



# Implications of the Second Circuit Decision in *CSX Corporation v. The Children's Investment Fund Management (UK) LLP*

**David H. Pankey  
David L. Ronn  
David N. Oakey**

[www.mcguirewoods.com](http://www.mcguirewoods.com)

**McGUIREWOODS**

McGuireWoods news is intended to provide information of general interest to the public and is not intended to offer legal advice about specific situations or problems. McGuireWoods does not intend to create an attorney-client relationship by offering this information, and anyone's review of the information shall not be deemed to create such a relationship. You should consult a lawyer if you have a legal matter requiring attention.

Copyright © 2011 by McGuireWoods LLP. All rights reserved.

# IMPLICATIONS OF THE SECOND CIRCUIT DECISION IN *CSX CORPORATION V. THE CHILDREN'S INVESTMENT FUND MANAGEMENT (UK) LLP*

## INTRODUCTION

CSX Corporation's (CSX) 2008 annual meeting resulted in significant litigation concerning the beneficial ownership provisions of Section 13(d) of the Securities Exchange Act of 1934 (Exchange Act). Two hedge funds, The Children's Investment Fund Management (TCI) and 3G Capital Partners (3G), conducted a proxy contest relating to the meeting.

TCI and 3G entered into cash-settled total return equity swaps (TRSs) relating to CSX common shares. TRSs are contracts in which parties agree to exchange sums equivalent to the income streams produced by specified assets. This type of swap does not transfer title to the underlying assets or require that either party actually own them.

The litigation arising out of the 2008 CSX proxy contest centered around the beneficial ownership implications of TRSs. Although the U.S. Court of Appeals for the Second Circuit recently dealt with these issues, it did not resolve the beneficial ownership questions raised by TRSs. However, the Second Circuit decision provides guidance on when a "group" is formed for purpose of Section 13(d), as well as the use of an injunction as a remedy for violations of Section 13(d).

## EXECUTIVE SUMMARY

The CSX case dramatically demonstrates the difficulty of using 13(d) violations as a defensive tactic. This litigation started in 2008, failed to impact the voting by TCI and 3G at the 2008 CSX annual meeting and just now, three years later, is being "decided" on appeal.

*TRS Implications.* The Second Circuit was unable to reach agreement concerning whether or when the long party in a cash-settled TRS will be deemed to beneficially own shares referenced by the TRS held by the counterparty. Legitimate hedging transactions may not be impacted by this litigation, or by the SEC rules described below. Risk continues to exist in situations like those presented in the CSX case, where swaps are used in connection with attempts to influence management.

*Implications for Group Formation.* The Second Circuit, however, did provide some guidance on when shareholders have formed a group for purposes of Section 13(d). The Second Circuit held that a group is not formed as a result of concerted action by

shareholders unless the purpose of the concerted action is to acquire, hold, vote or dispose of equity securities of the issuer.

When a “group” has been formed for the purpose of 13(d), all members of the group are deemed to beneficially own all the shares owned by the other members of the group. If the shares beneficially owned by all members of the group exceed 5 percent of the outstanding class, a filing with the SEC is required. Failure to file can result in securities law violations. In addition, creation of a “group” can have consequences under Section 16 of the Exchange Act, including Section 16(b).

This Second Circuit decision provides more leeway to shareholders to discuss with other shareholders the business of a company in which they hold shares. However, shareholders still need to be aware of the circumstances that could result in a finding of “group” status.

*Implications for Shareholder Rights Plans.* Because the beneficial ownership of TRSs is in a state of flux, issuers may want to review their shareholder rights plans and equity security-based compensation plans. Under these plans, beneficial ownership is usually based on the Section 13 definition. It is currently unclear whether this definition includes these types of TRSs, so an issuer may want to deal with these types of securities expressly in its plans, rather than relying solely on the Section 13(d) beneficial ownership definition.

## **EXPLANATION OF TRSs**

Total-return swaps are contracts in which parties agree to exchange sums equivalent to the income streams produced by specified assets. Total-return equity swaps involve an exchange of the income stream from:

- (1) a specified number of shares in a designated company’s stock; and
- (2) a specified interest rate on a specified principal amount.

The party that receives the stock-based return is called the “long” party and the party that receives the interest-based return is called the “short” party.

In a TRS, the long party periodically pays the short party a sum calculated by applying an agreed-upon interest rate to an agreed-upon notional amount of principal, as if the long party had borrowed that amount of money from the short party. The short party periodically pays the long party a sum equivalent to the return to a shareholder in the specified company – the increased value of the shares, if any, plus income from the shares – as if the long party owned actual shares in that company.

