98-164 A
Updated December 10, 1998

CRS Report for Congress
Received through the CRS Web

# Uniform Standards in Private Securities Litigation: Limitations on Shareholder Lawsuits

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## Summary

The 104th Congress enacted the Private Securities Litigation Reform Act, P.L. 104-67, to address the perceived problem of an increase in frivolous shareholder lawsuits. The stated reasons for bringing those lawsuits were varied -- fraud, mismanagement, nondisclosure of material information--but practically all of the lawsuits involved the loss of money by shareholders of the corporation. The Act limits shareholder lawsuits in federal courts. There are currently bills in Congress which would remove most state securities antifraud cases to federal courts.

## Background

Whether a shareholder lawsuit is meritorious or frivolous, the corporation sued in many cases must spend a great deal of money in defending itself. In some cases a corporation will settle the lawsuit in order to save large defense expenses. Critics have described these settlements as legal extortion.

Most shareholder lawsuits have been brought as alleged violations of the Securities Act of 1933 and the Securities Exchange Act of 1934, in particular the antifraud provision of the 1934 Act, referred to as section 10(b).

Because of a belief that unwarranted securities lawsuits have harmed American businesses, Congress enacted legislation to attempt to assure that securities class action lawsuits have some merit and are not frivolous. The Private Securities Litigation Reform Act attempts to limit these abuses of the securities laws by such actions as having the court appoint a lead plaintiff determined to be the most capable of adequately representing the interests of class members, prohibiting a person from being a lead plaintiff in no more than five class actions in a three-year period, guaranteeing that plaintiffs receive full disclosure of settlement terms, eliminating coverage of securities fraud by the Racketeer Influenced and Corrupt Organizations Act, providing for a safe harbor for forward-looking statements, providing for proportionate liability, and providing for auditor disclosure of corporate fraud.

Since enactment of P.L. 104-67, there have been allegations that more frivolous securities lawsuits are being brought in state courts. Congress has responded to these charges by introducing bills in both the House and the Senate. The House bills are H.R. 1653 and H.R. 1689; the Senate bill is S. 1260. These bills would prohibit bringing certain securities antifraud cases in state courts.

## Discussion

P.L. 104-67, the Private Securities Litigation Reform Act, was enacted to address the perceived problem of an increase in frivolous shareholder lawsuits. The stated reasons for bringing those lawsuits were varied--fraud, mismanagement, nondisclosure of material information--but practically all of the lawsuits involved the loss of money by shareholders of the corporation. Some of the lawsuits had merit because some corporate managers had without doubt misled or defrauded investors. However, some of the lawsuits were called frivolous and were brought, according to critics, when, for example, the share value of the stock of a corporation went down for reasons having nothing to do with the culpability of corporate managers.

Whether a shareholder lawsuit is meritorious or frivolous, a corporation sued must usually spend a great deal of money in defending itself. It has not been uncommon for a corporation sued by disgruntled investors to agree to a substantial settlement out of court. Some of these settlements have been described by critics as legal extortion because, despite the absence of wrongdoing by managers, corporations were essentially forced to pay out large sums of money to avoid even larger expenses associated with legal defense.

Most shareholder lawsuits have been brought as alleged violations of the two major federal securities laws. These laws, the Securities Act of 1933[1] and the Securities Exchange Act of 1934,[2] were enacted in large measure in response to the intense speculation in securities which led to the Stock Market Crash of 1929. The principal philosophy governing these securities laws is that investors and prospective investors should have access to all material information about corporations which offer securities so that the public can make informed investment decisions. Disclosure of all material information is the major requirement of the federal securities laws. The Securities and Exchange Commission (SEC) does not rule on the riskiness of investments in particular companies; instead, it is charged with making certain that the public has all of the necessary information for making its own investment decisions.

The 1933 Act attempts to assure the availability to the public of adequate reliable information about publicly offered securities. In order to accomplish this, the Act makes it illegal to offer for sale or to sell securities to the public unless they are registered with

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[1] 15 U.S.C. §§ 77a *et seq*.

[2] 15 U.S.C. §§ 78a *et seq*.

the SEC.[3] Registration under the 1933 Act covers only the securities actually being offered and only for the purposes of the offering which have been described in the registration statement. Material required to be included in the registration is specified.[4] Certain kinds of transactions are exempted from required registration.[5] These exempted transactions include private placements, intrastate offerings, and small offerings. Certain kinds of securities are also exempted.[6] Among the exempted securities are government securities, bank and savings and loan securities, and short-term commercial paper.

The 1934 Act is concerned with a variety of different areas, such as the creation of the Securities and Exchange Commission,[7] the regulation of publicly-held companies,[8] the regulation of the trading markets,[9] and the ongoing process of disclosure to the investing public through the filing of periodic and updated reports with the SEC.[10] Any issuer which has a class of securities traded on a national securities exchange or total assets exceeding $1,000,000 and a class of equity shareholders with at least 500 shareholders must register with the SEC.[11] Annual reports, referred to as 10-K's,[12] and other reports, such as quarterly reports, referred to as 10-Q's,[13] and material change reports, referred to as 8-K's,[14] as required by the SEC, must be filed.[15]

These reports require disclosure to the SEC and to shareholders of all material financial information and all other material information. Failure to disclose is actionable, and it is often allegations of nondisclosure which have formed the basis of shareholder lawsuits. For example, section 18(a) of the Securities Exchange Act[16] grants an express private right of action to investors who have been injured by reliance upon material misstatements or omissions of fact in reports which have been filed with the SEC. Section 10(b) of the 1934 Act,[17] the general antifraud provision, and Rule 10b-5,[18] issued by the SEC to carry out the statutory fraud prohibition, provide for a cause of action for

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[3] 15 U.S.C. § 77e.

