

# SECURITIES LITIGATION IN THE UTILITY SECTOR

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## I. INTRODUCTION

Federal and state laws provide owners of securities issued by public corporations the right to file suit against perceived wrongdoing. In recent years, utilities have seen an increase in the number of actions filed against management and board members. In 2002, almost ten percent of new federal securities fraud class actions involved an electric utility or a firm heavily involved in gas and electricity trading. This increase in litigation has followed a period of deregulation and restructuring among electric utilities and an accompanying rise in wholesale energy trading activities. Changes such as these alter the nature of a firm's risk exposures, as well as, generally increasing its overall risk. I find that the recent rise in securities litigation is one consequence of the fallout from electricity deregulation and restructuring. I also address the implications of securities litigation for utility managers and board members.

Litigation affects corporate conduct by providing a means for owners to sanction wrongdoing. The threat of involvement in an action may serve to create incentives for corporate officers and board members to better serve the interests of owners.<sup>1</sup> A change in industry structure may affect the importance of litigation as a means of control. Deregulation increases the amount of discretion afforded management. While an increase in discretion may allow for better use of corporate resources, it also provides insiders increased latitude to serve their own interests, rather than the best interests of the corporation.

But agency problems are not the only factor influencing the propensity of firms to become involved in some form of securities litigation. Securities actions are usually filed after a revelation of unfavorable news concerning the firm. Greater risk increases the likelihood that actual financial results will materially differ, on the minus side of the ledger, from expectations. Such an outcome may result from misleading disclosures or from a dereliction of management and board duties. But such developments may also result from unforeseen events. Given the difficulty in sorting out actual malfeasance from bad luck, an increase in the probability of bad outcomes by itself increases the litigation-risk exposure of officers and directors.

This article develops stylized facts concerning the recent experience of the utilities sector rather than constructing a formal model of the litigation process. I find that the incidence of litigation involving firms in the utility sector increased dramatically over the period between 1996 and 2003 (the sample period). I also find that most of the litigation involves companies in the electric power sector and firms with substantial unregulated energy trading activities or non-utility

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1. There is considerable disagreement as to whether securities litigation is effective in this role. An evaluation of the merits of securities litigation in general or the merits of any specific action is beyond the scope of this article.

investments. Relatively few actions allege some form of fraud or dereliction arising from traditionally regulated operations. Rather, most actions emerge from unregulated operations or investments outside of the utility business. I also find that these actions have been costly. As of April 2005, the total amount that utilities and their insurers have agreed to pay to settle securities class actions is almost \$1.4 billion.<sup>2</sup> Many actions remain ongoing. The experience of the utilities sector provides a useful case study for managers and directors of firms in industries that are about to undergo, or are currently undergoing, structural change. I suggest steps that managers and directors of such firms may take to reduce their exposure to the risk of a securities action.

Section II provides a thumbnail sketch of the four most common types of securities actions involving public corporations. This includes both actions filed under federal securities law and state corporation law. Section III provides an overview of the reasons that changes in the industry may have caused an increase in the level of litigation risk. This section also reviews the relationship between risk and the incidence of securities litigation. Section IV discusses methodology and the construction of my sample. Section V examines the incidence, allegations, and outcomes of securities actions involving firms in the utilities sector. This includes an examination of the frequency of different types of allegations put forth by plaintiffs. Section VI discusses the implications of the litigation boom and what companies can do to protect themselves. Section VII offers concluding observations.

## II. SECURITIES LITIGATION

Securities actions come in a variety of forms. This section provides a brief description of four common types of securities actions—derivative actions, securities class actions, actions under the Employment Retirement Income Security Act of 1974 (ERISA), and control-related securities actions. Each type of litigation is initiated by an investor. Officers and directors of the corporation are often personally named as defendants. Even if not named as a defendant, an officer or director may bear indirect costs as a result of the litigation.

Derivative actions have their basis in state corporation law. Derivative actions are filed on behalf of the corporation. Plaintiffs in derivative actions typically allege that officers or directors of the corporation have failed to meet their fiduciary duties. These duties encompass two and possibly three obligations. The duty of care requires officers and directors to exercise reasonable skill, diligence, and care in overseeing the affairs of the firm.<sup>3</sup> The duty of loyalty requires fairness in disclosure and in transactions in which an officer or director may have an interest.<sup>4</sup> Some courts have also recognized a duty of disclosure which requires that officers and directors provide investors with material information to corporate decisions.<sup>5</sup> Because the duties and procedures for litigating a derivative action arise under state corporate law, fiduciary duties vary. Plaintiffs in derivative actions typically seek either structural relief, or in the case of self-dealing, the return of funds to the

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2. See *infra* p. 496, tbl. 4.

3. Committee on Corporate Laws, ABA Section of Business Law, *Corporate Directors Guidebook: Fourth Edition*, 59 BUS. LAW. 1059, 1068–70 (2004).

4. *Id.* at 1070–72.

5. Committee on Corporate Laws, *supra* note 3, at 1072.

corporation.

Federal and state securities laws allow investors to file an action in the event that they suffer a loss as a result of fraudulent or misleading disclosures by the issuer.<sup>6</sup> These actions typically blossom into class actions. Class actions allow individual investors to pool their resources to take on expensive litigation. The formation of a class allows plaintiffs to overcome the free rider problem by spreading costs and benefits of the suit among the entire group of similarly situated investors. In a typical action of this type, plaintiffs allege that the company has caused its securities to become overpriced either through the dissemination of false or misleading information or the failure to disclose material information. Such claims typically allege a violation of section 11 of the Securities Act which prohibits material omissions or misstatements in registration statements issued in connection with the sale of securities<sup>7</sup> or Rule 10b of the Securities and Exchange Commission which proscribes the use of any manipulative device, the dissemination of any untrue statement of a material fact, or the omission of a material fact in connection with the purchase or sale of any security, including securities bought and sold in the aftermarket.<sup>8</sup> Relief takes the form of a financial recovery to members of the plaintiff class. The financial recovery is a function of the amount lost due to the fraud.

This article also examines two other forms of securities litigation that may expose management and directors to risk. Control transactions (e.g., mergers and acquisitions) frequently give rise to litigation. Plaintiffs in actions of this sort typically allege that managers of the target have agreed to an inadequate price or that the acquirer has used unfair tactics in the acquisition. These matters have their basis in state corporate law and typically take the form of a class action. These cases are referred to in this article as “acquisition-related actions.”

Actions under ERISA pertain to the management of employee holdings in 401(k) retirement plans.<sup>9</sup> In a typical ERISA action, plaintiffs allege that officers or directors breached their fiduciary duties towards plan participants by investing pension plan assets in company stock during periods in which it was overvalued or failing to sell shares in a timely fashion. As discussed below, companies in court under ERISA are often also defendants in class actions involving similar facts and legal theories.

### III. DEREGULATION, RESTRUCTURING AND THE INCREASE IN LITIGATION RISK FOR UTILITIES

I argue that deregulation and restructuring has increased the exposure of utilities and their officers and directors to the risk of litigation. The increase in litigation has been most pronounced among electric utilities and those firms that became heavily involved in wholesale energy trading. These activities experienced the highest rate of change over the sample period. At least four aspects of deregulation and restructuring contribute to the increased litigation

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6. State actions have been rare since the passage in 1998 of the Private Securities Litigation Uniform Standards Act. This Act preempted most state actions. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, § 1260, 112 Stat. 3227.

7. 15 U.S.C. § 77k (2000).

8. 17 C.F.R. § 240.10b5-2 (2004).

