No. 12-_____

In the Supreme Court of the United States

UBS FINANCIAL SERVICES INCORPORATED OF PUERTO RICO, ET AL.,
Petitioners,

v.

UNIÓN DE EMPLEADOS DE MUELLES DE PUERTO RICO PRSSA WELFARE PLAN, ET AL.,
Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the First Circuit

PETITION FOR WRIT OF CERTIORARI

JAY B. KASNER
SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP
Four Times Square
New York, New York 10036
Phone: (212) 735-3000

SALVADOR J. ANTONETTI-STUTTS
UBALDO M. FERNÁNDEZ
MAURICIO O. MUÑIZ-LUCIANO
O'NEILL & BORGES LLC
250 Muñoz Rivera Avenue
Suite 800
San Juan, Puerto Rico 00918
Phone: (787) 764-8181

PAUL J. LOCKWOOD
Counsel of Record
NICOLE A. DISALVO
SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP
One Rodney Square
P.O. Box 636
Wilmington, Delaware 19899
paul.lockwood@skadden.com
Phone: (302) 651-3000

Counsel for Petitioners UBS Financial Services Incorporated of Puerto Rico, UBS Trust Company of Puerto Rico, Miguel A. Ferrer, Carlos V. Ubiñas, Stephen C. Roussin and Leslie Highley, Jr.

Additional counsel listed on inside cover

JOSÉ C. SÁNCHEZ-CASTRO
JOSÉ LUIS BARRIOS-RAMOS
LOPEZ SÁNCHEZ PIRILLO &
HYMOVITZ LLC
P.O. Box 11917
San Juan, Puerto Rico 00922
Phone: (787) 522-6776

Counsel for Petitioners Puerto Rico Fixed Income Fund II, Inc., Puerto Rico Fixed Income Fund III, Inc., Puerto Rico Fixed Income Fund IV, Inc., and Tax-Free Puerto Rico Fund II, Inc.

RAFAEL ESCALERA-RODRÍGUEZ
PEDRO SANTIAGO-RIVERA
REICHARD & ESCALERA
P.O. Box 364148
San Juan, Puerto Rico 00936
Phone: (787) 777-8888

Counsel for Petitioners Mario S. Belaval, Agustín Cabrer-Roig, Gabriel Dolagaray-Balado, Carlos Nido, Luis M. Pellot-González, Vicente J. León and Clotilde Pérez

QUESTION PRESENTED

The question presented in this petition is:

Should, consistent with the standard of review employed by other Circuit Courts of Appeals, but in direct conflict with the decision below, the United States Court of Appeals for the First Circuit have reviewed for abuse of discretion the District Court's determination, pursuant to Rule 23.1, that the particularized facts alleged in a shareholder derivative complaint were insufficient to excuse a pre-suit demand on the corporation's board of directors?

PARTIES TO THE ACTION

The Petitioners are Miguel A. Ferrer, Carlos V. Ubiñas, Stephen C. Roussin, Leslie Highley, Jr., Mario S. Belaval, Agustín Cabrer-Roig, Gabriel Dolagaray-Balado, Carlos Nido, Luis M. Pellot-González, Vicente J. León, Clotilde Pérez, UBS Financial Services Incorporated Of Puerto Rico, UBS Trust Company Of Puerto Rico, Puerto Rico Fixed Income Fund II, Inc., Puerto Rico Fixed Income Fund III, Inc., Petitioner Puerto Rico Fixed Income Fund IV, Inc., and Tax-Free Puerto Rico Fund II, Inc.

The Respondents are Unión de Empleados de Muelles de Puerto Rico PRSSA Welfare Plan and Unión de Empleados de Muelles de Puerto Rico AP Welfare Plan.

STATEMENT PURSUANT TO RULE 29.6

Petitioners Miguel A. Ferrer, Carlos V. Ubiñas, Stephen C. Roussin, Leslie Highley, Jr., Mario S. Belaval, Agustín Cabrer-Roig, Gabriel Dolagaray-Balado, Carlos Nido, Luis M. Pellot-González, Vicente J. León, and Clotilde Pérez are members of the Board of Directors of Puerto Rico Fixed Income Fund II, Puerto Rico Fixed Income Fund III, Puerto Rico Fixed Income Fund IV, and Tax-Free Puerto Rico Fund II.

Petitioner UBS Financial Services Incorporated Of Puerto Rico is a wholly-owned subsidiary of UBS Financial Services Inc. UBS Financial Services Inc. is a wholly-owned subsidiary of UBS AG, which is a publicly-traded limited company formed under the laws of Switzerland.

Petitioner UBS Trust Company Of Puerto Rico is a wholly-owned subsidiary of PaineWebber International Inc. PaineWebber International Inc. is a wholly-owned subsidiary of UBS Americas Inc. UBS Americas Inc. is a wholly-owned subsidiary of UBS AG, which is a publicly-traded limited company formed under the laws of Switzerland.

Petitioner Puerto Rico Fixed Income Fund II, Inc. has no parent corporation. No publicly held corporation owns 10% or more of Puerto Rico Fixed Income Fund II, Inc.'s stock.

Petitioner Puerto Rico Fixed Income Fund III, Inc. has no parent corporation. No publicly held corporation owns 10% or more of Puerto Rico Fixed Income Fund III, Inc.'s stock.

Petitioner Puerto Rico Fixed Income Fund IV, Inc. has no parent corporation. No publicly held corporation owns 10% or more of Puerto Rico Fixed Income Fund IV, Inc.'s stock.

Petitioner Tax-Free Puerto Rico Fund II, Inc. has no parent corporation. No publicly held corporation owns 10% or more of Tax-Free Puerto Rico Fund II, Inc.'s stock.

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Petitioners UBS Financial Services Incorporated Of Puerto Rico, UBS Trust Company Of Puerto Rico, Miguel A. Ferrer, Carlos V. Ubiñas, Stephen C. Roussin, Leslie Highley, Jr., Mario S. Belaval, Agustín Cabrer-Roig, Gabriel Dolagaray-Balado, Carlos Nido, Luis M. Pellot-González, Vicente J. León, and Clotilde Pérez, Puerto Rico Fixed Income Fund II, Puerto Rico Fixed Income Fund III, Puerto Rico Fixed Income Fund IV, and Tax-Free Puerto Rico Fund II ("Petitioners"), by their counsel, respectfully ask this Court to grant a writ of certiorari to review the judgment of the United States Court of Appeals for the First Circuit vacating the dismissal of Respondents' shareholder derivative claims on the grounds that Respondents had met the requirements of Federal Rule of Civil Procedure 23.1.

OPINIONS BELOW

The opinion and order of the District Court (Delgado-Colón, J.) is unreported but is reproduced in the Appendix ("App.") at App. B, at 28a. The First Circuit opinion (Lipez, J., joined by Howard and Thompson, JJ.), is reported at 704 F.3d 155 (1st Cir. 2013) and is reproduced at App. A, at 1a ("*Unión de Empleados*").

STATEMENT OF JURISDICTION

The Judgment below was entered on January 4, 2013. No rehearing petition was filed. Petitioners invoke the Court's jurisdiction under 28 U.S.C. § 1254(1). Based on evidence acquired after the Judgment below was entered, on February 20, 2013, Petitioners filed a motion to dismiss for lack of subject matter jurisdiction in the District Court on

the grounds that Respondents have sold their shares in the four nominal defendant corporations and therefore lack standing. (No. 10-1141-ADC, Record No. 81) Briefing on the motion to dismiss for lack of subject matter jurisdiction was completed on April 3, 2013. In light of the deadline to file the petition for writ of certiorari and the fact that the District Court has not yet decided the jurisdiction issue, Petitioners submit that this petition for writ of certiorari is timely and appropriate.

STATUTORY PROVISION INVOLVED

Federal Rule of Civil Procedure 23.1 is the pertinent federal rule that is implicated in this Petition. Federal Rule of Civil Procedure 23.1 is reproduced here:

FEDERAL RULE OF CIVIL PROCEDURE RULE 23.1: DERIVATIVE ACTIONS

(a) **Prerequisites.** This rule applies when one or more shareholders or members of a corporation or an unincorporated association bring a derivative action to enforce a right that the corporation or association may properly assert but has failed to enforce. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of shareholders or members who are similarly situated in enforcing the right of the corporation or association.

(b) **Pleading Requirements.** The complaint must be verified and must:

(1) allege that the plaintiff was a shareholder or member at the time of the transaction complained of, or that the plaintiff's share or membership later devolved on it by operation of law;

(2) allege that the action is not a collusive one to confer jurisdiction that the court would otherwise lack; and

(3) state with particularity:

(A) any effort by the plaintiff to obtain the desired action from the directors or comparable authority and, if necessary, from the shareholders or members; and

(B) the reasons for not obtaining the action or not making the effort.

(c) Settlement, Dismissal, and Compromise. A derivative action may be settled, voluntarily dismissed, or compromised only with the court's approval. Notice of a proposed settlement, voluntary dismissal, or compromise must be given to shareholders or members in the manner that the court orders.

(Adopted February 28, 1966, effective July 1, 1966; amended March 2, 1987, effective August 1, 1987; April 30, 2007, effective December 1, 2007.)

STATEMENT OF THE CASE

A. *Introduction*

This Petition requests that the Court resolve the conflict that exists among the circuit courts as to the standard of appellate review applicable to a district court's determination, pursuant to Federal Rule of Civil Procedure 23.1, that the particularized facts alleged in a shareholder's derivative complaint were insufficient to excuse a pre-suit demand on the corporation's board of directors.[1]

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[1] The Courts of Appeals for the Second, Third, Seventh, Ninth, Tenth, Eleventh and D.C. Circuits have all applied an abuse of discretion standard to a district court's assessment of the particularized allegations of fact that would excuse the shareholder from making a pre-suit demand on the board of the corporation when reviewing Rule 23.1 dismissals. *See*, *e.g.*, *Potter v. Hughes*, 546 F.3d 1051, 1056 (9th Cir. 2008) ("[T]he district court's determination that Potter did not comply with Rule 23.1 or California law regarding the demand and regarding demand futility is reviewed for abuse of discretion."); *Staehr v. Alm*, 269 F. App'x 888, 891 (11th Cir. 2008) ("We review the district court's dismissal of a shareholder derivative lawsuit for abuse of discretion."); *Cadle v. Hicks*, 272 F. App'x 676, 677 (10th Cir. 2008) ("Determinations under Rule 23.1 are generally reviewed for an abuse of discretion."); *Scalisi v. Fund Asset Mgmt., L.P.*, 380 F.3d 133, 137 (2d Cir. 2004) ("[W]here 'determination of the sufficiency of allegations of futility depends on the circumstances of the individual case,' the standard of review for dismissals based on Fed. R. Civ. P. 23.1 is abuse of discretion.") (citation omitted); *Blasband v. Rales*, 971 F.2d 1034, 1040 (3d Cir. 1992) ("Generally, the district court's determination of demand futility depends upon the facts of each case and is reviewed for abuse of discretion."); *Starrels v. First Nat'l Bank of Chi.*, 870 F.2d 1168, 1169-70 (7th Cir. 1989) ("Whether the appellant was required to make a demand before bringing this suit is an issue left to the discretion of the district

(cont'd)

For more than a century, the federal appellate courts have afforded deference to the trial court's determinations under Rule 23.1 and reviewed dismissals for failure to adequately plead demand futility for abuse of discretion. *See Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 530 n.5 (1984) (explaining that in 1912, Equity Rule 27 was adopted "to codify a judicially recognized exception to the old rule in certain circumstances where, *in the discretion of the court*, a demand may be excused") (emphasis added). As shareholder derivative suits arose in equity, *see id.* at 529 n.4, applying the abuse of discretion standard to demand futility dismissals is consistent with the historical tradition of affording deference to the trial court on matters where the court has equitable jurisdiction.

The circuits other than the First Circuit have also long recognized that, although a Rule 23.1 dismissal occurs at the pleading stage, it nevertheless is frequently a fact-based judgment regarding whether the complaint sets forth particularized allegations of fact that could excuse the shareholder from making a pre-suit demand on the board of the corporation. Because a Rule 23.1 dismissal requires an individual, case-specific factual determination (at the pleading

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court. Therefore, assuming no error of law has been made, we review its determination under an abuse-of-discretion standard."); *Gaubert v. Fed. Home Loan Bank Bd.*, 863 F.2d 59, 61 (D.C. Cir. 1988) ("The district court dismissed Gaubert's complaint on the ground that it failed to aver with sufficient particularity why it would have been futile for Gaubert to [make] demand. . . . We find that the district court did not abuse its discretion in dismissing this suit . . . .").

stage), the circuit courts have deferred to the district court's assessment of those particularized allegations of fact.

Disregarding historical conventions, opinions of other circuit courts and precedent from its own prior opinion, the First Circuit held that *de novo* review is the appropriate standard of appellate review of all dismissals for failure to plead demand futility with particularity as required by Federal Rule of Civil Procedure 23.1.

Certiorari is warranted to resolve the direct conflict of authority among the circuit courts as to what standard of appellate review governs dismissal of shareholder derivative lawsuits for failure to plead demand futility with particularized facts.

B. *The Derivative Lawsuit Is Filed*

Respondents Unión de Empleados de Muelles de Puerto Rico PRSSA Welfare Plan ("UDEM PRSSA") and Unión de Empleados de Muelles de Puerto Rico AP Welfare Plan ("UDEM AP," and collectively, "Respondents"), two sophisticated institutional investors that allegedly owned shares in the Funds at the time they filed suit, sought to bring claims derivatively on behalf of Petitioners Puerto Rico Fixed Income Fund II, Inc. ("Fund II"), Puerto Rico Fixed Income Fund III, Inc. ("Fund III), Puerto Rico Fixed Income Fund IV, Inc. ("Fund IV") and Tax-Free Puerto Rico Fund II, Inc. ("Tax-Free Fund II," and collectively, the "Funds"). The Complaint pleads eight derivative claims against Petitioners UBS Trust Company of Puerto Rico ("UBS Trust"), UBS Financial Services Incorporated of Puerto Rico ("UBS Puerto Rico," and with UBS Trust, the "UBS

Defendants") and the directors of the Funds (the "Directors") in connection with the purchase of investment grade bonds issued by the Employee Retirement System of the Government of Puerto Rico ("ERS Bonds" and the "ERS Bond Transactions"). (App. C, at 66a) These claims include alleged violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (the "Exchange Act") and Section 12(a)(2) of the Securities Act of 1933 (the "Securities Act"), violations of Puerto Rico securities laws, breach of the duties of an agent, breach of the duty of good faith and fair dealing, breach of fiduciary duty under Puerto Rico corporation law and unjust enrichment.

The UBS Defendants: UBS Trust is a Puerto Rico trust company that acts as the administrator, custodian and transfer agent of the Funds. (App. 76a-77a) UBS Trust also provides investment advice to each Fund's board of directors through UBS Asset Managers of Puerto Rico, a division of UBS Trust. (*Id.*) UBS Puerto Rico, a Puerto Rico corporation and a broker-dealer registered with the United States Securities and Exchange Commission (the "SEC"), served as the underwriter for the issuance of the ERS Bonds. (App. 76a) UBS Puerto Rico has no administrative or advisory relationship with the Funds.

The Director Defendants: At the time the Complaint was filed, each of the Funds had eleven directors (collectively referred to as the "Directors" or the "Individual Defendants"). They are Michael A. Ferrer, Carlos V. Ubiñas, Stephen C. Roussin, Leslie Highley, Jr., Mario S. Belaval, Agustín Cabrer-Roig, Gabriel Dolagaray-Balado, Carlos Nido, Luis M.

Pellot-González, Vicente J. León and Clotilde Pérez. (App. 77a-81a) Only four of these directors – Ferrer, Ubiñas, Roussin and Highley – were employees of either UBS Trust or UBS Puerto Rico at the time the Complaint was filed. (App. 77a-78a) The majority – Belaval, Cabrer-Roig, Dolagaray-Balado, Nido, Pellot-González, León and Pérez (collectively, the "Independent Directors") – are outside directors who are not employees of UBS Puerto Rico or UBS Trust. (App. 78a-81a) Moreover, the Complaint alleged that each of the Independent Directors has had an impressive career separate and apart from his or her service as a non-employee director of the Funds:

- Mr. Belaval is a former Vice Chairman of the Board of Triple S Management Corp. and Triple S, Inc. and a former Chairman of the Board and Executive Vice President of Bacardí Corp. (No. 11-1605, Joint Appendix, filed Aug. 2, 2011 ("CA1JA") at A-133; App. 78a)
- Mr. Cabrer-Roig is the President of Starlight Development Group, Inc. and Antonio Roig Sucesores; a partner of Desarollos Agrícolas del Este S.E., El Ejemplo, S.E., Los Pinos, S.E. and Forest Cove Homes, Inc.; Director and Officer of TC Management and Candelero Holding and the 50% owner, President and Registered Principal of Starlight Securities, Inc. (CA1JA at A-133-134)
- Mr. Dolagaray-Balado is the former President of Cooperativa de Seguros de Vida, the Association of Insurance Companies of Puerto Rico, Inc. and the Puerto Rico Chamber of Commerce and is a member of the Advisory

Board to the Commissioner of Insurance of Puerto Rico. (CA1JA at A-134)

- Mr. Nido is the Senior Vice President of Sales of El Nuevo Día, President of Del Mar Events, former President and founder of Virtual, Inc. and Zona Networks and former special assistant to the President of the Government Development Bank of Puerto Rico. (CA1JA at A-135; App. 79a)
- Mr. Pellot-González is a tax attorney at Pellot-González PSC, former tax professor at the University of Puerto Rico Business School, former President of the Tax Committee of the Puerto Rico Chamber of Commerce and 98% partner and manager of Lepanto, S.E. (CA1JA at A-134-135)
- Mr. León is Vice Chairman of the Board of Triple S Management Corporation and a former partner at KMPG LLP. (CA1JA at A-135-136; App. 80a)
- Ms. Pérez is the Corporate Development Officer of V. Suarez & Co., Inc., member of the Board of Trustees of the University of the Sacred Heart, General Partner of Guayacan Fund of Funds Family, a former senior investment banker at Citibank, N.A. Puerto Rico and former Vice President of the Economic and Development Bank for Puerto Rico. (CA1JA at A-136)

Respondents filed suit in the District of Puerto Rico on behalf of the Funds for alleged wrongs to the Funds. Although Respondents purported to act on behalf of the Funds, they chose to file suit without

first making a demand on the board of directors for each of the Funds to request that the directors take action to redress the alleged wrongs to the Funds. Puerto Rico corporate law, like many jurisdictions, requires a pre-suit demand to allow corporate directors the opportunity to determine, in the first instance, what action each Fund should take with respect to its claims. *In re First Bancorp Derivative Litig.*, 465 F. Supp. 2d 112, 118 (D.P.R. 2006). *See also Aronson v. Lewis*, 473 A.2d 805, 811-12 (Del. Ch. 1984), *overruled as to standard of review by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).[2] "The purpose of requiring a precomplaint demand is to protect the directors' prerogative to take over litigation or to oppose it." *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 101 (1991).

Pursuant to Rule 23.1, in order to comply with the demand requirement, the shareholder must "state with particularity . . . any effort by the plaintiff to obtain the desired action from the directors or . . . the reasons for not obtaining the action or not making the effort." Fed. R. Civ. P. 23.1(b)(3). Because

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[2] The pleading standard of Rule 23.1 implements the substantive corporation law requirement that a shareholder respect the authority of the board of directors by making a pre-suit demand on the board. *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 96-99 (1991). Because the Funds are incorporated under the laws of Puerto Rico, Puerto Rico corporation law sets the standard as to whether a pre-suit demand is excused. *Id.* at 108-09 ("[A] court that is entertaining a derivative action . . . must apply the demand futility exception as it is defined by the law of the State of incorporation."). Because Puerto Rico corporation law was modeled after Delaware law, Delaware cases may be consulted when construing Puerto Rico's test for demand futility. *First Bancorp*, 465 F. Supp. 2d at 118.

Respondents had not pleaded with particularity facts that could excuse them from making a demand on the Funds' boards, Petitioners moved to dismiss the action for failure to plead demand futility pursuant to Rule 23.1.

C. *Proceedings Below*

On March 31, 2011 (App. B, at 28a), the District Court of Puerto Rico dismissed Respondents' derivative claims for failure to make a pre-suit demand or to plead demand futility with particularity. (App. 36a, stating that "plaintiffs' complaint concedes that no demand was made of the board"; App. 49a, App. 56a, dismissing derivative claims for failure to satisfy the Aronson test for demand futility) The District Court rejected Respondents' argument that demand was excused here because the Complaint lacks particularized facts that could show that (i) a majority of the directors had a personal financial interest in the transaction or they lacked independence, i.e., were dominated or controlled by an interested party, or (ii) the directors' decision to purchase the ERS Bonds was an irrational decision that fell outside the broad protections of the business judgment rule. (App. 49a, 56a)

Respondents claimed that the UBS Defendants had a financial interest in the Funds' purchase of the ERS Bonds because UBS Puerto Rico was the underwriter for those bond offerings. Respondents further argued that all of the Directors were beholden to the UBS Defendants because they received fees to serve as directors for so-called "UBS-affiliated" investment companies. The District Court

found that Respondents' allegations regarding the amount of compensation that the directors received for service on the boards of the Funds did not meet the requisite pleading standard as to the independence of the vast majority of the directors because the complaint did not allege that their compensation was both extraordinary and subjectively material to the directors. (App. 45a-46a) In dismissing the Complaint, the District Court held that Plaintiffs "provide no additional facts that allow this court to gauge the materiality of such benefits" to nine of the eleven Directors. (App. 46a; *see also* App. 43a, 46a-49a)

Respondents filed a timely notice of appeal of the District Court's dismissal of their derivative claims.[3] On appeal, the parties disputed the appropriate appellate standard of review of the District Court's decision that Respondents had not adequately alleged facts to excuse demand. Petitioners, citing earlier decisions from the First Circuit, and decisions from the Second, Seventh, Ninth, Eleventh and D.C. Circuits, argued that the appropriate federal appellate standard of review was abuse of discretion. Respondents argued that the First Circuit should adopt the standard used by the Delaware Supreme

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[3] Respondents also alleged two direct claims brought on behalf of a putative class of shareholders against the UBS Defendants for violation of the duty to act in good faith under Puerto Rico law and for breach of fiduciary duty under the Employee Retirement Income Security Act ("ERISA"). (App. 118a, 122a-123a) The District Court dismissed these claims for failure to state a claim under Federal Rule of Civil Procedure 12(b)(6) and Plaintiffs did not challenge the dismissal of these putative class claims on appeal. (App. 9a n.5; 56a-65a)

Court, which reviews *de novo* a trial court's dismissal for failure to plead demand futility.

D. *The Decision Below*

On January 4, 2012, the First Circuit vacated the District Court's decision dismissing the derivative claims and remanded the case to the District Court. (App. A, at 1a) In reaching that decision, the First Circuit addressed the "threshold question" of "the standard of review that applies to a district court's dismissal of a shareholder derivative action based on a failure to properly plead demand futility." (App. 10a) The court noted that its own prior opinion, *Heit v. Baird*, affirmed the dismissal of a shareholder derivative action on the grounds that the district court had not "abused its discretion." 567 F.2d 1157, 1161 (1st Cir. 1977). (App. 10a) Nevertheless, the court opined that *Heit* had not established an abuse of discretion standard and that the issue was unresolved in the First Circuit. (App. 10a)

The First Circuit recognized that other federal courts of appeals had traditionally reviewed dismissal of a derivative suit for failure to plead demand futility for abuse of discretion, citing opinions from the Third and Ninth Circuits. (App. 11a) However, the First Circuit stated that opinions from the Second, Ninth and D.C. Circuits had recently questioned the appropriateness of this standard of review, although there were no circuits that had ruled that the appellate review standard here should no longer be abuse of discretion. (App. 11a) The First Circuit indicated that three states' highest courts had decided that *de novo* review was the appropriate appellate standard under these

circumstances. (App. 11a) The First Circuit stated that appellate review of demand futility allegations in a derivative suit should not be treated differently than other rulings that concern the legal sufficiency of the pleadings. (App. 12a) Applying this reasoning, the First Circuit held that "a district court's dismissal of a shareholder derivative suit based on a failure to properly plead demand futility is subject to *de novo* review." (App. 12a)

The First Circuit then concluded, based on a *de novo* review of the particularized facts alleging demand futility in the Complaint, that Respondents had adequately pleaded demand futility as to a majority of the members of the Funds' boards of directors and reversed the decision of the District Court. (App. 26a-27a)

REASONS THE COURT SHOULD GRANT THE WRIT

The decision below addresses a threshold appellate issue – what is the proper appellate standard of review for a dismissal of a derivative action under Federal Rule of Civil Procedure 23.1 for failure to allege demand futility? If allowed to stand, the decision below to review Rule 23.1 dismissals *de novo* will be in direct conflict with at least one prior holding of the First Circuit and with the other federal appellate courts that have, for decades, afforded deference to the trial court and reviewed these dismissals under the abuse of discretion standard. Granting this writ will provide for consistency in the appellate review of shareholder derivative lawsuits throughout the federal courts.

Furthermore, the First Circuit's adoption of the *de novo* standard for Rule 23.1 appeals is flawed for two reasons. First, an assessment of whether a pleading contains sufficient particularized facts to excuse demand turns on the circumstances of each case and is best left to the discretion of the trial court. Second, a shareholder's ability to sue on behalf of a corporation arose in equity and, as with other matters of equity, should be committed to the sound discretion of the trial judge.

I. The First Circuit's Decision Directly Conflicts With The Other Circuits Concerning The Question Presented In This Case.

The First Circuit's holding in *Unión de Empleados* to review *de novo* an order dismissing a derivative claim for failure to plead demand futility conflicts with the appellate review standard employed by the Second, Third, Seventh, Ninth, Tenth, Eleventh and D.C. Circuits. As explained below, each of those Courts of Appeals has applied the abuse of discretion standard in reviewing a district court's dismissal of a derivative claim for failure to plead particularized facts that could, under the circumstances of that particular case, excuse a pre-suit demand on the board of directors by the shareholder plaintiff.

As an initial matter, Petitioners submit that the First Circuit's holding conflicts with its own decision in *Heit v. Baird*, where the court affirmed a dismissal of a shareholder derivative action on the grounds that the district court had not "abused its discretion." 567 F.2d 1157, 1161 (1st Cir. 1977). The First Circuit, however, determined that "*Heit* did not

establish the governing standard in this circuit." (App. 10a)

The First Circuit's holding also conflicts with decisions applying the abuse of discretion standard for Rule 23.1 dismissals as employed by the Second, Third, Seventh, Ninth, Tenth, Eleventh and D.C. Circuits. *See*, *e.g.*, *Potter v. Hughes*, 546 F.3d 1051, 1056 (9th Cir. 2008) ("[T]he district court's determination that Potter did not comply with Rule 23.1 or California law regarding the demand and regarding demand futility is reviewed for abuse of discretion."); *Staehr v. Alm*, 269 F. App'x 888, 891 (11th Cir. 2008) ("We review the district court's dismissal of a shareholder derivative lawsuit for abuse of discretion."); *Cadle v. Hicks*, 272 F. App'x 676, 677 (10th Cir. 2008) ("Determinations under Rule 23.1 are generally reviewed for an abuse of discretion."); *Scalisi v. Fund Asset Mgmt., L.P.*, 380 F.3d 133, 137 (2d Cir. 2004) ("[W]here 'determination of the sufficiency of allegations of futility depends on the circumstances of the individual case,' the standard of review for dismissals based on Fed. R. Civ. P. 23.1 is abuse of discretion.") (citation omitted); *Blasband v. Rales*, 971 F.2d 1034, 1040 (3d Cir. 1992) ("Generally, the district court's determination of demand futility depends upon the facts of each case and is reviewed for abuse of discretion."); *Starrels v. First Nat'l Bank of Chi.*, 870 F.2d 1168, 1169-70 (7th Cir. 1989) ("Whether the appellant was required to make a demand before bringing this suit is an issue left to the discretion of the district court. Therefore, assuming no error of law has been made, we review its determination under an abuse-of-discretion standard."); *Gaubert v. Fed. Home Loan Bank Bd.*, 863 F.2d 59, 61 (D.C. Cir. 1988) ("The district court

dismissed Gaubert's complaint on the ground that it failed to aver with sufficient particularity why it would have been futile for Gaubert to [make] demand. . . . We find that the district court did not abuse its discretion in dismissing this suit . . . .").

