



JONES DAY
COMMENTARY

THE *CSX* DECISION REGARDING BENEFICIAL OWNERSHIP AND GROUP FORMATION

On June 11, 2008, Judge Lewis A. Kaplan of the U.S. District Court for the Southern District of New York ruled in *CSX Corporation v. The Children's Investment Fund Management (UK) LLP* that:

- a hedge fund that entered into cash-settled total return equity swaps (“TRSs”) as the total return receiver, or “long party,” should be deemed the “beneficial owner” of the underlying common stock under Rule 13d-3(b) of the Securities Exchange Act of 1934 (the “Exchange Act”) because, on the facts of the case, the court determined that the fund used the TRSs as part of a plan or scheme to evade the reporting requirements of the Exchange Act to which it would have been subject had it bought the stock outright; and
- two hedge funds formed a “group” for purposes of Section 13(d) of the Exchange Act earlier than they reported, based on a long-standing informal relationship, exchanges of views regarding the issuer of the stock, purchases of stock following meetings

between their representatives, and parallel preparations for a proxy fight.

The decision was based upon highly fact-specific and circumstantial evidence, but we believe that it still could have a significant impact if its reasoning is applied in other cases. The decision suggests that the entry into TRSs, if motivated in part to avoid the disclosure requirements of Section 13(d), may be sufficient to result in deemed beneficial ownership under anti-evasion Rule 13d-3(b). The decision also suggests that a TRS may provide the long party with enough practical ability to influence its counterparty's exercise of investment or voting power over referenced shares to vest beneficial ownership in the long party, notwithstanding the absence of any legal right of the long party to direct the acquisition, disposition, or voting of any such shares. In addition, the decision underscores how questions regarding the formation of Section 13(d) groups can be decided entirely on inferences drawn from circumstantial evidence viewed in hindsight. Whether one views the CSX decision as an

occasion for cheers or jeers may depend largely on his or her feelings about event-driven investment strategies and unsolicited takeover attempts or about the use of equity derivatives in various contexts. In any event, the decision should be of interest to all parties concerned with these matters.

THE CSX DECISION

Beginning in late 2006, The Children's Investment Fund Management (UK) LLP ("TCI") and four hedge funds related to 3G Fund L.P. (collectively, "3G") separately began to accumulate positions in the common stock of CSX Corporation ("CSX"). Ultimately, TCI directly owned approximately 4 percent of CSX's shares and had entered into TRSs referencing more than 10 percent of CSX's shares. 3G directly owned approximately 4.1 percent of CSX's shares and had entered into TRSs referencing 0.8 percent of CSX's shares. TCI allocated its TRS among different bank counterparties so that these banks would not, as a practical matter, need to hedge more than 5 percent of CSX's stock. Between February and December 2007, the funds were in contact and apparently coordinated with each other to some extent. But, they did not file a Schedule 13D as a group until December 19, 2007, after they formally agreed to work together on December 12, 2007. In the subsequent proxy contest, TCI and 3G sought to replace five members of CSX's 12-member board of directors.

On March 17, 2008, CSX filed suit, alleging, among other things, that TCI violated Section 13(d) of the Exchange Act by failing to disclose its beneficial ownership of shares of CSX common stock referenced in its TRSs and that TCI and 3G violated Section 13(d) by failing to timely disclose the formation of a group. The court held that TCI should be deemed the beneficial owner of shares in CSX held by the counterparties to TCI's TRSs because TCI created and "used the TRSs with the purpose and effect of preventing the vesting of beneficial ownership in TCI as part of a plan or scheme to evade the reporting requirements of Section 13(d)." The court first considered whether TCI's investment in the TRSs conferred beneficial ownership of the referenced stock upon TCI directly under Rule 13d-3(a) but left that issue undecided and, instead, ruled under Rule 13d-3(b) that the TRSs were part of a scheme to evade the reporting requirements of Section 13(d). Rule 13d-3(b) is an anti-evasion rule that provides that a person who creates an arrangement that prevents the vest-

ing of beneficial ownership as part of a plan or scheme to evade the reporting requirements of Section 13(d) is deemed the beneficial owner of that security notwithstanding the fact that such person does not otherwise possess the requisite attributes of ownership.

TRS Analysis. By way of background, in a typical total return equity swap that is settled in cash, rather than shares, a total return payer, or "short party," and a total return receiver, or "long party," allocate between themselves economic rights associated with owning a referenced asset as follows: (1) the long party pays to the short party (a) periodic interest at a rate (typically LIBOR) comparable to that which would have been payable had the short party actually loaned the long party the aggregate price of the referenced stock upon commencement of the transaction and (b) any decrease in the market value of the referenced stock; and (2) the short party pays to the long party cash distributions, such as dividends, paid on the referenced stock and an amount equal to the market appreciation of the stock at the time of the final settlement of the transaction. The typical total return equity swap, as was the case with TCI's TRSs, does not contemplate that one party must actually own the referenced stock or whether or how either party might hedge its exposure under the total return equity swap.

