BOOK REVIEW

SHAREHOLDER LITIGATION, By Roger J. Magnuson.[1] Wilmette, Illinois: Callaghan & Co. 1981. Vols. I & II. Pp. xxiii, chs. 1-9; xv, chs. 10-21. $147.50 for set of two volumes.

Reviewed by Roderick M. Hills[2] *and Michael Chertoff*[3]

A good legal treatise shares the characteristics of both a menu and a meal: it guides the practitioner through the legal bill of fare, and also provides food for thought. Roger J. Magnuson's *Shareholder Litigation* performs both functions. It is not a legal source book for all purposes, but it is an excellent introduction to the practical dimensions of securities litigation, and to the theory of securities enforcement.

The author's metaphor is Biblical. Taking his cue from Ecclesiastes, Mr. Magnuson describes this two-volume work as an effort to describe the varieties of corporate "oppression," and their remedies.[4]

Sustaining—indeed, perhaps oversustaining—the Biblical metaphor throughout his work, Mr. Magnuson leads the reader through the gamut of federal and state remedies for injuries to shareholders. Included in the two-volume set is a broad, but not exhaustive, description of the elements of sections 9, 10, 14 and 16 of the Securities Exchange Act of 1934 and sections 11, 12 and 17 of the Securities Act of 1933.

Mr. Magnuson briefly considers state statutory remedies and common-law causes of action. *Shareholder Litigation* also discusses the procedural mechanisms for redress, including shareholder derivative actions, class actions, and SEC enforcement actions.

Of special interest to the practicing attorney is Mr. Magnuson's attentiveness to the practical problems faced by the securities litigator. Chapters of *Shareholder Litigation* consider the process of "educating" the client, and formal and informal methods of obtaining information.

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4. 1 R. MAGNUSON, SHAREHOLDER LITIGATION, § 1.01, at 2 (1981). *See Ecclesiastes* 4:1.

For example, the book quite usefully instructs the attorney to look beyond discovery procedures available in ordinary civil cases, and to consider sources of information such as federal and state corporate filings, the Freedom of Information Act, and professional financial information services. Finally, the treatise walks the prospective securities litigator through the pre-trial and trial process, directing the lawyer's attention to procedural matters of particular relevance in a shareholder litigation context.

The book is well-balanced between discussion of the substantive elements of securities law and "how to" advice about procedure, starting at the point that the client walks through the door. The footnote references are a valuable point of departure for research into procedural and substantive issues as they arise during the course of litigation.

Apart from its efforts to map the issues faced by the shareholder litigator, Mr. Magnuson's treatise occasionally delves into specific legal or practical questions. Mr. Magnuson's discussion of practical considerations includes illustrations from the experiences of unnamed attorneys. The lawyers' anecdotes are often amusing; whether they will assist the litigator who draws upon his own fund of experience is, perhaps, questionable. Elsewhere, the book discusses emerging legal questions generated by recent court decisions. For example, the book includes discussions of the continued viability of the "Birnbaum" rule of standing to sue under rule 10b-5, the duty to disclose or abstain requirement established by *Chiarella v. United States*,[5] and the impact of *Santa Fe Industries v. Green*.[6] Here, the book's reader should exercise caution. Recent decisions by the courts have significantly unsettled the contours of securities enforcement law. The reader is well-advised to use Mr. Magnuson's discussions as a beginning, rather than end, to exploration of securities law doctrine.

II

Beyond serving as a guide book and intellectual stimulant to the securities litigator, Mr. Magnuson's book purports to carry a moral message about shareholder litigation. Indeed, Mr. Magnuson's introduction instructs the "thoughtful advocate" to "attune himself to spiritual reality, to right and wrong."

5. 445 U.S. 222 (1980).
6. 430 U.S. 462 (1977).

But what is "right and wrong" in the field of shareholder law? Especially during the past ten years, courts, litigants, and the Securities and Exchange Commission have been engaged in struggling for the soul of the securities laws. A good deal of the uncertainty in rule 10b-5 doctrine is attributable to judicial and administrative decisions which embody differing visions of "right and wrong" under rule 10b-5.

