S. 38 (1941); Pearlstein v. Scudder & German, 429 F.2d 1136, 1141 (2d Cir. 1970), cert. denied, 401 U.S. 1013 (1971); Rosenberg v. Hano, 121 F.2d 818 (3d Cir. 1941); notes 89, 129-48 infra and accompanying text.
45. It should be unnecessary for the defendant to resort to one dubious argument which has been advanced, namely that securities cases should be held to be beyond the scope of Perma Life simply because the public policy favoring truth in securities dealings is not as strong a policy as that favoring business competition. See Kuehnert v. Texstar Corp., 412 F.2d 700, 703-05 (5th Cir. 1969).
Once the theoretical availability of the defense has been established, the courts' inquiry usually has been twofold: will the defense in the given case disserve the statutory purpose of investor protection, and how guilty is each party? It has been argued that these questions should be answered in sequence so that an affirmative answer to the first would excuse any inequitable conduct on the part of the plaintiff. The courts, however, appear to consider them concurrently in most cases. The effect of this approach has been to achieve more equitable results than when one broad policy rule is applied. When a court balances the equities rather than adhering to the broad policy of investor protection, neither party is favored. A balancing of the equities thus serves as a deterrent to prospective violations by plaintiffs that might otherwise be disregarded under the investor protection policy. However, the results in most margin violation cases and some inside information cases, where primary emphasis was placed on broad policy arguments rather than on the equities, have seemed to encourage rather than deter calculated violations of the Acts.

B. Margin Violations

Sections 7 and 8 of the 1934 Act forbid the extension of credit beyond specified limits for stock purchases. The legislative history of these sections provides the clearest statement of legislative purpose and the plainest designation of the class to be protected. Yet they have occasioned the most acrimonious dissension in the courts regarding the availability of in pari delicto. Although this dissension culminated in congressional amendment of these sections in 1970, the conclusions reached by the courts prior to amendment are instructive because they illustrate problems which still arise under other sections.

Congress originally had intended the imposition of margin requirements “to prevent a recurrence of the pre-crash situation,” referring to overinflation of stock prices by speculative purchases financed largely by unsecured credit. Its


51. 15 U.S.C. § 78g(f) (1970). Regulation X, which was established pursuant to this amendment, forbids the acceptance of credit in amounts not allowed, under section 7(c) and Regulations T and U, to be extended by lenders. See 12 C.F.R. § 224 (1975). See generally Comment, Civil Liability for Margin Violations—The Effect of Section 7(f) and Regulation X, 43 Fordham L. Rev. 93 (1974); Note, Regulation X and Investor-Lender Margin Violation Disputes, 57 Minn. L. Rev. 208 (1972).

express purpose was to protect the economy from excessive speculation. Protection of individual investors was specifically disclaimed as a goal of the sponsors, although it was recognized as a "by-product."53 By the terms of the statute, the violation was committed only by the lender. Notwithstanding the fact that the benefit of the violation generally inured to the borrower, his role in procuring the violation was ignored in the original Act. The usual result has been for the lender to forfeit all or part of the improper loan54—although the courts often expressed reluctance in reaching that result. In Avery v. Merrill Lynch, Pierce, Fenner & Smith,55 defendant broker, at the request of plaintiff customer, effected a short sale of certain stock. The margin regulations required that plaintiff, within five days, deposit with the broker sixty-five percent of the cost of the shares to be delivered. After plaintiff failed to do so, although she did have approximately sixty-one percent of the total in her account, she persuaded the defendant to delay several additional days rather than cancel the sale. When defendant completed the short sale, the price of the shares had risen and a large loss resulted, which defendant accordingly charged to plaintiff's account. Plaintiff then sued to rescind the sale and to recover the amount of the loss, on the ground that defendant had violated the margin requirements. She pointed out that, had the broker complied with the regulations, the sale at a loss would not have been consummated. The court's response illustrated the problem which the statute presented:

The Court is disturbed by the entire transaction. It appears that a knowledgeable customer experienced in the requirements and functions of the Exchange authorized a short sale of a considerable quantity of stock by one of the world's largest stockbrokers and then later repudiated the sale when she saw it was going poorly. It seems that both the plaintiff and the defendant were aware that the margin requirements were not met within the requisite five days. The defendant alleges that the plaintiff promised to supply the money to meet the margin requirements . . . and that because of these representations the defendant did not meet the[se] requirements by liquidating.

The Court will not entertain a cacophony of blame . . . . [T]he ultimate responsibility must be placed somewhere and Congress has indicated that it is with the brokers . . . . The Court deplores this type of alleged investor behavior and were not the mandate of Congress so unequivocal and the public policy considerations so strong, the Court might reach a substantially different decision than the one it does.56

Notwithstanding the statute's "unequivocal" mandate, however, the Second and Sixth Circuits exercised their equitable discretion to avoid unconscionable benefit to borrowers where it was shown that fraud was practiced upon the

53. Id.
54. E.g., Daley v. Capitol Bank & Trust Co., 506 F.2d 1375 (1st Cir. 1974); Grove v. First Nat'l Bank, 489 F.2d 512 (3d Cir. 1973); Avery v. Merrill Lynch, Pierce, Fenner & Smith, 328 F. Supp. 677 (D.D.C. 1971) (mem.). Plaintiff's actions have been either claims for cancellation of the debt or claims for damages representing the decline in value of their accounts preceding the broker's eventual selling out of the over-margined securities.
56. Id. at 678, 681 (emphasis added) (granting plaintiff's motion for summary judgment).
lender. In *Serzysko v. Chase Manhattan Bank*, the Second Circuit affirmed a denial of relief to either party where plaintiff borrower was himself a broker conversant with the margin rules, and the lending bank plainly had not met its burden of ascertaining the purpose of the loan. In *Spoon v. Walston & Co.*, the Sixth Circuit affirmed the trial court's award of one-half of plaintiff borrower's actual damages based on equitable principles, emphasizing its "conclusion that neither party's statement of facts is true." These decisions recognized that the statute in its pre-1970 form encouraged rather than deterred violations, and apparently concluded that it was the courts' obligation to fashion relief which might discourage such activity even though the courts were powerless to change the substantive rule of law.

Nonetheless, courts have held that even in a case of fraud on the part of the plaintiff borrower, the lender's violations, although innocent and technical, must be punished. If violations are to be deterred, however, such an inelastic approach should not be taken.  

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59. 478 F.2d at 247. The district court in *Avery v. Merrill Lynch, Pierce, Fenner & Smith*, 328 F. Supp. 677 (D.D.C. 1971) (mem.), indicated earlier that it would have followed this reasoning had any facts suggesting fraud or deception been presented to it. Id. at 680.

60. Congress' long delay in solving the problem in margin cases, which seemed a gross injustice to most courts which considered it, may be cited as one good reason for judicial adaptation, as typified by *Serzysko v. Chase Manhattan Bank*, 290 F. Supp. 74 (S.D.N.Y. 1968), aff'd per curiam, 409 F.2d 1360 (2d Cir.), cert. denied, 396 U.S. 904 (1969). See *Spoon v. Walston & Co.*, 345 F. Supp. 518 (E.D. Mich. 1972), aff'd per curiam, 478 F.2d 246 (6th Cir. 1973); cf. *Goldman v. Bank of the Commonwealth*, 467 F.2d 439 (6th Cir. 1972). The Supreme Court recently adverted in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), to the view that congressional failure to react to a given judicial interpretation "argues significantly in favor of" that interpretation. Id. at 733. But congressional inaction in these cases was inconclusive, since no consistent interpretation had emerged.

61. See, e.g., *Grove v. First Nat'l Bank*, 489 F.2d 512, 516 (3d Cir. 1974). Compare to *Avery v. Merrill Lynch, Pierce, Fenner & Smith*, 328 F. Supp. 677 (D.D.C. 1971) (mem.) the observation of the Sixth Circuit, quoting the trial court, in *Goldman v. Bank of the Commonwealth*, 467 F.2d 439 (6th Cir. 1972), that plaintiff presented "a sorry spectacle" and "was not a credible witness." . . . 'He impressed this Court as being very smooth and very glib.' " Id. at 441, 444. At least one court has adhered to this rule denying the defense where plaintiff merely persuaded, rather than deceived, the lender. *Pearlstein v. Scudder & German*, 429 F.2d 1136 (2d Cir. 1970), cert. denied, 401 U.S. 1013 (1971). Lenders' assertions of innocence are seldom successful. The regulations penalize overextensions of credit regardless of any claimed error or lack of wilfulness unless the improper loan is the result of mere "mechanical mistake." Regulation T, 12 C.F.R. § 220.6(k) (1975); see *Landry v. Hemphill, Noyes & Co.*, 473 F.2d 365, 371 (1st Cir.), cert. denied, 414 U.S. 1002 (1973).

