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NOTE

ESTOPPEL AND IN PARI DELICTO DEFENSES TO CIVIL BLUE SKY LAW ACTIONS

Every state has enacted statutes that attempt to protect the investing public from fraudulent and deceptive practices in the transfer of securities.¹ These laws, often called "blue sky laws,"² emerged in response to concerns that security trading is a business "in which opportunities for dishonesty are of constant occurrence and ever present."³

¹ ALA. CODE §§ 8-6-1 to -60 (1984 & Supp. 1987); ALASKA STAT. §§ 45.55.010-.270 (1986 & Supp. 1987); ARIZ. REV. STAT. ANN. §§ 44-1801 to -2041 (1987); ARK. CODE ANN. §§ 23-42-101 to -508 (1987); CAL. CORP. CODE §§ 25000-25706 (West 1977 & Supp. 1988); COLO. REV. STAT. §§ 11-51-101 to -129 (1987); CONN. GEN. STAT. ANN. §§ 36-470 to -502 (West 1987 & Supp. 1988); DEL. CODE ANN. tit. 6, §§ 7301-7328 (1975 & Supp. 1986); FLA. STAT. ANN. §§ 517.011-.32 (West 1972 & Supp. 1987); GA. CODE ANN. §§ 10-5-1 to -24 (1982 & Supp. 1987); HAW. REV. STAT. §§ 485-1 to -25 (1976 & Supp. 1984); IDAHO CODE §§ 30-1401 to -1458 (1980 & Supp. 1987); ILL. ANN. STAT. ch. 121 1/2, paras. 137.1-.16 (Smith-Hurd 1960 & Supp. 1987); IND. CODE ANN. §§ 23-2-1-1 to -24 (Burns 1984 & Supp. 1987); IOWA CODE ANN. §§ 502.101-.612 (West Supp. 1987); KAN. STAT. ANN. §§ 17-1252 to -1275 (1981 & Supp. 1987); KY. REV. STAT. ANN. §§ 292.310-.991 (Baldwin 1987); LA. REV. STAT. ANN. §§ 51:701-.724 (West 1987); ME. REV. STAT. ANN. tit. 32, §§ 10101-10710 (Supp. 1986); MD. CORPS. & ASS'NS CODE ANN. §§ 11-101 to -805 (1985 & Supp. 1987); MASS. ANN. LAWS ch. 110A, §§ 101-417 (Law. Co-op. 1985 & Supp. 1987); MICH. COMP. LAWS ANN. §§ 451.501-.818 (West 1967 & Supp. 1987); MINN. STAT. ANN. §§ 80A.01-.31 (West 1986 & Supp. 1988); MISS. CODE ANN. §§ 75-71-101-735 (Supp. 1987); MO. ANN. STAT. §§ 409.101-.419 (Vernon 1979 & Supp. 1988); MONT. CODE ANN. §§ 30-10-101 to -308 (1987); NEB. REV. STAT. §§ 8-1101 to -1124 (1983 & Supp. 1987); NEV. REV. STAT. ANN. §§ 90.220-.970 (Michie Supp. 1987); N.H. REV. STAT. ANN. §§ 421-B:1 to -B:34 (1983 & Supp. 1987); N.J. STAT. ANN. §§ 49:3-47 to -76 (West 1970 & Supp. 1987); N.M. STAT. ANN. §§ 58-13B-1 to -56 (1986); N.Y. GEN. BUS. LAW §§ 352 to 359-h (McKinney 1984 & Supp. 1988); N.C. GEN. STAT. §§ 78A-1 to -65 (1985); N.D. CENT. CODE §§ 10-04-01 to -19 (1976 & Supp. 1983); OHIO REV. CODE ANN. §§ 1701.01-.99 (Anderson 1985 & Supp. 1987); OKLA. STAT. ANN. tit. 71, §§ 1-502 (West 1987 & Supp. 1988); OR. REV. STAT. §§ 59.005-.995 (1983); PA. STAT. ANN. tit. 70, §§ 1-101 to -704 (Purdon Supp. 1987); R.I. GEN. LAWS §§ 7-11-1 to -30 (1985 & Supp. 1987); S.C. CODE ANN. §§ 35-1-10 to -1590 (Law. Co-op. 1987); S.D. CODIFIED LAWS ANN. §§ 47-31-1 to -147 (1983 & Supp. 1987); TENN. CODE ANN. §§ 48-2-101 to -201 (1984 & Supp. 1987); TEX. REV. CIV. STAT. ANN. art. 581-1 to -40 (Vernon 1964 & Supp. 1988); UTAH CODE ANN. §§ 61-1-1 to -30 (1986 & Supp. 1987); VT. STAT. ANN. tit. 9, §§ 4201-4241 (1984 & Supp. 1987); VA. CODE ANN. §§ 13.1-501 to -527.3 (1985 & Supp. 1987); WASH. REV. CODE ANN. §§ 21.20.005-.940 (1978 & Supp. 1987); W. VA. CODE §§ 32-1-101 to -4-418 (1988); WIS. STAT. ANN. §§ 551.01-.67 (West 1986); WYO. STAT. §§ 17-4-101 to -130 (1987).

² The name "blue sky" derives from the practices of persons who were so fraudulent "that it was stated that they would sell building lots in the blue sky in fee simple." L. LOSS & E. COWETT, BLUE SKY LAW 7 n.22 (1958).

³ *Id.* at 3 (quoting *Archer v. SEC*, 133 F.2d 795, 803 (8th Cir.), *cert. denied*, 319 U.S. 767 (1943)).

The majority of blue sky laws contain civil liability provisions. The effectiveness of these blue sky laws depends upon their civil liability provisions because, although such laws contain penal provisions, uneven state enforcement and inadequate enforcement budgets make civil remedies the most effective deterrent to securities fraud.⁴

Defendants in civil blue sky law actions have attempted to insulate themselves from liability by pleading the defenses of estoppel and *in pari delicto*. Some courts, however, refuse to allow these defenses in blue sky law actions. This Note analyzes the applicability of these two defenses to civil blue sky law actions and argues that courts should allow the defense of *in pari delicto* but not the defense of estoppel. By allowing only the defense of *in pari delicto*, courts will provide maximum protection for the investing public.

I

THE BLUE SKY LAWS' CIVIL LIABILITY PROVISIONS

A. The Uniform Securities Act

In an attempt to standardize the blue sky laws of the individual states,⁵ the National Conference of Commissioners on Uniform State Laws approved the Uniform Securities Act of 1956.⁶ Currently, thirty-four states have adopted all or substantial portions of the Act.⁷

⁴ "The inadequate budgets and uneven enforcement of the blue sky laws make civil liability the only really effective sanction in many states—perhaps most states." L. LOSS, *SECURITIES REGULATION* 1631 (2d ed. 1961).

⁵ UNIF. SECURITIES ACT § 415, 7B U.L.A. 678 (1958). This section states: This act shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it and to coordinate the interpretation and administration of this act with the related federal regulation.

Id.

⁶ The National Conference of Commissioners on Uniform State Laws approved the Uniform Securities Act on August 25, 1956. UNIF. SECURITIES ACT prefatory note, 7B U.L.A. 510 (1958), reprinted in L. LOSS, *COMMENTARY ON THE UNIFORM SECURITIES ACT* 5 (1976).

⁷ The following jurisdictions have adopted all or substantially all of the Uniform Securities Act of 1956: Alabama, Alaska, Arkansas, Colorado, Connecticut, Delaware, District of Columbia, Guam, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, North Carolina, Oklahoma, Oregon, Pennsylvania, Puerto Rico, South Carolina, Tennessee, Utah, Virginia, Washington, West Virginia, Wisconsin, and Wyoming. 7B U.L.A. 97 (Supp. 1988); 1 Blue Sky L. Rep. (CCH) ¶ 5500 (1985).

In 1985, the National Conference of Commissioners on Uniform State Laws approved the Uniform Securities Act of 1985 (1985 Act), which supercedes the Uniform Securities Act of 1956 (1956 Act). Because only three states have substantially adopted the 1985 Act, 7B U.L.A. 33 (Supp. 1988), and because, for purposes of this Note, the 1985 Act is very similar to the 1956 Act, this Note only focuses on the 1956 Act. Herein-

The Uniform Securities Act imposes civil liability on sellers⁸ who violate certain registration and disclosure requirements or commit fraud in the offer or sale of a security.⁹ Sellers face liability under the act if they fail to register as sellers,¹⁰ fail to register the securities,¹¹ represent to a purchaser that the securities' registration

after, the "Uniform Securities Act" refers to the Uniform Securities Act of 1956. The three states that have adopted the 1985 Act are Maine, ME. REV. STAT. ANN. tit. 32, §§ 10101-10710 (Supp. 1986), Nevada, NEV. REV. STAT. ANN. §§ 90.220-970 (Michie Supp. 1987), and New Mexico, N.M. STAT. ANN. §§ 58-13B-1 to -56 (1986).

