

Bullet Point ®

Second Circuit Decision Contemplates Section 13(d) and Equity Swaps ¹

On July 18, 2011, the Second Circuit Court of Appeals issued its decision in *CSX Corporation v. The Children's Investment Fund Management (UK) LLP*² nearly three years after hearing arguments in the case. The main issue on appeal involved beneficial ownership calculations relating to the reporting requirements under Section 13(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). The Second Circuit declined to rule on whether a party who is "long" to a cash-settled, total-return equity swap³ would be deemed to be the beneficial owner⁴ of shares purchased by the "short" party to the swap as a hedge to their short position. However, the decision does provide some guidance on what constitutes a "group" for purposes of Section 13(d) as well as the appropriateness of Section 13(d) injunctions.

Background

This case arose out of a proxy contest waged between two hedge funds, The Children's Investment Fund Management ("TCI") and 3G Capital Partners ("3G") (the "Funds"), and the CSX Corporation ("CSX"). Both TCI and 3G owned shares of CSX and were the long parties in cash-settled, total-return equity swaps of the CSX shares along with several investment banks. CSX filed suit against the Funds to prevent them from voting those shares in a proxy contest. The Funds eventually voted their shares and succeeded in electing a minority slate of candidates to the CSX board of directors. In the original suit, CSX alleged that TCI violated Section 13(d)⁵ by not timely filing a Schedule 13D stating that it beneficially owned more than 5% of CSX's outstanding stock. CSX also alleged that the Funds failed to timely disclose that they had formed a group that owned more than 5% of the outstanding CSX stock. CSX argued that the Funds specifically sought to evade these Section 13(d) reporting requirements. While TCI and 3G had eventually filed a Schedule 13D in December 2007 indicating their group status,

¹ This memorandum provides general information on the subject matter described, should not be relied on for legal advice in any jurisdiction and may constitute attorney advertising.

² 2011 WL 2750913 (2d Cir. July 18, 2011).

³ The Second Circuit defined a "total-return equity swap" as a contract in which parties agree to exchange sums equivalent to their 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. Upon termination of a "cash-settled" equity swap, the short party "pays the long party the sum of the referenced equity security's appreciation in market value and other net cash flows that have occurred since the most recent periodic payment."

⁴ Exchange Act Rule 13(d)-3 generally defines a "beneficial owner" for the purposes of Section 13(d) as one who has or acquires voting or investment power over a security.

⁵ Exchange Act Rule 13(d)-1 requires a beneficial owner of a security who acquires more than 5% of that security to report as such on a Schedule 13D within ten days of acquisition.

CSX alleged that the group was formed almost a year before that and that TCI alone owned more than 5% of CSX's outstanding shares as early as December 2006.

CSX claimed that the Funds' beneficial ownership percentages should have also included the shares purchased by the investment banks (the short parties to the total-return equity swaps) in addition to their own CSX shares. CSX alleged that the Funds knew that the swap counterparty investment banks would hedge their positions by purchasing shares of CSX, and that those shares should thus be calculated in the beneficial ownership levels of the Funds. The Funds, however, claimed that only their purchased shares should be included in this beneficial ownership calculation as they had neither influence over the banks nor any voting rights to those shares.

District Court

The District Court held that the Funds should be considered the beneficial owners of the hedge shares purchased by the short party to the total-return equity swaps.⁶ The District Court did not rule that all long parties to total-return equity swaps would automatically be considered beneficial owners of the shares owned by the short parties. It deemed the Funds to be beneficial owners in this circumstance only because they had used the swaps to create a "plan or scheme" to avoid the disclosure requirements under Section 13(d) and therefore should be held to be the beneficial owners of the CSX shares owned by the investment banks.

The District Court also held that the Funds formed a group with respect to the CSX shares long before they filed a Schedule 13D. This finding was based on communications between the two Funds relating to the possibility of a leveraged buyout of CSX, indicating a strategic plan to act as a group. The District Court granted an injunction against the Funds prohibiting further violations of Section 13(d) (in general, not only specific to CSX). The District Court did not, however, prohibit the Funds from voting their CSX shares due to the fact that they ultimately disclosed their ownership of CSX shares in a Schedule 13D filing prior to voting those shares.

Both parties appealed this ruling. The Funds appealed the District Court's finding that they violated Section 13(d) and the injunction against future violations, and CSX appealed the denial of the injunction against voting the shares.

Court of Appeals

The Second Circuit stated that it would not rule on the issue of whether a long party to an equity swap could generally be considered the beneficial owner of the shares of the short party. The majority decision noted that the panel was split on several issues regarding this classification. However, it did remand the case to the District Court for a determination as to whether there was a "group" violation of Section 13(d). The District Court only generally determined that the Funds had formed a group, but the Second

⁶ See *CSX Corp. v. The Children's Inv. Fund Mgmt.*, 562 F. Supp. 2d 511 (S.D.N.Y. 2008).

Circuit remanded this issue for a specific, evidence-based determination of whether the Funds formed a group for the purpose of purchasing or selling CSX shares (only in relation to the shares owned outright by the Funds), and, if so, when that group was formed. The Second Circuit affirmed the District Court's ruling that the Funds could vote their CSX shares and that an injunction was not applicable in these circumstances. The majority held that a voting injunction would be improper because the appropriate disclosures were made (regardless of the timing) in advance of the vote, thereby curing the failure to file a Schedule 13D in time.

In a concurring opinion, Judge Winter stated that a long party should not be considered to be the beneficial owner of shares purchased by the short party in a cash-settled, total-return equity swap. Judge Winter stated that because the long party does not have any voting power over those shares, all rights of the shares remain with the short party who owns the shares. He also stated that even if the Funds did take steps to evade the reporting requirements of Section 13(d), this did not automatically equate to beneficial ownership of the short party's shares. Judge Winter further noted that without an agreement between the parties giving the long party the right to acquire the short party's shares or control their voting rights, no beneficial ownership could be inferred.

Conclusion

The Second Circuit failed to provide clarity on the general issue of whether holding a long position in a cash-settled total-return equity swap makes that holder the beneficial owner of the shares held as a hedge by the short party. Although Judge Winter's concurrence does shed some light on the issue, it contradicts the finding at the District Court level. All funds that find themselves in these long positions would be well served to note the state of flux in this area of law and to take precaution in their beneficial ownership calculations so as not to find themselves in violation of Section 13(d).

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Should you have any questions regarding these issues and their implications, please feel free to contact us.

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