The relevance of "right and wrong" can be tested in many types of 10b-5 litigation, but the fluidity of that concept may be seen most clearly in the recent case law which deals with trading on "inside" information. It is axiomatic that one should not "misrepresent," and so the absolute prohibition of 10b-5 that punishes material misrepresentation of facts concerning securities is easily understood and enforced. But it is more difficult to address the issue of stock trading when material information is not disclosed. Trading without disclosure of information is not desirable in all cases. The problem is to determine when to prohibit and when to permit trading without disclosing. Because the SEC today under the new leadership of Chairman John Shad, and Director of Enforcement, John Fedders, has an announced policy of suppressing stock trading on "inside" information, it is timely to inquire into the "spiritual reality" that is Mr. Magnuson's theme.

One vision of rule 10b-5, embodied in cases such as *Affiliated Ute Citizens v. United States*,[7] and in the dissenting opinions of Chief Justice Burger and Justice Blackmun in *Chiarella*, sees the inside trading prohibition as a market equalizing device. Under this approach, rule 10b-5 aims as nearly as possible at ensuring that those who trade in securities markets have no unjustifiable informational advantages. The only advantages that are considered legitimate are those which rest upon the trader's own research, analysis, and judgment.[8] The dissenting opinion of Justice Blackmun in *Chiarella* encapsulates this view in stating that rule 10b-5 prohibits trading where there is "a structural disparity in access to material information" and a party exploits this "structural informational advantage through trading in affected securities."[9]

7. 406 U.S. 128 (1972).

8. 445 U.S. at 240 (Burger, J., dissenting). Rules allowing limited purchases of corporate stock without disclosure of intent to bid for a takeover may also be justified on the ground of special efficiencies. *Id.* at 242-43; United States v. Chiarella, 588 F.2d 1358, 1366-1367 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980).

9. 445 U.S. at 251 (Blackmun, J., dissenting).

Contrasting with this equalizing approach is a moral, fault-oriented vision which the Supreme Court has increasingly adopted in interpreting rule 10b-5. In decisions such as *Ernst & Ernst v. Hochfelder*,[10] and *Aaron v. SEC*,[11] the Supreme Court has imposed *scienter* requirements upon private damage and SEC enforcement actions under rule 10b-5. By establishing scienter as an element of rule 10b-5, especially in the context of enforcement actions, the Court has signaled that its primary focus in 10b-5 cases is deterring and compensating for intentional deceit—not the broader goal of promoting a marketplace in which all transactors are equally situated. Under these cases, liability pivots on the bad state of mind of the defendant, rather than on the effect of his conduct upon the marketplace.

The rejection of the equal access to information approach is even more striking in the Court's decision in *Chiarella*. There, the Court expressly declined to adopt a rule 10b-5 theory predicated upon trading on the basis of superior knowledge not obtainable by the public at-large. Instead, the Court emphasized that the foundation of rule 10b-5 liability in a nondisclosure case is the determination that the defendant had a fiduciary relationship with the shareholders with whom he transacted his purchase or sale of stock. Thus, the common-law principle of fiduciary obligation was engrafted upon rule 10b-5, and relief was predicated upon the classical misfeasance of betrayal of trust.

These recent Supreme Court decisions adopting a moral, fault-oriented vision of the rule 10b-5 disclosure requirement raise doctrinal problems. The obligations imposed upon an individual as a fiduciary are not necessarily related to the policy of full disclosure in the marketplace. A corporate fiduciary is often expected to maintain information about corporate plans in confidence. In such instances, publication of corporate plans is as gross a violation of the insider's fiduciary duty as would be secret trading on the information. Yet rule 10b-5 is satisfied if the corporate fiduciary discloses secret corporate plans to the world, and then makes his purchase of corporate stock. Indeed, when the SEC suspects that information about corporate plans has leaked out, the Commission may pressure the officers to disclose information to the public, without regard to whether such general disclosure comports

10. 425 U.S. 185 (1976).

11. 446 U.S. 680 (1980).

with the officers' fiduciary duty to serve the best interests of their corporation.

To be sure, rule 10b-5 and the common law of fiduciary obligations are not inconsistent: an insider can satisfy both by declining to trade at all when he possesses inside information. But the common law goes further than 10b-5 in the sense that it prohibits disclosure by the insider. The common law aims at policy goals of promoting fiduciary loyalty that are logically unrelated to the policies underlying disclosure requirements. This fundamental incongruity between rule 10b-5 and the common law of fiduciaries makes it dubious to link them by treating the fiduciary relationship as an element of the rule 10b-5 offense. As a result of this linkage, the rule is that an outside corporate consultant is proscribed from trading in stock on the basis of information he receives, while the casual passerby who overhears the same corporate secret is not so inhibited. Significantly, that difference in status has no discernable effect upon the behavior of the marketplace or upon the behavior of the ordinary investor.