⁸ Throughout this Note, "seller" refers to any person who sells or offers to sell a security, "purchaser" refers to any person who purchases a security, and "sale" refers to a sale or an offer to sell a security.

⁹ Section 410(a) of the Uniform Securities Act of 1956 provides:

(a) Any person who

(1) offers or sells a security in violation of section 201(a), 301, or 405(b), or any rule or order under section 403 which requires the affirmative approval of sales literature before it is used, or of any condition imposed under section 304(d), 305(g), or 305(h), or

(2) offers or sells a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading (the buyer not knowing of the untruth or omission), and who does not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission, is liable to the person buying the security from him, who may sue either at law or in equity to recover the consideration paid for the security, together with interest at six percent per year from the date of payment, costs, and reasonable attorneys' fees, less the amount of any income received on the security, upon the tender of the security, or for damages if he no longer owns the security.

UNIF. SECURITIES ACT § 410(a), 7B U.L.A. 643 (1958).

Currently, thirty-three of the states that have adopted the Uniform Securities Act have adopted some form of section 410. *See* ALA. CODE § 8-16-19 (1984); ALASKA STAT. § 45.55.220 (1987); ARK. CODE ANN. § 23-42-106 (1987); COLO. REV. STAT. § 11-51-125 (1987); CONN. GEN. STAT. ANN. § 36-498 (West Supp. 1988); DEL. CODE ANN. tit. 6, § 7323 (1975); IDAHO CODE § 30-1446 (Supp. 1987); IND. CODE ANN. § 23-2-1-19 (Burns 1984); KAN. STAT. ANN. § 17-1268 (Supp. 1987); KY. REV. STAT. ANN. § 292.480 (Baldwin 1987); MD. CORPS. & ASS'NS CODE ANN. § 11-703 (1985 & Supp. 1987); MASS. ANN. LAWS ch. 110A, § 410 (Law. Co-op. 1985); MICH. COMP. LAWS ANN. § 451.810 (West Supp. 1987); MINN. STAT. ANN. § 80A.23 (West 1986 & Supp. 1988); MISS. CODE ANN. § 75-71-717 (Supp. 1987); MO. ANN. STAT. § 409.411 (Vernon Supp. 1988); MONT. CODE ANN. § 30-10-307 (1987); NEB. REV. STAT. § 8-1118 (1983); N.H. REV. STAT. ANN. § 421-B:25 (1983 & Supp. 1987); N.J. STAT. ANN. § 49:3-71 (West Supp. 1987); N.C. GEN. STAT. § 78A-56 (1985); OKLA. STAT. ANN. tit. 71, § 408 (West 1987); OR. REV. STAT. § 59.115 (1983); PA. STAT. ANN. tit. 70, § 1-501 (Purdon Supp. 1987); S.C. CODE ANN. § 35-1-1490 (Law. Co-op. 1987); TENN. CODE ANN. § 48-2-122 (1984); TEX. REV. CIV. STAT. ANN. art. 581-33 (Vernon Supp. 1988); UTAH CODE ANN. § 61-1-22 (1986); VA. CODE ANN. § 13.1-522 (Supp. 1987); WASH. REV. CODE ANN. § 21.20.430 (Supp. 1987); W. VA. CODE § 32-4-410 (1988); WIS. STAT. ANN. § 551.59 (West 1986); WYO. STAT. § 17-4-122 (1987). Many of these statutes contain modifications of, additions to, and deletions from the Uniform Act.

¹⁰ UNIF. SECURITIES ACT § 201(a), 7B U.L.A. 528 (1958) (any person who transacts business as a broker-dealer as defined in § 401(c), or as an agent as defined in § 401(b), must register with the state administering agency).

¹¹ *Id.* § 301, 7B U.L.A. 550. Section 402 of the Act, however, exempts a number of securities and transactions from the registration requirements of section 301. *Id.* § 402,

operates as an expression of government approval or recommendation of the security,¹² fail to file disclosures intended for prospective investors,¹³ or fail to comply with disclosure requirements ordered by the state administering agency.¹⁴ The Act also imposes liability upon sellers who offer or sell securities by means of a false statement or an omission of a material fact.¹⁵

The Uniform Securities Act entitles purchasers to recover the consideration paid for the securities together with interest, costs, and attorneys' fees, less any income generated by the securities.¹⁶ To recover, purchasers must tender their securities back to the seller and prove that the seller sold the securities either in violation of certain provisions of the Act or by means of a misrepresentation of a material fact.¹⁷

B. Blue Sky Laws in Jurisdictions Not Following the Uniform Securities Act

Seventeen states have not adopted the civil liability provisions of the Uniform Securities Act.¹⁸ These states impose civil liability either for all blue sky law violations¹⁹ or for violations of only certain blue sky law provisions.²⁰ A few states fail to impose any civil liability for blue sky law violations.²¹

7B U.L.A. 599. A seller may thus sell a security without fear of liability if the security or transaction qualifies for an exemption under section 402.

¹² *Id.* § 405, 7B U.L.A. 622.

¹³ *Id.* § 403, 7B U.L.A. 620. If the disclosures pertain to transactions exempted under section 402, however, the Act does not require the seller to file. *Id.*

¹⁴ *Id.* § 304(d), 7B U.L.A. 565. In addition, section 410(a) imposes liability if the seller fails to comply with any state escrow or impounding requirements. *Id.* § 305(g), 7B U.L.A. 567.

¹⁵ *Id.* § 410(a)(2), 7B U.L.A. 528. See *supra* note 9 for the text of § 410(a)(2).

¹⁶ UNIF. SECURITIES ACT § 410(a)(2), 7B U.L.A. 528.

¹⁷ *Id.* § 410(a), 7B U.L.A. 643.

¹⁸ These states are Arizona, California, Florida, Georgia, Hawaii, Illinois, Iowa, Louisiana, Maine, Nevada, New Mexico, New York, North Dakota, Ohio, Rhode Island, South Dakota, and Vermont. See *supra* note 9. Maine, Nevada, and New Mexico follow the Uniform Securities Act of 1985. See *supra* note 7.

¹⁹ Six states fall into this category. See HAW. REV. STAT. § 485-20 (1985); ILL. ANN. STAT. ch. 121 1/2, para. 137.13 (Smith-Hurd Supp. 1987); N.D. CENT. CODE § 10-04-17 (Supp. 1983); OHIO REV. CODE ANN. § 1707.43 (Anderson 1985); S.D. CODIFIED LAWS ANN. § 47-31-133 (1983); VT. STAT. ANN. tit. 9, § 4225 (1984).

²⁰ Eight states fall into this category. See ARIZ. REV. STAT. ANN. § 44-2001 (1987); CAL. CORP. CODE § 25501 (West Supp. 1988); GA. CODE ANN. § 10-5-14 (Supp. 1987); IOWA CODE ANN. § 502.501 (West Supp. 1987); LA. REV. STAT. ANN. § 51:714 (West 1987); ME. REV. STAT. ANN. tit. 32, § 10605 (Supp. 1986); NEV. REV. STAT. ANN. § 90.770 (Michie Supp. 1987); N.M. STAT. ANN. § 58-13B-40 (1986).

²¹ Two states, New York and Rhode Island, do not provide for any civil liability. In *Coastal Fin. Corp. v. Coastal Fin. Corp. of N. Providence*, 120 R.I. 317, 387 A.2d 1373 (1978), the court rejected an implied rescission remedy. *Id.* at 325, 387 A.2d at 1378. See R.I. GEN. LAWS §§ 7-11-15, -11-24 (1985) (no mention of rescission remedy—explicit remedies include only revocation of seller's license, prohibition of sale, and possible

Six states currently provide for civil liability when a seller fails to comply with any requirement of their blue sky laws,²² creating a cause of action for violations of even the most formal and least important requirements.²³ Commentators have offered several criticisms of these statutes: (1) they place a tremendous burden on sellers to search thoroughly the often complex blue sky laws and familiarize themselves with the blue sky laws' technical details; (2) they frequently allow a purchaser to avoid contracts simply because the seller failed to comply with a statutory formality;²⁴ and (3) they enable sophisticated buyers to take unfair advantage of less-experienced sellers by intentionally entering into sales contracts that contain a formalistic defect, knowing that they can avoid the contracts if the securities decrease in value.²⁵

In order to avoid problems created by the imposition of liability for technical violations,²⁶ some states have adopted narrower civil liability provision similar to the Uniform Securities Act, limiting civil liability to only certain specified violations of the blue sky laws and to situations where a seller commits fraud in selling a security.²⁷ Currently, eight states not following the Uniform Securities Act have adopted this type of statute.²⁸

Both types of blue sky laws (those that impose liability for any statutory violation and those that impose liability only for violations of certain provisions), like the Uniform Securities Act, provide re-

penal sanctions). The New York Court of Appeals in *CPC Int'l, Inc. v. McKesson Corp.*, 70 N.Y.2d 268, 514 N.E.2d 116, 519 N.Y.S.2d 804 (1987), held that neither New York statutory law nor the 1933 Securities Act provides a private cause of action. See N.Y. GEN. BUS. LAW § 352-c (McKinney 1984). See also L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 1014-15 (1983).