62. Adopting an enforcement standard in securities actions, see, e.g., *Comment, The Demise of In Pari Delicto in Private Actions Pursuant to Regulatory Schemes*, 60 Calif. L. Rev. 572, 579 (1972), because of its inflexible approach, cannot account for the equities in each case. Indeed courts do not agree on how to apply the enforcement standard. See notes 69-73 infra and accompanying text.
As Judge Friendly noted in his dissent in *Pearlstein v. Scudder & German*, 63

[any 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. . . ."

. . . Equity would leave the loss where it lies. 64

This criticism seems applicable to the former statute as well as to the holding of the case. 65

The 1970 amendment of the margin provisions 66 makes it illegal for borrowers to accept what it had always been illegal for lenders to provide, thereby ending the borrowers' insulation from liability. The change in the margin rules has thus eliminated the need for some courts to emphasize their equitable discretion in order to limit the relief available to the culpable plaintiff borrowers. But the argument that such discretion should always be available because of its deterrent effect remains a compelling one. It is doubtful that a uniform rule favoring one class over another would likely deter violations more effectively than the uncertainty which would arise in the minds of both borrowers and lenders if relief were freely discretionary.

C. Inside Information

While the antagonism of the courts toward the inequity of the margin statute has not been equalled in cases arising under other sections of the Acts, a series of suits by tippees alleging fraud by their tippors in violation of

63. 429 F.2d 1136, 1145-49 (2d Cir. 1970), cert. denied, 401 U.S. 1013 (1971). Two other arguments presented by Judge Friendly were an appeal to the equities of the case—plaintiff "was no lamb," id. at 1148—and reference to the legislative purpose and its fulfillment: "Occasional and isolated violations" of § 7(c) do not pose such a threat to the economy as to justify rewarding such a plaintiff. Id. at 1147-48. It is noteworthy that the Second Circuit in *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967), recognizing the likelihood of abuse inherent in these cases, permitted a broker to sue his customer where the broker had alleged a scheme to purchase securities through him "with the fraudulent intent of paying for the securities only if their market value had increased by the date payment was due." Id. at 395. The trial court had granted defendants' motion to dismiss for failure to state a claim, on the sole ground that plaintiff was not a buyer. The Second Circuit emphasized that section 10(b) was designed "In the public interest" as well as "for the protection of investors." Id. at 396.

64. 429 F.2d at 1148, 1149 (Friendly, J., dissenting).

65. Other courts have felt strongly that the section's one-sided approach was unjust. See *Goldman v. Bank of the Commonwealth*, 467 F.2d 439, 446-47 (6th Cir. 1972); *Serzysko v. Chase Manhattan Bank*, 290 F. Supp. 74, 89-90 (S.D.N.Y. 1968), aff'd per curiam, 409 F.2d 1360 (2d Cir.), cert. denied, 396 U.S. 904 (1969).

section 10(b) of the 1934 Act and rule 10b-5 has presented a strongly analogous issue. In these cases, the recipients of inside information have sued the insiders when the information proved to be false and the recipients bought or sold securities in reliance upon it. Two Fifth Circuit cases, James v. DuBreuil and Kuehnert v. Texstar Corp., have admitted an in pari delicto defense against plaintiffs and barred their recovery, although arguably their participation was not equal. The court in both cases focused on the question that was present but unresolved in the margin cases: apart from the statutory policy of investor protection, which choice will serve the implicit statutory purpose of deterring violations?

In view of the substantial deterrent pressures already felt by the corporate insider we think it important that tippees, who present the same threat to the investing public as do insiders themselves, should be offered appropriate discouragement. We conclude that the better choice is to leave upon persons believing themselves tippees the restraint arising from the fear of irretrievable loss should they act upon a tip which proves to have been untrue. Hence the loss must lie where it falls.

However, a forceful contrary argument has been made. Since insiders are, after all, the source of inside information, imposing an additional sanction against them should help to eradicate the problem. Both views continue to coexist, awaiting resolution from the Supreme Court or from Congress. A preference for either class as a policy matter seems unwise, however, if the

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68. 17 C.F.R. § 240.10b-5 (1975). Corporate insiders and their tippees have a duty to disclose material non-public information about a corporation when buying or selling its shares. SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301 (2d Cir.), cert. denied, 404 U.S. 1005 (1971).
69. 500 F.2d 155 (5th Cir. 1974).
70. 412 F.2d 700 (5th Cir. 1969).
71. In James, defendant, an insider of a merging bank, persuaded plaintiff to sell defendant his shares in the bank on the pretext that their value would be enhanced when placed in a nonexistent "organizers' trust." Plaintiff's suit to rescind for fraud was dismissed because he had agreed to back-date the transfer documents so that sale to the insider during the merger period would appear legal under a rule then in effect. 500 F.2d at 155-57, 159.
72. In the earlier Kuehnert case, plaintiff bought stock in defendant corporation on the open market on the strength of false inside information from its president, knowing that his own nondisclosure of the information was improper. After losing his investment, he sought damages. The court dismissed the claim, while noting, however, that "Kuehnert knowing nothing, concealed nothing, and hence did not defraud his vendors." 412 F.2d at 704. The court recognized that the one question before it was: "[I]s an impure heart an equivalent [of a wrongful act, barring relief]" 412 F.2d at 703. But it concluded that enforcement of the Acts in this case required an affirmative answer.
lesson of the margin cases is recalled: violations are likely to multiply if one participant in an illegal transaction remains immune from liability.

The striking aspect of the inside information cases as they relate to equitable defenses generally is the short shrift invariably given the equities of the parties. It appears that the courts view insider violations as more serious, wilful, and insidious, and both tippers and tippees as more inherently undeserving, than those who engage in technical margin violations and other kinds of fraud. Far from favoring plaintiffs as members of the protected class of investors, the Fifth Circuit in James and in Kuehnert referred to each as a “dupe.” That their act of buying or selling, once in receipt of inside information, constituted a part of the same transaction as required by the in pari delicto doctrine seems to be presumed without analysis by the insider cases permitting the defense.

D. Other Fraudulent Transactions

In securities cases where the fraud does not concern inside information, the courts have generally embraced the doctrine of “resolving doubts in favor of those the statute is designed to protect.” Hence there has been reluctance to admit the traditional defenses or, if admitted, to find that they are sustained by the evidence. However, a recent Fifth Circuit case, Woolf v. S.D. Cohn

74. See notes 48-59 supra, 78-98 infra and accompanying text.
75. 500 F.2d at 160; 412 F.2d at 703. It may be noted on the side of plaintiffs in Kuehnert and even in James that there is contrary authority, stating that a “gullible” plaintiff participating in an illegal scheme is more, not less, worthy of relief. 6A Corbin, supra note 38, §§ 1536, 1540 (citing cases).
76. Dobbs, supra note 38, § 2.4, at 46.
79. See, e.g., Meyers v. C & M Petroleum Producers, Inc., 476 F.2d 427, 429 (5th Cir.), cert. denied, 414 U.S. 829 (1973); Carpenter v. Hall, 311 F. Supp. 1099, 1106-07 (S.D. Tex. 1970). However, in Malamphy v. Real-Tex Enterprises, No. 74-2050 (4th Cir., Oct. 20, 1975), the Fourth Circuit affirmed the availability of the defense, citing James v. DuBreuil, 500 F.2d 155 (5th Cir. 1974), and Kuehnert v. Texstar Corp., 412 F.2d 700 (5th Cir. 1969), and distinguishing Can-Am Petroleum Co. v. Beck, 331 F.2d 371 (10th Cir. 1964), see note 89 infra and accompanying text, but did not discuss the Perma Life or Woolf decisions. No. 74-2050 at 4-5. However, plaintiffs' violation was egregious in Malamphy. Plaintiffs, real-estate salesmen, were hired after defendant seller had been enjoined from further sales by the SEC, and were fully aware of the injunction. Upon defendant's bankruptcy, they sued claiming fraud in the offering and sale (each had purchased parcels himself as a promotional device). The jury found for the defendant. Id. at 2-4.

