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SECURITIES UPDATE

Investment Funds' Failure to Report Beneficial Ownership of CSX Shares "Owned" Through Total Return Swaps Violated Section 13(d)

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The United States District Court for the Southern District of New York recently held in *CSX Corporation v. The Children's Investment Fund Management (UK) LLP, et al*, (08 Civ. 2764 (LAK) June 11, 2008),[1] a case involving the proxy fight between two investment fund families and CSX Corporation, that the funds had violated Section 13(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), by failing to disclose beneficial ownership of CSX shares in which the funds had economic interests through total return swaps. The court sidestepped ruling on the central issue in the case, whether total return swaps confer beneficial ownership on the "long" party to the swap, and instead decided the case based on a finding that the total return swaps in which the investment funds participated were part of a plan or scheme to evade the reporting requirements of Section 13(d) and, thus, conferred on the funds beneficial ownership of the shares underlying the swaps.

Background

The case arose out of a proxy contest in which two groups of investments funds and related parties, one affiliated with The Children's Investment Fund Management (UK) LLP (the "TCI Funds") and one affiliated with 3G Capital Partners Ltd. (the "3G Funds"), were seeking, among other things, to elect their nominees to five of the twelve seats on the CSX board of directors.

The TCI Funds acquired their first investment exposure to CSX in October 2006 through total return swaps.[2] Ultimately, the TCI Funds acquired approximately 4 percent of CSX's outstanding shares and had an economic exposure to approximately an additional 11 percent through total return swaps. The TCI Funds contacted CSX's management following the TCI Funds' initial investment in CSX and at various times thereafter, disclosing their economic interest in CSX and suggesting various alternatives for enhancing the value of CSX's shares, including a possible leveraged buyout. In August 2007, the TCI Funds began working on plans for a proxy contest at CSX's 2008 annual stockholders' meeting at which they would propose a "short slate" of two directors.

The 3G Funds made their initial investment in CSX in February 2007, acquiring nearly 2 percent of CSX's outstanding shares. The 3G Funds ultimately acquired ownership and economic exposure (through total

return swaps) in an aggregate of over 4 percent of CSX's outstanding shares. The 3G Funds sought to meet with CSX's management, but to no avail. In October 2007, the 3G Funds began working on their own plans for a proxy contest at CSX's 2008 annual stockholders' meeting at which they would propose to elect directors.

On December 19, 2007, a group (collectively the "Group"), comprised of the TCI Funds, the 3G Funds and three individuals who had agreed to become nominees to serve on CSX's board of directors, filed a Schedule 13D with the Securities and Exchange Commission (the "SEC"). The filing disclosed that the members of the Group had entered into an agreement to coordinate certain of their efforts with regard to the purchase and sale of CSX shares and that the Group intended to conduct a proxy solicitation. The filing also disclosed that the Group collectively owned 8.3 percent of CSX's outstanding shares, that the TCI Funds had cash-settled swaps with respect to approximately 11 percent of CSX's outstanding shares and that the 3G Funds had similar swaps with respect to 0.8 percent of CSX's outstanding shares. Both the TCI Funds and the 3G Funds disclaimed beneficial ownership of the shares underlying their respective swaps.

On March 10, 2008, the Group filed its preliminary proxy statement with the SEC. The Group proposed to elect five directors and to amend CSX's by-laws to permit holders of 15 percent of CSX's shares to call a special stockholders meeting. The preliminary proxy statement noted that the Group collectively held 35.1 million shares, representing approximately 8.7 percent of CSX's outstanding shares, as well as the swap arrangements and the aggregate percentage of CSX shares subject to the swaps.

CSX filed suit against the Group contending, among other things, that the TCI Funds had violated Section 13(d) of the Exchange Act by failing to disclose their beneficial ownership of the shares of CSX subject to the total return swaps, and that the TCI Funds and the 3G Funds violated Section 13(d) by failing timely to disclose the formation of a group. Among the remedies sought by CSX, it asked the court to enjoin the TCI Funds and the 3G Funds from voting any of their CSX shares.

Discussion

DETERMINATION OF BENEFICIAL OWNERSHIP

Section 13(d) of the Exchange Act requires any person who acquires "beneficial ownership" of 5 percent or more any class of equity security registered under the Exchange Act to publicly disclose that fact in a filing with the SEC. Rule 13d-3(a) under the Exchange Act, which defines what constitutes "beneficial ownership," provides that:

> For the purposes of sections 13(d) and 13(g) of the Act a beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares:
>
> (1) Voting power which includes the power to vote, or to direct the voting of, such security; and/or,
>
> (2) Investment power which includes the power to dispose, or to direct the disposition of, such security.

