Second Circuit Sidesteps Whether Equity Swaps Confer Beneficial Ownership

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In a recent decision in *CSX Corp. v. The Children's Investment Fund Management (UK) LLP, et al.*, the U.S. Court of Appeals for the Second Circuit declined to determine whether the holder of a cash-settled total return equity swap should be deemed a beneficial owner of shares held by its swap counterparty as a hedge. A total return swap agreement is a contract pursuant to which the short party agrees to pay the long party cash flows based upon the performance of a specified underlying asset in exchange for payments by the long party based upon the interest accruing at a negotiated rate on a notional principal amount. Under a cash-settled equity swap, the long party (the total return receiver) receives from the short party the increase, if any, in the value of a specified number of shares of a designated company's stock, together with any cash distributions (such as dividend payments) over the life of the swap. In return, the short party (the total return payer) receives interest payments on the notional amount, as well as any decrease in the market value of the stock. While an equity swap simulates ownership of the underlying stock, the long party typically does not acquire any right to vote shares purchased by the short party as a hedge or, indeed, obligate the short party to hedge its short position at all.

Background

This case was an appeal from a decision in 2008 of the U.S. District Court for the Southern District of New York arising out of a proxy fight between NYSE-listed CSX Corp. (CSX), one of the country's largest railroad *operator*s and two hedge funds, The Children's Investment Fund Management (UK) LLP (and affiliated funds) (TCI) and 3G Fund L.P. (and affiliated funds) (together, the Funds). Beginning in late 2006, the Funds developed an interest in CSX and purchased both CSX common stock and equity swaps referencing CSX stock with the intention of either taking CSX private or forcing a change in management and practices that the Funds believed would unlock shareholder value. While building their position, the Funds sought both to exert pressure on CSX management to implement change and made approaches to other hedge funds in an effort to build support for their plans. Later in the process, after the company showed little interest in a buyout and the likelihood of a proxy fight increased, the Funds unwound some of the swaps and increased their holdings of CSX stock. Initially, TCI distributed its swaps among multiple counterparties so that no one would purchase as a hedge more than 5% of the issuer's securities, thereby necessitating disclosure under Section 13(d) of the Securities Exchange Act of 1934 (the Exchange Act).

Section 13(d) of the Exchange Act

Section 13(d) of the Exchange Act mandates disclosure by any person who directly or indirectly acquires beneficial ownership of more than 5 percent of an issuer's equity securities. Public disclosure also is required by persons owning in the aggregate more than 5 percent of the issuer's securities where such persons act as a group for purposes of acquiring, holding, or disposing of the securities. Rule 13d-3(a) under the Exchange Act provides that a beneficial owner of a security includes any person who, directly or indirectly, has (1) the power to vote, or to direct the voting of, such security, and/or (2) investment power, which includes the power to dispose, or to direct the disposition, of the security. Rule 13d-3(b) provides that any person who creates or uses a contract, arrangement or device with the purpose or effect of divesting such person of beneficial ownership of a security or preventing the vesting of such beneficial ownership as part of a plan or scheme to evade the reporting requirements of Section 13(d) shall be deemed to be the beneficial owner of the security.

District Court Ruling

The District Court, having viewed evidence and taken testimony from the various parties, ruled that the Funds had violated Section 13(d) of the Exchange Act and Rule 13d-3(b) thereunder. The lower court found that TCI was the beneficial owner of hedge shares purchased by its bank counterparties because it had created and used equity swaps, rather than buying CSX stock, with the intent to create a false appearance that there was no large accumulation of CSX stock with the potential for shifting corporate control (the very goal of Section 13(d) being to alert the marketplace to such events). The district court believed this constituted a plan or scheme to evade the disclosure requirements of Section 13(d) through preventing the vesting of beneficial ownership of CSX stock in TCI. In addition, the court found that TCI and 3G had formed a group for purposes of Section 13(d) much earlier than they claimed (the Funds, together with their director nominees, did not file a Schedule 13D until late 2007) and, accordingly, failed to make timely disclosure.