As a result, the financial return to the long party in a total-return equity swap is similar to the return when borrowed capital is used to purchase shares in the company in question. TCI and 3G were the long parties in these TRSs.

The short party's financial return, in turn, is similar to the return to someone who sold short and then lent out the proceeds of that sale. However, because of the inherent risks in short-equity positions, the short party in a TRS usually purchases an equivalent number of shares to hedge their short exposure. The short parties in the CSX case were financial institutions.

Total-return equity swaps may be "settled-in-kind" or "cash-settled."

### ***Settled-in-Kind***

Upon termination of settled-in-kind swaps, the long party receives the referenced security in exchange for a payment equal to the security's market price at the end of the previous payment period.

### ***Cash-Settled***

Upon termination of cash-settled swaps, the short party pays the long party the sum of the referenced equity security's appreciation in market value and other net cash flows (such as dividend payments) that have occurred since the most recent periodic payment. If this sum is negative, the short party receives the corresponding amount from the long party.

The TRSs in this case were cash-settled. Unlike settled-in-kind swaps, cash-settled swaps do not give the long party a right to acquire ownership of the referenced assets from the short party. Otherwise, settled-in-kind and cash-settled equity swaps are economically equivalent.

## **BACKGROUND**

In October 2006, TCI began acquiring a significant economic interest in CSX through cash-settled TRSs. By the end of 2006, TCI had TRS positions representing 8.8 percent of the outstanding CSX stock. By January 22, 2007, this percentage was 10.5 percent and by February 15, 2007, TCI's TRS position represented 13.6 percent of the CSX outstanding common stock.

In March 2007, TCI's position in TRSs represented approximately 14.1 percent of the outstanding shares of CSX. TCI told CSX on several occasions that these swaps could be immediately converted to actual shares, with voting rights.

TCI's cash-settled TRSs did not give TCI the ability to vote the CSX shares referenced by the TRSs. As a result, TCI did not file a 13D concerning its interest in CSX. TCI's eight counterparties purchased shares of CSX common stock in amounts virtually the same as the CSX shares referenced in the TRSs, to hedge their exposure. No single counterparty acquired more than 5 percent of the common stock of CSX to hedge their TRS risk.

TCI also sought corporate changes at CSX. TCI discussed CSX with other private funds, suggesting that they buy CSX shares and that CSX had become a TCI target. TCI also proposed a leveraged buyout of CSX and on March 2, 2007, filed a premerger notification under the Hart-Scott-Rodino Act.

3G also expressed interest in CSX. During 2007, 3G and TCI discussed CSX many times.

During 2007, 3G also began accumulating a position in CSX. 3G purchased 4.1 percent of the outstanding CSX shares and had TRS positions representing 0.8 percent of the outstanding CSX shares, for a total of 4.9 percent.

In October 2007, TCI and 3G started looking for director nominees for a potential proxy contest.

TCI, 3G and three potential directors entered into nominee agreements and shortly thereafter, on December 19, 2007, TCI and 3G filed a Schedule 13D, disclosing formation of a “group” under Section 13(d) and the possibility of a proxy contest.

On January 8, 2008, the funds notified CSX of their intent to conduct a proxy contest.

CSX sued TCI and 3G to prohibit them from voting at the 2008 CSX shareholders meeting.

## **THE DISTRICT COURT DECISION**

The U.S. District Court for the Southern District of NY found that:

- TCI was the beneficial owner of shares of CSX common stock referenced by cash-settled TRSs purchased by TCI, because TCI was using the TRSs as part of a plan to evade the 13(d) reporting requirements. The district court did not find that the TRSs themselves conveyed beneficial ownership.
- TCI and 3G formed a “group” before filing a 13D with the SEC.

The district court concluded that TCI and 3G had violated Section 13(d) and enjoined TCI and 3G from future 13(d) violations. This injunction was not limited to shares of CSX, but applied generally. The district court decision appears to have been influenced by the court’s obvious frustration with the testimony of several of the representatives of TCI and 3G.

However, the district court found that it was foreclosed as a matter of law from granting an injunction prohibiting TCI and 3G from voting their CSX shares at the 2008 CSX annual shareholders meeting because the required 13(d) disclosures were ultimately made in sufficient time for shareholders to cast informed votes at the shareholders’ meeting.

## THE SECOND CIRCUIT DECISION

*No Agreement on TRSs.* The Second Circuit was unable to reach agreement on whether the holder of a TRS is a beneficial owner of shares held by its swap counterparty as a hedge. As a result, the Second Circuit confined its analysis of the beneficial ownership issues to the CSX common shares directly owned by TCI or 3G.

