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RECENT DEVELOPMENTS

SECURITIES—*IN PARI DELICTO* DEFENSE MAY BAR RECOVERY IN SECTION 12(1) ACTION UNDER SECURITIES ACT OF 1933. *Pinter v. Dahl*, __ U.S. __, 108 S. Ct. 2063, 100 L. Ed. 2d 658 (1988).

Maurice Dahl purchased a $310,000 undivided interest in oil and gas leases from Billy Pinter after Dahl had toured drilling sites and reviewed production histories. When Dahl apprised a number of friends and relatives of his investment, each decided to invest $7,500 in the drilling venture. The purchasers subscribed to an agreement which warned that the oil and gas lease had not been registered pursuant to section 12(1) of the Securities Act of 1933 as required by law. Dahl aided fellow investors in completing the form, which set out the subscription agreement. When the venture failed, Dahl and the other investors sought rescission of the agreement and return of the purchase price based on Pinter's failure to register the securities. Pinter contended that Dahl's active solicitation, coupled with his knowledge that the leases were unregistered, rendered him *in pari delicto* (at equal fault) and barred his recovery. In addition, Pinter urged that Dahl be realigned as a defendant for the purpose of contribution.

The federal district court ruled that the *in pari delicto* defense did not bar Dahl's recovery and concluded that Pinter did not qualify for a registration exemption because the securities sale did not meet the requirements for a private offering. Additionally, the court refused to deem Dahl a seller and hold him responsible for contribution. On appeal, a divided fifth circuit affirmed, holding that section 12(1) of the 1933 Securities Act created strict liability for Pinter and that the *in pari delicto* defense would be effective only if Dahl's actions were "offensive to the dictates of natural justice." The court also rejected Pinter's claim that Dahl was a "seller" and refused to subject Dahl to contribution unless he received some type of benefit from his solicitations. The United States Supreme Court granted certiorari to determine whether the *in pari delicto* defense was applicable in a section 12(1) action when a purchaser of unregistered nonexempt securities sought rescission of the agreement and return of the purchase price. Held: *Vacated and*

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remanded. The *in pari delicto* defense may bar recovery in a section 12(1) action if the purchaser was equally responsible for the conduct which caused the illegal sale of unregistered securities and the purchaser's role was primarily that of promoter, not investor.

The majority reached this conclusion by utilizing a two prong test created by the Court in a previous securities case which determined the applicability of the *in pari delicto* defense in a section 10(b) action: whether the purchaser was at equal fault for the conduct from which he seeks redress and whether preclusion of his recovery would offend the Securities Act's objectives of protecting the investor. Writing for the majority, Justice Blackmun addressed the first prong and concluded that equal fault only existed if Dahl was equally responsible for Pinter's failure to either register the securities prior to their offering or comply with the registration exemption provisions. Under the second prong, the preclusion of recovery enhances the objective of protecting investors only if the purchaser's dominant role is that of a promoter, not investor. In contrast, when a purchaser's promotional activities are merely incidental to his role as investor, the Court would not preclude recovery based on the *in pari delicto* defense. The Court reasoned that preclusion would frustrate the objectives of the 1933 Act, because it is designed to protect the investor from making uninformed decisions regarding investments.

Traditionally, the *in pari delicto* defense bars recovery only in the limited situation where the individual who brings the suit bears substantial equal fault for his injury. *See Pinter v. Dahl*, __ U.S. __, __, 108 S. Ct. 2063, 2070-71, 100 L. Ed. 2d 658, 672 (1988); *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 306-07 (1985). This common law defense is based upon two principles: first, the judiciary should not waste its resources on resolving disputes between wrongdoers; and second, unacceptable conduct will be deterred if wrongdoers are denied judicial relief. *See Bateman Eichler*, 472 U.S. at 306. The United States Supreme Court has warned against allowing common law defenses that bar recovery when a private suit serves an important public interest. *See Perma Life Mufflers Inc. v. International Parts Corp.*, 392 U.S. 134, 138 (1968). In *Perma Life*, the Court criticized the lower court's use of the *in pari delicto* defense as applied to an express cause of action under the antitrust laws. *See id.* The Court prohibited this equitable defense, allowing recovery by the plaintiffs although they significantly contributed to their own injury. *See id.* at 139-40. Noting that Congress had not intended to incorporate the *in pari delicto* defense in antitrust suits, the Court did not address whether its analysis was applicable to federal securities law. *See id.* at 138, 140.