As the First Circuit noted, since 2004, panels of the Second, Ninth and D.C. Circuits have questioned whether abuse of discretion was the appropriate standard of review for Rule 23.1 dismissals, but none of those panels ultimately reached the issue. *See Israni v. Bittman*, 473 F. App'x 548, 550 n.1 (9th Cir. 2012), *Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust v. Raines*, 534 F.3d 779, 783 n.2 (D.C. Cir. 2008); *Scalisi v. Fund Asset Mgmt., L.P.*, 380 F.3d 133, 137 n.6 (2d Cir. 2004). These federal courts began to reassess the abuse of discretion standard for Rule 23.1 dismissals after the Delaware Supreme Court decided to abandon that standard and apply *de novo* review to appeals from Delaware Court of Chancery Rule 23.1 dismissals. *See Brehm v. Eisner*, 746 A.2d 244 (Del. 2000). However, no federal appellate court (including the First Circuit below) has suggested that it is bound to follow *Brehm*. The standard of review is a procedural matter determined by federal law.[4] *See Alison H. v. Byard*, 163 F.3d 2, 4

[4] A panel of the Seventh Circuit initially endorsed *Brehm* and applied the *de novo* review standard over the abuse of discretion standard in a Rule 23.1 appeal. *See In re Abbott Labs. Derivative S'holders Litig.*, 293 F.3d 378, 385 (7th Cir. 2002), *vacated and superseded* by 325 F.3d 795 (7th Cir. 2002). But the panel vacated that opinion and issued a new decision that no longer cited *Brehm* and instead cited the Seventh Circuit's 1989 decision in *Starrels* for the standard of review, *(cont'd)*

(1st Cir. 1998) ("Because the standard of review is a procedural matter, not a substantive one, we are bound by federal law."); *Milwaukee Metro. Sewerage Dist. v. Am. Int'l Specialty Lines Ins. Co.*, 598 F.3d 311, 316 (7th Cir. 2010) ("In diversity cases . . . federal law governs our standard of review."). As explained below, there are strong grounds for maintaining abuse of discretion as the standard of review for Rule 23.1 dismissals in the federal Courts of Appeals.

Importantly, no circuit, until the opinion below, has rejected abuse of discretion as the appropriate standard of review of Rule 23.1 dismissals. The decision in *Unión de Empleados* puts the First Circuit at odds with all other circuits, and creates inconsistency in appellate review of shareholder derivative actions.

II. The Question Presented Offers An Opportunity To Resolve A Conflict Among The Circuits On A Critical Threshold Issue.

The "'standard for [federal] appellate review'" is "'[a]n essential characteristic of [the federal court] system.'" *Gasperini v. Ctr. for Humanities, Inc.*, 518 U.S. 415, 431 (1996) (alterations in original) (citations omitted). This Court has recognized "that the difference between a rule of deference and the duty to exercise independent review is 'much more than a mere matter of degree.'" *Salve Regina Coll. v.*

(cont'd from previous page)
which applies the traditional abuse of discretion standard. *See Abbott Labs.*, 325 F.3d at 803.

Russell, 499 U.S. 225, 238 (1991) (quoting *Bose Corp. v. Consumers Union of U.S., Inc.*, 466 U.S. 485, 501 (1984)). The difference between abuse of discretion and *de novo* review is often case dispositive. *Dickinson v. Zurko*, 527 U.S. 150, 162 (1999) ("'The upshot," is a "practical difference in outcome depending upon which standard is used.")

It is well understood that the standard of appellate review is critical and often "decides cases." *See*, *e.g.*, *United States v. Pruett*, 681 F.3d 232, 250 (5th Cir. 2012) (Prado, J. concurring); *United States v. Smith*, 223 F.3d 554, 568 (7th Cir. 2000) (standard of review "critical"), *cert. denied*, 536 U.S. 957 (2002); *NLRB v. Brown-Graves Lumber Co.*, 949 F.2d 194, 198 (6th Cir. 1991) (standard of review "crucial").

This Court has granted certiorari on many occasions to resolve questions regarding the appropriate standard of appellate review. *See*, *e.g.*, *Gall v. United States*, 552 U.S. 38 (2007) (standard of appellate review for sentences outside Sentencing Guidelines range); *United States v. Booker*, 543 U.S. 220 (2005) (sentencing decisions generally); *Dickinson v. Zurko*, 527 U.S. 150 (1999) (Patent and Trademark Office fact-finding); *Ornelas v. United States*, 517 U.S. 690 (1996) (probable cause and reasonable suspicion determinations); *Wilton v. Seven Falls Co.*, 515 U.S. 277 (1995) (stays of declaratory judgment actions during parallel state court proceedings); *Salve Regina Coll. v. Russell*, 499 U.S. 225 (1991) (determinations of state law); *Cooter & Gell v. Hartmarx Corp.*, 496 U.S. 384 (1990) (imposition of Fed. R. Civ. P. 11 sanctions); *Pierce v. Underwood*, 487 U.S. 552 (1988) (award of fees under Equal Access to Justice Act).

Here, the First Circuit's mandate for *de novo* review of Rule 23.1 dismissals for failure to plead particularized facts excusing demand is in direct conflict with all of the other circuit courts. The question presented in this petition will not be further refined or resolved by allowing it to continue to percolate amongst the circuit courts. The question presented is a discrete – yet extremely important – threshold issue and thus, provides the perfect opportunity to resolve finally and succinctly, the appropriate appellate standard of review for shareholder derivative complaints that were dismissed for failure to properly allege particularized facts to show demand futility.

III. Abuse Of Discretion, Not *De Novo* Review, Is The Appropriate Standard Of Review For Assessing Whether A Shareholder Has Pleaded Sufficient Facts With Particularity To Excuse A Pre-Suit Demand.

The First Circuit's decision to apply *de novo* to the District Court's dismissal of this action, pursuant to Rule 23.1, for failure to allege particularized facts excusing a pre-suit demand, conflicts with the history and the purpose of Rule 23.1's particularized pleading requirement. A determination of demand futility is left to the discretion of the district court because that determination turns on the particularized facts alleged in each case. *See*, *e.g.*, *Blasband v. Rales*, 971 F.2d 1034, 1040 (3d Cir. 1992) ("Generally, the district court's determination of demand futility depends upon the facts of each case. . . ."); *Gaubert v. Fed. Home Loan Bank Bd.*, 863 F.2d 59, 68 n.10 (D.C. Cir. 1988) ("'[T]he decision as

to whether a plaintiff's allegations of futility are sufficient to excuse demand depends on the particular facts of each case . . . .'") (quoting *Lewis v. Graves*, 701 F.2d 245, 248 (2d Cir. 1983)). Thus, even though a Rule 23.1 dismissal comes at the pleading stage, it is a highly individualized, fact-based judgment that turns on the specific factual allegations in each particular case.[5] When a lawsuit turns on such individualized circumstances, it is appropriate to leave the decision to the sound discretion of the district court because uniformity of outcome is not necessary. *Cf. Wheat v. United States*, 486 U.S. 153, 164 (1988) (holding that under abuse of discretion standard: "[o]ther district courts might have reached differing or opposite conclusions with equal justification, but that does not mean that one conclusion was 'right' and the other 'wrong'.")

In rejecting this approach, the First Circuit incorrectly equated a review of a Rule 23.1 dismissal with a review of a dismissal under Rule 12(b)(6): "rulings concerning the legal sufficiency of pleadings are reviewed *de novo*. . . . There is no justification for treating the pleadings in a derivative suit differently. A district court is no better positioned than we are to read and evaluate a complaint in this sort of action." (App. 12a) This conclusion ignores that in the Rule 23.1 context, unlike the 12(b)(6) context, the

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[5] There is no reason to abandon the abuse of discretion standard merely because this fact-based judgment comes at the pleading stage. For example, whether a complaint is to be dismissed "with prejudice" is reviewed on appeal for abuse of discretion. *See Grain Traders, Inc., v. Citibank, N.A.*, 160 F.3d 97, 106 (2d Cir. 1998) (citing *Foman v. Davis*, 371 U.S. 178, 182 (1962)).

complaint must *plead facts with particularity* that are specific to the individual board members and the specific claims at issue. It also fails to consider the historic purpose and development of Rule 23.1.

This Court explained the history of Rule 23.1's demand excusal clause in *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523 (1984). In *Daily Income*, the Court noted the century-old rule that excusal of demand is at the discretion of the trial court:

> In 1912, the Court replaced the original rule with Equity Rule 27, identical to its predecessor except that it added at the very end the phrase "or the reasons for not making such effort." This language was apparently intended to codify a judicially recognized exception to the old rule in certain circumstances where, *in the discretion of the court*, a demand may be excused.
>
> When the federal rules were promulgated in 1937, the provisions of Equity Rule 27 were substantially restated in Rule 23(b). . . . Finally, in 1966, the present version of new Rule 23.1 was adopted as part of a comprehensive revision of the rules governing class actions.

Daily Income, 464 U.S. at 530 n.5 (citing *Del. & Hudson Co. v. Albany & Susquehanna R.R. Co.*, 213 U.S. 435 (1909); 3 B.J. Moore & J. Kennedy, MOORE'S FEDERAL PRACTICE ¶ 23.1.15[1], at p. 23.1-10 (2d ed. 1982) (emphasis added)).

The abuse of discretion standard is also consistent with the discretion historically afforded to trial courts in suits of equity – the shareholder derivative

suit arose in equity. See *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 95 (1991) (noting that a shareholder derivative suit is a "suit in equity"); *Hawes v. Oakland*, 104 U.S. 450, 454 (1881) (whether a shareholder may maintain an action on behalf of the corporation is "always a question of equitable jurisprudence").

> The essence of equity jurisdiction has been the power of the Chancellor to do equity and to mold each decree to the necessities of the particular case. Flexibility rather than rigidity has distinguished it. The qualities of mercy and practicality have made equity the instrument for nice adjustment and reconciliation between the public interest and private needs as well as between competing private claims.

Swann v. Charlotte-Mecklenburg Bd. of Educ., 402 U.S. 1, 15 (1971) (quoting *Hecht Co. v. Bowles*, 321 U.S. 321, 329-30 (1944), cited in *Brown v. Bd. of Educ.*, 349 U.S. 294, 300 (1955)).

It also bears emphasis that many of the circuit courts applying the abuse of discretion standard to a review of the district court's assessment of the particularized alleged facts concerning demand futility will still apply *de novo* review to issues of law arising under Rule 23.1. *See*, *e.g.*, *Cadle v. Hicks*, 272 F. App'x 676, 677 (10th Cir. 2008) ("Determinations under Rule 23.1 are generally reviewed for an abuse of discretion. . . . Nevertheless, to the extent that the district court's decision under Rule 23.1 rests on a question of law or a mixed question of law and fact that primarily involves legal principles, our review is de novo."); *Scalisi v. Fund Asset Mgmt., L.P.*, 380

F.3d 133, 137 (2d Cir. 2004) ("[W]here 'determination of the sufficiency of allegations of futility depends on the circumstances of the individual case,' the standard of review for dismissals based on Fed. R. Civ. P. 23.1 is abuse of discretion. . . . However, where a challenge is made to the legal precepts applied by the district court in making a discretionary determination, plenary review of the district court's choice and interpretation of those legal precepts is appropriate.") (quoting *Kaster v. Modification Sys., Inc.*, 731 F.2d 1014, 1018 (2d Cir. 1984)).

Thus, for example, in *Cadle*, the Tenth Circuit considered whether the "continuing wrong" theory applied to the "contemporaneous ownership" requirement found in Rule 23.1 and Delaware corporation law – that rule requires a shareholder derivative plaintiff to have owned stock at the time of the wrong. *Cadle*, 272 F. App'x 676 at 678-79. The court noted that abuse of discretion is the standard for Rule 23.1 appeals generally, but applied *de novo* review to this issue because it concerned "a question of law or a mixed question of law and fact that primarily involves legal principles . . . ." *Id.* at 677. Petitioners agree that in such circumstances where the appellate court reviews an issue of law, *de novo* review is appropriate. It is the district court's determination of whether the particularized facts alleged in the complaint are sufficient to plead demand futility that should be afforded discretion.

IV. The Correct Standard Of Review Is Necessary To The Proper Resolution Of This Action.

The correct standard of review is critical to the resolution of whether the District Court's dismissal for failure to properly plead demand futility was appropriate in this case. Petitioners specifically argued that, based on prior First Circuit holdings and other federal appellate jurisprudence, the abuse of discretion standard applied to the review of the District Court's findings regarding the sufficiency of the demand allegations. (No. 11-1605, Appellees' Brief, filed Sept. 21, 2011 at 21-22) Nevertheless, the First Circuit reviewed the District Court's dismissal *de novo*. (App. 12a) At a minimum, the First Circuit should be required to reconsider this case under the proper standard.

The First Circuit explicitly couched its ruling against Petitioners regarding the sufficiency of the demand futility allegations in the complaint in terms of *de novo* review. As an initial matter, the court did not, as many other circuits have done, indicate that their ruling would be the same, whether the standard employed was abuse of discretion or de novo. *See, e.g.*, *Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust v. Raines*, 534 F.3d 779, 783 n.2 (D.D.C. 2008) (declining to further consider whether abuse of discretion was the appropriate standard because "we affirm the District Court's decision even under *de novo* review"); *Staehr v. Alm*, 269 F. App'x 888, 891 (11th Cir. 2008) ("[T]his is not an appropriate case to reconsider the applicable standard, because Appellant loses under either mode of review."); *Scalisi v. Fund Asset Mgmt.*, L.P., 380

F.3d 133, 137 n.6 (2d Cir. 2004) (declining to choose between *de novo* or abuse of discretion as appropriate standard of review because "we would reach the same conclusion under either standard"). Therefore, it is reasonable to assume that the First Circuit's analysis and ultimate conclusion that demand futility was adequately pleaded would have been different if the District Court's decision had been reviewed for abuse of discretion.

Second, the heart of the First Circuit's opinion is its *de novo* rejection of the factual inferences and conclusions that the District Court drew from the particularized facts alleged in the complaint. *See*, *e.g.*, App. 23a ("The district court concluded that these facts were insufficient to establish a reasonable doubt that Ubiñas could evaluate demand objectively. We disagree."); *id.* at 24a ("In deciding that plaintiffs had not established a reasonable doubt about Belaval's independence, *the district court failed to consider the facts* alleged as a whole about Belaval's relationships with the institutional defendants.") (emphasis added); *id.* at 25a ("The district court *should have considered* Belaval's previous professional relationships . . . .") (emphasis added); *id.* ([T]he district court incorrectly dismissed plaintiffs' characterization of Belaval's entanglements with the institutional defendants as 'conclusory allegations,' and *failed to make reasonable, common sense inferences from the facts* alleged in the complaint.") (emphasis added); *id.* at 26a ("[W]e examine the facts alleged concerning director Vicente Leon . . . .").

The First Circuit divested the District Court of its discretion to draw conclusions based on the particularized facts alleged in the Complaint. Based

on its own evaluation of the demand futility pleadings in the Complaint, the First Circuit held that six of the eleven members of the boards of directors of the Funds lacked independence to objectively evaluate the demand. (App. 26a) If, however, the First Circuit had reviewed the holding of the District Court for abuse of discretion, which permits reversal for only clear error, *see Wheat v. United States*, 486 U.S. 153, 164 (1988), the First Circuit likely would have determined that the District Court did not abuse its discretion.

For example, the District Court reasonably concluded that Messrs. Mario Belaval and Vicente Leon were independent based on the particularized facts (or absence thereof) alleged in the complaint.[6] (App. 44a-47a) Specifically, Judge Delgado concluded that the compensation Mr. Belaval and the other eight of eleven directors received for service on the boards of the Funds did not raise a reasonable doubt as to their independence "because [Plaintiffs] provide no additional facts that allow this court to gauge the materiality of such benefits" to those directors. (App. 46a) In light of the fact that the Complaint alleged the prominent careers of each outside director – some of whom, such as Mr. Belaval, were alleged to have been executives of international publicly-traded companies, Judge Delgado held that the compensation allegations were conclusory because there were no particularized allegations that would allow the court to gauge the materiality of the

[6] Both the First Circuit and the District Court held that the allegations as to Mr. Leon were similar to those of Mr. Belaval. (App. 26a (1st Cir), App. 47a (District Court)

compensation claimed to create the director's conflict. (App. 46a) Likewise, the District Court considered the allegations in the Complaint that a business that Belaval and Leon were associated with might need to raise capital from the Puerto Rican capital markets sometime in the future, and would therefore want to remain in the good graces of the UBS Defendants. (App. 46a-48a) Judge Delgado reasonably rejected this factual hypothesis about the UBS Defendants' purported ability to dominate and control Belaval and Leon. (*Id.*) Nevertheless, when the First Circuit reviewed the same facts *de novo*, it credited Plaintiffs' factual hypothesis and found that these alleged facts were sufficient, for Rule 23.1 purposes, to challenge the independence of those directors. (App. 24a-26a) That rejection of Judge Delgado's reasonable factual conclusion is inconsistent with the abuse of discretion standard. *See Wheat*, 486 U.S. at 164 ("Other district courts might have reached differing or opposite conclusions with equal justification, but that does not mean that one conclusion was 'right' and the other 'wrong'.").

CONCLUSION

For the foregoing reasons, Petitioners respectfully request that this Court grant certiorari to review the judgment of the First Circuit.

Respectfully submitted,

PAUL J. LOCKWOOD
Counsel of Record
NICOLE A. DISALVO
SKADDEN, ARPS, SLATE,
MEAGHER & FLOM LLP
One Rodney Square
P.O. Box 636
Wilmington, Delaware 19899
paul.lockwood@skadden.com
Phone: (302) 651-3000

JAY B. KASNER
SKADDEN, ARPS, SLATE,
MEAGHER & FLOM LLP
Four Times Square
New York, New York 10036
Phone: (212) 735-3000

SALVADOR J. ANTONETTI-STUTTS
UBALDO M. FERNÁNDEZ
MAURICIO O. MUÑIZ-LUCIANO
O'NEILL & BORGES LLC
250 Muñoz Rivera Avenue
Suite 800
San Juan, Puerto Rico 00918
Phone: (787) 764-8181

Counsel for Petitioners UBS Financial Services Incorporated of Puerto Rico, UBS Trust Company of Puerto Rico, Miguel A. Ferrer, Carlos V. Ubiñas, Stephen C. Roussin and Leslie Highley, Jr.

JOSÉ C. SÁNCHEZ-CASTRO
JOSÉ LUIS BARRIOS-RAMOS
LOPEZ SANCHEZ PIRILLO & HYMOVITZ LLC
P.O. Box 11917
San Juan, Puerto Rico 00922
Phone: (787) 522-6776

Counsel for Petitioners
Puerto Rico Fixed Income Fund II, Inc.,
Puerto Rico Fixed Income Fund III, Inc.,
Puerto Rico Fixed Income Fund IV, Inc., and
Tax-Free Puerto Rico Fund II, Inc.

RAFAEL ESCALERA-RODRÍGUEZ
PEDRO SANTIAGO-RIVERA
REICHARD & ESCALERA
P.O. Box 364148
San Juan, Puerto Rico 00936
Phone: (787) 777-8888

Counsel for Petitioners
Mario S. Belaval, Agustín
Cabrer-Roig, Gabriel
Dolagaray-Balado, Carlos Nido,
Luis M. Pellot-González,
Vicente J. León and Clotilde
Pérez

DATED: April 4, 2013

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APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

NO. 11-1605

UNIÓN DE EMPLEADOS DE MUELLES DE PUERTO RICO PRSSA WELFARE PLAN, INDIVIDUALLY AND ON BEHALF OF ALL OTHERS SIMILARLY SITUATED, AND DERIVATIVELY ON BEHALF OF PUERTO RICO FIXED INCOME FUND II, INC., PUERTO RICO FIXED INCOME FUND III, INC., PUERTO RICO FIXED INCOME FUND IV, INC., AND TAX-FREE PUERTO RICO FUND II, INC., UNIÓN DE EMPLEADOS DE MUELLES DE PUERTO RICO AP WELFARE PLAN, INDIVIDUALLY AND ON BEHALF OF ALL OTHERS SIMILARLY SITUATED, AND DERIVATIVELY ON BEHALF OF PUERTO RICO FIXED INCOME FUND II, INC., PUERTO RICO FIXED INCOME FUND III, INC., PUERTO RICO FIXED INCOME FUND IV, INC., AND TAX-FREE PUERTO RICO FUND II, INC.,

PLAINTIFFS, APPELLANTS,

v.

UBS FINANCIAL SERVICES INC. OF PUERTO RICO; UBS TRUST COMPANY OF PUERTO RICO; MIGUEL A. FERRER; CARLOS V. UBIÑAS; STEPHEN C. ROUSSIN; LESLIE HIGHLEY, JR.; MARIO S. BELAVAL; AGUSTÍN CABRER-ROIG; GABRIEL DOLAGARAY-BALADO; CARLOS NIDO; LUIS M. PELLOT-GONZÁLEZ; VICENTE J. LEÓN; CLOTILDE PÉREZ; DOES 1 THROUGH 100,

DEFENDANTS, APPELLEES,

v.

PUERTO RICO FIXED INCOME FUND II, INC.; PUERTO RICO FIXED INCOME FUND III, INC.; PUERTO RICO FIXED INCOME FUND IV, INC.; TAX-FREE PUERTO RICO FUND II, INC.,

NOMINAL DEFENDANTS.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF PUERTO RICO

[HON. AIDA M. DELGADO-COLÓN, U.S. DISTRICT JUDGE]

BEFORE

HOWARD, LIPEZ, AND THOMPSON, CIRCUIT JUDGES.

Jay W. Eisenhofer, with whom Mary S. Thomas, Cynthia A. Calder, Grant & Eisenhofer P.A., Harold D. Vicente-Gonzalez, Harold D. Vicente-Colon, Vicente & Cuebas, Douglas R. Hirsch, Charles H. Dufresne, Jr., Sadis & Goldberg LLP, Mark C. Gardy, James S. Notis, Kelly A. Noto, and Gardy & Notis, LLP were on brief, for appellant.

Paul J. Lockwood, with whom Nicole A. DiSalvo, Skadden, Arps, Slate, Meagher & Flom LLP, Salvador J. Antonetti-Stutts, Mauricio O. Muñiz-Luciano, Ubaldo M. Fernández-Barrera, and O'Neill & Borges were on brief, for appellees UBS Financial Services Inc. of Puerto Rico, UBS Trust Company of Puerto Rico, Miguel A. Ferrer, Carlos V. Ubiñas, Stephen C. Roussin, and Leslie Highley, Jr.

Rafael Escalera Rodríguez, Pedro Santiago, and Reichard & Escalera on brief for appellees Mario S. Belaval, Agustín Cabrer-Roig, Gabriel Dolagaray-Balado, Carlos Nido, Luis M. Pellot-González, Vicente J. León, and Clotilde Pérez.

Jose C. Sánchez-Castro and Pirillo Hill González & Sánchez PSC on brief for nominal defendants.

January 4, 2013

LIPEZ, Circuit Judge. A shareholder derivative action permits a shareholder of a corporation to bring suit to enforce rights the corporation is unable or unwilling to enforce on its own behalf. *See Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 95 (1991). However, to prevent abuse of this procedural device, a shareholder seeking to assert a cause of action belonging to the corporation must state with particularity in the complaint either that the corporation declined to protect its own interests after suitable demand was made on the board of directors or that such a demand would have been futile. *See Gonzalez Turul v. Rogatol Distribs., Inc.*, 951 F.2d 1, 2 (1st Cir. 1991). This case raises important questions concerning the circumstances in which, under the applicable law, a presuit demand is considered futile.

Plaintiff-Appellants Unión de Empleados de Muelles de Puerto Rico AP Welfare Plan ("AP") and Unión de Empleados de Muelles de Puerto Rico PRSSA Welfare Plan ("PRSSA") are Puerto Rico pension plans that own shares in closed-end investment funds ("the Funds") advised by UBS Trust Company of Puerto Rico ("UBS Trust"), a subsidiary of the Swiss financial giant UBS AG. In 2008, UBS Trust, acting as the Funds' investment adviser, purchased approximately $757 million worth of bonds from a series of issuances underwritten by UBS Financial Services Incorporated of Puerto Rico ("UBS Financial"), another UBS AG affiliate, and then sold these bonds to the Funds. As a consequence, the Funds were so heavily invested in these bonds that they suffered significant losses when the value of these bonds soon depreciated.

Plaintiffs brought a shareholder derivative action in federal district court against the Funds' directors, UBS Trust, and UBS Financial, who jointly filed a motion to dismiss plaintiffs' claims. The district court granted the motion to dismiss on the ground that no presuit demand had been made on the Funds' boards of directors, and plaintiffs had failed in their complaint to state with particularity the reasons such a demand would have been futile. After careful consideration, we vacate the dismissal of the derivative claims and remand for further proceedings.

I.

The following facts, which we take as true, are drawn from the allegations in the complaint. *See In re Sonus Networks, Inc.*, 499 F.3d 47, 66 (1st Cir. 2007).

Plaintiff AP owns shares of four investment funds: the Puerto Rico Fixed Income Fund II, Inc. ("Fund II"), the Puerto Rico Fixed Income Fund III, Inc. ("Fund III"), the Puerto Rico Fixed Income Fund IV, Inc. ("Fund IV"), and the Tax-Free Puerto Rico Fund II, Inc. ("Tax-Free Fund"). Plaintiff PRSSA owns shares of Fund II, Fund III, and Fund IV. Though these four funds are separate investment companies, the board of directors for each fund has an identical composition.[1] We refer to these four funds collectively as the "Funds."

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[1] "Unlike other corporations, investment companies are typically created and managed by pre-existing entities known as investment advisers." *Verkouteren v. Blackrock Fin. Mgmt. Inc.*, 37 F. Supp. 2d 256, 258 (S.D.N.Y. 1999).

Each of the Funds is a closed-end fund, and is incorporated under the laws of Puerto Rico.[2] Generally, such funds fall under the purview of the Investment Company Act of 1940 ("the 40 Act"). The funds in this case, however, are unusual in that they are exempt from the 40 Act under section 6(a)(1), which provides an exemption for certain funds organized in Puerto Rico, so long as securities issued by that fund are sold only to residents of Puerto Rico. *See* 15 U.S.C. § 80a-6(a)(1). To ensure that shares of these exempt funds are sold only to residents of Puerto Rico, the securities they issue contain special restrictions on how and to whom shares of these funds can be transferred or sold. As a consequence, the pool of potential buyers for these funds is smaller than the pool available to a typical large, closed-end mutual fund.

