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New York District Court Finds Violations of SEC Disclosure Requirements by Hedge Funds' Acquisition of Swap Interests in a Target and by Acting as a Group Without Public Disclosure

The recent decision in *CSX Corporation* v. *The Children's Investment Fund Management (UK) LLP*, *et al.*, 08 Civ. 2764 (LAK), has significant implications for hedge funds that seek to influence target corporations by (individually or collectively) attempting to amass substantial voting positions without triggering the need for public disclosure. The 115-page opinion by Judge Lewis A. Kaplan of the Southern District of New York concludes that hedge funds may be a "group" for disclosure purposes under Section 13(d)(3) of the Exchange Act where the circumstantial evidence concerning communications between them indicates they are working together. In that event, public disclosure is required when their combined holdings reach 5%. It also holds that parties who accumulate swap positions in the equity of a target, for the purposes of preventing the vesting of beneficial ownership in order to avoid the reporting requirements of Section 13(d), are deemed the beneficial owners of the shares under Rule 13d-3(b) and must make appropriate disclosure. Finally, although Judge Kaplan found it unnecessary to decide the issue, the opinion strongly suggests that the swap holder may be the beneficial owner of the stock under Rule 13d-3(a).

CSX concerned a proxy fight between CSX Corp., a railroad company, and two hedge funds that had acquired substantial interests in it: The Children's Investment Master Fund ("TCI") and 3G Fund L.P. ("3G"). From October 2006 through late 2007, TCI and 3G acquired some CSX stock outright and substantial "swap" positions in the form of total return swaps ("TRSs"). At various times, TCI and 3G approached CSX management about possible changes to the Board of Directors. When CSX resisted, TCI and 3G investigated the possibility of a leveraged buyout. They ultimately began a proxy fight seeking to elect their nominees to five of the twelve seats on the CSX Board and to amend CSX's by-laws to permit holders of 15% of CSX shares to call a special meeting of shareholders at any time for any purpose permissible under the law of Virginia, CSX's state of incorporation.

Section 13(d) of the Exchange Act requires an investor to make disclosures, both to the Securities and Exchange Commission and to the relevant public markets, within 10 days of acquiring a 5% interest in the stock of a particular company.

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The Court concluded that TCI and 3G violated Section 13(d) because they failed to timely disclose that they had formed a group for the purpose of acquiring shares in CSX. The Court observed that whether individuals or entities can be deemed to act as a group does not depend on the existence of a formal agreement. Rather, the agreement "may be formal or informal, and need not be expressed in writing." Nor do the parties need to commit to a defined set of terms as long as they share a common objective.

Defendants argued that they did not reach an agreement to collaborate until December 12, 2007 and that the arrangement was duly disclosed in the Schedule 13D filed a week later. The Court disagreed, noting that the long-standing relationship between TCI and 3G, 3G's pattern of dramatically increasing its holdings in CSX directly following meetings with TCI, and preparations by both entities to engage in a proxy fight, among other things, indicated that defendants had formed a group early as February 2007.

In addition, the Court concluded that TCI's individual actions violated the statute and the relevant regulations through its acquisition of TRSs. In the past, TRSs have been used by hedge funds to amass a substantial position in a stock without making any disclosure. In a TRS, the "short" party agrees to pay the "long" party cash flows based on the performance of a defined underlying asset (here, shares of CSX) in exchange for interest payments by the long party at a negotiated rate on the agreed principal amount (the "notional amount"). The long party is entitled to the sum of: (1) any cash distributions, such as interest or dividends, that it would have received had it held the shares; and (2) either: (i) an amount equal to the market appreciation of the shares over the term of the swap; or (ii) the shares themselves in exchange for their value on the last refixing date prior to the winding up of the transaction. The short party is entitled to receive from the long party: (1) an amount equal to the interest at the negotiated rate that would have been payable had it actually loaned the long party the notional amount; and (2) any decrease in the market value of the shares. The short party almost invariably purchases an equivalent position in the underlying stock to hedge its short position.

