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Corporate Governance Group

Client Alert

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Federal District Court Rules that Hedge Funds Have “Beneficial Ownership” of CSX Corporation Shares Underlying Equity Swaps

Court Finds that Funds Engaged in a “Plan or Scheme to Evade” the Reporting Requirements of Section 13(d) of the Exchange Act

Ruling Also May Have Unintended Consequences for Takeover Defenses

On June 11, 2008, in *CSX Corporation v. The Children’s Investment Fund Management (UK) LLP et al.*,¹ a Federal District Court ruled that two hedge funds had violated U.S. federal securities laws by (i) using total return equity swaps (“TRSs”) – a type of derivative that gives the funds substantially all of the indicia of stock ownership other than formal voting rights – as part of a plan to evade the reporting requirements of Section 13(d) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and (ii) failing to make the requisite disclosures on Schedule 13D within 10 days following formation of a “group”. Despite these violations, the Court found itself unable to order a sterilization of the voting rights of shares owned by the hedge funds due to judicial precedent that required a finding (which the Court was not prepared to make) of irreparable injury. That being said, the Court was quite critical of the hedge funds’ actions,² and noted that if it were free to grant greater relief “it would exercise its discretion to do so.”

The *CSX* decision has attracted much attention in the worlds of both finance and politics, with several U.S. Senators lobbying the Securities and Exchange Commission to impose sanctions on the hedge funds and threatening legislation to close a perceived gap in the SEC’s disclosure rules. The purpose of this Client Alert is to examine the rationale for the Court’s decision, especially in light of its potential impact on the use of TRSs by activist investors and the unintended consequences that may result for takeover defenses.

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Corporate Governance Group, whose names and contact information are provided herein.

In addition, if you would like copies of our other Client Alerts or the *CSX Corporation* decision discussed herein, please contact any of the attorneys listed. You can also obtain this and our other Client Alerts by visiting our website at <http://www.milbank.com> and choosing the “Client Alerts & Newsletters” link under “Newsroom/Events”.

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¹ *CSX Corp. v. The Children’s Inv. Fund Management (UK) LLP et al.*, S.D.N.Y., 2008 WL 2372693, June 11, 2008.

² For example, in a rather remarkable lead-in to its opinion, the Court wrote that “Some people deliberately go close to the line dividing legal from illegal if they see a sufficient opportunity for profit in doing so. A few cross that line and, if caught, seek to justify their actions on the basis of formalistic arguments even when it is apparent that they have defeated the purpose of the law. *This is such a case.*” (emphasis added).

Background

On December 10, 2007, The Children's Investment Fund ("TCI") and 3G Capital Partners ("3G") filed a joint Schedule 13D with the SEC relating to CSX Corporation, one of the nation's largest rail systems. The Schedule 13D announced that the funds collectively owned 8.3% of the outstanding stock of CSX, with additional "economic exposure" to approximately 12% through TRSs, expressed their displeasure with the operation and direction of CSX and indicated that they were contemplating a proxy contest. On March 10, 2008, the funds filed proxy materials as part of their joint effort to elect five directors to CSX's 12-person board. Shortly thereafter, CSX brought suit to, among other things, prevent TCI and 3G from voting shares purchased prior to their Schedule 13D filing. CSX's claims are based on the theory that TCI acquired "beneficial ownership" of more than 5% of CSX stock through the use of TRSs, and that TCI and 3G formed a "group" for Section 13(d) reporting purposes through coordinated efforts, in each case long before their actual Schedule 13D filing.

When TCI first became interested in CSX, it did not buy shares in CSX directly but instead (as has become a common strategy) began accumulating an economic (although not a voting) position through TRSs with financial institution counterparties. The benefits of TRSs to activist investors include the ability to conceal their growing interest in a company so as not to trigger a rise in the price of the stock, as well as the ability, in most cases, to convert TRSs into the underlying shares. To hedge their risk to the TRSs, TCI's counterparties in turn purchased shares of CSX stock in amounts almost identical to those referenced in the swaps. TCI distributed these swaps among eight counterparties, ensuring that no individual counterparty would acquire more than 5% of CSX's shares through hedging and thereby become obligated to make its own Section 13(d) filing. During the course of 2007, TCI made it clear to CSX management that it had acquired a significant economic stake in the company's shares and intended to cause changes at CSX.³

Early in 2007, 3G approached TCI about its holdings in the railroad industry. TCI informed 3G that it had an interest in CSX, and shortly thereafter 3G began to invest both in CSX shares and in TRSs relating to CSX stock. The funds had subsequent conversations in which they discussed CSX, and as the year progressed they continued to invest in CSX. Despite the extended period of share accumulation and conversations between them, TCI and 3G did not file their joint Schedule 13D until December 2007 based on their belief, apparently supported by counsel, that the TRSs did not confer "beneficial ownership" of the related CSX shares and their pre-December activities did not result in them becoming a "group" for purposes of Section 13(d).

