
District Court Finds Hedge Funds' Use of Cash-Settled Total Return Swaps Constitutes Scheme to Evade Section 13(d) Reporting Requirements

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On June 11, 2008, in a significant case of first impression, the U.S. District Court for the Southern District of New York found that an "activist" hedge fund that had entered into various total return swaps ("TRSs")^[1] referencing shares of common stock of CSX Corporation ("CSX") was deemed to be the beneficial owner of such CSX stock for purposes of Section 13(d) of the Securities Exchange Act of 1934 (the "Exchange Act"). Relying on Rule 13d-3(b), the Court in *CSX Corporation v. The Children's Investment Fund (UK) LLP, et al.*, Case No. 08 Civ. 2764 (S.D.N.Y.), found that The Children's Investment Master Fund and two related funds that invested in it (collectively, "TCI"), became the beneficial owners of CSX shares when TCI entered into various TRSs with respect to CSX stock because those swaps constituted an arrangement with the purpose or effect of divesting TCI of beneficial ownership of CSX securities as part of a plan or scheme to evade the reporting requirements of Section 13(d) of the Exchange Act.

The Court concluded that TCI violated Section 13(d) by failing to file a Schedule 13D within 10 days of entering into TRSs referencing more than 5 percent of the CSX shares then outstanding. The Court also found that TCI and another hedge fund investor, 3G Capital Partners, Ltd. (collectively with certain affiliates, "3G"), which became a stockholder of CSX in February 2007, formed a "group" for Section 13(d) purposes at almost the very inception of 3G's investment in CSX and should have, contemporaneously, reflected such group formation in a Schedule 13D filing.^[2] The Court enjoined future violations of Section 13(d) by TCI (and certain other parties), but declined to enter an injunction barring TCI and 3G from voting at CSX's annual meeting of shareholders (currently scheduled for June 25, 2008).

The parties have appealed the Court's decision to the U.S. Court of Appeals for the Second Circuit. Pending the resolution of the appeal and pending further action by the Securities and Exchange Commission (whether in the form of rule-making or an amicus brief stating the Commission's views on the issues raised), the CSX case creates uncertainty under Section 13 of the Exchange Act for investors that use TRSs—especially for "activist" hedge funds or others seeking to influence corporate management.

Background

On October 20, 2006, TCI entered into the first of a series of TRSs referencing the common stock of CSX. By December 31, 2006, TCI entered into TRSs referencing 8.8 percent of the then outstanding common stock of CSX.

In December 2006, TCI began developing a leveraged buyout proposal with respect to CSX, which it discussed with CSX's financial advisors during January 2007. By the time of a February 15, 2007, transportation conference attended by CSX, TCI, and others, TCI had entered into TRSs referencing nearly 14 percent of the outstanding common stock of CSX. On March 2, 2007, TCI filed a pre-merger notification report under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 in which it stated that it would acquire CSX common stock that would equal or exceed \$500 million. Shortly thereafter, TCI notified CSX of its pre-merger filing. TCI met with CSX management at the end of March 2007. At the meeting, TCI criticized CSX and indicated that TCI held approximately 14 percent of CSX common stock through swaps that could easily be converted to direct, physical ownership.

In September 2007, TCI began preparations for a proxy contest with respect to the election of directors at CSX's next annual meeting. Preparations for a proxy contest continued throughout the fall of 2007 and included efforts to identify possible directors to run on a dissident slate. On December 12, 2007, TCI entered into a letter agreement with 3G, which had been a stockholder of CSX since February 2007, concerning the sale of CSX securities and swaps involving CSX securities, the conduct of a potential proxy contest with CSX and other matters. TCI and 3G jointly filed a Schedule 13D with the SEC on December 19, 2007, reporting that they might be deemed to be a "group" and thus might be deemed to have beneficial ownership of more than 8 percent of the CSX common shares outstanding. The Schedule 13D also disclosed the existence of cash-settled TRSs that gave TCI and 3G economic exposure to an additional 11 percent and 0.8 percent of CSX common stock, respectively.

