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SECURITIES LAW

Courts Clarify Road Map for Investment Managers to Lead Securities Cases

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Special to the Legal

Investment managers who handle retirement accounts are regulated under the Employee Retirement Income Security Act and the Investment Advisers Act of 1940. Under ERISA, an investment manager is defined as "any fiduciary … who has the power to manage, acquire, or dispose of any asset of a plan." Pursuant to ERISA, a fiduciary's duties are to protect the assets of the plan for the plan beneficiaries.

Some individual and institutional investors have sought to authorize their asset managers to assert federal securities claims on their behalf. In the years since Congress passed the Private Securities Litigation Reform Act of 1995, or PSLRA, investment managers acting on behalf of their clients have increasingly sought appointment as lead plaintiffs. While the issue of whether an investment manager has standing to bring a federal claim on behalf of its clients has been hotly contested, district courts have generally ruled that an investment manager is adequate to represent the interests of a class in securities litigation where the investment manager either obtained the power of attorney or may be deemed the attorney-in-fact authorized to bring such claims.

The *W.R. Huff Asset Management Co. v. Deloitte & Touche* decision from the 2nd U.S. Circuit Court of Appeals in December provides clarity to the contested principles governing the circumstances in which an investment manager may assert claims on behalf of its clients under the federal securities laws. The 2nd Circuit, relying in part on a recent Supreme Court decision in *Sprint Communications v. APCC Services*, provided clear guidance, by identifying the prerequisites necessary for an investment manager to lead a federal securities class action. The 2nd Circuit ruled that an investment manager may not properly assert federal securities claims on behalf of its clients where it does not have a valid assignment of its clients' claims.

PRIOR PRACTICE IN THE DISTRICT COURTS

The contention that an investment manager may properly lead a securities fraud class action on behalf of its clients had traditionally been premised by analogue to the *Restatement (Second) of Trusts*, which sets forth hornbook trust law that a fiduciary has an affirmative duty to take "reasonable steps to realize on claims" that are the property of the trust. Courts had ruled that Congress invoked the common law of trusts to define the general scope of investment managers' authority and responsibility under ERISA. As ERISA fiduciaries, investment managers contended that they are duty-bound to take reasonable steps to prosecute their clients' securities claims. By doing so, they argued, investment managers may act prudently to initiate litigation to protect property to which they are entrusted.

District courts found that discretionary investment managers — those with full

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authority to make investment decisions and manage the assets in client accounts — may bring securities claims on behalf of clients where the manager has the power of attorney to bring such claims. The reasoning of the district courts varied. Some courts held that a client's grant of authority to an investment manager to purchase stock, coupled with the investment manager's express power of attorney from, or status as attorney-in-fact for, its clients, conferred authority upon the investment manager to commence suit. Others ruled that money managers are "purchasers" under the securities laws because the discretionary manager is the party making the investment decisions.

Some cases predating the PSLRA ruled that an ERISA fiduciary, not its clients, was the "purchaser" within the meaning of the Securities Act of 1933 and the Securities Exchange Act of 1934, and, thus, could bring an action in its own name, whether it was acting for its own account or that of its clients. The courts reasoned that the source of invested funds was not determinative of statutory standing; rather, the determinative factor for statutory standing was the level of involvement in the decision to purchase securities.

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Investment manager statutory standing to assert securities claims on behalf of clients has received greater attention since the passage of the PSLRA; if an investment manager has no standing it could not be a lead plaintiff. Some courts that considered the issue appointed investment managers as lead plaintiffs in securities class actions where the manager had complete decision making authority. The key was that the investment manager was the person making the purchase, despite the fact that it purchased the securities on behalf of others.

The investment management agreement itself was found to provide the investment manager with "full discretionary authority to manage assets … without consultation or confirmation." The relevant contractual provision typically states: "Appointment & Authority of Manager. The Fund hereby appoints the Manager as a fixed investment manager with respect to the assets allocated to the Account. The Manager shall have full discretionary authority to manage assets in the Account. The Manager accepts responsibility as an Investment Adviser as the term is defined in the Investment Advisers Act of 1940 and acknowledges that it will act solely in the interest of the Fund as a fiduciary of the assets of the Fund. The Manager shall have full discretionary authority to manage, acquire or dispose of any or all securities, as it, without consultation or confirmation, may determine to be appropriate in accordance with the investment objectives and guidelines as communicated to Manager from time to time. To the extent applicable under federal law, the Manager accepts responsibility as an investment manager … in accordance with all applicable provisions of ERISA."