The tenuity of the connection between the rule 10b-5 policy of non-disclosure and the duty of fiduciary loyalty is further highlighted by the conceptual contortion performed by courts which seek to treat the corporate insider who sells securities as a fiduciary of the new purchaser of those securities. At the time the selling insider undertook his fiduciary duty, the purchaser was not a shareholder and hence not the beneficiary of that obligation. To establish a fiduciary relationship at the time of sale, therefore, the courts have maintained the metaphysical fiction that the fiduciary relationship arises at the very moment that the sale is consummated.[12]

Similarly, the concept of scienter which seems appropriate when analyzing a common law deceit claim, fits rather awkwardly into the elements of the rule 10b-5 offense of nondisclosure of material information. In a misstatement or half-truth case, it is fairly easy to identify the scienter question that will arise: Whether the defendant knew, or was reckless in not knowing, that the information he disseminated was false.

The application of scienter to a non-disclosure case is less clear. Is the scienter question whether the defendant knowingly or recklessly failed to disclose the information, as, for example, when he means to

12. 445 U.S. at 227 n.8; Gratz v. Cloughton, 187 F.2d 46, 49 (2d Cir. 1951).

communicate a particular fact but forgets to do so? That issue will arise very rarely. Is the scienter issue whether the defendant failed to discover information that he should have disclosed, or failed to supervise another who failed to disclose? That kind of scienter question only arises when the defendant is sued on a derivative liability theory, such as aiding and abetting, or the employer-employee relationship.[13]

But how does scienter apply in the ordinary case where the defendant has received material nonpublic information and trades without disclosing it? In such a circumstance, the scienter issue must revolve around whether the defendant knew, or was reckless in failing to know, that the information in question was material and nonpublic. Thus, in the simple nondisclosure setting, the scienter requirement serves no purpose other than to recapitulate the rule 10b-5 elements of materiality and nonpublication. In short, the element of scienter is redundant in the factual circumstances that generate a large number of garden variety 10b-5 nondisclosure cases.[14]

These conceptual difficulties suggest that legal principles associated with moral fault do not fit comfortably within a full disclosure statute. Two solutions may be indicated. One is to construe rule 10b-5 in the nondisclosure context as a mandate for equal access to the marketplace. So understood, the fiduciary duty rule established by *Chiarella* would have to be reversed, and the scienter requirement abolished at least in enforcement actions. Such a reconstructed 10b-5 nondisclosure principle would be coherent, since the scope of the disclosure obligation could be defined through explicit formulation of a policy governing the flow of information in the marketplace. However, adoption of such an overtly policy-making approach to rule 10b-5 would doubtless be controversial, unless undertaken or approved by Congress itself in the course of a reconsideration of section 10 of the Securities Exchange Act.

The alternative solution is to recognize that a federal 10b-5 rule governing failure to disclose makes no sense as a duplication of common-law rules governing breach of duty. Bare inside trading, therefore,

13. *See, e.g.,* 425 U.S. 185; 446 U.S. 680.

14. Scienter could be treated as a distinct element of the rule 10b-5 inside trading offense if it were defined to require a showing of the defendant's specific intent to take advantage of inside information. Such an interpretation would eliminate the redundancy problem but it would create two different versions of scienter: one for misrepresentation cases, and one for inside trading cases.

should be regulated as a breach of fiduciary obligation, under the appropriate state laws. That would leave rule 10b-5 enforcement to those situations where defendant has misrepresented or told half-truths. Since misrepresentation is always undesirable, there is no need to discriminate between "good" and "bad" misrepresentation by choosing between a morally-oriented and an efficiency-oriented view of securities trading.

It is no fault of Mr. Magnuson that these conceptual problems are beyond the scope of his book. The rhetoric of morality that *Shareholder Litigation* advances, however, inevitably stimulates further thought about the wisdom of the securities enforcement rules as currently constructed. Perhaps Mr. Magnuson will turn his knowledge and practical experience to exploring the deeper issues involved in shareholder litigation in his next book.