OnPoint

Dechert LLP

January 2013
A Legal Update From Dechert LLP

The First Circuit Court of Appeals Articulates a Stricter Independence Standard for Fund Directors When Evaluating Demand Futility in Shareholder Derivative Cases

The U.S. Court of Appeals for the First Circuit, in *Unión de Empleados de Muelles de Puerto Rico PRSSA Welfare Plan, v. UBS Financial Services Inc. of Puerto Rico*, No. 11-1605, --- F.3d ----, 2013 WL 49818 (1st Cir. Jan. 4, 2013), recently applied a stricter independence standard for fund directors and their business relationships in the context of shareholder derivative litigation against investment advisers. The Court's ruling may heighten courts' scrutiny of board directors' current and prospective business relationships with investment advisers and their affiliates.

Shareholders in a derivative action must first make a demand on the board before filing a complaint or plead why such demand would be futile. Demand is futile when a majority of the board is comprised of directors who cannot consider the lawsuit impartially. Failure to properly plead "demand futility" often leads to the dismissal of shareholder derivative actions.

Plaintiffs in *Unión de Empleados* are two Puerto Rico-based pension plans that own shares in several closed-end investment funds (the "Funds") advised by UBS Trust Company of Puerto Rico ("UBS Trust"), a subsidiary of UBS AG.[1] Their suit against the Funds' directors, UBS Trust and its affiliate UBS Financial Services Inc. of Puerto Rico ("UBS Financial") challenged the Funds' purchase of approximately $757 million worth of bonds underwritten by UBS Financial in 2008. Those purchases allegedly resulted in substantial losses to the Funds when the bonds' value declined. The district court granted the defendants' motion to dismiss on the ground that no presuit demand had been made and plaintiffs did not sufficiently plead demand futility. However, the First Circuit reversed that ruling.

The Court of Appeals first made the threshold ruling that the Delaware law demand futility test in *Rales v. Blasband*, 634 A.3d 927 (Del. 1993), would apply in the mutual fund context where directors delegate the authority to make investment decisions on behalf of the funds to the investment adviser, in this case UBS Trust. To allege demand futility under *Rales*, a plaintiff must allege particularized facts that 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."

The First Circuit then determined that the district court's demand futility analysis was flawed in two significant ways. First, the district court had focused too narrowly on whether Plaintiffs had alleged that the individual directors received a financial benefit from the board transactions. Rather, the Court explained that *Rales* required a broader analysis of the facts sufficient to demonstrate "that each director has . . . significant connections to the defendants, whether personal, financial, or otherwise . . ." Second, the First Circuit found the district court overstated the burden plaintiffs bore at the pleading stage to demonstrate relationships between the Fund directors and the UBS defendants. The Court held that plaintiffs need not demonstrate conclusive evidence of the materiality of these relationships, but only "some particulars from which it could reasonably be inferred that the director's objective judgment would be impaired."

The Court then evaluated the plaintiffs' allegations against six of the eleven members of the identical boards of directors for the funds, as the plaintiffs needed to only demonstrate that a majority of the board was not independent to satisfy the *Rales* demand futility test. Not surprisingly, the plaintiffs established the requisite lack of independence for four Fund directors who were employed by defendant UBS Trust, defendant UBS

Financial or other UBS affiliates. But the Court also held that plaintiffs' allegations were sufficient for two Fund directors who were not employed by any UBS affiliate, but rather by a large health care company in Puerto Rico ("HealthCo"). The plaintiffs had alleged that UBS Financial had served as the placement agent for a $35 million bond offering by HealthCo in 2006; UBS Trust had purchased the entire offering and resold the notes to several of the funds it advised. The Court found that HealthCo's use of the relationship between UBS Trust and UBS Financial in a transaction that had occurred four years before the Complaint was filed gave these directors "'reason to discourage scrutiny of any similar related party transactions.'" Moreover, the Court accepted the plaintiffs' argument that these two Fund directors were incentivized to remain in the good graces of UBS Trust and UBS Financial for possible *future* business ventures, since these two UBS defendants were alleged to be large and influential forces in Puerto Rico's financial markets. As a result of this ruling, the plaintiffs will be permitted to sue the Fund directors, UBS Trust and UBS Financial derivatively on behalf of the Funds.

The First Circuit's analysis of the two HealthCo directors potentially has broad implications for other fund directors who are not affiliated with investment advisers. The two HealthCo directors would not have been considered "interested persons" under section 2(a)(19) of the 40 Act. However, under the First Circuit's analysis, fund directors whose principal employers have done business with an investment adviser or its affiliates in the past, or who may do such business in the future, may not be considered disinterested for purposes of assessing shareholder litigation against the investment adviser. The analysis of incentives arising from possible future business relationships significantly expands a theory that has previously only been applied in limited circumstances where corporate directors expected future benefits from controlling shareholders because other directors had received similar benefits from those shareholders.[2] Although the First Circuit's ruling relies upon allegations that UBS Trust and UBS Financial dominate the financial services market in Puerto Rico, plaintiffs in future shareholder derivative suits will no doubt seek to apply the decision more broadly. This ruling may heighten courts' scrutiny of fund directors' business relationships and dealings to examine the mere possibility of a future *quid pro quo* – not simply past relationships.

This decision raises critical questions that fund boards and fund advisers should consider with regard to fund corporate governance, fund board composition, and fund director independence as well as in connection with investigations and responses to shareholder derivative actions.

Footnotes

[1] The Funds were exempt from registration under the Investment Company Act of 1940 ("the 40 Act"), pursuant to section 6(a)(1), which exempts certain funds sold only to Puerto Rican investors. UBS Trust was not registered under the Investment Advisers Act of 1940.

[2] *See, e.g., In re Tyson Foods, Inc. Consol. S'holder Litig.*, 919 A.2d 563, 584 (Del. Ch. 2007) (finding that a director's potential receipt of future benefits from a third party, which was not his employer, could compromise his independence where other employees in a similar role to the director had gone on to receive partnerships and significant income from related-party transactions).

This update was authored by:

Linda C. Goldstein*
New York
Send an email
T: +1 212 698 3817

Galia Porat
Philadelphia
Send an email
T: +1 215 994 2462

* Ms. Goldstein has advised the Funds at issue in this case in related litigation.

For more information about our Fund Litigation and Enforcement practice, please visit our website.