Encouraged by conflicting circuit decisions, the Supreme Court in *Eichler* addressed the application of the *in pari delicto* defense in the context of securities litigation, specifically, a section 10(b) suit. *Compare Tarasi v. Pittsburgh Nat'l Bank*, 555 F.2d 1152, 1164 (3d Cir.)(allowing defense), *cert.*

denied, 434 U.S. 965 (1977) *and Malamphy v. Real-Tex Enters., Inc.*, 527 F.2d 978, 980 (4th Cir. 1974)(sustaining submission of *in pari delicto* to jury) *with Woolf v. S.D. Cohn & Co.*, 515 F.2d 591, 604 (5th Cir. 1975)(rejecting defense on specific facts), *vacated and remanded on other grounds*, 426 U.S. 994 (1976) *and Kirkland v. E.F. Hutton & Co.*, 564 F. Supp. 427, 433-47 (E.D. Mich. 1983)(rejecting *in pari delicto* defense in summary judgment motion); *see also* Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1982)(creating cause of action where intentional material misrepresentations or omissions accompany sale of securities). In *Eichler*, the plaintiff received false inside information and brought suit based on section 10(b) of the 1934 Securities Exchange Act against the insider who sold him the security. *See Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 301 (1985). The insider defended by contending that reliance on inside information was unlawful and the plaintiff was therefore *in pari delicto*. *See id.* at 312. After the Court formulated and applied a two prong test, recovery was allowed despite the plaintiff's unlawful use of inside information. *Id.* at 319. The first prong of the Court's test was based on the traditional element of equal fault while the second prong focused on whether precluding recovery would interfere with the objectives of protecting the investing public. *See id.* at 310-11. In applying this test, the Court reasoned that the plaintiff's duty to refrain from using inside information was derivative of the insider's duty to keep privileged confidences. *See id.* at 313-14; *see also Dirks v. SEC*, 463 U.S. 646, 659 (1983)(duty of insider is derivative). Thus, if the duty of *Eichler*'s plaintiff was derivative of and less than the duty of an insider, the possibility for equal culpability could not exist. *See Eichler*, 472 U.S. at 313. Addressing the second prong, the Court concluded that objectives of the Act were furthered if the plaintiff was protected as an investor by allowing recovery. *See id.* at 315.

Although courts have held that investors do not relinquish the shelter of the Securities Act when they become *in pari delicto* with sellers, the *Eichler* Court neither indicates nor suggests the possible context in which the *in pari delicto* defense may bar recovery in a section 12(1) action under the Securities Act of 1933. *See Can-Am Petroleum Co. v. Beck*, 331 F.2d 371, 373 (10th Cir. 1964)(allowing recovery where investor's role adulterated by promotional activity); *see also* Securities Act of 1933, § 12(1), 15 U.S.C. § 771 (1982)(seller of unregistered securities liable for purchase price). The *Dahl* Court, however, extended this equitable defense to a section 12(1) strict liability cause of action and clarified the circumstances under which it is appropriate to hold a plaintiff *in pari delicto*. *See Pinter v. Dahl*, __ U.S.__, __, 108 S. Ct. 2063, 1072-75, 100 L. Ed. 2d 638, 673-77 (1988).