The *CSX* court observed that the question of whether a total return equity swap confers beneficial ownership under this rule was one of first impression. The court first noted that the SEC intended Rule 13(d)-3(a) to provide a broad definition of "beneficial ownership," and that this determination required "[a]n analysis of all relevant facts and circumstances in a particular situation ... in order to identify each person possessing the requisite voting power or investment power."[3] In the *CSX* matter, factors the court considered included:

- A total return equity swap placed the funds in the same economic position as though they owned the referenced shares outright.
- With respect to investment power, while counterparties are not obligated to hedge their positions with purchases of the underlying shares, they inevitably do so.
- Although a total return equity swap may be designed to settle in cash, the parties to the swap contract may consent to settlement in the form of delivery of the underlying shares.
- The funds had influence over the voting of the shares in question when the counterparties hedged their position in the total return equity swap contracts by purchasing the underlying shares. The voting policies of the counterparties vary: some will not vote them, or will not vote them in a contested matter, which would prevent these shares from being voted against the position that the funds were taking in a related proxy contest. Additionally, some counterparties may vote in accordance with the desires of the funds. The court also speculated that counterparties that claim to vote such shares in their own discretion, may be influenced in their voting to vote as the funds would like in the hopes of attracting new business from their clients.

While in this case, the court found the arguments for treating cash-settled total return equity swaps as conferring beneficial ownership for the purposes of Section 13(d) persuasive, the court ultimately found it unnecessary to make a ruling on that point. Instead the court relied on Rule 13d-3(b), which provides that:

> Any person who, directly or indirectly, creates or uses a trust, proxy, power of attorney, pooling arrangement or any other contract, arrangement, or device with the purpose of effect of divesting such person of beneficial ownership of a security or preventing the vesting of such beneficial ownership as part of a plan or scheme to evade the reporting requirements of section 13(d) or (g) of the Act shall be deemed for purposes of such sections to be the beneficial owner of such security.

Based on the facts in question, the court found that the hedge funds were amassing their swap positions as part of a plan or scheme to avoid disclosure that would have been required if they had bought the shares outright, and so deemed the hedge funds to be the beneficial owners of CSX stock represented by the swap.[4] In addition to the facts discussed above, the court was particularly persuaded by the fact that the hedge funds had spread their swap transactions among numerous counterparties in an attempt to avoid disclosure of the position they were building in CSX stock.

CSX sought, among other things, injunctive relief to preclude the investment funds from voting their shares at the upcoming annual meeting as a penalty for these violations of Section 13(d). The court concluded it could only apply this remedy if it found that the CSX shareholders would suffer irreparable injury because of the violations of Section 13(d). The court noted that "private plaintiffs usually are unable to establish an irreparable harm once the relevant information has been made available to the public" unless the defendant has obtained "a degree of effective control" as a result of purchases made before it had complied with Section 13(d). In light of the fact that the Group ultimately filed a Schedule 13D, which the court did not find was false, misleading or otherwise inadequate as to any material fact, the court was unable to find irreparable injury and the relief granted was limited to a permanent injunction restraining future violations of Section 13(d). The court did state that "[w]ere the Court free as a matter of law, however, to grant such an injunction, whether on the basis that such relief is warranted to afford deterrence or on another basis, it would do so."

Implications

Before discussing the implications of the case, we should remind readers of the old adage "bad facts make bad law." Total return swaps have many legitimate uses, including allowing an investor to leverage its capital, allowing an investor uninterested in waging a proxy fight to obtain a significant ownership interest in a company and thus a "seat at the table" to push for changes and allowing a non-US fund to gain economic exposure to a US company without having to pay withholding taxes on dividends. Total return swaps can also be used to gain significant economic exposure to a company without reporting. In the *CSX* case, the court found that the investment funds used total return swaps to intentionally circumvent the disclosure requirements of Section 13(d) and that they did so in a particularly flagrant manner. It is unclear whether the court would have reached the same conclusion had it been presented with less flagrant conduct.

While the court did not decide whether *all* long counterparties of cash-settled total return equity swaps, or even the investment funds in this case, should be considered beneficial owners of the referenced shares under Rule 13d-3(a) of the Exchange Act, the analysis clearly signals the court's receptiveness to such an argument on similar facts. For the time being,[5] investors using cash-settled total return equity swaps may very well feel the need to treat their derivative positions as the equivalent of the beneficial ownership of the referenced shares. The requirement to disclose this beneficial ownership may dampen the willingness of some funds to take positions in companies or, at least, will reduce the attractiveness of using total return swaps to do so.