UBS Trust, through its UBS Asset Managers Division, serves as the investment adviser and administrator for the Funds. As compensation for these services, UBS Trust is entitled to an annual administrative fee of .15% and an advisory fee of .75%, of the average weekly gross assets of the Funds.

UBS Trust is an affiliate of, and shares officers with, UBS Financial, a broker-dealer registered with the Securities and Exchange Commission ("SEC"). Since 2007, UBS Financial has served as a financial adviser to Puerto Rico's troubled Employee Retire-

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[2] A closed-end fund is "[a] mutual fund having a fixed number of shares that are traded on a major securities exchange or an over-the-counter market." *Black's Law Dictionary* 1116 (9th ed. 2009).

ment System ("ERS"), which is a public retirement system maintained by the government of Puerto Rico for its 278,000 retirees and employees.

During the first half of 2008, UBS Financial underwrote $2.9 billion of bonds issued by ERS. Because an underwriter buys bonds from an issuer and resells them to investors, with the difference between the purchase price paid by the underwriter to the issuer and the resale price accounting for the underwriter's profit or loss, *see* John P. Lucas, *Pruning the Antitrust Tree: Credit Suisse Securities (USA) LLC v. Billing and the Immunization of the Securities Industry from Antitrust Liability*, 59 Mercer L. Rev. 803, 804 (2008); *see also In re Scottish Re Group Sec. Litig.*, 524 F. Supp. 2d 370, 400-401 (S.D.N.Y. 2007) (defining "underwriter" for purposes of the Securities Act of 1933), UBS Financial's profits from these offerings were contingent upon finding investors willing to buy the ERS bonds at a premium above the price UBS Financial had paid ERS.

The ERS bonds were offered for purchase in three series: Series A in January 2008; Series B in May 2008; and Series C in June 2008. When there was little global interest in the Series A offering of the ERS bonds, ERS and UBS Financial abandoned their initial plans to offer Series B outside of the Puerto Rico market. Nevertheless, UBS Trust purchased nearly $1.5 billion worth of the ERS bonds from UBS Financial and then resold them to the funds it advises, with approximately $757 million worth of the bonds sold to the Funds at issue in this case. Not only did UBS Trust purchase more than half of the entire multi-billion dollar offerings, UBS

Trust purchased nearly $850 million, or 85%, of the Series B bonds. As a result of these purchases, the ERS bonds accounted for more than thirty percent of the assets of Funds II, III, and IV and approximately fifteen percent of Tax-Free Fund II.[3] For its role in bringing the bonds to market, UBS Financial shared in underwriters' fees of $27 million.[4]

Within one year of issuance, the ERS bonds lost ten percent of their value, dragging down the worth of the Funds. In response, and without first demanding corrective action from the Funds' boards of directors, plaintiffs filed a shareholder derivative suit in February 2010 in federal district court against the Funds' directors, UBS Trust, and UBS Financial. The complaint alleged that the institutional defendants engaged in a scheme of manipulative trading whereby they used the Funds to manufacture the appearance of market interest in the bonds and drive up the price other investors were willing to pay for them. Plaintiffs asserted derivative claims under Rule 10-b5 and Section 10(b) of the Exchange Act against UBS Trust and UBS Financial, derivative claims under Section 20(a) of the Exchange Act against certain directors individually, and derivative

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[3] To summarize the travel of the bonds: ERS sold the bonds to its underwriter, UBS Financial, which in turn sold them to UBS Trust and other buyers. UBS Trust then sold the bonds it had purchased to the funds it advises, including the Funds at issue in this case. Plaintiffs in this case are institutional investors in the Funds.

[4] The complaint does not indicate who the other underwriters were or what percentage of the total fees UBS Financial received.

claims under Section 12(a)(2) of the Securities Act against UBS Trust and UBS Financial.[5] The complaint also stated that a presuit demand would have been futile.

Appellees moved to dismiss the derivative claims on the ground that plaintiffs had inadequately pleaded demand futility. In opposing the motion to dismiss, plaintiffs requested an opportunity to cure any deficiencies in the complaint by filing an amended complaint if the district court were inclined to dismiss any or all of their claims.

The district court did not afford plaintiffs any such opportunity. Instead, it dismissed plaintiffs' derivative claims without prejudice for failure to properly plead demand futility. When plaintiffs sought leave to file an amended complaint, the district court denied plaintiffs' motion, citing our holding in *Fisher v. Kadant, Inc.* that "once judgment has entered, the case is a dead letter, and the district court is without power to allow an amendment to the complaint because there is no complaint left to amend." 589 F.3d 505, 509 (1st Cir. 2009). This appeal followed, challenging both the dismissal of plaintiffs' derivative claims and the denial of their motion to amend.

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[5] In addition to their derivative claims, plaintiffs asserted direct claims against UBS Trust and UBS Financial on behalf of a putative class of shareholders for breach of ERISA fiduciary duties and violations of the duty of good faith. These direct claims were dismissed by the district court pursuant to Federal Rule of Civil Procedure 12(b)(6). Their dismissal is not challenged on appeal.

II.

We must address a threshold question in this case about the standard of review that applies to a district court's dismissal of a shareholder derivative action based on a failure to properly plead demand futility. Our decisions have left this question open. *See*, *e.g.*, *Gonzalez Turul*, 951 F.2d at 1, 3 (holding that district court should have dismissed derivative suit but not discussing standard of review); *In re Kauffman Mut. Fund Actions*, 479 F.2d 257, 263, 267 (1st Cir. 1973) (affirming dismissal of derivative suit without describing standard of review). The closest we have come to setting forth the applicable standard of review was in *Heit v. Baird*, where we noted that the district court had not "abused its discretion" in dismissing a shareholder derivative action. 567 F.2d 1157, 1161 (1st Cir. 1977). However, we also determined for ourselves in *Heit* that the pleadings were inadequate without any discernible deference to the district court's conclusions, and our holding said only that dismissal of the case was "proper," *id.* at 1162, appearing to abjure a more deferential standard of review. Our view that *Heit* did not establish the governing standard in this circuit is confirmed by the conspicuous absence in our subsequent decisions of any statement to that effect. *See Gonzalez Turul*, 951 F.2d at 2 (citing *Heit* but no mention of standard of review); *Marquis Theatre Corp. v. Condado Mini Cinema*, 846 F.2d 86, 90-91 (1st Cir. 1988) (same); *Grossman v. Johnson*, 674 F.2d 115, 123 (1st Cir. 1982) (same); *Untermeyer v. Fid. Daily Income Trust*, 580 F.2d 22, 23 (1st Cir. 1978) (same).

Other courts of appeals have traditionally reviewed the dismissal of a derivative suit based on a failure to properly plead demand futility for abuse of discretion. *See*, *e.g.*, *Potter v. Hughes*, 546 F.3d 1051, 1056 (9th Cir. 2008); *Kanter v. Barella*, 489 F.3d 170, 175 (3d Cir. 2007). Recently, however, there have been expressions of skepticism regarding the appropriateness of this standard from the Second Circuit, *see Kautz v. Sugarman*, 456 F. App'x 16, 18 (2d Cir. 2011); *Scalisi v. Fund Asset Mgmt.*, L.P., 380 F.3d 133, 137 n.6 (2d Cir. 2004), the Ninth Circuit, *see Israni v. Bittman*, 473 F. App'x 548, 550 n.1 (9th Cir. 2012); *Laborers Int'l Union of N. Am. v. Bailey*, 310 F. App'x 128, 130 n.1 (9th Cir. 2009), and the D.C. Circuit, *see Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust v. Raines*, 534 F.3d 779, 783 n.2 (D.C. Cir. 2008). As the Second Circuit has observed, the abuse of discretion standard is incongruous in this context: "[W]hen a trial court rules on the legal sufficiency of a complaint the question presented should be one of law. When an appellate court reviews such a ruling, review should be de novo." *Scalisi*, 380 F.3d at 137 n.6.

State courts have trended even more strongly toward plenary review. In 2000, the Delaware Supreme Court expressly adopted a de novo standard of review, explaining that the nature of its analysis of a complaint in a derivative suit is no different than that of a lower court. *See Brehm v. Eisner*, 746 A.2d 244, 253-54 (Del. 2000). The highest courts of other states have followed suit. *See Fink v. Codey* (*In re PSE & G S'holder Litig.*), 801 A.2d 295, 313 (N.J. 2002); *Harhen v. Brown*, 730 N.E.2d 859, 866 (Mass. 2000) (same).

We are persuaded by the reasoning in these cases. As a general matter, rulings concerning the legal sufficiency of pleadings are reviewed de novo. *See Giragosian v. Ryan*, 547 F.3d 59, 63 (1st Cir. 2008). There is no justification for treating the pleadings in a derivative suit differently. A district court is no better positioned than we are to read and evaluate a complaint in this sort of action. *See Brehm*, 746 A.2d at 253-54. Accordingly, we now hold that a district court's dismissal of a shareholder derivative suit based on a failure to properly plead demand futility is subject to de novo review.

III.

Federal Rule of Civil Procedure 23.1 sets forth the rule of pleading requiring a shareholder filing a derivative action to allege with particularity either that a satisfactory presuit demand was presented to, and refused by, the board of directors or the reasons such a demand would have been futile. However, the circumstances in which a demand is required or, conversely, excused are determined by reference to the law of the state in which the corporation is incorporated. *See Gonzalez Turul*, 951 F.2d at 1 & n.3; *cf. Kamen*, 500 U.S. at 96-97 ("Rule 23.1 . . . does not *create* a demand requirement of any particular dimension."). That is, the federal rule merely requires that the complaint allege sufficient facts to enable a federal court to decide whether, as a matter of state substantive law, a presuit demand was necessary. *See Halebian v. Berv*, 590 F.3d 195, 211 (2d Cir. 2009).

Because the Funds are Puerto Rico corporations, Puerto Rico law ordinarily would inform our analysis as to whether a demand was excused in this case. However, Puerto Rico law "does not specifically elaborate the requirements of demand or when it is excused." *Gonzalez Turul*, 951 F.2d at 3 n.4. Hence, we look to Delaware corporate law, on which Puerto Rico corporate law is modeled. *See id.*; *Marquis Theatre*, 846 F.2d at 91.

Through its opinions in *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), *overruled on other grounds by Brehm*, 746 A.2d at 253-54, and *Rales v. Blasband*, 634 A.2d 927 (Del. 1993), the Delaware Supreme Court has established two interrelated tests for demand futility. "In simple terms, these tests permit a corporation to terminate a derivative suit if its board is comprised of directors who can impartially consider a demand." *In re Oracle Corp. Deriv. Litig.*, 824 A.2d 917, 939 (Del. Ch. 2003). Which test is appropriate in a given case depends on the nature of the plaintiff's allegations against the board: *Rales* applies where the plaintiff challenges a board's failure to discharge its oversight duties, while *Aronson* applies where the plaintiff alleges that the board as a whole has made a conscious business decision in violation of its fiduciary duties. *See Rales*, 634 A.2d at 933 ("The essential predicate for the *Aronson* test is the fact that a *decision* of the board of directors is being challenged in the derivative suit."); *see also Wood v. Baum*, 953 A.2d 136, 140 (Del. 2008) ("The *Aronson* test applies to claims involving a contested transaction."); *In re Baxter Int'l, Inc. S'holders Litig.*, 654 A.2d 1268, 1269 (Del. Ch. 1995) (holding that *Rales*

applies where plaintiffs "do not challenge directors' exercise of business judgment").

In the instant case, plaintiffs do not allege that the boards of each of the Funds made a formal, direct decision to purchase the ERS bonds. Rather, as is common practice, the directors delegated the authority to make investment decisions on behalf of the Funds to the investment adviser, here UBS Trust. Acting as investment adviser, UBS Trust then executed the purchases of ERS bonds from UBS Financial and placed them with the Funds. The *Rales* standard is thus the best fit for this case. *See Rales*, 634 A.3d at 933-34 (noting *Aronson* is inappropriate "where the subject of the derivative suit is not a business decision of the board"); *In re Mut. Funds Inv. Litig.*, 384 F. Supp. 2d 873, 878 (D. Md. 2005) (applying Delaware law and concluding that *Rales* was more appropriate in the mutual fund context).

For a plaintiff to succeed under *Rales*, she must allege particularized facts creating "a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." *Rales*, 634 A.2d at 934. Applying this test, we look to the individual directors rather than the board as a whole, and excuse demand "only if a majority of the board members are *interested* or lack *independence*." *In re Sonus Networks*, 499 F.3d at 67 (citing *Rales*, 634 A.2d at 930). A director is interested "whenever divided loyalties are present, or where the director will receive a personal financial benefit from a transaction that is not equally shared by the stockholders, or when a corporate decision will

have a 'materially detrimental impact' on a director but not the corporation or its stockholders." *In re Verisign, Inc. Deriv. Litig.*, 531 F. Supp. 2d 1173, 1189 (N.D. Cal. 2007) (quoting *Rales*, 634 A.2d at 936). Similarly, a director's independence may be compromised if he or she is so personally or financially beholden to an interested person, or an interested entity, that "his or her discretion [is] sterilized." *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1050 (Del. 2004) (quoting *Aronson*, 473 A.2d at 816) (internal quotation marks omitted); *see also Orman v. Cullman*, 794 A.2d 5, 25 n.50 (Del. Ch. 2002) (explaining that the independence inquiry "involves an inquiry into whether the director's decision resulted from that director being controlled by another"); *Aronson*, 473 A.2d at 816 ("Independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences."). Though disinterest and independence are separate concepts, "similar factual circumstances may implicate *both* interest and independence." *Orman*, 794 A.2d at 25 n.50.

In evaluating the directors' disinterest and independence, Delaware courts have understood *Rales* to signal a kind of realism in analyzing the human dynamics at play in a director's relationships. *See Mizel v. Connelly*, No. 16638, 1999 WL 550369, at *3 n.1 (Del Ch. Aug. 2, 1999) (describing the *Rales* standard as a "pragmatic, realist approach"); *Steiner v. Meyerson*, No. 13139, 1995 WL 441999, at *10 (Del. Ch. July 19, 1995) ("Realism of the kind signaled by *Rales* requires one to acknowledge the possibility that a partner at a small law firm bringing in close to

$1 million in revenues from a single client in one year may be sufficiently beholden to, or at least significantly influenced by, that client as to affect the independence of his judgment.").

Turning to the instant case, we find that the district court's analysis of whether plaintiffs had established demand futility was flawed in two significant ways. First, in analyzing each director, the district court focused too narrowly on whether plaintiffs had alleged that the individual directors received a financial benefit from the ERS bonds transaction. Alleging the receipt of a personal financial benefit is not the sine qua non of demand futility. Rather, *Rales* requires the trial court to analyze more broadly the facts alleged concerning the circumstances of each director to determine whether plaintiffs have created a reasonable doubt that the director could objectively evaluate demand "without regard for" inappropriate influences. *Aronson*, 473 A.2d at 815. In other words, the district court should have considered whether plaintiffs had pled facts sufficient to demonstrate that each director has such significant connections to the defendants, whether personal, financial, or otherwise, that he could not "impartially consider [demand] without being influenced by improper considerations." *Rales*, 634 A.2d at 934.

Second, the district court misconstrued plaintiffs' burden of demonstrating that the benefits –- financial or otherwise -– that the individual directors received from their place in the constellation of relationships between UBS Financial and UBS Trust were of "subjective material significance" as required under *Orman*, 794 A.2d at 25 n.50. To demonstrate

subjective materiality, plaintiffs in a shareholder derivative suit "need not [offer] conclusive evidence of the materiality," but they must "provide the Court with some particulars *from which it could reasonably be inferred* that [the director's] objective judgment would be impaired." *MCG Capital Corp. v. Maginn*, No. 4521-CC, 2010 WL 1782271, at *20 (Del Ch. May 3, 2010) (emphasis supplied). In reviewing the disinterest and independence of each individual director in this case, however, the district court repeatedly declined to make such reasonable inferences of materiality from the facts alleged by plaintiffs. For example, the district court concluded that the allegations that one director was CEO of both institutional defendants did not raise a reasonable doubt about his ability to independently evaluate demand in this case because these facts were insufficient to establish that these positions were "subjectively material." In looking for more conclusive evidence of materiality, the court overstated the burden plaintiff bears, and ignored the type of information available to plaintiffs at the pleading stage. *See Rales*, 634 A.2d at 934 (reasoning that plaintiffs should not be saddled with an "extremely onerous burden to meet at the pleading stage without the benefit of discovery"). At best, plaintiffs can only plead the particular facts of each director's public circumstances. It is then up to the court to evaluate the facts alleged regarding each individual director in light of common sense and practical experience in drawing an inference of subjective materiality.

IV.

With these errors in mind, we turn to the individual directors. As noted, each of the Funds is overseen by an identical eleven-member board of directors. Thus, for plaintiffs to establish demand futility, the complaint must create a reasonable doubt that at least six of the directors were not disinterested and independent under the *Rales* standard at the time of filing. Because Delaware law requires a plaintiff pleading demand futility to "allege facts as to the interest and lack of independence of the *individual members* of that board," we examine the facts plead concerning each director separately. *Orman*, 794 A.2d at 22.[6]

[6] In our discussion of the individual directors, we rely on the facts alleged in the complaint. For the purposes of our demand futility analysis, we take these facts as true. *See In re Verisign, Inc.*, 531 F. Supp. 2d at 1187.

A. The Individual Directors

1. Leslie Highley, Jr.[7]

We begin with the most straightforward case. Plaintiffs allege and defendants do not contest that Leslie Highley, Jr. is an insider with extensive ties to UBS AG affiliates. In addition to being a director of each Fund, Highley is an executive employee of both UBS Trust, where he is Managing Director and Executive Vice President, and UBS Financial, where he is Senior Vice President. For several years, Highley has also acted on behalf of UBS Trust as portfolio manager for several of the Funds. In other words, Highley is involved at a high level with both institutional defendants. The district court correctly held that these facts alone are sufficient to create a reasonable doubt that he could be disinterested and in-

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[7] Four directors – Highley, Ferrer, Ubiñas, and Roussin – are defendants in this suit in their individual capacity for alleged violation of section 20(a) of the Exchange Act. Though this personal liability claim might seem strong support for the proposition that they could not evaluate demand with disinterest and independence, the Delaware Supreme Court noted in *Aronson* that "the mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterestedness of directors." 473 A.2d at 815. Later decisions have interpreted *Aronson* to mean that only a "substantial likelihood of personal liability" is enough to establish demand futility. *See*, *e.g.*, *Wood*, 953 A.2d at 141 n.11. Because we find there are significant alternative factual allegations to establish that a majority of the board was not independent and disinterested, we pass no judgment as to whether the allegations against the individual directors create a "substantial likelihood of personal liability."

dependent in evaluating plaintiffs' demand in this case. *See Orman*, 794 A.2d at 25 n.50.

2. **Miguel Ferrer**

Plaintiffs allege that Miguel Ferrer serves as both Chairman and President of the Board of Directors of each of the four Funds. At the time of the ERS bond offering, Ferrer was also the Chief Executive Officer of both UBS Trust and UBS Financial. Before the complaint was filed, Ferrer concluded his employment with both UBS Financial and UBS Trust, but he did not leave the UBS AG family. Instead, at the time the complaint was filed, Ferrer was the Chairman of yet another UBS-affiliated entity known as UBS International & Puerto Rico ("UBS International").

Though the district court was correct in its ultimate conclusion that plaintiffs had created a reasonable doubt about Ferrer's ability to objectively evaluate demand, it improperly considered Ferrer's circumstances at the time of the ERS bonds transaction. By contrast, *Rales* requires the court to consider the facts pleaded concerning each director's circumstances at the time the complaint was filed. *See Rales*, 634 A.2d at 933-34 ("[A] court must determine whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, *as of the time the complaint is filed*, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." (emphasis supplied)).

Considering only the facts alleged concerning Ferrer's circumstances at the time the complaint was filed, we conclude that plaintiffs have established a reasonable doubt that Ferrer could have exercised his "independent and disinterested business judgment in responding to a demand." *Rales*, 634 A.2d at 934. Even though Ferrer was no longer a full-time employee at UBS Trust and UBS Financial, his extensive past ties to both UBS Trust and UBS Financial are important factors in our analysis. *See Krantz v. Fidelity Mgmt. & Research Co.*, 98 F. Supp. 2d 150, 156 (D. Mass. 2000) (citing with approval ten factors set out by the SEC relevant to determination of control over directors which included "former business associations between the director and the controlling person"); *In re Trump Hotels S'Holder Deriv. Litig.*, Nos. 96 Civ. 7820, 8527, 2000 WL 1371317, at *9 (S.D.N.Y. Sept. 21, 2000) ("[Director's] history of personally beneficial affiliation with Trump-controlled entities . . . diminishes the possibility that [he] had only the corporation's interests in mind when evaluating the transaction."). In particular, Ferrer's ability to leave his former UBS positions and assume a new role at a different UBS affiliate suggests that Ferrer has been able to leverage the relationships and goodwill he has built in the UBS family of companies into advancing his career. Given this history, we agree with the district court that plaintiffs have established a reasonable doubt that Ferrer could objectively evaluate the demand.

3. **Carlos Ubiñas**

According to the facts alleged in plaintiffs' complaint, Carlos Ubiñas is Vice Chairman of the

Board of Directors and Executive Vice President of each of the Funds. Like Highley and Ferrer, Ubiñas serves in multiple executive positions at UBS AG affiliates. Since 2005, Ubiñas has been the President of UBS Financial, the institutional defendant that received substantial remuneration for its services as a financial advisor to ERS and shared in $27 million in underwriting fees for its role as lead underwriter for the $2.9 billion bond offering at the heart of this dispute. He is also currently the CEO of UBS International, the same UBS AG affiliate where his fellow director Ferrer is Chairman.

As both president of defendant UBS Financial and a director of each Fund, Ubiñas's loyalties would necessarily be divided in evaluating plaintiffs' demand between his obligations to the Funds and his obligations to UBS Financial. *See In re Verisign, Inc.*, 531 F. Supp. 2d at 1189 ("Directorial 'interest' exists whenever divided loyalties are present. . . ."). Similarly, as President of UBS Financial and CEO of another UBS AG affiliate, Ubiñas is beholden to the UBS defendants. *See In re NutriSystem, Inc. Deriv. Litig.*, 666 F. Supp. 2d 501, 515 (E.D. Pa. 2009) ("Delaware courts have found that directors . . . lack independence because of their substantial interest in retaining their employment."); *In re The Student Loan Corp. Deriv. Litig.*, 2002 WL 75479, at *3 & n.3 (concluding that directors who "owe their livelihood" to institutional defendant could not consider demand without "ponder[ing] the effect affirmative action on a demand would have on [their] future"); *see also Rales*, 634 A.2d at 937; *Mizel*, 1999 WL 550369, at *3 (finding directors lacked independence where they could not "consider the demand on its merits without

also pondering whether an affirmative vote would endanger their continued employment").

The district court concluded that these facts were insufficient to establish a reasonable doubt that Ubiñas could evaluate demand objectively. We disagree. Viewing the facts alleged concerning Ubiñas's circumstances as a whole, we conclude that plaintiffs have created a reasonable doubt that Ubiñas could "impartially consider [the] merits" of bringing a lawsuit alleging that his employer, UBS Financial, engaged in an unlawful scheme "without being influenced by improper considerations." *Rales*, 634 A.2d at 934.

4. **Stephen Roussin**

Like Ubiñas, Stephen Roussin is a Director of each of the Funds and a full-time employee of UBS Financial, where he is the Managing Director. For the same reasons discussed in relation to Ubiñas, we conclude that plaintiffs have plead sufficient facts to raise a reasonable doubt as to Roussin's independence and disinterest in evaluating the demand.

5. **Mario Belaval**

According to the allegations in plaintiffs' complaint, Mario Belaval's principal employer is Triple S, the largest managed care company in Puerto Rico, where Belaval is Vice Chairman. Belaval is also a director of twenty-three UBS-affiliated funds, including the four Funds at issue in this case. In the recent past, Triple S has enjoyed a lucrative relationship with UBS Financial and UBS Trust. In fact, in 2006, with the help of UBS Trust and UBS Financial, Tri-

ple S engaged in a transaction similar to the ERS bonds offering at issue in this case. In the 2006 transaction, UBS Financial served as the placement agent for a $35 million bond offering from Triple S. UBS Trust purchased this *entire offering*, and then re-sold the notes to several of the funds it advises, including Fund IV. In other words, Belaval is an officer of a company that benefitted significantly from the same affiliation that is at the heart of this case, using UBS Financial to sell Puerto Rican securities to UBS Trust for resale to its exempt funds. Plaintiffs allege that Triple S's previous use of the relationship between UBS Financial and UBS Trust gives Belaval "reason to discourage scrutiny of any similar related-party transactions, such as the purchase of the ERS Bonds."

In addition to Belaval's prior reliance on UBS Trust and UBS Financial to raise capital, plaintiffs allege that by remaining in the good graces of UBS affiliates, Belaval would receive benefits including "opportunities to use UBS captive funds to support [his] other business ventures." These opportunities are particularly valuable to businesses in Puerto Rico because UBS Trust is "the largest asset manager" in Puerto Rico, and UBS Trust and its "alter ego" UBS Financial "are an unusually pervasive force in Puerto Rico's financial markets."

In deciding that plaintiffs had not established a reasonable doubt about Belaval's independence, the district court failed to consider the facts alleged as a whole about Belaval's relationships with the institutional defendants. *See In re Trump Hotels*, 2000 WL 1371317, at *9 (noting that while one allegation

standing alone "is insufficient to raise a reasonable doubt[,] . . . the totality of the circumstances raises a reasonable doubt" as to the director's independence). The district court should have considered Belaval's previous professional relationships with both institutional defendants and the possibility that Belaval will need the assistance of the UBS defendants in the future as a constellation of facts which, considered together, create a reasonable doubt about Belaval's independence. *See*, *e.g.*, *id.* at *8 ("Courts have considered the possibility of future influence or remuneration as a factor when weighing director independence."); *Krantz*, 98 F. Supp. 2d at 156 (listing factors relevant to determining whether a director is controlled including "former business associations between the director and the controlling person").

Similarly, the district court incorrectly dismissed plaintiffs' characterization of Belaval's entanglements with the institutional defendants as "conclusory allegations," and failed to make reasonable, common sense inferences from the facts alleged in the complaint. *See In re Oracle Corp.*, 824 A.2d at 943 (reasoning that in assessing a director's independence the chancellor must "necessarily draw on a general sense of human nature"). The complaint depicts the institutional defendants as powerful actors in Puerto Rico's capital markets who play multiple roles in Belaval's life: employer, underwriter, investor, and gate-keeper to Puerto Rico's capital markets. For Belaval, deciding to bring plaintiffs' lawsuit would mean not only suing two institutions that are important to Triple S, but also accusing four of his co-directors – who are themselves prominent players in Puerto Rico's business community – of violating fed-

eral securities law. Considering all of these allegations together, we conclude that plaintiffs have established a reasonable doubt that a person in Belaval's position could evaluate demand in this case without "ponder[ing] the effect affirmative action on a demand would have on [his] future." *In re The Student Loan Corp.*, 2002 WL 75479, at *3.

