securities cases, a number of other questions should be raised about the adequacy and fairness of section 33 of the Texas Securities Act. For example: What are the proper standards of scienter? What defenses or limitations upon liability, if any, should be available to non-issuer defendants, such as underwriters and experts? Is the rescission-type measure of actual damages sufficient? Should the Act continue to permit an award of exemplary damages? Should the period of limitations for an action for violation of the registration provisions be different from the period applicable to a fraud claim?

Regardless of the manner in which these questions may ultimately be answered, it is obvious that the principal civil remedies section of the Texas Securities Act is deficient in many respects and often precipitates unfair results in litigation. It should be a matter of urgency for the Texas securities bar, acting as in the past through the State Bar of Texas,[33] to propose for legislative enactment a completely revised approach to civil liabilities and remedies in the area of securities law.

Survey

A paucity of federal securities cases were decided by the Fifth Circuit during the current survey year. Those that were decided dealt with certain jurisdictional issues, with the defense of *in pari delicto*, and with rule 10b-5 as a vehicle to remedy violations of the Securities Act of 1933.[1]

I. JURISDICTION

Rule 10b-5 and its implementing statute, section 10(b) of the Securities Exchange Act of 1934 (1934 Act),[2] proscribe certain acts done "in connection with" the purchase or sale of a security "by the

33. *See* Bateman & Dawson, *The 1975 Amendments to the Texas Business Corporation Act and the Texas Securities Act*, 6 TEX. TECH L. REV. 951 (1975).

1. Securities cases decided by the Fifth Circuit but not discussed in this survey are Associated Builders, Inc. v. Alabama Power Co., 505 F.2d 97 (5th Cir. Dec. 1974) (prospectus not misleading as a matter of law), and McCormick v. Esposito, 500 F.2d 620 (5th Cir. Sept. 1974) (action against stockbroker for allegedly illegal extension of credit to a customer on his margin account).

2. 15 U.S.C. § 78j (1970).

use of any means or instrumentality of interstate commerce."[3] Thus, the use of an interstate instrumentality is one essential jurisdictional element of any 10b-5 case.[4]

To protect investors the courts have interpreted this jurisdictional requirement broadly. With respect to transactions conducted via intrastate telephone calls, some cases have taken a restrictive view of the requirement and have held that such calls do not constitute a use of an interstate instrumentality.[5] The majority of courts, on the other hand, have held that local phone calls satisfy the requirement.[6] In *Dupuy v. Dupuy*[7] the Fifth Circuit aligned itself with the majority view by holding that the mere intrastate use of the telephone for securities transactions satisfies the interstate jurisdictional requirement found in section 10(b) of the 1934 Act.[8] In so far as the court stressed Congressional intent in its decision, *Dupuy* was an accurate prognostication of the will of Congress. The Securities Act Amendments of 1975[9] specifically state that interstate commerce includes intrastate use of the telephone. Both the holding in *Dupuy* and the 1975 amendments appear to be desirable. The inclusion of intrastate phone calls within the interstate jurisdictional requirement should provide added protection to investors without subjecting the federal courts to a deluge of securities fraud cases.

A second jurisdictional dispute addressed by the Fifth Circuit centered around the purchase or sale requirement of section 10(b) of the 1934 Act and the rules promulgated thereunder. The purchase or sale requirement came into sharp focus in the case of *Lutgert v. Vanderbilt Bank.*[10] There plaintiff failed to allege that he was a purchaser or seller of securities. The Fifth Circuit affirmed the district court's dismissal of plaintiff's cause of action and thereby restated the circuit's adherence to the *Birnbaum* rule[11] that requires

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3. *Id.*

4. Rochez Bros. v. Rhoades, 353 F. Supp. 795, 806 (W.D. Pa. 1973).

5. Burke v. Triple A Machine Shop, Inc., 438 F.2d 978 (9th Cir. 1971); Rosen v. Albern Color Research, Inc., 218 F. Supp. 473 (E.D. Pa. 1963).

6. *E.g.*, Aquionics Acceptance Corp. v. Kollar, 503 F.2d 1225 (6th Cir. 1974); Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967).

