

INVESTMENT FUNDS ALERT



U.S. DISTRICT COURT RULES ON DISCLOSURE OF TOTAL RETURN SWAPS

CSX Corporation vs. The Children's Investment Fund Management (UK) LLP, et al., S.D.N.Y. 08 Civ. 2764 (June 11, 2008).

In a case closely watched by the M&A community, the U.S. District Court for the Southern District of New York ruled on June 11, 2008, that total return equity swaps held by a hedge fund conferred beneficial ownership on the hedge fund of the securities referenced in the swaps for purposes of Section 13(d) of the Securities Exchange Act of 1934, as amended.¹ The court found that The Children's Investment Fund (TCI) entered into the swaps with respect to the CSX shares as part of a "plan or scheme" to evade the reporting requirements of Section 13(d). Therefore, the court concluded that TCI was the beneficial owner of the underlying securities pursuant to Rule 13d-3(b), which provides that any person who uses a contract, arrangement or device with the purpose of preventing the vesting of beneficial ownership of securities as part of a plan or scheme to evade the reporting requirements of Section 13(d) is deemed to be the beneficial owner of the securities.

The court stopped short of holding that a total return swap in and of itself confers beneficial ownership of the referenced securities for purposes of Rule 13d-3(a), which provides that a person beneficially owns securities with respect to which the person, directly or indirectly, through contract, arrangement, understanding, relationship or otherwise, has or shares voting or dispositive power. However, Judge Lewis Kaplan expressed the view that when a total return swap is hedged by the short counterparty (the party that pays the increase in the value of the referenced securities), there are "persuasive arguments" to conclude that the swap provides the long counterparty (the party that is paid such increase) the ability to indirectly influence the sale of the securities, and thereby confers sufficient dispositive power to make the long counterparty the beneficial owner of the shares referenced by the swap. The decision is expected to have a major impact on the use of equity swaps by activist investors.

BACKGROUND

In the United States, total return swaps are generally structured by contract only to confer on the long counterparty the equivalent of economic ownership of shares of stock of an issuer, without the ability to sell or vote such shares. However, the short counterparty typically purchases the

security referenced in the total return swap to hedge the amounts that it would have to pay the long counterparty if the referenced securities increase in value during the term of the swap. As discussed below, CSX claimed, among other things, that the large economic incentive of the short counterparty to follow the desires of the long counterparty confers indirect power to direct the disposition or voting of the shares referenced by the swap on the long counterparty (in this case, TCI).

TCI entered into total return swaps relating to approximately 14 percent of the outstanding common stock of CSX in 2006 and 2007 and also purchased approximately 4.2 percent of CSX's outstanding common stock partially to avoid disclosing its positions or intentions to the marketplace. Throughout this period, TCI met with several funds to discuss its investment in CSX, including 3G Capital Partners, Ltd. and its related funds. Although TCI and the 3G funds contended that they did not at such time form a group for Section 13(d) purposes, 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 Item 6 of the Schedule 13D 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, which 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 (the "TCI defendants") in the U.S. District Court for the Southern District of New York, alleging that the TCI defendants violated Sections 13(d) and 14(a) of the Exchange Act, due to the fact that the TCI defendants, among other things, (a) 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, (b) 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, (c) should be determined to have formed a group with the 3G funds no later than November 2007 due to the amount of coordinated activity between TCI and the 3G funds and (d) 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.

SEC ADVISES THE COURT

In connection with the above case, Judge Kaplan requested that the SEC answer (a) if TCI had beneficial ownership of the CSX shares held by the counterparties to total return swaps entered into with TCI within the meaning of Regulation 13D-G and (b) if entering into total return swaps in order to, among other things, avoid disclosure in a Schedule 13D constituted a sufficient mental state to establish the existence of a plan or scheme to evade the reporting requirements of Section 13(d) or (g), such that TCI should be deemed to be the beneficial owner of the securities.

The deputy director of the Division of Corporation Finance of the SEC responded to the court's request by stating that, assuming that the swap agreement does not contractually confer any right to vote or dispose of the shares owned by the

short counterparty, the economic incentives of short counterparties to vote in accordance with the wishes of long counterparties are not sufficient to confer beneficial ownership on such long counterparty. In addition, he stated that the words “plan or scheme to evade” used in Rule 13d-3(b) require the intent to enter into an arrangement that “creates a false appearance of non-ownership of a security.”