Because of its ruling under Rule 13d-3(b), the District Court determined that it was not necessary to decide the beneficial ownership question under Rule 13d-3(a). Nonetheless, it noted substantial reasons for concluding that TCI had investment power over the hedge shares within the meaning of Rule 13d-3(a), and thus should be deemed a beneficial owner for that reason also. TCI, it concluded, patently had the power to cause its short counterparties to buy CSX, or, at least, had the power to influence them to do so. The court believed the very nature of equity swaps, as a practical matter, required the counterparties to purchase the stock to hedge their short exposures. And once the counterparties bought the shares, the court felt TCI had the practical ability to cause them to sell simply by unwinding the swaps. The court noted furthermore that TCI in theory may have the ability to influence how the counterparties voted the shares.

Decision of the Court of Appeals

Citing disagreement among the panel as to whether and under what circumstances the long party to an equity swap should be deemed the beneficial owner of shares purchased by the short party as a hedge, the Second Circuit did not resolve the issue. Instead, the court addressed only whether there was a "group" violation of Section 13(d), and remanded to the District Court to determine, without reference to the hedge shares, whether the defendants had formed a group for purposes of acquiring shares of CSX outright, and, if so, the date by which such a group was formed. Only if such a group's *outright ownership* of CSX shares exceeded the 5 percent threshold prior to the filing of a Schedule 13D can a group violation be found. If such a violation is found – limited to a group violation with respect to the purchase of the shares outright – the District Court also will have to reconsider the appropriateness of its injunction prohibiting future violations of Section 13(d).

In his concurring opinion, Judge Winter refuted the notion that the Funds had the economic ability to cause their short counterparties to buy and sell CSX shares and therefore had "investment power" over those shares. He maintained that both literally, and in the context of the term "beneficial ownership" and Section 13(d)'s concerns regarding control, such an argument gave too much breadth to the term "direct the disposition of." Without an agreement or informal understanding committing the banks to buy shares to hedge their CSX-referenced swaps or to sell those shares to the Funds when the swaps terminated, the Funds possessed only the power to predict (albeit with confidence) the purchase of shares as a hedge, not the power to direct such a purchase, much less to direct those shares' disposition. Accordingly, the Funds' act of entering into swaps fell well short of "directing" their counterparties to purchase the stock. Similarly, absent an agreement as to the voting of shares purchased as a hedge, the fact that the Funds entered into swap agreements with counterparties believed to be inclined to vote as the Funds desired was insufficient of itself to constitute voting "power." Judge Winter noted in this regard that when the probability of a proxy battle intensified, TCI unwound swaps and bought CSX shares in order to vote the shares as it pleased, indicating that the Funds' swap positions did not give the power, directly or indirectly, to direct the voting of the banks' shares. Finally, Judge Winter observed that swaps are not sham transactions creating a false appearance while lacking economic substance. Long counterparties to such swaps have legitimate economic purposes. In this instance, the swaps would have enabled the Funds to reap a leverage-amplified profit if CSX's management had instituted new policies that increased the value of the company.

The SEC Is Looking to the Question

While the Second Circuit has declined to clarify the law in this area in any comprehensive way, the SEC has been reviewing the area for several months and may provide additional guidance next year. The Dodd-Frank Act, which gave the SEC authority to regulate security-based swaps, amended the definition of "beneficial owner" in the Exchange Act to include holders of security-based swaps to the extent the SEC determines the purchase of the swap to provide incidents of ownership is comparable to direct ownership of the security. It remains to be seen whether the SEC will engage in rulemaking in this area, provide interpretive guidance, or take other action. Historically, the SEC has been reluctant to write new rules addressing complex derivatives, given the risk of disrupting legitimate economic activity. In the meantime, investors and swap dealers should be mindful that any arrangement regarding the voting of hedge stock or physical settlement of a swap with hedge stock could implicate a finding of beneficial ownership on the part of the investor.

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