Initially, when examining *Eichler*'s first prong, attention is given to whether the purchaser equally contributed to the issuer's failure to comply with registration requirements by failing to properly register the securities or

meet the requirements for a registration exemption. *See id.* This determination is based on how the purchaser cooperated in planning and developing the distributional scheme of the unregistered securities. *See id.* at __, 108 S. Ct. at 2073-74, 100 L. Ed. 2d at 676; *see also Lawler v. Gilliam*, 569 F.2d 1283, 1292 (4th Cir. 1978)(defense disallowed because plaintiff unaware of scheme to defraud investors); *Malamphy v. Real-Tex Enters., Inc.*, 527 F.2d 978, 980 (4th Cir. 1975)(defense allowed because plaintiff actively distributed and convinced others to purchase).

In a section 12(1) action, the second prong of *Eichler* is satisfied if the purchaser who offers or sells the unregistered securities takes on the role of a promoter rather than merely an investor. *See Pinter v. Dahl*, __ U.S. at __, 108 S. Ct. at 2074, 100 L. Ed. 2d at 677. However, even when a purchaser has actively participated in selling or offering unregistered securities, the purchaser will not be barred from recovery when the promotional efforts are merely incidental to the role as investor. *See id. Compare Can-Am Petroleum Co. v. Beck*, 331 F.2d 371, 373-74 (10th Cir. 1964)(naive investor's culpability not equal to seller's culpability despite promotional activities) *with Athas v. Day*, 186 F. Supp. 385, 389 (D. Colo. 1960)(precluding recovery because plaintiff extensively participated in illegal securities distribution). *See generally* Ruder, *Multiple Defendant in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. Pa. L. Rev. 597, 662-63 (1972)(defense rejected if promotional activities incidental to investing). Whether the purchaser is an investor or a promoter rests upon a myriad of facts which include the financial involvement of the purchaser as compared to solicited third parties, the purchaser's role in developing the distributional plans of the offering, and the nature of the benefit for any of these services. *See Pinter*, __ U.S. at __, 108 S. Ct. at 2074-75, 100 L. Ed. 2d at 677; *see also Malamphy v. Real-Tex Enters., Inc.*, 527 F.2d 978, 980 (4th Cir. 1975)(barring recovery where plaintiff received large commissions for promotional expertise); *Can-Am Petroleum*, 331 F.2d at 373-74 (disallowing defense noting incidental nature of investor's promotional solicitations). These factors are not exhaustive and the courts are given broad discretion to determine the extent and nature of the promotional activity in each instance. *See Pinter*, __ U.S. at __, 108 S. Ct. at 2074-75, 100 L. Ed. 2d at 677; *see also Kuehnert v. Texstar Corp.*, 412 F.2d 700, 704 (5th Cir. 1969)(courts have discretion in application of *in pari delicto* defense).

The Fifth Circuit failed to recognize these factors which determine the outcome of the two prong test. *See Dahl v. Pinter*, 787 F.2d 985, 987 (5th Cir. 1986)(defense permissible only if Dahl's conduct offensive to natural justice). Relying on the absence of a private placement exemption, the court of appeals rejected Pinter's *in pari delicto* defense and distinguished the section 10(b) action in *Eichler* from the section 12(1) action in *Dahl*. *See id.* at

988 (*in pari delicto* unavailable); *see also Henderson v. Hayden*, 461 F.2d 1069, 1072 (5th Cir. 1972)(allowing sophisticated investor recovery if exemption not proven). This distinction emphasizes that section 10(b), which renders the use of deceptive practices in the sale of securities unlawful, required a degree of intent. *See id.*; *see also* Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1982). Because a section 12(1) action under the Securities Act of 1933 does not require intent for recovery, the Fifth Circuit concluded that section 12(1) recovery was nearly absolute. *See Dahl*, 787 F.2d at 988 (violation of section 12(1) strict liability offense); *see also Raiford v. Buslease, Inc.*, 825 F.2d 351, 354 (11th Cir. 1987)(imposing strict liability in section 12(1) action); *Lawler v. Gilliam*, 569 F.2d 1283, 1285 (4th Cir. 1978)(section 12(1) virtually creates absolute liability).