Because of the broad public policy in favor of investor protection, however, some courts have overstated the law beyond the requirements of the case before them. For example, in Rosen v. Dick, [1974-1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,786 (S.D.N.Y. 1974), even though plaintiff was plainly not in pari delicto, Judge Metzner wrote: “The doctrine of in pari
& Co.,\textsuperscript{80} announced new standards even more favorable to plaintiffs. In 
Woolf, plaintiff buyers sought damages under section 10(b) of the 1934 Act\textsuperscript{81} 
from the defendant issuer and its management, alleging inadequate disclosure 
of the issuer's financial condition. The court held that the buyers were entitled 
to maintain an action for damages,\textsuperscript{82} and discounted defendants' claim that 
misrepresentation on the part of plaintiffs—that they were buying for invest-
ment and not resale when in fact they had already arranged for resale—put 
them \textit{in pari delicto} with the issuer. Although plaintiffs' misrepresentation 
might well have defeated the defendant issuer's section 4(2) exemption,\textsuperscript{83} the 
court concluded that it was not a part of defendants' violation of section 10(b) 
and that defendants' success would adversely affect the investing public, 
whose protection was a primary purpose of the 1934 Act.\textsuperscript{84} Strongly endorsing 
the \textit{Perma Life} rationale of private enforcement, the court reformulated its 
test for \textit{in pari delicto}:

[T]he fault of the parties must be "mutual, simultaneous, and relatively equal," and 
the plaintiff must be an active, essential, and knowing participant in the unlawful 
activity. Moreover, because of the twofold purpose of the implied private rights of 
action . . . deterrence . . . and compensation . . . the degree to which the defendant's 
unlawful activity affects the investing public must be given substantial weight in 
determining whether to permit interposition of the \textit{in pari delicto} defense. Thus, even 
in a case where the fault of the plaintiff and defendant were relatively equal, 
simultaneous and mutual, the court might still reject the defense if it appeared that the 
defendant's unlawful activities were of a sort likely to have a substantial impact on the 
investing public, and the primary legal responsibility for and ability to control that 
impact is with the defendant.\textsuperscript{85}

The court's emphasis on the impact of a defendant's activities upon the 
investing public in \textit{Woolf} is the strictest test yet proposed for availability of 
the defense. There are few activities which do not at least indirectly affect the 
investing public.\textsuperscript{86} The \textit{Woolf} standard averse the importance of deterring

delicto is inapplicable to cases where former officers and directors of a corporation are charged 
with participating with others in the perpetration of a fraud against the corporation and its 
shareholders." Id. at 96,606.

An additional factor present in most of the reported cases is that plaintiffs, as small investors, 
have tended to receive the benefit of the doubt unless defendants vigorously pursue the extent 
of plaintiffs' sophistication. See, e.g., Fey v. Walston & Co., 493 F.2d 1036, 1042-43 (7th Cir. 1974) 
(plaintiff struck allegation of little or no investment experience after defense sought to discover 
her income tax returns).

80. 515 F.2d 591 (5th Cir. 1975), petition for cert. filed, 44 U.S.L.W. 3442 (U.S. Jan. 8, 1976) 
(No. 75-969).
82. 515 F.2d at 605-06.
84. 515 F.2d at 604-05.
85. Id. at 604.
86. Even in the false inside information cases the Fifth Circuit had "assumed" that the denial 
of relief would have no public impact. Kuehnert v. Texstar Corp., 412 F.2d 700, 703 (5th Cir. 
1969). The assumption seems unrealistic. Certainly, if in pari delicto were always available, 
increased activity by knowledgeable insiders would be likely to displace the market artificially,
violations and compensating victims of violations of the securities acts, but fails to deal at all with the consequent diminution of deterrence to plaintiffs, not all of whom may fairly be termed "victims." The final clause of the Woolf test, regarding primary legal responsibility for compliance, emphasizes the one-sidedness of the deterrence aspect. It is similar to that of the pre-1970 margin violation cases, which held that liability must ultimately rest upon those on whom Congress imposed the duty of compliance. However, the idea that a full participant in a violation might be immune from liability is foreign to Perma Life and to settled authority.

Nonetheless, Woolf seems correct on its facts, since plaintiff's hands were not soiled in the same transaction as that from which her right arose, nor was her conduct equivalent to the issuer's. But the essence of the Woolf test—barring in pari delicto whenever a court finds that a defendant's activities have substantial impact beyond the parties—is an inadequate guide to the courts now obliged to apply it. It imposes the burdensome requirement of additional determinations of "substantial impact" and "primary responsibility." The trial courts are not well equipped to make these determinations, nor are they certain to rule consistently. Moreover, the test unduly restricts the courts' traditional equitable discretion which, even under

and insiders' relative immunity from private suit would dramatically affect the availability of inside information and the amount of unpunished fraud. Notably, the Supreme Court has since held that liability in securities fraud does not depend upon market effect. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 9-12 (1971). Hence the best view from the deterrence standpoint is avoidance of the Woolf recommendation, which puts an artificial, rather than an equitable, limitation upon availability of the defense.

87. 515 F.2d at 604.
88. In Woolf, qualifying for the section 4(2) exemption from registration was the issuer's burden. Id. at 605.
89. See, e.g., Katz v. Amos Treat & Co., 411 F.2d 1046, 1054 (2d Cir. 1969); Can-Am Petroleum Co. v. Beck, 331 F.2d 371, 373 (10th Cir. 1964); Athas v. Day, 186 F. Supp. 385 (D. Colo. 1960). Moreover, the idea should have even less application here, where the plaintiff Woolf was an attorney and an experienced investor; her violations did not appear to be unknowing. 515 F.2d at 597. Although Woolf is correct on its facts since plaintiff's violation was sufficiently separate from defendant's, such plaintiffs have met with judicial scorn in other pari delicto cases. See, e.g., Goldman v. Bank of the Commonwealth, 467 F.2d 439, 441, 447 (6th Cir. 1972).
90. 515 F.2d at 604-05; see text accompanying note 84 supra. In a subsequent opinion denying rehearing, the Woolf court suggested a possible limitation upon the holding by emphasizing the nature of defendants' violation: "The private action... arguably occupies an even more important place in the area of private placements than in other areas of Securities Act enforcement where activities of an issuer must both be reported to and approved by the S.E.C." Woolf v. S.D. Cohn & Co., 521 F.2d 225, 227-28 (5th Cir. 1975) (per curiam).
91. On petition for rehearing the court rephrased and clarified its test: "[T]he question is... whether [plaintiffs' conduct] was equal, simultaneous, and vital to the effectuation of the fraudulent scheme (as the cooperation of a co-conspirator is vital to... a conspiracy); and whether the remedial purposes of the securities laws will be furthered more by allowing the defense than by disallowing it." 521 F.2d at 228. The language "vital to the effectuation" is not contrary to the usual standard for determining what constitutes participation. But the second part of the test remains objectionable; such a determination should not be left to the trial court. See Brodsky, In Pari Delicto Defense Reviewed, 174 N.Y.L.J., Nov. 5, 1975, at 2, col. 1-2.
Securities Defenses

Perma Life, would allow the assertion of the defense where there has been substantial equality of involvement. Hence Woolf might best be limited to its facts.

The better model in cases where in pari delicto is asserted is that provided by Katz v. Amos Treat & Co. and by James v. DuBreuil. In Katz, plaintiff's subsequent transfers to third parties in violation of section 12 of the 1933 Act were properly regarded as separate transactions from defendant's sale to plaintiff of unregistered securities—a situation analogous to Woolf. In James, however, plaintiff's agreement to back-date certain documents illegally was essential to the very sale that plaintiff claimed was fraudulent and sought to rescind. The court emphasized that plaintiff's intent was to consummate and profit from a plainly illegal transaction. These two cases provide a simple rule: where the plaintiff's violation is a part of the transaction he complains of and is roughly equal in magnitude to defendant's, the plaintiff's complaint should be barred. This test has the advantage of favoring those whom the statute was meant to protect—the investing public—without immunizing culpable plaintiffs from liability. In addition, the test permits ready applicability without the need of tenuous policy determinations by the trial court, such as estimates of "public impact." This test as applied in Katz and James resulted in holdings that the defense was available in both cases, but was only established in the latter.

In both cases defendants' violations must have affected the market in the shares they were selling; but whether that kind of effect is "significant" is unclear under Woolf. In practice the courts have generally regarded the defense as admissible in fraud cases, but apparently because of the presence of the statutorily "protected class" of investors, the defense, once admitted, has been difficult for defendants to establish.

E. Illegality and In Pari Delicto

In many cases where in pari delicto is asserted an additional defense alleged is that the transaction is void because it was illegal, and the plaintiff's participation in it bars his suit for performance, rescission, or damages. This common law theory is still regularly asserted.