7. 511 F.2d 641 (5th Cir. Apr. 1975).

8. *Id.* at 644.

9. Pub. L. No. 94-29 (June 4, 1975).

10. 508 F.2d 1035 (5th Cir. Feb. 1975).

11. Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). As originally formulated the *Birnbaum* rule simply limited rule 10b-5 protection to the defrauded buyer or seller. Others had no standing to sue. In an effort to provide investor protection, however, the courts have given the rule an expansive reading. Thus, private

that a plaintiff be a security purchaser or seller to have standing to sue under rule 10b-5. When viewed in light of the 1975 decision by the United States Supreme Court in *Blue Chip Stamps v. Manor Drug Stores*,[12] which proclaimed the *Birnbaum* rule to be the law of the land, the *Lutgert* case is of limited significance.

Both *Lutgert* and *Blue Chip* reflect a practical approach to the standing requirements under rule 10b-5. The purchase or sale requirement prevents an avalanche of frivolous lawsuits, often prosecuted only for their settlement value, with the attendant expense and interruption of business activities.[13]

The purchase or sale requirement was also in controversy in *Spector v. L.Q. Motor Inns, Inc.*[14] The case was unusual in that plaintiff sought relief under the federal securities laws for an alleged sale of stock transferred in conjunction with a divorce and property settlement. Plaintiff received 18 shares of the stock in question in partial settlement of his community property claims. Simultane-

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plaintiffs have been allowed to sue under rule 10b-5 even though their action would be barred under the *Birnbaum* rule as it was originally announced. Two commentators have observed the modifications to the *Birnbaum* rule and have grouped them into four categories: (1) "abortive transactions" where the fraud prevented consummation of the transaction; (2) "constructive transactions" where the plaintiff has not changed his position as a security holder, but is practically forced to purchase or sell; (3) "derivative suits" where the shareholder can sue derivatively, provided the corporation can be considered a purchaser or seller; and (4) "injunctive relief" actions where the suit is not compensatory in nature. Boone & McGowan, *Standing to Sue under SEC Rule 10b-5*, 49 TEX. L. REV. 617 (1971). The variations of the rule as stated by R. JENNINGS & H. MARSH, SECURITIES REGULATION 1182-83 (3d ed. 1972), concern the forced seller, aborted seller, frustrated seller, would-be seller, and the injunctive plaintiff. Additionally, the United States Supreme Court has recognized an exception to the strict reading of the *Birnbaum* rule in the case of Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971). There the Court made reference to what could be called the "touch test" modification. *Id.* at 12-13. The Fifth Circuit recently had occasion to interpret the "touch test" modification in Sargent v. Genesco, Inc., 492 F.2d 750 (5th Cir. 1974). The court there viewed the *Bankers Life* case as requiring that a plaintiff actually purchase or sell securities, but not as requiring that the defendant's fraud specifically relate to the plaintiff's transaction. It is sufficient if the fraud merely "touches" the transaction. *Id.* at 763.

12. 95 S. Ct. 1917 (1975). In *Blue Chip* plaintiff alleged that his failure to purchase stock, offered to him as a result of the terms of an antitrust consent decree, was caused by defendant's gloomy prospectus. The court of appeals concluded that because plaintiff was a member of a well-defined closed class (those to benefit from the antitrust decree) that an exception to the *Birnbaum* rule should be allowed. The Supreme Court disagreed, holding that the *Birnbaum* rule precluded plaintiff's suit. The court did not, however, overrule any of the cases establishing exceptions to *Birnbaum*. The opinion does reflect, however, that the court would be reluctant to allow any further erosion of *Birnbaum*.

13. *See id.* at 1927.