Beneficial Ownership for Purposes of Section 13(d)

Section 13(d) of the Exchange Act requires a person or group that acquires more than 5% of the voting stock of an SEC-registered company to make public disclosure of such holding, together with its intentions with regard to that company and its management. It was adopted to "alert the marketplace to every large, rapid aggregation or accumulation of securities, regardless of technique employed, which might represent a potential shift in corporate control." In determining whether the funds had beneficial ownership of the shares of CSX stock referenced by their respective TRSs, the Court analyzed "beneficial ownership" under both Rule 13d-3(a) and Rule 13d-3(b) promulgated under the Exchange Act. The Court also considered when the funds' activities led to them becoming a "group" under Section 13(d).

Beneficial Ownership under Rule 13d-3(a)

First, the Court analyzed beneficial ownership under Rule 13d-3(a), which provides that:

"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."

³ TCI's suggested changes included firing CSX's CEO as well as pursuing a leveraged buyout whereby a TCI-led group would acquire CSX.

TRSs are not commonly thought of as conferring “beneficial ownership” of the underlying shares for purposes of Section 13(d) and Rule 13d-3(a). This is consistent with the SEC’s current interpretation of its rules. And in fact, the terms of the TRSs purchased by TCI and 3G *did not* give the funds any legal rights with respect to voting or disposition of any CSX shares, nor did they require the counterparties to hedge their positions by purchasing CSX shares. However, the Court noted that the inquiry into beneficial ownership should focus not only on legal rights, but also on whether, as a “factual matter”, the relationship provides a party with a *significant ability* to affect voting and investment of such shares. In the words of the Court, “[t]he securities markets operate in the real world, not in a law school contracts classroom. Any determination of beneficial ownership that failed to take account of the practical realities of that world would be open to the gravest of abuse.”

Accordingly, in analyzing whether the TRSs conferred beneficial ownership on TCI of the related CSX shares, the Court identified two key questions: “whether TCI’s TRSs contemplated that its counterparties would hedge their positions with CSX shares and, if so, whether TCI had a significant ability to affect how voting power or investment power will be exercised.” With respect to the first question, the Court noted that these counterparties are generally not in “the business of speculating on the market fluctuation of the shares referenced by the TRSs into which they enter as short parties. Accordingly, they typically hedge their short exposures by purchasing the referenced securities in amounts identical to those referenced in their swap agreements.” The Court found the evidence “overwhelming” that “this is precisely what TCI contemplated and, indeed, intended.” With respect to the second question, the Court found that TCI selected counterparties who “it thought would be most likely to vote with TCI in a proxy contest.”

Despite the circumstantial evidence which, in the Court’s eyes, strongly suggested that the funds had significant ability to affect voting and investment, and therefore had beneficial ownership, of the CSX shares underlying the TRSs, the Court ultimately determined, in this case of “first impression”, that it was not necessary to decide whether TCI had “beneficial ownership” of these shares for purposes of Rule 13d-3(a). Instead the Court relied on Rule 13d-3(b) and the “group” analysis described below in determining that the funds had violated Section 13(d) by failing to timely disclose their beneficial ownership of CSX shares and filing a late Schedule 13D. As such, the Court did not disturb what the SEC described in an *amicus* letter to the Court as the “settled expectation of the marketplace that equity swaps, *in and of themselves*, do not confer beneficial ownership of the referenced shares.”

Beneficial Ownership under Rule 13d-3(b)

The Court then turned to Rule 13d-3(b), which provides that:

“Any person who, directly or indirectly, [1] creates or uses a trust, proxy, power of attorney, pooling arrangement or any other contract, arrangement, or device [2] with the purpose of [*sic*] effect of divesting such person of beneficial ownership of a security or preventing the vesting of such beneficial ownership [3] as part of a plan or scheme to evade the reporting requirements of section 13(d) or (g) of the [Exchange] Act shall be deemed for purposes of such sections to be the beneficial owner of such security.”

In this portion of its analysis, the Court considered whether TCI created and used TRSs as part of a “plan or scheme to evade” Section 13(d)’s reporting requirements. The Court found that TCI had done just that, citing several examples of the “overwhelming” evidence of TCI’s use of TRSs to gain a significant economic position in CSX shares which hung “like the sword of Damocles over the neck of CSX”, while at the same time evading the reporting requirements of Section 13(d). In this vein, the Court noted that:

- The CFO of one of the TCI funds told its board that one of the reasons for using swaps “is the ability to purchase without disclosure to the market or the company.”
- 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.”

- TCI distributed the TRSs “among eight counterparties so as to prevent any one of them from acquiring greater than 5% of CSX’s shares and thus having to disclose its swap agreements with TCI.”
- Representatives of TCI told members of CSX management, many months before the filing of the Schedule 13D, that TCI “owned” 14% of CSX’s stock, the bulk of which “could be converted to physical shares, and that there were ‘no limits’ to what TCI would do absent CSX’s acquiescence in its demands.”

By acquiring beneficial ownership of more than 5% of the CSX stock without filing a Schedule 13D, TCI was found to have violated Section 13(d).