9. Employment Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified in scattered sections of 29 U.S.C.).

risk. First, deregulation and restructuring generally involve a shift of risks from ratepayers to investors. All else equal, the greater the risk borne by investors, the greater the likelihood that investors will experience a substantial loss in the value of their holdings. Such losses, whether from fraud or circumstance, trigger lawsuits. Second, deregulation and restructuring may lead to or hasten the development of new institutional arrangements, technologies, and models of business organization. Rapid structural or technological change increases the likelihood that some firms will have difficulty adapting to the new environment. As discussed below, change has been particularly fast-paced and sweeping in the electric power sector. Third, regulatory change exposes firms to heightened levels of policy risk. Policy change involves experimentation. Sometimes, outcomes differ substantially from expectations making it difficult for regulators to maintain earlier commitments. Fourth, deregulation and electricity restructuring have allowed managers greater discretion. Increased managerial discretion enhances efficiency by providing corporate decision-makers the ability to more readily reallocate resources to their highest valued uses. But, greater discretion also allows managers more opportunity to use the resources of the corporation to satisfy their own goals, rather than those of investors.

#### *A. Allocation of Risk*

Theorists of political economy postulate that regulators respond to pressure from organized interests. In his seminal work on regulation theory, Professor Sam Peltzman develops a model of regulation whereby regulators act to maximize political support by redistributing between shareholders and consumers the gains and losses resulting from volatility in the market.<sup>10</sup> For instance, if a sudden increase in demand were to inordinately benefit producers, political pressure from consumer interests would intensify. Regulators seeking to maximize political support would intervene to redistribute some of the benefits from producers to consumers. Likewise, should a change threaten to harm producers, there will be increased political pressure from producer interests seeking a bailout. In response, regulators would reallocate some of the burdens from producers to consumers.

The actions of regulators tend to buffer the regulated firm from the full impact of the laws of supply and demand. As a result, the volatility of earnings, cash flows, and stock price of the regulated firm will be lower than it would have been absent regulation. Deregulation will have the opposite effect. Deregulation reduces the latitude for regulators to intervene by reallocating gains and losses between consumers and producers. As a result, the buffering hypothesis implies that all else equal, deregulation should lead to an increase in volatility of earnings, cash flow, and stock prices of the deregulated firm.

Recent research concerning the effects of deregulation on firms in the electric power sector suggests that firms in this sector became more risky following important milestones in the movement toward competition. This is consistent with the buffering hypothesis. Professors Richard Michelfelder and Richard Perniciaro examine changes in the volatility of electric utility stock prices following the Federal Energy Regulatory Commission's (FERC) issuance of Orders 888 and 889 in 1996.<sup>11</sup> They find evidence of an increase in stock

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10. Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976).

11. Richard A. Michelfelder & Richard C. Perniciaro, *Stickiness of Electric Utility Costs of Common*

price volatility after the issuances of these two orders.<sup>12</sup> Professor Emeka Nwaeze examines the volatility of accounting measures of electric utility profitability following earlier movements to expand competition.<sup>13</sup> He finds that the volatility of electric utility return on assets and return on equity increased following the 1978 passage of Public Utility Regulatory Policies Act of 1978 (PURPA) and the 1992 passage of the Energy Policy Act.<sup>14</sup>

Managers and directors of more risky firms have a higher exposure to the risk of litigation. Cross-sectional studies of the probability that a firm will experience a securities class action demonstrate that riskier firms are more likely to be involved in litigation.<sup>15</sup> Damages are based on the difference between the price level that would have prevailed “but-for” the firm’s failure to properly disclose the information and the actual price of the security. Plaintiffs have an incentive to file a suit if the potential recoveries exceed their expected costs of litigation. The higher the level of risk, the greater the probability that investors will experience losses large enough that the potential recovery will cover the expected costs of litigation. Prospective plaintiffs must weigh the probability of a successful lawsuit. Deregulation may also affect the likelihood that plaintiffs will prevail in certain types of actions. Restructuring and deregulation lessens the extent to which managers can rely on regulations to defend their decisions.

Although ERISA litigation and derivative actions have not received as much attention in the academic literature, they too probably arise more frequently in riskier firms.<sup>16</sup> As is the case with securities class actions, the probability of a substantial loss in the value of a company’s securities held by a pension plan is greater when the price of those securities is more volatile.

### B. Innovation and Structural Change

Deregulation and restructuring may also hasten the adoption of new models of business organization and new technologies. These changes give rise to heightened levels of uncertainty during the transition period. Heightened uncertainty may also make it harder to detect opportunistic behavior and false or misleading disclosures by market participants. Therefore, one would expect that the incidence of securities litigation would rise during a period of rapid structural change.

From 1996 to 2003, the electric utility industry underwent major

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Equity, Depressed Stock Prices and Volatility (Apr. 2004) (working paper, Rutgers University); Order No. 888, *Promoting Wholesale Competition Through Open Access Nondiscriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, [Regs. Preambles 1991–1996] F.E.R.C. STATS. & REGS. ¶ 31,036 (1996), 61 Fed. Reg. 21,540 (1996) (codified at 18 C.F.R. pts. 35, 385); Order No. 889, *Open Access Same-Time Information System (Formerly Real-Time Information Networks) and Standards of Conduct*, [Regs. Preambles 1991–1996] F.E.R.C. STATS. & REGS. ¶ 31,035 (1996), 61 Fed. Reg. 21,737 (1996) (codified at 18 C.F.R. pt. 37).

12. Michelfelder & Perniciaro, *supra* note 11.

13. Emeka T. Nwaeze, *Deregulation of the Electric Power Industry: The Earnings, Risk, and Return Effects*, 17 J. REG. ECON. 49, 54–57 (2000).

14. *Id.*; Public Utility Regulatory Policies Act of 1978, Pub. L. No. 95-617, 92 Stat. 3117 (codified in scattered sections of 16 U.S.C.); Energy Policy Act of 1992, Pub. L. No. 102-486, 106 Stat. 2776 (codified in scattered sections of 42 U.S.C.).

15. See, e.g., Philip E. Strahan, *Securities Class Actions, Corporate Governance and Managerial Agency Problems* (1998) (working paper, Federal Reserve Bank of New York).

16. Employment Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified in scattered sections of 29 U.S.C.).

restructuring. Three important developments were: (i) the advent of independent generators and marketers with increased access to wholesale—and some retail—markets; (ii) a large growth in investment in generation capacity; and (iii) a dramatic increase in the volume of financial transactions to hedge physical positions. In this, the electric industry followed trends in the natural gas industry.<sup>17</sup> The introduction of institutional arrangements to facilitate wholesale transactions in electric power involved continuing experimentation with different markets designs. Some arrangements have been more successful than others. Flaws in market design can increase volatility in prices, and hence, bring about greater cash flow risk and risk management challenges. The power markets in the Western United States in 2000 and 2001 offer one conspicuous example.<sup>18</sup> Section V examines the effect that the events in California and other western states in 2000 and 2001 had on the incidence of securities litigation.

Technological change may increase uncertainty both for companies that adapt new technologies as well as those that do not. The returns from new technologies are often highly uncertain. The high level of uncertainty makes new technologies prone to overvaluation.<sup>19</sup> In the electric power sector, open access requirements and advances in gas turbine technology led to a dramatic increase in investment in gas-fired generation capacity.<sup>20</sup> However, in 2001 and 2002, equity values of companies with substantial merchant generation capacity declined sharply as analysts became concerned with the possibility of overbuilding.<sup>21</sup>

The volume of and the number of firms engaged in energy trading increased rapidly in the late 1990's. Wholesale trading in energy markets created new challenges for risk management, internal control, and disclosure policy. Pricing and managing the risks in energy contracts is highly complex. Some firms engaged in energy trading encountered problems because they lacked the ability to adequately evaluate and manage these risks.<sup>22</sup> The revelation of abuses of mark-to-market accounting prompted industry analysts to reexamine the financial disclosures of other utilities with substantial energy trading operations.<sup>23</sup> Section V examines the impact of problems associated with energy trading activities on the incidence of securities litigation.