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92. 411 F.2d 1046 (2d Cir. 1969).
93. 500 F.2d 155 (5th Cir. 1974).
95. 411 F.2d at 1054; accord, Meis v. Sanitas Serv. Corp., 511 F.2d 655 (5th Cir. 1975) (postmerger misuse of funds by target management did not bar their suit to rescind merger).
96. 500 F.2d at 157-58.
97. See text accompanying note 85 supra.
99. 6A Corbin, supra note 38, § 1536, at 822-26; 2 Pomeroy, supra note 38, §§ 402(f), 403.
The weight of authority, however, is that if the investor protection policy in securities cases will be furthered, plaintiff's recovery is permissible, especially if there has been substantial performance. In *A.C. Frost & Co. v. Coeur d'Alene Mines Corp.*, an early case under the 1933 Act, the Supreme Court held that the plain intent of that Act was to protect purchasers by giving them express causes of action. Thus, application of the usual rule denying enforcement to illegal contracts would do violence to the express public policy of the Act. The petitioner in *Frost* was the assignee of an option to purchase unregistered securities. He sued for damages when respondent repudiated the option contract after partial performance. The lower courts refused to enforce the remainder of the option and as to this the Supreme Court agreed. But the Idaho Supreme Court had also refused to enforce petitioner's claim for damages based on the issuer's failure to remit as agreed the payments it had received on its sale to third parties of some of the optioned shares. Those shares were already delivered and in the hands of the investing public. The Supreme Court reversed, compelling respondent to pay damages based on the executed portion of the contract, even though the Court assumed that the failure to register the shares violated the 1933 Act and that the assignee was aware of this fact.

The 1934 Act has an express provision concerning illegal transactions. Section 29(b) of the Act provides:

Every contract made in violation of any provision of this chapter . . . and every contract . . . the performance of which involves the violation of . . . any provision of this chapter . . . shall be void . . . as regards the rights of any person who, in violation of any such provision . . . shall have made or engaged in the performance of any such contract . . . .

Despite the fact that this language appears to bar anyone who has performed under, or even entered into, an illegal contract, the section is uniformly construed in accord with *Frost*, so that such a contract will not be held void but may be enforced to the extent plaintiff has performed under it. This construction has recently been supported by the Supreme Court. The controlling premise has been a finding that plaintiffs were not primarily

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101. See *A.C. Frost & Co. v. Coeur d'Alene Mines Corp.*, 312 U.S. 38 (1941); cf. 6A Corbin, supra note 38, § 1540, at 836; 2 Pomeroy, supra note 38, §§ 402(c), (f), 403.

102. 312 U.S. 38 (1941).

103. Id. at 41-43.

104. Id. at 39-40; cf. *Kaiser-Frazer Corp. v. Otis & Co.*, 195 F.2d 838 (2d Cir.), cert. denied, 344 U.S. 856 (1952), in which the court refused to compel performance by defendant underwriter of a wholly executory contract found to be illegal, despite plaintiff issuer's assertion that defendant had been aware of plaintiff's misrepresentations even before signing the contract. Id. at 843-44.

105. 312 U.S. at 43-45.


108. The Supreme Court has recently cited section 29(b) as "providing that a contract made in
responsible for the illegality. In *Frost*, petitioner merely had knowledge of the issuer's failure to register. In other cases the rule has commonly been stated that such contracts are not void but merely voidable at the option of an innocent party.\textsuperscript{109}

Nonetheless, when there is a semblance of equality in the violations by each party, the courts have sometimes devised flexible interpretations of section 29(b). In *Occidental Life Insurance Co. v. Pat Ryan & Associates*,\textsuperscript{110} plaintiff, having contracted to sell defendant a subsidiary company, sued for damages after defendant's failure to make certain periodic payments. The case was removed to federal court where defendant counterclaimed that plaintiff's failure to disclose material facts about the subsidiary was in violation of the 1934 Act, thus entitling defendant to rescission.\textsuperscript{111} The court, in denying rescission, based its ruling on the statute of limitations and defendant's lack of diligence.\textsuperscript{112} However, most of its analysis was devoted to defendant's alternative theory: that under the explicit language of section 29(b), plaintiff was one who had "engaged in the performance of" an illegal contract—by transferring title under the sale—and therefore should be barred from enforcing it.\textsuperscript{113} The court noted that *Frost* and its progeny were based on the presumption that voiding a contract except at an innocent party's request would usually reward wrongdoers. It took the view that section 29(b) supplemented rather than superseded the common law, especially when the violator had performed under the contract.\textsuperscript{114}

The decision to compel performance while awarding defendant some damages was based on the fact that since the defendant had benefited under the contract, voidance would benefit it twice.\textsuperscript{115} Equitable considerations would violation of any provision of the 1934 Act is voidable at the option of the deceived party." Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 735 (1975).

109. See, e.g., Reserve Life Ins. Co. v. Provident Life Ins. Co., 499 F.2d 715, 726 (8th Cir. 1974), cert. denied, 419 U.S. 1107 (1975); cases cited in note 89 supra. There is contrary authority, however, holding such contracts void. Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968). In Myzel, however, the court was unconvinced of either party's honesty at trial. 386 F.2d at 736.


111. Id. at 1259-60.

112. Id. at 1268.


114. 496 F.2d at 1265-67. The court relied upon Pearlstein v. Scudder & German, 429 F.2d 1136, 1149 (2d Cir. 1970), cert. denied, 401 U.S. 1013 (1971) (Friendly, J., dissenting) ("There has been a conspicuous lack of judicial enthusiasm for the doctrine . . . when there has been performance by the violator . . . .") (citations omitted).

115. 496 F.2d at 1267. For equitable reasons the court also denied defendant's alternative request for rescission, which was based on the assertion that under section 12(2) of the 1933 Act, rescission is "statutory" and therefore the district court had no discretion to bar it. The court's holding on this point is supported by analogy to Rondeau v. Mosinee Paper Corp., 422 U.S. 49 (1975), where the Supreme Court found that traditional equitable requirements governed the availability of a non-"statutory" injunction and, arguably, any injunction sought on a technical violation.
seem to compel a strict application of section 29(b) had defendant's unclean hands resulted from securities violations in the same transaction, rather than from subsequent breaches of contract.116

F. Plaintiffs' Participation and Statutes of Limitation

Even when resort to in pari delicto or illegality is unavailable, a significant number of federal courts, as courts of equity, have barred culpable plaintiffs by discretionary use of statutes of limitations. The Acts provide limitation periods for express actions,117 and the settled rule in implied actions is that the most analogous state statute governs.118 However, the period for express actions is often extended for innocent plaintiffs by the equitable tolling rule.119 In determining the applicable period for implied actions, federal courts may choose among the forum state's statutes of limitations for securities, general fraud, or contract actions.120 With regard to implied actions, the courts frequently choose the longer statute of limitations in order to effectuate better the investor protection function of the securities laws.121 But the courts have also shown willingness to withhold that discretionary power in appropriate cases, where plaintiffs' conduct has been questionable.

A good example of the courts' exercise of equitable discretion was presented by Maine v. Leonard.122 Shares of an electronics corporation (ECI) which was about to merge were sold through a broker by Maine, ECI's chief engineer, to Leonard, an attorney who was familiar with ECI and had represented it. The evidence showed that, at the time of sale, both had inside information regarding the company and the proposed merger. After hearing evidence of each party's fraudulent conduct, the court noted that both were so involved with the questionable affairs of ECI that they must have been on notice of the violations123 almost immediately upon the sale. Consequently, the court refused to toll the statute of limitations and dismissed the claims.124

116. See 496 F.2d at 1266-67. Compare the dissent in Pearlstein: "Equity and justice are qualities that [plaintiff's] claim conspicuously lacks. He bought the bonds against defendant's advice, refused to sell them on its urging, remained silent when defendant was pressing for payment, and settled his liability after having had legal advice. Equity would leave the loss where it lies." 429 F.2d at 1149.


118. Holmberg v. Armbrecht, 327 U.S. 392, 395 (1946); Sackett v. Beaman, 399 F.2d 884, 890 (9th Cir. 1968).


123. Id. at 1278.

124. Id. at 1285-86.
The clearest case on the use of statutes of limitations against undeserving investors remains *Rosenberg v. Hano.* In that case, plaintiff purchased stock in reliance on defendant's false promise to engage in illegal conduct that would inflate the value of the shares. When their value declined plaintiff sued. The court found that it was irrelevant whether plaintiff's theory was misrepresentation or price manipulation, since he had notice of the intended violation even before the sale. However, because plaintiff buyer did not participate in but merely knew of the planned illegal conduct, the court found the *in pari delicto* defense unavailable. Nonetheless, the court held that plaintiff was barred by the statute of limitations because of the lapse of more than a year since he had become aware of all the relevant facts.