14. 517 F.2d 278 (5th Cir. Aug. 1975).

ously, plaintiff signed a stock purchase agreement whereby he obligated himself to transfer the shares back to the issuing corporation in exchange for cash and notes worth $370,000. Defendants, who controlled the corporation, then purchased the stock from the corporation for the same price. The stock was soon thereafter registered and sold publicly for more than $1.8 million. Plaintiff brought suit alleging that defendants' failure to disclose the proposed public offering at the time he obligated himself to sell his shares violated rule 10b-5. In dismissing the action without an evidentiary hearing, the trial court stated that jurisdiction was lacking because the alleged sale of his stock was not the type of transaction protected by the federal securities laws.[15]

The Fifth Circuit remanded the case for a plenary hearing on the merits. Writing for the court, Judge Gibson rejected defendants' argument that the stock was used merely as a means of supplying capital for part of plaintiff's divorce settlement. Instead, he characterized the question as whether plaintiff was the owner of the stock with freedom to sell it. The answer to this question was governed by Texas community property law which presumes that the one-half community property interests of a husband and wife are of equal value. Judge Gibson therefore concluded that plaintiff was entitled to an inference that he owned an alienable interest in the stock[16] and that the trial court's dismissal without a plenary hearing was premature.[17]

These recent cases dealing with jurisdictional issues illustrate the Fifth Circuit's ability to balance the necessity of providing relief to the defrauded investor against the various policy considerations that militate against overextending rule 10b-5 standing to sue.

II. DEFENSE OF IN PARI DELICTO

The defenses available to a defendant in securities litigation generally depend on jurisdictional issues and whether the elements of the cause of action, such as causation, reliance, and materiality, have been established by the plaintiff.[18] In addition, the judiciary has interjected nonstatutory defenses into the area of securities law.

15. *Id.* at 281.
16. *Id.* at 285.
17. *Id.* at 284.
18. 3 A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10B-5 § 11.5, at 253 (1968).

Under rule 10b-5 some of these nonstatutory defenses include laches, waiver, estoppel, and *in pari delicto.*[19]

The *in pari delicto* defense is based on the premise that a plaintiff who is guilty of wrongdoing related to the offense of which he complains should be denied relief. Although the defense is deeply engrained in our jurisprudence,[20] its introduction into securities law is of rather recent vintage.[21] The defense was considered in the securities context by the Fifth Circuit in two recent cases.

In *James v. DuBreuil*[22] plaintiff sold stock in a corporation that was anticipating a merger. He sold it in return for cash and a percentage of the stock's future appreciation. As a director of the corporation, defendant was an insider for purposes of the 1934 Act. He was therefore prohibited from obtaining stock prior to the merger because of then-existing rule 133[23] that precluded insider purchases pending mergers. To escape the rule, plaintiff prepared, executed, and predated an option to purchase the stock in favor of defendant.[24] Judge Ainsworth characterized the scheme as a " 'mutually profitable plan' to violate the securities laws prohibiting insider trading."[25] The Fifth Circuit concluded that plaintiff's complicity in the scheme made his cause of action ripe for the defense of *in pari delicto.*[26] The Fifth Circuit stressed that the parties were mutually, simultaneously, and equally at fault and that the evasion of law had no "direct involvement with the public investor."[27] Thus, the dismissal of plaintiff's cause of action by the district court was affirmed.

The court again considered the *in pari delicto* defense in *Woolf v. S.D. Cohn & Co.*,[28] a case decided subsequent to *James*. In *Woolf*,

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19. 1 A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10B-5 § 2.3(500), at 25 (1971).

20. *See* 3 J. POMEROY, EQUITY JURISPRUDENCE § 940-42, at 397-403 (5th ed. 1941).

21. In the securities area the defense apparently dates back to 1959 when the Third Circuit held that the unclean hands doctrine would bar a plaintiff's action. Gaudiosi v. Mellon, 269 F.2d 873, 881 (3d Cir.), *cert. denied*, 361 U.S. 902 (1959). The defense lay somewhat dormant, however, until its continued viability was accentuated by the Fifth Circuit in the case of Kuehnert v. Texstar Corp., 412 F.2d 700 (5th Cir. 1969).

22. 500 F.2d 155 (5th Cir. Sept. 1974).

23. 17 C.F.R. § 230.133 (1975) (partially rescinded January 1, 1973).

24. 500 F.2d 155, 158 n.3 (5th Cir. Sept. 1974). There were no precise findings of fact, and the defendant testified that the option had not been backdated. *Id.* at 158. The Fifth Circuit concluded that the trial court findings were sufficient and decided the case as if the option was predated.