### C. Policy Risk

The transition period in which deregulation or restructuring takes place may

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17. The winds of change have not blown yet over the water industry. See, e.g., PAUL SEIDENSTAT, DAVID HAARMAYER & SIMON HAKIM, *REINVENTING WATER AND WASTEWATER SYSTEMS: GLOBAL LESSONS FOR IMPROVING WATER MANAGEMENT* 7–26 (John Wiley & Sons, Inc. 2002).

18. See, e.g., U.S. GEN. ACCOUNTING OFFICE, GAO-02-828, *RESTRUCTURED ELECTRICITY MARKETS: CALIFORNIA MARKET DESIGN ENABLED EXERCISE OF MARKET POWER* (2002).

19. See, e.g., Michael C. Jensen, *Agency Costs of Overvalued Equity* 3 (Harvard Negotiation, Organizations and Markets, Working Paper No. 04-26, 2005), available at <http://ssrn.com>.

20. See, e.g., Robert L. Sansom & A. Michael Schaal, *Gas Turbine Mania: The Merchant Power Plant Shake Out*, PUB. UTIL. FORT., June 15, 2002, at 14.

21. See, e.g., Richard Stavros, *Reversal of Fortune? Wall Street Rethinks Merchant Power*, PUB. UTIL. FORT., Sept. 15, 2001, at 12; see also Sansom & Schaal, *supra* note 20.

22. INT'L SWAPS & DERIVATIVES ASS'N, *RESTORING CONFIDENCE IN U.S. ENERGY TRADING MARKETS* 8 (Apr. 2003).

23. See, e.g., Derivatives Study Center, *Trading Firms, Under the Gun, Embrace Broader Disclosure, Find 'New Metrics'*, POWER MKTS. WK., Feb. 4, 2002, at 1.

involve heightened levels of policy risk. Deregulation and restructuring has given rise to challenges for regulators as well as market participants. Whether policy risk increases during the transition, and if so by how much, depends on whether actual outcomes remain close enough to initial expectations. The experience with deregulation in California in 2000 and 2001 provides a vivid example of a divergence between actual and intended outcomes. When the California Public Utilities Commission restructured retail markets, it made it clear that the financial integrity of the utilities was to remain sacrosanct.<sup>24</sup> Yet, one of the utilities in its jurisdiction later declared bankruptcy due to the consequences of the restructuring which the California regulators did not foresee.

#### D. Agency Costs

Litigation is one instrument which influences corporate governance. It provides a means of punishing conduct by managers and directors that is not in the interest of the owners of the firm. A divergence of interest between owners and their fiduciaries "agency costs" takes a variety of forms. Managers may have an interest in increasing the size of the firm or scope of its operations beyond its optimal level in order to increase their compensation—financial or psychological.<sup>25</sup> A top management position in a larger or more complex organization is viewed as more prestigious than that in a smaller, simpler firm.<sup>26</sup> Also, compensation for management of larger organizations is also generally higher.<sup>27</sup> The desire to increase the size or scope of a firm may lead the management team to undertake investments or acquisitions to achieve growth rather than the maximization of value. Likewise, the management team of an organization may view itself as more capable than it actually is. Such hubris may also lead the firm to undertake ultimately unproductive growth or acquisition strategies.<sup>28</sup>

Deregulation and restructuring can affect the alignment between the interests of owners and managers. Regulation provides an additional layer of oversight of the management of the regulated firm.<sup>29</sup> The management team of a regulated firm that is being run poorly or engaging in excessively risky activities may find itself the object of increased regulatory scrutiny.<sup>30</sup> Regulatory oversight may also provide a check on empire building. For example, the Public Utility Holding Company Act (PUHCA) restricts the businesses in which electric utility holding companies may participate and state commissions had similar

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24. Rulemaking 94-04-031, *Order Instituting Rulemaking on the Commission's Proposed Policies Governing Restructuring California's Electric Services Industry and Reforming Regulation; Order Instituting Investigation on the Commission's Proposed Policies Governing Restructuring California's Electric Services Industry and Reforming Regulation*, CAL. PUB. UTIL. COMM'N (Apr. 20, 1994), 1994 Cal. PUC LEXIS 336.

25. See, e.g., René M. Stulz, *Managerial Discretion and Optimal Financing Policies*, 26 J. FIN. ECON. 3 (1990).

26. See, e.g., GORDON DONALDSON & JAY W. LORSCH, *DECISION MAKING AT THE TOP; THE SHAPING OF STRATEGIC DIRECTION* (Basic Books, Inc. 1983).

27. See e.g., Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990).

28. Richard Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 J. BUS. 197 (1986).

29. See Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. POL. ECON. 1155, 1161 (1985).

30. See, e.g., KURT A. STRASSER & MARK F. KOHLER, *REGULATING UTILITIES WITH MANAGEMENT INCENTIVES* 17-22 (Quorum Books 1989).

restrictions.<sup>31</sup> The traditional utility integrated resource planning process required utility managers to seek public service commission approval for new resource development. Though the FERC and states still review utility acquisitions and mergers, state deregulation has removed some level of oversight over utility investment decisions.

The methods used to restructure the electric power sector by the states may have resulted in an increase in agency costs. Restructuring involved the unbundling of the elements of vertically integrated utilities that were thought to be competitive from those which were considered to be natural monopolies. Between 1998 and 2002, almost 100,000 megawatts (MW) of generation capacity was divested by vertically integrated electric utilities.<sup>32</sup> The sale price in generation asset divestitures often exceeded expectations and left some utilities flush with cash, even after offsetting stranded costs.<sup>33</sup> Some utilities paid out excess cash to shareholders. Other firms engaged in diversifying investments outside of the United States, in telecommunications and in non-utility businesses.<sup>34</sup> Utility diversification efforts have resulted in some spectacular failures along with successes.<sup>35</sup> An increase in litigation following deregulation is consistent with the notion that for at least some firms, deregulation has led to an increase in incentive misalignment.

#### IV. METHOD AND SAMPLE COMPOSITION

My sample consists of firms involved in electric power generation and electric, gas, and water utility services. I select all firms appearing on Standard and Poor's Compustat with a Global Industrial Classification Standard (GICS) code of 55-Utilities. This GICS code includes four industry segments: (i) electric utilities; (ii) gas utilities; (iii) water utilities; and (iv) multi-utilities and unregulated power producers. Multi-utilities are defined as firms that have a diversified portfolio of utility operations (combinations of gas, electric, and water operations). I eliminate firms that are not publicly traded, utilities that are foreign owned, and a small number of firms that are classified by Compustat as utilities but are primarily involved in the distribution of propane and bottled gas.

I identify securities actions from the disclosure of legal proceedings appearing in Forms 10-K and 10-Q filed by sample firms. I examine all 10-K's filed by sample firms for fiscal years 1996 through 2003. If a firm is no longer publicly traded by year-end 2003, I examine the last 10-Q filed by that firm while it was a public corporation. Companies filing Forms 10-K and 10-Q are

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31. Public Utilities Holding Company Act of 1935, 15 U.S.C. § 79 (2000).

32. Paul L. Joskow, *The Difficult Transition to Competitive Electricity Markets in the U.S.*, 19 (May 2003) (working paper, Massachusetts Institute of Technology). Amounts exclude capacity transferred from regulated to unregulated affiliates.

33. See, e.g., Richard Stavros, *Generation Asset Divestiture: Steal of the Century?*, PUB. UTIL. FORT., Sept. 1, 1999, at 42; Art Holland, *Did Power Plant Buyers Pay Too Much?*, PUB. UTIL. FORT., Nov. 1, 1999, at 26.