Such decisions demonstrate the desirability of broad equitable discretion in the hands of the trial court. In cases involving *in pari delicto,* inequitable results are reached when plaintiffs are allowed to take unconscionable advantage of broad policy formulations or the general investor protection purpose of the Acts which create a presumption in their favor.

II. DEFENSES OF PLAINTIFFS' ACQUIESCENCE

Waiver, estoppel, and laches are frequently asserted against plain-

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125. 121 F.2d 818 (3d Cir. 1941).
128. It will be recalled that the Supreme Court mandated "resolving doubts in favor of those the [Acts are] designed to protect," based on their legislative history. Mills v. Electric Auto-Lite Co., 396 U.S. 375, 385 (1970). One commentator has argued that in pari delicto should not be recognized in any case arising under the 1934 Act, stating that in pari delicto and unclean hands are "ill-defined." 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, 23 (1970). He further observed that "this conclusion does not preclude [elimination of confusion and injustice] since an 'actively participating' plaintiff can be barred from recovery on a policy basis." Id. How such a rule would differ from the in pari delicto rule is unclear. It is certainly more "ill-defined" and further tends to diminish the deterrent effect of the Acts. See note 38 supra.
130. An estoppel is created by conduct of plaintiff which he knows is inconsistent with the assertion of his right against defendant, upon which the latter reasonably relies to his detriment. Hampton v. Paramount Pictures Corp., 279 F.2d 100, 104 (9th Cir.), cert. denied, 364 U.S. 882 (1960); Dobbs, supra note 38, § 2.3, at 41-43.
131. The doctrine of laches is a defense that may be raised in an action brought after an
tiffs in securities cases. These claims of plaintiffs' acquiescence generally have met with more success than assertions of plaintiffs' complicity.\textsuperscript{132} This success may be due in part to the absence of any limitations formulated by the Supreme Court, comparable to the \textit{Perma Life} ruling on \textit{in pari delicto}, that might qualify the statutory language which preserved such legal or equitable actions and rights that are normally available in the federal courts.\textsuperscript{133} It may also follow from the fact that few of the reported decisions turning on these arguments have been close cases. Since the equities were clear, the threshold issue of the availability of the defenses was seldom discussed.\textsuperscript{134}

The waiver, estoppel and laches defenses are frequently raised in "churning" cases, where it is alleged that the defendant broker-dealer overtraded plaintiff's discretionary investment account over a period of time in an effort unjustified delay that has prejudiced the defendant. Costello v. United States, 365 U.S. 265, 282 (1961); Dobbs, supra note 38, § 2.3, at 43-44.

132. Frequently, the defenses based on assertions of plaintiffs' complicity are summarily dismissed. See Stadia Oil & Uranium Co. v. Wheelis, 251 F.2d 269, 277 (10th Cir. 1957) ("The other contentions of the defendants have been considered. They are all so obviously lacking in merit as to deserve no mention herein."). Presumably, assiduous counsel will assert each defense so long as the suit or defense, as a whole, is not meritless under Securities Act of 1933 § 11(e), 15 U.S.C. § 77k(e) (1970) (permitting the assessment of costs against any party making a claim or defense "without merit"). Cf. Rucker v. La-Co, Inc., 496 F.2d 850, 853 (8th Cir. 1974). The defense of ultra vires is still raised, albeit infrequently, although it is practically a dead letter as a defense in corporation law. H. Henn, Corporations § 184 (2d ed. 1970); see Myzel v. Fields, 386 F.2d 718, 749-50 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968); Stadia Oil & Uranium Co. v. Wheelis, supra, at 276.

133. See text accompanying notes 3-5 supra.

134. See, e.g., Walpert v. Bart, 280 F. Supp. 1006, 1016 (D. Md. 1967), aff'd per curiam, 390 F.2d 877 (4th Cir. 1968). A trend to strike the defense of laches on the theory that the statutes of limitations in the Acts were intended to supersede the doctrine—a theory not used in modern times outside securities cases—seems to be near an end. Such a view is described as outdated, 2 Pomeroiy, supra note 38, § 419b, at 174-75, but the Ninth Circuit has regarded investor protection as paramount in holding laches unavailable in a damage action. Straley v. Universal Uranium & Milling Corp., 289 F.2d 370, 373 (9th Cir. 1961). The court later modified its view to permit laches in a 10b-5 action for the reason that the action was implied by the courts and not statutory. Royal Air Properties, Inc. v. Smith, 312 F.2d 210, 214 (9th Cir. 1962). The restriction has been followed only rarely. See Myzel v. Fields, 386 F.2d 718, 742 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968). The weight of authority is opposed. See Baumel v. Rosen, 412 F.2d 571 (4th Cir. 1969), cert. denied, 396 U.S. 1037 (1970); Gordon v. Burr, 366 F. Supp. 156, 170-71 (S.D.N.Y. 1973), modified on other grounds, 506 F.2d 1080 (2d Cir. 1974); Tobacco & Allied Stocks, Inc. v. Transamerica Corp., 143 F. Supp. 323, 327-28 (D. Del. 1956), aff'd, 244 F.2d 902 (3d Cir. 1957). The obvious failing of the old rule was that the investor was given a "free ride" of up to three years under section 13 of the 1933 Act. Note, Applicability of Waiver, Estoppel, and Laches Defenses to Private Suits Under the Securities Act and S.E.C. Rule 10b-5: Deterrence and Equity in Balance, 73 Yale L.J. 1477, 1487-88 (1964). As the Ninth Circuit itself noted in another context, "[t]he purpose of the [1934] 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." Royal Air Properties, Inc. v. Smith, 312 F.2d 210, 213-14 (9th Cir. 1962).
to increase his commissions without regard to his customer's interest. One illustrative case was *Fey v. Walston & Co.*, where the court noted that the plaintiff maintained at least two other investment accounts in addition to that with the defendant, took investment advice from her son who had a "gambling problem," attempted to conceal these facts from defendant, and gave contradictory testimony at trial. The court of appeals, overturning plaintiff’s verdict, held that the trial court had improperly excluded much of the evidence of these facts and suggested that the circumstances could have been viewed by the jury as acquiescence by the plaintiff in the amount and kind of trading being done for her account. In *Hecht v. Harris, Upham & Co.*, plaintiff met weekly with her broker to discuss all transactions made for her account. After nearly seven years she alleged overtrading. The court affirmed the trial court's finding that laches and estoppel barred plaintiff's claim.

The equities were less clear in *Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, although the court did not indulge any presumption in favor of the investor. The alleged churning occurred over a five-year period and suit was filed two years and eight months after plaintiff had closed her account with defendant. The trial court granted defendant's summary judgment motion, holding that the statutory period had run. The Tenth Circuit reversed on the ground that plaintiff, who was foreign-born, had only heard of churning ten months before filing suit. The court of appeals found, however, that plaintiff was not necessarily entitled to judgment on these facts alone, but remanded the case, instructing the district court to try the issue of laches.

The potential for abuse in all these cases is plain. If the plaintiffs who permit brokers to engage in speculation are allowed to disaffirm if the return is disappointing, manifest injustice will result. Consequently, the courts avoid broad policy statements, focusing instead on plaintiffs' credibility and thus on equitable considerations. The same is also true in most non-margin cases where sufficient facts emerge about plaintiffs' knowledge and intent. For

136. 493 F.2d 1036 (7th Cir. 1974).
137. Id. at 1040-45.
138. Id. at 1051.
139. 430 F.2d 1202 (9th Cir. 1970).
140. Id. at 1207-09. One commentator has questioned what harm came to defendants in Hecht so as to justify this holding. Cobine, Elements of Liability and Actual Damages in Rule 10b-5 Actions, 1972 U. Ill. L.F. 651, 665. Plainly, had plaintiff expressed dissatisfaction with the course of trading earlier, the broker would have attempted to limit its potential damages.
141. 494 F.2d 168 (10th Cir. 1974).
142. Id. at 169-70.
143. Id. at 171-73.
example, in *Walpert v. Bart*,144 a fifty-day delay constituted laches where a dissenting shareholder silently opposed an acquisition, intending to seek an injunction but failing to so advise defendant management.145 The latter, along with innocent third parties, had predictably embarked on an expensive course of conduct in concluding the acquisition.