Florida falls into none of the categories. Its statute parallels federal securities law by providing that state civil remedies will match those afforded "by laws of the United States for the purchasers or sellers of securities." FLA. STAT. ANN. § 517.241(3) (West Supp. 1988).

This Note provides no further discussion of the New York, Rhode Island, or Florida blue sky laws.

²² See *supra* note 19.

²³ For examples of such provisions, see L. LOSS & E. COWETT, *supra* note 2, at 135. *But see* HAW. REV. STAT. § 485-20 (1985) (providing an exception for faulty registrations made in good faith, thus allowing escape from strict liability).

²⁴ "For example, why should a sophisticated buyer be able to recover the purchase price from the seller when the market generally has gone down just because he later discovers that the seller filed a required report a day late?" Draftsmen's Comment to UNIF. SECURITIES ACT § 410(a) (1958), reprinted in L. LOSS & E. COWETT, *A PROPOSED UNIFORM SECURITIES ACT: FINAL DRAFT AND COMMENTARY* 145 (1956).

²⁵ *Id.*; Note, *Voidability Provisions Under State Blue Sky Laws*, 17 W. RES. L. REV. 1148, 1150-51 (1966) (authored by Dale LaPorte).

²⁶ See UNIF. SECURITIES ACT § 410(a) (1956) (draftsmen's comments), reprinted in L. LOSS & E. COWETT, *supra* note 24, at 145; Note, *supra* note 25, at 1154.

²⁷ See the statutes cited *supra* note 20.

²⁸ See *supra* note 20.

scission as the basic remedy.²⁹ Upon tender of the securities, a purchaser generally can recover the purchase price of the securities, interest, costs, and attorneys' fees, less any income generated by the securities.³⁰

II

THE DEFENSES OF IN PARI DELICTO AND ESTOPPEL

Defendants in civil blue sky law actions sometimes plead the defenses of estoppel and in pari delicto, both of which bar recovery when the purchaser shares culpability with the seller. In pari delicto generally concerns a purchaser's conduct before or at the time of the sale.³¹ Estoppel, on the other hand, is a defense created by the purchaser's culpable conduct after the sale.³² No blue sky law provides for these defenses;³³ instead, in pari delicto derives from common law,³⁴ and estoppel has both common law and equity origins.³⁵ Some states allow in pari delicto or both in pari delicto and estoppel, while others permit neither defense.³⁶

²⁹ See *supra* note 16 and accompanying text.

³⁰ E.g., ARIZ. REV. STAT. ANN. § 44-2001 (1987); N.D. CENT. CODE § 10-04-17 (Supp. 1983). If the purchaser has resold the securities, he can recover damages equal to the amount recoverable upon tender less the value he received from the sale, plus interest.

³¹ See Note, *Civil Remedies Available to Buyers Under The Iowa Securities Law*, 14 DRAKE L. REV. 131, 138 (1965) (authored by Arvid Wendland) (defines in pari delicto as "some degree of participation by the buyer in perpetrating the violation before the sale took place").

³² *Id.* at 137 (estoppel is "some degree of participation or acquiescence in the affairs of the issuer by the buyer after the illegal transaction has taken place"). Equitable estoppel involves reliance by the party asserting estoppel on words or conduct of the other party. In blue sky law cases, however, courts use the term "estoppel" loosely, and generally do not require reliance. Estoppel in civil blue sky law actions also includes the defenses of laches, ratification, and waiver. Cf. *Hayden v. McDonald*, 742 F.2d 423, 431 (8th Cir. 1984) (in securities regulation, "ratification by conduct" actually generates an estoppel defense).

³³ Generally, the failure to tender the securities back to the seller, the statute of limitations, and a showing that the transaction was exempted under the statute are the only defenses available to sellers under blue sky laws. E.g., UNIF. SECURITIES ACT § 410(a), 7B U.L.A. 643 (tender); § 410(e), 7B U.L.A. 643 (statute of limitations); § 301, 7B U.L.A. 550 (transactions exempted), § 403, 7B U.L.A. 620 (same) (1958). *But see* IND. CODE ANN. § 23-2-1-19 (Burns 1984) (purchasers not entitled to recover if they knowingly participated in violation, or if they knew, at time of transaction, that transaction violated blue sky laws).

³⁴ See *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 301 (1985).

³⁵ See *Aclin v. Caplener*, 229 Ark. 718, 723, 318 S.W.2d 141, 144 (1958). See also 28 AM. JUR. 2D *Estoppel & Waiver* § 3 (1966).

³⁶ Many early blue sky laws declared that sales in violation of the statute were either "void" or "voidable." See L. LOSS & E. COWETT, *supra* note 2, at 131-33 (discussing distinction between void and voidable). Generally, courts held that where a sale was "void," defenses of in pari delicto and estoppel did not apply. See *id.* at 167-68 and cases cited therein. On the other hand, if the sale was merely "voidable," these defenses would apply. See, e.g., *Moore v. Manufacturers Sales Co.*, 335 Mich. 606, 56 N.W.2d 397

A. In Pari Delicto

"In pari delicto" is shorthand for "*in pari delicto potior est conditio defendentis*," a Latin phrase meaning "[i]n a case of equal or mutual fault . . . the condition of the [defending party] is the better one."³⁷ In pari delicto traditionally applies where the plaintiff and the defendant stand equally culpable in the transaction producing the statutory violation.³⁸ In securities cases, states have generally required proof of equal fault before allowing in pari delicto to bar an action. Courts approach "equal fault" in two ways. In the most common approach, courts attempt to weigh or balance the relative culpabilities of the parties. Less commonly, courts find equal fault when the purchaser participated in the violation to the extent that the culpable purchaser also violated the blue sky laws and would be liable to any innocent purchasers. Although courts appear to employ these two different approaches, no practical difference exists between the two.

*Moore v. Manufacturers Sales Co.*³⁹ exemplifies the more common balancing approach in which a court attempts to weigh the relative culpabilities of the parties. In *Moore* the plaintiff agreed to invest in a company only if he received a salary from the corporation and could participate in its management. After the directors elected the plaintiff treasurer and secretary, the company issued stock to him.⁴⁰ The plaintiff signed his own stock certificates after ample opportunity to make an examination of the company's affairs.⁴¹ Later, when

(1953). This distinction no longer holds because the vast majority of statutes do not use any "void" or "voidable" language. No jurisdiction employs "void" language, only six employ "voidable" language (Hawaii, Illinois, Ohio, North Dakota, South Dakota, and Vermont), and the Uniform Securities Act uses neither.

³⁷ BLACK'S LAW DICTIONARY 711 (5th ed. 1979). See also Annotation, *Purchaser's Right to Set up Invalidity of Contract because of Violation of State Securities Regulation as Affected by Doctrines of Estoppel or Pari Delicto*, 84 A.L.R.2d 479, 491 (1962).

³⁸ See *Young v. Kwock*, 52 Haw. 273, 277, 474 P.2d 285, 288 (1970) ("This defense [of in pari delicto] generally requires that the plaintiff be equally culpable in the transaction producing the defendant's liability."); BLACK'S LAW DICTIONARY, *supra* note 37, at 711.

Traditionally, in pari delicto has included a policy prong. Courts have precluded the defense of in pari delicto where "there may be on the part of the court itself a necessity of supporting the public interests or public policy in many cases, however reprehensible the acts of the parties may be." 1 J. STORY, EQUITY JURISPRUDENCE 305 (M. Bigelow 13th ed. 1886) (4th ed. 1846). In blue sky law cases, however, state courts that allow the defense of in pari delicto do not explicitly address any policy prong.

³⁹ 335 Mich. 606, 56 N.W.2d 397 (1953). The Michigan statute at that time declared that "[e]very sale or contract for sale of any security . . . made contrary to any provision of this act, shall be voidable at the election of the purchaser." *Id.* at 609, 56 N.W.2d at 398 (quoting Mich. Comp. Laws § 451.120 (1948)). The court in *Moore* also found estoppel. *Id.* at 611, 56 N.W.2d at 399.

⁴⁰ *Id.* at 608, 56 N.W.2d at 398.

