AKIN GUMP
STRAUSS HAUER & FELD LLP

Investment Funds Alert

Second Circuit Rules on Formation of Groups - No Decision on Total Return Swaps Confer Beneficial Ownership

July 27, 2011

On July 18, 2011, the United States Court of Appeals for the 2nd Circuit vacated[1] part of Judge Lewis Kaplan's controversial decision in *CSX Corporation v. The Children's Investment Fund Management (UK) LLP*[2] and remanded the case to the U.S. district court for further findings regarding whether The Children's Investment Fund (TCI) and another defendant, 3G Capital Partners, Ltd. and related funds (the "3G Funds"), had agreed to act together "for the purposes of acquiring, holding, voting or disposing of equity securities of an issuer."

The panel for the 2nd Circuit was divided on numerous issues concerning whether and under what circumstances the long party[3] to a cash-settled total return swap may be deemed to beneficially own the securities purchased by the short party and, therefore, did not decide this key issue. Instead, the opinion dealt exclusively with group issues and whether sterilization of TCI's vote was an appropriate remedy for a delay in the filing of a Schedule 13D. Judge Winter, however, wrote a concurring opinion that discussed at length why that type of swap contract would not confer beneficial ownership absent an agreement among the long and short counterparties that permits the long party to control the voting or disposition of shares purchased by the short party.

Background

In the United States, cash-settled total return swaps are generally structured by contract to pay the long party the increase in the value of a specified number of shares of stock of an issuer over the life of the contract. The short party typically purchases the security referenced in the total return swap to hedge the amounts that it would have to pay the long party if the referenced securities increase in value during the term of the swap. The swap contract does not typically permit the long party to control the voting or disposition of those shares or specify how, if at all, the short party would hedge its exposure.

TCI entered into total return swaps relating to approximately 14 percent of the outstanding common stock of CSX Corporation in 2006 and 2007 and also purchased approximately 4.2 percent of CSX's outstanding common stock. TCI acquired exposure to CSX's common stock through these swaps, in part to avoid disclosing its positions or intentions to the marketplace. Throughout this period, TCI met with several funds, including the 3G Funds, to discuss TCI's investment in CSX.

[1] *CSX Corporation v. The Children's Investment Fund Management (UK) LLP, et al.*, 2d Cir. 08-2899-CV (July 18, 2011).
[2] 562 F. Supp 511 (S.D.N.Y. 2008)
[3] The "long party" is the party to a total return swaps contract that is paid the increase in the value of the referenced securities, and the "short party" is the part that pays the increase in value.

According to the district court, the 3G Funds engaged in activities that were remarkably coordinated with those of TCI after these meetings. On December 12, 2007, TCI sent a notice to CSX of TCI's intention to nominate directors to the CSX board. Concurrent with the delivery of the notice, TCI entered into a letter agreement with the 3G Funds to coordinate the purchase and sale of CSX shares and derivative securities related to CSX shares and to propose actions and transactions to CSX.

As a result of entering into the letter agreement with the 3G Funds, TCI and the 3G Funds filed a Schedule 13D with the Securities and Exchange Commission (SEC) on December 19, 2007. The Schedule 13D reported group ownership of 8.3 percent of the outstanding common stock of CSX and also reported that TCI had contractual arrangements for total return swaps with several counterparties that reference CSX shares and "constitute economic exposure to" approximately 11.8 percent of the outstanding common stock of CSX. TCI and the 3G Funds filed a joint preliminary proxy statement on Schedule 14A on March 13, 2008, that also reported total return swaps referencing CSX shares constituting economic exposure to 12.3 percent for TCI and the 3G Funds.

CSX subsequently filed a lawsuit against TCI, the 3G Funds and their respective affiliates in the district court, alleging that they violated Sections 13(d) and 14(a) of the Securities Exchange Act of 1934 (the "Exchange Act") due to the fact that they, among other things, (i) should be deemed to beneficially own the CSX shares referenced in total return swaps because their statements showed that they believed they had control over the referenced CSX shares, (ii) were using total return swaps as a scheme or artifice to avoid reporting their interest in CSX shares pursuant to Section 13(d) and should be deemed to own the shares referenced by such swaps, (iii) should be determined to have formed a group with the 3G Funds earlier in 2007 than when they filed their Schedule 13D due to the amount of coordinated activity between TCI and the 3G Funds and (iv) failed to disclose their intention to control CSX in their proxy statement. Accordingly, CSX requested injunctive relief that would require TCI to sell its shares or prohibit TCI from voting at CSX's 2008 annual meeting of shareholders.