34. See, e.g., Harry M. Trebing, *Assessing Deregulation: The Clash Between Promise and Reality*, 38 J. ECON. ISSUES 1 (2004); Robert H. Picchi, *Managing the Telecom Value Curve*, PUB. UTIL. FORT., June 15, 2002, at 22 (noting that eighty percent of the largest 100 U.S. utilities have some telecommunications activities); see also Frank Reeves, *As Regulators Step Back, Utilities Remake Themselves*, PITT. POST-GAZETTE, Apr. 9, 2000.

35. See, e.g., Bill Richards, *Power Outage: For a Montana Utility, A Gamble on Telecom Looks Like a Bad Call*, WALL STREET J., Aug. 22, 2001, at A1; Paul Kamazis, *Diversify or Die? Recent History Has Proved Otherwise*, ELEC. WORLD, Nov. 1, 1998, at 50.



required to report in Item 3 material legal proceedings to which they are a party.<sup>36</sup> My sample includes actions filed between January 1, 1996 and December 31, 2003. In the event that a firm experienced two or more actions of a particular type with similar allegations, I consolidate them into a single action and record as the filing date the date that the first of the actions was filed. For each action, I gather information on the nature of the suit and the allegations put forth by plaintiffs from descriptions appearing in company disclosures, news releases, complaints, and settlement notices. For securities class actions, I obtained the current status of the action and the terms of settlements from Institutional Shareholder Services.<sup>37</sup>

The final sample consists of 218 utilities. The sample size varies from a high of 201 firms in 1996 to a low of 117 in 2003. The decline reflects the high level of control activity in the utilities sector in recent years. In terms of the four sub-categories: 102 sample firms are classified by Compustat as electric utilities, 65 as gas utilities, 18 as water utilities, and 33 as multi-utilities and unregulated power producers. I was able to matching 10-K's on the SEC's EDGAR website for 1,258 firm-years. The sample of lawsuits includes 122 lawsuits. This includes forty-three securities class actions, thirty derivative actions, thirty-two acquisition-related actions, and seventeen actions arising under ERISA.

## V. ANALYSIS OF TRENDS AND OUTCOMES OF SECURITIES ACTIONS

### A. Frequency of Litigation

If deregulation and restructuring has heightened the risk of litigation, then one would expect that shareholder claims would be more numerous in recent years and that a high proportion would involve either deregulated activities or non-utility operations. Likewise, the increase in the incidence of litigation should be highest among firms in the segments of the industry experiencing the most sweeping change. The distribution of actions by type and year filed appears in Panel A of Table 1. For securities class actions, derivative and actions arising under ERISA, the number of filings peaked in 2002. The twenty-four securities class actions involving utilities filed in 2002 constitute about 10% of all securities class actions filed in that year.<sup>38</sup> The connection between the annual incidence of filings of securities class actions, derivative suits, and ERISA suits is not unexpected. In all three cases, plaintiffs typically file suits following the revelation of bad news or after a period of poor stock price performance.

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36. SEC. EXCH. COMM'N., REGULATION S-K, PART 229, STANDARD INSTRUCTIONS FOR FILING FORMS UNDER SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, AND ENERGY POLICY AND CONSERVATION ACT OF 1975, *available at* <http://www.sec.gov/about/forms/regs-k.pdf>.

37. Institutional Shareholder Services (ISS) is a provider of research and data on corporate governance and securities class actions. About ISS, <http://www.issproxy.com/about/index.jsp> (last visited Aug. 22, 2005).

38. There is no single definitive listing of securities class actions although a number of organizations track filings. The Stanford Securities Class Action Clearing House reports that there were 226 filings in 2002. A study by National Economics Research Associates reports 241 filings. STANFORD LAW SCH. SEC. CLASS ACTION CLEARINGHOUSE, INDICES OF SECURITIES CLASS ACTION FILINGS, *available at* [http://securities.stanford.edu/litigation\\_activity.html](http://securities.stanford.edu/litigation_activity.html) (last visited Aug. 23, 2005); ELAINE BUCKBERG, TODD FOSTER, RONALD MILLER & STEPHANIE PLANCICH, NERA ECON. CONSULTING, RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION: BEAR MARKET CASES BRING BIG SETTLEMENTS (Feb. 2005) *available at* [http://www.nera.com/image/recent\\_trends\\_final\\_2.28.05.pdf](http://www.nera.com/image/recent_trends_final_2.28.05.pdf).

The incidence of securities class actions, derivative actions, and ERISA actions is higher in the later half of the sample period. Between 2000 and 2003, thirty-nine securities class actions were filed versus only four from 1996 to 1999. Because of consolidation, the difference in the increase in the rate of filings is even higher. The rate of class action filings in the period from 1996 to 1999 was .005 actions per firm-year compared to .074 per firm-year from 2000 to 2003.<sup>39</sup> If securities class actions, derivative actions, and actions under ERISA are combined, eighty actions were filed in the second four years of the sample period versus ten in the first four years. The higher incidence of litigation in the second part of the sample period coincides with the emergence of difficulties in the movement towards deregulation and competition in electric power markets.

The annual incidence of acquisition-related actions differs from the other three types of lawsuits covered in this study. These actions arise out of control transactions. Their frequency is a function of the level of merger and acquisition activity. Results in Panel A of Table 1 show that the incidence of acquisition-related actions is higher in the early part of the sample. The higher volume of litigation reflects the higher level of merger and acquisition activity involving companies in the utility sector in the late-1990's compared to recent years.<sup>40</sup>

Panel B of Table 1 divides the firms involved in shareholder litigation into the four GICS utilities industry segments. The majority of actions filed (106 of 122) involve electric utilities and firms in the multi-utilities and unregulated power segments. Deregulation and restructuring activity was much more intense during the sample period in the electric power sector than among gas or water utilities. Firms in the multi-utilities and unregulated power segment have the highest incidence of litigation per firm-year of operations. This segment includes firms such as Enron, Dynegy, El Paso, and Williams Companies which had electric power, pipeline, trading, and other operations. As a check, I examine the type of activities that gave rise to plaintiffs' allegations for all companies in the multi-utility and unregulated power segment. In no case did the primary allegations arise from regulated operations. Rather, actions were the result of unregulated electric power, energy trading, or investments outside of the utility sector. As discussed in Section III, deregulation and restructuring can result in an increase in risks and agency costs. The higher incidence of litigation in the electric power segments of the industry is consistent with this hypothesis.

The increase in the filing rate for securities class actions involving utilities in the second half of the sample period is far greater than the growth in the number of filings.<sup>41</sup> During the sample period, the risk of involvement in a securities class action was higher for managers and directors of companies in the utility sector than for the average public company. My sample includes forty-three securities class actions in 1,258 firm-years of activity—an average of .034

39. BUCKBERG, *supra* note 38. The sample contains 730 firm-years between 1996 and 1999 and 528 firm-years between 2000 and 2003.

40. John R. Becker-Blease, Lawrence G. Goldberg & Fred R. Kaen, Post Deregulation Restructuring of the Electric Power Industry: Value Creation or Value Destruction? 7, 29 (Feb. 21, 2004) (working paper, University of New Hampshire) available at <http://www.unh.edu/wsbe/faculty/frk/utility.doc>. Professors Becker-Blease, Goldberg & Kaen report that the annual number of control transactions announced involving publicly-traded electric power and gas utilities peaked in 1999. The average annual number of control transactions in their sample during the period from 2000 to 2002 was approximately half that of 1996 to 1999.

