# GRANT & EISENHOFER
# CLIENT ALERT 2008-1

## Court Finds That Hedge Funds "Crossed The Line" By Attempting To Circumvent The Reporting Requirements Of Section 13(d)

In a June 11, 2008 decision in CSX Corp. *v. Children's Investment Fund Management (UK) LLP,*[1] Judge Kaplan of the U.S. District Court for the Southern District of New York addressed two issues of importance to hedge funds and shareholder activists: (1) whether the obligation to file a Schedule 13D can be purposefully avoided through ownership of derivatives that do not carry the full panoply of contractual rights accompanying beneficial ownership, and (2) whether investors can avoid identifying themselves as a "group" in a Schedule 13D by disclaiming an intention to form a group.

The answer on both counts was no, based on the Court's view that the hedge funds at issue had deliberately tried to subvert the goals underlying Section 13(d) of the Securities Exchange Act of 1934 (the "Exchange Act"). While different circumstances may yield a different result, investors should be aware of the risks that certain conduct will subject them to the reporting requirements of Section 13(d).

### The Requirements of Section 13(d)

Section 13(d)(1) requires prompt disclosure following the acquisition of "beneficial ownership" of more than 5% of a company's equity securities.[2] This requirement was enacted as a means "to alert the marketplace to every large, rapid aggregation or accumulation of securities … which might represent a potential shift in corporate control."[3]

S.E.C. Rule 13d-3(a) defines "beneficial ownership" as the possession or sharing of "voting power" or "investment power."[4] Rule 13d-3(b) further provides that persons who enter into arrangements to divest themselves of beneficial ownership or prevent the vesting of beneficial ownership as part of a "plan or scheme to evade the reporting requirements" are deemed to be beneficial holders.[5]

To prevent investors from colluding to circumvent the filing requirements, Section 13(d)(3) also provides that two or more persons who act as a "group" for purposes of "acquiring, holding or disposing of securities" are subject to the reporting requirements of Section 13(d) as if they were a single person.[6]

### The Facts of the CSX Case

Two hedge funds, The Children's Investor Master Fund ("TCI") and 3G Fund L.P. ("3G"), are presently engaged in a proxy fight in which they seek, among other things, to elect five nominees to the board of CSX Corporation ("CSX").

TCI and 3G first started acquiring interests in CSX in 2006 and 2007, in the form of total return equity swaps ("TRSs"), a type of derivative that gave them "substantially all the indicia of stock ownership save the formal legal right to vote the shares." The Court described a TRS as a swap whereby two counterparties agree to exchange cash flows for a fixed period of time on two financial instruments, an asset

(such as a security) and a benchmark loan. The "short" party (in this case a financial institution) pays cash flows based on the performance of the asset, in exchange for payments by the "long" party (TCI or 3G) based on a negotiated interest rate on an agreed principal amount.[7] In practical terms, the long party does not have record ownership or voting rights in the shares and must look to the short party for distributions. The long party can later decide to unwind the swaps and acquire the underlying shares and voting rights.

The evidence showed that from the outset, TCI and 3G sought to effect significant policy changes and/or mount a proxy fight at CSX, and that the reason they acquired their interests in the form of TRSs was to avoid alerting the marketplace to their accumulation of those interests. Representatives of TCI and 3G began communicating about CSX in early 2007, although they declared during these conversations that they were not acting as a group. In December 2007, TCI and 3G entered into agreements with two director nominees, and it was only then that they filed a Schedule 13D disclosing the existence of their "group." The filing indicated that the group collectively owned 8.3% of CSX's stock, and that TCI had TRSs giving it economic exposure to another 11%, though TCI disclaimed beneficial ownership of those shares.

CSX filed suit against TCI and 3G, claiming that they had violated the securities laws by failing to file a Schedule 13D earlier.

**The Meaning of "Beneficial Ownership"**

The first question the Court addressed was whether TCI, by virtue of its long positions in the TRSs, was the "beneficial owner" of CSX shares. If so, it had violated Section 13(d)(1) by failing to file a Schedule 13D after acquiring TRSs on more than 5% of CSX's shares.