25. 500 F.2d at 159.

26. *Id.* at 160.

27. *Id.*

28. 515 F.2d 591 (5th Cir. July 1975).

however, the court refused to allow the defense to operate as a bar to an action by a plaintiff guilty of wrongdoing. Two plaintiffs in *Woolf* purchased convertible debentures via a private offering. As is customary in private placements, defendants required the purchasers to warrant in writing that they purchased the stock not with a view toward distribution, but for investment, and that there were no other beneficial owners. In fact, plaintiffs represented five investors in addition to themselves.[29] Plaintiffs brought suit under rule 10b-5 alleging omissions and misrepresentations in disclosure.[30] The district court entered judgment for defendants and concluded that the misrepresentation as to additional investors rendered plaintiffs *in pari delicto*.

The Fifth Circuit disagreed. Judge Wisdom, relying on the *James* decision, again stated that in order for the defense to be available, plaintiffs must have been active participants in the unlawful scheme and, with respect to defendants, must have been mutually, simultaneously, and equally at fault. Judge Wisdom concluded, however, that the more decisive factor was the extent to which defendants' allegedly unlawful conduct affected the investing public.[31] Here public investors purchased securities which had not received the scrutiny that registration provides. Noting that registration was the means Congress chose to protect investors, the court was of the opinion that the use of the *in pari delicto* defense to bar private suits in situations such as that in *Woolf* would destroy the only effective means of detecting and deterring wrongdoing occasioned by those who utilize the various exemptions from registration provided by the Securities Act of 1933 (1933 Act).[32]

It is difficult to determine from *Woolf* and *James* when the

29. *Id.* at 599. In addition to misrepresenting the other investors' beneficial ownership, plaintiffs wrote the issuer and stated that they represented 22 other investors. Moreover, they threatened to inform Chemical Bank, with whom the issuer was negotiating for credit, of that fact. The effect of plaintiffs' threatened actions would have been to raise a question as to the legality of the private placement, thus impeding the loan negotiations. To avoid this, the issuer offered to purchase plaintiffs' debentures. They accepted this offer to purchase and then brought suit. The court characterized this misrepresentation as a plan of self-help unrelated in time and purpose to plaintiffs' cause of action. The court refused to allow the *in pari delicto* defense.

30. Plaintiffs also based their cause of action on the alleged failure of defendants to conduct the placement of the debentures in such a way as to qualify for the private placement exemption under section 4(2) of the Securities Act of 1933. See text accompanying note 42 *infra*.

31. 515 F.2d at 604-05.

32. *Id.* at 605.

defense of *in pari delicto* will be allowed. Suffice it to say that the permissibility of its use will be determined on a case-by-case basis with the court's sense of fairness as the final arbiter. These cases and a prior case[33] do establish, however, that in the Fifth Circuit a "plaintiff-tippee" who purchases stock, incorrectly believing himself to be in possession of material undisclosed information,[34] and a plaintiff who conspires to avoid the prohibitions on insider trading[35] will be excluded from a federal forum because of their own complicity in the misconduct. On the other hand, a plaintiff who facilitates a private placement by falsely stating the number of persons he represents[36] will be able to overcome the defense of *in pari delicto* and thus assure himself access to the federal courts.

III. Rule 10b-5 as a Remedy for Violations of the 1933 Act

The fundamental purposes of the securities laws enacted in 1933 and 1934 are to provide disclosure of the character of securities and to prevent fraud in their sale.[37] Congress determined that a fully informed investor would be in the best position to make an investment decision.[38] To provide this information, Congress required that a distributor of securities file a registration statement with the Securities and Exchange Commission and deliver to investors a prospectus containing vital information about the issuer and the securities to be distributed.[39] Exemptions from these requirements were extended where Congress felt that the benefits of registration were too remote or impractical.[40] One of these exemptions, section 4(2) of the 1933 Act, the private placement exemption, exempts from registration "transactions by an issuer not involving any public offering."[41]