⁴¹ *Id.*

another stockholder brought suit against the company claiming a violation of the blue sky laws, the company bank account was transferred to the plaintiff's name to avoid attachment.⁴² Then, after seven months of employment, the plaintiff brought suit against the corporation claiming violations of the blue sky laws; he did not leave his employment, however, until two months later.⁴³ The court held that the plaintiff was in *pari delicto* and thus disallowed recovery because the plaintiff signed his own stock certificates, he had full opportunity to examine the company's affairs, and he was secretary-treasurer and an active participant in the company's management.⁴⁴

*Schvaneveldt v. Noy-Burn Milling & Processing Corp.*⁴⁵ provides another example of this balancing approach. The seller in *Schvaneveldt* violated Utah's blue sky laws by selling unregistered securities to the plaintiff,⁴⁶ who knew that the securities were unregistered. In addition, the plaintiff attended meetings at which the incorporation of the business was discussed, served as the general manager of a closely related corporation, and encouraged others to buy the corporation's stock.⁴⁷ Despite the plaintiff's knowledge of the blue sky law violation and his close relationship to the corporation, the Utah Supreme Court found that the plaintiff was not as culpable as the sellers, who were officers and directors of the corporation. Therefore, the defense of *in pari delicto* failed.⁴⁸

Under the balancing approach, knowledge of a blue sky law violation alone is insufficient to find a purchaser in *pari delicto*.⁴⁹ Rather, the purchaser must engage in some type of affirmative action, such as participation in the management of the company at the time he receives stock. The court in *Theye v. Bates*,⁵⁰ for example, adopted the following rule of *in pari delicto*: "Where a purchaser of stock participates in the organization or management of the cor-

⁴² *Id.* at 609, 56 N.W.2d at 398.

⁴³ *Id.*

⁴⁴ *Id.* at 611, 56 N.W.2d at 399; *see also* Schrier v. B. & B. Oil Co., 311 Mich. 118, 18 N.W.2d 392 (1945), *cited in* Moore, 335 Mich. at 610, 56 N.W.2d at 399.

⁴⁵ 10 Utah 2d 1, 347 P.2d 553 (1959).

⁴⁶ *Id.* at 3, 347 P.2d at 554.

⁴⁷ *Id.*

⁴⁸ *Id.* For another close case in which a court found unequal culpability, *see* Trump v. Badet, 84 Ariz. 319, 327 P.2d 1001 (1958).

⁴⁹ *See, e.g.,* Fierer v. Ashe, 142 Ga. App. 290, 292, 235 S.E.2d 598, 600 (1977); Annotation, *supra* note 37, at 493 (1962) (and cases cited therein); L. Loss, *supra* note 4, at 1677. *But see* Ladd v. Knowles, 505 S.W.2d 662 (Tex. Ct. App. 1974) (knowledge alone enough to hold purchaser in *pari delicto*); Restlawn Memorial Park Ass'n v. Solie, 233 Wis. 425, 432, 289 N.W. 615, 617-18 (1940) (knowledge at time of sale and for three months afterwards that sale violated blue sky laws because stock not registered barred purchaser from recovering); IND. CODE ANN. § 23-2-1-19 (Burns 1984) (purchaser cannot recover unless he can prove no knowledge of blue sky law violation).

⁵⁰ 166 Ind. App. 652, 337 N.E.2d 837 (1975).

poration issuing or selling the stock, he may be considered as in pari delicto with the seller, precluding him from asserting the invalidity of the contract on the ground that it violates state securities regulations.' ”⁵¹ The *Theye* court then barred recovery by the purchasers because they participated in the incorporation of the company and subsequently served as corporate directors and officers.⁵²

The other approach to in pari delicto requires purchaser participation in the violations of the blue sky laws to the extent that the purchaser would also be liable under the laws. The civil liability provisions hold certain “nonsellers” as well as sellers liable for violations.⁵³ These “nonsellers” include officers, directors, partners, and similar persons.⁵⁴ Under this approach to in pari delicto, if the purchaser violated the blue sky laws as either a seller or nonseller, then the purchaser is in pari delicto.

The Supreme Court of Georgia applied this approach in *Nash v. Jones*.⁵⁵ In *Nash* a seller sold unregistered securities to the plaintiff in violation of Georgia’s blue sky laws.⁵⁶ The plaintiff was a corporate officer and director at the time of the sale.⁵⁷ The court found that the plaintiff violated the blue sky laws because he was a director in the corporation at the time of the violation,⁵⁸ making him liable under the statute to an innocent purchaser. Relying on this finding, the court held that the plaintiff was in pari delicto and barred his recovery.⁵⁹

⁵¹ *Id.* at 663, 337 N.E.2d at 844 (quoting Annotation, *supra* note 37, at 498).

⁵² *Id.* at 664, 337 N.E.2d at 845.

⁵³ Section 410(b) of the Uniform Securities Act identifies nonsellers who may be liable under section 410. Section 410(b) states, in part:

(b) Every person who directly or indirectly controls a seller liable under subsection (a), every partner, officer, or director of such a seller, every person occupying a similar status or performing similar functions, every employee of such a seller who materially aids in the sale, and every broker-dealer or agent who materially aids in the sale are also liable . . . unless the non-seller who is so liable sustains the burden of proof that he did not know, and in exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist.

UNIF. SECURITIES ACT § 410(b), 7B U.L.A. 643 (1958).

⁵⁴ *Id.*

⁵⁵ 224 Ga. 372, 162 S.E.2d 392 (1968).

⁵⁶ *Id.* at 373, 162 S.E.2d at 393.

⁵⁷ *Id.*

⁵⁸ *Id.* at 374-75, 162 S.E.2d at 394. At the time, Georgia law, in part, provided: “The person making such sale or contract for sale, and every director, officer, salesman or agent of or for such seller who shall have participated or aided in any way in making such sale, shall be jointly and severally liable.” *Id.* at 374, 162 S.E.2d at 394 (quoting 1957 Ga. Laws 161) (emphasis added by court).

⁵⁹ *Id.* at 375, 162 S.E.2d at 394; accord *Young v. Kwock*, 52 Haw. 273, 278, 474 P.2d 285, 288 (1970) (“for to be culpable and, hence, in pari delicto those who aid or participate must be an officer, director or agent of the seller”); see also *Stevens v. Crystal Lake Transp. Sales, Inc.*, 30 Ill. App. 3d 745, 748, 332 N.E.2d 727, 730-31 (1975) (purchaser

In practice, the two approaches to in pari delicto differ little because they usually yield the same results. Most purchasers found in pari delicto under the balancing approach would also be found in pari delicto under the other approach. In these cases, the purchaser participated in the management of the company and thus presumably violated the blue sky laws.⁶⁰ Thus, no practical difference exists between the approaches in the majority of cases. Thus, this Note assumes that a purchaser will not be in pari delicto unless the purchaser violated the blue sky laws.⁶¹

B. Estoppel

Unlike in pari delicto, which applies to a purchaser's conduct before or at the time of a sale, the defense of estoppel generally bars a purchaser's recovery when the purchaser participates in or acquiesces to the affairs of the seller following a blue sky law violation.⁶² Whether estoppel applies to a plaintiff depends upon the level of the plaintiff's involvement in the seller's activities.⁶³ Courts often consider the following factors in determining whether a purchaser is estopped: the purchaser's acceptance of dividends or other financial benefits; participation in the management of the corporation; the purchaser's knowledge of any statutory violations; delay in bringing an action to rescind after acquiring knowledge of the violation; and the seller's reliance upon the conduct of the purchaser.⁶⁴

The most important factor for a finding of estoppel is purchaser participation in the management of the company.⁶⁵ For example, in

who was officer and director at time of sale cannot later rescind purchase of stock sold in violation of blue sky laws); *Theye v. Bates*, 166 Ind. App. 652, 663-64, 337 N.E.2d 837, 844 (1975) (if purchasers cooperated with sellers in violating laws, recovery barred).

⁶⁰ *But see* *Ladd v. Knowles*, 505 S.W.2d 662 (Tex. Ct. App. 1974) (knowledge alone enough to hold purchaser in pari delicto); *Restlawn Memorial Park Ass'n v. Solie*, 233 Wis. 425, 432, 289 N.W. 615, 617-18 (1940) (same).

⁶¹ For purposes of this Note's analysis, any use of in pari delicto that violates this assumption should be considered as the use of estoppel rather than in pari delicto.

⁶² *See supra* note 32 and accompanying text.

⁶³ *Midwest Management Corp. v. Stephens*, 291 N.W.2d 896, 908 (Iowa 1980).

⁶⁴ *See id.* at 908; Note, *A Definition of "Investment Contracts" and Equitable Defenses to Suit for Rescission for Nonregistration Under the Arkansas Securities Act*, 1 U. ARK. LITTLE ROCK L.J. 366, 377 (1978) (authored by Anne Ritchey) [hereinafter Note, *Investment Contracts*] (and cases cited therein); Note, *The Minnesota Supreme Court: 1980*, 65 MINN. L. REV. 1063, 1071 (1981) [hereinafter Note, *Minnesota Supreme Court*] (and cases cited therein). Courts find estoppel more often when the rights of third parties are involved. *See* L. Loss, *supra* note 4, at 1679-80.

