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Expert Analysis
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MEANING OF SECOND CIRCUIT'S 'W.R. HUFF' FOR INVESTMENT ADVISERS

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When Congress enacted the Private Securities Litigation Reform Act of 1995 (the PSLRA), one of its goals was to encourage plaintiffs with large stakes in securities class actions to take a more active role in litigation.

To achieve this goal, the PSLRA created the concept of a 'lead plaintiff' to represent the interests of a class of aggrieved shareholders. The lead plaintiff provisions of the PSLRA require courts to appoint as lead plaintiff the member of the class that is 'most capable of adequately representing the interests of class members' [FN1] and creates a rebuttable presumption that the most adequate plaintiff is the person or group of persons that 'has the largest financial interest in the relief sought by the class.' [FN2] Once appointed, the lead plaintiff is responsible for selecting lead counsel, subject to court approval, and overseeing the litigation.

Although the PSLRA set forth the statutory requirements for appointment of lead plaintiff, questions have arisen about what types of investors have standing to serve in that role.

One of the issues that courts have struggled with is whether investment advisers or asset managers, who do not purchase stock for themselves, but purchase stock on behalf of other investors can serve as lead plaintiffs. Some courts have held that, under certain circumstances, an investment adviser may be an adequate lead plaintiff; while others have held that investment advisers cannot serve as lead plaintiffs because they lack standing to assert a legal claim on behalf of their clients.

After about 13 years of uncertainty, the recent decision in W.R. Huff Asset Management Co. LLC v. Deloitte & Touche LLP, 549 F.3d 100 (2d Cir. 2008) (W.R. Huff), appears to resolve the debate holding that an investment adviser lacks constitutional standing to bring a securities action in a representative capacity on behalf of its clients. Id. at 111.

Investment Adviser Debate

- A Split Among District Courts

An investment adviser often manages the assets of its investors and purchases or

sells stock on behalf of its clients. In recent years, investment advisers have sought lead plaintiff status, arguing that they have the largest financial interest in the action because their clients, collectively, suffered the greatest losses.

Prior to the W.R. Huff decision, the issue of whether an investment adviser could serve as lead plaintiff had been a matter of some debate among district courts throughout the country. [FN3] The disagreement centered on whether an adviser has Article III standing to serve as lead plaintiff.

In order to establish Article III standing, three conditions must be met:

(1) the plaintiff must have suffered an injury-in-fact;

(2) there must be a causal connection between the injury and the challenged conduct; and

(3) it must be likely that the injury will be redressed by a favorable ruling. See Lujan v. Defenders of Wildlife, 504 U.S. 555, 560-61 (1992).

Opposing Rationales

In cases where investment advisers have sought lead plaintiff status, courts traditionally considered two opposing rationales. On the one hand, investment advisers suing on behalf of their institutional investor clients have no financial interest because any alleged injury was suffered by the clients themselves, and not by the investment adviser. On the other hand, investment advisers argue that because of their authority to make investment decisions for their institutional investor clients, they are entitled to sue on behalf of their clients.

Several courts have held that an investment adviser does not have standing to serve as lead plaintiff because it does not purchase the stock for itself, but rather for the accounts of its clients. For example, in In re Turkcell Iletisim Hizmetler, Judge Naomi Reice Buchwald held that an investment adviser, who made an investment on behalf of two mutual funds, lacked standing to sue on behalf of its investors because it did not invest its own assets and, therefore, was not the 'legal purchaser' of the stock. 209 F.R.D. 353, 357-58 (S.D.N.Y. 2002). Importantly, under Blue Chip Stamps v. Manor Drug Stores, standing to bring securities claims is limited to actual purchasers and sellers of a security. 421 U.S. 723, 730 (1975). In Smith v. Suprema Specialties Inc. (Suprema), an investment adviser that purchased stock on behalf of individual investors, pension funds and profit-sharing plans, was also denied lead plaintiff status. 206 F.Supp.2d 627, 634 (D.N.J. 2002). The court in Suprema held that although the investment adviser had the largest aggregate losses, it was not a 'single investor' and was not entitled to 'bring the claim on behalf of its clients who were the actual owners of the stock.' Id. at 634. Likewise, in In re Tyco International Ltd., in the class certification context, the court held that an investment adviser lacked constitutional standing 'to recover for damages that were suffered by third parties' because it was not directly injured by the defendants' misconduct. 236 F.R.D. 62, 73 (D.N.H. 2006). In so holding, the court rejected the investment adviser's argument that it had purchased the company's stock pursuant to an agreement that granted the adviser discretionary authority to effect transactions for its clients. Id. at 72.

Other courts have held that, under certain circumstances, investment advisers may have standing to serve as lead plaintiff. These cases often focus on whether an investment adviser has discretionary authority to make investment decisions and the power of attorney to bring suit on behalf of its client. For example, in Weinberg v. Atlas Air Worldwide Holdings Inc., the court appointed an investment adviser as lead plaintiff because it established that it was the 'attorney-in-fact for its clients with unrestricted decision-making authority. ' 216 F.R.D. 248, 255 (S.D.N.Y. 2003).

The court noted that while mere authority to purchase stock on behalf of a client does not confer standing to sue, if an investment adviser obtains an explicit grant of authority as an attorney-in-fact, it is 'considered the ' purchaser' under the federal securities laws with standing to sue in its own name.' Id. (citation omitted).