The District Court's Decision

In June 2008, the district court, focusing on TCI's statements that swap exposure to shares was preferable to actual ownership of shares in order to avoid disclosure, ruled that TCI had entered into the swaps with the intent to create the false appearance that TCI was not accumulating a large amount of securities. The district court also stated that cash-settled total return swaps may confer beneficial ownership on a long party because of the influence that the long party has on the short party if such short party hedges its exposure to the increase in the value of the securities referenced by the swap by purchasing the referenced shares. The district court also ruled that the previous relationship between TCI and the 3G Funds, when coupled with the purchases after they met and their parallel actions in preparing for a proxy contest, were sufficient to find that TCI and the 3G Funds had formed a group in February 2007, 10 months before the date they filed their Schedule 13D. However, the district court did not permit the sterilization (i.e., removal of voting privileges) of TCI's and the 3G Funds' CSX common stock, as the formation of the group and the existence of the securities-based swaps had been disclosed prior to the vote. The district court did, however, enter a permanent injunction against TCI and the 3G Funds prohibiting any future violations of Section 13(d).

Second Circuit Opinion

The 2nd Circuit vacated the injunction against violations of Section 13(d) because the district court failed to make a finding that TCI and the 3G Funds had agreed to act together for the purpose of acquiring, holding, voting or disposing of securities as required in Rule 13d-5 under the Exchange Act. In the view of the 2nd Circuit, communication among defendants prior to the purchase of securities and the similarity of the defendants' actions are insufficient to determine that a group was formed for purposes of Section 13(d) unless they agreed to act as a group for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer. The 2nd Circuit remanded to the district court for a determination of (i) whether a group was formed for purposes of acquiring CSX shares outright, (ii) the date by which that group was formed and (iii) whether an injunction is appropriate based on the failure to file a Schedule 13D in a timely manner.

The 2nd Circuit also ruled on the appropriateness of share sterilization as a remedy for violations of Section 13(d). It agreed with the district court that share sterilization is not an appropriate remedy when the information that would have been disclosed earlier through Schedule 13D filings was known to the public well in advance of the relevant meeting.

Judge Winter's Concurrence

Rather than resolve issues regarding whether the long party to a cash-settled total return equity swap may be deemed to beneficially own the shares purchased by the short party, as to which there was disagreement within the panel, the 2nd Circuit limited itself to the group and share sterilization issues discussed above. Judge Winter, however, addressed the issue in depth in his 51-page concurring opinion and stated that that type of swap would not confer beneficial ownership under the law at the time of the original action or after the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

In brief, Judge Winter's concurring opinion states that, without some sort of actual agreement between the long party and the short party as to the acquisition, voting or disposition of the subject securities, the long party does not beneficially own those securities. In Judge Winter's view, the influence that the long party has over the shares that the short party has purchased to hedge its obligations does not amount to the type of control that Section 13(d) of the Exchange Act and Regulation 13D-G contemplated.

In addition, he stated that the absence of such control by contract is not a means of evading Section 13(d) and that the economic benefit of a cash-settled total return swap does not result in a false impression of nonownership. Instead, that type of swap does not implicate the policy purposes of Section 13(d)—the acquisition of control without public knowledge. In Judge Winter's opinion, structuring around Section 13(d) by embarking on transactions that do not implicate the concerns of Section 13(d) is similar to a person structuring around short-swing liability under Section 16 of the Exchange Act by maximizing exemptions or controlling timing of transactions.

Furthermore, Judge Winter cited previous and current congressional determinations that securities-based swaps do not pose the same risks to the clandestine aggregation of control as securities or options. At the time that TCI entered into the relevant total return swaps, Section 3A of the Exchange Act, as amended the Commodity Futures Modernization Act of 2000, excluded securities-based swaps from the definition of "security" and prohibited the SEC from interpreting its rules to include securities-based swaps in its filings or other obligations. The Dodd-Frank Act now permits the SEC to determine that securities-based swaps do confer beneficial ownership in new Section 13(o) of the Exchange Act, but expressly states that a securities-based swap only confers beneficial

ownership to the extent that the SEC specifies in a rule. Instead of proposing such a rule, the SEC recently readopted the current definition of beneficial ownership under Regulation 13D-G.

Conclusion

As the 2nd Circuit did not address whether cash-settled securities-based swaps confer beneficial ownership, the uncertainty regarding securities-based swaps continues. The 2nd Circuit's opinion does, however, re-emphasize the requirement that two entities have agreed to act together for the acquisition, voting or disposition of securities in order to form a group under Section 13(d) instead of merely looking to whether the entities activities were products of concerted action.

CONTACT INFORMATION

If you have any questions concerning this alert, please contact —

Mark H. Barth
mbarth@akingump.com
212.872.1065
New York

David M. Billings
dbillings@akingump.com
44.20.7012.9620
London

Jason M. Daniel
jdaniel@akingump.com
214.969.4209
Dallas

Patrick J. Dooley
pdooley@akingump.com
212.872.1080
New York

Robert M. Griffin
bgriffin@akingump.com
971.2.406.8500
Abu Dhabi

Prakash H. Mehta
pmehta@akingump.com
212.872.7430
New York

Eliot D. Raffkind
eraffkind@akingump.com
214.969.4667
Dallas

Fadi G. Samman
fsamman@akingump.com
202.887.4317
Washington, D.C.

Simon Thomas
swthomas@akingump.com
44.20.7012.9627
London

Stephen M. Vine
svine@akingump.com
212.872.1030
New York

Ying Z. White
ywhite@akingump.com
86.10.8567.2212
Beijing