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Corporate Governance Group Client Alert

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SECOND CIRCUIT VACATES INJUNCTION ISSUED AGAINST HEDGE FUNDS RELATING TO THEIR ACCUMULATION OF CSX STOCK

Remands case for further consideration of section 13(d) "group" formation issues, but agrees with lower court that "sterilization" of voting rights is not an appropriate remedy

On June 11, 2008, the United States District Court for the Southern District of New York permanently enjoined two hedge funds, The Children's Investment Fund Management ("TCI") and 3G Capital Partners ("3G" and, together with TCI, the "Funds"), from future violations of section 13(d) of the Securities Exchange Act of 1934.[1] This action arose from the Funds' activities relating to shares of common stock of CSX Corporation, one of the nation's largest rail systems. The District Court found that, for purposes of section 13(d), (i) TCI was the beneficial owner of shares of CSX common stock referenced by cash settled total return equity swaps ("TRSs") purchased by TCI, not because TRSs themselves convey beneficial ownership[2] of the referenced shares (an issue which the District Court declined to decide), but rather as a result of "a plan to evade the reporting requirements of section 13(d);"[3] and (ii) the Funds formed a "group"[4] with respect to their activities involving CSX shares prior to formally declaring so in a filing with the SEC. On this basis, the District Court found that the Funds failed to timely file Schedule 13Ds and, as a result, violated section 13(d). Nevertheless, the District Court concluded that it was "foreclosed as a matter of law from granting an injunction prohibiting the Funds from voting" their CSX shares at the upcoming 2008 annual shareholders meeting.

[1] *CSX Corp. v. The Children's Inv. Fund Management (UK) LLP et al.,* S.D.N.Y., 2008 WL 2372693, June 11, 2008. For a discussion of the District Court decision, *see* our Client Alert entitled "Federal District Court Rules that Hedge Funds Have 'Beneficial Ownership' of CSX Corporation Shares Underlying Equity Swaps" (dated June 19, 2008).

[2] *See* SEC Rule 13d-3(a).

[3] *See* SEC Rule 13d-3(b).

[4] *See* SEC Rule 13d-5(b)(1).

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All sides appealed this ruling. On July 18, 2011, in *CSX Corporation v. The Children's Investment Fund Management (UK) LLP et al.,*[5] the United States Court of Appeals for the Second Circuit vacated the injunction relating to future section 13(d) violations and affirmed the District Court's refusal to "sterilize" the Funds' voting rights. The Second Circuit's ruling points out the significant obstacles that will be encountered by companies who seek to use section 13(d) as a defensive weapon against stock accumulators.

Background

When TCI first became interested in investing in CSX, it did not buy shares in CSX directly but instead began accumulating an economic, although not a voting, position through cash-settled TRSs[6] referencing CSX common stock. This strategy enabled TCI to avoid disclosure of its growing interest in CSX so as not to trigger a rise in the price of the stock. To hedge their risk to the TRSs, TCI's counterparties in turn purchased shares of CSX stock in amounts almost identical to those referenced in the swaps. TCI distributed these swaps among eight counterparties, ensuring that no individual counterparty would acquire more than 5% of CSX's shares through hedging.

Early in 2007, 3G approached TCI about its holdings in the railroad industry. TCI informed 3G that it had an interest in CSX and, shortly thereafter, 3G began to invest both in CSX shares and in TRSs referencing CSX stock. The Funds had subsequent conversations in which they discussed CSX, and as the year progressed they continued to invest in the company. Also during the course of 2007, TCI made it clear to CSX management that it had acquired a significant economic stake in the company's shares and intended to cause changes at CSX.

Then, on December 10, 2007, the Funds made their initial joint Schedule 13D with the Securities and Exchange Commission relating to CSX. The Schedule 13D (i) announced that the Funds collectively owned 8.3% of the outstanding stock of CSX, with additional "economic exposure" to approximately 12% through TRSs, (ii) expressed their displeasure with the operation and direction of CSX and (iii) indicated that they were contemplating a proxy contest. As forecasted in that filing, on March 10, 2008, the Funds filed proxy materials as part of a joint effort to elect five directors to CSX's 12-person board at the upcoming 2008 annual meeting. Shortly thereafter, CSX brought suit to, among other things, prevent the Funds from voting their shares at that meeting. After the District Court enjoined the Funds from future section 13(d) violations but refused to "sterilize" their voting rights, both sides appealed.

The Second Circuit's Analysis

At the outset, the Second Circuit acknowledged that it was "divided on numerous issues concerning whether and under what circumstances the long party to a credit-default swap may be deemed, for purposes of section 13(d), the beneficial owner of shares purchased by the short party as a hedge." Accordingly, the Second Circuit limited its analysis and decision to the CSX shares owned by the Funds "outright" (that is, *not* including any shares referenced by the TRSs). Next, the Second Circuit turned to the issues surrounding the Funds' potential status as a "group" under section 13(d), as well as the appropriateness of injunctive relief for section 13(d) violations.

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[5] *CSX Corp. w. The Children's Inv. Fund Mgmt. (UK) LLP et al.,* 2d Cir., 2011 WL 2750913, July 18, 2011.

