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The CSX Ruling Impact On Swaps

On June 11, the U.S. District Court for the Southern District of New York issued an opinion with potentially far-reaching ramifications regarding the use of equity swaps by activist shareholders to build ownership positions in their portfolio companies.

In *CSX Corporation v. The Children's Investment Fund Management* Judge Lewis Kaplan ruled that TCI violated applicable securities laws by failing to timely disclose in a Schedule 13D its investment in CSX through total return equity swaps.

Following a fact specific analysis, the court concluded that TCI beneficially owned the shares underlying the equity swaps as they were used with the purpose and effect of preventing the vesting of beneficial ownership as part of a plan or scheme to evade the reporting requirements of Section 13(d) of the Securities Exchange Act of 1934.

The Alleged Violations

The TCI and 3G Capital Partners violations of securities laws alleged by CSX occurred in the context of an election contest started by the two hedge funds against CSX with respect to its 2008 annual meeting of shareholders. TCI began to build a position in CSX in October 2006 and eventually formed a Section 13(d) group with 3G for the purpose of running a proxy contest in support of their slate of directors for election at the annual meeting. TCI used equity swaps to build its position in CSX, at one point obtaining an economic interest in close to 14% of CSX's outstanding shares.

Later, in a joint Schedule 13D filing, the two hedge funds disclosed direct ownership of approximately 8% of CSX's outstanding shares and equity swaps referencing an additional 12% of outstanding shares. CSX filed suit, claiming, among other things, that the two hedge funds used equity swaps as leverage to influence management while failing to publicly disclose their true position in the company in a Schedule 13D.

The SEC Weighs In

TCI argued that it did not beneficially own the shares underlying the equity swaps under the beneficial ownership definition of Rule 13d-3(a) of the Exchange Act because it did not directly or indirectly have the legal right to vote or dispose of those shares. This was essentially the position taken by the

Securities and Exchange Commission's Division of Corporation Finance in a friend of the court letter submitted to Judge Kaplan.

CSX argued that TCI beneficially owned the shares held by the counterparties to the swaps because TCI had voting and/or investment power over such shares by virtue of the counterparties having an economic incentive to vote, dispose or take other action with respect to the shares that would be favorable to TCI. The SEC disagreed, stating that such an economic incentive is not sufficient to create beneficial ownership and that there must be actual authority to vote or dispose or to direct the voting or disposition of the shares.

The SEC concluded, "As a general matter, a person that does nothing more than enter into an equity swap should not be found to have engaged in an evasion of the reporting requirements."

The Ruling

The court on the other hand stated that the definition of beneficial ownership is very broad and is not confined merely to the right to vote or dispose of securities. The court found that TCI's ability to affect voting or investment power over the shares underlying the equity swaps would be exercised, and therefore TCI beneficially owned those shares under the Rule 13d-3(a) definition of beneficial ownership.

As a practical matter, the court noted, TCI was aware the counterparties to the swaps would hedge their positions by directly acquiring the shares. The court further noted that TCI also had the ability to unwind the swaps in kind, meaning that at the conclusion of each swap transaction the counterparties could have been required to deliver the referenced shares to TCI. The court also found that TCI took specific steps to ensure that it would have greater control over the voting of the referenced shares, including concentrating its swap positions among friendly banks that it believed were more likely to vote with TCI in the proxy contest and among banks whose policies allowed TCI to request that the referenced shares not be voted against it in the proxy contest.

Ultimately, however, the court determined that it was not necessary to make a ruling under the basic definition of beneficial ownership under Rule 13d-3(a) of the Exchange Act. Instead, relying on Rule 13d-3(b), it held that TCI beneficially

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owned the shares because of its plan or scheme to evade the reporting requirements of Section 13(d).

Rule 13d-3(b) provides that a person is deemed to be the beneficial owner of securities if that person directly or indirectly creates or uses any contract or arrangement with the purpose of divesting such person of beneficial ownership of a security as part of a plan or scheme to evade the reporting requirements of Section 13(d). The court held that based on the facts at hand, TCI used the equity swaps for the purpose of avoiding its disclosure obligations. Such facts included (i) a statement by TCI's cfo to its Board of Directors that one of the benefits of equity swaps is "the ability to purchase without disclosure to the market or the company;" (ii) TCI e-mails discussing the need to ensure counterparties to the swaps stayed below 5% ownership; and (iii) the admission by TCI that one of its motivations in avoiding disclosure was to avoid paying a higher price for shares of CSX.

The court also found that the two hedge funds violated Section 13(d) for failing to file the required disclosure within 10 days of acquiring beneficial ownership of more than 5% of CSX shares and for failing to timely file a Schedule 13D after the group was formed. But the court did not find that the defendants' Schedule 13D disclosure was false or misleading. The court enjoined TCI from further Section 13(d) violations, but declined to grant the more severe relief sought by CSX—to preclude TCI from voting its shares at CSX's 2008 annual meeting of shareholders.

The Annual Meeting

The ruling did not have an effect on the voting recommendation provided by RiskMetrics Group—ISS Governance Services on the matters presented at CSX's annual meeting of shareholders. ISS, the U.S.' leading proxy

advisory firm, recommended that CSX shareholders vote for four of the five dissident nominees, noting that in ISS' opinion, "The court unfairly singles out TCI and 3G as part of a larger indictment of common industry practice. As such, the 13(d) swaps 'issue' does not impact our analysis of this proxy contest."

CSX held its meeting as scheduled June 25. However, CSX adjourned the meeting without announcing the outcome of the election, stating that it was, "Too close to call at this time." Following the meeting, TCI and 3G issued a joint statement claiming that, based on preliminary results of the election, four of their nominees were elected. The meeting is scheduled to reconvene July 25 to receive certification of the voting results. It is interesting to note that on the day of the annual meeting, CSX announced a 22% increase in its quarterly dividend.

Conclusion

Both CSX and the two hedge funds quickly appealed the court decision. TCI and 3G scored a crucial victory on appeal when, before the annual meeting, the higher court denied CSX's request that the two hedge funds be enjoined from voting their shares at the meeting. Oral arguments by both parties are expected to be heard during the first week of August. Although it remains to be seen what the outcome of the case will be on appeal, it is likely Judge Kaplan's ruling will, unless overturned, impact how activist investors utilize and disclose swap arrangements in building positions in their portfolio companies.

This week's Learning Curve was written by Steve Wolosky, Ken Silverman and Ron Berenblat, partners with Olshan Grundman Frome Rosenzweig & Wolosky, a New York City-based law firm.

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