Affirmative Defenses to Securities Exchange Act Rule 10b-5 Actions

Arnold S. Jacobs

Follow this and additional works at: http://scholarship.law.cornell.edu/clr

Part of the Law Commons

Recommended Citation
Available at: http://scholarship.law.cornell.edu/clr/vol61/iss6/1

This Article is brought to you for free and open access by the Journals at Scholarship@Cornell Law: A Digital Repository. It has been accepted for inclusion in Cornell Law Review by an authorized administrator of Scholarship@Cornell Law: A Digital Repository. For more information, please contact jmp8@cornell.edu.
AFFIRMATIVE DEFENSES TO SECURITIES EXCHANGE ACT RULE 10b-5 ACTIONS*

Arnold S. Jacobs†

TABLE OF CONTENTS

I. THE STATUTE OF LIMITATIONS ......................................................... 860
   A. Time Period .............................................................................. 861
   B. When the Period Begins to Run ................................................ 870
   C. Tolling the Statute of Limitations ........................................... 879

II. LACHES ........................................................................................................ 881

III. WAIVER, ESTOPPEL, AND RATIFICATION ........................................... 886
   A. Waiver ..................................................................................... 886
   B. Estoppel ................................................................................... 893
   C. Ratification .............................................................................. 898

IV. IN PARI DELICTO AND UNCLEAN HANDS .............................................. 899
   A. In Pari Delicto ........................................................................ 899
   B. Unclean Hands ....................................................................... 903

V. RES JUDICATA AND COLLATERAL ESTOPPEL ......................................... 905

VI. OTHER DEFENSES .............................................................................. 908

CONCLUSION ............................................................................................... 910

In 1942, the Securities and Exchange Commission¹ promul-

* Substantial parts of this Article will become part 10 of A. Jacobs, THE IMPACT OF RULE 10b-5 (Clark Boardman & Co., Ltd. 1974). The author gratefully acknowledges the suggestions of Allan Kramer, member of the New York Bar, the editorial assistance of Ellen K. Jacobs and Ann S. Kheel, and the stenographic help of Mary Ann Assicurato.


¹ Hereinafter the "SEC" or the "Commission."
gated Rule 10b-5under the Securities Exchange Act of 1934. In the succeeding decades, 10b-5 has become the primary deterrent against fraudulent activities in securities transactions. Its evolution is largely due to the private rights of action that have been implied under the Rule.

The Rule applies to six distinct factual patterns: trading on the basis of undisclosed material information; issuing misleading corporate publicity; selectively disclosing important nonpublic data, commonly called "tipping;" mismanaging a corporation; manipulating a securities market; and trading and other activities of broker-dealers. Each of these types of breaches requires that a successful plaintiff demonstrate a number of substantive elements.

Failure to prove one of these elements defeats a plaintiff's claim because a 10b-5 breach is then not shown. For example, a plaintiff's knowledge that a defendant's face-to-face statement is false precludes his claim based on that misstatement. The focus of this Article is different. We treat here the affirmative defenses which thwart liability even though the defendant breached the Rule.

Being an implied remedy, Rule 10b-5 contains no express affirmative defenses. However, courts have identified a number of defenses that block recovery against both primarily and secondarily liable defendants.

---

2 17 C.F.R. § 240.10b-5 (1973) [hereinafter cited as the "Rule" or "10b-5"]). The Rule provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentalities of interstate commerce, or of the mails or of any facility of any national securities exchange.

(a) To employ any device, scheme, or artifice to defraud,
(b) To make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
in connection with the purchase or sale of any security.


4 A. JACOBS, THE IMPACT OF RULE 10b-5, § 8 (Clark Boardman & Co., Ltd. 1974) [hereinafter cited as A. JACOBS].

5 A. Jacobs, at parts 2-9.

6 See id. § 64.01[b][ii] nn.56-60 and accompanying text.


The policies underlying 10b-5, and its remedial nature and broad construction, suggest that affirmative defenses be as narrow as possible. Regardless of the scope of the defense, under the Federal Rules of Civil Procedure, defendants must plead them in their answer. An exception to this pleading rule occurs when the plaintiff exhibits unclean hands, since that defense protects the court's integrity.

A knotty issue arises when the class representative in a class action or the plaintiff suing on behalf of the company in a derivative suit is personally subject to a defense, while those he represents are not. For example, he and the defendants might be equally guilty of perpetrating the fraud, although the other class members (in a class action) or the company and the remaining stockholders (in a derivative suit) were innocent of any wrongdoing. Courts should disqualify the individual plaintiff from acting as the class representative, but should permit him to prosecute a derivative suit.

The SEC may seek disgorgement of profits as ancillary relief "in order to remove any monetary reward for violations of section 10(b) and Rule 10b-5." Even though an affirmative defense in a private action will bar recovery for those persons who would receive the profits, a court should nonetheless deprive a defendant of his illicit gains in an SEC suit.

---

9 See A. Jacobs § 6.
10 See id. § 7 n.8 and accompanying text.
13 This would make him in pari delicto with the defendant, and preclude recovery. See supra part IV A infra.
This Article examines a defendant’s right to defeat a claim by interposing a defense. Yet defenses can cut both ways: a plaintiff can claim a defense to keep a defendant from raising another defense. For instance, a defendant might intentionally waive his right to assert laches.18

I

THE STATUTE OF LIMITATIONS

In the context of 10b-5 suits, a statute of limitations defense is available whether the cause of action is considered legal or equitable,19 and whether or not laches is a defense in the pending suit.20 The authorities rightly conclude that the same statute of limitations principles govern buyers and sellers.21 Our assessment of statute of limitations only involves private rights of action. The Commission is not subject to any statute of limitations when it sues under 10b-5, even if it seeks ancillary relief.22 Criminal actions are governed by the catch-all period in the federal criminal laws.23 The ensuing

discussion examines the appropriate statutory time period, when that time period begins to run, and the events that stop it.

A. The Time Period

Federal law governs the statutory period of limitations in the area of securities regulation. However, neither section 10(b) nor Rule 10b-5 contains a statute of limitations, and no general statutory period exists for breaches of the 1934 Act or for civil actions based on a federal statute. Other 1933 Act and 1934 Act remedies require that the plaintiff sue within one year after discovering the offense, but in any event not more than three years after the violation. Some authorities advocate this period for 10b-5 actions. The cases refuse to adopt this measure, however, even if the

24 See part I A infra.
25 See part I B infra.
26 See part I C infra.
29 See Securities Act § 13 (must bring suits under 1933 Act §§ 11 & 12 within one year of discovery or should plaintiff have discovered, but in any event within three years; must bring suits under 1933 Act § 12(1) within one year of violation and within three years of making offer to public); Exchange Act § 9(e) (within one year after discovery of facts and within three years after violation); § 16(b) (within two years after profit realized); § 18(c) (within one year after discovery of facts and within three years after cause of action accrued); and § 29(b) (within one year after discovery and within three years after violation). Section 13 of the 1933 Act was changed from two and ten year periods to its present one and three year periods when Congress enacted the 1934 Act. Securities Exchange Act of 1934, § 207, 15 U.S.C. § 77m (1970), formerly ch. 38, § 13, 48 Stat. 84 (1933).
plaintiff could have sued under one of the sections containing a specific limitations period. Courts instead adopt a state statute of limitations. This raises two obvious questions: which state should be chosen and which statute in that state should be selected? Even if most of the acts constituting the 10b-5 breach occurred outside the forum, federal courts, with two minor exceptions, will adopt a limitations period from the forum state.

The first exception arises if a case is transferred between courts in different states. When a transfer occurs for the convenience of the parties, the transferee court adopts a statute of limitations from the state in which the transferor court sits. But if venue considerations cause the transfer, the transferee court chooses the appropriate period from the laws of the state in which it sits. Class


For convenience, this Article will use the term "forum" to designate the state from which the court adopts a statutory period. This definition therefore does not reflect the two exceptions.


actions attacking the same conduct may be transferred for the convenience of the parties to one state from a number of other states. The transferee court should then apply the longest period any transferor court would adopt to the extent that: (1) identical defendants are named; (2) the complaints contain the same substantive allegations; and (3) the size of the class is comparable.

The second "exception" to the application of the forum state's statute of limitations requires a federal court to observe the forum's borrowing statute. Borrowing statutes compel state courts to borrow a shorter period from another state under certain circumstances. For example, the New York borrowing statute requires its courts to apply the shorter of New York's statute of limitations and the period of the state in which the cause of action accrued, if the plaintiff is not a New York resident. The proper application of borrowing statutes involves a combination of federal and state law. When a borrowing statute refers to a cause of action "accruing without the state," state case law must fix what the quoted words mean. For example, New York has construed such a clause to mean the place from which the fraudulent scheme was controlled. Federal law then applies the facts of the pending case to the state court's construction of the borrowing statute. Thus, federal law determines the state from which control was exercised.

When a case is transferred for the convenience of the parties, or a borrowing statute is used, a court must choose from among the statutes of limitations of a state other than the one in which it sits. In making this selection, the court should rely on precedents of the

---


40 Id.


43 See note 27 and accompanying text supra. But see Saylor v. Lindsley, 302 F. Supp. 1174, 1179 (S.D.N.Y. 1969) (unclear if court refers to this question or to issue discussed in note 44 and accompanying text infra).
circuit in which the foreign state is situated. The courts of appeals have formulated generalized tests for choosing the proper statute. Their results are not uniform, however, due to the absence of hard-and-fast guidelines, the diversity of 10b-5’s substantive elements as construed by the eleven courts of appeals, the variety among states as to the types of causes of action that have statutes of limitations, and the dissimilarities among state blue sky laws.

State law does not determine when the period begins to run or what events interrupt it. Nor does a federal court adopt the state statute’s procedural or substantive nuances. A 10b-5 plaintiff, therefore, is not required to make a tender within the period specified by the state statute of limitations. In short, the state supplies only the measuring period—a specific number of years.

Courts have espoused some general principles for choosing the proper limitations period. Following a Supreme Court decision construing another federal law, the Sixth Circuit opined in Charney v. Thomas that the correct statute is the one that “best effectuates the federal policy at issue.” The “federal policy” should consider the

---

46 Parrent v. Midwest Rug Mills, Inc., 455 F.2d 123, 126 (7th Cir. 1972) (divergent results lay in differing interpretations of the scope of 10b-5); Ruder & Cross, supra note 30, at 1146-47 (different substantive elements of 10b-5); see Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 104 (10th Cir.), cert. denied, 404 U.S. 1001 (1971), and 405 U.S. 918 (1972) (choice depends in part on elements of 10b-5). Even if the elements of a 10b-5 cause of action were uniform among the circuits, different limitations periods might remain. The courts are reluctant to change limitations periods because prospective litigants rely on the periods. See notes 108-09 and accompanying text infra.
47 Blue sky laws are one choice of the type of statute a federal court has to supply the period.
48 See parts I B & I C infra.
50 See, e.g., Wolf v. Frank, 477 F.2d 467, 475 (5th Cir. 1973).
52 572 F.2d 97 (6th Cir. 1967).
Rule’s underlying philosophy, its remedial nature, and broad construction. Judge Hill analyzed this test:

[T]wo things must be considered: first, which state substantive statute is closer in purpose to Rule 10b-5; second, which limitation period, considered apart from the substantive law it controls, best effectuates the purposes of Rule 10b-5.