*Group Formation.* The Second Circuit did not rule on whether the district court mistakenly concluded that TCI and 3G had formed a group before their first 13D filing, and remanded to the district court for further deliberations based on shares owned directly, and without regard to the TRSs. However, the court did rule that the district court's findings of a group based on concerted actions by TCI and 3G were insufficient because the district court failed to make a finding that the purpose of the concerted actions was to acquire, hold, vote or dispose of CSX shares, as required by Section 13(d) and Rule 13d-5(b)(1).

*Injunction too Broad.* The Second Circuit vacated the district court's injunction imposed on TCI and 3G and directed the district court to reconsider the scope of the injunction, particularly whether the injunction should be limited to CSX common shares.

An issuer has an implied right to seek injunctive relief for a violation of Section 13(d), and to obtain an injunction an issuer needs to demonstrate that it meets the traditional requirements for equitable relief, irreparable harm, as well as a danger of future violations.

The Second Circuit questioned whether an injunction covering all equity securities was justified, in other words, not just CSX common shares. The Second Circuit directed the district court to reconsider the scope of its injunction on remand.

*No Prohibition on Voting.* The district court found that it was foreclosed as a matter of law from enjoining the funds' voting of CSX shares acquired between the latest date on which their Section 13(d) disclosure obligations might have begun and the date on which they actually made those disclosures.

In *Treadway Companies, Inc. v. Care Corp.*, 638 F2d 357 (2d Cir. 1980), the Second Circuit held that because shareholders had received the required information four months before the proxy contest in that case, "there was no risk of irreparable injury and no basis for injunctive relief."

In the CSX case, TCI and 3G filed their 13D in December 2007, approximately six months before the June 25, 2008, shareholders' meeting. Therefore, based on *Treadway*, the Second Circuit concluded that injunctive share "sterilization" was not available.

After the Second Circuit issued its decision, CSX withdrew its appeal.

## **RELEVANT SEC PROVISIONS**

Section 766 of the Dodd-Frank Act amended the Exchange Act by adding Section 13(o), which provides that a person will acquire beneficial ownership of an equity security based on the purchase or sale of a security-based swap, only to the extent that the SEC, by rule, determines that the security-based swap provides incidents of ownership comparable to direct ownership of the equity security.<sup>1</sup>

Section 766 and Section 13(o) became effective on July 16, 2011.

On March 17, 2011, the SEC proposed to readopt the applicable portions of Rules 13d-3 and 16a-1(a) that relate to determinations of beneficial ownership as they pertain to security-based swaps.

On June 8, 2011, the SEC adopted this proposal. The SEC intended to make sure that the effectiveness of Section 13(o) of the Exchange Act did not result in the beneficial ownership provisions ceasing to apply to security-based swaps.

The SEC did note in the adopting release that the staff of the SEC is working on proposals to modernize reporting under Sections 13(d) and 13(g). Thus, it is possible that the SEC will provide greater clarity in the future as to the beneficial ownership implications of TRSs.

Where a security-based swap confers voting and/or investment power (or a person otherwise acquires such power based on the purchase or sale of a security-based swap), grants a right to acquire an equity security, or is used with the purpose or effect of divesting or preventing the vesting of beneficial ownership as part of a plan or scheme to evade the reporting requirements, the SEC rules may require the reporting of beneficial ownership.

### ***Voting or Investment Power***

Under Rule 13d-3(a), to the extent a security-based swap provides a person, directly or indirectly, with exclusive or shared voting and/or investment power over the equity security through a contractual term of the security-based swap or otherwise, the person becomes a beneficial owner of that equity security.

Under Rule 13d-3(a), a person may become a beneficial owner even though the person has not acquired the equity security. The SEC stated that under readopted Rule 13d-3(a), a determination may continue to be made that a beneficial owner of equity securities includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has or shares voting

---

<sup>1</sup> The term “security-based swap” is defined in Section 3(a)(68) of the Exchange Act.

power and/or investment power over the securities based on the purchase or sale of a security-based swap.

### ***Arrangement or Device***

Rule 13d-3(b) generally provides that a person is deemed to be a beneficial owner if that person uses any contract, arrangement or device as part of a plan or scheme to evade the beneficial ownership reporting requirements.

To the extent a security-based swap is used with the purpose or effect of divesting a person of beneficial ownership or preventing the vesting of beneficial ownership as part of a plan or scheme to evade Sections 13(d) or 13(g), the security-based swap may be viewed as a contract, arrangement or device within the meaning of those terms as used in Rule 13d-3(b). The SEC stated that under readopted Rule 13d-3(b), any person who uses a security-based swap as part of a plan or scheme to evade reporting beneficial ownership continues to be subject to the requirement to disclose the accumulation of an influential or control position in a public issuer.