6. **Vincente Leon**

Finally, we examine the facts alleged concerning director Vincente Leon, which are nearly identical to those regarding Belaval. Leon is both a director of each of the Funds and a vice-chairman of Triple S. He sits on the boards of many UBS Trust affiliated funds. Under these circumstances, Triple S's past use of the UBS affiliates' financial network in a transaction similar to the ERS bonds transaction, UBS Trust's significant past purchases and current holdings of Triple S notes, the power of the UBS defendants in Puerto Rico's financial markets and the likelihood that in the future Leon will need assistance from the UBS defendants in accessing the Puerto Rican markets, lead us to conclude that plaintiffs have plead sufficient facts to create a reasonable doubt that Leon could objectively consider the demand.

V.

In summary, the plaintiffs' allegations have established with sufficient particularity a reasonable doubt about the ability of the six directors identified above to evaluate plaintiffs' demand to bring this action on behalf of the Funds with the disinterest and independence required under Puerto Rico law. Be-

cause the boards of directors of the Funds have eleven members, plaintiffs have established under *Rales* that a presuit demand would have been futile. The district court erred in reaching a contrary conclusion. Plaintiffs' derivative claims should not have been dismissed. We therefore *vacate* the dismissal of those claims and remand for further proceedings consistent with this opinion.[8] Costs are awarded to the appellants.

SO ORDERED

[8] In light of this decision, there was no need for plaintiffs to file an amended complaint. However, if plaintiffs wish to file an amended complaint for reasons unrelated to the sufficiency of their demand futility pleadings, they will have an opportunity to request permission to do so upon remand.

APPENDIX B

IN THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF PUERTO RICO

CIVIL NO.10-1141 (ADC)

UNION DE EMPLEADOS DE MUELLES DE PUERTO RICO PRSSA WELFARE PLAN, ET AL.

PLAINTIFFS,

V.

UBS FINANCIAL SERVICES INC. OF PUERTO RICO, ET AL.,

DEFENDANTS.

O P I N I O N A N D O R D E R

Plaintiffs, Unión de Empleados de Muelles de Puerto Rico PRSSA Welfare Plan ("PRSSA") and Unión de Empleados de Muelles de Puerto Rico AP Welfare Plan ("AP") (collectively, "plaintiffs") filed the present action for violations of federal securities

law and Commowealth law against three groups of defendants: the "UBS defendants" - UBS Financial Services Incorporated of Puerto Rico ("UBS PR"), UBS Trust Company of Puerto Rico ("UBS Trust") (collectively, "UBS defendants"); the "Director defendants" - Miguel A. Ferrer ("Ferrer"), Carlos V. Ubiñas ("Ubiñas"), Stephen C. Roussin ("Roussin"), Leslie Highley, Jr. ("Highley"), Mario S. Belaval ("Belaval"), Agustín Cabrer-Roig ("Cabrer-Roig"), Gabriel Dolagaray-Balado ("Dolagaray"), Carlos Nido ("Nido"), Luis M. Pellot-González ("Pellot"), Vicente J. León ("León"), Clotilde Peŕez ("Pérez"); and "Nominal defendants" - Puerto Rico Fixed Income Fund II, Inc. ("Fund II"), Puerto Rico Fixed Income Fund III, Inc. ("Fund III"), Puerto Rico Fixed Income Fund IV, Inc. ("Fund IV") and Tax-Free Puerto Rico Fund II, Inc. ("Tax-free fund," collectively "Funds") (all three sets of defendants collectively referred to as "defendants").[1] ECF No. 1. With specific regards to the claims, plaintiffs allege eight (8) derivative claims[2] on

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[1] Plaintiffs also brought the present action against "Does" No. 1-100.

[2] Plaintiffs allege the following derivative action claims: I - Derivative Claim for Violation of Section 10(b) of the Exchange Act and Rule 10b-5 against the UBS defendants; II - Derivative Claim for Violation of Section 20(a) of the Exchange Act against Ferrer, Ubiñas, Roussin and Highley; III - Derivative Claim for violation of Section 12(a)(2) of the Securities Act against UBS defendants; IV - Derivative Claim for Unjust Enrichment/Constructive Trust against all defendants; V - Derivative Claim for violations of Duty to Act in Good Faith against all defendants; VI - Derivative Claim for violations of duties as Agent of the Funds pursuant to Commonwealth law against UBS Trust; VII - Derivative Claims for violations of fiduciary duties pursuant to Commonwealth law against the Director defend-

(cont'd)

behalf of the Nominal defendants for violations of the Securities Exchange Act and other common law claims; two (2) class action claims for breach of ERISA Fiduciary duties and violations of the duty to act in good faith; and one (1) claim pursuant to 28 U.S.C. § 1367 for attorneys' fees and prejudgment interest. ECF No. 1. Presently pending before the court is defendants' motion to dismiss the complaint[3], plaintiffs' timely opposition and defendants' reply. ECF Nos. 35, 41, 47.

I. Background

Unless otherwise mentioned, the following facts arise from plaintiffs' complaint. ECF No. 1.

Plaintiffs, PRSSA and AP are welfare plans that own stock in some of the Funds. ECF No. 1 at ¶¶ 23, 24. UBS Trust is the issuing, paying and transfer agent for the Funds. *Id.* at ¶ 27. The Director defendants each serve on the Board of Directors of each of

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ants; VIII - Derivative Claim for violation of Commonwealth Securities law against the UBS defendants.

[3] Defendants' motion to dismiss presents three separate arguments: (1) that the derivative claims should be dismissed for failure to comply with the pleading requirements of derivative action claims; (2) that all the claims should be dismissed for failure to state a claim upon which relief can be granted; and (3) that the fraud claims should be dismissed for failure to plead with particularity. ECF No. 35 at 12. While all three sets of defendants have joined the arguments for dismissal in a single motion to dismiss, the court notes that Nominal defendants have joined only that portion of the motion raising to the first argument, namely, that the derivative claims should be dismissed for failure to comply with the pleading requirements. ECF No. 35 at 12, n. 2.

the Funds.[4] *Id.* at ¶¶ 30-41. Plaintiffs allege that the Director defendants owed the Funds: (1) the duty to exercise due care and diligence in the management and administration of the Funds; and (2) owed its shareholders as well, duties of loyalty, good faith and candor. *Id.* at ¶ 43. Plaintiffs also allege that UBS Trust, and UBS PR as its alter ego, had a contractual obligation to the Funds to act in good faith and in a loyal, honest and fair manner. *Id.* at ¶ 46.

In 2007, UBS PR became a financial advisor to the Employee Retirement System of the Government of Puerto Rico ("ERS"). *Id.* at ¶ 4. The ERS is a public retirement plan that the government of Puerto Rico maintains for its employees. *Id.* at ¶ 3. In or around 2008, ERS sought to sell pension bonds ("ERS bonds") in a series of three bond offerings. *Id.* at ¶ 50. UBS PR served as an underwriter for these bond offerings and received, along with other co-underwriters, approximately $27 million in fees. *Id.* Plaintiffs allege that the ERS bonds were of low quality. *Id.* at ¶ 51.

Series A of the ERS bonds were offered in Puerto Rico in late January 2008. *Id.* at ¶ 53. In a statement describing the Series A ERS bonds, dated January 29, 2008, the underwriters, including UBS

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[4] Based on the allegations of the complaint, the court understands that each of the individual Director defendants serve on the Boards of Directors of each of the Funds, with Ferrer as the Chairman of the Board of Directors and President of each of the Funds, and Ubiñas as the Vice Chairman of the Board of Directors and Executive Vice President of each of the Funds. ECF No. 1 at 30-41.

PR, stated, "[i]n connection with the offering of the series A bonds, the underwriters may effect transactions which stabilize or maintain the market prices of the series A bonds at levels above those which might otherwise prevail in the open market. Such stabilizing, if commenced, may be discontinued at any time." *Id.* at ¶ 54. The Funds purchased almost $325 million in ERS bonds from the Series A offering. *Id.* at ¶ 56.

Series B of the ERS bonds were offered in late May 2008. *Id.* at 58. The underwriters again stated, "[i]n connection with the offering of the series B bonds, the underwriters may effect transactions which stabilize or maintain the market prices of the series B bonds at levels above those which might otherwise prevail in the open market. Such stabilizing, if commenced, may be discontinued at any time." *Id.* at ¶ 59. The Funds purchased over $430 million in ERS bonds from this offering. *Id.* at ¶ 61.

Finally, in June of 2008, Series C of the ERS bonds were offered. *Id.* at ¶ 62. The underwriters again stated, ""[i]n connection with the offering of the series C bonds, the underwriters may effect transactions which stabilize or maintain the market prices of the series C bonds at levels above those which might otherwise prevail in the open market. Such stabilizing, if commenced, may be discontinued at any time." *Id.* at ¶ 63. The Funds purchased nearly $2 million in ERS bonds from this offering. *Id.* at ¶ 64.

II. Motion to Dismiss Under Fed. R. Civ. P. 12(b)(6)

Under Fed. R. Civ. P. 12(b)(6), the court "take[s] as true all well-pleaded allegations and

draw[s] all reasonable inferences in the plaintiff's favor." *Ezra Charitable Trust v. Tyco Int'l, Ltd.*, 466 F.3d 1, 5-6 (1st Cir. 2006); *see also Ashcroft v. Iqbal*, No. 07-1015, 129 S. Ct. 1937, 2009 WL 1361536, *13 (May 18, 2009); *Maldonado v. Fontanes*, 568 F.3d 263 (1st Cir. 2009). The overall assessment of the adequacy of a plaintiff's pleading is guided by two principles. "First, the tenet that a court must accept as true all of the allegations contained in a complaint is inapplicable to legal conclusions. Threadbare recitals of the elements of a cause of action, supported by mere conclusory statements, do not suffice." *Iqbal*, 2009 WL 1361536, at *13. Second, "only a complaint that states a plausible claim for relief survives a motion to dismiss." *Id.* (citing *Bell Atl. v. Twombley*, 550 U.S. 544, 556 (2007)). Whether a complaint states a plausible claim for relief is a context-specific task, where the court must "draw on its judicial experience and common sense." *Id.* "But where the well-pleaded facts do not permit the court to infer more than the mere possibility of misconduct, the complaint has alleged—but it has not 'show[n]'—'that the pleader is entitled to relief.'" *Id.* (citing Fed. Rule Civ. Proc. 8(a)(2)). After evaluating the allegations in the complaint, the court then determines whether the plaintiff has stated a claim under which relief can be granted.

III. Discussion

Defendants' motion seeks dismissal of plaintiffs' entire complaint by way of three arguments: (1) that the derivative claims should be dismissed for failure to comply with the pleading requirements of derivative action claims; (2) that all the claims

should be dismissed for failure to state a claim upon which relief can be granted; and (3) that the fraud claims should be dismissed for failure to plead with particularity. ECF No. 35 at 12. The court entertains each argument separately.

A. Pleading Requirements of a Derivative Claim

Pursuant to Fed. R. Civ. P. 23.1(b) ("Rule 23.1(b)") a complaint alleging a derivative action must be verified and must allege: (1) that the plaintiff was a shareholder or member at the time of the transaction complained of, or that the plaintiff's share or membership later devolved on it by operation of law; (2) that the action is not a collusive one to confer jurisdiction that the court would otherwise lack; and (3) the efforts by plaintiff to obtain the desired action from the directors and the reasons for not obtaining the action or not making the effort. Fed. R. Civ. P. 23.1(b). Importantly, the requirements of Rule 23.1(b) establish only the elements required to be pled, and do not relate to plaintiff's standing to bring the claim.[5] *González Turel v. Rogatol Distributors, Inc.*, 951 F.2d 1, 2 (1st Cir. 1991).

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[5] Accordingly, a motion to dismiss based on failure to adequately conform to the requirements of Rule 23.1(b) is governed by the dictates of Rule 12(b)(6) in which all well-pleaded allegations are taken as true and all reasonable inferences will be drawn in plaintiff's favor. *Beam v. Stewart*, 883 A.2d 961, 976 (Del. Chl. 2003)("On a motion to dismiss pursuant to Rule 23.1, the Court considers the same documents, similarly accepts well-pled allegations as true, and makes reasonable inferences in favor of the plaintiff – all as it does in considering a motion to dismiss under Rule 12(b)(6)").

At the outset, the court notes that plaintiff PRSSA alleges only that it is a shareholder of Funds II, III and IV. ECF No. 1 at ¶ 98[6]. Inasmuch as PRSSA has not alleged that it was, or is, a shareholder in the tax-free fund, PRSSA cannot bring any claims on behalf of the tax-free fund. *See* Rule 23.1(b)(1). Accordingly, defendants' motion to dismiss the derivative claims of PRSSA brought on behalf of tax-free fund is GRANTED. Plaintiff PRSSA's derivative claims on behalf of tax-free fund are DISMISSED. Plaintiff AP was a shareholder of each of the Funds at the time of the relevant transactions, and therefore, may bring derivative claims on behalf of the Funds. ECF No. 1 at ¶ 99.

Returning to Rule 23.1(b), the third requirement, referred to as the "demand requirement," represents a deliberate departure from the relaxed policy of "notice" pleading promoted elsewhere in the Federal Rules and places the burden on the shareholder to demonstrate why the directors are incapable of filing the case themselves. *Grossman v. Johnson*, 89 F.R.D. 656, 659 (D.C. Mass 1981). Thus, the statute's explicit requirement that the efforts made to request the desired action or the reasons for not making such effort be pled "with particularity." Fed. R. Civ. P. 23.1(b).

Whether or not a plaintiff has adequately pled the demand requirement is a question of state law.

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[6] "Plaintiff UDEM PRSSA was a shareholder of Funds II, III, and IV at the time of the relevant transactions alleged herein and has continued to hold shares of Funds II, III and IV since that time." ECF No. 1 at ¶ 98.

Kamen v. Kemper Fin. Servs. 500 U.S. 90 (1991). However, Puerto Rico law does not provide guidance as to the specifics of pleading the demand requirements. *González Turel*, 951 F.2d at 3. Inasmuch as Puerto Rico law is modeled after Delaware's corporate law, this court considers the question of whether plaintiff has adequately pled the demand requirement under Delaware corporate law. *Id.*; *see also Wiley v. Stipes*, 595 F. Supp. 2d 179, 185 (D.P.R. 2009).

Given that plaintiffs' complaint concedes that no demand was made of the board, the sole question before the court is whether plaintiffs adequately pled that making such demand would be futile. Delaware law establishes two separate tests for demonstrating futility: the *Aronson* test and the *Rales* test. The *Aronson* test excuses demand if a "reasonable doubt" arises from the particularized facts alleged that (1) the directors are disinterested and independent; or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment. *García v. Carrión*, 2010 U.S. Dist. Lexis 85705, *9 (D.P.R. 2010) (citing *Aronson v. Lewis*, 473 A.2d 805, 812, 815 (Del. 1984)). The *Rales* test inquires as to whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time of the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand. *Id.* (citing *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993). Because demand futility is analyzed on a claim by claim basis, the test used is dependent on the particular facts of the claim being analyzed. *Beam v. Stewart*,

883 A.2d 961, 977, n. 48 (Del. Ch. 2003). Where the claim alleges that the directors themselves have acted or have consciously failed to act, the *Aronson* test applies. *García*, 2010 U.S. Dist. Lexis 85705 at 10; *see also Wood v. Baum*, 953 A.2d 136, 140 (Del. 2008). On the other hand, the *Rales* test is employed where the claim alleges that the director-defendants are not themselves responsible for the conscious act or failure in question. *Id.*

Using the above framework, the court turns to plaintiffs' remaining derivative claims. Plaintiffs' complaint states that "all claims asserted derivatively challenge the Funds' boards' decisions to purchase the ERS bonds on behalf of the Funds." ECF No. 1 at ¶ 102. Since plaintiffs have affirmatively represented that all eight of the derivative claims deal with the same action, the court applies the *Aronson* test to determine whether plaintiffs have adequately pled demand futility.[7] *García*, 2010 U.S. Dist. Lexis 85705 at 10. Under the *Aronson* test, plaintiffs can establish demand futility by alleging particular facts that create a reasonable doubt as to either the Director defendants' independence or interest or that the decision to purchase the ERS bonds was not a valid business judgment.

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[7] Plaintiffs agree that the *Aronson* test is the applicable test in that their opposition recites the test as the applicable one: "A plaintiff demonstrates demand futility and demand is excused where, "under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested or independent [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." ECF No. 41 at 32.

1. ***Aronson* First Prong**

A director will be considered unable to act objectively with respect to a pre-suit demand if he or she is interested in the outcome of the litigation or is otherwise not independent. Beam v. Stewart, 845 A.2d 1040, 1049 (Del. 2004). In determining the sufficiency of factual allegations made by a plaintiff as to a director's interest or lack of independence, the court is to use a subjective "actual person" standard to determine whether a particular director's interest is material and debilitating or that he lacks independence because he is controlled by another. *Orman v. Cullman*, 794 A.2d 5, 24 (Del. Ch. 2002).

While the inquiry as to interest and/or independence of a particular director may overlap, they are two separate and distinct issues. *Orman*, 794 A.2d at 25, n.50. A disabling "interest," as defined by Delaware common law exists in two situations. *Id.* The first is when a director personally receives a benefit, or suffers a detriment, as a result of the challenged transaction which is not generally shared with, or suffered by, the other shareholders of his corporation, and that benefit, or detriment, is of such subjective material significance to that particular director that it is reasonable to question whether that director objectively considered the advisability of the challenged transaction to the corporation and its shareholders. *Id.* The second instance is when a director stands on both sides of the challenged transaction. In such an instance, no allegations of materiality are required since he is deemed interested. *Id.* "Independence" involves an inquiry into whether the director's decision resulted from that director being

controlled by another - it does not involve a question of whether the challenged director derives a benefit from the transaction. *Id.* A director can be controlled by another if in fact he is dominated by that other party, whether through close personal or familial relationship or through force of will. *Id.* A director may also be considered beholden when the controlling entity has the unilateral power to decide whether the challenged director continues to receive a benefit, financial or otherwise, upon which the challenged director is so dependent that the threatened loss of such, might create a reason to question whether the controlled director is able to consider the corporate merits of the challenged transaction. *Id.* The key issue under either analysis is not simply whether a particular director receives a benefit or whether he is controlled by another, but whether the possibility of gaining or losing such is likely to be of such importance to that director that it is reasonable to question the director's vote. *Id.*

The court looks at each of the Director defendants separately.

a. Ferrer

Plaintiffs' complaint alleges that there is reasonable doubt as to Ferrer's independence and impartiality in that he is a highly placed officer at UBS PR and UBS Trust, therefore, he financially benefitted from the ERS bonds transaction. ECF No. 1 at ¶¶ 30[8], 114[9]. Additionally, plaintiffs argue that Ferrer

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[8] As to Ferrer, the complaint alleges, "Defendant Miguel A. Ferrer ("Ferrer") is Chairman of the Board of Directors and *(cont'd)*

had a strong incentive to retain his position with the board and, therefore, was beholden to the UBS defendants.[10] ECF No. 41 at 34-37. As the court understands it, plaintiffs question defendants' interest and independence.

President of each of the Funds. Until September 2009, Ferrer served as the Chief Executive Officer ("CEO") of UBS Financial and CEO of UBS Trust. Ferrer is now reportedly Chairman of an entity known as UBS International & Puerto Rico." ECF No. 1 at ¶ 30.

[9] The complaint states, "A reasonable doubt exists that the inside directors, Defendants Ferrer, Ubiñas, Roussin, and Highley, are independent, and would have been able to impartially consider a demand at the time this complaint was filed. As highly placed officers of UBS Financial [UBS PR], UBS Trust, or, in Ferrer's case, of both, these defendants were direct beneficiaries of the fraud worked on the Funds. Those defendants who were officers of UBS Trust benefitted from the Funds payment of inflated management fees. Similarly, those defendants who were officers of UBS Financial benefitted from the manipulative conduct engaged in by the UBS Defendants in connection with the distribution of the ERS Bonds. The benefits received by these defendants as a consequence of their participation in the fraud and their relationships with the UBS Defendants are both pecuniary and reputational in nature." ECF No. 1 at ¶ 114.

[10] 10 Plaintiffs' argument, as set in their opposition to the motion to dismiss, does not refer to Ferrer individually, but the allegations are made in relation to all the Director defendants: "Here, there can be no doubt that a majority of the Director Defendants lack independence from UBS Defendants. The fact that most of the outside directors serve, or have served, as directors of numerous other UBS affiliates demonstrates that they have reasons other than the Funds' best interests to accede to the UBS Defendants wishes. . . These defendants therefore have a strong incentive to preserve those positions by doing UBS's bidding, e.g., engaging in the transactions at issue." ECF No. 41 at 33-35.

With regards to independence, the court finds that plaintiffs have not raised a reasonable doubt as to Ferrer's independence. While plaintiffs allege that Ferrer is beholden to the UBS defendants because of benefits received, they provide no additional facts that allow this court to gauge the materiality of such benefits to Ferrer. Conclusory allegations that a director's independence is compromised where his continued employment and/or compensation can be affected are insufficient without showing how such compensation or employment is material to the director. *Orman v. Cullman*, 794 A.2d 5, 25 n. 50 (Del. Ch. 2002); *see also MCG Capital Corp. v. Maginn*, 2010 Del. Ch. Lexis 87, *74 (Del. Ch. 2010)("For Director compensation to create independence problems, however, it must be shown that the compensation is material to the director.").

However, taking all reasonable inferences from the complaint, plaintiffs' allegations do allow this court to infer that Ferrer was on all sides of the transaction such that interest may be presumed. *Orman*, 794 A.2d at 25, n.50. Plaintiffs allege that Ferrer was Chief Executive Officer of UBS PR and UBS Trust until September 2009. ECF No. 1 at ¶ 30. UBS PR acted as an advisor to ERS and as the underwriter for the ERS bonds transaction and UBS Trust, who is alleged to have been charged with ensuring that the Funds purchased suitable and appropriate investments, purchased the ERS bonds for the Funds it managed. ECF No. 1 at ¶¶ 70, 71, 72. Thus, the court finds that plaintiffs have adequately pled that Ferrer was interested or had an interest in the transaction and therefore may not have been able to objectively evaluate any demand by plaintiffs.

b. Ubiñas

Plaintiffs advance identical arguments and allegations regarding Ubiñas - that he was beholden to UBS and that he had an interest in the ERS bonds transaction. ECF No. 1 at ¶¶ 31[11], 114; ECF No. 41 at 34-37. Similarly, as the court has already found with regard to Ferrer, plaintiffs' allegations do not raise a reasonable doubt as to Ubiñas' independence.

With regards to interest, the court cannot, as it did with Ferrer, presume interest because plaintiffs' allegations do not establish that Ubiñas was on all sides of the ERS bonds transaction. Ubiñas is alleged to serve as President of UBS PR, but has no role with UBS Trust. ECF No. 1 at ¶ 31. Nor can the court find that Ubiñas had an interest in the ERS bonds transaction in that no particularized allegations have been made to show the "subjective material significance" of the financial or reputational benefit gained by Ubiñas from said transaction. *Orman*, 794 A.2d at 25 n. 50 ("The first is when a director personally receives a benefit, or suffers a detriment, as a result of the challenged transaction which is not generally shared with, or suffered by, the other shareholders of his corporation, and that benefit, or detriment, is of such subjective material significance to that particular director that it is reasonable to question whether that director objectively considered the advisability of

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[11] "Defendant Carlos V. Ubiñas ("Ubiñas") is Vice Chairman of the Board of Directors and Executive Vice President of each of the Funds. Ubiñas has served as President of UBS Financial since 2005 and now reportedly serves as CEO of an entity known as UBS International & Puerto Rico." ECF No. 1 at 31.

the challenged transaction to the corporation and its shareholders."). Thus, the court finds that plaintiffs have not sufficiently pled that Ubiñas was interested or lacked independence.

c. Roussin

Again, plaintiffs make similar arguments for Roussin as those made for Ubiñas and Ferrer. ECF No. 1 at ¶¶ 32[12], 114; ECF No. 41 at 34-37. As has been stated previously, plaintiffs' naked allegations regarding benefits received without showing how such benefits are material to Roussin do not establish a reasonable doubt as to Roussin's independence. *Orman*, 794 A.2d at 25 n. 50. As for interests, plaintiffs' allegations do not establish that Roussin was on all sides of the ERS bonds transaction - the complaint states only that Roussin was a Managing Director of UBS PR. *Id.* at ¶ 32. Thus, the court cannot presume interest.

Nor can the court find that Roussin had an interest in the ERS bonds transaction in that no particularized allegations have been made to show the "subjective material significance" of the financial or reputational benefit gained from the transaction to Roussin. *Id.* Thus, the court finds that plaintiffs have not sufficiently pled that Roussin was interested or lacked independence.

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[12] "Defendant Stephen C. Roussin ("Roussin") is a Director of each of the Funds and Managing Director of UBS Financial." ECF No. 1 at 32.

d. Highley

Plaintiffs make the same arguments for Highley that they made for the preceding three directors. ECF No. 1 at ¶ ¶ 33[13], 114; ECF No. 41 at 34-37. Having examined plaintiffs' allegations, as in Roussin's case, plaintiffs' allegations do not establish a reasonable doubt as to Highely's independence. However, as to interest, Highley, like Ferrer, is alleged to hold positions at both UBS PR and UBS Trust. Specifically, he is alleged to be the Managing Director and Executive Vice President of UBS Trust and Senior Vice President of UBS PR. ECF No. 1 at ¶ 33. Thus, plaintiffs' allegations allow this court to infer that Highley was on all sides of the transaction such that interest may be presumed. *Orman*, 794 A.2d at 25, n.50. Thus, the court finds that plaintiffs have adequately pled that Highley was interested in the transaction and therefore may not have been able to objectively evaluate any demand by plaintiff.

e. Belaval

Plaintiffs allege and argue that Belaval is beholden to the UBS defendants, and Ferrer, Ubiñas, Roussin and Highley ("inside directors"), because he is a director of other funds affiliated with UBS, including UBS's IRA Select Growth and Income Fund,

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[13] "Defendant Leslie Highley, Jr. ("Highley") is a Director of each of the Funds, managing Director and Executive Vice President of UBS Trust, and Senior Vice President of UBS Financial. Highley, acting on behalf of UBS Trust (through its UBS Asset Mangers division), has served as Portfolio Manager for Fund II and Fund III since 2004, for Fund IV since 2005, and for Tax-Free Fund II since 2002." ECF No. 1 at ¶ 33.

and receives remuneration for such positions.[14] ECF No. 1 at ¶¶ 34, 115; *see also supra* n.8. In support of their allegation that such remuneration makes Belaval beholden, plaintiffs further allege that for the fiscal year ending July 31, 2009, Belaval's aggregate compensation for service on the boards of Funds advised or co-advised by UBS Trust was reported to be $137,531 and that such income is approximately four times the median household income in Puerto Rico. *Id.*

Plaintiffs' allegations, without more particularized facts, do not establish reasonable doubt. *Aronson*, 473 A.2d at 815-816 ("[I]n the demand-futile context a plaintiff charging domination and control of one or more directors must allege particularized facts manifesting a direction of corporate conduct in such a way as to comport with the wishes or interests of the corporation (or persons) doing the controlling. The shorthand shibboleth of 'dominated and controlled directors' is insufficient."); *see also In re Affiliated Computer Servs. S'holders Litig.*, 2009 Del. Ch. Lexis 35, *31 (Del. Ch. 2009)("Thus, the mere allegation that a director is dominated and controlled does not raise a reasonable doubt as to his or her independence."). Moreover, plaintiffs' allegations of the actual

[14] The complaint states: "Moreover, each of the outside directors of the Funds, defendants Belaval, Cabrer-Roig, Nido, León, Pérez, Dolagaray-Balado, and Pellot-González, are beholden to the inside directors or so under their influence that their discretion would be sterilized. Each of the "outside" directors acts as a director for numerous other UBS-affiliated investment funds. Thus, each "outside" director depends on the UBS Defendants for substantial remuneration in addition to the director fees received for services rendered to the Funds." ECF No. 1 at ¶ 115.

compensation received does not help the argument because they provide no additional facts that allow this court to gauge the materiality of such benefits to Belaval. Conclusory allegations that a director's independence is compromised where his continued employment and/or compensation can be affected are insufficient without showing how such compensation or employment is material to the director. *Orman*, 794 A.2d at 25 n. 50; *see also MCG Capital Corp. v. Maginn*, 2010 Del. Ch. Lexis 87, *74 (Del. Ch. 2010)("For Director compensation to create independence problems, however, it must be shown that the compensation is material to the director.").