The Eighth Circuit expanded on the Sixth Circuit’s test in *Vanderboom v. Sexton*:

Since the standard for determining the applicable statute of limitations is to select the statute that best effectuates the federal policy involved, it is appropriate to look to the local statute which bears the closest resemblance to the federal statute involved.

Both state and federal law play a role in this “resemblance test.” Under the first step, federal law determines 10b-5’s characteristics. The Rule proscribes many kinds of activities. A court could therefore reasonably apply one statute of limitations of the forum state in a first type of 10b-5 action (e.g., misrepresentation) and another in a second type of 10b-5 case (e.g., mismanagement). The rationale for selecting the periods from different state causes of action is that the parameters of the two types of 10b-5 violations are so dissimilar; the former is akin to common-law fraud or a violation of a blue sky law, while the latter resembles a breach of fiduciary duties by corporate management. Fortunately, courts use the same statute of limitations of a forum for all species of 10b-5 actions. Perhaps the first court


See A. Jacobs § 7 n.8 and accompanying text.


See A. Jacobs, parts 2-9.

For example, the same New York statute has been used in misrepresentation, manipulation, and mismanagement cases. See, e.g., Klein v. Shields & Co., 470 F.2d 1344 (2d Cir. 1972); Klein v. Auchincloss, Parker & Redpath, 436 F.2d 339 (2d Cir. 1971).
selecting a limitation period for a state—a choice that will govern all kinds of 10b-5 cases—is influenced by the sort of 10b-5 cause of action alleged in the pending lawsuit. The second step in the resemblance test employs the forum's law to establish the parameters of the various sorts of state causes of action. Following these two steps—one using federal and the other state law—a court can compare the characteristics of 10b-5 with those of the state causes of action and then select the state cause of action most closely resembling 10b-5.

Aside from the Eighth Circuit's resemblance test and the Sixth Circuit's criterion focusing on the period that best effectuates the Rule's purposes, courts have announced other guides for selecting the proper period. First, regardless of the test used, a choice is questionable if the period is unusually long or short. Ten years is

60 See Nickels v. Koehler Mgmt. Corp., 392 F. Supp. 804, 809 (N.D. Ohio 1975) (distinguishing prior case under different facts); In re Alodex Corp. Sec. Litigation, 392 F. Supp. 672, 674 (S.D. Iowa 1975); Dudley v. Southeastern Factor & Fin. Corp., 57 F.R.D. 177, 184 (N.D. Ga. 1972) (used fraud statute of limitations "since the complaint in the present case is most nearly akin to a complaint of fraud"). If the first 10b-5 case to posit the statute of limitations issue is a mismanagement case, the statute of limitations chosen is more likely to resemble that for mismanagement than if the first 10b-5 case involved a misrepresentation.


not "unusually long," although the one-year period used in some forums could easily be considered "unusually short." Second, the period for 10b-5 should be at least as long as the forum's period for common-law fraud. Third, some authorities generally favor short time spans, while others tend toward longer ones.

The various tests have not produced a uniform statutory period. The differences arise from two sources. First, courts have not consistently selected the same kind of state law. They have drawn the limitations periods from statutes dealing with common-law fraud, blue sky laws, "catch-all" provisions, and even from a personal action in trespass and action on the case. Second, the period for a specific type of state statute varies among the fifty states. Courts therefore adopt different periods for 10b-5 cases arising in different jurisdictions: California (3 years); Arkansas (2 years); Colorado (3 years); Connecticut (2 or 3 years).

---

63 Id.
64 See notes 74-106 and accompanying text infra regarding those states supplying a one-year period.
68 E.g., Alabama, California, Colorado, Connecticut (split of opinion), District of Columbia, Georgia, Idaho, Kansas, Kentucky, Louisiana, Michigan, Minnesota, New York, Ohio (split of opinion), Oregon, Texas, Utah, and Washington. For relevant authority, see notes 79-105 infra.
69 E.g., Arkansas, Connecticut (split of opinion), Florida, Illinois, Iowa, Ohio (split of opinion), Virginia, and Wisconsin. For relevant authority, see notes 75-106 infra.
70 E.g., Tennessee. See note 101 infra.
71 Pennsylvania is such a state. For authority, see note 99 infra.
72 Delaware is such a jurisdiction. See note 79 infra.
73 The following jurisdictions lack authority: Alaska, Arizona, Hawaii, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Puerto Rico, Rhode Island, South Carolina, Vermont, West Virginia, and Wyoming.
76 United Cal. Bank v. Salik, 481 F.2d 1012, 1014-15 (9th Cir. 1973); Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1210 (9th Cir. 1970); Sackett v. Beaman, 399 F.2d 884, 890 (9th Cir. 1968).
years); Delaware (3 years); Missouri (2 years); Florida (2 years); Georgia (4 years); Idaho (3 years); Indiana (6 years); Iowa (2 years); Kansas (2 years); Kentucky (5 years); Louisiana (1 year); Maine (2 years); Maryland (unclear); Massachusetts (2 years); Michigan (6 years); Minnesota (6 years); New York (the later of 6 years after violation, and 2 years after discovery or the time plaintiff should have discovered); Ohio (2 or 4 years); Oklahoma (2 years); and Oregon (2


Cf. Sharp v. Idaho Inv. Corp., 95 Idaho 113, 504 F.2d 386 (1972) (1935 Act § 17(a)).

Schaefer v. First Nat'l Bank, 509 F.2d 1287, 1291, 1294 (7th Cir. 1975), cert. denied, 96 S. Ct. 1682 (1976); Hupp v. Gray, 500 F.2d 993, 996 (7th Cir. 1974); Parrent v. Midwest Rug Mills, Inc., 455 F.2d 123, 126 (7th Cir. 1972).


E.g., Klein v. Shields & Co., 470 F.2d 1344, 1346 (2d Cir. 1972); Klein v. Auchincloss, Parker & Redpath, 436 F.2d 339, 341 (2d Cir. 1971).

years); Pennsylvania (6 years); South Dakota (6 years); Tennes-
see (10 years); Texas (2 years); Utah (3 years); Virginia (2 years); Washington (3 years); and Wisconsin (3 years).

Complications follow if the forum state changes its law. The forum's legislature might enact a new cause of action after a federal court adopts a period from an existing cause of action. This presents no problem if the statute to which federal courts looked in the past satisfies the applicable tests better than the new statute. But even when the reverse is true, courts have properly refrained from adopting the time span associated with the new cause of action. Their refusal to change is partly based on the reliance prospective litigants place on the old period. A forum state might also amend its law to increase or decrease the statutory period that the federal courts had adopted as the 10b-5 standard. Federal courts should then use the old period for causes of action arising before the effective date of years); Toledo Trust Co. v. Nye, 392 F. Supp. 484, 490-91 (N.D. Ohio 1975) (four years); Connelly v. Balkwill, 174 F. Supp. 49, 63-64 (N.D. Ohio 1959), aff'd per curiam, 279 F.2d 685 (6th Cir. 1960) (four years).


Douglass v. Glenn E. Hinton Inv., Inc., 440 F.2d 912, 914 (9th Cir. 1971); Erinion v. Connell, 236 F.2d 447, 455 (9th Cir. 1956); Fratt v. Robinson, 203 F.2d 627, 634-35 (9th Cir. 1953).


See notes 51-65 and accompanying text supra.

the amendment, and the amended period for claims arising on or after that date. Another type of change occurs when a district court applies a different period from what its court of appeals establishes in a later suit. If the first case is still pending, the district judge should modify his holding.

All of this is needlessly complicated. Congress should enact a statute of limitations for 10b-5 similar to the one federal courts adopt from New York State: the later of six years after the cause of action arose and two years after the plaintiff discovered or should have discovered the fraud with due diligence. Congress has already acted similarly in the antitrust field.

B. When the Period Begins to Run

The commencement of the statute of limitations period depends on two elements: (1) when the plaintiff’s cause of action accrued (for the period cannot start prior to that time); and (2) whether the period begins before the plaintiff discovered or should have discovered the fraud.

State law establishes the standard for when a cause of action accrues, but federal law applies those criteria. For example, under New York law a claim arises when the plaintiff first becomes entitled to maintain the suit in question. Using that standard,

---

111 See Statutes Of Limitations, supra note 19, at 117; Schulman, supra note 61, at 649.
federal law then determines if the plaintiff has acquired sufficient rights to bring a 10b-5 action.\textsuperscript{116} For multi-stepped schemes, an integration concept sometimes governs the time of accrual. If one or more acts are part of a common plan,\textsuperscript{117} the statute does not commence until the scheme's last act is completed.\textsuperscript{118} On the other hand, the statute commences before the last action if the acts are a series of independent breaches or merely lull the plaintiff after the fraud.\textsuperscript{119}

Once a cause of action has accrued, federal law determines when the period begins to run.\textsuperscript{120} The general rule is that the temporal period, adopted from the forum's law, begins when the plaintiff knew or should have known of the fraud.\textsuperscript{121} This principle is sometimes called

\begin{footnotesize}
\textsuperscript{116} See id.
\textsuperscript{117} See A. Jacobs § 115.02.
\textsuperscript{119} See Parrent v. Midwest Rug Mills, Inc., 455 F.2d 123, 128 (7th Cir. 1972).
\textsuperscript{121} See Schaefer v. First Nat'l Bank, 509 F.2d 1287, 1295-96 (7th Cir. 1975), cert. denied, 96 S. Ct. 1682 (1976); Hochfelder v. Ernst & Ernst, 503 F.2d 1100, 1119 (7th Cir. 1974), rev'd on other grounds, 96 S. Ct. 1375 (1976); Hupp v. Gray, 500 F.2d 993, 996 (7th Cir. 1974); Dzenits v. Merritt Lynch, Pierce, Fenner & Smith, Inc., 494 F.2d 168, 171 (10th Cir. 1974) ("actual or constructive discovery of the fraud"); Johns Hopkins Univ. v. Hutton, 488 F.2d 912, 917 (4th Cir. 1973), modifying 343 F. Supp. 245 (D. Md. 1972), cert. denied, 416 U.S. 916 (1974) (actually discovered or should have discovered with reasonable diligence); United Cal. Bank v. Salik, 481 F.2d 1012, 1014 n.7, 1015 (9th Cir.), cert. denied, 414 U.S. 1004 (1973) ("the fraud is, or should be, discovered"); Parrent v. Midwest Rug Mills, Inc., 455 F.2d 123, 128 (7th Cir. 1972); Richardson v. MacArthur, 451 F.2d 35, 39 (10th Cir. 1971) (discovered or should have discovered fraud); Abousie v. Abousie, 441 F.2d 150, 156 (5th Cir. 1971) ("actual knowledge or notice of facts which in the exercise of due diligence would have led to actual knowledge"); Douglass v. Glenn E. Hinton Inv., Inc., 440 F.2d 912, 916 (9th Cir. 1971) (not "before the plaintiff reasonably could discover the violation"); Vanderboom v. Sexton, 422 F.2d 1233, 1240 (8th Cir. 1970) ("until the fraud is, or should be, discovered"); Saylor v. Lindsley, 391 F.2d 965, 970 (2d Cir. 1968) (discovered, or reasonably should have discovered, "the facts which give rise to the action"); Janigan v. Taylor, 344 F.2d 781, 784 (1st Cir.), cert. denied, 382 U.S. 879 (1965); Tobacco & Allied Stocks, Inc. v. Transamerica Corp., 244 F.2d 902, 903 (3d Cir. 1957) (discovered or could have discovered with due diligence), aff'd 143 F. Supp. 323,
the federal tolling doctrine. Because the doctrine delays all time periods, it lessens the forum shopping that stems from the variety of state-derived 10b-5 limitation periods. Even if the state statute specifies that the period commences on the date of the transaction, a judge in a 10b-5 case will apply the federal tolling doctrine while adopting the state’s statutory time period. This period therefore starts when the plaintiff knew or should have known of the fraud. However, when state law itself contains a tolling rule similar to the federal tolling doctrine, does state or federal law determine when the plaintiff knew or should have known of the fraud? Federal law should control this issue, although many cases hold differently.