[6] As described by the Second Circuit, TRSs are "contracts in which parties agree to exchange sums equivalent to the income streams produced by specified assets … [that] do not transfer title to the underlying assets or require that either party actually own them."

"Group" Formation

The Second Circuit began its analysis of this issue by referencing SEC Rule 13d-5(b)(1), which provides that section 13(d) disclosure requirements apply to the aggregate holdings of any "group" formed "'for the purpose of acquiring, holding, voting or disposing' of equity securities of an issuer." Thus, the question whether a group has been formed "turns on 'whether there is sufficient direct or indirect circumstantial evidence to support the inference of a formal or informal understanding between [members] *for the purpose of acquiring, holding, or disposing of securities.*'"

The Second Circuit avoided ruling on whether the District Court erred in concluding that the Funds had formed a group earlier than their initial Schedule 13D filing, and instead remanded to the District Court for further deliberations, on two separate grounds:

- First, the Second Circuit explained that the District Court's findings were "insufficient for proper appellate review" because the District Court "did not explicitly find a group formed for the purpose of *acquiring* CSX securities" (emphasis added). In other words, the District Court's finding that "the parties' *activities* ... were products of concerted action ..." was not, in the Second Circuit's opinion, adequately related to the specific language of the rule.

- Second, consistent with its focus on shares owned outright by the Funds to the exclusion of shares referenced by any TRSs, the Second Circuit noted that the District Court "did not distinguish in its group findings between CSX shares deemed to be beneficially owned by the Funds and those owned outright by the Funds."

Appropriateness of Injunctive Relief

The Second Circuit next turned to the Funds' appeal of the permanent injunction issued by the District Court against their future section 13(d) violations (with respect to *both* CSX shares and any other securities). The Second Circuit noted that "an issuer has an implied right of action to seek injunctive relief for a violation of section 13(d)," but the issuer must nonetheless satisfy traditional equitable requirements. In the context of an injunctive prohibition on future securities laws violations, "the usual basis for prospective injunctive relief is not only irreparable harm, which is required for all injunctions ... but also 'some cognizable danger of recurrent violations.'"

The Second Circuit indicated that a broad injunction covering securities in addition to CSX shares might no longer be appropriate under the circumstances, and directed the District Court to reconsider the scope of its injunction on remand. In this connection, the Second Circuit noted that:

- "[T]he threat of future violations would be less substantial than appeared to the District Court, which based its broad injunction ... on its view that the Funds were deemed to be beneficial owners of the hedged shares" referenced by the TRSs as well as the shares owned outright.

- CSX, in one of its own SEC filings, had disclosed the particulars of a Hart-Scott-Rodino antitrust filing by the Funds and, as a result, TCI's "control ambitions were known to the public before it was required to file under section 13(d) ...."

- A broad injunction might be appropriate if the District Court determines (on remand) that "some of the parties 'testified falsely in a number of respects, notably including incredible claims of failed recollection,'" because the District Court has the discretion to conclude "that people who have lied about securities matters can reasonably be expected to attempt securities laws violations in the future."

"Sterilization" of Voting Rights

The Second Circuit responded to CSX's demand that the Funds be enjoined from voting their shares acquired while they were delinquent in making section 13(d) disclosures by noting that "[t]he goal of § 13(d) is to alert the marketplace to every large, rapid aggregation or accumulation of securities ... which might represent a potential shift in corporate control." Contrary to CSX's argument that the disclosure requirements of section 13(d) do "not aim merely at timely dissemination of information but more broadly 'seek[] to provide a level playing field and to promote compliance,'" the Second Circuit found "no reason to conclude that adequate timely disclosure of the information covered by the [Exchange] Act would be insufficient to ensure the 'fairness' of a subsequent shareholder vote."

Given the disclosures of the Funds' positions by CSX, as well as subsequent filings by the Funds, the Second Circuit concluded that "injunctive share 'sterilization' was not available." At the same time, the Second Circuit noted that "[t]he inappropriateness of share sterilization in such circumstances leaves open the question of what remedies might be appropriate when disclosure that is timely with respect to a proxy contest is not made, and we do not reach that issue here."

Conclusion

Even though the District Court left open the question whether TRSs convey beneficial ownership of the securities they reference, the harsh approach taken by the District Court has had an impact both on the tactics adopted by hedge funds who seek to influence corporate policies, as well as on corporate takeover defenses. In the latter case, numerous corporations have amended their advance notice bylaws and shareholder rights plans to provide that the concept "beneficial ownership" as used therein contemplates instruments akin to TRSs, even if the SEC and the federal courts have not clarified the issue. So the Second Circuit decision probably does not alter the landscape significantly in this regard.

One could argue that the Second Circuit's holding is perhaps most instructive in alerting issuers to the impediments to using section 13(d) as a defensive weapon against stock accumulators. Ultimately, "in the case of section 13(d), an injunction prohibiting the voting of shares is inappropriate when the required disclosures were made in sufficient time for shareholders to cast informed votes." The Second Circuit's opinion makes clear that section 13(d) is all about disclosure, and that once such disclosure has been made (even by the issuer), "whether timely or not, the stated purpose of disclosure – allowing informed action by shareholders ... was fulfilled."

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