CSX Decision Results in Beneficial Ownership but No Meaningful Relief

In a much-anticipated decision in the CSX Corporation (CSX) proxy fight, Judge Lewis A. Kaplan of the U.S. District Court for the Southern District of New York held that a hedge fund, The Children's Investment Fund (TCI), violated Exchange Act Section 13(d) by failing timely to disclose beneficial ownership of equity securities related to cash settled total return swaps it held in CSX common stock. In addition, the court ruled that TCI and another hedge fund, 3G Fund L.P. (3G), failed to disclose in a timely manner the formation of a Section 13(d) group. This victory may have been empty, however, as the court was constrained in the relief it could grant, declining to "sterilize" shares acquired during the period of violation and ordering only that the hedge funds cease from further violations of the securities laws.

The case is heavily fact-specific. The court did not hold that a total return swap confers beneficial ownership—in the sense of the right to vote or dispose—of the number of shares represented by the position, although the judge edged close to that conclusion. It was obvious to the court that TCI knew that the swap counterparty—a commercial or investment bank—would purchase CSX shares to hedge its position because TCI entered into swaps with multiple banks so that no single bank would exceed the 5 percent disclosure threshold. Trading records showed that the bank counterparties purchased shares—in the court's words, "virtually on a share-for-share basis"—at the time a swap was entered into and sold shares when a swap was terminated. As for voting, the court observed that there were "large and aberrant movements of CSX shares in and out of [the bank counterparty's] hands" immediately before and after a record date, suggesting that the bank counterparty was bringing the shares, which it had lent in the stock loan market, back in so it could vote them, presumably influenced by TCI's wishes. Focusing purely on what legal rights the parties had under the relevant documentation, in the court's view, "exalts form over substance."

The court did not find that TCI was a beneficial owner because of any voting or dispositive power it possessed, either directly or indirectly, over the hedged shares. Rather, the court relied on that portion of Rule 13d-3 that deems a person to be the beneficial owner of a security if that person "uses [an] . . . arrangement . . . with the purpose or effect of divesting or preventing the vesting of . . . beneficial ownership as part of a plan or scheme to evade the reporting requirements of Section 13(d) . . . ." The SEC's Division of Corporation Finance submitted an *amicus* letter in which it stated its view that the quoted provision required an "intent to create the false appearance of non-ownership," and that "as a general rule, 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 court concluded that TCI entered into the swaps with the intent of creating the false appearance that there was no large accumulation of securities with a potential for shifting corporate control. As such, it was deemed to be the beneficial owner of the number of securities represented by the swaps and should have reported them earlier than it did.

The court also concluded that TCI and 3G formed a Section 13(d) group earlier than December 2007, when they first reported it. The court based its conclusion on circumstantial evidence—the history of relations between TCI and 3G, the discussions that took place between them and the timing of their respective transactions. Based on these circumstances, the court concluded that they formed a group no later than February 2007.

CSX alleged that the Schedule 13D and proxy materials that TCI and 3G filed contained various disclosure violations, such as failing to disclose beneficial ownership of the shares represented by the swaps (even though the swaps were described), disclosing the incorrect date of the group formation, omitting to file the swap contracts as exhibits, and disclosing a false reason for originally acquiring the shares. In each case, the court found that the omission or misstatement was not material.

CSX sought to have TCI and 3G enjoined from voting any shares they owned at the 2008 annual meeting. To obtain this relief, CSX needed to show irreparable injury. Cases in the Second Circuit suggest that irreparable harm cannot be established once corrective disclosure has been made, unless the violator had obtained "a degree of effective control" as a result of purchases made before complying with Section 13(d). The Second Circuit had found that a 31 percent stake was insufficient to establish effective control. Thus, under the circumstances, the court was unable to conclude that the approximately 20 percent stake that TCI and 3G had established constituted effective control.

Conclusion

This case was decided under the "anti-avoidance" provision of Rule 13d-3, which deems a person to be the beneficial owner of a security over which it may not actually have investment control. Such a finding will always depend heavily on the particular facts, and Judge Kaplan's decision was no doubt influenced by his belief that TCI and 3G had a control purpose far earlier than they disclosed to the market.

The court did not hold that the long party to a total return swap is a beneficial owner of the number of securities represented by the swap, requiring the holder immediately to aggregate those holdings with shares that it otherwise beneficially owns. We can take at its word the SEC's Division of Corporation Finance statement that a person who does "nothing more than enter into an equity swap should not be found to have engaged in an evasion" of Section 13(d). On the other hand, if Judge Kaplan's view prevails, if there is something more, a holder will have to look at all the facts and circumstances—focusing on substance rather than form—to determine whether beneficial ownership is present in a swap transaction.

Because the beneficial ownership standards of Section 13(d) are used to determine beneficial ownership under Section 16(b), this case could embolden Section 16 plaintiffs to bring short-swing profit cases when a Schedule 13D or 13G shows aggregate holdings—including swaps—in excess of 10 percent.

The decision serves as a reminder that courts will judge group formation with the benefit of hindsight and, where circumstantial evidence permits, will likely assume that a common understanding was reached relatively early, especially where the holders have a history of prior contacts. The ubiquity of email communications makes this inquiry easier.

The case also illustrates that Schedule 13D disclosure need not be perfect to satisfy the requirements of the rules. Although CSX alleged several disclosure violations, the court found in each instance that the violations were not material and that a contrary result would have elevated form over substance.

Finally, the decision highlights the limited recourse issuers have for Section 13(d) violations. This decision comes on the heels of the Fifth Circuit's May 27, 2008 decision in *Motient Corp. v. Dondero et al.*, in which the court held that Section 13(d) does not give rise to a private right of action for monetary damages. Absent a different result on appeal in this case, the injunction on future Section 13(d) violations is likely to have little impact on the current CSX proxy contest.

If you have any questions concerning Judge Kaplan's decision, please contact your usual Ropes & Gray adviser.