The Supreme Court first announced the federal tolling doctrine in the 1875 bankruptcy case of Bailey v. Glover. The Court held that

where the party injured by the fraud remains in ignorance of it without any fault or want of diligence or care on his part, the bar of the statute does not begin to run until the fraud is discovered, though there be no special circumstances or efforts on the part of


126 88 U.S. 342 (1875).
the party committing the fraud to conceal it from the knowledge of the other party.

\[\ldots\]

\[\ldots\] When there has been no negligence or laches on the part of a plaintiff in coming to the knowledge of the fraud which is the foundation of the suit, and when the fraud has been concealed, or is of such a character as to conceal itself, the statute does not begin to run until the fraud is discovered by, or becomes known to, the party suing, or those in privity with him.\textsuperscript{127}

Based in part on this direction, most 10b-5 decisions permit a plaintiff to invoke the federal tolling doctrine even though the defendants did not actively or fraudulently conceal their acts.\textsuperscript{128} The minority and less well-reasoned view requires fraudulent or active concealment;\textsuperscript{129} proof of a 10b-5 breach does not ipso facto show such concealment.\textsuperscript{130} Under either approach, fraudulent and active concealment alone does not toll the statute.\textsuperscript{131} The federal tolling doctrine applies even if the state statute of limitations does not contain a tolling provision,\textsuperscript{132} and applies when federal common law or state law does not classify the activities that constitute a 10b-5 breach as fraud,\textsuperscript{133} the defendant is primarily or secondarily liable,\textsuperscript{134} or the limitations period is not adopted from the state statute.

\textsuperscript{127}Id. at 348-50 (footnote omitted).


\textsuperscript{132}See note 123 and accompanying text supra.

\textsuperscript{133}See Newburger, Loeb & Co. v. Gross, 365 F. Supp. 1364, 1373 (S.D.N.Y. 1973) (applies to actual fraud and constructive fraud). Contra, Schulman, supra note 61, at 639, 642 n.42 (toll only if fraud or active concealment; unclear if state or federal law determines existence of cause of action for fraud); Statutes Of Limitations, supra note 19, at 1161 (suit based on fraud or active concealment required).

\textsuperscript{134}See Schaefer v. First Nat'l Bank, 509 F.2d 1287, 1296 (7th Cir. 1975), cert. denied, 96 S. Ct. 1682 (1976); Hochfelder v. Ernst & Ernst, 503 F.2d 1100, 1119 (7th Cir. 1974), rev'd on other grounds, 96 S. Ct. 1375 (1976); Hochfelder v. Midwest Stock Exch., 503 F.2d 365, 375-76 (7th Cir. 1974).
for common-law fraud. The federal tolling doctrine is employed whether the Rule is considered legal or equitable.

A plaintiff "knows" of a fraud when he has actual knowledge (1) that the statements made were false, that material facts were omitted, or that other acts constituting a 10b-5 breach existed, and (2) that the defendant acted with the requisite degree of scienter. Actual knowledge of these facts is not enough if the plaintiff cannot perceive the fraud because he mistakenly believes other facts are true. However, the plaintiff need not realize the legal conclusion that the actions violated 10b-5. Unless the plaintiff admits knowledge or is shown to have received actual notice, a defendant as a practical matter will have great difficulty proving that the plaintiff "knew" of the facts.

 Authorities are split on whether a subjective or objective standard determines constructive knowledge (i.e., whether the plaintiff should have known of the fraud). Following a subjective approach, the better-reasoned cases impute constructive knowledge only if the particular plaintiff (with all his foibles and sophistication) should have known the facts. Other decisions adopt an objective standard, holding that a claimant has constructive knowledge if a reasonable man in his position should have known the facts, even though he is so naive or unsophisticated that he would not have discovered them.

---

135 See Douglass v. Glenn E. Hinton Inv., Inc., 440 F.2d 912, 916 (9th Cir. 1971). But see Schulman, supra note 61, at 642 (use federal tolling if fraud statute of limitations and affirmative concealment).


139 For convenience, the subjective approach is assumed correct in the rest of this section. Thus, when discussing due diligence, reference is made to the plaintiff rather than to a reasonable man.

140 Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 494 F.2d 168, 172 (10th Cir. 1974) ("plaintiff or a person in plaintiff's position"); Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1210 (9th Cir. 1970) (seems to use subjective standard); Vanderboom v. Sexton, 422 F.2d 1233, 1241 (8th Cir. 1970); Azalea Meats, Inc. v. Muscat, 386 F.2d 5, 10 (5th Cir. 1967) ("state of mind" of plaintiff); Maine v. Leonard, 365 F. Supp. 1277, 1282 (W.D. Va. 1973) (man of plaintiff's experience and sophistication); cf. Bahlman, supra note 11, at 774 n.192 (laches may bar sophisticated but not naive plaintiff).

Under both the subjective and the objective approach, a two-step process determines when a plaintiff "should have known" the facts:

First, whether the circumstances surrounding the sale of the stock and the knowledge available to [the plaintiff] were sufficient to put a man of his experience and sophistication on notice, or to raise the suspicion of fraud in his mind. Secondly, if the suspicion arose or should reasonably have arisen, whether [the plaintiff] exercised reasonable diligence under the circumstances to discover the alleged fraud.142

_Tobacco & Allied Stocks, Inc. v. Transamerica Corp.,_143 an early Delaware district court case, highlighted the difference in the quantum of proof required by each step:

What on the one hand is tantamount to an actual discovery of fraud should not be confused with what on the other carries a duty to investigate. It is impossible to lay down any general rule as to the amount of evidence or number or nature of evidential facts admitting discovery of fraud. But, facts in the sense of indisputable proof or any proof at all, are different from facts calculated to excite inquiry which impose a duty of reasonable diligence and which, if pursued, would disclose the fraud. Facts in the latter sense merely constitute objects of direct experience and, as such, may comprise rumors or vague charges if of sufficient substance to arouse suspicion.144

The initial stage of this two-step process analyzes whether the plaintiff acquired a suspicion of fraud. Suspicions arise only if the plaintiff has _actual_ knowledge of facts sufficient to put him on notice.

---


143 143 F. Supp. 323 (D. Del. 1956), _aff'd_, 244 F.2d 902 (3d Cir. 1957).

If suspicions are not aroused, the plaintiff has no duty to investigate, and the statute of limitations never begins to run under the constructive knowledge branch of the federal tolling doctrine. Once a suspicion of fraud arises, the second step of the analysis questions whether a plaintiff exercised reasonable diligence to uncover the fraud. When a plaintiff is not duly diligent, the statutory period commences at the time he would have discovered the facts with reasonable diligence. The period never begins, however, if the plaintiff could not have discovered the facts with due diligence, even though he may have exercised little or no diligence. In contrast, a plaintiff might earnestly try to investigate his suspicions. In that event, either the period commences when he discovers the facts, or the period never starts because the facts were not sufficiently discoverable.

The reasonableness of the plaintiff's investigation does not affect a determination of what facts he must discover before the statute begins to run. The requisite amount of proof has been expressed in different ways. Courts will not await leisurely discovery of the full details; the plaintiff must be aware of the acts constituting the 10b-5 breach and must know that the defendant acted with the necessary scienter; and the claimant must be able to recognize the fraud or at least its possibility.

146 As to whether the standard of diligence is "reasonableness" with respect to the individual plaintiff, or as to a reasonable man, see notes 134-36 and accompanying text supra.
148 See Mittendorf v. J.R. Williston & Beane Inc., 372 F. Supp. 821, 832 (S.D.N.Y. 1974) (date of actual discovery or date when should have been discovered with reasonable diligence); A. Jacobs § 63 n.45 (defendant's due diligence), § 64.01[b][ii] n.72 (plaintiff's subjective reliance), and accompanying texts; note 291 and accompanying text infra (estoppel). See also Morgan v. Koch, 419 F.2d 993, 998 (7th Cir. 1969), quoting Wood v. Carpenter, 101 U.S. (9 Otto) 135, 140, 143 (1879) ("There must be reasonable diligence; "the means of knowledge are the same thing in effect as knowledge itself.").
151 See note 147 and accompanying text supra.
152 See Klein v. Shields & Co., 470 F.2d 1344, 1347 (2d Cir. 1972); Mittendorf v. J.R.
Under either the objective or the subjective approach, the federal tolling doctrine bristles with fact issues. Did the plaintiff have actual knowledge of the facts? Were suspicions raised in his mind? Was he duly diligent? When did he discover sufficient facts to start the period running? Could he have discovered the facts with due diligence? A court will impute to a plaintiff the actual or constructive knowledge of his agent, even if the agent does not convey the facts to him.

A variety of factors weigh in determining whether a plaintiff held suspicions and made a duly diligent investigation. Among those factors which may apply in any one situation are: the plaintiff's

---


158 However, a reasonable man standard determines this issue for class actions. Seiffer v. Topsy's Int'l, Inc., 64 F.R.D. 714, 719 (D. Kan. 1974).

159 In re Alodex Corp. Sec. Litigation, 392 F. Supp. 672, 682 n.3 (S.D. Iowa 1975) (impute husband's knowledge to wife); Mittendorf v. J.R. Williston & Beane Inc., 372 F. Supp. 821, 830 (S.D.N.Y. 1974) ("plaintiff or his counsel"); see Bailey v. Glover, 88 U.S. 342, 350 (1875) ("the party suing, or those in privity with him"). As to the process and limitations of imputing knowledge, see A. JACOBS § 64.01[b][ii] n.59 (subjective reliance), § 118.01 nn.13-16 (deception in mismanagement cases) and accompanying texts.
sophistication;\footnote{160} his access to information;\footnote{161} the amount of money he invested;\footnote{162} his knowledge of related lawsuits;\footnote{163} any fiduciary relationship between plaintiff and defendant;\footnote{164} plaintiff's trust in defendant;\footnote{165} whether the corporation issued the misleading statement;\footnote{166} the nature of the fraud;\footnote{167} whether the acts constituting the breach were hidden or practiced convincingly;\footnote{168} how widely the offending acts were publicized;\footnote{169} plaintiff's opportunity to detect the fraud;\footnote{170} defendant's lulling activities;\footnote{171} and position in the


\footnote{161} See A. Jacobs \textsection 64.01[b][ii] n.27 and accompanying text (subjective reliance).