The court recognized that the TRSs did not give TCI any rights to vote or dispose of the stock under Rule 13d-3(a) and, as such, the normal features of beneficial ownership did not exist. However, the court was sympathetic to the argument of CSX that TCI had the ability to influence the investment in CSX stock because TCI knew, consistent with market practice, that its TRS counterparties would hedge their short positions with CSX shares and that TCI might be able to influence whether and how some of its counterparties would vote those shares in a proxy contest. This argument was challenged not only by the defendants in the case, but also by the staff of the SEC's Division of Corporation Finance, partially in reliance on a published SEC staff interpretation to the effect that cash-settled securities futures do not confer beneficial ownership on the long party. The SEC staff's position, echoed by the International Swaps and Derivatives Association, was that cash-settled equity swaps, in and of themselves, do not confer beneficial ownership of the referenced shares on the long counterparties where short counterparties buy, sell, or vote their hedge shares as a result of their own economic incen-

tives and not pursuant to legal obligations owed to their long counterparties. Ultimately, the court avoided a determination of whether TCI directly possessed beneficial ownership under Rule 13(d)-3(a) by holding that TCI was deemed to possess beneficial ownership under Rule 13d-3(b).

The court's Rule 13d-3(b) analysis was that TCI used the TRSs to prevent the vesting of beneficial ownership as part of a scheme to evade the reporting requirements of Section 13(d). The decision appears to be one of first impression, and the court did not cite to any precedent that directly supports this holding. Moreover, the court was troubled by the nature of TCI's behavior that led to the proxy contest, TCI's use of TRSs, and TCI's motives, in light of its trading activities. The court specifically noted TCI's motive to avoid disclosing its position so that the stock price would not rise at a time that it was buying shares in the market. The court also noted that TCI's representatives characterized the TRS positions as conferring ownership and control when they spoke directly to representatives of CSX. Ultimately, the court relied heavily on the Rule 13d-3(b)'s purpose of preventing circumvention of Section 13(d) where securities are accumulated by any means that has the potential to shift corporate control without the acquisition of direct beneficial ownership.

Group Analysis. The court ruled that TCI and 3G violated Section 13(d) of the Exchange Act by failing to disclose in a timely manner that they were acting as a group in relation to CSX shares. That is, the court found that their filing was not timely because they formed a group in February 2007, when "concerted" action began, well before the December 19 filing. The court cited precedent for the proposition that such a group may be formal or informal and put great weight on the following facts and their sequence: the preexisting relationship between TCI and 3G; their exchanges of views and information regarding CSX; 3G's share purchases immediately following meetings between TCI and 3G executives; and parallel proxy fight preparations.

Relief Granted. The court granted CSX a permanent injunction restraining future violations of Section 13(d) of the Exchange Act by the defendants. However, the court declined to grant the full relief CSX requested, including enjoining defendants from voting the CSX shares they acquired prior to making their Section 13D filing. The case is currently on appeal in the U.S. Court of Appeals for the Second Circuit.

OBSERVATIONS

A few observations regarding the potential impact of the CSX decision follow:

- Companies should attempt, when relevant, to monitor the effects of TRSs and other derivatives referencing their stock. This is difficult to do if such positions are not disclosed, but it can be accomplished to a degree through monitoring the accumulation of positions by large banks known to deal in TRSs. In addition, it is important to note that shareholders rights plans and state law interested stockholder statutes frequently look to federal securities law to determine beneficial ownership of securities for the purpose of determining whether their provisions have been triggered. With respect to shareholders rights plans, companies seeking greater certainty as to whether TRSs and similar arrangements should be counted for purposes of determining beneficial ownership should consider amending their plans to make this clear, rather than relying on what may continue to be an uncertain area of the case law.
- The court's decision represents a significant departure from the previously accepted view that cash-settled TRSs do not confer beneficial ownership of the referenced stock. Investors and dealers that are parties to TRSs should reexamine their swap agreements and closely follow regulatory and case law developments in this area. Investors and dealers should also use caution in considering the use of equity swaps covering shares, which, when aggregated with their other shareholdings, would equal or exceed 5 percent of the issuer's outstanding shares.
- Pending a decision on appeal and other developments, the ultimate import of the CSX decision remains to be seen. We could imagine, for example, a court concluding that the use of TRSs in a change-of-control context conferred beneficial ownership, particularly if the TRS allowed the long party to cause the settlement of the swap with physical shares rather than cash, required hedging in physical shares, and/or allowed the long party to direct or influence the voting of the short party's hedge shares. In other circumstances, however, a court could distinguish the facts before it from CSX if the long party demonstrated a more passive approach to its TRS positions, utilizing them for investment only and not as part of a plan to obtain leverage over an issuer.

- The decision may also have wider implications beyond the use of TRSs or other derivative instruments in the context of corporate control contests, such as in connection with the regulation of derivatives and their transparency to the market generally. We believe that the SEC is facing significant pressure in this area, including with respect to concerns about the “empty voting” of shares.
- Investors should use caution in their discussions with fellow investors in connection with activities involving a company’s stock that occur in parallel, as those discussions can be characterized as a significant fact in the hindsight determination of whether a Section 13(d) group exists.

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