Although *Perma Life* and *Eichler* applied a narrow reading of the equitable *in pari delicto* defense, this defense is not antiquated. Courts have long recognized equitable defenses in strict liability actions such as section 12(1) suits under the 1933 Securities Act. *See Pinter v. Dahl*, __ U.S. __, __, 108 S. Ct. 2063, 2072, 100 L. Ed. 2d 658, 673-74 (1988). Although stressing the importance of deterring wrongdoing, the *Dahl* Court recognized situations in which barring recovery is a more effective way to promote statutory ends. *See Pinter*, __ U.S. at __, 108 S. Ct. at 2072, 100 L. Ed. 2d at 674. Accordingly, the *Dahl* Court continued the narrow application of the *in pari delicto* defense in *Perma Life* and *Eichler* by describing the limited circumstances which satisfy *Eichler's* two prong test in a section 12(1) context. *See id.* at __, 108 S. Ct. at 2072-75, 100 L. Ed. 2d at 673-77.

Prior to *Eichler*, some courts barred recovery from an insider in a section 10(b) action. *See, e.g., Tarasi v. Pittsburgh Nat'l Bank*, 555 F.2d 1152, 1164 (3d Cir.)(allowing defense to bar recovery), *cert. denied*, 434 U.S. 965 (1977); *Malamphy v. Real-Tex Enters., Inc.*, 527 F.2d 978, 980 (4th Cir. 1975)(sustaining submission of *in pari delicto* to jury); *Kuehnert v. Texstar Corp.*, 412 F.2d 700, 704-05 (5th Cir. 1969)(allowing *in pari delicto* defense). Subsequent to the denial of *in pari delicto* in *Eichler*, courts have been reluctant to bar recovery when a defendant has failed to comply with registration requirements. *See Dahl v. Pinter*, 787 F.2d 985, 988 (5th Cir. 1986)(holding *in pari delicto* defense unavailable); *Wolken v. Erck*, 421 N.W.2d 63, 64 (S.D. 1988)(applying *Eichler* logic to allow recovery). Where *Eichler* overrules the line of cases which denied recovery to one who relied on inside information, *Dahl* does not overrule cases which deny the *in pari delicto* defense to purchasers of unregistered securities. *Compare Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 319 (1985)(allowing recovery to investors using inside information) *and Rothberg v. Rosenbloom*, 628 F. Supp. 746, 756 (E.D. Pa. 1986)(*Eichler* rejects *Tarasi* rationale which barred insider's recovery) *with Pinter v. Dahl*, __ U.S. __, __, 108 S. Ct. 2063, 2074, 100 L. Ed. 2d 658, 677 (1988)(promotional activities permissible if incidental to role of in-

vestor) *and Can-Am Petroleum Co. v. Beck*, 331 F.2d 371, 373-74 (5th Cir. 1964)(refusing to bar investor who actively sold to others). Instead, *Dahl* recognizes that the facts in each case must be analyzed to ascertain the applicability of the *in pari delicto* defense and prescribes the test formulated in *Eichler* as the guide for this determination. *See Pinter*, __ U.S. at __, 108 S. Ct. at 2073-74, 100 L. Ed. 2d at 676.

Even though *Dahl* has given lower courts freedom to bar section 12(1) recovery via the *in pari delicto* defense, the Court has not abandoned its narrow application of the defense set forth in *Perma Life* and *Eichler*. In future section 12(1) actions, the *in pari delicto* defense is applicable only in limited situations where the two prong *Eichler* test is satisfied. Because *Dahl* requires the purchaser's extensive participation in the offering beyond that of a mere investor to trigger the use of the *in pari delicto* defense, the decision does not give broad protection to sellers of securities. Rather, the decision grants sellers limited permission to use this equitable defense in an otherwise strict liability cause of action.

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