41. I am not aware of any time-series data on the incidence of derivative actions, acquisition-related class actions, or ERISA actions.

suits per firm-year. This rate is roughly double that reported for all public companies over the sample period.<sup>42</sup> Aggregate annual data on securities class action filings from the Stanford Law School Securities Class Action Clearinghouse indicates that the average annual number of filings in 2000 to 2003 was only ten percent higher than the number of filings during the previous four years.<sup>43</sup> This is much lower than the increase in the rate of securities class action filings for utilities reported in Panel A of Table 1.<sup>44</sup>

Previous studies of securities class actions that examine earlier periods also provide some indications that the rate of securities litigation in the utilities sector in recent years is also likely higher than it was prior to 1996. Early studies of securities class actions that focused on litigation-prone industries did not single out utilities as a high risk sector.<sup>45</sup> Instead, some of the industries identified as litigation-prone were computers and business equipment, financial services, healthcare, chemicals, and retailing. My finding of a higher incidence of litigation in the utilities sector is also consistent with that of Professors Gilbert, Grundfest, and Perino who report the distribution of securities class actions by industry.<sup>46</sup> In their study, utilities are part of a broader industry group that also includes firms in the transport and telecommunications sectors.<sup>47</sup> They find that the proportion of all securities class actions that involved a firm in these sectors increased between 1990–1995 and 1996–2002. Since the latter period also coincides with a large amount of restructuring activity in other infrastructure industries—namely the telecommunications industry—the results reported by Professors Gilbert, Grundfest, and Perino are consistent with the notion that deregulation and restructuring can cause an increase in the risk of securities litigation.

### B. Allegations

As discussed above, the nature of the allegations in shareholder lawsuits can

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42. ELAINE BUCKBERG, TODD FOSTER & STEPHANIE PLANCICH, NERA ECON. CONSULTING, RECENT TRENDS IN SECURITIES CLASS ACTION LITIGATION: 2003 EARLY UPDATE 4 (2004). The authors estimate an average incidence of .018 securities class action suits per firm-year for publicly traded companies.

43. STANFORD LAW SCH. SEC. CLASS ACTION CLEARINGHOUSE, INDICES OF SECURITIES CLASS ACTION FILINGS, available at <http://securities.stanford.edu/litigation-activity.html> (last visited Aug. 23, 2005). I calculated the number of filings for each time period based on the annual number of filings reported by the Clearinghouse. The average number of filings per year increased from 181 per year in 1996 to 199 per year from 2000 to 2003. The rate from 1993 to 1995 was 194 filings per year.

44. See *infra* p. 492, tbl. 1, panel A.

45. See, e.g., Jennifer Francis, Donna Philbrick & Katherine Schipper, Determinants and Outcomes in Class Action Securities Litigation (1994) (working paper, Duke University & Portland State University); Willard T. Carleton, Michael S. Weisbach & Elliott J. Weiss, *Securities Class Action Lawsuits: A Descriptive Study*, 38 ARIZ. L. REV. 491 (1996); Joseph A. Grundfest & Michael A. Perino, *Securities Litigation Reform: The First Year's Experience—A Statistical and Legal Analysis of Class Action Securities Fraud Litigation Under the Private Securities Litigation Reform Act of 1995* (Stanford Law Sch. John M. Olin Program in Law & Econ., Working Paper No. 140, 1997); Marilyn F. Johnson, Ron Kasznik & Karen K. Nelson, *The Impact of Securities Litigation Reform on the Disclosure of Forward-Looking Information by High Technology Firms*, 39 J. ACCT. RES. 297, 305 (2001); see also Christopher L. Jones & Seth E. Weingram, *Why 10b-5 Litigation Risk is Higher for Technology and Financial Services Firms* (Stanford Law Sch. John M. Olin Program in Law & Econ., Working Paper No. 132, 1996).

46. Paul A. Griffin, Joseph A. Grundfest & Michael A. Perino, *Stock Price Response to News of Securities Fraud Litigation: An Analysis of Sequential and Conditional Information*, 40 ABACUS 21 (2004).

47. *Id.* Form industry groups by one-digit SIC code. Their transportation and public utility sector includes firms with a primary SIC code between 4000 and 4999.

also provide some insights into whether deregulation has increased the litigation risk of officers and directors. Complaints must provide some indication of the facts that gave rise to their allegations.<sup>48</sup> In addition, companies must describe the nature of pending litigation when filing their Forms 10-K and 10-Q with the Securities and Exchange Commission. If deregulation and restructuring increases the risk of litigation, then competitive activities should be cited frequently by plaintiffs in their complaints.

Table 2 concerns the nature of plaintiffs' allegations in securities class action suits. Panel A contains the distribution of suits by the type of plaintiff. In forty-two of forty-three suits, plaintiffs include utility shareholders who purchased securities during the period that the securities were allegedly mispriced. Securities laws also apply to purchasers of other securities including debt. In nine securities class actions the plaintiffs included purchasers of a company's debt.

Panel B of Table 2 contains the type of utility activities that gave rise to plaintiffs' allegations in securities class action lawsuits. Seven of the forty-three actions concern regulated utility operations. The allegations concerning regulated activities varied.<sup>49</sup> Most securities class actions involve utility activities that are not subject to strict regulatory oversight. Thirty-five actions arose as a result of unregulated operations or investments outside of the utility sector. One action was unrelated to operations, but instead concerned corporate governance practices. For suits involving unregulated activities, the most common types of allegations involved energy trading (seventeen cases) and investments outside of the utilities sector (seventeen cases). The latter includes investments in financial assets as well as investments in telecommunications and service company affiliates. Allegations concerning investments in unregulated electric power generation resources arose in four cases. The high proportion of shareholder class action suits that involve unregulated activities is consistent with the notion that deregulation and the movement towards greater competition in the utilities sector has increased the litigation risk exposure of utility officers and directors. In particular, the high frequency of securities actions involving investments outside of the utility sector are consistent with an increase in agency costs (i.e., the empire building and hubris hypotheses) for at least some firms in the industry.

Panel C of Table 2 examines the nature of the allegation in securities class actions involving firms in the utilities sector.<sup>50</sup> Of the forty-three securities class actions filed during the sample period, twenty-six (60%) involved some form of an accounting violation. Revenue recognition allegations were prominent. Revenue recognition issues were cited in nineteen cases (73% of the actions citing accounting violations). A substantial portion of these cases involving revenue recognition allegations concerned the effects of round-trip or wash trading on reported revenues. As discussed in Section III, energy trading activities expanded rapidly following the creation of competitive wholesale

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48. For example, in a securities class action, plaintiffs are required to state in their complaint each statement that they allege to have been misleading, and if they believe that material facts were not disclosed, the facts upon which those beliefs were formed. 15 U.S.C. § 78u-4(b)(1) (2000).

49. Three actions concerned improper accounting for transition revenues, two concerned disclosures of the length of outages of nuclear generating units, and two concerned other misrepresentations of financial performance and prospects.

50. See *infra* p. 494, tbl. 2, panel C.

electric power markets. Some firms that entered into wholesale energy trading may not have had adequate risk management and internal control capabilities. Energy trading also gave rise to a number of disclosure issues. Overall, the percentage of utility securities class actions that involve accounting allegations in general and revenue recognition problems in particular, is similar to that reported for all securities class actions.<sup>51</sup> Allegations that the company failed to disclose a source of risk were also common. Plaintiffs alleged a failure to disclose material facts or risks in twenty-six securities class actions. Failures to disclose were closely tied to developments concerning unregulated and non-utility operations. Of the twenty-six actions involving allegations of a failure to disclose risks, twenty-three involved unregulated utility activities or non-utility operations.