⁶⁵ Many cases have barred recovery where the plaintiffs participated in the management of the company. *See, e.g.,* *Hayden v. McDonald*, 742 F.2d 423, 434 (8th Cir. 1984) (participation in management of corporation necessary to finding of estoppel); *Krasny v. Richter*, 211 So. 2d 612, 613 (Fla. Dist. Ct. App. 1968) (participation in management one method of barring recovery); *Coldblum v. Boyd*, 341 So. 2d 436, 443 (La. Ct. App. 1976) (participation in company's management a determinative factor); *Moore v. Manufacturers Sales Co.*, 335 Mich. 606, 611, 56 N.W.2d 397, 399 (1953) (purchaser was

Tucker v. McDell's, Inc.,⁶⁶ the defendant corporation sold fifty shares of stock to an investor in violation of Tennessee's blue sky laws.⁶⁷ The investor subsequently became a director and vice-president of the corporation.⁶⁸ After the corporation failed, and liquidation proceedings began, the investor tendered his stock and asked for rescission.⁶⁹ The court held that the purchaser's participation in the management of the corporation estopped him from rescinding the purchase, even though his participation occurred after the sale and after the blue sky law violation.⁷⁰

A purchaser's knowledge of a blue sky law violation and delay in bringing an action to rescind often accompany a purchaser's participation in management.⁷¹ For example, in *Logan v. Panuska*⁷² the plaintiffs knowingly invested in a business with financial problems.⁷³ They participated in the business's management and control, and they took no steps to rescind their purchase until after the business failed.⁷⁴ The court concluded that the purchasers' conduct estopped them from asserting a violation of the blue sky laws because the Minnesota legislature did not enact the blue sky law to protect investors from their business errors.⁷⁵ The court reasoned that it would be inequitable to allow the purchasers to force their losses

secretary-treasurer and active in corporation's management); *Logan v. Panuska*, 293 N.W.2d 359, 363-64 (Minn. 1980) (active participation in management and control of corporation); *Tucker v. McDell's, Inc.*, 50 Tenn. App. 62, 71, 359 S.W.2d 597, 600 (1961) ("where an investor takes as active a part in the management of a corporation . . . as did the plaintiff in this case, his conduct should and does estop him from rescinding his stock purchase"). One court went so far as to state that "[e]stoppel . . . requires that the stock purchaser directly participate in the management of the issuing corporation or otherwise exercise some control over the corporation." *Henderson v. Hayden, Stone, Inc.*, 461 F.2d 1069, 1073 (5th Cir. 1972) (interpreting Florida law).

For cases refusing to apply estoppel even though the purchaser participated in the management of the company, see, e.g., *Krutel v. Stolberg*, 356 So. 2d 1299 (Fla. Dist. Ct. App. 1978) (participation alone not sufficient); *Loewenstein v. Midwestern Inv. Co.*, 181 Neb. 547, 149 N.W.2d 512 (1967) (participation must be at sufficiently high level to trigger estoppel). See also, Note, *supra* note 31, at 138; Note, *supra* note 25, at 1170-71.

⁶⁶ 50 Tenn. App. 62, 359 S.W.2d 597 (1961).

⁶⁷ *Id.* at 70, 359 S.W.2d at 598.

⁶⁸ *Id.*

⁶⁹ *Id.* at 70, 359 S.W.2d at 598-99.

⁷⁰ *Id.* at 71, 359 S.W.2d at 600.

⁷¹ See, e.g., *De Polo v. Greig*, 338 Mich. 703, 708-09, 62 N.W.2d 441, 442-43 (1954) (purchaser estopped from recovering where purchaser involved in management of corporation, had knowledge that purchased securities were sold in violation of blue sky laws, signed waiver surrendering rights to rescind and acknowledging that securities were sold in violation of blue sky laws, made second purchase of securities, and waited until corporation sustained huge loss before bringing rescission action).

⁷² 293 N.W.2d 359 (Minn. 1980).

⁷³ *Id.* at 361.

⁷⁴ *Id.* at 361-62.

⁷⁵ *Id.* at 363-64.

upon the seller.⁷⁶

Some courts have refused to find estoppel where the purchaser did not participate in the management of the corporation, even where other factors, such as knowledge of the violation and receipt of benefits from the securities, existed.⁷⁷ In *Graham v. Kane*,⁷⁸ for example, the plaintiff, seeking a tax shelter, purchased interests in a limited partnership that he had reason to know were not properly registered.⁷⁹ This transaction violated the Arkansas blue sky law because the interests qualified as securities.⁸⁰ Three years after the purchase the plaintiff became dissatisfied with his investment and brought an action for rescission, claiming a blue sky law violation.⁸¹ By the time of the trial, the investment had created total tax savings of \$24,600.⁸² The court allowed the plaintiff to recover, despite his tax savings and his knowledge that the interests were not properly registered.⁸³

Management participation, however, will not always estop a purchaser. For example, the court in *Krutel v. Stolberg*⁸⁴ refused to find estoppel even though the plaintiff participated in the corporation's management because the level of participation " 'was not to the substantial extent necessary to make available to the defendants the doctrine of estoppel.' " ⁸⁵ In *Krutel* the plaintiff purchased securities in reliance upon the corporation's materially false financial

⁷⁶ *Id.* at 364; *see also* Bond v. Charlson, 374 N.W.2d 423 (Minn. 1985) (purchasers estopped from rescinding where they participated in corporation's management, knew of statutory violation, and delayed in bringing action for rescission).

⁷⁷ *See* Hall v. Johnston, 1982-84 Blue Sky L. Rep. (CCH) ¶ 71,903 (D. Or. 1983), *aff'd*, 758 F.2d 421 (9th Cir. 1985) (purchaser not estopped where he knew sale violated blue sky laws and he received tax benefits from investment); Fierer v. Ashe, 142 Ga. App. 290, 292, 235 S.E.2d 598, 600 (1977) (knowledge of violations and additional contributions of capital insufficient to establish estoppel); Martin v. Orvis Bros. & Co., 25 Ill. App. 3d 238, 250, 323 N.E.2d 73, 82-83 (1974) (purchaser not estopped from rescinding where he received dividends and tax benefits from shares); *see also* D.K. Properties, Inc. v. Osborne, 143 Ga. App. 832, 240 S.E.2d 293 (1977) (purchaser not estopped merely because he was an associate in law firm that provided seller with legal services in regard to sale of securities).

⁷⁸ 264 Ark. 949, 576 S.W.2d 711 (1979).

⁷⁹ *Id.* at 950-51, 576 S.W.2d at 712.

⁸⁰ *Id.* at 951, 576 S.W.2d at 712.

⁸¹ *Id.*

⁸² *Id.*

⁸³ *Id.* at 954, 576 S.W.2d at 714.

⁸⁴ 356 So. 2d 1299 (Fla. Dist. Ct. App. 1978).

⁸⁵ *Id.* at 1301 (quoting trial court judgment). The court listed four essential elements to the estoppel defense: " '(1) That the party to be estopped must know the facts; (2) that he must intend that his conduct be acted on or must so act that the party asserting the estoppel has a right to believe it is so intended; (3) that the latter party must be ignorant of the true facts; and (4) that he must rely on the former's conduct to his injury.' " *Id.* at 1301 (quoting trial court judgment).

statements⁸⁶ and brought suit for rescission after he learned of the misrepresentations. The court rejected the defendant's estoppel defense even though the plaintiff became the secretary and treasurer of the corporation after purchasing the securities, had the sole authority to sign the corporation's checks, and conferred with the other officers on certain business decisions.⁸⁷

Some courts have found estoppel by relying on factors other than management participation. In *In re Racine Auto Tire Co.*⁸⁸ the court held that estoppel barred the purchasers from rescinding the stock transaction because they received dividends for over two years, had exchanged their stock certificates for new ones when the corporation increased the capital stock, and had participated in stockholder meetings.⁸⁹

C. Availability of the Defenses

Many courts allow either in pari delicto or both in pari delicto and estoppel as defenses to civil actions brought under blue sky laws.⁹⁰ Some courts that recognize in pari delicto do not recognize estoppel, or only recognize it when extreme circumstances exist.⁹¹ Courts often permit these defenses in order to prevent the receipt of inequitable windfalls by purchasers who are not wholly innocent victims in a transaction.⁹²

⁸⁶ *Id.* at 1300.

⁸⁷ *Id.* at 1301.

⁸⁸ 290 F. 939 (7th Cir. 1923).