TCI argued that the TRSs did not give rise to beneficial ownership because they did not give TCI any legal or contractual rights with respect to the voting or disposition of CSX shares. The Court acknowledged TCI's lack of *direct* investment or voting power, but noted that focusing on TCI's rights under the swap agreements would exalt form over substance. It described the proper inquiry as whether TCI had "a *significant ability to affect* how voting power or investment power will be exercised, because [Section 13(d)] is primarily designed to ensure timely disclosure of market-sensitive data about changes in the identity of those who are able, as a practical matter, to influence the use of that power."[8]

The Court found that TCI had significant influence over the investment power in the CSX shares underlying the TRSs because TCI knew and intended that its counterparties would purchase those shares in order to hedge their short positions. In fact, knowing that this would occur, TCI purposefully spread its TRS agreements across eight counterparty banks so none of them would acquire a 5% interest that would trigger their own disclosure requirement. TCI also had the practical ability to cause the banks to sell the shares, simply by unwinding the swaps. Additionally, the Court found reason to believe that TCI could influence the banks' voting of the shares, given its ability to select those counterparty banks that would most likely support TCI in a proxy contest. Judge Kaplan dismissed TCI's prediction of dire market consequences if swap holders were deemed beneficial owners – concerns that were echoed to some extent in an *amicus* letter from the S.E.C. Division of Corporate Finance – as exaggerated and "Cassandra-like."

However, after this lengthy analysis that appeared to be leading to the conclusion that long positions in TRSs constitute "beneficial

ownership" under Section 13(d), the Court found it unnecessary to decide that issue because it found TCI to be a "beneficial owner" of those shares for another reason: it had entered the swap contracts as part of a "plan or scheme to evade the reporting requirements" as described in Rule 13d-3(b). Among the "overwhelming" evidence cited by the Court was the fact that a TCI officer told the board that one reason for using swaps was "the ability to purchase without disclosure to the market or the company," and TCI's admission that it wanted to avoid disclosure so as to avoid paying the higher price for CSX shares that would result if the market learned of its intentions to acquire or influence the company. TCI emails also discussed the need to keep the holdings of each counterparty bank below 5%. The fact that TCI had disclosed its interest *to CSX* before filing the Schedule 13D was of no moment, because Section 13(d) requires disclosure to the market in general, and because the disclosure to TCI did not include all of the information required by the statute. Accordingly, the Court found that TCI's actions fell squarely within Rule 13d-3(b) and were contrary to the overall purpose of Section 13(d). As a result, TCI violated the securities laws by failing to file a timely Schedule 13D after entering TRSs with respect to 5% of CSX's stock.

**Formation Of A "Group"**

"The existence of a group turns on 'whether there is sufficient direct or circumstantial evidence to support the inference of a formal or informal understanding between [members] for the purpose of acquiring, holding, or disposing of securities.'"[9] Judge Kaplan explained that an allegation that persons have formed a group "is analogous to a charge of conspiracy in that both assert that two or more persons reached an understanding, explicit or tacit, to act in concert to reach a common goal."[10]

Although they had gone to "considerable lengths to cover their tracks," including beginning each conversation by disclaiming that they were a group,[xi] the Court found substantial circumstantial evidence that TCI and 3G had been acting as a group since February 2007 – ten months before filing their Schedule 13D. For example, the funds had a long-standing relationship because 3G's Synergy Fund was an investor in TCI. Representatives from the two funds met in January 2007 to discuss TCI's investment in CSX, including its approximate size. Perhaps most tellingly, 3G began buying CSX shortly after having conversations with TCI, and engaged in a pattern of increasing its CSX purchases after meetings with TCI. The Court was not persuaded by the fact that 3G sold a large portion of its holdings in August and September 2007, reasoning that both funds had reduced their holdings during this period and that "[c]o-conspirators and members of cartels act on their own from time to time."[11]