\footnote{162} See id. \textsection 64.01[b][iii] n.35 and accompanying text (subjective reliance).


\footnote{166} deHaas v. Empire Petroleum Co., 435 F.2d 1223, 1227 (10th Cir. 1970) (corporate statement requires less due diligence).

\footnote{167} Hupp v. Gray, 500 F.2d 993, 997 (7th Cir. 1974); Morgan v. Koch, 419 F.2d 993, 997 (7th Cir. 1969).


\footnote{169} Morgan v. Koch, 419 F.2d 993, 998 (7th Cir. 1969); Azalea Meats, Inc. v. Muscat, 386 F.2d 5, 9 (5th Cir. 1967).


\footnote{171} Hupp v. Gray, 500 F.2d 993, 997 (7th Cir. 1974); Errion v. Connell, 236 F.2d 447, 455-56 (9th Cir. 1956); Batchelor v. Legg & Co., 55 F.R.D. 557, 563 (D. Md. 1972). Factors occurring after the breach can determine whether suspicions were raised or the plaintiff was duly diligent. But none of this permits a plaintiff to prosecute a suit if the statutory period ran before the lulling activities commenced. Cf. Livens v. William D. Witter, Inc., 374 F. Supp. 1104, 1108 (D. Mass. 1974) (1933 Act §§ 5, 13).
industry.\textsuperscript{172} Some of these factors are considered when a plaintiff proves subjective reliance\textsuperscript{173} or a defendant demonstrates due diligence.\textsuperscript{174} But the due diligence that the federal tolling doctrine requires of the plaintiff is a different concept. Authorities dealing with the other two issues therefore do not control the commencement of the limitations period.

The plaintiff has the burden of proving that his actions satisfy the federal tolling doctrine.\textsuperscript{175} Nonetheless, the better-reasoned cases do not require a complaint to assert that the plaintiff was duly diligent or to set forth the time and circumstances of the discovery of fraud.\textsuperscript{176}

In a multi-defendant suit, the time period as to each particular defendant begins when the plaintiff discovers facts relating to that defendant. Consequently, the limitations period for one defendant may expire before the period for other defendants.\textsuperscript{177} The federal tolling doctrine does not delay the statute of limitations for pendent state claims.\textsuperscript{178}

C. Tolling the Statute of Limitations

Certain events toll the statute of limitations. The period does not start to run if one of these events exists when the statute would

\textsuperscript{173} See A. JACOBS § 64.01[b][ii] nn.24-42, 73 and accompanying text.
\textsuperscript{174} See id. at § 63 nn.43-44 and accompanying text.
\textsuperscript{177} Schaefer v. First Nat'l Bank, 509 F.2d 1287, 1298 (7th Cir. 1975), cert. denied, 96 S. Ct. 1682 (1976).
otherwise commence. If such an event happens after the period begins, the period is suspended for the duration of the event. For example, filing a class action suspends the limitations period while that suit is pending.\(^7\) Thus, if a purported class action is filed on January 2 and the court decides on the following October 2 not to certify that class, the intervening period extends the time during which members of the purported class must bring suit.\(^8\) Instituting a class action does not toll the period for, or resurrect the claims of, those class members whom the statute of limitations had barred when the complaint was filed.\(^9\) A plaintiff’s individual suit brought in state court does not toll the period.\(^1\) 2

Section 11(e) of the Bankruptcy Act\(^1\) 3 provides another type of tolling. That section permits a trustee in bankruptcy to sue on any cause of action existing when the petition in bankruptcy was filed, as long as the suit is commenced within two years from the date of adjudication.\(^1\) 4 The statutory period is also tolled while the wrongdoers adversely dominate a defrauded corporation.\(^1\) 5

The plaintiff and defendant may contractually agree to extend the period of limitations. Tolling agreements are usually executed when the statute is about to expire and the parties are negotiating


\(^{182}\) Sackett v. Beaman, 399 F.2d 884, 892 (9th Cir. 1968); see Vanderboom v. Sexton, 422 F.2d 1233, 1241 (8th Cir. 1970).


\(^{184}\) Bailes v. Colonial Press, Inc., 444 F.2d 1241, 1247 (5th Cir. 1971); Hooper v. Mountain States Sec. Corp., 282 F.2d 195, 205-06 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961); Carpenter v. Hall, 311 F. Supp. 1099, 1106-07 (S.D. Tex. 1970). The two year period does not run until the fraud was or should have been discovered. Hooper v. Mountain States Sec. Corp., 282 F.2d 195, 206.

settled. Tolling agreements should be valid,\textsuperscript{186} although in a different context the Supreme Court has cast some doubt on their enforceability.\textsuperscript{187}

Every 10b-5 case involving the statute of limitations poses the issue of whether commencement of the suit stops the limitations period. This is an issue of federal law. Under the Federal Rules of Civil Procedure, the plaintiff need only file the complaint within the period, even though he does not serve one or more defendants before the period expires.\textsuperscript{188} Federal law also governs counterclaims and relation-back of amendments to the original complaint.\textsuperscript{189}

II

LACHES

The Ninth Circuit, in \textit{Hecht v. Harris, Upham & Co.},\textsuperscript{190} described the affirmative defense of laches as

(1) a lack of diligence by the party against whom the defense is asserted, and (2) prejudice to the party asserting the defense. . . . Where these elements are present, the damage to the party asserting the defense is caused by his detrimental reliance on his adversary's conduct.\textsuperscript{191}


\textsuperscript{187} Midstate Horticultural Co. v. Pennsylvania R.R., 320 U.S. 356, 356-67 (1943) (express agreement made before period ends cannot waive statute of limitations built into cause of action under Interstate Commerce Act (49 U.S.C. § 16(3)(a) (1970)); running of period extinguishes right). The case is distinguishable because the limitation period was provided by federal statute and the remedy in question was express rather than implied.


\textsuperscript{190} 430 F.2d 1202, 1208 (9th Cir. 1970).

\textsuperscript{191} Id. at 1208; \textit{accord}, Royal Air Props., Inc. v. Smith, 333 F.2d 568, 570 (9th Cir. 1964) ("must show that the delay of the other party has resulted in a disadvantage to him"); Tobacco & Allied Stocks, Inc. v. Transamerica Corp., 244 F.2d 902, 904 (3d Cir. 1957) (delay plus prejudice), affg 143 F. Supp. 323, 328 (D. Del. 1956) (need more than mere lapse of time; inexcusable delay plus resulting prejudice, as viewed by court); Goodman v. Poland, 395 F. Supp. 660, 677-78 (D. Md. 1975) (unreasonable or inexcusable delay plus prejudice); Gordon v. Burr, 356 F. Supp. 156, 171 (S.D.N.Y. 1973) (lack of diligence and resulting prejudice); Popkin v. Wheelabrator-Frye, Inc., [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,091, at 94,371 (S.D.N.Y. 1973) (lack of diligence and prejudice); Cohen v. Franchard Corp., 51
Laches developed in common-law equity courts, partly because the statute of limitations did not bar equitable claims. With both legal and equitable aspects, a 10b-5 suit is barred either by laches, by the statutes of limitations, or by both defenses. However, laches is applicable solely in 10b-5 cases requesting equitable relief. Laches may therefore preclude a plaintiff from obtaining relief.


The topic of the statute of limitations is treated in Part I supra.

See A. Jacobs § 14 nn.21-27 and accompanying text.


A split of authority has developed as to the applicability of laches when rescission is sought under § 29(b) of the 1934 Act. The better-reasoned cases permit the defense. Guarantee Ins. Agency Co. v. Mid-Continental Realty Corp., 57 F.R.D. 555, 562 (N.D. Ill. 1972). Some cases would not apply laches if the complaint seeks equitable relief as an alternative to legal remedies. Morgan v. Koch, 419 F.2d 993, 996 (7th Cir. 1969); Myzel v. Fields, 386 F.2d 718, 742 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968). Other sub silentio do not concur. See notes 197-200 and accompanying text infra.
an equitable remedy such as rescission,\textsuperscript{197} although he might still recover under the legal remedy of damages.\textsuperscript{198} As a corollary, only those defendants capable of supplying equitable relief can successfully assert laches.\textsuperscript{199} Suppose the plaintiff seeks rescission and damages in a multi-defendant suit arising from the sale of a private company. If only the defendant who traded with the plaintiff can satisfy the judgment ordering rescission,\textsuperscript{200} he alone can invoke laches to defeat the complaint’s rescissional claims. One rationale for the application of laches is that the Rule is designed to protect innocent claimants, not those who lose their innocence by acting with less than due diligence.\textsuperscript{201} Laches is not a defense in criminal actions\textsuperscript{202} or in suits instituted by the SEC, even when the Commission seeks equitable ancillary relief.\textsuperscript{203}

Laches differs from other 10b-5 defenses.\textsuperscript{204} Waiver contemplates “the voluntary or intentional relinquishment of a known right.”\textsuperscript{205} Ratification is similar to waiver,\textsuperscript{206} in that it requires voluntary or intentional actions. Laches is distinguishable from both waiver and ratification because rights can be lost unintentionally. \textit{In pari delicto} precludes one of equal fault from obtaining any recovery.\textsuperscript{207} Laches is narrower in that it precludes only equitable relief,

\textsuperscript{197} The classic legal remedy is damages. Equitable remedies include appointing a receiver; rescinding a trade, a merger, a stockholders vote, or another transaction; and enjoining the use of fraudulently solicited proxies, the holding of a stockholders meeting, the completion of another act, or another violation of 10b-5.

\textsuperscript{198} Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1306 n.27 (2d Cir. 1973) (dictum); Johns Hopkins Univ. v. Hutton, 488 F.2d 912, 916 n.12 (4th Cir. 1973); Baumel v. Rosen, 412 F.2d 571, 574-75 (4th Cir. 1969) (granting damage recovery). \textit{See also} D. Dobbs, supra note 193, § 2.4, at 45 (laches may constitute defense to all rights, or may preclude equitable relief while permitting legal remedies).


\textsuperscript{200} As to the validity of this condition, see Gordon v. Burr, 506 F.2d 1080, 1083 (2d Cir. 1974).


\textsuperscript{202} This is not to say that a delay in bringing a case to trial is permissible under principles of criminal law.

\textsuperscript{203} \textit{Cf.} note 22 and accompanying text \textit{supra}.

\textsuperscript{204} For a comparison of laches with estoppel and statutes of limitation, see text accompanying note 297 \textit{infra} (estoppel) and notes 194-98 and accompanying text \textit{supra} (statute of limitations).

\textsuperscript{205} \textit{See} part III A \textit{infra}.

\textsuperscript{206} \textit{See} notes 323-24 and accompanying text \textit{infra}.

\textsuperscript{207} \textit{See} part IV A \textit{infra}.
but is broader in that a defendant can establish the defense even though the plaintiff was not as guilty. A defendant can use unclean hands as an affirmative defense if the plaintiff engaged in unlawful or inequitable conduct arising out of the matter in controversy.\(^\text{208}\) Laches has a lower threshold since it can bar a plaintiff who merely delays; he need not participate in the scheme.