⁸⁹ *Id.* at 941. *See also* Farmer's Union Coop. Royalty Co. v. Little, 182 Okla. 178, 180, 77 P.2d 33, 35 (1938) (acceptance of dividends and delay in bringing suit estopped purchaser from rescinding). In *Ladd v. Knowles*, 505 S.W.2d 662 (Tex. Ct. App. 1974), the court held that knowledge of the statutory violation alone prevented the purchasers from rescinding their purchase. *Ladd* might be more appropriately classified as an in pari delicto case rather than as an estoppel case because of its use of in pari delicto terminology. The court viewed knowledge of the statutory violation as evidence of the need for an in pari delicto defense rather than as estoppel. *See id.* at 668.

⁹⁰ For examples of courts permitting either defense, *see, e.g.*, *Hall v. Johnston*, 1982-84 Blue Sky L. Rep. (CCH) ¶ 71,903 (D. Or. 1983), *aff'd*, 758 F.2d 421 (9th Cir. 1985); *Black Point Aggregates, Inc. v. Niles Sand & Gravel Co.*, 188 Cal. App. 2d 375, 381-82, 10 Cal. Rptr. 761, 765 (1961); *Gowdy v. Richter*, 20 Ill. App. 3d 514, 525, 314 N.E.2d 549, 557 (1974); *Covert v. Cross*, 331 S.W.2d 576 (Mo. 1960) (en banc); *Lintz v. Dillon*, 568 S.W.2d 147, 151, (Tex. Ct. App. 1978) *rev'd on other grounds*, 582 S.W.2d 394 (Tex. 1979).

⁹¹ *See, e.g.*, *Data Lease Fin. Corp. v. Barad*, 291 So. 2d 608 (Fla. 1974) (estoppel only where purchaser is in pari delicto, participates in corporation's management, or unusual circumstances exist); *Allen v. Smith & Medford, Inc.*, 129 Ga. App. 538, 199 S.E.2d 876 (1973) (estoppel where purchaser engaged in gross misconduct or fraud); *McCauley v. Michael*, 256 N.W.2d 491 (Minn. 1977) (purchaser can rescind contract if he is not in pari delicto with seller).

⁹² One court noted that the purpose of the blue sky laws is to protect innocent purchasers, rather than purchasers who themselves are somewhat culpable. *William's Delight Corp. v. Harris*, 87 Mich. App. 202, 273 N.W.2d 911 (1978). Further, the Min-

In contrast, courts that disallow the defenses reason that the public policy of maintaining compliance with the blue sky laws outweighs any inequitable windfalls received by culpable plaintiffs.⁹³ These courts often emphasize the penal purpose of the blue sky laws, which courts would defeat by allowing the nonstatutory defenses.⁹⁴ Some courts refuse to apply estoppel to situations involving an illegal agreement or instrument because to invoke estoppel would violate an express mandate of the law or the dictates of public policy.⁹⁵

*Dunn v. Bemor Petroleum, Inc.*⁹⁶ demonstrates the concern courts have for the enforcement of blue sky laws. In *Dunn* the purchasers brought an action against the sellers, who sold securities in oil and gas leases, alleging that the securities were unregistered and thus in violation of Missouri blue sky laws.⁹⁷ The sellers raised the defenses of estoppel and *in pari delicto*.⁹⁸ While recognizing that other states allow the defenses, the court refused to allow them.⁹⁹ The court stated:

Our blue sky laws were drafted with the intent to prevent fraud in the sale of securities. It is primarily through civil liability proceedings that the Missouri Act is enforced. The equitable de-

nesota Supreme Court stated that the purpose of the blue sky laws "is not served by permitting one who loses his innocence to await the outcome of his investment before invoking the securities act." *Bond v. Charlson*, 374 N.W.2d 423, 429 (Minn. 1985).

⁹³ See *Black Point Aggregates, Inc. v. Niles Sand & Gravel Co.*, 188 Cal. App. 2d 375, 381, 10 Cal. Rptr. 761, 765 (1961) ("questions of public policy far beyond the equities of the immediate parties are involved"); *Lintz v. Dillon*, 568 S.W.2d 147, 151 (Tex. Ct. App. 1978) ("Though this result may seem harsh . . . this outcome is evidently the clear intention of the Legislature . . ."), *rev'd on other grounds*, 582 S.W.2d 394 (Tex. 1979); *Hederman v. George*, 35 Wash. 2d 357, 362, 212 P.2d 841, 843-44 (1949) (although unjust and inequitable results may occur by holding for purchaser, "the law sustains him in this position, because it takes into account the interests of society and of the state") (quoting J. POMEROY, *SPECIFIC PERFORMANCE OF CONTRACTS* § 286 (3d ed. 1926)); see also *Edwards v. Trulis*, 212 So. 2d 893 (Fla. Dist. Ct. App. 1968) (securities law was enacted pursuant to police power, and any contract made in violation of it is void and creates no enforceable rights).

⁹⁴ See *Gowdy v. Richter*, 20 Ill. App. 3d 514, 525, 314 N.E.2d 549, 557 (1974) ("The penal character of the statute negates the utilization of *in pari delicto* or estoppel defenses."); *Covert v. Cross*, 331 S.W.2d 576, 585 (Mo. 1960) (en banc) (estoppel no defense under Missouri's blue sky laws because it "would tend to nullify and defeat the very purpose of the statute, which is clearly penal in nature"); see also cases cited *supra* note 93.

⁹⁵ See generally Annotation, *supra* note 37, at 483-85.

⁹⁶ 680 S.W.2d 304 (Mo. Ct. App. 1984).

⁹⁷ *Id.* at 306.

⁹⁸ *Id.* The seller contended that the buyers knew the securities were not registered, and that this knowledge constituted estoppel and *in pari delicto*. *Id.* Because knowledge alone is generally insufficient for a court to invoke estoppel or *in pari delicto*, proof of this contention would not result in allowance of the defenses by the court in any event. See *supra* notes 49-50 and accompanying text.

⁹⁹ *Dunn*, 680 S.W.2d at 306-07.

fense of estoppel and *in pari delicto* are not defenses to the liability created [under our blue sky law]. With such defenses, sellers could avoid liability under the registration provisions by informing would-be purchasers that the securities were unregistered. This would defeat the purpose of our blue sky laws.¹⁰⁰

The court concluded that the policy of requiring blue sky law compliance outweighs concerns that tainted plaintiffs might receive inequitable windfalls.¹⁰¹

IV

AN ANALYSIS OF THE DEFENSES OF IN PARI DELICTO AND ESTOPPEL

A rule rejecting the defense of estoppel but recognizing the defense of *in pari delicto* will best achieve the goal of the blue sky laws. This rule would further the blue sky laws' goal of protecting the investing public by maximizing compliance with the laws.

A. The Goals of the Blue Sky Laws

Blue sky laws seek to protect the investing public from fraud and deception in securities transactions.¹⁰² They accomplish this goal by threatening sellers with civil liability for violations of the

¹⁰⁰ *Id.* at 306 (citation omitted). The *Dunn* court relied on *Covert v. Cross*, 331 S.W.2d 576, 585 (Mo. 1960) (en banc) (estoppel no defense under Missouri's blue sky laws because it "would tend to nullify and defeat the very purpose of the statute, which is clearly penal in nature").

¹⁰¹ *Dunn*, 680 S.W.2d at 306.

¹⁰² In *Fred J. Schwaemmle Constr. Co. v. Department of Commerce*, 420 Mich. 66, 77, 360 N.W.2d 141, 145 (1984), the court stated:

The [Michigan blue sky law] was designed to protect the public from fraud and deception in the issuance, sale, exchange or disposition of securities within this state by requiring the registration of certain securities and transactions. Its purpose 'is to prevent stockholders and promoters from perpetrating frauds and impositions on unsuspecting investors in hazardous undertakings and to protect credulous and incompetent persons from their own inclinations to speculate in hazardous enterprises.'

Id. at 77, 360 N.W.2d at 145-46 (quoting *People v. Breckenridge*, 81 Mich. App. 6, 14-15, 263 N.W.2d 922, 926, *cert. denied*, 402 Mich. 915 (1978)) (citations omitted). See also *Jenkins v. Dearborn Sec. Corp.*, 42 Ill. App. 3d 20, 23, 355 N.E.2d 341, 344 (1976) ("The Illinois Securities Act is designed to protect the public not only from fraud and dishonesty, but also from incompetency, ignorance and irresponsibility of persons engaged in the business of disposing of securities to the public."); *Bond v. Charlson*, 374 N.W.2d 423, 429 (Minn. 1985) ("The fundamental purpose of 'Blue Sky Laws' is to protect the investing public from fraudulent sales of securities."); *Covert v. Cross*, 331 S.W.2d 576, 585 (Mo. 1960) ("The Act was passed to protect investors against their own weaknesses . . ."); *Hofer v. General Discount Corp.*, 86 S.D. 133, 139, 192 N.W.2d 718, 722 (1971) ("statutes governing the registration and sale of securities are remedial in nature and are designed to protect the unwary buyer"); *Pollok v. Commonwealth*, 217 Va. 411, 229 S.E.2d 858 (1976) (securities laws are intended to protect investors from fraudulent sale of securities).

blue sky laws.¹⁰³ Although blue sky laws contain penal provisions, uneven enforcement and inadequate enforcement budgets make civil remedies the only effective sanction.¹⁰⁴ As one commentator noted, "It is largely the threat of civil liability which makes the securities industry so sensitive to the blue sky laws."¹⁰⁵ A rule disallowing the estoppel defense but allowing the in pari delicto defense would maximize the deterrent effect of such a threat.