**The Consequences Of The Violations**

To remedy the violations of Section 13(d), CSX asked the Court to "sterilize," *i.e.* enjoin the voting of, all shares held by TCI and 3G. CSX argued that this drastic remedy was necessary to prevent the funds from retaining "the fruits of their violations" and to deter future violations. The Court limited its analysis to the 6.4% of CSX shares the funds had acquired during the period in which they had not satisfied their disclosure obligations, and held that under binding Second Circuit precedent, altering the corporate electorate by this number of votes would not create the "irreparable harm" necessary for an injunction.[12] The Court also rejected the deterrence argument under Supreme Court precedent that mere public interest considerations are insufficient to justify an injunction where there is no irreparable harm.[13]

Instead, the Court issued a permanent injunction against the funds, restraining them from future violations of Section 13(d).

**Lessons To Be Learned**

The CSX decision is significant for several reasons. First, it reaffirms that investors cannot avoid the Schedule 13D reporting requirement by engaging in conduct designed to subvert the purposes of those requirements. Second, the Court's flexible analysis of "beneficial ownership" and what constitutes "investment power" and "voting power" demonstrate a willingness to look beyond the four corners of an investor's contractual agreements and focus on the realities of the investment world. As Judge Kaplan explained, "[t]he securities markets operate in the real world, not in a law school contracts classroom. Any determination of beneficial ownership that failed to take account of the practical realities of that world would be open to the gravest abuse." Accordingly, investors cannot assume that the lack of *direct* voting or investment power necessarily translates to a lack of beneficial ownership for purposes of Section 13(d).

Similarly, the Court looked to substance rather than form when determining whether a group had been formed, finding it inconsequential that when the funds met with each other they had declared among themselves that they were not a group. Finally, although the Court declined to "sterilize" the funds' voting rights, it noted that if it were not constrained by Second Circuit precedent, it would have granted such relief. Therefore, in jurisdictions with a lower standard for demonstrating "irreparable harm," funds that try to circumvent Section 13(d) may find themselves precluded from voting their shares.

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[1] No. 08 Civ. 2764 (LAK), 2008 WL 2372693 (S.D.N.Y. June 11, 2008).

[2] 15 U.S.C. § 78m(d)(1).

[3] *GAF Corp. v. Milstein*, 453 F.2d 709, 717 (2d Cir. 1971), *cert denied*, 406 U.S. 901 (1972); *CSX*, 2008 WL 2372693, at *18.

[4] 17 C.F.R. § 240.13d-3.

[5] Id. at § 240.13d-3(b).

[6] 15 U.S.C. § 78m(d)(3).

[7] By way of example, the Court explained that for a TRS involving 100,000 shares of stock, (1) the short party would pay the long party an amount equal to any dividends, cash flow and increase in market value that the long party would have gained if it owned the 100,000 shares, and (2) the long party would pay the short party an amount equal to the interest it would have had to pay had it borrowed the notional amount from the short party plus any depreciation the long party would have suffered if it owned the 100,000 shares. *CSX*, 2008 WL 2372693, at *18.

[8] *Id*. at *20 (quoting *SEC v. Drexel Burnham Lambert Inc*., 837 F. Supp. 587, 607 (S.D.N.Y. 1993), *aff'd sub nom. SEC v. Posner*, 16 F.3d 520 (2d Cir. 1994), *cert. denied*, 513 U.S. 1077 (1995)).

[9] *Id*. at *29 (quoting *Hallwood Realty Partners, L.P. v. Gotham Partners, L.P*., 286 F.2d 613, 617 (2d Cir. 2002)).

[10] *Id.* (citation omitted).

[11] *Id*. at *29 & n.220.

[12] *Id*. at *43 (citing *Treadway Cos. v. Care* Corp., 638 F.2d 357, 380 n.45 (2d Cir. 1980), for the proposition that acquisition of a 31% block during a period of non-compliance with Section 13(d) is insufficient to threaten irreparable harm to the remaining shareholders).

[13] *Id*. at *44 (citing *Rondeau v. Mosinee Paper Corp*., 422 U.S. 49, 64-65 (1975)).