The events in California and other parts of the Western United States in 2000 and 2001 have been the source of a large amount of litigation. The high level of price volatility for a sustained period and the regulatory response to the market fluctuation had a negative effect on many market participants. Panel D of Table 2 reports the effects of the disruption in power markets in California and the Western United States on the incidence of securities class actions.<sup>52</sup> Of the forty-three securities class action suits filed during the sample period, ten suits contained allegations concerning activities in Western electric power and/or gas markets during the crisis period. Four suits contained both allegations arising from the Western power crisis as well as other allegations. Therefore, these four actions are included in both categories. Both sellers as well as buyers were the subject of securities class actions. In seven actions, plaintiffs alleged that the defendant failed to disclose that it had benefited from improper activities. While important, the western power crisis is only part of the story. Most securities class actions are not related to the crisis.

Table 3 contains summary statistics concerning the thirty derivative suits in the sample.<sup>53</sup> Panel A contains the nature of the allegations. In derivative suits, plaintiffs typically put forth a broad range of allegations. Of the thirty suits in the sample, thirteen involved allegations of a breach of the duty of loyalty, fourteen involved a breach of the duty of disclosure, and twenty-four a breach of the duty of care.<sup>54</sup> Plaintiffs in duty of care claims alleged that management or the board failed to exercise adequate levels of supervision. Half of the duty of care claims concerned alleged failures by management to adequately supervise trading operations. Five actions involving an alleged failure of management to meet its duty of care concerned oversight over physical assets. Of these five claims, four concerned the management of nuclear generation assets.

Panel B of Table 3 concerns the type of activity that gave rise to the claims

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51. PricewaterhouseCoopers reports that among securities class actions filed in 2002, sixty-eight percent involved some form of accounting violation and that revenue recognition issues were cited in sixty-one percent of the cases in which an accounting violation was alleged. See PRICEWATERHOUSECOOPERS, 2002 SECURITIES LITIGATION STUDY (2003), available at [http://www.1065.com/2002\\_study.pdf](http://www.1065.com/2002_study.pdf).

52. See *infra* p. 494, tbl. 2, panel D.

53. See *infra* pp. 495, tbl. 3.

54. In many instances, the discussion of the case appearing in company disclosures did not refer to alleged misconduct in terms of a breach of a specific duty, but instead, provided a general description of the alleged wrongdoing. In such instances, I classified the allegations based on the nature of the claim (i.e., self-dealing, failure to disclose, and inadequate supervision).

in derivative suits.<sup>55</sup> I was able to determine the activities that gave rise to suits in twenty-eight of thirty derivative actions. Four derivative suits involved activities that were not related to utility activities.<sup>56</sup> Of the remaining twenty-four cases, six involved regulated utility activities and eighteen involved unregulated operations.<sup>57</sup> As was the case for securities class action suits, energy trading and investments outside of the domestic utilities sector were the two most frequently cited unregulated activities in derivative actions.

### C. Outcomes

Most securities actions end in settlement or dismissal. Trials are rare. Settlements in securities class actions and ERISA actions involve the payment of money damages to investors. Derivative actions may involve a structural settlement, a financial settlement, or elements of both. Acquisition-relation actions are typically settled with a modification of the terms of a tender offer. In recent years, there have been a number of large settlements in securities class actions. These large settlements have attracted considerable attention in the media.

I determined the status of the forty-three securities class actions in the sample as of April 30, 2005.<sup>58</sup> As of that date, fifteen of the forty-three securities class actions were active, twelve had been dismissed, fifteen had been settled, and one action had been partially settled. Partial settlements are actions in which plaintiffs have settled with certain defendants, but not others.<sup>59</sup> Among the seven securities class actions involving regulated activities, four ended in a dismissal and three ended in a settlement. Table 4 lists the five largest securities class action settlements and total amount of the settlement funds in the sixteen securities class actions that have been either settled or partially settled.<sup>60</sup> The aggregate amount of the settlement funds in the fifteen settled actions and the one partial settlement is \$1.387 billion.<sup>61</sup> Of the five largest settlements, four involved alleged accounting violations. In the other case, the allegations concerned the failure to disclose financial difficulties. The settlement fund includes both compensation paid to investors and the fees and expenses of plaintiffs' counsel. The settlement amounts reported in Table 4 include only settlements with the company and its officers and directors. A small number of important cases also involve other types of defendants, such as, auditors and perhaps other parties. For example, the Enron litigation includes actions involving the company's auditors and financial institutions that were party to transactions involving Enron's special purpose entities. Table 4 does not include settlements with auditor or financial institution defendants.

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55. See *infra* p. 495, tbl. 3, panel B.

56. One suit involved the adoption of a shareholder rights plan and three concerned misuse of corporate funds.

57. Of the seven cases involving regulated activities, three concerned the management of nuclear power assets, one involved the administration of a performance-based rate plan, one involved environmental liabilities, and two involved the sale of regulated utility assets.

58. See *infra* p. 496, tbl. 4.

59. For instance, a partial settlement may involve an instance in which defendants have settled with one class of plaintiffs, such as equity holders, but are actively engaged in litigation with another class, such as debt holders.

60. See *infra* p. 496, tbl. 4.

61. *Id.*

Settlements in actions involving utilities tended to be larger than typical securities class action settlements. For the fifteen settlements involving firms in the utility sector, the average settlement size was \$92.1 million. The median settlement was \$41 million. By comparison, a study by National Economics Research Associates of securities class actions settled in 2004 reports an average settlement size of \$27.1 million and a median settlement of \$5.3 million.<sup>62</sup> The larger average and median settlements for utilities may be due in part to the larger size of utilities versus the average public company. The average size of the settlements in the three securities class actions involving regulated activities was \$49.6 million.

## VI. CONSEQUENCES FOR CORPORATE STEWARDSHIP

### A. *Implications for Directors and Officers*

Liability rules are intended to better align the interests of corporate officers and directors with that of the owners of the firm.<sup>63</sup> In practice, the use of liability rules to achieve these ends is problematic. The actions that constitute a breach of the duties of officers and directors is vaguely defined. For example, in matters concerning disclosure policy, what constitutes material information and when such information should properly be disclosed is often in dispute. Likewise, it is unclear what constitutes the proper level of supervision and investigation that meets the obligations of directors' duty of care. In any enterprise, there is some risk that even if officers and directors meet their fiduciary duties, plans may go awry and result in a securities action. As a result, the potential for involvement in some sort of securities litigation may be an incentive to managers and directors to forgo risky investments or strategies, even if these activities are in the interest of investors. That is, rather than better aligning interests, the desire of managers and officers to avoid litigation may cause interests to diverge and decrease the value of the holdings of investors. Concerns over litigation risk can also make it more difficult for companies to attract high quality outside board members. A recent survey by a major executive search firm found that "23 percent of Board Directors on *Fortune* 1000 companies in the Americas turned down additional board roles in 2002" because of concerns about personal liability.<sup>64</sup>

The direct financial costs of a securities action fall primarily on the corporation and its liability insurers rather than on officers and directors themselves. Public corporations typically indemnify managers and directors and purchase directors' and officers' (D&O) liability insurance to protect managers and board members from liability arising from a securities suit. Insurance and indemnification typically covers both the direct costs associated with settlements paid to investors and legal expenses awarded to plaintiff's counsel.<sup>65</sup> In only a

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62. See BUCKBERG, *supra* note 42, at 6.

63. See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 90-93 (Harvard Univ. Press 1991).

64. Press Release, Korn/Ferry International, Fortune 1000 Board Members are Turning Down Directorships at Twice the Rate of Last Year Due to Personal Liability Risk (Oct. 28, 2003), *available at* [http://kornferry.com/library/process.asp?p=pr\\_detail&CID=543&lid=1](http://kornferry.com/library/process.asp?p=pr_detail&CID=543&lid=1).