Courts that allow the defense of estoppel lessen the blue sky laws' deterrent value and thus decrease compliance with the laws by hampering plaintiffs' chances of recovery.¹⁰⁶ Repeated successful use of the defenses will result in decreased compliance with the laws. Courts that disallow estoppel, on the other hand, increase deterrence by allowing for more successful suits and creating a "general climate of fear of the statutory civil actions."¹⁰⁷ To the extent that such courts increase deterrence, they further the primary goal of the laws.¹⁰⁸

Courts that permit in pari delicto also advance the goals of the blue sky laws by deterring purchasers from inducing sellers to violate the laws. Because purchasers who are in pari delicto often have a close relationship with the seller, they are often able to induce sellers to commit violations. For example, a director might cause or

¹⁰³ See *Hall v. Johnston*, 1982-84 Blue Sky L. Rep. (CCH) ¶ 71,903, at 70,269 (D. Or. 1983), *aff'd*, 758 F.2d 421 (9th Cir. 1985) ("the focus of the civil liability section as it relates to registration is on forcing sellers to comply with the registration requirements, rather than scrutinizing the purchaser's conduct"); Comment, *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, 1477 (1964) (stating that civil liabilities sections of the Securities Act of 1933 were designed to "terrorize" issuers into compliance with its requirements).

¹⁰⁴ See *Hall*, 1982-84 Blue Sky L. Rep. (CCH) ¶ 71,903, at 70,269 ("it is primarily through civil liability proceedings that the Oregon Securities Law is enforced"); *Young v. Kwock*, 52 Haw. 273, 277, 474 P.2d 285, 288 (1970) ("it is the civil liability provisions and not the criminal section of the Blue Sky Law that generally promote compliance"); L. LOSS, *supra* note 4, at 1631; Note, *supra* note 25, at 1148; cf. COMMITTEE ON THE OFFICE OF ATTORNEY GEN., NATIONAL ASS'N OF ATTORNEYS GEN., *SECURITIES: ATTORNEYS GENERAL ENFORCEMENT OF BLUE SKY LAWS* 18 (1980) (most difficult problems in enforcing blue sky laws is lack of personnel and resources).

¹⁰⁵ L. LOSS & E. COWETT, *supra* note 2, at 129-30.

¹⁰⁶ See *Hall*, 1982-84 Blue Sky L. Rep. (CCH) ¶ 71,903, at 70,269 ("To allow a seller of unregistered securities to escape liability on the basis of a purchaser's actions would totally ignore the state's interest in enforcement of the registration provisions."); *Young v. Kwock*, 52 Haw. 273, 277, 474 P.2d 285, 288 (1970) ("Because it is the civil liability provisions . . . of the Blue Sky law that generally promote compliance we agree that the defense of in pari delicto should be carefully limited to those situations where the plaintiff is equally culpable." (footnote omitted)); *Logan v. Panuska*, 293 N.W.2d 359, 364 (Minn. 1980) (Scott, J., dissenting) (estoppel defense "neither serves to compensate the innocent purchaser nor does it deter future violations of the Blue Sky Law").

¹⁰⁷ Comment, *supra* note 103, at 1483 (analyzing estoppel's effect on actions brought under sections 11 and 12(1) of the Securities Act of 1933).

¹⁰⁸ *Id.* at 1481.

encourage his corporation to issue securities in violation of the blue sky laws because the director could then rescind his purchase of the securities if the value of the securities falls. In effect, he could eliminate the risk of an unprofitable investment.

If, however, the *in pari delicto* defense prevents directors and officers from rescinding their purchases, it destroys their incentive to induce or permit the corporation to violate the blue sky laws. Because the *in pari delicto* defense removes officers' and directors'¹⁰⁹ incentives to induce their corporation to violate the blue sky laws, the proposed rule furthers the goals of the laws.¹¹⁰

Rejecting the estoppel defense also will increase deterrence by giving notice of blue sky violations to other purchasers. Culpable plaintiffs are unlikely to sue if the defense of estoppel will apply to them. Eliminating the estoppel defense is desirable because it will not discourage such suits. Culpable plaintiffs often stand in the best position to know of blue sky law violations and their lawsuits will give notice to innocent purchasers who might not otherwise learn of the blue sky law violations. Additionally, suits by culpable plaintiffs will give notice to state officials, who might decide to undertake state investigations and bring actions against the sellers.¹¹¹

¹⁰⁹ The discussion in this Note applies to all "nonsellers," not just to officers and directors. See *supra* note 53 for a discussion of nonsellers.

¹¹⁰ Such action by officers and directors might expose them to personal liability under the blue sky laws. In some cases this potential liability might sufficiently deter such a purchaser notwithstanding the *in pari delicto* defense. Such deterrence will occur only if several conditions are met: (1) the transaction will significantly involve other purchasers (because the blue sky laws frequently involve very small sales, often to only one purchaser or group of purchasers, this condition will often not be met); (2) the purchaser knows that he will incur liability to the other purchasers; (3) the purchaser believes that if he sues, the suit will give notice to the other purchasers; and (4) the potential liability that the purchaser faces will be larger than his profits from the transaction (the purchaser will probably not have to pay all of the damages because he is jointly liable with the corporation and other officers). The *in pari delicto* defense, on the other hand, directly deters purchasers in nearly all cases.

¹¹¹ Because of minimal enforcement capabilities and inadequate budgets, state agencies might not otherwise detect the violations. See *supra* notes 103-05 and accompanying text.

In some cases, however, culpable purchasers not *in pari delicto* will not sue even though estoppel does not apply, thereby preventing other purchasers and the state from receiving notice. This will occur if culpable purchasers fear that the suit will give others notice of other illegal conduct by the culpable purchasers that might subject them to liability. Such liability, of course, would not include liability for involvement in the original violation itself, because such culpable involvement would occur only if the purchaser was *in pari delicto*. For example, suppose a broker, Y, sells some of the securities he bought (which were sold in violation of the blue sky laws) to another person, X. In addition, Y knew that the securities were unregistered, but did not tell this to X. The sale by Y to X was fraudulent because Y's failure to notify X was a material misstatement; thus, Y would be liable to X for fraud. If Y believes that X will learn of the fraudulent sale if he sues the original seller for the first blue sky law violation, Y might not bring the action. In this instance, the notice function, although not defeated, will not be furthered

By giving notice to other purchasers, the proposed rule should increase the number of successful suits, which will make violations of the blue sky laws more costly and thus deter violations. This "notice function" will also serve to ensure compensation for all injured purchasers.

Allowing the *in pari delicto* defense does not hamper this notice function. A purchaser who would be subject to the *in pari delicto* defense would also be liable to any innocent purchasers for these violations. Thus, to avoid notice to innocent purchasers and the chance of suit, a purchaser subject to *in pari delicto* would not sue regardless of whether the defense applied.

One major drawback to the proposed rule remains: purchasers bearing some culpability, but not enough to subject them to the *in pari delicto* defense, might receive inequitable windfalls. For example, the rule would allow a tainted purchaser who knows that he bought securities sold in violation of the blue sky laws to rescind his purchase if the securities ever decline in value. The proposed rule's goal of deterring blue sky law violations, however, outweighs any such inequities.

B. Statutory Language

By disallowing estoppel, the proposed rule achieves the deterrence goal of the blue sky laws by disallowing estoppel. The majority of blue sky laws, by imposing strict liability, demonstrate that their primary goal is deterring violations. Under section 410(a) of the Uniform Securities Act, the plaintiff need only prove that either the seller did not properly register the security, the seller was not registered, or that the seller did not give proper disclosure.¹¹² The purchaser need not prove that the seller's violation caused damages or that he relied upon the seller not to violate the act. The seller's

even though estoppel is not allowed. Such cases, however, will probably not arise often, and any resulting impact on the notice function would therefore be minimal.