Laches is discretionary with the trial judge.\(^\text{209}\) Set by federal law,\(^\text{210}\) its two elements each raise questions of fact.\(^\text{211}\) The first element, lack of diligence, can be shown even if the applicable statute of limitations has not run.\(^\text{212}\) It is measured by the period between the time the plaintiff "discovered" the fraud and the time he sued, except in rescission actions. There the period is between such "discovery" and the earlier of the time the plaintiff disclaimed the sale and the time he tendered to the defendant the security or payment for the security.\(^\text{213}\) The federal tolling doctrine governs the time a plaintiff is deemed to "discover" the fraud.\(^\text{214}\) In other words,

\(^{208}\) See part IV B infra.

\(^{209}\) Tobacco & Allied Stocks, Inc. v. Transamerica Corp., 244 F.2d 902, 904 (3d Cir. 1957).

\(^{210}\) See note 191 and accompanying text supra.


\(^{214}\) Vanderboom v. Sexton, 422 F.2d 1233, 1240 (8th Cir. 1970); Tobacco & Allied
this doctrine determines both when the statutory period of limitations commences and the beginning of the plaintiff's delay under laches. Both periods start either when the plaintiff has actual knowledge of the fraud or when he should have discovered the fraud with due diligence after receiving notice of facts arousing his suspicions. Those events that suspend the statute of limitations have a similar application to laches.

Prejudice to the party raising the defense is the second element of laches. Rule 10b-5 cases have not fully explored either the acts that constitute prejudice or the requisite degree of prejudice. Common law and blue sky authorities treating prejudice are not controlling, for the policies underlying 10b-5 and its remedial nature suggest that laches is a narrower defense in a 10b-5 context. Prejudice under the Rule could arise if the defendant either acted or forebore from acting after the plaintiff "discovered" the fraud, if third parties' rights arose after "discovery" of the 10b-5 violation, if principal witnesses died or their memories dimmed, or if stock prices moved subsequent to the plaintiff's "discovery." The necessary degree of prejudice should vary with the facts involved and the relief sought. A more stringent remedy (such as rescission) should be barred by a smaller degree of prejudice than less radical relief.
To secure rescission or rescissional damages, a plaintiff must act promptly once he receives notice of the fraud. Although prompt action is required even if the defendant cannot show prejudice, prejudice is an element in determining how quickly the plaintiff must act. The same principles regarding unreasonable delay govern both laches and rescission.

III
WAIVER, ESTOPPEL, AND RATIFICATION

The defenses of waiver, estoppel, and ratification are recognized by the common law. Such a recognition, however, does not compel their availability to 10b-5 defendants.

A. Waiver

The Ninth Circuit defines waiver as

"the voluntary or intentional relinquishment of a known right. It emphasizes the mental attitude of the actor." Since waiver is a voluntary act, there must be knowledge of the right in question before the act of relinquishment can occur.

---


If a plaintiff loses his right to rescind under 10b-5, he also loses his right to rescind under section 29(b) of the 1934 Act. Occidental Life Ins. Co. v. Pat Ryan & Assoc., Inc., 496 F.2d at 1267-68 n.9.


226 E.g., Goodman v. Poland, 395 F. Supp. 660, 677-78 (D. Md. 1975) (finding of no unreasonable delay for rescission also controls for laches). Therefore rescission cases are freely cited in this discussion of laches.

227 Royal Air Props., Inc. v. Smith, 333 F.2d 568, 571 (9th Cir. 1964), citing Matsuo Yoshida v. Liberty Mut. Ins. Co., 240 F.2d 824, 829 (9th Cir. 1957); accord, Metro-Goldwyn-Mayer, Inc. v. Ross, 509 F.2d 930, 933 n.3 (2d Cir. 1974) (necessarily intentional); Fey v.
Judicial hostility to waiver of 10b-5 rights requires courts to investigate scrupulously whether the relinquishment was intentional or voluntary. Authorities disagree on what degree of knowledge a plaintiff must have of rights before he can waive them. Some courts correctly hold that only actual knowledge of the right will suffice. The opposing view requires either actual knowledge or knowledge a plaintiff would obtain after a reasonable investigation. If courts impose on plaintiffs a duty to conduct a reasonable investigation, the scope of such knowledge should rest on a subjective standard. Thus a plaintiff may have constructive knowledge of a right under one set of facts, while such knowledge might not be imputed to another plaintiff under the same facts, or to the same plaintiff under different facts. Courts adopting the "reasonable-investigation" approach should use the following factors, among others, to determine the extent of a plaintiff's diligence: the plaintiff's general business experience or sophistication; his familiarity with the corporation's affairs; his access to information; his opportunity to detect the fraud; whether he was investing a large amount of money; whether he

---


229 Andrews v. Blue, 489 F.2d 367, 375 (10th Cir. 1973) (full knowledge); Royal Air Props., Inc. v. Smith, 333 F.2d 568, 571 (9th Cir. 1964); Childs v. RIC Group, Inc., 391 F. Supp. 1078, 1083 (N.D. Ga. 1970), aff'd per curiam, 447 F.2d 1407 (5th Cir. 1971) ("actually known").


231 The proper measurement should relate to the percentage of the plaintiff's net worth involved, rather than the number of dollars invested.
put his trust in the defendant's advice; and whether the defendant was a fiduciary or occupied a position of trust and confidence.²³²

The legislative and administrative histories of 10b-5 do not indicate when defendants can assert a waiver defense.²³³ However, section 29(a) of the Exchange Act is germane:

> Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void.²³⁴

Rule 10b-5's remedial nature,²³⁵ and its underlying policies of protecting investors and fostering their trust,²³⁶ suggest that waiver should not be a defense.²³⁷ These policies also indicate that if waiver is ever a 10b-5 defense, its availability should be limited to the narrowest common-law construction.²³⁸

The recognition of waiver as a defense to a 10b-5 suit is a question of federal law.²³⁹ The Supreme Court examined this issue in two opinions involving the question of 10b-5's arbitrability. Arbitrability is closely related to the waiver defense, because both rest in part on section 29(a). In Wilko v. Swan,²⁴⁰ the Court held that section 14 of the 1933 Act²⁴¹ precludes a plaintiff from agreeing to arbitrate

²³² See A. Jacobs § 64.01(b)(ii) nn.24-42 and accompanying text (subjective reliance).
²³³ Note, supra note 8, at 1477-78. See generally A. Jacobs §§ 5.01-.02 (legislative and administrative histories of Rule). The absence of authority is not surprising, since 10b-5 is an implied remedy.
²³⁵ See A. Jacobs § 7 nn.8-9 and accompanying text.
²³⁶ See id. §§ 6.06-08.
²³⁷ These policies alone justify the rejection of the waiver defense. Note, supra note 234, at 500 n.9 (suggesting that waiver is a contract notion and should be limited to face-to-face transactions).
²³⁸ Bell, supra note 11, at 5.

> Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regula-
future Securities Act claims, since section 14 prohibits waivers of stipulations, and an agreement to arbitrate is a "stipulation." Twenty-one years later, in Scherk v. Alberto-Culver Co., the Court decided that the 1934 Act does not prohibit two sophisticated parties engaged in an international transaction from agreeing to arbitrate future controversies before the International Chamber of Commerce in Paris. This case is correctly construed to create a narrow exception only for international transactions. The Supreme Court decisions can be synthesized: an agreement to arbitrate future claims under the 1933 or 1934 Acts is a stipulation which waives compliance with the Acts and is therefore voidable, except in transactions where principles of international law override the nonwaiver provisions of the two Acts.

Lower courts have not permitted a plaintiff to waive a 10b-5 right before the right matures or before he knows it exists. However, a plaintiff may waive a matured 10b-5 right if he knows the facts. A matured right is one that arose in the past—i.e., the...
plaintiff waived the right after the 10b-5 breach occurred.\textsuperscript{247} One court justified waivers of matured claims by opining that

\[\text{[t]he purpose of the Securities Exchange Act is to protect the}\]

\[\text{innocent investor, not one who loses his innocence and then waits}\]

\[\text{to see how his investment turns out before he decides to invoke}\]

\[\text{the provisions of the Act}.\textsuperscript{248}\]

Despite the general rule that matured claims can be waived, courts will not enforce a waiver which continues a 10b-5 violation.\textsuperscript{249} Thus a voluntary settlement of a case is unenforceable if the terms of the settlement require (or perhaps permit) the continuation of the actionable manipulation attacked in the complaint.

A wide variety of future, or unmatured, claims cannot be waived. The most obvious is a plaintiff's agreement, in a contract for the purchase or sale of a security, to waive his rights under the Rule or to refrain from suing for any related 10b-5 breach.\textsuperscript{250} Clearly, a plaintiff cannot waive rights about which he is ignorant by delivering a general or a specific release when he contracts to buy or sell a security, when the transaction is consummated, or at any time thereafter.\textsuperscript{251} More subtle types of waivers are also barred. Thus a


plaintiff does not waive his rights if a contract for the purchase or sale of a security provides that: he obtained all relevant information; the plaintiff is fully familiar with the business, is not relying on the defendants' duty to disclose, and has made all necessary investigations; all representations are contained in the contract; the defendant makes no representation; or no representation survives the closing. Courts will admit parol evidence to refute contractual waivers. In addition, a claimant cannot waive any remedy that arises out of an unmatured claim. For example, it is unenforceable to limit contractually the plaintiff's right to offset against the note that the defendant received from the plaintiff. A procedural obstacle—such as a requirement for posting bond or a short statute of limitations contained in a contract—cannot be imposed on rights arising from unmatured claims. Asking for, but not insisting on, a contractual representation during negotiations does not establish a waiver.

Nevertheless, courts have found a waiver when: the plaintiff executed a stipulation settling a suit or a claim; a release was given after litigation commenced; or a customer of a broker-dealer

252 Stier v. Smith, 473 F.2d 1205, 1208 n.8 (5th Cir. 1973) (plaintiff represented that he received all information necessary to make decision); Note, supra note 234, at 505-06.
255 Adelman v. CGS Scientific Corp., 332 F. Supp. 137, 140 (E.D. Pa. 1971). Nor is it sufficient to state in a contract that the plaintiff will be supplied with whatever information he desires. See A. Jacons, § 64.04 n.4 and accompanying text. See also Note, supra note 234, at 506-07 (type of impermissible waiver).
256 Lockwood, supra note 118, at 373-74.
259 Note, supra note 294, at 515-16.
received confirmations after churning took place. Moreover, a plaintiff who, with full knowledge of the facts, obtains a judgment affirming a contract, waives his right to sue for damages in a later action.

Cases assessing waiver have limited precedential value, since the presence of waiver is a question of fact. A plaintiff can nullify his waiver if it was obtained by fraud. A waiver can be binding even though it is given for no consideration. A waiver by some members of a class binds only those members and not other class members.

A plaintiff's actions may bar him from obtaining a form of equitable relief, such as rescission or an injunction. The defense of waiver is different. It precludes all types of recoveries. The ability to prohibit equitable relief is less drastic, since a plaintiff who is prevented from obtaining rescission (for example) may be able to recover damages.