65. Insurance policies for directors and officers typically have exclusions for intentional or criminal misconduct. Absent evidence of such intent, the prospect that an outside director will experience a financial

few instances have directors contributed personal assets to the settlement fund.<sup>66</sup> Officers and directors also bear little risk from an unfavorable outcome at trial because the vast majority of securities actions are either settled or dismissed.<sup>67</sup>

While officers and directors rarely pay any legal expenses or settlement costs, they may bear indirect costs as a result of an action.<sup>68</sup> Involvement in a securities action may place added demands on corporate boards as well as managers and directors individually. Officers and directors may be subject to the inconvenience and unpleasantness of being deposed by plaintiff's counsel or responding to discovery requests.<sup>69</sup> Boards of corporations involved in a securities action may become involved in the consideration of such issues as the corporation's legal response as well as public and investor relations issues. Procedural requirements may also place demands on corporate boards.<sup>70</sup> For instance, boards typically are required to approve the terms of settlements in securities class actions. In a derivative action, the board usually instigates and evaluates the findings of an investigation of the allegations of plaintiffs. All else equal, a corporate officer or director would probably prefer to spend his or her time in other ways.

Involvement in a securities action may also reduce the perceived value of an officer's or director's human capital. Officers and directors often cite concerns that possible involvement in a securities action may harm their reputation as a provider of oversight and advice to management.<sup>71</sup> Managers and directors gain a number of rewards from participation in the management of a well-run corporation. In addition to financial rewards, service as a top corporate officer or board member enhances one's visibility and prestige.<sup>72</sup> Top managers of successful corporations enjoy higher value in the market for managerial talent.<sup>73</sup>

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loss as a result of a shareholder lawsuit is remote. See Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability* 6-7, 15 (Stanford Law Sch. John M. Olin Program in Law and Econ., Working Paper No. 250, 2003).

66. Ben White, *Former Directors Agree to Settle Class Actions: Enron, WorldCom Officials to Pay Out of Pocket*, WASH. POST, Jan. 8, 2005, at E01; see also Ben White, *WorldCom Ex-Leaders Reach Deal in Lawsuit: Directors Personally Will Pay \$20 Million to Shareholder Class*, WASH. POST, Mar. 19, 2005, at E01. Former directors contributed \$13 million to the settlement of the Enron securities class action from their own personal funds. Former WorldCom directors contributed \$20.25 million to the settlement fund.

67. See, e.g., Roberta Romano, *The Shareholder Suit: Litigation Without Foundation*, 7 J.L. ECON. & ORG. 55, 60 (1991). Professor Robert Romano examines the outcomes of 128 derivative and class action suits. Only one ended with a judgment for the plaintiff. See also Frederick C. Dunbar, Vinita M. Juneja & Denise N. Martin, *Shareholder Litigation: Deterrent Value, Merit and Litigants' Options* (1995) (working paper, Washington University, John M. Olin School of Business). Of 656 securities class actions in the authors' sample, only seventeen ended in a judgment. See also Stephen P. Ferris, Robert M. Lawless & Anil K. Makhija, *Derivative Lawsuits as a Corporate Governance Mechanism: Empirical Evidence on Board Changes Surrounding Filings* (Univ. of Mo. Contracting and Orgs. Research Inst., Working Paper No. 2001-03, 2001) available at <http://cor.missouri.edu.r18>. Most derivative actions are settled or terminated by the court in favor of the firm. No actions cited in the sample ended in a judgment against the firm.

68. See, e.g., William Sahlman, *Why Sane People Shouldn't Serve on Public Boards*, HARV. BUS. REV., 28, 30, 34 (1990); Black, Cheffins & Klausner, *supra* note 65, at 48-49.

69. Black, Cheffins & Klausner, *supra* note 65, at 46-48.

70. *Id.*

71. Sahlman, *supra* note 68, at 30; Black, Cheffins & Klausner, *supra* note 65, at 46-48.

72. See, e.g., DONALDSON & LORSCH, *supra* note 26, at 22-24, 160-63; MYLES L. MACE, *DIRECTORS: MYTH AND REALITY* 86-110 (Harvard Bus. Sch. Press 1986).

73. See Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. OF POL. ECON. 288 (1980); see also Albert A. Canella Jr., Donald R. Fraser & D. Scott Lee, *Firm Failure and Managerial Labor Markets: Evidence from Texas Banking*, 38 J. FIN. ECON. 185 (1995) (showing that managers of banks that failed for



Outside directors of successful enterprises enjoy better opportunities to gain additional income and prestige through service on other boards.<sup>74</sup> The prospect of harm to their reputation as the result of involvement in a securities suit may be an inducement to managers and directors to avoid strategies that could increase their exposure to litigation risk or avoid serving on boards that are perceived to be high risk.

### B. Suggested Protective Measures

The experience of electric utilities provides a useful case study for managers and directors of firms in industries that are either currently undergoing structural change or that may undergo such a change in the future. There are at least three issues that managers and directors of firms in that position should consider. First, officers and directors should be aware that while deregulation or other changes in industry structure may create new opportunities, they may also lead to an increase in litigation risk.<sup>75</sup> In particular, outside directors should weigh the benefits from board service against their tolerance for the risk of litigation.<sup>76</sup> Second, the period prior to structural change is an opportune time to review corporate and board policies. This may include a review of procedures for documentation and record retention. It may also involve a review of the adequacy of measures to protect the financial interests of officers and board members including indemnification and D&O insurance. Insurance coverage limits should be reviewed. Firms with greater stock price volatility tend to purchase higher levels of D&O insurance coverage.<sup>77</sup> Likewise, it is also appropriate to review the terms of D&O insurance policies. D&O insurance policies differ in terms of the types of actions covered and the methods for the allocation of costs between the insurer and the company (e.g., co-payments and deductibles). Third, it may be useful to consider changes in corporate governance structures. Industry structure affects corporate governance practices.<sup>78</sup> For instance, firms in the airline industry tended to reduce the size of their boards following deregulation.<sup>79</sup> There is also evidence that after deregulation, banks tended to adopt executive compensation contracts that increased the sensitivity of compensation to performance.<sup>80</sup> Financial incentives may motivate managers to take actions that enhance shareholder value. But they may also give managers an incentive to behave opportunistically by inflating equity values in order to boost their compensation.<sup>81</sup>

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reasons beyond the managers control were more likely to subsequently obtain comparable positions as managers of other banks.).

74. See Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 315 (1983).

75. George D. Kaltchev, *The Demand for Directors' and Officers' Liability Insurance by US Public Companies* 39 (July 2004) (working paper, Southern Methodist University), available at [http://papers.ssrn.com/papers.cfm?abstract\\_id=565183](http://papers.ssrn.com/papers.cfm?abstract_id=565183).

76. *Id.*

77. Kaltchev, *supra* note 75, at 38–39, 43–46.

78. Stacey R. Kole & Kenneth M. Lehn, *Deregulation and the Adaptation of Governance Structure: The Case of the U.S. Airline Industry*, 52 J. FIN. ECON. 79, 105–08 (1999).

79. *Id.*

80. Anthony J. Crawford, John R. Ezzell & James A. Miles, *Bank CEO Pay-Performance Relations and the Effects of Deregulation*, 68 J. BUS. 231, 236–39 (1995); R. Glenn Hubbard & Darius Palia, *Executive Pay and Performance: Evidence from the U.S. Banking Industry*, 39 J. FIN. ECON. 105, 129 (1995).