TCI and 3G had both amassed substantial TRS positions in CSX through a variety of swaps with several different financial institution counterparties. The Court noted that TCI was careful to ensure that all of the counterparties were short on TRSs by less than 5% of CSX stock to ensure that none of the counterparties had 13(d) disclosure obligations. When TCI and 3G finally disclosed their positions in the course of initiating the proxy fight, CSX brought suit, alleging, among other things, violations of Section 13(d) of the Exchange Act for defendants' failure to make a timely disclosure that they were acting as a group or disclose their beneficial ownership of CSX stock.

The Court was sympathetic to the argument. The Court found that "TCI manifestly had the economic ability to cause its short counterparties to buy the CSX shares" because it knew that these counterparties would do so to hedge their short positions. The Court noted that "once the counterparties bought the shares, TCI had the practical ability to cause them to sell simply by unwinding the swap transactions." The Court found that "TCI was in a position to influence the counterparties … with respect to the exercise of their voting rights[,]" thus strengthening the argument that TCI was a beneficial owner of the CSX stock.

The Court was unmoved by the plain language of the swap contracts, which did not include agreements with respect to voting, or even explicitly prevented TCI from directing how its counterparty voted its shares, noting that such an argument "exalts form over substance." The Court pointed to a number of facts in the case that made it likely that TCI could exercise considerable influence over its counterparties' voting decisions. Likewise, the Court rejected the arguments by the defendants and by the SEC Division of Corporate Finance, that ruling that swaps confer beneficial ownership "would be novel and upset settled expectations of the market." The Court called these "Cassandra-like predictions," pointing out that tighter disclosure requirements had been effectuated in London and "there is no reason to believe that the sky has fallen, or is likely to fall, in London."

Although the Court all but concluded that TRSs confer beneficial ownership under Rule 13d-3(a), it felt it unnecessary to decide the issue. Instead, it based its decision on Rule 13d-3(b), which, as the Court noted, "provides in substance that one who creates an arrangement that prevents the vesting of beneficial ownership as part of a plan or scheme to avoid the disclosure that would have been required if the actor bought the stock outright is deemed to be a beneficial owner of those shares." The Court held that "[t]hat is exactly what the defendants did here in amassing their swap positions." Defendants' deliberate spreading of their swaps across a variety of different investment and commercial banks, so that no counterparty would by itself own more than 5% of CSX, weighed heavily in the Court's assessment of the facts.

The consequences of *CSX*'s holdings concerning beneficial ownership are considerable. Shielding an investor from the disclosures to the markets necessitated by beneficial ownership is one of the principal purposes of TRSs. The *CSX* decision concludes disclosure is required essentially because of that purpose. Under the Court's reading of Rule 13d-3, the difference between swaps and actual equity is effectively erased for the purposes of disclosing an ownership position.

The Court's reasoning blurs somewhat the distinction between beneficial ownership under Rule 13d-3(a) and (b). That is, the same facts that animate the Court's near-conclusion that TCI could influence its swap counterparties' voting decisions and buy-sell decisions and, thus, could be a beneficial owner under Rule 13d-3(a), are the basis for the Court's conclusion that TCI's use of the swaps to avoid disclosure obligations required that it be deemed the beneficial owner of the equity under Rule 13d-3(b). We note, however, that the Court's conclusions were based in large part on what it considered evidence of affirmative attempts to avoid disclosure obligations and, absent this evidence, it is possible that the Court would have reached a different result.

Notwithstanding its sweeping findings on liability, the Court denied most of the remedies sought by CSX. CSX had sought sterilization of the shares acquired by TCI and 3G during the period before their disclosure. The Court refused to order sterilization because it held that it was precluded from doing so by Second Circuit precedent, which holds "that irreparable harm cannot be established once corrective disclosure is made."[1] The court noted that if it were free to order sterilization, it would have done so. Accordingly and because the hedge funds' belated disclosures were accurate, the Court merely enjoined the defendants from violating Section 13(d)

1 *See, generally, Treadway Cos., Inc. v. Care Corp.*, 638 F.2d 357 (2d Cir. 1980).

in the future. The Court noted that any additional penalties for defendants' violations would have to come by way of appropriate action by the SEC or the Department of Justice.[2]

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any of the following:

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2 Plaintiff and defendants have filed notices of appeal to the United States Court of Appeals for the Second Circuit.