[4] 15 U.S.C. § 77g, which refers to Schedule A, located at 15 U.S.C. § 77aa.

[5] 15 U.S.C. §77d.

[6] 15 U.S.C. § 77c.

[7] 15 U.S.C. § 78d.

[8] 15 U.S.C. §§ 78*l*-78o.

[9] 15 U.S.C. §§ 78g-78i.

[10] 15 U.S.C. § 78i.

[11] 15 U.S.C. § 78*l*.

[12] 17 C.F.R. § 240.13a-1.

[13] 17 C.F.R. § 240.13a-13.

[14] 17 C.F.R. § 240.13a-11.

[15] 15 U.S.C. § 78m.

[16] 15 U.S.C. § 78r(a).

[17] 15 U.S.C. § 78j(b).

[18] 17 C.F.R. § 240.10b-5.

injuries which have been caused by omissions, misrepresentations, or manipulations of material facts in statements other than those filed in documents with the SEC.[19]

In the 104th Congress both the House and the Senate had multiple bills concerning securities litigation reform. Bills in the House included Title II of H.R. 10, referred to in the Republicans' Contract with America as the Common Sense Legal Reforms Act; H.R. 1058, which is what Title II of H.R. 10 was designated after being separated from the tort reform proposals of Title I of H.R. 10; H.R. 555, and H.R. 675. Bills in the Senate included S. 240 and S. 667. The House passed H.R. 1058, and the Senate passed its version of H.R. 1058 (formerly S. 240). On November 28, 1995, the Conference Committee reconciling the House and Senate versions of private securities litigation reform issued H.Rept.104-369. This bill passed both Houses of Congress. President Clinton vetoed it, but both the House and the Senate overrode the veto, and the measure is now law.

P.L. 104-67 attempts to limit frivolous lawsuits and other perceived abuses of the securities laws by such actions as having the court appoint a lead plaintiff determined to be the most capable of adequately representing the interests of class members, prohibiting a person from being a lead plaintiff in no more than five class actions in a three-year period, guaranteeing that plaintiffs receive full disclosure of settlement terms, eliminating coverage of securities fraud by the Racketeer Influenced and Corrupt Organizations Act, providing for a safe harbor for forward-looking statements, providing for proportionate liability, and providing for auditor disclosure of corporate fraud.

Since enactment of P.L. 104-67, there have been allegations that more frivolous securities lawsuits are being brought in state courts. Congress has responded to these charges by introducing bills in both the House and the Senate. The House bills are H.R. 1653 and H.R. 1689; the Senate bill is S. 1260. These bills would prohibit bringing certain securities antifraud cases in state courts.

H.R. 1653, referred to the Subcommittee on Finance and Hazardous Materials of the Committee on Commerce, is referred to as the Securities Litigation Improvement Act of 1997. It would amend the Securities Act of 1933 and the Securities Exchange Act of 1934 to prohibit bringing a private civil action in a state court or under state law, including a pendent state claim to an action under federal law, which alleges either: 1. a misrepresentation or omission in connection with the purchase or sale of any covered security or 2. that the defendant used or employed any manipulative or deceptive device in connection with the purchase or sale of any security.

H.R. 1689, also referred to the Subcommittee on Finance and Hazardous Materials of the Committee on Commerce, is referred to as the Securities Litigation Uniform Standards Act of 1997. It would amend the Securities Act of 1933 and the Securities Exchange Act of 1934 to prohibit bringing a private class action based upon state or municipal law in state or federal court by any private party alleging: 1. an untrue statement or omission in connection with the purchase or sale of a covered security or 2. that the defendant used any manipulative or deceptive device in connection with the

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[19] *See, e.g., State Teachers Retirement Board* v. *Fluor Corp.*, 654 F.2d 843 (2d Cir. 1981), and *Goldberg* v. *Meridor*, 567 F.2d 209 (2d Cir. 1977).

purchase or sale of any security. A "class action" would be defined as any single lawsuit or group of lawsuits in which damages are sought on behalf of more than twenty-five persons, one or more named parties seek to recover damages on a representative basis, or one or more of the parties seeking to recover damages did not personally authorize the filing of the lawsuit.

S. 1260 was referred to the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs. As introduced, it was very similar to H.R. 1689. After the White House and the Securities and Exchange Commission agreed to support the bill if certain changes were made in it, the Committee on April 29 approved the bill with the following changes: 1. Class action was redefined to increase the limit on the number of parties allowed in state suits from twenty-five to fifty; 2. Shareholders could continue to bring lawsuits in Delaware courts under a state law which holds the information which corporations give to shareholders to higher standards than given to the general public; 3. There was also an agreement to include in the Senate report language that stated that P.L. 104-67 was not intended to prohibit plaintiffs from filing claims alleging "reckless misconduct" by a nationally traded company. S. 1260 was approved by the Senate 79-21 on May 13, 1998.

On July 22, 1998, a similar measure, H.R. 1689, was laid on the table without objection. On July 29 the Senate disagreed to the House amendment and requested conference. On October 9 the Conference Report, H.Rept. 105-803, was filed, and on October 13 the House and Senate agreed to the Report. On November 13 the President signed the bill, P.L. 105-353.

According to the Conference Report (As of this writing the Public Law has not yet been printed.), federal courts would become the exclusive venue for most securities class action lawsuits. Uniform national rules are established for secuirities class action litigation involving the national capital markets. Class actions concerning a covered security alleging fraud or manipulation must be maintained in federal courts and pursuant to the provisions of federal securities laws. Class actions barred from state courts include actions brought on behalf of more than fifty persons and by one or more unnamed parties. Exemptions are provided for specific types of actions. These include actions based upon the law of the state in which the issuer of the security is incorporated and actions brought by states and political subdivisions and state pension plans.