Finally, plaintiffs argue that Belaval is beholden to the UBS defendants because he knows that, in order to raise capital in the Puerto Rican market he will need the UBS defendants' cooperation and therefore, as a person with other business enterprises, would be more apt to make decisions that favor the UBS defendants. ECF No. 41 at 36-37. Again, plaintiffs fail to allege particularized facts that would demonstrate to the court that Belaval consistently put the concerns of the UBS defendants above those of the Fund when making decisions regarding the Fund. *Aronson*, 473 A.2d at 815-816 (" The shorthand shibboleth of 'dominated and controlled directors' is insufficient."). Thus, the court finds that plaintiffs have not established a reasonable doubt as to Belaval's independence. Inasmuch as plaintiffs have made no argument as to interest, the court does not go further in its analysis.

f. Nido and León

Plaintiffs make the exact same arguments with regards to Nido and León as they did with Belaval. Inasmuch as the allegations regarding the three directors are similar, the court finds that the court's analysis as to Belaval applies to both Nido and León.[15] Accordingly, the court finds that plaintiffs

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[15] The complaint, in its relevant parts, states as follows:

34. Defendant Mario S. Belaval ("Belaval") is a Director of each of the Funds. Belaval is Vice Chairman of Triple S management ("Triple S"), the largest managed care company in Puerto Rico. UBS Investment Bank received large fees from acting as co-lead underwriter of Triple S's IPO. In 2006, UBS Financial served as the placement agent for $35 million in notes issued by Triple-S, all of which were purchased by Fund IV and another UBS-affiliated fund. Belaval has also served as a director of numerous other UBS-affliated funds including UBS's IRA Select Growth and Income Fund. *Id.* For the fiscal year ending July 31, 2009, Belaval's aggregate compensation for service on the boards of Funds advised or co-advised by UBS Trust was reported to be $137,531.

37. Defendant Carlos Nido ("Nido") is Director of each of the Funds. Nido is Vice President of Sales for El Nuevo Día, a leading newspaper in Puerto Rico. Fund III and other UBS-affiliated funds have at times invested in notes issued by El Nuevo Dia. Nido sits on the board of several other UBS funds, including the AAA Portfolio Bond Fund II and the Puerto Rico Short Term Investment Fund. For the fiscal year ending July 31, 2009, Nido's aggregate compensation for services on the boards of funds advised or co-advised by USB Trust was reported to be $92,031 (excluding expenses).

39. Defendant Vicente J. León ("León") is a Director of each of the Funds. Leon is, along with Belaval, Vice Chairman of Triple-S. In 2006, UBS Financial served as the placement agent for $35 million in notes issued by Triple-s, all *(cont'd)*

have not established a reasonable doubt as to Nido's or León's independence.

g. Cabrer-Roig, Dolagaray, Pellot, Pérez

As to the remaining four directors, Cabrer-Roig, Dolagaray, Pellot, and Pérez, plaintiffs argue, as they did with Belaval, that they are beholden to the UBS defendants, and the inside directors, because they are directors of other funds affiliated with UBS and receive remuneration for such positions. ECF No. 1 at ¶¶ 35, 36, 38, 40, 115; *see also supra* n. 13. Moreover, the allegations as to each of these four directors, although different in detail, generally allege that the directors sit on the boards of other UBS funds and specifies the income received by the director for the fiscal year ending July 31, 2009. ECF No. 1 at ¶¶ 35, 36, 38, 40. Thus, the court finds that the analysis as to Belaval's independence also applies to Cabrer-Roig, Balado, Pellot and Clotilde. Accordingly, the court finds that plaintiffs have not

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of which were purchased by Fund IV and the Puerto Rico AAA Portfolio Target Maturity Fund. León also sits on the board of several UBS funds, including Tax-Free Puerto Rico Fund, Target Maturity Fund, Puerto Rico AAA Portfolio Target Maturity Fund, Portfolio Bond Fund, Portfolio Bond Fund-H, Puerto Rico GNMA & U.S. Government Target Maturity Fund, Puerto Rico Mortgage-Backed and U.S. Securities Fund, UBS IRA Selected Growth and Income Fund, Multi-Select Securities Puerto Rico Fund, and the Puerto Rico Short Term Investment Fund. For the fiscal year ending July 31, 2009, Leon's aggregate compensation for service on the boards of Funds advised or co-advised by UBS Trust was reported to be $68,531.

established a reasonable doubt as to Cabrer-Roig, Dolagaray, Pellot, and Pérez' independence.

Having looked at each director and the facts alleged as to each, the court finds that plaintiffs have not established a reasonable doubt as to a majority of the directors independence or interest. Therefore, plaintiffs have failed on the first prong of *Aronson*.

2. ***Aronson* Second Prong**

As discussed earlier, the two prongs of *Aronson* are disjunctive, thus a plaintiff need only establish one of the prongs in order for demand to be excused. Having found that plaintiffs' have not satisfied prong one, the court moves on to prong two. *Aronson's* second prong requires plaintiffs to establish a reasonable doubt that the decision to purchase the ERS bonds was not a valid business judgment.

When applying this second prong, the court does not assume the challenged transaction constitutes a wrong to the corporation; instead the court must examine the substantive nature of the challenged transactions and the board's approval thereof. *Khanna v. McMinn*, 2006 Del. Ch. Lexis 86, 91 (Del. Ch. 2006) (citing *Aronson*, 473 A.2d at 814). Absent particularized allegations to the contrary, the directors are presumed to have acted on an informed basis and in the honest belief that their decisions were in furtherance of the best interests of the corporation and its shareholders. *Id.* Thus, demand futility will be established under this prong if the plaintiff pleads particularized facts that create a reasonable doubt (1) that the action was taken honestly and in good faith or (2) that the board was adequately informed in

making the decision - meaning whether the directors took steps to inform themselves of material information and whether they adequately inquired into the reasons for or terms of the transaction. *MCG Capital Corp. v. Maginn*, 2010 Del. Ch. Lexis 87, *60 (Del. Ch. 2010). The court's inquiry in this context is predicated upon concepts of gross negligence. *Khanna*, 2006 Del. Ch. Lexis 86 at 92-93. Importantly, the second prong of *Aronson* is directed to "extreme cases in which despite the appearance of independence and disinterest a decision is so extreme or curious as to itself raise a legitimate ground to justify further inquiry and judicial review. . . . As a consequence, a plaintiff will bear a difficult, but not insurmountable, burden in pleading particularized facts demonstrating demand futility under this prong of *Aronson*." *Khanna*, 2006 Del. Ch. Lexis 86 at 92-93.

Plaintiffs identify several grounds upon which they contend that the ERS bonds transaction was not a valid exercise of the Funds' Board of Directors' business judgment. They argue that (1) the purchase of the ERS bonds was an interested -director transaction; (2) the ERS bond purchases were not undertaken in good faith in violation of the Director defendants' duty of loyalty; (3) the Director defendants were grossly negligent in their failure to inform themselves of the details and circumstances surrounding the ERS bonds transaction; and (4) the very nature of the ERS bonds transaction creates reasonable doubt as to whether the purchase of the ERS bonds transaction was the product of a valid business judgment. ECF No. 1 at 102-112; *see also* ECF No. 41 at 37-40. The court addresses each argument separately.

a. Interested-Director Transaction

Plaintiffs first argue that the ERS bonds transaction constitutes an "interested-director" transaction in that the Director defendants stood to receive, and did receive, significant personal benefits – meaning additional compensation or opportunities to serve as directors of other UBS funds – not shared equally by the Funds' shareholders. ECF No. 1 at ¶ ¶ 104¬107. As far as the court can understand, plaintiffs are arguing that the alleged benefits received from the ERS bonds transaction prevented the Director defendants from objectively considering the transaction and therefore, the decision to purchase the ERS bonds was not a valid business judgment.

However, besides their conclusory pleadings, plaintiffs' complaint contains no particularized allegations that demonstrate that the Director defendants were interested in the transaction. There are no allegations regarding the materiality of the alleged benefits to the individual directors, nor are there any allegations as to a pattern of conduct that would show that the Director defendants were motivated by such benefits. Accordingly, the court finds that plaintiffs have failed to adequately plead that the ERS bonds transaction was an "interested-director" transaction such that the business judgment rule does not apply to the Funds' Board of Directors' decision to purchase the ERS bonds.[16]

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[16] Plaintiffs' complaint alleges that the "entire fairness" doctrine should apply to the ERS bonds transaction. When looking at conduct of a board, courts may use either the "business judgment rule" or the "entire fairness doctrine." The determina-

(cont'd)

b. Duty of Loyalty

Plaintiffs next argue that the Director defendants acted in bad faith, violating or disregarding their duties of loyalty, in that they participated in a scheme to inflate the price of the ERS bonds, causing the Funds to overpay for the ERS Bonds and to cause misstatements of their value. ECF No. 1 at 110-111. Again, as best as the court can understand, plaintiffs are arguing that the UBS defendants intended to inflate and misstate the price of the ERS bonds by participating on both sides of the ERS bonds transaction, that the Director defendants knew of such intention and, with such knowledge, purchased the ERS bonds for the Funds because of their own self interest. As such, plaintiffs argue that the Director defendants knowingly participated in a scheme that was against the interests of the Funds.

Bad faith, and thus a breach of the duty of loyalty, arises only when a fiduciary knowingly and completely fails to undertake their responsibilities. *Robotti & Co., LLC v. Liddell*, 2010 Del. Ch. Lexis 4, 44 (Del. Ch. 2010). While plaintiffs allege that the Director defendants knowingly participated in the UBS scheme to inflate and misstate the price of the

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tion of which is applicable turns on whether the directors had a financial interest sufficient to render them incapable of exercising objective business judgment. *President and Fellows of Harvard College v. Glancy*, 2003 Del. Ch. Lexis 25, 66 (Del. Ch. 2003). While the court finds that plaintiffs have failed to adequately plead that the directors had a sufficient financial interest, the court makes no determination as to whether the "entire fairness doctrine" ultimately applies to the ERS bonds transaction.

ERS bonds, such allegation is conclusory at best. Plaintiffs have failed to allege any particularized facts that would allow this court to infer that the Director defendants knew that the price was inflated and that, which such knowledge, purchased the ERS bonds. In fact, plaintiffs have failed to allege any facts regarding the Board of Directors' decision to purchase the ERS bonds, nor are there any facts establishing the self-interest promoted by the ERS bonds transaction.[17] The court has no way of knowing and evaluating the process through which the Director defendants made their decision and, as such, finds that plaintiffs have not raised a reasonable doubt as to whether the Director defendants' decision to purchase the ERS bonds was a valid business judgment.

c. Duty of Care

Plaintiffs next allege that the Director defendants failed to adequately inform themselves about the details of and circumstances surrounding the ERS bonds transaction and thereby violated their duty of care. ECF No. 1 at ¶ 112. Such intentional disregard of their duty to inform themselves creates a reasonable doubt as to whether the Director defendants' decision to purchase the ERS bonds was a valid business judgment.

Again, plaintiffs' complaint completely fails to provide the court with particularized facts supporting

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[17] Consistent with the court's prior determinations, plaintiffs' complaint fails to raise a reasonable doubt as to the interest of a majority of the individual Director defendants.

this allegation. As observed earlier, there are absolutely no allegations in the complaint that go to the Director defendants' process or procedure in considering the ERS bonds purchase. *In re Citigroup Inc. S'holder Derivative Litig*, 964 A.2d 106, 122 (Del. 2009)(citing *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967-968 (Del. Ch. 1996). Plaintiffs' only allegation going to this point states, in full, "[t]he Director defendants did not adequately inform themselves about the details of and the circumstances surrounding the ERS Bond Transactions, including: (a) the true value of the ERS bonds; (b) the UBS Defendants' motive in pushing the bulk of the distribution onto its captive affiliates; (c) the advisability of assuming so large a position in the ERS Bonds; and (d) the suitability of the investment for the Funds." ECF No. 1 at 112. There are no allegations stating that such information was readily available, nor are there any allegations illustrating the failings of the Director defendants' process of gathering information. *See MCG Capital Corp.*, 2010 Del. Ch. Lexis 87 at 61 (finding that second prong of *Aronson* had been established where complaint contained specific allegations dealing with the approval process); *Khanna*, 2006 Del. Ch. Lexis 86 at 104 (finding that second prong of *Aronson* had been established where complaint contained specific allegations that the "Covad Board had members with significant, material interests in the transaction, ignored a management that objected to the acquisition 'almost uniformly,' failed to evaluate management due diligence findings that expressed serious concerns about the transaction and knew of significant conflicts held by the investment banker rendering the fairness opinion on which the Board relied."). As such, the court finds

that plaintiffs have failed to allege sufficient facts to create a reasonable doubt that the Director defendants' decision regarding the ERS bonds was a valid business judgment.

d. ERS Bonds Transaction

Finally, plaintiffs argue that the size, timing and effect of ERS bonds transaction itself creates a reasonable doubt as to whether the decision of the Directors defendants was a valid business judgment. ECF No. 41 at 38-39.

First, the cases cited in support of plaintiffs' arguments are inapposite to the facts in the case at bar. In *Ryan v. Gifford*, 918 A.2d 341 (Del. Ch. 2007), in finding that the transaction itself created reasonable doubt, the court specifically noted that the board made a decision in contravention of the explicit terms of the stock option plans. Plaintiffs point to no explicitly illegal or incorrect decision of the Director defendants. While plaintiffs attempt to argue, by analogy, that the ERS bonds transaction was presumptively in bad faith pursuant to the Investment Company Act, they also admit that such Act does not apply to Puerto Rico. ECF No. 41 at 39. The Director defendants' decision cannot be measured by rules that are not applicable to them.

Moreover, while plaintiffs allege that the timing of the purchases and the impact of the purchases allow this court to infer bad faith, this is exactly the type of hindsight analysis courts should avoid. *In re Citigroup Inc. S'holder Derivative Litig*, 964 A.2d 106, 122 (Del. 2009) (citing *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967-968 (Del. Ch.

1996))("[C]ompliance with a director's duty of care can never appropriately be judicially determined by reference to the content of the board decision that leads to a corporate loss. . . That is, whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through "stupid" to "egregious" or "irrational", provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests."). Inasmuch as plaintiffs have alleged no facts regarding the process of the Board of Directors' decision, this court cannot find that the ERS bonds transaction itself creates a reasonable doubt as to whether the decision was a valid business judgment.

Having disposed of all of plaintiffs' arguments, the court finds that plaintiffs have not met the second prong of *Aronson*. Accordingly, defendants' motion to dismiss the derivative claims is GRANTED. Plaintiffs' derivative claims are DISMISSED.

B. Failure to State a Claim

UBS defendants and Director defendants also argue that all of plaintiffs' class ation claims should be dismissed for failure to state a claim for which relief can be granted.[18] Plaintiffs assert two class ac-

[18] Since the court has already dismissed plaintiffs' derivative claims pursuant to Rule 23.1(b), the court goes no further in its analysis regarding the derivative claims - as such, this court makes no determination as to the viability of plaintiffs' derivative claims.

tions claims: Count IV - Class Claim for Breach of ERISA Fiduciary Duties against the UBS Defendants and Count VI - Class Claims for Violations of Duty to Act in Good Faith against the UBS Defendants. ECF No. 1 at 164-173, 182-184. The court looks at each claim separately.

1. **Breach of ERISA Fiduciary Duties**

While plaintiffs do not specify as much, the court understands plaintiffs' claims are brought pursuant to 29 U.S.C. § 1132(a)(2), which states, "[a] civil action may be brought– by the Secretary, or by a participant, beneficiary or fiduciary for appropriate relief under section 409." Section 409 of ERISA, 29 U.S.C.S. § 1109 states, "[a]ny person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this title shall be personally liable to make good to such plan any losses to the plan resulting from each such breach. . . ."

In the present case, plaintiffs allege that the UBS defendants are fiduciaries of PRSSA and, therefore, are liable for the alleged violations of fiduciary duties. UBS defendants and Director defendants argue that the UBS defendants are not fiduciaries of PRSSA and, therefore, the claim must be dismissed.

The ERISA statue provides for two different types of fiduciaries: a "functional fiduciary" and a "named fiduciary." A "named fiduciary" is one who is named in the plan instrument, or who, pursuant to a procedure specified in the plan, is identified as a fiduciary by a person who in an employer or employee organization with respect to the plan or by such an

employer and such an employee organization acting jointly. 29 U.S.C. §1102(a)(2). A "functional fiduciary" is "a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plans." 29 U.S.C. §1002 (21) ("Rule 1002(21)").

The above is further qualified by the Department of Labor's specifications in which a person rendering investment advice is further defined as one who renders advice to the plan as to value of securities or other property, or makes recommendation as to the advisability of investing in, purchasing or selling securities or other property; and such person has discretionary authority or control, with respect to purchasing or selling securities or other property for the plan or renders such advice on a regular basis to the plan. 29 C.F.R. 2510.3-21.[19] As is demonstrated

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[19] 29 C.F.R. 2510.3-21 states, in full, "A person shall be deemed to be rendering "investment advice" to an employee benefit plan, within he meaning of section 3(21)(A)(ii) of the Employee Retirement Income Security Act of 1972 (the Act) and this paragraph, only if: (i) Such person renders advice to the plan as to the value of securities or other property, or makes recommendations as to the advisability of investment in, purchasing or selling securities or other property; and (ii) Such person either directly or indirectly (e.g., through or together with *(cont'd)*

by the specific definition, the focus of the functional fiduciary inquiry is on the actual duties and tasks being performed and their relation to the Plan. *Livick v. The Gillette Co.*, 524 F.3d 24, 29 (1st Cir. 2008)(the question of fiduciary status comes down to whether "the person was acting as a fiduciary, that is, was performing a fiduciary function, when taking the action subject to complaint."); *Beddall v. State St. Bank & Trust Co.*, 137 F.3d 12, 18 (1st Cir.).

It is undisputed neither of the UBS defendants are a named fiduciary. Thus, the court must determine whether plaintiffs have adequately alleged UBS defendants as functional fiduciaries. Ultimately, as the court reads the complaint, plaintiffs allege that UBS defendants are fiduciaries to PRSSA because PRSSA has purchased shares in the Funds which are managed by UBS Trust, and UBS PR as its alter

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an affiliate) – (A) Has discretionary authority or control, whether or not pursuant to agreement, arrangement or understanding, with respect to purchasing or selling securities or other property for the plan; or (B) Renders any advice described in paragraph (c)(1)(I) of this section on a regular basis to the plan pursuant to a mutual agreement, arrangement or understanding, written or otherwise, between such person and the plan or a fiduciary with respect to the plan, that such service will serve as a primary basis for investment decisions with respect to plan assets, and that such person will render individualized investment advice to the plan based on the particular needs of the plan regarding such matters as, among other things, investment policies or strategy, overall portfolio composition, or diversification of plan investments."

ego.[20] Thus, the discretionary authority and control UBS defendants allegedly exert relates to the ERISA

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[20] The court's summary of plaintiffs' argument is based, mainly, on the following allegations within the complaint:

27. UBS Trust acts as the issuing, paying and transfer agent of the Funds. . . . UBS Trust manages the assets of the Funds throuhg its UBS Asset Managers division. Throughout the Relevant Period, UBS Trust derived substantial income from managing the Funds and from acting as investment advisor to certain shareholders of the Funds.

29. UBS Trust and UBS Financial act as alter egos in their financial dealings in Puerto Rico. As alleged herein, they have substantial overlap in directorships and upper management, and otherwise disregard corporate distinctions in order to conduct their business.

46. By reason of its position as asst manager and fund advisor for the Funds (through its UBS Asset Mangers Division), UBS Trust and its alter ego UBS Financial had various contractual obligations to the Funds.

71. . . . UBS Trust, who was charged with ensuring that the Funds purchased suitable and appropriate investments, purchased over $750 million of these low grade high risk pension bonds for the Funds that it managed, the shares of which were held or purchased by Plaintiffs and other members of the Class.

130. Defendants are fiduciaries of any ERISA plans that invested in the Funds, including Plaintiff UDEM PRSSA, pursuant to ERISA §§ 409 and 502, 29 U.SC. §§ 1109 and 1132.

134. Consequently, in light of the foregoing duties, responsibilities, and actions, Defendants were *de facto* fiduciaries of ERISA plan Class members, including UDEM PRSSA, withing the meaning of ERISA § 3(21), 29 U.S.C. § 1002(21), during the Class Period in that the Defendants exercised discretionary authority or discretionary control respecting management of ERISA monies in Funds II,

(cont'd)

monies invested in the Funds via the purchase of shares. Plaintiffs make no claim that UBS defendants provide any investment advice or services to PRSSA directly, the only connection between the two parties are the Funds which UBS defendants allegedly managed and in which PRSSA has purchased shares.

The court finds that plaintiffs' allegations do not sufficiently allege that UBS defendants are fiduciaries of PRSSA. First, UBS Trust's management of the Funds does not function as rendering investment advice, either directly or indirectly, to PRSSA. As the Department of Labor has specified, in order to qualify as a fiduciary under this prong of Rule 1002(21) one must render advice to the plan itself - advice or management of the funds in which the plan invests is not encompassed by the definition. *See supra* n. 19 ("A person shall be deemed to be rendering "investment advice" to an employee benefit plan . . . only if: (I) Such person renders advice to the plan . . . and (ii) Such person either directly or indirectly . . . (A) Has discretionary authority or control, . . . for the plan; or (B) Renders any advice described in paragraph (c)(1)(I) of this section on a regular basis to the plan. . . ").

Similarly, the court finds that plaintiffs' argument that UBS Trust has authority or control over

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III, IV, exercised authority or control respecting management or disposition of the assets of Funds II, III, and IV and/or discretionary authority or discretionary responsibility in the administration of the ERISA monies in Funds II, III, and IV.

PRSSA's assets because they manage Funds in which PRSSA purchased shares is too attenuated of a string upon which to hang fiduciary liability. While the statutory language does state a person is a functional fiduciary if they exercise any authority or control over Plan assets, the court does not read such as intending only a minimal level of control to establish fiduciary status. *Finkel v. Romanowicz*, 577 F.3d 79 (2nd Cir. 2009)("Although we have recognized that Congress intended ERISA's definition of fiduciary to be broadly construed, we have also concluded that "management or disposition" of ERISA plan assets refers to the common transactions in dealing with a pool of assets: selecting investments, exchanging one instrument or asset for another, and so on.")(citations omitted). Thus, it is not clear that UBS defendants actually would have been able to assert any control over the ERISA monies invested in the Funds - UBS Trust could not control the amount invested or whether the shares would be retained or sold.

In light of the above, the court finds that plaintiffs have failed to allege that UBS defendants are functional fiduciaries. Our conclusion is further supported by holdings in other courts dealing with similar factual scenarios and finding that the entity was not a fiduciary. *In re Mut. Funds Inv. Litig.*, 403 F. Supp. 2d 434, 447 (D. Md. 2005)("The defendants are correct that providing investment services to the underlying mutual funds would not make an entity a fiduciary for any retirement plan that simply invests in those funds."); *Walsh v. Marsh & McLennan Cos.*, 2006 U.S. Dist. Lexis 12020, *9 (D. Md. 2006)("Investment Trusts and Putnam Investments are not named fiduciaries. They both provided investment

services to the mutual funds included within the Plan, but that is not a fiduciary function.").

Accordingly, defendants' motion to dismiss the class action claim for breach of ERISA fiduciary duties is GRANTED.

2. **Violations of Duty to Act in Good Faith**

Plaintiff AP brings the second class action claim alleging that the UBS Defendants "throughout the Class Period clearly and expressly demonstrated a lack and complete absence of any basic good faith principles or compliance with fair dealing standards in fulfilling their contractual obligations to Plaintiff UDEM AP and the Class, including the contractual obligations arising from Plaintiff UDEM AP and the Class' investments in the Funds." ECF No. 1 at ¶ 184.

However, the court is unable to find a single allegation regarding the existence of a contract or contractual obligations between plaintiff AP and UBS Defendants. While the complaint contains allegations regarding a contract[21] between UBS Trust

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[21] The court notes that the following allegations from the complaint explicitly refer to a contract:

> 6. Advisory agreements with each of the Funds (the "Advisory Agreements") provide that UBS Asset Managers is entitled to receive annual investment advisory fees in the amount of .75% of the Funds' average weekly gross assets. Separate contracts with each of the Funds ("Administration Agreements") provide that UBS Trust is enti-
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> *(cont'd)*

and the Funds and discusses UBS defendants' contractual obligations[22] to the Funds, there is nothing that establishes the source of any contractual obligations owed by the UBS defendants to AP.

Inasmuch as plaintiffs' claim is a contractual claim without any allegations of a contract existing

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tled to receive annual administrative fees in the amount of .15% of the Funds' average weekly gross assets.

46. By reason of its position as asset manager and fund advisor for the Funds (through its UBS Asset managers Division), UBS Trust and its alter ego UBS Financial had various contractual obligations to the Funds. In performing those contractual duties, the UBS defendants were required to act in good faith and in a loyal, honest and fair manner. This good faith obligation required the UBS defendants to faithfully comply with the representations and agreements reached with the Funds and not to defraud or abuse the trust given to them by the Funds

[22] The court notes that the following allegations from the complaint refer to "contractual obligations":

66. Because of the statutory and contractual duties described above, defendants were required to manage the Funds' investments solely in the interest of the Funds and its shareholders.

82. Throughout the Relevant Period, the Funds justifiably expected the defendants, who were fiduciaries of and/or had contractual obligations to the Funds, to disclose material information as required by law. . . .

128. By reason fo the sale of shares of the Funds to members of the Class and their position as asset manager and fund advisor for the Funds, the UBS defendants had various contractual obligations to the Funds. In performing those contractual duties, the UBS defendants were required to act in good faith and in a loyal, honest and fair manner.

between UBS defendants and AP, there is not basis for an implied covenant of good faith and fair dealing and the court must dismiss the claim. (*Platten v. HG Berm. Exempted Ltd.*, 437 F.3d 118, 129-130 (1st Cir. 2006)("Having concluded that no contract exists, there can be no derivative implied covenant of good faith and fair dealing applicable to these parties."). Defendants' motion to dismiss plaintiff AP's class action claim is GRANTED.