THE COURT’S DECISION

The court ruled that the total return swaps at issue were entered into as a scheme to evade reporting under Section 13(d). The court determined that a person has entered into a plan or scheme to evade the reporting requirements of Section 13(d) and is deemed to beneficially own securities under Rule 13d-3(b) if the person 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.” In the court’s view, TCI’s admission that it wanted to avoid disclosing its position to the marketplace (in addition to its conduct of spreading its total return swaps among several short counterparties to avoid the short counterparties triggering their own Schedule 13D filing requirement) demonstrates that TCI attempted to create a false appearance that is contrary to Section 13(d)’s purpose of alerting security holders of the rapid acquisition of securities that could represent a shift in control of a company. The court also determined that many short counterparties are likely to either vote their securities in accordance with the desires of the long counterparty or abstain from voting, which could, in either case, alter the control of a company.

Judge Kaplan also stated that the practical realities of total return swaps favor deeming shares referenced in the swaps to be beneficially owned by the long counterparty. Judge Kaplan determined that short counterparties almost always hedge their risks in swap positions by purchasing the referenced securities and selling the shares as soon as the swap is terminated. The close connection between entry into a total return swap and the purchase of the referenced securities suggests that the long counterparty has the indirect power to dispose of securities by contract. As mentioned above, the tendency of a short counterparty to vote in accordance with the interests of the long counterparty may also confer indirect voting authority. It should be noted, however, that Judge Kaplan’s refusal to rule on whether a total return swap per se confers beneficial ownership renders his statements *obiter dicta*, or without formal precedential value.

Judge Kaplan also determined that TCI and the 3G funds had formed a group in early 2007 but evaded disclosure by failing to file a timely Schedule 13D. Judge Kaplan found that a group existed because of, among other things, (a) the pre-existing relationship between TCI and an affiliate of the 3G funds that invests in TCI, (b) TCI’s efforts to “cover its tracks” when it was close to the group status threshold, (c) the pattern of purchases and sales by the 3G funds after meeting with TCI and (d) the parallel actions of TCI and the 3G funds with respect to CSX, such as commencing proxy contests and making filings under the Hart-Scott-Rodino Antitrust Improvements Act of 1976.

In its ruling, Judge Kaplan did not grant CSX’s requested injunctive relief that would have required TCI to sell its shares and prohibited TCI from voting at the annual meeting. The court noted that TCI’s disclosure of its total return swaps in its Schedule 13D and preliminary proxy put CSX shareholders on notice of the swaps at issue such that they were not materially misled by TCI’s violation of Section 13(d). The court ultimately entered an injunction against TCI not to engage in future violations of Section 13(d).

CONCLUSION

Judge Kaplan ruled that entering into a total return swap to evade Schedule 13D disclosure is a “plan or scheme” that would result in a long counterparty being deemed to beneficially own the securities referenced by the swap. While

Judge Kaplan did not rule on whether a total return swap confers beneficial ownership, he indicated in *obiter dicta* that the close relationship between the unwinding of a total return swap by a long counterparty and the sale of the securities used to hedge the swap by the short counterparty (especially when taken together with the economic incentive of the short counterparty to vote such securities in accordance with the desires of the long counterparty) may confer indirect beneficial ownership of the securities referenced by the swap on the long counterparty. Judge Kaplan also analyzed when a group is deemed to be formed for the purposes of Section 13(d) and concluded that a group is formed before entering into a written agreement if there is a significant pattern of coordinated action and communication between two parties.

In light of this ruling, investors should review their Section 13(d) and Section 16 filings to determine if their beneficial ownership reporting should be revised because of swap or group issues. Investors should also carefully review poison pills of any companies in which they invest to ensure that they will not be unexpectedly triggered, with resulting changes in beneficial ownership. Finally, investors should proceed with caution in utilizing total return swaps because of the risk of being deemed the beneficial owner of the referenced securities.

1. Regulation 13D-G requires a person who acquires beneficial ownership relating to more than 5 percent of equity securities registered under the Exchange Act to file a Schedule 13D or 13G with the Securities and Exchange Commission.

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