Courts interpreted similar language as authorization to bring actions on behalf of clients because the right to initiate the suit was deemed to be within the money manager's discretionary authority.

But litigants continued to dispute the contention that an asset manager with authority to make investment decisions for clients was the "real party in interest" in securities cases, arguing that without actual ownership of the security the investment manager has no constitutional standing to bring the action because the manager itself has suffered no injury. Litigants opposing the appointment of investment managers as lead plaintiffs argued that standing under Article III of the U.S. Constitution may not be assessed using the test for statutory standing under the federal securities laws. The 2nd Circuit recently agreed.

STANDING REQUIREMENTS CLARIFIED

Deciding *W.R. Huff v. Deloitte & Touche*, the 2nd Circuit ruled that the statutory factors for standing under the federal securities laws "are separate and apart from the elements of constitutional standing … and cannot be used to avoid constitutional requirements." Article III of the Constitution limits the jurisdiction of federal courts to the resolution of cases and controversies. To ensure that this bedrock case-or-controversy requirement is met, courts require that plaintiffs establish their standing as "the proper part[ies] to bring" suit. The 2nd Circuit reasoned that these requirements ensure that a plaintiff has a sufficiently personal stake in the outcome of the suit so that the parties are adverse.

Article III requires the party who invokes the court's authority to show that she personally has suffered some injury as a result of the putatively wrongful conduct of the defendant. Thus, relying on Supreme Court precedents, the 2nd Circuit ruled that a party may invoke the court's authority only to "seek redress for injury done to him … not [to] seek redress for injuries done to others."

The 2nd Circuit further explained that courts permit a party with standing to assign its claims to a third party, who will stand in the place of the injured party and satisfy the constitutional requirement of an "injury-in-fact." Generally, legal claims are freely assignable.

The court noted: "[A] valid and binding assignment of a claim (or a portion thereof) — not only the right or ability to bring suit — may confer standing on the assignee."

To confer standing, an assignment of a claim must transfer not just the authority to initiate a lawsuit but also an actual interest in the outcome of the suit.

The typical circumstances for an assignment creating standing occur where the assignee obtains the assignment in exchange for consideration and replaces the assignor with respect to the claim assigned; the assignee thus stands in the assignor's stead with respect to both injury and remedy. In *Huff*, the 2nd Circuit explained that transfer of title or ownership through an assignment does not require a "particular form … so long as the language manifest[ed the] intention to transfer at least title or ownership."

Last year the Supreme Court explained in *Sprint Communications* that federal courts have historically permitted assignees to bring suits in their own right when they were assigned title of a claim for the sole purpose of collection. The Supreme Court explicitly rejected the argument that, because the assignees planned to remit the litigation proceeds to the assignors, those assignees lacked standing, stating: "What does it matter what the aggregators do with the money afterward?" Thus, an assignment is not rendered invalid by an agreement that the assignee remit the proceeds of the suit on an assigned claim.

The Supreme Court explained: "There is an important distinction between simply hiring a lawyer and assigning a claim to a lawyer (on the lawyer's promise to remit litigation proceeds). The latter confers a property right (which creditors might attach); the former does not." Echoing the Supreme Court, the 2nd Circuit held in *Huff* that the minimum requirement for an injury-in-fact is that the plaintiff has legal title to or a proprietary interest in the claim. "An assignment of claims transfers legal title or ownership of those claims and thus fulfills the constitutional requirement of an 'injury-in-fact.'"

In *Indemnified Capital Investors v. R.J. O'Brien & Associates*, the 7th Circuit ruled consistently, explaining: "if [the investment manager]'s customers were interested in bringing this claim against the defendants, they could very easily have assigned their rights to [the investment manager]." Because the "remedies being sought … flow to the

Securities Law continues on 8

Securities Law

continued from 5

[named plaintiff] as assignee," an assignee of a federal securities claim has standing to assert it. Whether and how the assignee has contracted to dispose of those remedies after the lawsuit is irrelevant.

BEST PRACTICES

The caselaw provides clear best practices by which investment managers may be authorized by their clients to prosecute the clients' federal securities claims. An investment manager with discretionary authority over investment decisions may offer its clients binding agreements that assign securities claims to the manager. The agreements may also contain provisions that require remittance of all proceeds from successful securities litigation into client accounts. In that way, investment managers and their clients may follow the road map from the courts clarifying how asset managers may be authorized to participate as representative parties in securities litigation. Investment managers may thereby promote the philosophy of transparency through disclosure that is at the heart of the federal securities laws •