C. Supplemental Claim

Plaintiffs' sole remaining claim is Count XI, entitled "Supplemental Jurisdiction under 28 USC § 1367 and Attorneys Fees and Prejudgment Interest." As best as the court can tell, the claim seems to be one for attorneys' fees, costs as well as pre-judgment and postjudgment interest pursuant to Commonwealth law. Since all of plaintiffs' claims have been dismissed, the court declines to exercise supplemental jurisdiction to adjudicate this claim. Defendants' motion to dismiss is GRANTED.

IV. Conclusion

Based on the foregoing, defendants' Motion to Dismiss at Docket No. 35 is GRANTED. Plaintiffs' complaint is DISMISSED WITHOUT PREJUDICE. Clerk of Court is to enter judgment accordingly

SO ORDERED.

At San Juan, Puerto Rico, this 31st day of March, 2011.

S/AIDA M. DELGADO-COLON
United States District Judge

APPENDIX C

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF PUERTO RICO

UNION DE EMPLEADOS DE MUELLES DE PUERTO RICO PRSSA WELFARE PLAN AND UNION DE EMPLEADOS DE MUELLES DE PUERTO RICO AP WELFARE PLAN, INDIVIDUALLY AND ON BEHALF OF ALL OTHERS SIMILARLY SITUATED, AND DERIVATIVELY ON BEHALF OF PUERTO RICO FIXED INCOME FUND II, INC., PUERTO RICO FIXED INCOME FUND III, INC., PUERTO RICO FIXED INCOME FUND IV, INC., AND TAX-FREE PUERTO RICO FUND II, INC.

PLAINTIFFS

v.

UBS FINANCIAL SERVICES INCORPORATED OF PUERTO RICO; UBS TRUST COMPANY OF PUERTO RICO; MIGUEL A FERRER; CARLOS V. UBIÑAS; STEPHEN C. ROUSSIN; LESLIE HIGHLEY, JR.; MARIO S. BELAVAL; AGUSTIN CABRER-ROIG; GABRIEL DOLAGARAY-BALADO; CARLOS NIDO; LUIS M. PELLOT-GONZÁLEZ; VINCENTE J. LEON; CLOTILDE PÉREZ; AND DOES 1 THROUGH 100,

DEFENDANTS,

v.

PUERTO RICO FIXED INCOME FUND II, INC., PUERTO RICO FIXED INCOME FUND III, INC., PUERTO RICO FIXED INCOME FUND IV, INC. AND TAX-FREE PUERTO RICO FUND II, INC.,

NOMINAL DEFENDANTS.

VERIFIED SHAREHOLDER DERIVATIVE ACTION AND CLASS ACTION COMPLAINT FOR BREACHES OF FIDUCIARY DUTY, VIOLATIONS OF THE SECURITIES LAWS, VIOLATIONS OF ERISA, AND BREACHES OF THE DUTY OF GOOD FAITH

JURY TRIAL DEMANDED

Plaintiffs Union de Empleados de Muelles de Puerto Rico PRSSA Welfare Plan ("UDEM PRSSA") and Union de Empleados de Muelles de Puerto Rico AP Welfare Plan ("UDEM AP" and, together with UDEM PRSSA, the "Plaintiffs"), by and through their attorneys, bring this action derivatively on behalf of Nominal Defendants Puerto Rico Fixed Income Fund II, Inc. ("Fund II"), Puerto Rico Fixed Income Fund III, Inc. ("Fund III"), Puerto Rico Fixed Income Fund IV, Inc. ("Fund IV"), and Tax-Free Puerto Rico Fund II, Inc. ("Tax-Free Fund II") (Funds II, III, and IV

and Tax-Free Fund II collectively referred to hereafter as "the Funds"), and on behalf of a Class (as defined herein) of similarly situated shareholders of the Funds, against Defendants UBS Financial Services Incorporated of Puerto Rico ("UBS Financial"), UBS Trust Company of Puerto Rico ("UBS Trust and, together with UBS Financial, the "UBS Defendants"), Miguel A. Ferrer, Carlos v. Ubiñas, Stephen C. Roussin, Leslie Highley, Jr., Mario S. Belaval, Agustin Cabrer-Roig, Gabriel Dolagaray-Balado, Carlos Nido, Luis M. Peilot-González, Vicente I. Leon, and Clotilde Pérez (collectively, the "Director Defendants" and, together with the UBS Defendants, the "Defendants").

The allegations herein are based on personal knowledge as to Plaintiffs and Plaintiffs' own acts, and upon information and belief (including the extensive investigation of counsel and review of publicly available information) as to all other matters stated herein.

NATURE AND SUMMARY OF THE ACTION

1. Defendants violated federal laws and breached and/or aided and abetted in the breach of fiduciary and other duties owed to the Funds, Plaintiffs, and other members of the Class by engaging in a series of transactions fraught with conflicts of interest and designed to benefit Defendants to the detriment of the Funds, Plaintiffs and other members of the Class.

2. Defendants — all affiliated with the Swiss financial giant UBS AG — seized upon unique aspects of the Puerto Rico financial markets to craft a scheme that allowed them to wrongfully garner millions of dollars in fees for the UBS Defendants. Operating on all sides of mutual fund and bond transactions — as investment advisor, bond underwriter, and mutual fund manager — the UBS Defendants manipulated the Funds and the bond market to the detriment of the Funds and its unsuspecting investors, including Plaintiffs herein and other members of the Class.

3. The most egregious example of this conflicted and fraudulent dealing centers on Defendants' role in underwriting and trading pension bonds issued by the Employee Retirement System of the Government of Puerto Rico ("the ERS"). The ERS is a statute based, public retirement plan that the government of Puerto Rico maintains for its employees and for the employees of its governmental instrumentalities and Puerto Rican municipalities. The ERS provides pensions for approximately 278,000 government employees and retirees.

4. In 2007, UBS Financial became a financial advisor to the ERS. In the following year, UBS Financial served as underwriter when the ERS sold $2.9 billion in pension bonds (the "ERS Bonds" described more fully below). These bond offerings resulted in approximately $27 million in fees for UBS Financial and its co-underwriters.

5. The ERS Bonds were of low quality and rated just one step above junk by Moody's Investors Service, Standard & Poor's and Fitch Ratings.

6. In total, UBS Trust purchased approximately $1.5 billion of the ERS Bonds (more than half of the total bond offering) for twenty mutual funds it manages through its division named UBS Asset Managers of Puerto Rico ("UBS Asset Managers"), including the Funds. Advisory agreements with each of the Funds (the "Advisory Agreements") provide that UBS Asset Managers is entitled to receive annual investment advisory fees in the amount of .75% of the Funds' average weekly gross assets. Separate contracts with each of the Funds ("Administration Agreements") provide that UBS Trust is entitled to receive annual administrative fees in the amount of .15% of the Funds' average weekly gross assets. The end result is that not only did the UBS Defendants benefit from the initial sale of the ERS Bonds to the Funds, they also derived additional investment and management fees on an ongoing basis from these inappropriate investments.

7. Over $750 million in purchases of the near-junk ERS Bonds were concentrated in the Funds. The ERS Bond purchases by UBS Trust amounted to approximately 30% of the total holdings of Funds II, III, and IV and approximately 15% of the total holdings of Tax-Free Fund II such that the Funds were overly concentrated in low quality ERS Bonds.

8. The Funds are a series of UBS closed-end fixed income funds. A closed-end fixed income fund issues a fixed number of shares to raise capital, similar to selling stock through initial public offerings. However, after the initial trading, shares of the Funds are traded through a trading desk at UBS Financial, which is the private, principal secondary market

dealer for the Funds. Shares of the Funds do not trade on any public securities exchanges.

9. Plaintiffs' claims arise from Defendants' material misstatements and fraudulent omissions concerning the nature, purpose, and suitability of the purchases of the ERS Bonds for the Funds and the failure of Defendants to act solely in the best interests of the Funds and shareholders of the Funds, and to exercise the required skill, care, prudence, and diligence in administering the Funds and the Funds' assets between January 24, 2008 and the present (the "Relevant Period" or the "Class Period").

10. These conflicted transactions would have been expressly prohibited by the Investment Company Act of 1940 for any company registered thereunder. Because they operate exclusively in Puerto Rico, the Funds are exempt from those express requirements. In fact, the UBS Defendants have attempted to exploit that loophole in order to dominate the Puerto Rico market and extract exorbitant and unwarranted fees by forcing its captive investor-Funds to engage in wholly unsuitable transactions. The transactions, however, are no less harmful to the Funds' investors merely as a result of the limited geographical territory of their sale and are prohibited by other provisions of federal and Commonwealth law, as set forth herein.

11. Defendants, who stood on all sides of the transactions, materially misrepresented and fraudulently omitted vital facts about the ERS Bond issuance and purchases and allowed the imprudent investment of the Funds' assets in over $750 million of

these high risk, low grade bonds despite blatant conflicts of interest and in violation of statutory duties.

12. Defendants' breaches of their statutory duties, material misstatements, and fraudulent omissions concerning the purchase of the ERS Bonds, have caused millions of dollars in principal loss to the Funds (losses which are exacerbated for the Funds' investors as a result of the illiquidity of the market for the Funds, which is in large part controlled by the UBS Defendants, and by the fact that the Funds are highly leveraged), plus additional damages of millions of dollars in unwarranted fees paid to the UBS Defendants, to the detriment of the Funds and the Class herein.

JURISDICTION AND VENUE

13. Counts I and II asserted herein arise under Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. §78j(b), and the rules and regulations promulgated thereunder, including SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 ("Rule 10b-5"), and Section 20(a) of the Exchange Act, 15 U.S.C. §78t(a). This Court has jurisdiction over the subject matter of this action pursuant to Section 27 of the Exchange Act, 15 U.S.C. §78aa and 28 U.S.C. §1331.

14. The Defendants used, directly or indirectly, means or instrumentalities of interstate commerce in connection with the manipulative or deceptive devices described in Counts I and II, within the meaning of section 10(b) of the Exchange Act. Specifically, Defendants made extensive use of the telephone, internet, and the mails in preparing the Official Statements for the ERS Bond Offerings; communicating

with ERS and other members of the underwriting syndicate; communicating with each other for, among other things, coordinating the manipulative purchases of the ERS Bonds by the captive Funds ahead of sales to the rest of the market for the purpose of inflating demand for the ERS Bonds; using the internet to post the Official Statements circulated in connection with the ERS Bond Offerings; and use of the internet to post misleading statements regarding the Funds' asset values.

15. Count III asserted herein arises under Section 12(a)(2) of the Securities Act of 1933 (the "Securities Act"), 15 U.S.C. §77a. This Court has jurisdiction over the subject matter of this action pursuant to Section 22 of the Securities Act, 15 U.S.C. § 77v(a) and 28 U.S.C. §1331.

16. The Defendants used means or instruments of transportation or communication in interstate commerce or of the mails, as contemplated by Section 12(a)(2) of the Securities Act. Specifically, Defendants made extensive use of the telephone, internet, and the mails to communicate with each other, ERS, other members of the syndicate, and with purchasers of the ERS Bonds for the purpose of preparing and distributing the Official Statements for the ERS Bond Offerings.

17. Count IV asserted herein arises under the Employee Retirement Income System Act of 1974, as amended ("ERISA"). This Court, therefore, also has subject matter jurisdiction over the subject matter of this action pursuant to ERISA §502(e)(1), 29 U.S.C. §1132(e)(1) and 28 U.S.C. §1331.

18. This Court has supplemental jurisdiction over the related Commonwealth law claims (Counts V through XI) pursuant to 28 U.S.C.A. § 1367 as the claims arising from said violations arise from the same nucleus of operative facts as Counts I-IV.

19. This action is not a collusive one to confer jurisdiction that the Court would otherwise lack.

20. Venue is proper in this District pursuant to Section 27 of the Exchange Act, 15 U.S.C. §78aa, Section 22 of the Securities Act, 15 U.S.C. §77v(a), and 28 U.S.C. §1391(b). The Funds maintained their headquarters and principal place of business in this District. Virtually all of the acts and transactions that constitute the violations of law complained of herein occurred in this District.

21. Venue is also proper in this District pursuant to ERISA § 502(e)(2), 28 U.S.C. § 1132(e)(2), because some or all of the fiduciary breaches for which relief is sought occurred in this District, and the UBS Defendants have a principal place of business in this District.

22. Moreover, the Funds are headquartered in this District. Allegations contained herein are brought derivatively on behalf of the Funds as Nominal Defendants and Defendants' conduct was purposefully directed at this District. As such, jurisdiction in this District over any non-resident Defendant is reasonable under these circumstances.

THE PARTIES

A. Plaintiffs

23. Plaintiff UDEM PRSSA is a multi-employer welfare plan established in 1981 to provide retirement benefits and severance pay for employees of contributing companies represented by the Union de Empleados de Muelles de Puerto Rico, ILA, Local 1901 (mainly workers employed by shipping and related companies at San Juan's port) and is subject to ERISA. UDEM PRSSA is a stockholder of Funds II, III, and IV. UDEM PRSSA has been a stockholder of Funds II, III, and IV at all material times alleged in this Complaint, and will continue to be a stockholder of Funds II, III, and IV through the conclusion of this litigation.

24. Plaintiff UDEM AP is a welfare plan established for the benefit of employees of the Puerto Rico Port Authority (Autoridad de los Puertos). The plan invests funds in order to provide retirement benefits and severance pay for its members. UDEM AP is a stockholder of the Funds. UDEM AP has been a stockholder of the Funds at all material times alleged in this Complaint, and will continue to be a stockholder of the Funds through the conclusion of this litigation.

B. Nominal Defendants

25. Nominal Defendants Puerto Rico Fixed Income Fund II, Inc., Puerto Rico Fixed Income Fund III, Inc., Puerto Rico Fixed Income Fund IV, Inc., and Tax-Free Puerto Rico Fund II are corporations organized and existing under the laws of the Common-

wealth of Puerto Rico. They are closed-end management investment companies registered under the Puerto Rico Investment Companies Act. They are *not* registered under the Investment Company Act of 1940, pursuant to the statutory exception created by 15 U.S.C. §80a-6(a)(1).

C. The UBS Defendants

26. Defendant UBS Financial is a subsidiary of UBS Financial Services Inc., which in turn carries accounts as a clearing broker for UBS Financial. UBS Financial is registered with the United States Securities and Exchange Commission ("SEC") as a broker-dealer. UBS Financial is incorporated under the laws of the Commonwealth of Puerto Rico and has its principal offices in San Juan, Puerto Rico. Throughout the Relevant Period, UBS Financial derived substantial income from acting as a financial advisor to the ERS and as the underwriter of the approximately $2.9 billion offering of the ERS Bonds in 2008.

27. Defendant UBS Trust is a trust company incorporated under the laws of the Commonwealth of Puerto Rico and has its principal offices in San Juan, Puerto Rico. UBS Trust is a trust company offering personal and corporate trust services, retirement services, investment consulting services and money management services. UBS Trust acts as the issuing, paying and transfer agent of the Funds. UBS Trust is not registered as an investment adviser with the SEC. UBS Trust manages the assets of the Funds through its UBS Asset Managers division. Throughout the Relevant Period, UBS Trust derived substan-

tial income from managing the Funds and from acting as investment advisor to certain shareholders of the Funds.

28. The UBS Defendants are the largest asset managers in Puerto Rico, with over 100 financial advisors and tens of thousands of retail accounts.

29. UBS Trust and UBS Financial act as alter egos in their financial dealings in Puerto Rico. As alleged herein, they have substantial overlap in directorships and upper management, and otherwise disregard corporate distinctions in order to conduct their business. Information regarding the exact relationship between these entities is within the exclusive control of the UBS Defendants and discovery will therefore demonstrate the extent to which these entities act for each other.

D. The Director Defendants

30. Defendant Miguel A. Ferrer ("Ferrer") is Chairman of the Board of Directors and President of each of the Funds. Until September 2009, Ferrer served as the Chief Executive Officer ("CEO") of UBS Financial and the CEO of UBS Trust. Ferrer is now reportedly Chairman of an entity known as UBS International & Puerto Rico.

31. Defendant Carlos V. Ubiñas ("Ubiñas") is Vice Chairman of the Board of Directors and Executive Vice President of each of the Funds. Ubiñas has served as President of UBS Financial since 2005 and now reportedly serves as CEO of an entity known as UBS International & Puerto Rico.

32. Defendant Stephen C. Roussin ("Roussin") is a Director of each of the Funds and Managing Director of UBS Financial.

33. Defendant Leslie Highley, Jr. ("Highley") is a Director of each of the Funds, Managing Director and Executive Vice President of UBS Trust, and Senior Vice President of UBS Financial. Highley, acting on behalf of UBS Trust (through its UBS Asset Managers division), has served as Portfolio Manager for Fund II and Fund III since 2004, for Fund IV since 2005, and for Tax-Free Fund II since 2002.

34. Defendant Mario S. Belaval ("Belaval") is a Director of each of the Funds. Belaval is Vice Chairman of Triple S Management ("Triple S"), the largest managed care company in Puerto Rico. UBS Investment Bank received large fees from acting as co-lead underwriter of Triple S's IPO. In 2006, UBS Financial served as the placement agent for $35 million in notes issued by Triple-S, all of which were purchased by Fund IV and another UBS-affiliated fund. Belaval has also served as a director of numerous other UBS-affiliated funds, including UBS's IRA Select Growth and Income Fund. For the fiscal year ending July 31, 2009, Belaval's aggregate compensation for service on the boards of funds advised or co-advised by UBS Trust was reported to be $137,531 (excluding expenses).

35. Defendant Agustin Cabrer-Roig ("Cabrer-Roig") is a Director of each of the Funds. Cabrer-Roig also sits on the board of several other UBS funds, including the Puerto Rico Short-Term Investment Fund, Puerto Rico GNMA & U.S. Gov't Target Ma-

turity Fund, and the Puerto Rico AAA Portfolio Bond Fund. For the fiscal year ending July 31, 2009, Cabrer-Roig's aggregate compensation for service on the boards of funds advised or co-advised by UBS Trust was reported to be $101,531 (excluding expenses).

36. Defendant Gabriel Dolagaray-Balado ("Dolagaray-Balado") is a Director of each of the Funds. Dolagaray-Balado sits on the board of several other UBS funds, including the AAA Portfolio Bond Fund II and Puerto Rico Short Term Investment Fund. For the fiscal year ending July 31, 2009, Dolagaray-Balado's aggregate compensation for service on the boards of funds advised or co-advised by UBS Trust was reported to be $92,031 (excluding expenses).

37. Defendant Carlos Nido ("Nido") is a Director of each of the Funds. Nido is Vice President of Sales for El Nuevo Dia, a leading newspaper in Puerto Rico. Fund III and other UBS-affiliated funds have at times invested in notes issued by El Nuevo Dia. Nido sits on the board of several other UBS funds, including the AAA Portfolio Bond Fund II and the Puerto Rico Short Term Investment Fund. For the fiscal year ending July 31, 2009, Nido's aggregate compensation for service on the boards of funds advised or co-advised by UBS Trust was reported to be $92,031 (excluding expenses).

38. Defendant Luis M. Pellot-Gonzalez ("Pellot-González") is a Director of each of the Funds. Pellot-González sits on the board of several other UBS funds, including the Puerto Rico Short Term Investment Fund, AAA Portfolio Bond Fund, and Puerto

Rico Mortgage Backed and U.S. Government Securities Fund. For the fiscal year ending July 31, 2009, Pellot-González' aggregate compensation for service on the boards of funds advised or co-advised by UBS Trust was reported to be $100,031 (excluding expenses).

39. Defendant Vicente J. Leon ("Leon") is a Director of each of the Funds. Leon is, along with Belaval, Vice Chairman of Triple-S. In 2006, UBS Financial served as the placement agent for $35 million in notes issued by Triple-S, all of which were purchased by Fund IV and the Puerto Rico AAA Portfolio Target Maturity Fund. Leon also sits on the board of several UBS funds, including the Tax-Free Puerto Rico Fund, Target Maturity Fund, Puerto Rico AAA Portfolio Target Maturity Fund, Portfolio Bond Fund, Portfolio Bond Fund II, Puerto Rico GNMA & U.S. Government Target Maturity Fund, Puerto Rico Mortgage-Backed and U.S. Securities Funds, UBS IRA Selected Growth and Income Fund, Multi-Select Securities Puerto Rico Fund, and the Puerto Rico Short-Term Investment Fund. For the fiscal year ending July 31, 2009, Leon's aggregate compensation for service on the boards of funds advised or co-advised by UBS Trust was reported to be $68,531 (excluding expenses).

40. Defendant Clotilde Pérez ("Pérez") is a Director of each of the Funds. Pérez also sits on the board of several other UBS funds, including the Multi-Select Securities Puerto Rico Fund.

41. Defendants Ferrer, Ubiñas, Roussin, Highley, Belaval, Cabrer-Roig, Dolagaray-Balado, Nido,

Pellot-González, Leon and Pérez are referred to collectively as the "Director Defendants."

E. The Doe Defendants

42. The true names and capacities of defendants sued herein as Does 1 through 100 are other participants in the conduct alleged herein whose identities have yet to be ascertained. Such unnamed defendants potentially include, but are not limited to: (a) other officers and/or directors who breached their duties to Plaintiffs and/or the Funds and/or otherwise acted in concert with Defendants; (b) other UBS-affiliated entities who breached their duties to Plaintiffs and/or the Funds and/or otherwise acted in concert with the Defendants; and (c) insurance companies and/or bond companies who provided insurance coverage to Defendants for the acts alleged herein. Plaintiffs will seek to amend this complaint to state the true names and capacities of said unnamed defendants when they have been ascertained.

FIDUCIARY DUTIES AND OBLIGATIONS OF THE DIRECTOR DEFENDANTS TO THE FUNDS

43. By reason of their positions as directors and/or officers of the Funds, and pursuant to Articles 2.03, 4.03, 4.04, and 4.05 of Act Number 144 of August 10, 1995, as amended, also known as the "General Corporations Act of 1995," each of the Director Defendants owed the Funds the duty to exercise due care and diligence in the management and administration of the Funds. Furthermore, each of the Director Defendants owed the Funds and its shareholders duties of loyalty, good faith and candor, which required

them to refrain from engaging in self-interested transactions with the Funds, and to disclose material facts relating to their dealings with the Funds.

44. The Director Defendants are required to act in good faith, in the best interests of the Funds and with due care, including reasonable inquiry, as would be expected of an ordinarily prudent person. To diligently comply with this duty, the Director Defendants may not take any action that:

a. adversely affects the value of the Funds;

b. contractually prohibits them from complying with or carrying out their fiduciary duties;

c. fails to fully disclose all material information; or

d. otherwise adversely affects their duty to search and secure the best value reasonably available under the circumstances.

45. By virtue of the Director Defendants' positions as officers and directors of the Funds, the Director Defendants, at all relevant times, had the power to control and influence, and did control and influence and cause the Funds to engage in the practices complained of herein.

DUTIES AND OBLIGATIONS OF THE UBS DEFENDANTS TO THE FUNDS

46. By reason of its position as asset manager and fund advisor for the Funds (through its UBS Asset

Managers Division), UBS Trust and its alter ego UBS Financial had various contractual obligations to the Funds. In performing those contractual duties, the UBS Defendants were required to act in good faith and in a loyal, honest and fair manner. This good faith obligation required the UBS Defendants to faithfully comply with the representations and agreements reached with the Funds and not to defraud or abuse the trust given to them by the Funds.

47. By reason of its position as asset manager and fund advisor for the Funds (through its UBS Asset Managers Division), UBS Trust and its alter ego UBS Financial acted as Agent ("Mandatario") for the Funds as Principal ("Mandante") and therefore had a duty to act and perform the services hired in accordance to the instructions of the Funds and in good faith. In the absence of instructions, all acts of UBS Trust should have been exercised according to the standard of conduct of a good father of a family ("buen padre de familia").

48. To diligently comply with these duties and obligations, the UBS Defendants may not take any action that:

a. adversely affects the value of the Funds;

b. prohibits the officers and directors of the Funds from complying with or carrying out their fiduciary duties;

c. fails to fully disclose all material information; or

d. otherwise adversely affects their duty to search and secure the best value reasonably available under the circumstances.

49. By virtue of the UBS Defendants' positions as advisors and asset managers, the UBS Defendants, at all relevant times, had the power to control and influence, and did control and influence and cause the Funds to engage in the practices complained of herein.

THE ERS BOND OFFERINGS AND DEFENDANTS' FALSE STATEMENTS

50. In 2008, UBS Financial served as underwriter when the ERS sold $2.9 billion in pension bonds (the ERS Bonds described below), in a series of three bond offerings. These bond offerings resulted in approximately $27 million in fees for UBS Financial and its co-underwriters.

51. The ERS Bonds were of low quality and rated just one step above junk by Moody's Investors Service, Standard & Poor's and Fitch Ratings.

52. In assigning this low rating to the ERS Bonds, Fitch cited a "very long final maturity" and the "rising debt service profile," noting that "growth [was] needed to generate one times (x) coverage of debt service." Fitch also took into account the fact that "[t]here is no retirement system asset or commonwealth backstop on bonds, and no claim on employee contributions."

53. Series A of the ERS Bonds was offered in the local Puerto Rico market in late January 2008 and available for delivery shortly thereafter.

54. In the "Official Statement" describing the Series A ERS Bonds, dated January 29, 2008, the underwriters (including UBS Financial) provided the following sentence:

> IN CONNECTION WITH THE OFFERING OF THE SERIES A BONDS, THE UNDERWRITERS MAY EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICES OF THE SERIES A BONDS AT LEVELS ABOVE THOSE WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.

55. As discussed herein, however, rather than merely "stabilizing" or "maintaining" the market prices for the ERS Bonds, the UBS Defendants virtually created the market for the Series A ERS Bonds, in the absence of demand from outside investors.

56. Closed-end mutual funds controlled by the UBS Defendants purchased over $600 million of the approximately $1.6 billion Series A offering. The Funds purchased almost $325 million in ERS Bonds from this offering.

57. The Official Statement for the Series A ERS Bonds indicated that a planned Series B of the ERS Bonds was to have been sold outside of the Puerto Rico market. On February 22, 2008, the Government Development Bank of Puerto Rico announced that

such a global offering had been suspended, presumably due to lack of demand. To date, such a global offering has not occurred.

58. Instead, a new Series B of the ERS Bonds was offered in the local Puerto Rico market in late May 2008 and available for delivery shortly thereafter.

59. In the "Official Statement" describing Series B ERS Bonds, dated May 28, 2008, the underwriters (including UBS Financial) provided the following sentence:

> IN CONNECTION WITH THE OFFERING OF THE SERIES B BONDS, THE UNDERWRITERS MAY EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICES OF THE SERIES B BONDS AT LEVELS ABOVE THOSE WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.

60. Rather than merely "stabilizing" or "maintaining" the market prices for the ERS Bonds, however, the UBS Defendants again created the market for the Series B ERS Bonds in the absence of outside demand.

61. Closed-end mutual funds controlled by the UBS Defendants purchased over $850 million of the approximately $1 billion Series B offering. The Funds purchased over $430 million in ERS Bonds from this offering.

62. Series C of the ERS Bonds was offered in the local Puerto Rico market in late June 2008 and available for delivery shortly thereafter.