Section 29(a) of the Exchange Act and its policy considerations do not limit waivers of unmatured common-law claims that are pendent to a 10b-5 cause of action. Thus, a contractual waiver operates against unmatured common-law claims (absent some other public policy precluding the waiver), although it has no force regarding the 10b-5 cause of action.
Waiver has been confused with the in pari delicto and unclean hands defenses. For example, a party's guilt is sometimes said to constitute a waiver. Waiver must also be distinguished from disclosure and curing. A defendant can cure a prior misstatement or omission by making full disclosure before the plaintiff is committed to act. The defendant thus avoids breaching 10b-5. If the plaintiff waives his rights after the defendant has violated 10b-5, the defendant's affirmative defense of waiver precludes the plaintiff from recovering.

B. Estoppel

Estoppel is a recognized defense to a 10b-5 cause of action. Although the 10b-5 cases have not explored the parameters of estoppel in depth, common-law authorities and 10b-5 itself yield some conclusions.

The Ninth Circuit has recognized four necessary elements of an estoppel defense.

1. The party to be estopped must know the facts;
2. he must and if the clause is against public policy as to the 10b-5 portion, must the whole provision fall? Apparently no reported case has considered this question.
3. E.g., Can-Am Petroleum Co. v. Beck, 331 F.2d 371, 373 (10th Cir. 1964); Eyman v. Marsh Dev. Corp., 301 F. Supp. 931, 934 (E.D. Mo. 1969), citing Can-Am Petroleum Co., supra ("one party's own culpability does not waive or bar his action where the other party is more culpable").
4. See A. Jacobs § 64.04.

Estoppel is available both against aiders and abettors, and against primarily liable actors. See Hochfelder v. Ernst & Ernst, 503 F.2d 1100, 1118 (7th Cir. 1974), rev'd on other grounds, 96 S. Ct. 1375 (1976). But it is not recognized as a defense to a claim under § 16(b) of the 1934 Act. See A. Jacobs § 3.02[g] n.29 and accompanying text. Those cases are not apt in a 10b-5 context, however, since different policies underlie 10b-5 and § 16(b). To the same effect, see id. at §§ 3.01[c] n.16 (1933 Act § 12(1)) and 3.02[b] n.33 (margin rules), and accompanying text. The Rule's sparse legislative and administrative history sheds no light on the availability of estoppel as a defense. Note, supra note 234, at 503 n.20.

Estoppel is limited to early cases. Note, supra note 234, at 503 n.20.
intend that his conduct shall be acted on or must so act that the party asserting the estoppel has a right to believe it is so intended; (3) the latter must be ignorant of the true facts; and (4) he must rely on the former's conduct to his injury.\textsuperscript{278}

Examining these four elements is the best way to explore the scope of estoppel.

The first element requires the plaintiff to "know the facts."\textsuperscript{279} The word "know" clearly includes actual knowledge. Many courts also impose on plaintiffs a due diligence obligation to ascertain the facts.\textsuperscript{280} Plaintiffs are therefore estopped if they knew or should have known the facts.\textsuperscript{281} A plaintiff must know those "facts" that comprise the data on which the defendant relies to his injury.\textsuperscript{282} For instance, a plaintiff must know that his statement is wrong if he is to be estopped from denying its truth. The facts a plaintiff must know might consist of an inaction, as when a customer, after receiving without objection confirmation slips from his broker, charges that his account was churned. The customer knew the "fact" that he objected to the churning. A plaintiff adequately knows the facts if he has knowledge when he makes a statement, takes an action, or remains silent despite a duty to disclose. Estoppel should also be available when the plaintiff acquires knowledge thereafter but before the defendant is irrevocably bound to an

\textsuperscript{278} Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1208 (9th Cir. 1970), quoting Hampton v. Paramount Pictures Corp., 279 F.2d 100, 104 (9th Cir. 1960). This is equitable estoppel (also called estoppel in pais) under common law. The other two common law estoppels are estoppel by record and estoppel by deed. 28 AM. JUR. 2d Estoppel and Waiver § 1, at 600 (1966).

\textsuperscript{279} Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1208 (9th Cir. 1970), quoting Hampton v. Paramount Picture Corp., 279 F.2d 100, 104 (9th Cir. 1960).


The cases do not concentrate on whether the due diligence standard looks to the plaintiff's individual foibles and sophistication (a subjective standard) or on what a reasonable man would learn (an objective standard). A subjective standard should be used.

\textsuperscript{281} Estoppel exists under common law even if the plaintiff believes his statement is true, he was not negligent in obtaining facts, or he stated something other than what he intended. RESTATEMENT OF TORTS, Explanatory Notes § 894, comment b at 503 (1939).

\textsuperscript{282} See Hampton v. Paramount Pictures Corp., 279 F.2d 100, 104-05 (9th Cir. 1960), quoted in Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1208 (9th Cir. 1970). See also California State Bd. of Equalization v. Coast Radio Prods., 228 F.2d 520, 525 (9th Cir. 1955) (relied on by Hampton, supra). But see Royal Air Props., Inc. v. Smith, 333 F.2d 568, 571 (9th Cir. 1964) ("diligence in discovering his rights").
action that injures him, at least if the plaintiff has a continuing duty to correct the misleading impression.  

The second element of estoppel in the Ninth Circuit requires that the plaintiff "intend that his conduct shall be acted on or must so act that the party asserting the estoppel has a right to believe it is so intended." The first prong of this element—that the plaintiff intend that his conduct be acted on—focuses on the plaintiff's subjective intent. However, the outward appearance of the plaintiff's actions measures his subjective intent unless he admits that he intended the defendant to act on that conduct. The subjective prong of this element therefore rarely has any practical weight. Courts usually employ the objective second half—that the defendant has a right to believe it is so intended. It applies if the defendant reasonably believes that the plaintiff intended him to act on the plaintiff's conduct. This "conduct" could consist of oral or written statements, actions, or silence when a duty to speak exists.

The third element of the Ninth Circuit's formulation is that the defendant "must be ignorant of the true facts." This wording appears to require actual knowledge by the defendant. But the better-reasoned authorities demand that defendants exercise due diligence to learn the true facts. A defendant who fails to meet that requirement cannot use estoppel as a defense, unless the plaintiff's acts were more than negligent, or perhaps unless the defendant...
dant would not have learned the truth after a reasonable investigation. Although 10b-5 cases supply little guidance, the "true facts" are those on which the defendant relies. This follows, in part, from the first case to espouse the Ninth Circuit's definition of estoppel. That case, which did not involve the securities law, adopted the definition in the context of a plaintiff's concealment or misstatement. The "true facts" in that situation are readily discerned. However, "true facts" are not as easy to identify in some 10b-5 cases. When a customer charges that his account was churned after receiving, without objection, the confirmation slip, the "true fact" is that the customer-plaintiff objected to the volume of trading in his account. The broker-dealer is ignorant of this fact because the customer never conveyed his dissatisfaction.

Under the last element of estoppel, the defendant "must rely on the [plaintiff's] conduct to [the defendant's] injury." Even though the requisite reliance has not been definitively charted, an appropriate analogy is to the kind of reliance by plaintiffs required to prove a cause of action. Nor has the form of injury been explored in depth. Sufficient injury should exist if a defendant changes position or continues a course of conduct that he would have stopped but for plaintiff's actions or inactions.  

In contrast to laches, which only precludes equitable remedies, estoppel bars all relief in a private right of action. The defenses of estoppel and waiver are sometimes confused. The defenses of estoppel and waiver are sometimes confused.

---

291 See A. Jacobs §§ 63 n.5, 64.01[b][ii] n.72, 235.03 n.36 and accompanying text (same point valid for defendant's due diligence under scienter, plaintiff's due diligence under subjective reliance, and plaintiff's due diligence under federal tolling doctrine (see notes 120-78 and accompanying text)).

292 California State Bd. of Equalization v. Coast Radio Prods., 228 F.2d 520, 525 (9th Cir. 1955).

293 Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1208 (9th Cir. 1970), quoting Hampton v. Paramount Pictures Corp., 279 F.2d 100, 104 (9th Cir. 1960). See A. Jacobs § 64.01. See also 28 Am. Jur. 2d Estoppel and Waiver § 35, at 641 (1966) (need good faith reliance); Restatement of Torts § 894, at 502 (1959) (reasonable reliance needed); Note, supra note 8, at 1477 n.7, 1486 (reasonable reliance; "reasonable man in the defendant's position"). This ties into—but is different from—the defendant's due diligence. See note 289 and accompanying text supra. As to differences between the concepts, compare A. Jacobs § 64.01[b][ii] (plaintiff's subjective reliance and due diligence), with id. at § 64.01[b][iii] (plaintiff's reasonable reliance).


296 Cf. 28 Am. Jur. 2d Estoppel and Waiver § 35, at 641 (1966) (common law; "action or inaction").

297 See notes 196-98 and accompanying text supra.

essence of waiver is a voluntary or intentional relinquishment of a right; hence, the defense rests on the plaintiff's intention. On the other hand, estoppel occurs when the defendant detrimentally relies on the plaintiff's acts or silence. Because a defendant can base estoppel on his reaction to the plaintiff's conduct, a plaintiff may be bound regardless of his intent. Estoppel is not the same as disclosure and curing. Before a breach occurs, a defendant can cure any prior misinformation by making adequate disclosure to the plaintiff. Estoppel focuses on the plaintiff's conduct after his breach and the defendant's detrimental reliance.

Because estoppel is a question of fact, prior opinions have limited precedential utility in defining what actions constitute an estoppel. Few cases decide whether a set of acts estops a plaintiff in a 10b-5 action. Authorities interpreting blue sky laws or the common law are not controlling, since actions which estop a plaintiff in those cases may be insufficient to estop him in a 10b-5 action. This derives in part from the Rule's remedial nature and its underlying policy of protecting investors and fostering their trust. These policy considerations have no force against pendent claims, however. A court may therefore find that a plaintiff's actions are sufficiently serious to estop him from asserting his pendent claims but not his 10b-5 cause of action. In contrast to private action, estoppel will not operate against a suit by the Commission or in a criminal action.

Subject to the above qualifications, the estoppel defense has succeeded when: the plaintiff-buyer refused both the defendant-seller's demand for securities and his tender of the proper measure of damages; a broker's customer received confirmations for twenty-two months during which he believed his account was

299 As to disclosure and curing, see A. Jacobs § 64.04.
301 The variation in fact patterns is one reason blue sky and common law cases are not uniform in determining whether the defendant should rely. Note, supra note 8, at 1486.
302 See Bell, supra note 11, at 5.
303 See A. Jacobs § 7 n.8 and accompanying text.
304 See id. §§ 6.06, 6.08.
churned;\textsuperscript{307} for five to seven months a customer received confirmations indicating that his broker did not execute his orders;\textsuperscript{308} a plaintiff brought a state court action to affirm a contract and then sued under 10b-5 to disaffirm it;\textsuperscript{309} and a plaintiff assumed control of the corporation after knowing it defrauded him.\textsuperscript{310} Estoppel does not operate in a 10b-5 suit when plaintiff-customers, who were not sent confirmations by the broker-dealer's accountant, failed to inform those accountants of a fraud.\textsuperscript{311} Nor is a plaintiff estopped merely because he gave proxies,\textsuperscript{312} accepted dividends,\textsuperscript{313} attended stockholders' meetings,\textsuperscript{314} or was the defendant's fiduciary.\textsuperscript{315} Similarly, a defendant is not estopped from raising an affirmative defense solely because he was the plaintiff's fiduciary.\textsuperscript{316}

C. Ratification

Ratification validates a prior act.\textsuperscript{317} Whether ratification has occurred is a question of fact.\textsuperscript{318} It arises as a 10b-5 defense in two distinct factual settings. First, a corporation's stockholders or its directors may ratify the mismanagement aspects of a 10b-5 violation.\textsuperscript{319} In the second type of ratification, a plaintiff voluntarily or intentionally approves or confirms prior conduct with full knowledge of the facts.\textsuperscript{320} This defense has been recognized under 10b-5


\textsuperscript{310} Note, supra note 8, at 1486.