Following this logic, in Kaplan v. Gelfond, the court said that a 'declaration stating that the investment manager or adviser was the attorney-in-fact with the authorization to bring suit to recover investment losses' was sufficient to confer standing for an investment adviser. 240 F.R.D. 88, 95. Similarly, in Miller v. Dyadic Int'l Inc. (Dyadic), the court held that an investment adviser acting as attorney-in-fact for its clients and with full authority to make the purchase and sale of the stock in question, had standing to sue in its own name, on its clients' behalf. No. 07-80946, 2008 U.S. Dist. LEXIS 32271, at*30. (S.D. Fla. April 18, 2008). The court in Dyadic further held that the investment adviser had constitutional standing because it suffered an injury of goodwill and possible future business as a result of its clients' losses. Id. at*31-*32.

The 'W.R. Huff ' Case

The question of whether an investment adviser has standing to sue under the federal securities laws on behalf of its clients was finally addressed by the U.S. Court of Appeals for the Second Circuit in W.R. Huff. In W.R. Huff, an investment adviser filed suit on behalf of its clients, institutional investors that invested in Adelphia Communications Corp. (Adelphia) before it went bankrupt. 549 F.3d at 104. Although the investment adviser, W.R. Huff Asset Management Co. LLC (Huff), was not itself an investor in Adelphia, it purchased stock in the company on behalf of its clients who suffered a financial loss when Adelphia collapsed. Id. Huff brought suit as 'the investment adviser and attorney-in-fact' against firms that provided underwriting, auditing or legal services to Adelphia, alleging that the firms prepared, facilitated, or certified inaccurate and misleading disclosures in the company's financial statements, in violation of the federal securities laws. Id.

The defendants moved to dismiss Huff's complaint, arguing that an investment adviser does not have constitutional standing to sue on behalf of its clients. Id. In the district court, Judge McKenna held that Huff had standing to sue as an attorney-in-fact who had discretion to make investment decisions for its clients, and adhered to that ruling on a motion for reconsideration. Id. at 104-05. Defendants appealed to the Second Circuit.

Reversing the lower court's decision, the Second Circuit held that an investment adviser, even one that has discretionary authority to make investment decisions and power of attorney to file suit on behalf of its clients, lacks constitutional standing to bring a securities action in a representative capacity on behalf of its clients. Id. at 111.

Focusing on whether Huff suffered an 'injury-in-fact,' the Second Circuit found that Huff's investment discretion and power of attorney were insufficient to confer standing because it was not Huff, but its clients, that suffered the injury. Id. at 109-10. Accordingly, the court rejected the analysis in Weinberg v. Atlas Air Worldwide Holdings Inc. and similar cases that allowed investment advisers with power of attorney and unrestricted decision-making authority to serve as lead plaintiffs. W.R. Huff, 549 F.R.D. at 106.

According to the court, 'the minimum requirement for an injury-in-fact is that the plaintiff have legal title to, or a property interest in, the claim. ' Id. at 108. In other words, a party with standing may '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.'' Id. at 107. Since Huff's clients did not transfer ownership of, or title to, their claims to Huff, Huff lacked constitutional standing. Id. at 109. The court also rejected Huff's argument that it suffered an injury to its reputation as an investment adviser and an 'informational injury' as a result of its reliance on the false information provided by defendants. Id. at 110. The court noted that since Huff brought the suit on behalf of its clients, the 'remedies sought in the complaint...would not redress either the alleged injury to Huff's reputation or its 'informational injury.'' Id. (citation omitted).

Implications of 'W.R. Huff '

Although W.R. Huff was not a class action, its holding applies equally to investment advisers seeking lead plaintiff status and limits the ability of investment advisers who suffered no direct injury to serve as lead plaintiffs in securities class actions. Indeed, in a footnote, the court noted that while 'we need not decide when, in the context of a class action under the PSLRA, an investment adviser could qualify as a suitable lead plaintiff [,]...district courts should be mindful that [named] plaintiffs in a class action 'must allege and show that they personally have been injured, not that injury has been suffered by other, unidentified members of the class.'' W.R. Huff, 549 F.3d at 106, n.5 (citation omitted). In other words, the court acknowledged that unless investment advisers can demonstrate that they suffered an injury in fact, they may not seek relief on behalf of themselves or any other class member. And, if they do seek to be appointed lead plaintiff because of their own injury in fact, they will not be able to aggregate the losses of their clients to increase the size of their own claimed financial interest.

Conclusion

The holding in W.R. Huff is in line with the PSLRA, which requires courts to appoint as lead plaintiff the class member that can fairly and adequately represent the interests of the class. To appoint an investment adviser who lacks an actual financial interest in the relief sought would be contrary to one of the fundamental

principles of the PSLRA, which is to appoint as lead plaintiff, those 'class members with large amounts at stake.' [FN4]

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FN1. 15 U.S.C. §78u-4(a)(3)(B)(i).

FN2. 15 U.S.C. §78u-4(a)(3)(B)(iii)(I). The presumption may be rebutted, however, if the presumptively-most-adequate plaintiff is subject to 'unique defenses' or 'will not fairly and adequately protect the interests of the class.' 15 U.S.C. §78u-4(a)(3)(B)(iii)(II).

FN3. Although a number of courts have addressed other concerns about investment adviser lead plaintiffs, other than lack of standing, those issues are beyond the scope of this article.

FN4. H.R. Conf. Rep. 104-369, 104th Cong. 1st Sess., at 34 (1995).

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