63. In the "Official Statement" describing the Series C ERS Bonds, dated June 26, 2008, the underwriters (including UBS Financial) provided the following sentence:

> IN CONNECTION WITH THE OFFERING OF THE SERIES C BONDS, THE UNDERWRITERS MAY EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICES OF THE SERIES C BONDS AT LEVELS ABOVE THOSE WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.

64. As discussed herein, however, rather than merely "stabilizing" or "maintaining" the market prices for the ERS Bonds, the UBS Defendants had virtually created the market.

65. Closed-end mutual funds controlled by the UBS Defendants purchased $17 million of the approximately $300 million Series C offering. The Funds purchased nearly $2 million in ERS Bonds from this offering.

SUBSTANTIVE ALLEGATIONS OF DEFENDANTS' BREACH OF THEIR OBLIGATIONS TO THE FUNDS

66. Because of the statutory and contractual duties described above, Defendants were required to

manage the Funds' investments solely in the interest of the Funds and its shareholders.

67. These duties require Defendants to avoid conflicts of interest and to resolve them promptly when they occur. Defendants have failed to act accordingly.

68. Defendants may not ignore circumstances, such as those here, which increase the risk of loss to shareholders of the Funds to an imprudent and unacceptable level.

69. The challenged transactions in which Defendants breached their fiduciary and other duties involved the purchase of over $700 million of the ERS Bonds, over 30% of the total assets of Funds II, III, and IV and approximately 15% of the total assets of Tax-Free Fund II. The UBS Defendants stood on all sides of these transactions and artificially created demand for the ERS Bonds in order to maximize fees for the UBS Defendants.

70. Specifically, UBS Financial, who was the financial advisor for ERS, acted as the underwriter for the ERS Bond offerings. UBS Financial stood to receive large fees when the bond offerings were completed, thus creating a strong financial incentive for Defendants to find purchasers to buy the ERS Bonds. In fact, UBS Financial and its co-underwriters reportedly received $27 million in fees from the ERS Bond offerings.

71. On the other side of the transactions, UBS Trust, who was charged with ensuring that the Funds purchased suitable and appropriate investments, purchased over $750 million of these low

grade high risk pension bonds for the Funds that it managed, the shares of which were held or purchased by Plaintiffs and other members of the Class. The UBS Defendants also received millions of dollars in annual fees for managing and administering the Funds (in addition to a hefty 4.75% upfront commission).

72. These actions created a disabling conflict of interest which caused the UBS Defendants (and the Director Defendants who, as discussed in more detail above and below, were beholden to the UBS Defendants) to breach their fiduciary and other duties to the Funds because Defendants should not provide advice to the bond issuer, underwrite those bonds and then buy the bulk of those bonds for the mutual funds that it manages. These actions were particularly inappropriate under the circumstances present here, where UBS Trust, by purchasing over half of those bonds for mutual funds that it controlled, improperly generated artificial demand for the ERS Bonds to ensure that UBS Financial received its full fees for successfully completing the bond offering.

73. The obvious conflicts of interest among the UBS Defendants have been noted by Bloomberg News. For example, in an article titled, "*UBS in Puerto Rico Pension Gets Fee Bonanza Seen as Conflicted*," Bloomberg News reported:

> "I've never seen such a blatant series of conflicts of interest," says James Cox, professor of law at Duke University School of Law in Durham, North Carolina.

> Cox, who has published three books on finance an law, including "Securities Regulation: Cases and Materials" (Aspen Publishers, 2006), says a bank shouldn't provide advice to a bond issuer, underwrite the bonds and buy them for mutual funds that it manages.
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> * * *
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> "The public wasn't aware they were buying a pig in a poke," Cox says. "This whole thing appears to be engineered by UBS as a way of syndicating bonds without disclosing to the public the very substantial risk of those bonds."
>
> * * *
>
> Mercer Bullard, a professor at the University of Mississippi School of Law, says the 1940 law was passed to halt abuses of mutual fund shareholders that he sees being repeated in Puerto Rico.
>
> "These are precisely the kinds of conflicts that led to passing the Investment Company Act," he says. "it's a series of conflicted relationships designed to put money in UBS's pocket at the expense of its clients."

74. These disabling conflicts of interest put the Defendants in the position of having to choose between their own financial interests, and the interests of the Funds.

75. In this case, Defendants placed their own interests ahead of the interests of the Funds, to the detriment of the Funds and investors in the Funds.

76. Defendants used the Funds as a dumping ground for the toxic pension bonds underwritten by UBS Financial in order to maximize the ERS Bonds' offering price and the UBS Defendants' fees, thereby breaching their fiduciary and other duties to the Funds and their shareholders.

77. In the year following their issuance, the ERS Bonds reportedly lost approximately ten percent of their value. The actual losses suffered by the Funds likely far exceed this amount and include the fees wrongfully extracted from the Funds by UBS Trust.

78. Defendants did nothing to protect the Funds from the inevitable losses the Funds would suffer, or the exorbitant fees incurred by the Funds, as a result of their purchases of the ERS Bonds.

79. While the Defendants enriched themselves with lucrative fees, they ignored their duties to the Funds and the blatant conflicts of interest connected with the ERS Bonds.

DEFENDANTS FAILED TO DISCLOSE MATERIAL FACTS

80. As a result of Defendants' fiduciary and other obligations to the Funds, they had a duty to disclose all material information concerning the ERS Bonds to the Funds.

81. Defendants had such a duty, but failed to disclose to the Funds the following material facts, as alleged herein: (a) that demand for the ERS Bonds was falsely created by UBS Trust's massive purchases of the ERS Bonds for the Funds and other mutual funds managed and controlled by UBS; (b) that the ERS Bonds were severely overpriced as a result of the false demand created by the UBS Defendants' manipulation of the market on a massive scale; (c) that the ERS Bonds were not suitable for purchase by the Funds, particularly in light of the closed-end nature of the Funds and the stated goal of the Funds to create dividend income; and (d) that the stated asset values published for the Funds were overstated, in large part due to the overvaluation of the ERS Bonds.

82. Throughout the Relevant Period, the Funds justifiably expected the Defendants, who were fiduciaries of and/or had contractual obligations to the Funds, to disclose material information as required by law. The Funds would not have purchased the ERS Bonds if Defendants had disclosed all material information then known to them, as detailed herein. Thus, reliance by the Funds should be presumed with respect to the Defendants' omissions.

83. Because of their positions, each of the Defendants had access to adverse undisclosed information about the ERS Bonds' business prospects, financial condition, suitability and performance as particularized herein, and knew (or recklessly disregarded) that these adverse facts had not been disclosed in such a manner that the Funds could make an informed decision concerning the purchase of the ERS Bonds.

DEFENDANTS' MARKET MANIPULATION ACTIVITIES

84. As alleged above, throughout the Relevant Period the UBS Defendants were an unusually pervasive force in Puerto Rico's financial markets. Approximately 50% of the brokerage licenses in Puerto Rico are held by employees of the UBS Defendants. The UBS Defendants utilized this substantial market force improperly and manipulated the market for the ERS Bonds to the detriment of the Funds.

85. At its essence, the manipulative scheme was simple — the UBS Defendants controlled the buyers and the sellers (and collected fees from both of them). UBS Financial advised ERS to issue the ERS Bonds and then, despite the fact that the mainland bond market had all but collapsed by the time of the offering in 2008, quickly managed to place the majority of the ERS Bonds with buyers, such as the Funds, controlled by UBS Trust. Because the UBS Defendants created such false demand for the ERS Bonds, the Government Development Bank for Puerto Rico was able to quickly tout the ERS Bond issuance as a success (even before the bonds were actually delivered), claiming that "[t]he market showed a big appetite for this bond issue, and this display of confidence by local investors opens the door for us to float a second pension obligation bond issue in the local markets in the future." In fact, the market did not have an "appetite" for the ERS Bonds, it was simply the UBS Defendants who had an "appetite" for its own cooking.

86. By dominating trading in the ERS Bonds and absorbing the majority of the issuance into its own

inventory ahead of any release to the rest of market, the UBS Defendants were able to falsely validate and maintain the ERS Bonds' inflated offering price, thus defrauding the Funds and causing them to overstate their asset values. Moreover, because the UBS Defendants used the Funds as a conduit for repurchases of the ERS Bonds, they were able to conceal from investors the fact that the UBS Defendants were the main source of demand for the ERS Bonds. In so doing, the UBS Defendants engaged in market activity aimed at deceiving investors as to how other market participants have valued a security, thereby sending false pricing signals to the market.

87. Although the ERS Bond offerings were not subject to the requirements of SEC Regulation M (relating to affiliated purchasers of the issuer), reference to that regulation by way of analogy clearly demonstrates the UBS Defendants' trading activity was outside the natural interplay of supply and demand and that its high volume trading was designed to create a false impression of supply and demand for the security. Regulation M is a prophylactic regulation aimed at preventing manipulation in the context of distributions, and Rule 101 thereof governs when and how offers and purchases can be made by underwriters and others participating in a distribution. Rule 101 prohibits an underwriter from purchasing the securities being offered for almost the entire period that underwriter participates in the distribution. Here, the UBS Defendants were far and away the *largest* purchaser of the securities they were underwriting during the distribution. Moreover, even after the underwriter ceases to participate in the distribution, its ability to purchase the offered securities for

purposes of stabilizing the market price are greatly restricted. In particular, it may only engage in stabilization for the purpose of "preventing or retarding a decline in the market price of a security." Here, the UBS Defendants engaged in massive repurchases of the ERS bonds, not to prevent or retard a decline in market price, but, instead, to *create* a market out of thin air. Thus, the UBS Defendants' trading activities constitute conduct that the SEC has determined is presumptively manipulative.

88. The Funds relied to their detriment on the price of ERS Bonds when they purchased them from the UBS Defendants. As a result of the UBS Defendants' manipulative conduct, the price of the ERS Bonds was greatly inflated. Had the market been allowed to value the ERS Bonds, as Professor Cox observed, the price would have been informed by the substantial risk of those bonds. Instead, as a result of Defendants' manipulative activity, the Funds paid highly inflated prices for the ERS Bonds.

89. At all relevant times, the UBS Defendants knew that, as a result of their conduct, the price of the ERS Bonds would be artificially inflated relative to the known lack of demand for these securities underwritten by UBS Financial. Alternatively, the UBS Defendants recklessly disregarded the propensity of their conduct to manipulate the price of the ERS Bonds.

90. Indeed, the UBS Defendants' conduct in connection with the Series B Offering is particularly illustrative of the UBS Defendants' state of mind. Even though global bond markets were collapsing

and UBS Financial had to abandon a planned U.S. offering of the Series B ERS Bonds for lack of any investor demand for the bonds, the UBS Defendants actually *increased* the Funds' position in the ERS Bonds by purchasing approximately *85%* of the entire Series B issuance on behalf of closed-end funds controlled by UBS. Thus, despite the UBS Defendants' knowledge of the lack of demand for the ERS Bonds and the fact that the ERS Bonds were unsuitable for a registered public offering in the U.S., it nevertheless decided that Funds ought to buy much, much more of them. The only inference that can be drawn from such conduct is that the UBS Defendants had something other than the Funds' best interests in mind when trading on their behalf. Rather, it is precisely because the market's appetite for bonds was turning against the UBS Defendants and its planned syndication that the UBS Defendants had to significantly increase the scope and extent of the manipulative trading vis-à-vis the captive Funds in order to successfully prop up the price of the ERS Bonds.

LOSS CAUSATION

91. Throughout the Relevant Period, the price of the ERS Bonds was artificially inflated as a result of Defendants' material misrepresentations, omissions, and market manipulation. The true value of the ERS Bonds during the Relevant Period was far less than the value that was advocated by the UBS Defendants upon their issuance and published by the UBS Defendants thereafter. The UBS Defendants have at all times had an incentive to artificially inflate the stated value of the ERS Bonds in order to obtain exorbitant fees both in the underwriting of the ERS Bonds

and in the management fees it charged the Funds for those "assets."

92. As the true value of the ERS Bonds and the scope of UBS' self-dealing was revealed, the ERS Bond prices declined, causing harm to the Funds. While some of that decline is reflected in the values assigned to the ERS Bonds by UBS, which controls the market for the ERS Bonds, those values are not a reliable indicator of the ERS Bonds' true value, given UBS's incentive to inflate those values for its own gain.

93. The declines in the value of the ERS Bonds, and the resulting damages suffered (including the exorbitant fees charged by UBS), are directly attributable to the Defendants' misrepresentations and omissions. Had the Funds known of the material adverse information not disclosed by the Defendants named herein, or been aware of the truth behind the Defendants' material misstatements, they would not have purchased the ERS Bonds nor paid the inflated fees associated therewith.

DERIVATIVE ACTION ALLEGATIONS

94. Plaintiffs bring this action derivatively on behalf of and for the benefit of the Funds to redress injuries suffered, and yet to be suffered, by the Funds as a direct and proximate result of the breaches of fiduciary duty and other legal violations alleged herein. The Funds are named as nominal defendants in a derivative capacity.

95. Plaintiff UDEM PRSSA is a shareholder of Funds II, III, and IV and will adequately and fairly

represent the interests of Funds II, III, and IV and their shareholders in this litigation and have retained counsel competent and experienced in securities litigation and stockholder derivative actions.

96. Plaintiff UDEM AP is a shareholder of each of the Funds and will adequately and fairly represent the interests of each of the Funds and their shareholders in this litigation and have retained counsel competent and experienced in securities litigation and stockholder derivative actions.

97. Plaintiffs intend to retain their respective shares in the Funds throughout the duration of this litigation.

98. Plaintiff UDEM PRSSA was a shareholder of Funds II, III, and IV at the time of the relevant transactions alleged herein and has continued to hold shares of Funds II, III and IV since that time.

99. Plaintiff UDEM AP was a shareholder of each of the Funds at the time of the relevant transactions alleged herein and has continued to hold shares of each of the Funds since that time.

100. The wrongful acts complained of herein subject, and will persist in subjecting, the Funds to continuing harm because the adverse consequences of the injurious actions are still in effect and ongoing.

101. The wrongful actions complained of herein were unlawfully concealed from the Funds' shareholders.

DEMAND IS EXCUSED

A. Demand is Excused Because the Subject Transactions Were Not the Product of a Valid Exercise of Business Judgment.

102. All claims asserted derivatively on behalf of the Funds challenge a business decision or decisions of the Funds' boards. Specifically, all claims asserted derivatively challenge the Funds' boards' decisions to purchase ERS Bonds on behalf of the Funds.

The ERS Bond Purchases Were Interested-Director Transactions that Were Not Entirely Fair and Were, Therefore, Not the Product of Valid Business Judgment.

103. Demand on the Funds' boards of directors (all of which are identical and consist solely of the Director Defendants) is excused because the facts set forth in this Complaint create a reasonable doubt that the purchase of the ERS Bonds (and the associated payment of fees to UBS) was the product of valid business judgment.

104. As alleged herein, the Director Defendants were participants in a scheme to manipulate the price of the ERS Bonds purchased by the Funds in order to benefit the UBS Defendants and their investment banking client ERS and to artificially inflate the management and other fees payable to the UBS Defendants.

105. As a consequence of this scheme, the Director Defendants stood to receive, and did receive, significant personal benefits not shared equally by the

Funds' shareholders. These benefits include additional compensation received either as a direct consequence of the increase in the Funds' management fees attributable to the scheme, additional opportunities to serve as directors of other UBS-affiliated investment funds, and opportunities to use UBS captive funds to support their other business enterprises.

106. As a result of this financial interest, the Director Defendants bear the burden of proving the entire fairness of the ERS Bond purchases by the Funds. Because the entire fairness doctrine applies, the business judgment rule is rebutted and demand is therefore excused.

107. Because the Director Defendants stood to receive financial benefits not shared by the shareholders generally, the ERS Bond Transactions constitute interested-director transactions. As interested-director transactions that were not entirely fair to the Funds, the Director Defendants' negotiation, consummation, and ratification of the ERS Bond purchases and related transactions constitutes a breach of their duties of loyalty to the Funds and their shareholders.

108. As alleged herein, the transactions were not entirely fair because the Funds did not receive a fair price in the transactions and there was no process employed to ensure fairness to the Funds. Instead the Director Defendants, in concert with the UBS Defendants, forced the Funds to pay inflated prices for the ERS Bonds in order to benefit themselves and ERS, an important UBS investment banking client,

at the Funds' and the shareholders' expense. Moreover, the timing, structure, and negotiation of, as well as disclosures concerning, the transactions fail that the Funds were not treated fairly.

109. Because there is reason to doubt that the ERS Bond transactions were consummated at a fair price and was the product of fair dealing, there is reason to doubt that the transactions were entirely fair and therefore reason to doubt that the Director Defendants' acts in furtherance of these interested transactions comport with their duties of loyalty and were the product of valid business judgment. Because there is reason to doubt that the transactions are the product of valid business judgment, demand is excused.

The ERS Bond Transactions Were not Undertaken in Good Faith and, Therefore, Were Not the Product of Valid Business Judgment.

110. Because the ERS Bond purchases were undertaken for a purpose other than a genuine attempt to advance the Funds' welfare, the transactions were not undertaken in good faith. Where directors fail to act in good faith, their duties of loyalty are violated. Because the Director Defendants' duties of loyalty were implicated with regard to the ERS Bond Transactions, there is reason to doubt that the transactions were the product of valid business judgment.

111. Moreover, because the Director Defendants, in consummating the ERS Bond purchases, consciously disregarded their known duty to act in the best interests of the Funds, the transactions were not undertaken in good faith. As alleged herein, the Director

Defendants knowingly participated in a scheme to inflate the price of the ERS Bonds, causing the Funds to overpay for the ERS Bonds and to cause misstatements of their value. Thus, in regards to the ERS Bond purchases, the Director Defendants knowingly and completely failed to attempt to fulfill their duties to advance the Funds' welfare, and there is reason to doubt that the Transactions were the product of valid business judgment, demand is excused.

The Director Defendants did not Exercise Due Care in Consummating the ERS Bond Transactions and, Therefore, Demand is Excused

112. The Director Defendants did not adequately inform themselves about the details of and the circumstances surrounding the ERS Bond Transactions, including: (a) the true value of the ERS Bonds; (b) the UBS Defendants' motive in pushing the bulk of the distribution onto its captive affiliates; (c) the advisability of assuming so large a position in the ERS Bonds; and (d) the suitability of the investment for the Funds. At a minimum, these circumstances indicate that the Director Defendants' approval of the Funds' purchases of the ERS Bonds were grossly negligent and creates a reason to doubt that the underlying transactions were the product of valid business judgment. Demand is therefore excused.

B. Demand is Excused Because a Majority of the Funds' Directors are Not Independent

113. To the extent that any of the derivative claims asserted in this Complaint do not challenge a business decision or decisions of the boards of directors of the Funds, demand is excused because the facts al-

leged in this Complaint create a reasonable doubt that a majority of the Director Defendants are independent and could impartially consider a demand at the time the complaint was filed.

114. A reasonable doubt exists that the inside directors, Defendants Ferrer, Roussin, and Highley, are independent, and would have been able to impartially consider a demand at the time this Complaint was filed. As highly placed officers of UBS Financial, UBS Trust, or, in Ferrer's case, of both, these defendants were direct beneficiaries of the fraud worked on the Funds. Those defendants who were officers of UBS Trust benefitted from the Funds' payment of inflated management fees. Similarly, those defendants who were officers of UBS Financial benefitted from the manipulative conduct engaged in by the UBS Defendants in connection with the distribution of the ERS Bonds. The benefits received by these defendants as a consequence of their participation in the fraud and their relationships with the UBS Defendants are both pecuniary and reputational in nature.

115. Moreover, each of the outside directors of the Funds, Defendants Belaval, Cabrer-Roig, Nido, Leon, Pérez, Dolagaray-Balado, and Pellot-González, are beholden to the inside directors or so under their influence that their discretion would be sterilized. Each of the "outside" directors acts as a director for numerous other UBS-affiliated investment funds. Thus, each "outside" director depends on the UBS Defendants for substantial remuneration in addition to the director fees received for services rendered to the Funds.

116. Defendants Belaval, Dolagaray-Balado and Nido are or were directors of every fund that has retained UBS Trust as an advisor or co-advisor. In total, these defendants sit on the boards of at least 26 UBS-affiliated funds. The remaining outside directors serve on the boards of every fund that has retained UBS Trust to be its sole advisor. In total, these defendants sit on the boards of at least 17 UBS-affiliated funds.

117. From their part-time jobs as directors for the UBS-affiliated funds, all but one of the outside directors reportedly receive, on average, yearly compensation at a rate approximately four times the median household income in Puerto Rico.

118. These directors' dependence on the UBS Defendants for substantial remuneration apart from the compensation received for serving as a director of the Funds makes these directors beholden to the inside directors.

119. Additionally, Defendants Belaval, Nido and Leon had previously benefited from using UBS-affiliated funds as vehicles to support investments in their other business enterprises and therefore have reason to discourage scrutiny of any similar related-party transactions, such as the purchase of the ERS Bonds.

120. In light of the foregoing, demand is excused.

CLASS ACTION ALLEGATIONS

121. Class Definition. This action is brought by Plaintiffs, for themselves and on behalf of all others

similarly situated, as a class action pursuant to Fed. R. Civ. P. 23(a) and (b)(3). The proposed class is defined as follows:

> All shareholders in Puerto Rico Fixed Income Fund II, Inc., Puerto Rico Fixed Income Fund III, Inc., Puerto Rico Fixed Income Fund IV, Inc., and Tax-Free Puerto Rico Fund II, Inc. (the "Funds") between January 24, 2008 and the present. Excluded from the Class are Defendants and any person, firm, trust, corporation, or other entity related to or affiliated with any of them.

122. Subclass. Appropriate for treatment in a subclass are the ERISA-based claims for breach of fiduciary duty brought by those members of the Class, including UDEM PRSSA, whose investment was made through an ERISA qualified plan.

123. Numerosity. The members of the Class are so numerous that joinder of all members is impracticable. While the exact number of Class members is unknown to Plaintiff at this time, and can only be ascertained through appropriate discovery, Plaintiff believes there are thousands of members of the Class. Each of the Funds has issued over 45 million shares and it is reasonable to assume, therefore, that there are (at a minimum) thousands of distinct shareholders in each Fund. The exact number is within the knowledge of the Defendants.

124. Commonality. There are common questions of law and fact in this class action that relate to and affect the rights of each member of the Class including:

a. Whether Defendants owed a fiduciary or other duty to Plaintiffs and members of the Class, under statutory and/or other law, including a duty of loyalty, a duty of candor, a duty of fair dealing, a duty to avoid self-dealing, a duty of good faith, and an affirmative duty to act in the interests of Plaintiffs and the Class, rather than in Defendants' own interests;

b. Whether Defendants breached their fiduciary and other duties to Plaintiffs and members of the Class by failing to act prudently and solely in the interests of Plaintiffs and the Class;

c. Whether Defendants are liable to Plaintiffs and members of the Class for damages they suffered due to breach of fiduciary and other duties;

d. Whether Defendants are liable to Plaintiffs and other members of the Class for the amounts in which Defendants have been unjustly enriched by their breaches of fiduciary and other duties;

e. Whether a constructive trust exists in favor of Plaintiffs with respect to the fees improperly obtained by Defendants as a result of their breaches of fiduciary duty;

f. Whether the Plaintiffs and members of the Class are entitled to a reasonable award of attorneys' fees, interest and costs of suit.

125. Typicality. The claims of Plaintiffs are typical of the claims of all Class members. Plaintiffs are situated identically to all members of the Class with respect to the prevailing issues presented in this case. The claims of Plaintiffs are based on the same fundamental allegation and legal theories as the claims of all other members of the class.

126. Adequacy of Representation. Plaintiffs will fairly and adequately protect the interests of the members of the Class and have retained counsel competent and experienced in class action, complex, and ERISA litigation. Plaintiffs have no interests antagonistic to or in conflict with those of the Class.

127. Superiority. A class action is superior to all other available methods for the fair and efficient adjudication of this controversy since joinder of all members is impracticable. Furthermore, as the damages suffered by individual Class members may be relatively small, the expense and burden of individual litigation makes it virtually impossible for members of the Class to individually redress the wrongs done to them by Defendants. There will be no difficulty in the management of this action as a class action.

OBLIGATIONS OF THE UBS DEFENDANTS TO PLAINTIFF UDEM AP AND THE CLASS

128. By reason of their sale of shares of the Funds to members of the Class and their position as asset manager and fund advisor for the Funds, the UBS Defendants had various contractual obligations to the Funds. In performing those contractual duties, the UBS Defendants were required to act in good

faith and in a loyal, honest and fair manner. This good faith obligation required the UBS Defendants to faithfully comply with the representations and agreements reached with the Plaintiff and the Class and not to defraud or abuse the trust given to them Plaintiff and the Class.

129. The UBS Defendants are required to act in good faith, in the best interests of the Fund's shareholders. To diligently comply with this duty, the Defendants may not take any action that:

a. adversely affects the value provided to the Class;

b. fails to fully disclose all material information; or

c. otherwise adversely affects their duty to search and secure the best value reasonably available under the circumstances for the members of the Class.

ERISA FIDUCIARY DUTIES OF THE DEFENDANTS TO PLAINTIFF UDEM PRSSA AND THE CLASS

130. Defendants are fiduciaries of any ERISA plans that invested in the Funds, including Plaintiff UDEM PRSSA, pursuant to ERISA §§ 409 and 502, 29 U.S.C. §§ 1109, and 1132.

131. ERISA treats as fiduciaries not only persons explicitly named as fiduciaries under § 402(a)(1), but also any other persons who in fact perform fiduciary functions. See ERISA § 3(21)(A)(i), 29 U.S.C. §

1002(21)(A). Such fiduciaries are referred to herein as "*de facto*" or "functional" fiduciaries. Thus, a person is a fiduciary to the extent "(i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan." *Id.*

132. Here, to the extent that Funds II, III, and IV held and controlled ERISA monies invested in Funds II, III, and IV, each of the Defendants owed fiduciary duties to the participants and beneficiaries of the ERISA plans in the manner and to the extent set forth under ERISA.

133. As fiduciaries, Defendants were required by ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1), to manage and administer Funds II, III, and IV and the investments of Funds II, III, and IV solely in the interest of the ERISA plan's participants and beneficiaries.

134. Consequently, in light of the foregoing duties, responsibilities, and actions, Defendants were *de facto* fiduciaries of ERISA plan Class members, including UDEM PRSSA, within the meaning of ERISA § 3(21), 29 U.S.C. § 1002(21), during the Class Period in that the Defendants exercised discretionary authority or discretionary control respecting management of ERISA monies in Funds II, III, and IV,

exercised authority or control respecting management or disposition of the assets of Funds II, III, and IV, and/or had discretionary authority or discretionary responsibility in the administration of the ERISA monies in Funds II, III, and IV.

SUBSTANTIVE ALLEGATIONS OF DEFENDANTS' BREACH OF FIDUCIARY AND OTHER DUTIES TO THE CLASS

135. During the Class Period, as fiduciaries of the Class members under ERISA and with obligations to act in good faith under Commonwealth law, Defendants were required to manage the Funds' investments solely in the interest of the shareholders of the Funds, and for the exclusive purpose of providing benefits to the participants, beneficiaries and shareholders. These duties require Defendants to avoid conflicts of interest and to resolve them promptly when they occur. Defendants have failed to act accordingly.

136. Moreover, Defendants could not ignore circumstances, such as those here, which increase the risk of loss to shareholders of the Funds to an imprudent and unacceptable level.