Formation of a Group for Purposes of Section 13(d)

The Court also found that TCI and 3G violated Section 13(d) by acting for some time in “close coordination with each other” but failing to file the required Schedule 13D within 10 days following their formation of a “group”. The existence of a “group” depends on “whether there is sufficient evidence to support the inference of a formal or informal understanding between [members] for the purpose of acquiring, holding, or disposing of securities.” The Court made a factual determination that, based upon the discussions and relationship between TCI and 3G, the funds formed a “group” no later than February 13, 2007, nearly 10 months *before* they filed their Schedule 13D announcing their relationship. Some of the facts that led to this conclusion included the pre-existing relationship between TCI and 3G, their frequent discussion of TCI’s investment in and plans for CSX and 3G’s “striking patterns of share purchases immediately following” these discussions. The Court was very critical of the funds’ actions and “frequent lack of credibility”, noting that “the likelihood that any agreement in this case would be proved, if at all, only circumstantially is perhaps greater than usual because the parties went to considerable lengths to cover their tracks.”

Judicial Remedy

Although the Court found that (1) TCI became, through its use of TRSs, a beneficial owner of more than 5% of CSX stock by virtue of Rule 13d-3(b) and, as a result, failed to timely disclose its beneficial ownership of those shares, and (2) TCI and 3G failed to timely disclose their formation of a “group”, the Court declined to grant CSX’s request for an injunction sterilizing the voting rights of the shares that TCI and 3G acquired during the period of non-compliance. Citing higher court decisions, the Court noted that “the determinative question is whether, absent an injunction there would be irreparable harm to the interests which Section 13(d) seeks to protect – *viz.* ‘alert[ing] investors to potential changes in corporate control.’” The Court ultimately found that “the alteration of the corporate electorate arguably effected by defendants’ actions, which did no more than increase its likelihood of prevailing in the current contest, cannot be regarded as irreparable injury that properly may be remedied by preventing the voting of the stock acquired while the defendants were in violation of Section 13(d).”⁴ The only remedy the Court felt it could grant was a permanent injunction restraining TCI and 3G from future violations of Section 13(d).⁵

CSX’s Impact on Activist Investors and Unintended Consequences for Takeover Defenses

Although the Court declined to decide whether the funds’ ownership of TRSs, in and of itself, made them beneficial owners of the shares underlying the TRSs, the *CSX* decision, if not overturned on appeal, will likely diminish the utility of TRSs for activist investors who seek to amass large economic positions, without making public disclosures, as a prelude to exerting influence over a company. Unless activist investors can demonstrate that TRSs were entered into for legitimate hedging purposes, they will be subject to close scrutiny and second-guessing by target companies, and perhaps ultimately by

⁴ Additionally, the Court found that the public disclosures made by TCI and 3G in their Schedule 13D and in their proxy materials were not materially misleading, and consequently concluded that it had no basis for ordering corrective disclosure or voiding proxies obtained by TCI and 3G.

⁵ It should be noted that the SEC is not foreclosed from bringing civil or criminal actions against the funds by virtue of their breach of Section 13(d). In fact, New York’s U.S. Senator Charles Schumer has urged the Commission, in a letter to Chairman Cox, to take such action.

the courts and/or the SEC, seeking to prove a plan or scheme to evade reporting requirements under Section 13(d). Of course, disclosure of these positions will solve the Section 13(d) issue, but such disclosure will remove an element of surprise and likely drive up the price of the target company stock before a really significant position can be obtained.

The *CSX* Court's decision also could impact takeover defenses that employ a definition of "beneficial ownership" similar to Section 13(d). For instance, stockholder rights plans often use a definition of "beneficial ownership" similar to the SEC's. Based on *CSX*, any stockholder who enters into TRSs such that its share accumulation (when combined with all other shares owned) exceeds the level permitted by a stockholder rights plan could be viewed as having triggered the rights under such plan, resulting in unacceptable dilution of its position.⁶ Moreover, Section 203 of the Delaware General Corporation Law prohibits a stockholder who acquires 15% or more of the outstanding shares of a publicly-traded corporation, without prior board approval, from conducting a business combination transaction with that corporation for a period of three years unless such business combination is approved by a supermajority vote of the disinterested stockholders. Section 203 broadly defines "beneficial ownership" to include, among other things, shares acquired pursuant to an agreement, arrangement or understanding, which based on the *CSX* decision could be read to include TRSs. In addition to their SEC reporting obligations, therefore, activist investors will need to be aware that, in the wake of *CSX*, the purchase of TRSs could constrain their ability to amass positions in excess of the thresholds provided for in stockholders rights plans and under applicable state anti-takeover statutes.

Finally, as noted in a recent article in *The Wall Street Journal*, companies have been aware for some time of investors' "quiet" accumulation of economic interest through the use of derivatives. In response, the article notes that at least two companies have changed their stockholder rights plans to include within the definition of "beneficial ownership" shares of common stock underlying derivative securities. Whether other companies will see a need to adopt this approach will depend in large measure on whether the *CSX* decision survives an appeal and/or the SEC takes steps to change its position with respect to the application of Rule 13d-3(a) to derivatives such as TRSs.

⁶ TCI and 3G were not confronted with this issue because *CSX* does not have a stockholder rights plan in place.

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