In *Woolf v. S.D. Cohn & Co.*[42] the court dealt with the private placement exemption in a most unusual way. The unique aspect of the case sprang from the fact that plaintiffs were suing under rule

33. Kuehnert v. Texstar Corp., 412 F.2d 700 (5th Cir. 1969).
34. *Id.*
35. James v. DuBreuil, 500 F.2d 155 (5th Cir. Sept. 1974).
36. Woolf v. S.D. Cohn & Co., 515 F.2d 591 (5th Cir. July 1975).
37. Preamble to the Securities Act of 1933.
38. SEC Securities Act Release No. 5223 (Jan. 11, 1972).
39. *Id.*
40. *Id.*
41. 15 U.S.C. § 77d(2) (1970).
42. 515 F.2d 591 (5th Cir. July 1975).

10b-5, promulgated pursuant to the anti-fraud provisions of the 1934 Act, for defendant's failure to conduct the placement in such a manner as to qualify for the private placement exemption under the 1933 Act. Plaintiffs were forced to sue under rule 10b-5 because a suit under the express liability provisions of the 1933 Act would have been barred by limitations.[43] The Fifth Circuit concluded that rule 10b-5 would provide a remedy for violations of the private placement exemption under the 1933 Act.

The opinion in *Woolf*, however, failed to make clear whether rule 10b-5 would provide a remedy in all situations involving a section 4(2) violation[44] or only in those in which a violation results from inadequate disclosure. The confusion results from the court's emphasis on a detailed explanation of the availability of the private placement exemption[45] and from language that would lend support to the argument that rule 10b-5 provides a remedy for *every* private placement violation.[46] This portion of the court's opinion should be regarded as mere dictum, instructional as to whether the private placement exemption is available (with the attendant risk of liability under the 1933 Act), but irrelevant as to liability under rule 10b-5.

If the failure to qualify for the private placement exemption results from a reason other than inadequate disclosure, rule 10b-5 should not provide a remedy. Rule 10b-5 is admittedly "more than a disclosure provision."[47] As stated by the Second Circuit, however, ". . . it seems clear that [the] emphasis on improper self dealing did not eliminate non-disclosure as a key issue in Rule 10b-5 cases. Section 10(b) of the Exchange Act and Rule 10b-5 are designed principally to impose a duty to disclose and inform . . . ."[48] There-

43. Under section 13 of the Securities Act of 1933, 15 U.S.C. § 77m (1970), there is a 1-year statute of limitations for causes of action based on violations of the private placement exemption.

44. The exemption could fail either because offers were extended to too many individuals or because the offerees could be unsophisticated and incapable of evaluating the investment. *See* Rule 146, 17 C.F.R. § 230.146 (1975).

45. *See* 515 F.2d at 608-13.

46. After dismissing as irrelevant the question of whether defendants were underwriters, the court stated that "[w]hat matters here is whether they violated § 5 of the 1933 Act by selling unregistered securities, and this in turn depends upon whether they and Fiberglass, the issuer, had a valid claim to the § 4(2) exemption." 515 F.2d at 613. The court also alluded to the absence of SEC scrutiny of a private placement, *id.* at 611, the size of the offering, *id.* at 614, and the impersonal manner of the offering, *id.*

47. *See* Popkin v. Bishop, 464 F.2d 714, 718 (2d Cir. 1972).

48. *Id.* at 719-20.

fore, the more desirable reading of the *Woolf* opinion would confine relief under rule 10b-5 to those instances in which the private placement exemption fails because of inadequate disclosure. Under this interpretation, liability under rule 10b-5 would lie only if a defendant failed affirmatively[49] to disclose what registration would have revealed and if the failure to disclose was sufficiently material that a reasonable investor would have considered the information important in making his investment decision.[50] Any other reading of *Woolf* would completely destroy the 1-year limitations period Congress established in the 1933 Act for violations of the private placement exemption.

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49. The court referred to a 1971 Fifth Circuit case where the court said "[t]he (offerees) do not have to prove that they could not have discovered the falsity upon reasonable investigation. . . . To put it simply, the availability of information elsewhere does not excuse misleading or incomplete statements." 515 F.2d at 609.

50. *Id.* at 614.