In the few reported cases in which the validity of a waiver of a securities violation has been ruled upon, the courts have sometimes honored waivers unless it has been demonstrated that they were made before any claim arose or without the claimant's full knowledge of his rights.146 However, it is commonly held that a waiver having the effect of perpetuating a violation will be voided.147 Moreover, in cases of fraud, a valid waiver may be inferred from plaintiff's conduct or inaction.148 This distinction between fraud and other violations seems a sound one.149 To bar waivers of fraud would encourage speculation, as, for example, in churning cases. To permit waiver in other cases, allowing a "victim" to affirm proscribed conduct, would give judicial sanction to continuing violations of the Acts—besides arguably putting the "victim" *in pari delicto* with the offender.150

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145. Id. at 1017.
148. See, e.g., Fey v. Walston & Co., 493 F.2d 1036, 1049 (7th Cir. 1974); cf. Landry v. Hemphill, Noyes & Co., 473 F.2d 365, 373-74 (1st Cir.), cert. denied, 414 U.S. 1002 (1973) (plaintiff customer held estopped from arguing he was an "investor" as basis of his allegation of churning, because of his "uncomplaining acceptance of what was done for him by defendants over a twenty-two month period"); Carr v. Warner, 137 F. Supp. 611, 615 (D. Mass. 1955) (plaintiff "by failing seasonably to make complaints of facts of which she was informed [was] barred from her late assertion of wrong").
149. The distinction is, of course, consistent with common law. 6A Corbin, supra note 38, § 1515 at 727, 730-31; W. Seavey, Agency § 98 (1964).
150. In pari delicto could be found in such situations because the factors of equal knowledge, intent and cooperation in a single transaction would be present, despite the non-simultaneous acts. See Rosen v. Dick, [1974-1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,786, at 96,606 (S.D.N.Y. 1974) (waiver between two defendants allegedly made to defraud plaintiffs held void); cf. 11 S. Williston, Contracts § 1429 (3d ed. 1968).
III. THE "CONTROLLING PERSONS" SECTIONS: JUDICIAL RESISTANCE TO A STATUTORY DEFENSE

The third significant defense question which is currently debated in securities cases and arises frequently is the interrelation of common law vicarious liability with the "controlling persons" sections. The 1933 Act provides:

Every person who, by or through stock ownership, agency, or otherwise controls any person liable under sections 77k or 77l . . . shall also be liable . . . unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.152

The 1934 Act has a comparable provision: "Every person who, directly or indirectly, controls any person liable . . . shall also be liable . . . unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation . . . ."153

In contrast to the courts' frequent resistance to common law defenses, there is a strong judicial preference for the common law over the Acts in this instance. The reason may be that inclusion of agency arguments tends to benefit securities plaintiffs, whereas the statutory versions are favorable to defendants because of the good faith defense they provide. The SEC and most other plaintiffs have consistently urged that section 15 of the 1933 Act and section 20(a) of the 1934 Act154 are merely supplemental and should only be applied when a particular employer or principal cannot be reached through common law theories.155 However, there is a strong division of opinion among the courts of appeals.156


156. The view that the sections are exclusive and do not supplement common law seems to be taken by the Third, Ninth and Tenth Circuits and until recently was the general rule of the Second Circuit. See, e.g., Rochez Bros. v. Rhoades, [Current Binder] CCH Fed. Sec. L. Rep. ¶ 95,313 (3d Cir., Sept. 29, 1975) (but see discussion at note 181 infra); Zweig v. Hearst Corp., 521 F.2d 1129 (9th Cir.), cert. denied, 430 U.S. 908 (1975); Richardson v. MacArthur, 451 F.2d 34, 41-42 (10th Cir. 1971); Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1206-07 (9th Cir. 1970); Kamen v. Paul H. Aschkar & Co., 382 F.2d 689, 697 (9th Cir. 1967), cert. denied, 393
In favor of excluding respondeat superior and agency theories it is argued that, first, the statutory language on its face appears all-inclusive, i.e., "[e]very person who . . . through stock ownership, agency, or otherwise . . . controls" in the 1933 Act, and "[e]very person who, directly or indirectly, controls" in the 1934 Act. Hence every employer who could under common law be liable as a principal or through respondeat superior is now brought within the terms of these sections, so that the sections' good faith defense should always be available. Second, as the court stated in Lanza v. Drexel & Co., since Congress provided the good faith defenses, "[t]he intent of Congress in adding [these sections] was obviously to impose liability only on those directors who fall within [their] definition of control and who are in some meaningful sense culpable participants in the fraud perpetrated by controlled persons." Third, it would be "unreasonable" to suppose that Congress meant to provide a good faith defense only for superiors who are not within the employment or agency relationship, and strict liability (the result under common law) for those who are. Finally, it is argued that respondeat superior and agency doctrines should be excluded by analogy to Blau v. Lehman, in which the Supreme Court held that section 16(b) of the 1934 Act, specifying those persons who may be sued for taking short-swing profits, was exclusive. If, under Blau, a restrictive statute with a clear limit on securities acts liability is to be exclusive when it designates those against whom an action may be maintained, sections 15 and 20(a) should also be exclusive, particularly since their language is broad and inclusive. In Blau the Court ruled that a partnership was not liable for short-swing trading in the shares of a corporation in which one partner served as a director, absent a


158. 479 F.2d 1277 (2d Cir. 1973).

159. Id. at 1299 (dictum).


163. The case's authority may be uncertain beyond its facts, since it was relied upon by the lower court in SEC v. Capital Gains Research Bureau, Inc., 306 F.2d 606 (2d Cir. 1962)(en banc), which was reversed by the Supreme Court, 375 U.S. 180 (1963), a year after Blau was decided. The Second Circuit had cited Blau for the proposition that courts were to avoid "excessive judicial expansion of provisions of the securities laws to accomplish objectives believed to be salutary." 306 F.2d at 609. But see discussion at note 168 infra and accompanying text.
finding that the particular partner had advised the purchase or was deputized to represent the partnership on the board of directors. The Court wrote: "[L]iability under § 16(b) is to be determined neither by general partnership law nor by adding to the 'prophylactic' effect Congress itself clearly prescribed in § 16(b)." 164

A similar view seems to prevail in the Court's recent decision in Blue Chip Stamps v. Manor Drug Stores. 165 In that case, defendant Blue Chip had prepared a prospectus on a common stock offering under the terms of an antitrust consent decree. Plaintiffs sought damages, alleging that the prospectus was overly pessimistic and materially misleading, and had been prepared in an effort to dissuade plaintiffs from accepting the offer. The Court held that only purchasers and sellers have standing to bring an action for damages under section 10(b). 166 While acknowledging that it had often urged flexible construction of the Acts 167 and that "[n]o language in either [section 10(b) or rule 10b-5] speaks at all to the contours of a private cause of action for their violation," 168 the Court pointed out that "[w]hen Congress wished to provide a remedy to those who neither purchase nor sell securities, it had little trouble in doing so expressly [in section 16(b) of the 1934 Act]." 169 The Court's clear reliance upon the statutory language 170 seems to signal a far more conservative approach to "flexible" construction of the Acts and by analogy it supports a construction of the "controlling persons" sections as applying in all cases, to the exclusion of the common law of agency.

However, the large majority of circuit courts have stated that, at least in some circumstances, sections 15 and 20(a) merely supplement prior law. One argument advanced to support this interpretation is that, "given the pervasive applicability of agency principles elsewhere in the law, it would take clear evidence to persuade us that Congress intended to supplant such principles by enacting the 'controlling person' provisions." 171 Another court has concluded

164. 368 U.S. at 414. Lehman Bros. had partners sitting on 100 corporate boards. The dissent noted: "[F]ormal designation is no more significant than informal approval." Id. at 415 (Warren, C.J., & Douglas, J., dissenting). This is no longer a common practice of investment advisors. See Solomon & Wilke, Securities Professionals & Rule 10b-5: Legal Standards, Industry Practices, Preventative Guidelines and Proposals for Reform, 43 Fordham L. Rev. 505, 519-20 & n.50 (1975).


166. 421 U.S. at 755.

167. Id. at 748-49.

168. Id. at 749.

169. Id. at 734. Blue Chip's precise holding and this particular analogy seem to revive the rule of Blau v. Lehman, 368 U.S. 403 (1962), discussed in text accompanying notes 161-64 supra, that statutory language should not lightly be expanded merely to achieve policy results favored by a court.