81. Lin Peng & Alisa Röell, *Executive Pay, Earnings Manipulation and Shareholder Litigation* 31–33

The Sarbanes-Oxley Act of 1992<sup>82</sup> has increased the importance of being proactive in the face of an increase in operating or financial risks. The Act contains a number of provisions that heighten the exposure of officers and directors to the risk of involvement in a securities action. Sarbanes-Oxley increased disclosure requirements for off-balance sheet items as well as requiring that issuers disclose in a timelier manner. The increase in the volume and speed of disclosure makes it more likely that something will be missed or not disclosed as quickly as required. The Act also increases the responsibilities of members of the board of directors and, in particular, the audit committee.<sup>83</sup> These increased responsibilities may be a source of increased liability in the event that fraud is uncovered by making it less likely that managers or directors could escape involvement by claiming to have been unaware of the alleged malfeasance.<sup>84</sup> Sarbanes-Oxley also increases the exposure of officers and directors to the risk of securities actions by extending the time limits for filing a complaint. The Act increases the limitation from one to two years after discovery and from three to five years after the occurrence of the alleged violation.<sup>85</sup>

## VII. CONCLUSIONS

I find that the upsurge in the number of securities actions against utilities is a consequence of the fallout from deregulation and restructuring. The increase in filings coincides with the emergence of difficulties in experiments with competition in the electric power sector. Most of the securities actions involve electric utilities or companies heavily involved in energy trading and unregulated power production. Beginning in the mid-1990's, firms in these segments of the industry experienced dramatic changes in their regulatory environment and business practices. My examination of the pattern of allegations in securities actions produced similar results. Most derivative and securities class actions stem from unregulated activities and investments outside of the utility sector. Less than one-fourth of the actions filed between 1996 and 2003 involved regulated utility operations.

Managers and directors of public corporations often express concern over the risk that they will become involved in some way in a securities action. Such involvement may be unpleasant and harmful to their reputation as effective monitors and decision-makers. The experience of the utilities sector may be instructive for officers and directors of firms in industries that are about to undergo deregulation or some other form of structural change. Officers and

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(Dec. 2004) (working paper, AFA Philadelphia Meetings), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=488148](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=488148).

82. The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §705, 116 Stat. 745, 799.

83. For instance, section 204 codified at 15 U.S.C. § 78j-1 (Supp. II 2002) requires any accounting firm performing an audit to inform the audit committee of "(1) all critical accounting policies and practices to be used; (2) all alternative treatments of financial information within Generally Accepted Accounting Principles . . . ; and (3) . . . communications between the registered public accounting firm and the management . . . ." Sarbanes-Oxley Act of 2002 § 204. Section 301, codified at 15 U.S.C. § 78f, specifies that the "audit committee . . . shall be directly responsible for the . . . oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) . . . ." § 301.

84. Such requirements make it more difficult for audit committee and board members to claim that they were unaware of the fraud.

85. Corporate and Criminal Fraud Accountability Act of 2002, Pub. L. No. 107-204, §804, 116 Stat. 800, 801 (codified at 28 U.S.C. § 1658).

directors of such firms should be aware that while these changes may present new opportunities, they may also heighten their exposure to the risk of involvement in a securities action. Prudent managers and directors will account for this increase in risk in evaluating potential changes to administrative and board policies as well as means for protecting officers and directors from personal liability should they be named as a defendant in a suit. The passage of Sarbanes-Oxley only serves to heighten the importance of these preparations.

Finally, the increased frequency of securities litigation should not be interpreted as a critique of the efficacy of deregulation. Deregulation has many dimensions. An increase in litigation is but one consequence of increased competition and managerial discretion. A useful area for further research would be to examine the adaptation of other elements of corporate governance, such as board structure and executive compensation practices, to deregulation and restructuring in the utility sector.

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**Table 1: Securities Litigation Involving Utilities**  
**Panel A: By Year Filed and Type of Action**

Year	Securities Class Actions	Derivative Actions	Acquisition- Related Actions	ERISA Actions	Total Actions
1996	1	1	6	0	8
1997	0	4	1	0	5
1998	2	1	4	0	7
1999	1	0	9	0	10
2000	4	1	4	0	9
2001	4	4	1	1	10
2002	24	13	6	12	55
2003	7	6	1	4	18
Total	43	30	32	17	122

Note: Year is defined as the year that the action was first filed.

**Table 1: Securities Litigation Involving Utilities**  
**Panel B: By Industry Segment and Type of Action.**

Industry Segment	Segment Size (# of Firms and Firm Years)	Securities Class Actions	Derivative Actions	Acquisition- Related Actions	ERISA Actions	Total Actions
Electric Utilities	102 Firms/580 Firm-years	18	19	12	7	56
Gas Utilities	65 Firms/341 Firm-years	4	2	8	0	14
Multi-utilities & Unregulated Power Producers	33 Firms/219 Firm-years	20	9	11	10	50
Water Utilities	18 Firms/118 Firm-years	1	0	1	0	2
Total	218 Firms/1258 Firm- years	43	30	32	17	122

**Table 2: Securities Class Action Suits****Panel A: Identity of Plaintiffs**

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Equityholders	42
Debtholders	9
Total Actions	43

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**Panel B: Activities Cited by Plaintiffs**

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Regulated Activity	7
Unregulated Activity	35
Energy Trading	17
Investments Outside the Utility Sector/Foreign Investments	17
Regulatory Intervention or Restructuring Activity	8
Risk Management	5
Merchant Generation Investments	5
Actions Not Related to Utility Operations	1

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**Table 2: Securities Class Action Suits (continued)**  
**Panel C: Nature of the Allegations**

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Accounting Violation	26
Revenue Recognition	19
Round-Trip or Wash Trading	12
GAAP Violation	18
Non-Disclosure of Material Fact	26
False or Misleading Forecast	10

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**Panel D: Western Power Markets**

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Actions Involving Firm Conduct in Power Markets in the Western United States in 2000 and 2001	10
Other Allegations	37

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Note: Four actions involved allegations concerning both conduct in power markets in the Western United States during 2000 and 2001 and other allegations.

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**Table 3: Derivative by Allegation and Activity****Panel A: By Allegation**


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Duty of Loyalty	
Compensation/Insider Trading/Self-Dealing	13
Duty of Disclosure	14
Duty of Care	24
Management of Physical Assets	5
Oversight of Trading Activities	12
Investments in Unregulated Affiliates	2
Asset Sale or Restructuring Activity	3
Total Actions	30

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**Panel B: By Activity**


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Regulated Activities	6
Unregulated Activities	18
Energy Trading	12
Investments Outside the Utility Sector/Foreign Investments	6
Not related to Utility Operations	4
Unknown	2

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**Table 4: Securities Class Action Settlements**

Settlements approved by the court or announced as of April 30, 2005. Settlement fund includes amounts available for distribution to the plaintiff class and plaintiff attorney fees and expense. Settlements include only actions in which the company and/or its auditor were the primary defendants.

Top 5 Settlements					
	Company	Allegations	Year Filed	Year Settled	Settlement Fund
1	Dynegy	Accounting violations. Misleading characterization of Project Alpha.	2002	2005	\$468,000,000
2	Enron	Accounting violations. Misrepresentation of transactions with related party entities. False and misleading statements concerning prospects of certain business units.	2001	2005	168,000,000 <sup>1</sup>
3	TXU	Failure to disclose Co.'s financial difficulties and problems in Co's UK and European operations.	2002	2005	150,000,000
4	DPL	GAAP violations and misrepresentations of the nature and value of financial investments.	2002	2003	140,000,000 <sup>2</sup>
5	FirstEnergy	Accounting violations and overstatement of earnings.	2003	2004	84,900,000
Total: 15 securities class action settlements and one partial settlement					\$1,387,100,000

Source: Institutional Shareholder Services

<sup>1</sup> Excludes settlement with auditors, settlement with unsecured creditors, and settlements with underwriter and financial institution defendants. There are multiple actions relating to the collapse of Enron Corp. that are ongoing.

<sup>2</sup> Includes settlements in federal and state securities class actions.