The district court based its analysis on Rule 13d-3(b).

### ***Right to Acquire***

Under Rule 13d-3(d)(1), a person is deemed to be a beneficial owner of an equity security if the person has a right to acquire the equity security within 60 days or holds the right with the purpose or effect of changing or influencing control of the issuer of the security for which the right is exercisable, regardless of whether the right to acquire originates in a security-based swap or an understanding in connection with a security-based swap. This type of right to acquire an equity security, if obtained through the purchase or sale of a security-based swap, is treated the same as any other right to acquire an equity security and results in a person being deemed a beneficial owner under Rule 13d-3(d)(1). The SEC stated that readopted Rule 13d-3(d)(1) continues to apply to any person who obtains such a right based on the purchase or sale of a security-based swap.

The SEC readopted these rules approximately a month before the Second Circuit decision. Accordingly, this readoption by the SEC did not include a reconsideration of the application of these rules to the types of swaps used in the CSX case based on the Second Circuit decision.

The Second Circuit was unable to reach a conclusion on whether these rules result in beneficial ownership for the types of swaps at issue in the CSX case. On specific facts, these rules could result in a finding of beneficial ownership based on a TRS. A TRS could be used as part of a “scheme or device.” While the Second Circuit was unable to reach a consensus on this approach, risk remains on this issue. The next time around, the Second Circuit might be able to reach agreement on this issue, and of course, other courts might agree with the district court. In addition, the short

counterparties in a cash-settled TRS almost always cover their risk by purchasing the referenced shares. As a practical matter, the long counterparty can usually acquire these shares from the short counterparty. As a result, TRSs held with the purpose or effect of changing or influencing control of an issuer could also result in beneficial ownership under the “right to acquire” rule.

Accordingly, substantial uncertainty exists with respect to the beneficial ownership of the shares referenced in a cash-settled TRS by the long party.

## **IMPLICATIONS FOR TRSs**

Because the district court’s ruling was based on “concerted action” and a “plan to evade,” the district court determined that it wasn’t necessary to decide the beneficial ownership question under Rule 13d-3(a). There are, nevertheless, facts a plaintiff, the SEC, or another court might cite as evidence that the long party has beneficial ownership of the TRS shares including:

- Usually TRS counterparties buy shares to hedge their exposure; and
- Usually the long party has the practical ability to cause the counterparties to deliver the hedge shares to the long party.

The Second Circuit did not decide whether or under what circumstances the long position in a TRS will be considered to provide beneficial ownership of shares purchased by the short party. Judge Winter, in a lengthy concurring opinion, discusses this issue in some depth. His view was that unless there was an agreement or understanding on acquiring or voting the counterparty’s hedge position, these types of swaps are not a means of indirectly facilitating a control transaction.

As a result, the status of cash-settled TRS positions in terms of beneficial ownership under Section 13(d) remains unclear. The original district court opinion probably has had a negative impact on the use of TRSs by “activist” hedge funds and in other situations. It remains to be seen whether TRS use will increase in these situations as a result of the Second Circuit opinion.

## **IMPLICATIONS FOR GROUP FORMATION**

The Second Circuit determined that group formation turns on whether sufficient direct or indirect circumstantial evidence exists to support the inference of a formal or informal understanding between members for the purpose of acquiring, holding, voting or disposing of securities.

The district court based its finding of a 13(d) violation on the existence of concerted action. The Second Circuit stated that the district court’s findings were “insufficient for proper appellate review in that the district court did not find that a group was

formed for the purpose of acquiring CSX securities.” The district court’s finding that the actions of TCI and 3G were “products of concerted action” was insufficient.

It is not at all clear that this language represents a change in the law. Concerted action could form the basis for a finding that there was an informal understanding between group members for the purpose of acquiring, holding, voting or disposing of securities. In other words, concerted action could constitute circumstantial evidence of group formation if the purpose of the group is to acquire, hold, vote or dispose of issuer securities.

However, concerted action that does not have the acquisition, holding, voting or disposition of securities as its purpose would not seem to support a finding that a group had been formed.

## **POISON PILL IMPACT**

Shareholder rights plans are triggered by beneficial ownership exceeding a certain percentage of outstanding shares. Most plans provide that beneficial ownership is to be determined pursuant to Regulation 13D.

Because of the uncertainty as to whether TRSs convey beneficial ownership of the referenced securities under current SEC regulations, issuers may wish to consider whether to include provisions in their shareholder rights plan that deal specifically with the impact of TRS positions.

Many issuers that do not have a shareholder rights plan in place keep a rights plan “on the shelf.” Issuers in this position may wish to review the beneficial ownership definitions in those plans and to consider dealing with TRSs, if they have not done so already.