¹¹² For the text of the statute, see *supra* note 9. See *supra* notes 8-14 and accompanying text for a discussion of a seller's liability. See also *Hall v. Johnston*, 1982-84 Blue Sky L. Rep. (CCH) ¶ 71,903, at 70,269 (D. Or. 1983) (The court interpreted Oregon's blue sky law, which is patterned after the Uniform Securities Act, and stated "The statute's language is unambiguous and clear: it says that anyone who violates the registration requirements is liable, to the extent provided by the statute. The legislature could have included in the statute a provision allowing equitable defenses to be raised in a civil liability suit."), *aff'd*, 758 F.2d 421 (9th Cir. 1985); *cf.* Comment, *supra* note 103, at 1481-82 (discussing strict liability language of federal civil liability provisions). This argument does not extend to section 410(a)(2) of the Uniform Securities Act. *Cf. id.* at 1478-80 (distinguishing section 12(1) of the 1933 Securities Act, which is similar to section 410(a), from section 12(2) of the 1933 Securities Act, which is similar to section 410(a)(2)).

intent and knowledge are also irrelevant.¹¹³ The defendant escapes liability only upon a showing that the statute of limitations period expired¹¹⁴ or that the transaction was exempted.¹¹⁵ By using strict-liability language, legislatures demonstrate their intent to deter noncompliance with the blue sky laws and not merely a desire to provide a remedy for injured purchasers.¹¹⁶

Two other provisions commonly found in blue sky laws support the proposed rule. First, "antiwaiver" provisions such as section 410(g) of the Uniform Securities Act¹¹⁷ express a legislative desire to protect all purchasers. Such antiwaiver provisions disallow enforcement of a waiver provision even if the parties agreed to waive the Act for purposes of their transaction.¹¹⁸

If courts allowed estoppel, the parties could effectively circumvent the antiwaiver rule by having the purchaser participate in the transaction to an extent that would trigger estoppel.¹¹⁹ Such a tainted transaction would provide the seller with the same insulation afforded by a valid waiver. Permitting the in pari delicto defense,

¹¹³ *But see* IND. CODE ANN. § 23-2-1-19 (Burns 1984) (defendant's reasonable lack of knowledge of the violation constitutes defense).

¹¹⁴ *See* UNIF. SECURITIES ACT § 410(e), 7B U.L.A. 643 (1958).

¹¹⁵ *See supra* notes 11 & 13.

¹¹⁶ *See* Comment, *supra* note 103, at 1411. Strict liability also plays another role: it furthers judicial efficiency. The use of estoppel will impair this goal because it creates more complicated and time consuming litigation, which requires additional proof and introduces additional issues. Indeed, strict liability encourages settlement because a guilty seller will know if he is liable and both sides will wish to avoid additional litigation fees.

¹¹⁷ UNIF. SECURITIES ACT § 410(g), 7B U.L.A. 644 (1958). *See* L. Loss, *supra* note 21, at 1191 (1983) (antiwaiver provisions should aid person asserting a violation against arguments of estoppel or ratification); Note, *Minnesota Supreme Court, supra* note 64, at 1071 n.13 (waiver clause could be interpreted to exclude implied waiver or ratification).

The Uniform Securities Act of 1985 did not adopt an antiwaiver provision, and the comments to the act do not explain this omission.

¹¹⁸ "Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this act or any rule or order hereunder is void." UNIF. SECURITIES ACT § 410(g), 7B U.L.A. 644 (1958).

But see Gannett Co. v. Register Publishing Co., 428 F. Supp. 818 (D. Conn. 1977) (suggesting that antiwaiver rule may not apply to conduct after sale).

¹¹⁹ *See* Dunn v. Bemor Petroleum, Inc., 680 S.W.2d 304, 306 (Mo. Ct. App. 1984) (The court disallowed the defense of estoppel because "[w]ith such defenses, sellers could avoid liability under the registration provisions by informing would-be purchasers that the securities were unregistered. This would defeat the purpose of our blue sky laws."); *see also* Hall v. Johnston, 1982-84 Blue Sky L. Rep. (CCH) ¶ 71,903, at 70,269 (D. Or. 1983) ("if defendants could escape liability under the registration provisions simply by informing would-be purchasers that the securities to be purchased were unregistered, defendants could essentially write the registration provisions out of the Oregon Securities Law"), *aff'd*, 758 F.2d 421 (9th Cir. 1985); Logan v. Panuska, 293 N.W.2d 359, 364 (Minn. 1980) (Scott, J., dissenting) (allowance of estoppel "could prompt clever promoters of questionable investments to ignore the Blue Sky regulations and, instead, encourage an investor to participate in the management of the company so that an estoppel defense could later be established").

however, would not circumvent the antiwaiver rule in most instances because the purchaser would have to expose himself to liability to other purchasers in order for a seller to have a valid *in pari delicto* defense. A purchaser would likely not agree to such an arrangement.

This argument is much weaker for the fourteen states whose statutes do not include antiwaiver provisions.¹²⁰ The lack of an antiwaiver provision could arguably empower courts to allow waiver and related defenses where equity requires.¹²¹ The absence of antiwaiver provisions in these states, however, does not weaken the other arguments in favor of restricting defenses to blue sky law violations.

The second common provision, the statute of limitations for civil blue sky law actions, implicitly supports the proposal that courts should not permit an estoppel defense. A number of cases considered the plaintiff's delay in bringing an action important in permitting an estoppel defense.¹²² Using a plaintiff's delay in bringing suit to prevent him from recovering, however, conflicts with the statute of limitations provisions. By enacting short statute of limitations periods, legislatures decided the time limits (delays) that should bar plaintiffs from recovering.¹²³ Courts that bar a plaintiff's recovery on the ground that a plaintiff's delay estops him

¹²⁰ Arizona, California, Florida, Georgia, Hawaii, Illinois, Louisiana, Nevada, New Mexico, North Dakota, Ohio, Oregon, South Dakota, and Vermont do not have antiwaiver provisions in their blue sky laws. This argument is especially weak in Oregon, which adopted parts of the civil liability provisions of the Uniform Securities Act but not section 410(g) (presumably considering but rejecting the antiwaiver provision).

¹²¹ See L. Loss & E. COWETT, *supra* note 2, at 174-75 (antiwaiver provision should aid person asserting a violation against defense of estoppel as well as waiver).

¹²² See, e.g., *Krutel v. Stolberg*, 356 So. 2d 1299, 1302 (Fla. Dist. Ct. App. 1978) (discussing cases where plaintiff delayed too long to rescind); *Walton v. Semmler*, 6 Mich. App. 596, 149 N.W.2d 885 (1967) (purchaser who did not attempt to repudiate until sued fell outside the scope of the act); *Bond v. Charlson*, 374 N.W.2d 423, 429 (Minn. 1985) ("the purpose of the act is not served by permitting one who loses his innocence to await the outcome of his investment before invoking the securities act"); *Logan v. Panuska*, 293 N.W.2d 359, 364 (Minn. 1980) (purchasers did not attempt to rescind until business failed); see also Note, *Investment Contracts*, *supra* note 64, at 378-79 (discussing defense of laches). The defense of "laches" refers to neglect by the defendant to assert a right which, with a lapse of time and other circumstances disadvantaging the defendant, bars the action. BLACK'S LAW DICTIONARY, *supra* note 37, at 787. In the context of blue sky laws, laches is typically included within the meaning of estoppel. See *supra* note 32.

¹²³ The Uniform Securities Act section 410(e) provides for a two year limitations period. UNIF. SECURITIES ACT § 410(c), 7B U.L.A. 643 (1958). Statutes of limitations are commonly used to argue against the use of laches, especially when the period is short. See Comment, *supra* note 103, at 1485-86. But see *Gannett Co. v. Register Publishing Co.*, 428 F. Supp. 818, 828-29 (D. Conn. 1977) (Connecticut, Uniform Securities Act jurisdiction, has two-year statute of limitations period that does not abrogate rule requiring purchaser to give prompt notice of intention to rescind).

from recovering violate this legislative judgment.¹²⁴

CONCLUSION

The defenses of in pari delicto and estoppel often arise in actions brought under the civil liability provisions of state blue sky laws. Courts are split on whether they should allow such defenses. This Note proposes a rule prohibiting estoppel but allowing in pari delicto. This rule maximizes compliance with the blue sky laws and therefore furthers the goal of these laws—the protection of the investing public. The statutory language of many blue sky laws supports this proposed rule. Thus, by adopting this rule, courts will further the legislative intent to protect the public.

Charles G. Stinner

¹²⁴ Although not relying on the statute of limitations, another argument against using delay as a reason for authorizing estoppel is that “[i]t would not be expected of anyone that he would elect to treat a sale of stock as void until he had discovered it was not profitable for him to retain it.” L. Loss, *supra* note 4, at 1677 (quoting *Bunge v. Kirchoff*, 251 Ill. App. 119, 126 (1928)).