\textsuperscript{311} Hochfelder v. Ernst & Ernst, 503 F.2d 1100, 1118 n.24 (7th Cir. 1974), rev'd on other grounds, 96 S. Ct. 1375 (1976).

\textsuperscript{312} Note, supra note 8, at 1486.

\textsuperscript{313} Id. at 1486. See also Metro-Goldwyn-Mayer, Inc. v. Ross, 509 F.2d 930, 933 n.3 (2d Cir. 1975) (plaintiff does not waive right to rescind by paying dividends on stock issued to defendants in fraudulent acquisition).

\textsuperscript{314} Note, supra note 8, at 1486.

\textsuperscript{315} See Tobacco & Allied Stocks, Inc. v. Transamerica Corp., 143 F. Supp. 323, 329 (D. Del. 1956), aff'd, 244 F.2d 902 (3d Cir. 1957) (defendant not estopped to assert affirmative defense).

\textsuperscript{316} Id.


\textsuperscript{318} Id. at 839.

\textsuperscript{319} See A. Jacobs § 121.03.

\textsuperscript{320} This principle was established at common law. 17 Am. Jur. 2d Contracts § 7, at 342 (1964); 28 Am. Jur. 2d Waiver and Estoppel § 31, at 635 n.6 (1966); 17 C.J.S. Contracts § 10, at 587-88 (1963); 31 C.J.S. Estoppel § 61, at 385 (1964); 75 C.J.S. 608-09 (1952) (ratification).
when a brokerage customer continued doing business after receiving confirmation slips that revealed prior violations and when a plaintiff sued to affirm a contract in state court.

Waiver is the intentional relinquishment of a known right. Ratification approves a prior act, and hence gives the act validity. The consequences of these two defenses are similar, since relinquishing a known right gives validity to the prior act, and approving a prior act operates to relinquish a known right. Estoppel is quite different. Its essence is in having induced another to act to his prejudice; a plaintiff can be estopped even if he does not intend to be. On the other hand, a plaintiff must intend to ratify an action.

IV

IN PARI DELICTO AND UNCLEAN HANDS

The next two defenses discussed—in pari delicto and unclean hands—bar recovery for plaintiffs who are sufficiently involved in the 10b-5 breach.

A. In Pari Delicto

In pari delicto literally means "of equal fault." Accepted as a defense in some 10b-5 cases, it has traditionally been a defense to actions at law. In pari delicto bars recovery of all relief in private damage actions, but plays no role when the Commission sues or in criminal actions.


323 See part III A supra.

324 Cf. 31 C.J.S. Estoppel § 61, at 385 (1964) (common law).

325 See part III B supra.


328 But see 1 LOYOLA U.L.J. 146, 150 (1970) (in both law and equity historically). Unclean hands may supply the desired defense in suits requesting equitable relief. See part IV B infra.

329 See text following note 17 supra.
The availability of in pari delicto in a particular suit depends on whether the defense applies to that type of fact pattern, the comparative guilt of the parties, and the trial court's discretion. At common law, in pari delicto was available under either the strict or the modern approach, depending on the jurisdiction. A defendant can invoke the defense under the strict approach only if the plaintiff wronged the defendant in the transaction on which the plaintiff predicates his relief. The modern approach allows the defense if both parties mutually intended to commit the same wrongful action. In addition to these traditional approaches, courts sometimes apply in pari delicto when the plaintiff breaches 10b-5 or engages in other unsavory conduct that is connected to his loss in some way, even if his actions are unrelated to the defendant's misconduct. An example of this third approach is a tippee suing his tipper for the amount the tippee lost when he bought stock based on facts falsely represented by the tipper to be true inside information. The third approach has been correctly criticized. Courts should apply in pari delicto only to fact patterns within the two traditional common-law approaches.


The person who was defrauded by the plaintiff and the defendant when they were in pari delicto need not be a party to the lawsuit.

Kuehnert v. Texstar Corp., 412 F.2d 700, 704-05 (5th Cir. 1969); Comment, The Demise of In Pari Delicto in Private Actions Pursuant to Regulatory Schemes, 60 Calif. L. Rev. 572, 589-90 n.94 (1972); Comment, supra note 330, at 1165-66; see Bell, supra note 11, at 20 (since parties not in pari delicto, court used unclean hands doctrine).

Kuehnert v. Texstar Corp., 412 F.2d 700, 703-05 (5th Cir. 1969) (invoked defense); Wohl v. Blair & Co., 50 F.R.D. 89, 93 (S.D.N.Y. 1970) (refused to reject defense). The Fifth Circuit in Kuehnert admitted it was going beyond the typical scope of in pari delicto. 412 F.2d at 704 ("cannot be seen as in pari delicto even as to intention"). Prior to Kuehnert, the Fifth Circuit espoused the view that in pari delicto applied only when a defendant was a knowing party to [the] fraud." Hooper v. Mountain States Sec. Corp., 282 F.2d 195, 208 (5th Cir. 1960). With respect to the Kuehnert approach, see Cobine, Elements of Liability and Actual Damages in Rule 10b-5 Actions, 1972 U. Ill. L.F. 651, 666-67 n.79 (not really in pari delicto, but deny relief because plaintiff's own breach caused loss). See A. Jacobs § 167 nn.28-34 and accompanying text.


Woolf v. S.D. Cohn & Co., 515 F.2d 591, 601 (5th Cir. 1975), quoting Keystone Driller Co. v. General Excavator Co., 290 U.S. 240, 245 (1933) (patent infringement case describing origin of in pari delicto doctrine) ("only where some unconscionable act of one coming for relief has immediate and necessary relation to the equity that he seeks in respect of the matter in litigation"; not every transgression bars suit; unrelated conspiracy insufficient); Herzfeld v. Laventhal, Krekstein, Horwath & Horwath, 378 F. Supp. 112, 137 (S.D.N.Y. 1974), quoting Comment, 54 Minn. L. Rev. 878, 879 (1970) ("where the plaintiff has knowingly participated as an equal in the illegal act which caused the loss"); Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50, 53 n.11 (S.D.N.Y. 1971); Comment, supra note 15, at 184, 186-87 (do not use in pari delicto if plaintiff violated one securities act provision and defendant commits indepen-
Courts should first determine the fact patterns in which the in pari delicto defense might be available. Next they should analyze the comparative guilt of plaintiff and defendant. In pari delicto is available only if the plaintiff’s acts are made knowingly and are at least as serious as the defendant’s. Thus, one party’s knowledge of another party’s wrongdoing without the first party’s active participation does not constitute in pari delicto, unless perhaps the first party is obligated to act once he has knowledge.

Even if the first two steps indicate that the defendant could employ in pari delicto, the trial court has discretion to permit or disallow the defense. A judge should base his judgment on the following:

338 Woolf v. S.D. Cohn & Co., 515 F.2d 591, 604 (5th Cir.); petition for rehearing and rehearing en banc denied, 521 F.2d 225 (5th Cir. 1975), vacated and remanded sub. nom. S.D. Cohn & Co. v. Woolf, 96 S. Ct. 3161 (1976) ("knowing participant"); Hooper v. Mountain States Sec. Corp., 282 F.2d 195, 208 (5th Cir. 1960) ("a knowing party to such fraud"); Herzfeld v. Laventhal, Kerkstein, Horwath & Horwath, 378 F. Supp. 112, 137 (S.D.N.Y. 1974) ("knowingly participated"); Hogan v. Teledyne, Inc., 328 F. Supp. 1043, 1047 (N.D. Ill. 1971) ("a knowing, culpable party"); deHaas v. Empire Petroleum Co., 286 F. Supp. 809, 815 (D. Colo. 1968) (indemnity case; knowingly participated in fraud); 54 MINN. L. REV. 878, 879 (1970) ("knowingly participated as an equal in the illegal act which caused the loss"). The term "knowing" probably means that the plaintiff was or should have been aware that he was engaged in a scheme with the defendant, whether or not he knew of its illegality, and that he was not coerced or unwillingly involved. See Comment, supra note 15, at 185-86; note 337 infra.


whether permitting the defense furthers the Rule's underlying policies\textsuperscript{340} and whether the threat of a private right of action deters defendants from violating the Rule.\textsuperscript{341} Authorities treating the availability of \textit{in pari delicto} under other securities acts remedies\textsuperscript{342} or under the common law\textsuperscript{343} are not persuasive, since 10b-5 has different underlying policies. Similarly, a court could find \textit{in pari delicto} appropriate for one type of 10b-5 violation (e.g., tipping), but not for another (e.g., mismanagement).

Although a trial court's discretion limits our ability to predict when \textit{in pari delicto} will be successfully asserted,\textsuperscript{344} past holdings are of some precedential value. \textit{In pari delicto} defeated a plaintiff's claim when: management accepted a bribe from a tenderer;\textsuperscript{345} plaintiff back-dated a document to circumvent the securities laws;\textsuperscript{346} claimant willfully misrepresented;\textsuperscript{347} and one party to a contract to purchase securities concealed that the same investment banker was acting for


\textsuperscript{341} Comment, The Demise of In Pari Delicto in Private Actions Pursuant to Regulatory Schemes, 60 CALIF. L. REV. 572, 584, 591, 604 (1972). A final factor determining the application of \textit{in pari delicto} is whether the defendant used economic duress to force the plaintiff to join him in the breach. Kuehnert v. Texstar Corp., 412 F.2d 700, 704 (5th Cir. 1969).

\textsuperscript{342} See A. Jacobs § 3.01[b] n.10 (1933 Act § 12(1)), § 3.02[b] n.34 (margin rules) and accompanying texts. See also id. § 3.02[e] nn.38-39 and accompanying text (unclean hands under proxy rules).

\textsuperscript{343} Kuehnert v. Texstar Corp., 412 F.2d 700, 704 (5th Cir. 1969) (avoid common-law technicalities).

\textsuperscript{344} Id. at 706 n.3 (dissenting opinion) ("there are problems of deciding when a party's 'badness' is sufficient to warrant the application of \textit{in pari delicto}, which makes [sic] it almost impossible to create an orderly and consistent body of law on the subject"); Ruder, supra note 337, at 660-62 (policies of deterrence and compensation do not produce consistent application of \textit{in pari delicto}).

\textsuperscript{345} Hogan v. Teledyne, Inc., 328 F. Supp. 1043, 1047 (N.D. Ill. 1971).