170. The Court emphasized that its focus was on the words of § 10(b), "in connection with the purchase or sale," although it must be noted that this is hardly the clearest language in the Acts and a contrary interpretation of it is certainly plausible. See 421 U.S. at 764-68 (Blackmun, Douglas & Brennan, J.J., dissenting); 44 Fordham L. Rev. 452, 460-62 (1975).

171. SEC v. Management Dynamics, Inc., 515 F.2d 801, 812 (2d Cir. 1975) (defendants'
that section 15 was not intended to apply to the "employer (brokerage house)-employee relationship" because employers could "seemingly escape all liability . . . by the simple expedient of making certain 'not to know or have reasonable grounds to believe . . . ." 172 A third rationale for combining common law liability with "controlling persons" liability is that "the recognized policy of public protection requires the two types of remedy to be complementary, rather than mutually exclusive."173 Indeed, the effect of this policy rationale has occasionally been to exclude altogether the statutory version and thereby the defense Congress specifically provided.174

It is submitted that most of the cases in which the statutory version has been held non-exclusive have stated an overbroad rule, perhaps influenced by the language of the Supreme Court encouraging flexibility,175 and can be harmonized on their facts to coincide with the better view that the sections should be an exclusive determinant of liability.176 When such a view is taken, if the culpable "controlled person" is a corporate officer or inside director, corporate liability will still be appropriate, since "it is difficult to conceive of a corporation acting in any other way than by its managing officers and directors."177 This logic would not seem to be in conflict with the language and purpose of the Acts since the good faith defense remains available. The effect is merely to make the central question one of the wrongdoer's position in the corporate structure. If he is directly responsible to other persons, those supervisors' good faith is then the issue. But if he is vested with significant power and authority and is independent of other persons, it has been suggested that his knowledge is imputed to the corporation, thus destroying its good faith defense.178 In conventional employment cases, e.g., where relationship was that of corporation and officer); accord, Kerbs v. Fall River Indus., Inc., 502 F.2d 731 (10th Cir. 1974).


173. Fey v. Walston & Co., 493 F.2d 1036, 1052 n.18 (7th Cir. 1974); see cases cited in notes 171-72 supra.

174. 493 F.2d at 1052 & n.19 (it was not error for trial court to refuse to read jury the statutory defenses); accord, Armstrong, Jones & Co. v. SEC, 421 F.2d 359, 362 (6th Cir.), cert. denied, 398 U.S. 958 (1970).

175. See text accompanying notes 25 & 167 supra.


177. SEC v. Lum's, Inc., 365 F. Supp. 1046, 1061 (S.D.N.Y. 1973). This, of course, is the rationale of corporate liability at common law. See Salt Lake City v. Hollister, 118 U.S. 256, 261-62 (1886). However, the same court, in the same year held a corporate president not to be controlled by the corporation when fraudulently promoting its shares, but for reasons not appearing in the opinion. The court indicated that the plaintiff's case against the corporation was meager. Gordon v. Burr, 366 F. Supp. 156 (S.D.N.Y. 1973), aff'd in part & rev'd in part, 506 F.2d 1080 (2d Cir. 1974).

178. SEC v. Lum's, Inc., 365 F. Supp. 1046, 1061 (S.D.N.Y. 1973). The court in SEC v. Management Dynamics, Inc., 515 F.2d 801 (2d Cir. 1975), may have had this distinction between managing officers or directors and other employees in mind when it held defendant liable for its
brokerage house employees are defendants, a more detailed analysis of "control," "good faith" and "reasonable ground to believe," particularly in light of extensive regulations requiring employee supervision, should yield more consistent decisions. The theory that supervisors can evade knowledge and thereby liability is seriously weakened by the duty to supervise arising from their capacities as brokers, dealers, underwriters, or investment advisers under the Acts, and also, as some argue, by the good faith defense itself. A court unwilling to hear evidence on the issue of good faith will hold the broker or other employer strictly liable. This clearly contravenes vice president's violation but cautioned that it expressed no view concerning lesser employees "or respondeat superior." Id. at 813; see note 156 supra. But see SEC v. Geon Indus., Inc., [Current Binder] CCH Fed. Sec. L. Rep. ¶ 95,441 (2d Cir. Feb. 9, 1976).

179. See notes 152-53 supra and accompanying text.


181. The court in Gordon v. Burr, 506 F.2d 1080 (2d Cir. 1974) reached a proper conclusion in holding the broker-dealer not "controlling" where its customers' man both met plaintiff and transacted plaintiff's purchase away from the broker's office. Id. at 1082-83, 1085-86. In SEC v. First Sec. Co., 463 F.2d 981 (7th Cir.), cert. denied, 409 U.S. 880 (1972), corporate liability was properly found where defendant's president had unsupervised power to misuse the corporate name and facilities and to keep knowledge of his illegal acts from other officers and employees. Similarly, in Rochez Bros. v. Rhoades, [Current Binder] CCH Fed. Sec. L. Rep. ¶ 95,313, at 98,589 (3d Cir. Sept. 29, 1975), the court, holding section 20(a) to be exclusive, found that the defendant corporation established the good faith defense where the corporate president's purchase was shown to be "personal." Although the corporation was a "nominal party" to the contract, its function was ministerial since the purchase price was paid by the president and the shares were transferred to him. Id. at 98,592-93.

182. See text accompanying note 172 supra.

183. See, e.g., Securities Exchange Act of 1934 § 15(b)(5)(E), 15 U.S.C. § 78o(b)(5)(E) (1970) (for purposes of disciplinary action by the SEC, "no person shall be deemed to have failed reasonably to supervise any person, if . . . there have been established procedures, and . . . such person has reasonably discharged [his] duties [under] such procedures . . . without reasonable cause to believe that [they] were not being complied with"); Hochfelder v. Ernst & Ernst, 503 F.2d 1100 (7th Cir. 1974), rev'd on other grounds, 44 U.S.L.W. 4451 (U.S. Mar. 30, 1976) (No. 74-1042); SEC v. First Sec. Co., 463 F.2d 981 (7th Cir.), cert. denied, 409 U.S. 880 (1972).


185. See, e.g., Fey v. Walston & Co., 493 F.2d 1036, 1052-53 (7th Cir. 1974). Zweig v. Hearst Corp., 521 F.2d 1129 (9th Cir.), cert. denied, 96 S. Ct. 469 (1975), the Ninth Circuit's most recent application of section 20(a), would have presented a very different issue had it arisen in a circuit which does not exclude the respondeat superior theory. In Zweig, the issue was whether a newspaper publisher could be held liable for a recommendation made by
its financial columnist for investment in a stock that he owned. The price rose "dramatically" after the columnist's recommendation and he sold immediately. The price later declined and the plaintiffs brought a section 10(b) action against the columnist and the newspaper. Id. at 1131. The Ninth Circuit reaffirmed its rule that respondeat superior is unavailable in securities actions and went on to find that the newspaper had acted in good faith, although the court set a far lower standard than that generally required of broker-dealers under section 20(a).

The court noted that Hearst did not in fact supervise the financial columnist. Id. at 1132-33. However, the court emphasized that the writer had been so employed for thirty years without prior complaint, and held that in judging the publisher's liability "[s]ome lesser standard amounting more nearly to culpability is indicated." The court reasoned that, although the investing public relies to some extent on such investment advice as defendants published, "to liken the relationship . . . to the practically fiduciary relationship between the broker and his customer is to depart from reality." Id. at 1135. The court concluded that the broker-dealer's duty is greater because such an employer derives direct financial gain from the acts of its employees and "[t]he opportunity and temptation to take advantage of the client is ever present." Compare Milberg v. Western Pac. R.R., 51 F.R.D. 280 (S.D.N.Y. 1970) (mem.), appeal dismissed, 443 F.2d 1301 (2d Cir. 1971) (proper standard under section 10(b) for defendant, Barron's Weekly, considering its first amendment privilege, should be recklessness, where allegation was of negligence in printing estimated earnings).

The precise question, whether the publisher of a newspaper, either financial or general, might be held liable if an employee is found to have inserted financial advice in its columns in order to stimulate interest in shares he owns, has apparently never been decided. However, certain dicta, as well as analogous cases, suggest that, had respondeat superior been available in Zweig, a different result might have been reached. Where a writer or publisher agrees for a "past or prospective" consideration to write about a security, publication failing to disclose the payment violates § 17(b) of the Securities Act of 1933, 15 U.S.C. § 77q(b) (1970). Newspapers' liability in this context does not violate the first amendment. United States v. Amick, 439 F.2d 351, 365 (7th Cir.), cert. denied, 403 U.S. 918 (1971). Congress had apparently not meant any publication to be exempt from section 17(b). It was "particularly designed to meet the evils of the 'tipster sheet' as well as articles in newspapers or periodicals that purport to give an unbiased opinion but which opinions are in reality bought and paid for." H.R. Rep. No. 85, 73d Cong., 1st Sess. 24 (1933).

