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Second Circuit Provides Guidance on Section 13(d) "Group" Issues but Declines to Address Beneficial Ownership Issues in the Swap Context

On July 18, 2011, almost three years after the appeal was argued, the Second Circuit rendered its decision in *CSX Corporation v. The Children's Investment Fund Management (UK) LLP*,[1] a case raising significant issues under Section 13(d) of the Securities Exchange Act of 1934. Although it provided some guidance regarding the definition of a "group" for purposes of Section 13(d), the opinion for the court did not reach a central issue raised by the appeal – whether, or under what circumstances, a long party to a cash-settled total-return equity swap agreement will be deemed to beneficially own shares purchased by the short party as a hedge.

Two hedge funds -- The Children's Investment Fund Management ("TCI") and 3G Capital Partners ("3G") -- each separately owned shares of CSX and was the long party in cash-settled total-return equity swaps with respect to CSX shares. After filing a Schedule 13D that acknowledged they were acting as a group, the funds launched a proxy contest to elect a minority slate of directors to the CSX board. CSX filed suit in U.S. District Court in response to the proxy contest. The District Court held that TCI was a beneficial owner of all CSX shares owned by the short parties to its swaps and violated Section 13(d) by not reporting ownership of those shares. The court reasoned that such swaps were part of a scheme or plan to evade the reporting requirements of Section 13(d), and therefore, the CSX shares owned by the short parties would be deemed beneficially owned by TCI under Rule 13d-3(b). The court also found that TCI and 3G did not make timely disclosure regarding formation of a group that, in the court's view, occurred several months prior to the filing of the Schedule 13D. The District Court entered a

[1] Docket Nos. 08-2899-cv (L), 08-3016-cv (XAP) (2d Cir. July 18, 2011).

broad permanent injunction prohibiting further violations of Section 13(d) by TCI and 3G whether or not relating to CSX shares, but it refused CSX's request that TCI and 3G be prohibited from voting certain of their CSX shares. The decision was appealed to the Second Circuit.

At the outset of its discussion of the issues, the Second Circuit panel stated that it would not address the swap issue and instead would focus only on the issue of the TCI and 3G group with respect to shares owned outright by the funds:

> [T]he panel is divided on numerous issues concerning whether and under what circumstances the long party to [such an equity] swap may be deemed, for purposes of section 13(d), the beneficial owner of shares purchased by the short party as a hedge. In view of that disagreement, we conclude it is appropriate at this time to limit our consideration to the issue of group formation… .

As a result, despite the seeming centrality of the issue to the case, the opinion for the court did not provide any guidance on the issue of long party beneficial ownership of shares owned by a short party. In this regard, it is worth noting that the District Court's 2008 opinion may have led some long parties to take a more conservative position regarding treating equity swaps as conferring beneficial ownership of the short party's hedge shares, and the Second Circuit's failure to address the issue may lead some – including some hedge funds – to revert to more aggressive reporting positions. Consequently, some issuers may now consider defining beneficial ownership in nomination by-laws and poison pill rights plans to explicitly include derivative positions.

With regard to the group issue, the court noted that the District Court determined only that TCI and 3G formed a group "with respect to CSX securities" and acted in concert with respect to those securities. The Second Circuit held that this was insufficient for proper appellate review and remanded this issue to the District Court to consider the specific types of concerted action that result in group formation under Rule 13d-5(b)(1). In particular, the Second Circuit

instructed the District Court to make "a precise finding, adequately supported by specific evidence…" as to whether the funds "formed a group for the purpose of 'acquiring, holding, voting or disposing' . . . CSX shares." Given the limit of the Second Circuit's review, the District Court was further instructed to limit its finding to the CSX shares owned outright by the funds. The court concluded that "[o]nly if such a group's outright ownership of CSX shares exceeded the 5 percent threshold prior to the filing of a section 13(d) disclosure can a group violation of section 13(d) be found."

The Second Circuit also provided some measure of guidance to the District Court with regard to whether a broad injunction against all Section 13(d) violations by TCI and 3G should issue in the event that the District Court finds a group violation. In particular, the panel stated that weighing against such a broad injunction are the facts that fewer shares will be at issue in the remanded case (i.e., the shares owned by the short parties would be excluded from consideration) and that CSX publicly disclosed the TCI and 3G ownership in its Form 10-Q before any vote of the shareholders. On the other hand, the panel noted that if the District Court concludes, as it did initially, that some of the TCI and 3G parties testified falsely, a broad injunction may be appropriate.

Finally, the court affirmed the District Court's denial of the injunction prohibiting TCI and 3G from voting certain of their CSX shares. The Second Circuit noted that the relevant purpose of Section 13(d) is the timely disclosure of required information. As a result, such an injunction is inappropriate where -- as in this case -- the required disclosure is made sufficiently in advance of the shareholder vote.

Although the opinion for the court did not address the swap issue, in a separate concurring opinion, Judge Winter rehearsed the arguments why a long party in a total-return cash-settled equity swap should not be deemed to beneficially own hedge shares purchased by the short party. Among other observations, Judge Winter noted that, in itself, such an arrangement does not confer on the long party the investment or voting power over the shares that amount to beneficial ownership under Rule 13d-3(a). Such rights remain under the sole control of the short party.

With respect to the District Court's conclusion that the swaps amounted to a scheme or plan to evade the reporting requirements of Section 13(d), Judge Winter argued that to implicate Section 13(d) "the transaction must include a component that provides a substantial equivalence of the rights of ownership relevant to control, or include steps that stop short of, or conceal, the vesting of ownership, while nevertheless ensuring that such ownership will vest at the signal of the would-be owner." In other words, the mere desire to avoid filing a Schedule 13D is not in itself enough to create beneficial ownership; rather, the party must have taken steps to avoid otherwise applicable requirements of Section 13(d) through an artifice related to ownership. As a result, Judge Winter concluded that absent an agreement between the long and short parties permitting the long party to acquire the hedge shares or control their voting, total-return cash-settled equity swaps do not confer on the long party beneficial ownership of the short party's hedge shares. However, because the panel as a whole declined to consider the issue, it remains unclear whether the view of the District Court or that of Judge Winter will be law.

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