Some funds may, however, view the court's unwillingness to rule on this specific point as proof that, absent egregious facts, long positions under cash-settled total return swaps are not the equivalent of beneficial ownership. Certainly, guidance from the Second Circuit or further rulemaking from the SEC or its staff, would be helpful.

Public companies may see in this ruling a potential new defense for safeguarding themselves against activist shareholders.

However, given the court's asserted inability to provide any meaningful sanctions once proper disclosure is made, it is unclear whether this new weapon has any teeth.

Finally, the *CSX* decision may have implications for financial institutions acting as the short party on total return swaps. In order to avoid reputational risks, financial institutions often adopt policies to ensure that their customers are entering into transactions for legitimate business reasons and are otherwise complying with applicable laws, including federal securities laws. In light of the *CSX* court's finding that the investment funds had entered into the total return swaps with the intent to evade the reporting requirements of Section 13(d), financial institutions may decide that, under appropriate circumstances, they will want to confirm that their customers or counterparties have legitimate business reasons for entering into the transactions other than avoiding the reporting requirements of Section 13(d) and that they are complying with all applicable laws.

Endnotes

1. http://www1.nysd.uscourts.gov/cases/show.php?db=special&id=79

2. Under the terms of the total return swaps, the "short" party" (i.e., the financial institution counterparties) agreed to pay the "long" party (i.e., either the TCI Funds or the 3G Funds) (1) any cash distributions on the underlying CSX shares, and (2) an amount equal to the market appreciation in the value of the CSX shares over the term of the swap. In turn, the long party agreed to pay the short party the interest that would have been payable had the long party actually borrowed the CSX shares plus any decrease in the market value of the CSX Shares. Under the terms of the swaps, the long party did not have the right to vote the referenced CSX shares or to direct the short party as to how to vote the shares nor did it have the right to acquire the underlying CSX shares.

3. It is interesting to note that the SEC's Division of Corporation Finance submitted an amicus letter, in response to a request by the judge, stating that "a standard cash-settled equity swap agreement, in and of itself, does not confer on a party, here the investment funds, any voting power or investment power over the shares a counterparty purchases to hedge its position. In our view, the conclusion is not changed by the presence of economic or business incentives that the counterpart may have to vote the shares as the other party wishes or to dispose of the shares to the other party."

4. The SEC's amicus letter stated that "[i]n the Division's view, the long party's underlying motive for entering into the swap transaction generally is not a basis for determining whether there is a 'plan or scheme to evade' Rule 13d-3. . . We believe that the mental state contemplated by the words 'plan or scheme to evade' is generally the intent to enter into an arrangement that creates a false appearance." The court disagreed with the SEC's position stating "An appearance of non-ownership cannot be false unless one in fact is at least a beneficial owner. That beneficial ownership would satisfy Rule 13d-3(a), thus making Rule 13d-3(b) superfluous. In consequence, Rule 13d-3 as a whole is inconsistent with any view that a false appearance of non-ownership is a prerequisite to application of Rule 13d-3(b)."

5. Both CSX and the investment funds have filed notices of appeal.

If you have any questions regarding the court's decision discussed above, please contact any of the attorneys listed below or any other member of our Corporate & Securities group.

Edward S. Best
312 701 7100
ebest@mayerbrown.com

Michael T. Blair
312 701 7832
mblair@mayerbrown.com

Michael R. Butowsky
212 506 2512
mbutowsky@mayerbrown.com

James B. Carlson
212 506 2515
jcarlson@mayerbrown.com

Robert E. Curley
312 701 7306
rcurley@mayerbrown.com

Sterling M. Dorish
212 506 2587
sdorish@mayerbrown.com

Eric J. Finseth
650 331 2066
efinseth@mayerbrown.com

Marc H. Folladori
713 238 2696
mfolladori@mayerbrown.com

Robert F. Gray
713 546 0522
rgray@mayerbrown.com

Lawrence R. Hamilton
312 701 7055
lhamilton@mayerbrown.com

Robert A. Helman
312 701 7020
rhelman@mayerbrown.com

Michael L. Hermsen
312 701 7960
mhermsen@mayerbrown.com

Philip J. Niehoff
312 701 7843
pniehoff@mayerbrown.com

Elizabeth A. Raymond
312 701 7322
eraymond@mayerbrown.com

Laura D. Richman
312 701 7304
lrichman@mayerbrown.com

David A. Schuette
312 701 7363
dschuette@mayerbrown.com

Jodi A. Simala
312 701 7920
jsimala@mayerbrown.com

Frederick B. Thomas
312 701 7035
fthomas@mayerbrown.com

Mark R. Uhrynuk
44 207 246 6217
muhrynuk@mayerbrown.com

James R. Walther
213 229 9597
jwalther@mayerbrown.com

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