Similarly, where a "publication is engaged in . . . the offering of professional investment advice without revealing the possibility of personal gain to the publisher," it may be required to register under § 202(a)(11)(D) of the Investment Advisors Act of 1940, 15 U.S.C. § 80b-2(a)(11)(D) (1970). SEC v. Wall St. Transcript Corp., 422 F.2d 1371, 1378 (2d Cir.), cert. denied, 403 U.S. 918 (1970); cf. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963). Although the Act exempts "bona-fide newspapers," the Second Circuit found that "[w]hat matters [in making the determination of 'bona-fide' status] is whether or not a specific publication is engaged in practices which the Act was intended to regulate . . . ." 422 F.2d at 1378. Defendants in the Wall Street Transcript case argued that their activities were merely those of a typical financial columnist "on a larger scale." The court disagreed, but noted: "[W]e express no opinion concerning the practices of [such] other publications . . . ." Id. at 1377 & n.10.

Facts similar to those in the Zweig case were considered in In re Carl M. Loeb, Rhoades & Co., Exchange Act Rel. No. 5870 (Feb. 9, 1959) [1957-1961 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 76,635, at 80,426. Underwriters of an offering sent a pre-offering news release that omitted material facts to the press, and were ruled by the SEC to have violated § 5(c) of the Securities Act of 1933, 15 U.S.C. § 77e(c) (1970). The Commission noted: "It should be clear that our interpretation of Section 5(c) in no way restricts the freedom of news media to seek out and publish financial news. Reporters presumably have no securities to sell and, absent collusion with sellers, Section 5(c) has no application to them." Id. at 80,432 n.19; see 1 L. Loss, Securities Regulation 221 (2d ed. 1961) ("It goes without saying that genuine news articles about securities
the congressional purpose in enacting sections 15 and 20(a). Since Congress has spoken with reasonable clarity, such cases overstep the courts' discretion to import prior law and procedure into the Acts, notwithstanding the policy of investor protection.

IV. Conclusion

Congress' plan for a comprehensive scheme of securities regulation seemingly provided for judicial flexibility in its application, as evidenced by legislative reference to the existing systems and presumptions of courts of law and equity. Because of imprecision in the statutory language, however, the courts have been flexible in their interpretation of the Acts. A liberal interpretation of the securities laws' investor protection function has led some courts to eliminate or curtail traditional equitable defenses and theories.

Plaintiffs' violations are frequently minimized or ignored by courts which inappropriately resort to policy arguments in cases to which, in equity, they do not apply. Such overbroad rules inhibit the courts' traditional equitable discretion. As a result, investors have been able to escape their debts when suing on margin violations for which they were responsible. These were the least deserving beneficiaries of the overextended presumptions favoring plaintiffs. Similarly, tippees defrauded by insiders often have their own violations overlooked, although the courts are in complete disagreement on whether such a policy helps or hinders enforcement of the Acts. And, again relying on unsatisfactory policy arguments, the majority of circuit courts have unjusti-

or their issuers are in no sense prohibited by § 5, since the newspaper is not selling any securities' ); cf. SEC v. Starmont, 31 F. Supp. 264, 267-69 (E.D. Wash. 1939) ("description" by offeror-publisher held an unregistered public offering).

While the result in Zweig seems correct, especially since the newspaper was disinterested and was not on notice to suspect its employees as a broker-dealer would be, other courts would not be so willing to provide Hearst with the good faith defense to the exclusion of common law liability. Moreover, it might successfully be argued to those courts that section 10(b) should extend to writers and publishers who are interested by reason of potential sale, since the policy expressed in Securities Exchange Act section 17(b) and in the 1940 Act plainly reaches writers and publishers interested by reason of compensation. Where the newspaper's employee, about whom it has notice (the standard of section 20(a)) or who acts in the course of his employment (the common law test), is shown to have owned shares, recommended them, and then sold them, then theoretical liability might well be found (although the issue of causation might frequently defeat a plaintiff in a market purchase).

186. Although the hearings, debates and reports prior to enactment lack discussion of what evidence might demonstrate "good faith," it seems reasonable to look to the industry regulations (required and outlined by § 15A of the Securities Exchange Act of 1934, 15 U.S.C. § 78o-3 (1970) and SEC rules thereunder) which deal with employee supervision, in order to determine what Congress might have envisioned when it provided in § 20(a) of that Act, 15 U.S.C. § 78t(a) (1970), that "good faith" would negate employer liability. If an employer has fully complied with the letter and spirit of the extensive self-regulation requirements of the industry, see, e.g., note 180 supra, and of the "controlling persons' sections, he should not be held liable for an employee's violation. Otherwise, the self-regulatory provisions and section 20(a) would have meaning only when an employer has violated them, and never when it has complied with them.

187. See text accompanying notes 157-64 supra. Compare text accompanying notes 3-4 supra.
fiably resisted the express statutory defense of good faith or virtually read it out of the Acts by holding that it is supplemental to common law vicarious liability theories. By contrast, most courts have readily entertained the laches, estoppel and waiver defenses and, by exercising equitable discretion, have generally reached results within the spirit of the Acts. No rationale has been expressed by the courts explaining their acceptance of these defenses in contrast with their resistance to the defense of in pari delicto. The distinction is unclear, especially since a plaintiff guilty of mere delay is not normally so culpable or undeserving as one who has participated in acts constituting violations of the securities laws. Perhaps the courts simply presume the availability of waiver, estoppel and laches in proceedings "at law or in equity." That justification for admitting these defenses seems proper and should apply equally to defenses of plaintiffs' participation.

There is an ongoing conflict between the language of the securities acts on one hand and common law "gap-filling" and policy considerations on the other. The courts have developed sometimes inconsistent standards for admitting non-statutory defenses in different kinds of cases. Their judgments have frequently been warranted considering both the purpose of the Acts and a realistic weighing of the equities of the parties. However, the tendency is still to favor plaintiffs with an inflexible construction of the Acts. It is submitted, for example, that there is no valid policy ground for limiting the availability of in pari delicto. Applied under traditional rules, it bars only actual participants—equal and willing violators. In a proper case the defense of in pari delicto may be denied if it is found that enforcement considerations mandate recovery, although it is submitted that the defense should not be excluded lightly in view of the likelihood that potential plaintiffs' violations will be encouraged rather than deterred. This case-by-case approach, effectively used by the courts in laches and estoppel cases, is the essence of equity. It would most often avoid unjust rewards to culpable plaintiffs while offering increased deterrence to all parties. Regular use of equitable discretion would be a more effective deterrent to culpable parties who could not be certain whether a particular defense would be available.

Congressional action has corrected earlier injustice in margin violation cases where in pari delicto had been held unavailable. But this only brings the in pari delicto problem into better focus. The remaining disagreement over punishment of tippers and tippees emphasizes the need for authoritative reaffirmation of proceedings "at law or in equity," employing traditional defenses in the interest of deterrence and fairness.

Finally, just as when the common law defenses are excluded and equitable discretion is curtailed, congressional intent is again disserved by some courts' weakening of the explicit "controlling persons" good faith defense in the Acts. Congress has broad power to alter the common law within constitutional bounds and although the statutory defense is broadly worded, a substantial burden remains on securities defendants to establish their good faith. For

188. See note 38 and text accompanying notes 38-40 supra.

189. See notes 62-65 supra and accompanying text.
these reasons, rulings which exclude the defense or vitiate it by "supplementing" it with common law theories seem patently unwarranted.

The Supreme Court's recent securities decisions may signal a salutary receptiveness to both common law and statutory defenses. The Court's decision in Mosinee emphasized the traditional equitable requirements for obtaining injunctive relief. In Blue Chip the Court emphasized the importance of statutory language rather than broad policy considerations in its analysis of a fraud claim. This is in contrast to the Court's earlier securities acts decisions. The lower courts may adopt a reading of these two cases that would result in a lessening of the dilution of common law defenses in securities cases, a greater regard for express statutory provisions, and the exclusion of common law theories where appropriate. It is submitted that such a policy would lead to more just and equitable results and better effectuation of congressional intent in cases arising under the securities acts.

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