CSX filed its preliminary proxy statement with the SEC on February 21, 2008, urging shareholders to vote for its board's proposed nominees and to reject those proposed by TCI and 3G. On March 10, 2008, TCI and 3G filed a preliminary proxy statement with the SEC, urging shareholders to vote for their slate of five nominees to the board of directors and for a proposal to allow any investors holding 15 percent or more of the outstanding shares to call a special meeting for any permissible purpose under Virginia law, CSX's state of incorporation.

On March 17, 2008, CSX filed a lawsuit against TCI, 3G, and certain individuals associated with them, alleging, inter alia, violations of Sections 13(d) and 14(a) of the Exchange Act. CSX contended that TCI violated Section 13(d) of the Exchange Act by failing to file a Schedule 13D when it first acquired TRSs referencing more than 5 percent of the outstanding shares of CSX common stock, and that TCI and 3G violated Section 13(d) by failing to timely report the formation of a "group."

Court Discussion Regarding Beneficial Ownership Under Rule 13d-3(a)

In the first part of its discussion of whether TCI and 3G violated Section 13(d), the Court focused on whether being the long party under TRSs was alone sufficient to establish beneficial ownership under Rule 13d-3(a).^[3] The Court noted that the TRSs did not give TCI any legal rights with respect to the voting or disposition of CSX shares, but nonetheless found that legal rights did not solely determine the beneficial ownership question. Rather, the Court stated that:

[the] inquiry focuses on any relationship that, as a factual matter, confers on a person a significant ability to affect how voting power or investment power will be exercised, because it is primarily designed to ensure timely disclosure of market-sensitive data about changes in the identity of those who are able, as a practicable matter, to influence the use of that power.

Much of the decision's Rule 13d-3(a) discussion concerned the hedging activities of TCI's counterparties. The Court acknowledged TCI's assertions that the counterparties under the TRSs were under no obligation to hedge such counterparties' investment exposure (by acquiring the same securities referenced by the TRS or otherwise) nor to sell such securities when the TRSs were terminated. Nevertheless, the Court found that, as a factual matter, TCI both contemplated and intended that the swap counterparties would hedge their exposure to CSX by acquiring the securities referenced by the TRSs when the swaps were initiated and would sell them when the swaps terminated. Moreover, the Court noted that the swap counterparties acquired the shares underlying the swaps "on virtually a share-for-share basis and in each case on the day or the day following the commencement of each swap." Based on its findings, the Court concluded that "TCI significantly influenced the [counterparties] to purchase the hedge shares upon entering the swaps" and to sell such shares when the transactions were unwound.^[4] While the Court thus came close to equating being the long party under a TRS with being a beneficial owner under Rule 13d-3(a), the Court ultimately declined to rule on the question of whether, under Rule 13d-3(a), TCI was a beneficial owner of the CSX securities underlying the swaps.

Court Decision Regarding Beneficial Ownership Under Rule 13d-3(b)

The Court next turned to Rule 13d-3(b). Rule 13d-3(b) provides:

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 [or] 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.

At the request of the Court, the SEC's Deputy Director of the Division of Corporation Finance had sent an amicus letter identifying the Division's views regarding Rule 13d-3(a) and (b). The Division's amicus letter appeared to stake out two positions with respect to Rule 13d-3(b). First, it stated that "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.'" Second, it stated 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," and that "a person who entered into a swap would be a beneficial owner under Rule 13d-3(b) if it were determined that the person did so with the intent to create the false appearance of non-ownership of a security."

The Court, however, was perplexed by the Division's proposed formulation of the Rule 13d-3(b) test: "An appearance of non-ownership cannot be false unless one is in fact the beneficial owner." The Court noted that if Rule 13d-3(b) were to apply only where the person in question was already the beneficial owner, the rule would be superfluous as such beneficial ownership would be required to be reported by Rule 13d-3(a). The Court, therefore, reinterpreted the Division's proposed Rule 13d-3(b) requirements as follows: "Rule 13d-3(b) applies where one enters into a transaction with the intent to create the false appearance that there is no large accumulation of securities that might have a potential for shifting corporate control by evading the disclosure requirements of Section 13(d) or (g) through preventing the vesting of beneficial ownership in the actor." As to the key elements of this reformulated Rule 13d-3(b) test--the prevention of vesting of beneficial ownership to give a false appearance--the Court stated:

The evidence that TCI created and used the TRSs, at least in major part, for the purpose of preventing the vesting of beneficial ownership of CSX shares in TCI and as part of a plan or scheme to evade the reporting requirements of Section 13(d) is overwhelming. Joe O'Flynn, the chief financial officer of TCI Fund told its board, albeit not in the specific context of CSX, that one of the reasons for using swaps is 'the ability to purchase without disclosure to the market or the company.' TCI emails discussed the need to make certain that its [swap] counterparties stayed below 5 percent physical share ownership, this in order to avoiding triggering a disclosure obligation on the part of a counterparty. TCI admitted that one of its motivations in avoiding disclosure was to avoid paying a higher price for the shares of CSX, which would have been the product of front-running that it expected would occur if its interest in CSX were disclosed to the market generally. Indeed, TCI acquired only approximately 4.5 percent in physical CSX shares to remain safely below the 5 percent reporting requirement until it was ready to disclose its position. (Internal footnotes omitted.)

The Court thus found, based on the existence of a plan or scheme to evade the reporting requirements of Section 13(d), that TCI was deemed to be the beneficial owner of the CSX securities in which TCI had an economic interest by virtue of the swaps.

Court Decision Regarding Remedies

The Court did not rule that TCI and/or 3G needed to revise their Schedule 13D or proxy filings to reflect the facts concerning the swap ownership. Although the defendants did not count the shares underlying the TRSs toward their beneficial ownership calculation in their Schedule 13D filings, the material facts concerning the swaps were included in the initial Schedule 13D filing in December 2007. Likewise, the Court did not rule that the filings needed to be updated concerning the formation of a group long before the first group disclosure was made as the Court viewed the date of such formation as "immaterial." In light of its findings regarding the Rule 13d-3(b) and group issues, the

Court enjoined the defendants from violating Section 13(d) in the future.

Insofar as CSX sought to "sterilize" the shares held by TCI and/or 3G and prohibit their voting at the 2008 annual meeting, the Court concluded that the Second Circuit's decision in *Treadway Cos., Inc. v. Care Corp.*, 638 F.2d 357, 380 (2d Cir. 1980), precluded such relief. At the same time, the Court said that "were this Court free as a matter of law ... to grant ... an injunction, whether on the basis that such relief is warranted to afford deterrence or on another basis, it would do so" and noted that any additional penalties would have to come from appropriate action by the SEC or the Department of Justice.

* * *

The Court's decision has been appealed by both sides to the U.S. Court of Appeals for the Second Circuit. Although the CSX opinion is nominally limited to the particular facts found by the judge in that case, the potential breadth of the decision creates uncertainties for various participants in the equity markets as to whether and how the decision would be applied to Section 13(d) reporting under different facts.

[1] A total return swap is an instrument whereby two counterparties agree to exchange the cash flows on two financial instruments over a specified period of time. In the CSX case, the counterparties on each TRS agreed to pay the hedge fund an amount equal to the distributions or dividends paid on, and any increase in the market value of, a specified number of CSX common shares over a specified time period. (Such a party is sometimes referred to as the "short party.") The hedge fund agreed to pay the counterparty interest at the negotiated rate on the "notional amount" (i.e., the value of the specified number of CSX shares at the time the parties entered into the TRS transaction) plus an amount equal to any decrease in the market value of such shares over the relevant period. (This party is sometimes referred to as the "long party.")

[2] This alert does not address in any detail the claims that TCI and 3G should have earlier reported the formation of a group. The Court's decision regarding when a group was formed and when the parties should have reported its formation is highly fact specific and appears to have been significantly influenced by the Court's view that the testimony of certain key personnel in this regard could not be credited.

[3] Rule 13d-3(a) provides: "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."

[4] Regarding voting power, the Court found the record mixed and did not rule on whether TCI possessed "the power to vote, or to direct the voting of CSX securities."

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