137. The same breaches of fiduciary and other duties to the Funds alleged above, were also breaches of duty to the Class, and constituted a clear conflict of interest given the UBS Defendants' position on all sides of the transactions.

138. In one year, the ERS Bonds lost approximately ten percent of their value. The actual losses suffered by the Class likely far exceed this amount, in part as

a result of the limited market for the Funds and their closed-end nature, and also as a result of fees wrongfully extracted by the UBS Defendants.

139. Defendants did nothing to protect Plaintiffs and the Class as shareholders of the Funds from the inevitable losses the Funds would suffer or the exorbitant fees extracted from the UBS Defendants acting on all sides of the transaction.

COUNT I

Derivative Claim For Violation Of Section 10(b) Of the Exchange Act and Rule 10b-5 Promulgated Thereunder (Against the UBS Defendants)

140. Plaintiffs incorporate by reference and reallege each and every allegation contained above, as though fully set forth herein.

141. Throughout the Relevant Period, the UBS Defendants, individually and in concert, directly and indirectly, by the use and means of instrumentalities of interstate commerce and/or of the mails, including postings on UBS's website, engaged and participated in a continuous course of conduct designed to create a market for ERS Bonds and artificially inflate the value of the ERS Bonds in order to extract unearned fees.

142. The UBS Defendants employed devices, schemes, and artifices to defraud, and engaged in acts, practices, and a course of conduct that included the omission of material facts that Defendants had a duty to disclose to the Funds. The UBS Defendants

also participated in a fraudulent scheme and artifice to defraud that included looting of the Funds by, among other things, causing the Funds to purchase ERS Bonds to maintain a market for those bonds and to benefit the UBS Defendants, who stood to gain from underwriting and other fees related to the ERS Bond issuance, at the expense of the Funds and its shareholders.

143. The UBS Defendants are liable as direct participants in the wrongs complained of herein. Through their positions of control and authority, each of the UBS Defendants was able to and did control the conduct complained of herein.

144. The UBS Defendants acted with scienter throughout the Relevant Period in that they either had actual knowledge of the omissions of material facts set forth herein, or acted with reckless disregard for the truth by failing to ascertain the true facts, even though such facts were available to them. The UBS Defendants were affirmatively obligated to disclose material information to the funds. The UBS Defendants are therefore liable under section 10(b) and Rule 10b-5 for any omissions alleged herein, even if disclosure of the omitted information was not necessary to make an existing statement not misleading.

145. The UBS Defendants participated in a scheme to defraud with the purpose and effect of defrauding the Funds. The UBS Defendants caused the Funds to purchase at least $700 million in ERS Bonds that the Funds would not have purchased had they been aware of the UBS Defendants' omissions concerning

the reasons for purchasing the ERS Bonds on the Funds' behalf - to wit, propping up an investment banking client's bond offering and inflating their management fees. Moreover, the UBS Defendants caused the Funds to purchase the ERS Bonds at artificially inflated prices knowing that only the UBS Defendants' creation of a market for these shares, through dissemination to captive closed-end funds, would further maintain the artificial inflation at a time that the UBS Defendants were themselves profiting by reaping fees on all sides of the ERS Bond transactions.

146. As described herein, the UBS Defendants made the omissions knowingly and intentionally, or in such an extremely reckless manner as to constitute willful deceit and fraud upon the Funds during the Relevant Period.

147. The purchase of the ERS Bonds caused the Funds economic loss, both in the value of the ERS Bonds and the associated fees related thereto.

148. The decline in the value of the ERS Bonds, and the resulting damages suffered (including the exorbitant fees charged by UBS), were directly attributable to the UBS Defendants' omissions. Had the Funds known of the material adverse information not disclosed by UBS Defendants, or been aware of the truth behind the UBS Defendants' material misstatements, they would not have purchased the ERS Bonds nor paid the inflated fees associated therewith.

149. By virtue of the foregoing, the UBS Defendants have violated Section 10(b) of the Exchange Act,

and Rule 10b-5 promulgated thereunder, and caused the Funds to sustain damages, as alleged herein. Total damages incurred are at least tens of millions of dollars, and likely substantially higher.

COUNT II

Derivative Claim For Violation Of Section 20(a) Of the Exchange Act (Against Individual Defendants Ferrer, Ubiñas, Roussin, and Highley)

150. Plaintiffs incorporate by reference and reallege each and every allegation contained above, as though fully set forth herein.

151. Individual Defendants Ferrer, Ubiñas, Roussin, and Highley ("Inside Director Defendants") acted as controlling persons within the meaning of Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a), as alleged herein. By virtue of their positions as officers and/or directors of the UBS Financial and/or UBS Trust, their high-level positions, and participation in and/or awareness of the UBS Defendants' operations, the Inside Director Defendants had the power to influence and control and did influence and control, directly or indirectly, the content and dissemination of the omitted information and had the ability to communicate the correct information to the Funds.

152. In particular, each of the Inside Director Defendants had direct involvement in or intimate knowledge of the day-to-day operations of the UBS Defendants during the Relevant Period. Therefore, each is presumed to have had the power to control or influence the particular transactions giving rise to

the securities violations as alleged herein, and exercised (or could have exercised) the same.

153. By reason of such wrongful conduct, the Inside Director Defendants are liable pursuant to Section 20(a) of the Exchange Act. As a direct and proximate result of the wrongful conduct, the Funds suffered damages in connection with their purchases of the ERS Bonds during the Relevant Period. Total damages incurred are at least tens of millions of dollars, and likely substantially higher.

COUNT III

Derivative Claim For Violation of Section 12(a)(2) of the Securities Act (Against the UBS Defendants)

154. Plaintiffs repeat and reallege each and every allegation contained in the foregoing paragraphs of this Complaint as if set forth fully herein. Plaintiffs assert this claim pursuant to Section 12(a)(2) of the Securities Act, 15 U.S.C. §771(a)(2) derivatively on behalf of the Funds against the UBS Defendants.

155. The Official Statements distributed in connection with the Series A, B, and C ERS Bond offerings each qualify as a "prospectus" as that term is defined in section 2(a)(10) of the Securities Act.

156. The Official Statements describe "public offerings" of securities by an issuer.

157. The Official Statement distributed in connection with the Series A ERS Bond offering is dated January 29, 2008. According to the Official State-

ment, the underwriters "provided the following sentence for inclusion in" the Official Statement:

> IN CONNECTION WITH THE OFFERING OF THE SERIES A BONDS, THE UNDERWRITERS MAY EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICES OF THE SERIES A BONDS AT LEVELS ABOVE THOSE WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.

158. The above-quoted language is false and misleading in that it fails to disclose that UBS' trading activities would far exceed mere price stabilization or maintenance. Instead, UBS, by repurchasing the ERS Bonds through their captive Funds, intended to, and did, create the market for the ERS Bonds. The omitted fact is material in that, had it been included in the Official Statement, it would have significantly altered the total mix of information made available to investors.

159. At the time the Official Statement was promulgated, January 29, 2008, the UBS Defendants had *already* engaged in the manipulative trading described above. Therefore, UBS knew the statement was false and misleading as a matter of historical fact. The UBS Defendants did not exercise, and could not have exercised, due diligence with respect to this false and misleading statement.

160. The Official Statements distributed in connection with the Series B and C offerings contain lan-

guage identical to that cited with reference to the Series A Official Statement above. In the context of those offerings, the UBS Defendants fully anticipated and expected to employ the same trading scheme they had so successfully employed in the Series A Offering. Indeed, because the bond market had worsened, and because UBS had abandoned its plans to offer the Series B Bonds in U.S. markets, UBS had to dramatically increase the scope and extent of its manipulative trading in order to prop up the price of the Series B and C ERS Bonds. As alleged above, it did this by purchasing approximately 85 percent of the Series B issuance on behalf of the captive Funds. Consequently, the UBS Defendants did not exercise, and could not have exercised, due diligence with respect to these false and misleading statements in the Series B and C Official Statements.

161. The Funds sustained damages as a result of the UBS Defendants' violations of Section 12(a)(2) alleged herein.

162. The UBS Defendants are statutory "sellers" within the meaning of section 12(a)(2) of the Securities Act in that they offered and sold the Bonds for value, or they solicited the purchase, "motivated at least in part by a desire to serve their own financial interests or those of the securities owner." UBS Financial, as underwriters of the Bond Offerings, offered the securities for sale. UBS Trust, as advisor to the Funds, urged the Funds to purchase the Bonds, motivated at least in part by a desire to serve both its own interests and the interests of ERS.

163. To the extent that the Funds continue to own Series A, B, or C ERS Bonds, they hereby tender those shares to the UBS Defendants and seek rescission of their purchases.

COUNT IV

Class Claims For Breach of ERISA Fiduciary Duties
(Against the UBS Defendants)

164. Plaintiff UDEM PRSSA incorporates by reference and realleges each and every allegation contained above, as though fully set forth herein.

165. This Count alleges fiduciary breach against the Defendants.

166. UBS Trust is a *de facto* fiduciary within the meaning of 29 U.S.C. § 1002(21)(A), in part, because UBS Trust rendered investment advice for a fee, direct or indirect, with respect to plan property or had the authority or responsibility to do so. As the alter ego of UBS Trust, or because of enterprise liability, or both, UBS Financial is also a *de facto* fiduciary of Funds II, III, and IV. Therefore, the UBS Defendants were both bound by the duties of loyalty, exclusive purpose and prudence.

167. Each of the UBS Defendants was a co-fiduciary of Funds II, III, and IV under ERISA § 405, 29 U.S.C. § 1105. As co-fiduciaries, each of the UBS Defendants is liable for the other's misconduct under the terms of ERISA § 405(a), 29 U.S.C. § 1005(a).

168. As alleged above, the scope of the fiduciary duties and responsibilities of the UBS Defendants included managing the assets of the Funds for the sole and exclusive benefit of the shareholders of Funds II, III, and IV, and with the care, skill, diligence, and prudence required by ERISA.

169. Yet, contrary to their duties and obligations to the shareholders of Funds II, III, and IV, the Defendants failed to loyally and prudently manage the assets of Funds II, III, and IV. Specifically, during the Class Period, the UBS Defendants knew or should have know that the ERS Bonds were not a suitable and appropriate investment for Funds II, III, and IV (particularly in light of the captive and closed-end nature of Funds II, III, and IV and the high percentage of the assets of Funds II, III, and IV to be invested therein) but were, instead, a highly risky investment.

170. The UBS Defendants' decisions respecting the investment of Funds II, III, and IV in the ERS Bonds described above, under the circumstances alleged herein, abused their discretion as ERISA fiduciaries in that a prudent fiduciary acting under similar circumstances would have made different investment decisions. Specifically, based on the above, a prudent fiduciary could not have reasonably believed that the investments by Funds II, III, and IV in the ERS Bonds was how a prudent fiduciary would operate.

171. The fiduciary duty of loyalty entails, among other things, a duty to avoid conflicts of interest and to resolve them promptly when they occur. Fiduciaries laboring under such conflicts, must, in order to

comply with the duty of loyalty, make special efforts to assure that their decision making process is untainted by the conflict and made in a disinterested fashion, typically by seeking independent financial and legal advice obtained only on behalf of the plan.

172. As a consequence of the UBS Defendants' breaches of fiduciary duty alleged in this Count, Funds II, III, and IV suffered tremendous losses. If the UBS Defendants had discharged their fiduciary duties to prudently invest the assets of Funds II, III, and IV, the losses suffered by Funds II, III, and IV would have been minimized or avoided.

173. Therefore, as a direct and proximate result of the breaches of fiduciary duty alleged herein, Plaintiff UDEM PRSSA and the other Class members, lost millions of dollars.

COUNT V

Derivative Claim
For Unjust Enrichment/Constructive Trust
(Against All Defendants)

174. Plaintiffs incorporate by reference and reallege each and every allegation contained above, as though fully set forth herein.

175. Defendants, and each of them, have been unjustly enriched through a self-dealing scheme aimed at enriching themselves at the expense of the Funds.

176. Defendants, and each of them, received fees or other remuneration from the Funds, directly or indi-

rectly, by breach of fiduciary duty, violation of trust, and other wrongful acts.

177. Such fees or other remuneration has been wrongfully retained by Defendants for their personal benefit at the expense of the Funds.

178. As a result of Defendants' unjust enrichment, the Funds have suffered and continue to suffer damages totaling millions of dollars.

179. In addition, as a result of Defendants' wrongful conduct, the Funds sustained and suffered further unconscionable injuries which, with the fees or other remuneration received by Defendants, totaling, at a minimum, tens of millions of dollars.

180. The Funds are entitled to the imposition of a constructive trust over all funds constituting the excessive fees and other remuneration paid to Defendants for their faulty and conflict-ridden advice, and Defendants, and each of them jointly and severally, are subject to the equitable duty to convey such excessive compensation back to the Funds.

181. Plaintiffs and the Funds have no adequate remedy at law.

COUNT VI

Class Claims For Violations of Duty to Act in Good Faith (Against The UBS Defendants)

182. Plaintiff UDEM AP incorporates by reference and realleges each and every allegation contained above, as though fully set forth herein.

183. Article 1258 of the Civil Code provides that contracts are perfected by mere consent, and from that time they are binding, not only with regard to the fulfillment of what has been expressly stipulated, but also with regard to all the consequences which, according to their character, are in accordance with good faith, use, and law. The Supreme Court of the Commonwealth of Puerto Rico has stated and reiterated that any contract and agreement must have as its foundation principles of good faith and fair dealing in the trade. Requiring good faith in the conduct and actions of all parties is a governing principle in all legal activity and consist in acting in a loyal, honest and fair manner. It assumes faithful compliance with the representations and agreements reached and that a party will not defraud or abuse the trust given by the other. Good faith is a source of duties and conduct that can be demanded in each case in accordance to the nature of the legal relationship and the purpose or objective pursued by the parties through it.

184. The actions and conduct of the UBS Defendants throughout the Class Period clearly and expressly demonstrate a lack and complete absence of

any basic good faith principles or compliance with fair dealing standards in fulfilling their contractual obligations to Plaintiff UDEM AP and the Class, including the contractual obligations arising from Plaintiff UDEM AP and the Class' investments in the Funds. To the contrary, the conduct, actions and dealings of Defendants clearly show complete and absolute bad faith and disregard, not only of the applicable laws and regulations, but of basic principles of fair and honest dealings. This conduct in bad faith has caused damages to Plaintiffs. Total damages incurred are at least tens of millions of dollars, and likely substantially higher. Defendants are jointly and severally liable for all damages, losses and injuries caused thereby.

COUNT VII

Derivative Claims For Violations of Duty to Act in Good Faith
(Against All Defendants)

185. Plaintiffs incorporate by reference and reallege each and every allegation contained above, as though fully set forth herein.

186. Article 1258 of the Civil Code provides that contracts are perfected by mere consent, and from that time they are binding, not only with regard to the fulfillment of what has been expressly stipulated, but also with regard to all the consequences which, according to their character, are in accordance with good faith, use, and law. The Supreme Court of the Commonwealth of Puerto Rico has stated and reiterated that any contract and agreement must have as

its foundation principles of good faith and fair dealing in the trade. Requiring good faith in the conduct and actions of all parties is a governing principle in all legal activity and consist in acting in a loyal, honest and fair manner. It assumes faithful compliance with the representations and agreements reached and that a party will not defraud or abuse the trust given by the other. Good faith is a source of duties and conduct that can be demanded in each case in accordance to the nature of the legal relationship and the purpose or objective pursued by the parties through it.

187. The actions and conduct of Defendants throughout the Relevant Period clearly and expressly demonstrates a lack and complete absence of any basic good faith principles or compliance with fair dealing standards in fulfilling their contractual obligations to the Funds, including the obligations arising out of the Advisory Agreements and the Administrative Agreements. To the contrary, the conduct, actions and dealings of Defendants clearly show complete and absolute bad faith and disregard, not only of the applicable laws and regulations, but of basic principles of fair and honest dealings. This conduct in bad faith has caused damages to the Funds and their shareholders. Total damages incurred are at least tens of millions of dollars, and likely substantially higher. Defendants are jointly and severally liable for all damages, losses and injuries caused thereby.

COUNT VIII

Derivative Claim for Violation of Duties as Agent ("Mandatario") of the Funds Pursuant to the Civil Code of the Commonwealth of Puerto Rico (Against UBS Trust)

188. Plaintiffs incorporate by reference and reallege each and every allegation contained above, as though fully set forth herein.

189. UBS Trust, as investment adviser of the Funds as Principal ("Mandante"), had a duty to act and perform the services hired in accordance to the instructions of the Funds, and in accordance to the applicable laws and regulations and to the nature of the business and the services hired, all in the framework of good faith as described in Count VII above. In the absence of instructions, all acts of UBS Trust, as Agent ("Mandatario") of the Funds, should have been exercised according to the standard of conduct of a good father of a family ("buen padre de familia").

190. UBS Trust breached all instructions and agreements by and between the Funds by advising and acting in furtherance of its interest and the financial benefit of the Defendants against the instructions and best interest of the Funds as Principal.

191. By exceeding the scope of the Agency ("Mandato"), by failing to comply with the Principal's instructions, and actively by participating in a scheme to defraud and deceive and by omitting material information from the Funds as Principal, UBS Trust is

jointly and severally liable with other defendants to the Funds for negligence and fraud. The damages caused and which Defendants are jointly and severally liable are at least tens of millions of dollars, and likely substantially higher.

COUNT IX

Derivative Claims For Violations of Fiduciary Duties Owed to the Funds And Their Shareholders Pursuant to Articles 2.03, 4.03, 4.04 and 4.05 of Act Number 144 of August 10, 1995, as amended, also known as the "General Corporations Act of 1995"
(Against the Director Defendants)

192. Plaintiffs incorporate by reference and reallege each and every allegation contained above, as though fully set forth herein.

193. Director Defendants, as Directors of the Funds, owed to the Funds and its shareholders the duties of care, diligence, fairness and loyalty required pursuant to Articles 2.03, 4.03, 4.04 and 4.05 of Act Number 144 of August 10, 1995, as amended, also known as the "General Corporations Act of 1995." Due to their positions and personal interest in the UBS Defendants, and the clear existence of a conflict of interest, those duties were subject to the highest standard of fiduciary duties.

194. The actions, conduct, decisions and dealings of the Director Defendants as Directors of the Funds in the affairs of the Funds were all undertaken for the benefit and best interest of the UBS Defendants in a

clear breach of all fiduciary duties owed to the Funds and its shareholders.

195. The Defendant Directors were grossly negligent in the exercise of their fiduciary duties of loyalty, fairness and diligence to the Funds and its shareholders and all decisions and transactions approved by the Director Defendants in which the UBS Defendants had a direct or indirect financial and economic interest, including the purchase of the ERS Bonds, are null and void. As a result of this gross negligence Defendant Directors are jointly and severally liable with other defendants to the Plaintiffs for the amounts claimed in this Complaint. Total damages incurred are at least tens of millions of dollars, and likely substantially higher.

COUNT X

Derivative Claims For Violations of Article 101(1-4), Article 102(a) and 103 of the Uniform Securities Act of the Commonwealth of Puerto Rico and Violations of Article 11, 12, 25.1, 25.2, 25.3.4, 25.3.5, 25.36, 25.3.8 25.3.13, 25.6.3. and 25.6.5 of Regulation 6078 (Against the UBS Defendants)

196. Plaintiffs incorporate by reference and reallege each and every allegation contained above, as though fully set forth herein.

197. The UBS Defendants, throughout the Relevant Period, individually and in concert, directly and indirectly, engaged and participated in a continuous course of conduct designed to create, manipulate and artificially inflate the value of the ERS Bonds in or-

der to extract unearned fees. They conspired and employed schemes, devices and artifices to defraud and engage in acts, practices, dealings and course of conduct that included, among others, the omission of material facts that the UBS Defendants had a duty to disclose to the Funds.

198. The UBS Defendants through their participation in all aspects of the transactions, underwriting, investment adviser and broker-dealer, and through the positions of control of the Board of Directors of the Funds, created and participated in a fraudulent and illegal scheme and artifice to defraud that included the looting of the Funds by, among other things, causing the Funds to purchase ERS Bonds to maintain a market for those bonds and to benefit the UBS Defendants, at the expense of the Funds and its shareholders.

199. The UBS Defendants and Director Defendants are liable as direct participants and conspirators in the wrongs complained herein. It was through their positions of control, power and authority of each aspect of the transactions that each of them was able to and did control the conduct herein complained. The actions and omissions by all Defendants have caused and are jointly and severally liable to Plaintiffs for these losses. Total damages incurred are at least tens of millions of dollars, and likely substantially higher.

COUNT XI
Supplemental Jurisdiction Under 28 USC § 1367 and Attorneys Fees and Prejudgment interest

200. Plaintiffs incorporate by reference and reallege each and every allegation contained above, as though fully set forth herein

201. The facts set forth in this Complaint constitute violations to Federal as well as Commonwealth of Puerto Rico statutes. The claims arising from said violations arise from the same nucleus of operative facts. Supplemental jurisdiction to adjudicate all claims under Commonwealth law is appropriate under 28 USC § 1367. Defendants are liable jointly and severally to Plaintiffs for said violations.

202. The Defendants are jointly and severally liable to Plaintiffs for all sums requested in this Complaint, as well as for all prejudgment and post judgment interest, cost and attorneys fees as prescribed by Commonwealth law.

PRAYER FOR RELIEF

WHEREFORE, Plaintiffs demand judgment as follows:

A. Determining that Counts I, II, III, V, VII, VIII, IX, and X are properly maintained as a derivative action and that demand is excused;

B. Certifying Counts IV and VI for treatment as a class action and appointing Plaintiffs and their counsel to represent the Class;

C. A declaration that the Defendants have breached their fiduciary duties under ERISA to Plaintiff UDEM PRSSA and the ERISA Sub-Class;

D. A declaration that the Defendants have breached their fiduciary duties under Commonwealth law to Plaintiff UDEM AP and the Class;

E. A declaration that the Defendants have breached their fiduciary duties under Commonwealth law to the Funds and its shareholders;

F. Judgment in favor of Plaintiffs, on behalf of the Funds, jointly and severally against Defendants, in an amount of actual and other damages to be determined at trial;

G. Judgment in favor of Plaintiffs and members of the Class, jointly and severally against Defendants, in an amount of actual and other damages to be determined at trial;

H. Awarding pre- and post-judgment interest;

I. Awarding attorneys' fees;

J. Awarding compensatory damages;

K. Declaring a constructive trust with regard to all fees obtained in breach of Defendants' fiduciary and other duties to Plaintiffs, the Funds and/or the Class;

L. Requiring disgorgement of all fees obtained from the Funds, Plaintiffs and/or the Class in breach of Defendants' fiduciary and other duties;

M. Awarding cost of suit; and

N. Granting such other and further relief as the Court deems just and proper.

JURY DEMAND

Plaintiffs demand a trial by jury as to all causes of action averred in this Complaint.

UDEM AP VERIFICATION

I, Luis A. Malavé Trinidad, President of the Board of Directors of UNION DE EMPLEADOS DE MUELLES DE PUERTO RICO AP WELFARE PLAN ("UDEM AP"), am authorized to execute this verification on behalf of UDEM AP.

I verify that I have reviewed the foregoing VERIFIED SHAREHOLDER DERIVATIVE ACTION AND CLASS ACTION COMPLAINT ("Complaint"). The facts set forth in the Complaint that relate to UDEM AP's acts and deeds are true to my own knowledge and upon information and belief. With respect to the facts set forth in the Complaint that relate to the acts and deeds of others, as to those matters, I believe them to be true.

I further verify that, as alleged in the complaint, UDEM AP was a shareholder of Puerto Rico Fixed Income Fund II, Inc., Puerto Rico Fixed Income Fund III, Inc., Puerto Rico Fixed Income Fund IV,

Inc., and the Tax-Free Puerto Rico Fund II, Inc. and will remain a shareholder during the course of the lawsuit.

I declare under penalty of perjury that the foregoing is true and correct.

Executed this 19th day of February, 2010 in San Juan, Puerto Rico.

S/LUIS A. MALAVÉ TRINIDAD
LUIS A. MALAVÉ TRINIDAD

UDEM PRSSA VERTIFICATION

I, Luis A. Malavé Trinidad, President of the Board of Directors of UNION DE EMPLEADOS DE MUELLES DE PUERTO RICO PRSSA WELFARE PLAN, ("UDEM PRSSA"), am authorized to execute this verification on behalf of UDEM PRSSA.

I verify that I have reviewed the foregoing VERIFIED SHAREHOLDER DERIVATIVE ACTION AND CLASS ACTION COMPLAINT ("Complaint"). The facts set forth in the Complaint that relate to UDEM PRSSA's acts and deeds are true to my own knowledge and/or upon information and belief. With respect to the facts set forth in the Complaint that relate to the acts and deeds of others, as to those matters, I believe them to be true.

I further verify that, as alleged in the complaint, UDEM PRSSA was a shareholder of Puerto Rico Fixed Income Fund II, Inc., Puerto Rico Fixed Income Fund III, Inc., and the Puerto Rico Fixed Income Fund IV, Inc. and will remain a shareholder during the course of the lawsuit.

I declare under penalty of perjury that the foregoing is true and correct.

Executed this 19th day of February, 2010 in San Juan, Puerto Rico.

S/LUIS A. MALAVÉ TRINIDAD
LUIS A. MALAVÉ TRINIDAD

Dated:
February 19, 2010

Harry Anduze Montaño - 114910
HARRY ANDUZE MONTAÑO
LAW OFFICES
1454 Fernández Juncos Avenue
San Juan PR 00909
Tel: (787) 723-7171
Fax: (787) 723-7278
handuze@microjuris.com

By: s/Harry Anduze Montaño
Harry Anduze Montaño

José Sosa Llorens- 203801
SOSA LLORENS, CRUZ
NERIS & ASSOCIATES, LLP
Centro Internacional de Mecadeo
Carr. 165, Torre I,
Suite 605
Guaynabo, PR 00968
Tel: (787) 782-3400
Fax: (787) 782-3440
j.sosa@slcnlaw.com
By: s/José Sosa Llorens
José Sosa Llorens

Jay W. Eisenhofer
Keith M. Fleischman
GRANT & EISENHOFER P.A.
485 Lexington Avenue
New York, NY 10017
Tel.: 646-722-8500
Fax: 646-722-8501
jeisenhofer@gelaw.com
kfleischman@gelaw.com

Cynthia A. Calder
Mary S. Thomas
GRANT & EISENHOFER P.A.
1201 North Market Street
Wilmington, DE 19801
Tel: 302-622-7000
Fax: 302-622-7100
ccalder@gelaw.com
mthomas@gelaw.com

Mark C. Gardy
James S. Notis
Kelly A. Noto
GARDY & NOTIS, LLP
560 Sylvan Avenue
Englewood Cliffs, NJ 07632
Tel.: 201-567-7377
Fax: 201-567-7337
mgardy@gardylaw.com
jnotis@gardylaw.com
knoto@gardylaw.com

Douglas R. Hirsch
Charles H. Dufresne, Jr.
Christiaan D. Johnson-Green
SADIS & GOLDBERG LLP
551 Fifth Avenue, 21st Floor
New York, NY 10176
Tel: 212-573-6660
Fax: 212-573-6661
dhirsch@sglawyers.com
cdufresne@sglawyers.com
cjohnson-green@sglawyers.com

Attorneys for Plaintiffs