\textsuperscript{346} James v. DuBreuil, 500 F.2d 155, 158-60 (5th Cir. 1974).

both parties.\textsuperscript{348} On the other hand, \textit{in pari delicto} was not employed when: defendants defrauded a corporation into issuing shares for inadequate consideration;\textsuperscript{349} ostensibly to establish a value for condemnation purposes, defendant fraudulently sold land to plaintiff;\textsuperscript{350} a plaintiff gave a false investment representation;\textsuperscript{351} and a customer traded on the basis of advance notice of his broker's recommendation.\textsuperscript{352}

B. \textit{Unclean Hands}

Unclean hands is a companion defense to \textit{in pari delicto}. It denies affirmative equitable relief to a plaintiff who is guilty of unlawful or inequitable conduct arising out of the matter for which he seeks relief.\textsuperscript{353} The defense is designed to protect the court's integrity and the public interest, rather than to aid the defendant.\textsuperscript{354} Unclean hands has been recognized as a defense to a 10b-5 action for equitable relief.\textsuperscript{355} Because few 10b-5 cases discuss this defense, how-


\textsuperscript{350} Errion v. Connell, 236 F.2d 447, 451, 457 (9th Cir. 1956).

\textsuperscript{351} Woolf v. S.D. Cohn & Co., 515 F.2d 591, 604-05 (5th Cir.), petition for rehearing and rehearing en banc denied, 521 F.2d 225 (5th Cir. 1975), vacated and remanded sub. nom. S.D. Cohn & Co. v. Woolf, 96 S. Ct. 3161 (1976).


ever, the conclusions regarding this action rely in part on common-law authorities.\textsuperscript{356}

The first question regarding the availability of unclean hands is whether the plaintiff’s acts were sufficiently reprehensible and closely enough connected to the wrong.\textsuperscript{357} A breach by the plaintiff of 10b-5, another statute, or the common law is sufficient. Inequitable conduct also meets the requirements of this defense.\textsuperscript{358} However, the objectionable actions must be intentional. Acts done inadvertently or with misapprehension of legal rights will not support the unclean hands defense.\textsuperscript{359} The plaintiff’s actions must arise out of the subject of the suit,\textsuperscript{360} although he need not participate directly in the defendant’s illegal conduct.\textsuperscript{361} Unclean hands cannot be founded upon the plaintiff’s bad moral character or on his deeds in other transactions.\textsuperscript{362} If the plaintiff’s actions adequately establish

\begin{itemize}
\item Kuehnert v. Texstar Corp., 412 F.2d 700, 703 (5th Cir. 1969) (“actual illegal conduct”); cf. 30 C.J.S. Equity § 95, at 1018-19 (1965).
unclean hands under these criteria, the defense is not lost merely because the plaintiff's actions were less objectionable than the defendant’s\textsuperscript{363} and did not injure him.\textsuperscript{364} Obviously, whether these criteria are met is a question of fact.\textsuperscript{365}

Even if the plaintiff’s acts indicate that unclean hands is available, a trial court has discretion not to allow the defense.\textsuperscript{366} Unfavored at common law,\textsuperscript{367} unclean hands should be applied even more narrowly in 10b-5 cases.\textsuperscript{368} In exercising their discretion, judges should consider the comparative guilt of plaintiff and defendant, and the amount of injury flowing from the plaintiff’s acts. The most important measure, however, is whether the policies underlying 10b-5 and its remedial nature\textsuperscript{369} are better promoted by granting or withholding the defense. Stated differently, a court should adopt unclean hands as a defense only when this result promotes the ends the securities laws seek to achieve.\textsuperscript{370} As the policies underlying 10b-5 differ from those involved in other securities acts remedies, the availability of unclean hands under those other provisions\textsuperscript{371} is at best a weak analogy.

V

RES JUDICATA AND COLLATERAL ESTOPPEL

Section 27 of the 1934 Act vests exclusive subject matter jurisdiction in federal courts over actions brought under that Act, includ-

\textsuperscript{363} 40 Fordham L. Rev. 725, 727 n.19 (1972) (if strictly construed, dismiss no matter how slight plaintiff’s guilt); cf. 30 C.J.S. Equity § 93, at 1009-11, § 95, at 1023 (1965).
\textsuperscript{364} 38 Geo. Wash. L. Rev. 337, 341 (1969); cf. 30 C.J.S. Equity § 95, at 1025-26 (1965).
\textsuperscript{365} Cf. 30 C.J.S. Equity § 93, at 1013 (1965).
\textsuperscript{367} 30 C.J.S. Equity § 99, at 1048 (1965).
\textsuperscript{368} See Kuehnert v. Texstar Corp., 412 F.2d 700, 704 (5th Cir. 1969) (avoid common law technicalities).
\textsuperscript{369} See A. Jacobs § 6, § 7 n.8 and accompanying text.
\textsuperscript{370} James v. DuBreuil, 500 F.2d 155, 159, 160 n.8 (5th Cir. 1974) (increase protection of public); Kuehnert v. Texstar Corp., 412 F.2d 700, 704 (5th Cir. 1969); Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50, 53 (S.D.N.Y. 1971); Bell, supra note 11, at 20-21; 1 Loyola U.L.J. 146, 149 n.18 (1970); 44 Tulane L. Rev. 618, 622-24 (1970); see Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937, 948 n.7 (2d Cir. 1969) (if management and tender offeror breach securities law, unclean hands provides cold comfort to innocent stockholders); Wohl v. Blair & Co., 50 F.R.D. 89, 91 (S.D.N.Y. 1970) (strike balance between policies); cf. Wolf v. Frank, 477 F.2d 467, 474 (5th Cir. 1973) (1933 Act § 5) (whether application or non-application of defense will better promote objectives of securities laws).
\textsuperscript{371} See A. Jacobs § 3.02(e) nn.38-39 and accompanying text (proxy rules).
This jurisdictional restriction raises difficult issues involving the defenses of res judicata and collateral estoppel in 10b-5 actions. Federal law governs the scope of res judicata and collateral estoppel in 10b-5 cases. A prior state court settlement or judgment has no res judicata effect on a subsequent 10b-5 suit. This conclusion is grounded both in the state court's lack of jurisdiction to adjudicate the 10b-5 claim and in the fact that 10b-5 is a different cause of action from the state claim.

The vast majority of cases recognize collateral estoppel as a defense, whether the prior litigation was determined by a state court's lack of jurisdiction to adjudicate the 10b-5 claim or in the fact that 10b-5 is a different cause of action from the state claim.
court,\textsuperscript{378} or in arbitration.\textsuperscript{379} But slight authority suggests that the litigation of issues in a prior state action should not bind a federal court in a 10b-5 suit because the state court had no subject matter jurisdiction over the 10b-5 cause of action.\textsuperscript{380} The following example illustrates the crucial impact this defense may have on the outcome of a 10b-5 action. The plaintiff claims that a merger proxy statement is misleading and that the exchange ratio is unfair. In a common-law fraud action, the state court finds these claims to lack merit. A federal court in a subsequent 10b-5 action would use collateral estoppel to resolve these two issues against the plaintiff and to dismiss the 10b-5 claim.\textsuperscript{381} An analogous situation arises when a state court determines 10b-5 issues that are raised as a defense in that action. These issues could collaterally estop the parties in a subsequent 10b-5 federal case arising from the same transactions.\textsuperscript{382}

If a jury trial was not available in the prior state court action, the right to a jury trial in 10b-5 cases can prevent the application of collateral estoppel as a defense to a federal suit. For the same reason, an adjudication against a defendant in a 10b-5 civil suit brought by the SEC in federal court cannot be used against him in a later private action arising from the same fact pattern. But the plaintiff in a 10b-5 civil suit can premise collateral estoppel on an earlier criminal conviction rendered after trial, since a jury is available in criminal matters. If a 10b-5 suit is prosecuted in federal court, res judicata or collateral estoppel determines any common-law fraud claims the parties may assert subsequently as to the same transaction in state court.

VI

OTHER DEFENSES

Defendants have argued that a few other, less important topics should be affirmative defenses.

—Appraisal rights. A defendant cannot successfully assert as a defense either that the plaintiffs had no appraisal rights in a corporate transaction such as a merger, or that they failed to exercise them.

—Disclosure and Curing. Actions that would constitute a non-substantive 10b-5 violation if uninterrupted can be cured by full

(1971) (consent judgment in state court has no res judicata effect against federal counterclaim).

383 U.S. Const. amend. VII.


388 See A. Jacobs § 117.02 n.11.
disclosure prior to the time the plaintiff acts or is irrevocably committed to act. Disclosure in this context is not an affirmative defense, for it cures the prior misleading statement before a breach occurs. But disclosure cannot cure a substantive breach of the Rule.

—Contract for an illegal purpose. A contract by which the parties agree to violate Rule 10b-5 is illegal and unenforceable. For example, the parties may agree to manipulate the market for a security. Illegal contracts must be distinguished from agreements having a legal purpose—such as a merger agreement—but which are voidable by one party because the other misrepresented material facts.

—Death of parties. A 10b-5 cause of action survives the death of either plaintiff or defendant.

—Contributory negligence. Courts should reject contributory negligence as a defense in 10b-5 suits, even if negligence were the standard for the defendant's care.

—Assumption of the risk. Some scant authority would bar recovery under 10b-5 if the plaintiff assumes the risk. Under the rationale of the better-reasoned contributory negligence decisions, judges should not embrace this defense, particularly since a plaintiff must prove the defendant's fraudulent intent.

—Assignees. If a person obtains for value and without notice a defendant's contractual rights against the plaintiff, he may have a defense that the defendant did not possess.

—Sovereign immunity. The United States may not be sued with-

389 See id. § 64.04.
390 See id. § 64.04 n.9 and accompanying text.
393 See A. Jacobs § 64.01[b][ii] n.71 for decisions treating the question of contributory negligence.
394 The Supreme Court has recently rejected negligence in private damage actions, however. Hochfelder v. Ernst & Ernst, 96 S. Ct. 1375 (1976). Regarding the standard of care previously adopted in private damage actions for misleading statements, see A. Jacobs § 63 nn.26-30 and accompanying text.
396 See notes 393-94 and accompanying text supra.
out its consent, and it has not consented to suit under 10b-5. Aside from a state’s sovereign immunity, the eleventh amendment of the United States Constitution prohibits actions against a state by one of its citizens for its 10b-5 breaches.

—Bankruptcy. A defendant’s discharge in bankruptcy should not release his provable 10b-5 liabilities if he acted with fraudulent intent or recklessly.

—Parol evidence rule. Although not an affirmative defense, the parol evidence rule cannot defeat a 10b-5 claim.

—Insanity. A psychiatric defense might be available in 10b-5 suits.

—Legal advice. Legal advice that an action is permissible under 10b-5 does not provide a defense, although it may bear on scienter or on penalties in an administrative proceeding.

**Conclusion**

The topic of affirmative defenses has become increasingly important as 10b-5 has grown lustily in many areas. A plaintiff should insure that he does not lose a valid claim by acting in a manner that enables a defendant to establish a defense. On the other hand, a defendant should try to limit his exposure by raising all available defenses.

---

402 McClure v. First Nat’l Bank, 352 F. Supp. 454, 455 (N.D. Tex. 1973), aff’d, 497 F.2d 490 (5th Cir. 1974); cf. Wright v. Lubinko, 515 F.2d 260 (9th Cir. 1975) (construing California blue sky law). As to the scienter standard now in force, see note 394 supra.
403 See note 257 supra and accompanying text.
405 See A. Jacobs § 63 n.43 and accompanying text.