WSGR ALERT

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FEDERAL COURT ALLOWS ACTIVIST STOCKHOLDERS TO VOTE SHARES AT ANNUAL MEETING DESPITE FAILURE TO COMPLY WITH DISCLOSURE OBLIGATIONS OF FEDERAL SECURITIES LAWS

On June 11, 2008, the Federal District Court for the Southern District of New York ruled that investors having a significant ownership position in "derivative securities" in a company risk violating the federal securities laws when one of the reasons they acquire such securities is to avoid the disclosure requirements under the federal securities laws. However, the limited penalties the court found available to it for such violations may not be sufficient to deter such behavior.

The opinion represents a call for regulatory reform (a call that may be answered by U.S. Senator Charles Schumer, who has indicated that he may propose new legislation on this issue) and may result in changes to corporate "defensive measures" such as shareholder-rights plans (also known as "poison pills"). More broadly, the decision raises the question of whether companies will be willing to engage in litigation against their shareholders, even when these shareholders may have violated the federal securities laws, particularly given the potentially limited benefits of the additional disclosure that may be required.[1] At the same time, the ruling raises the question of whether the heightened risk of being held to have violated the federal securities laws will cause activist stockholders to provide greater disclosure concerning their ownership of derivatives or other non-traditional securities that may create economic interests in companies without ownership of actual stock. These important legal and policy issues have significant implications for boards and shareholders during this period of increased shareholder activism, including what duties boards have to such investors.

The litigation that raised many of these issues arose over the battle for control of CSX Corporation (CSX). In *CSX Corporation v. The Children's Investment Fund Management (UK) LLP, et al.*, 08 Civ. 2764 (LAK) (S.D.N.Y. June 11, 2008), the court held that the defendants[2] violated Section 13(d) of the Securities Exchange Act of 1934[3] (Exchange Act) because (i) TCI failed to file required disclosures with the Securities and Exchange Commission (SEC) within 10 days of acquiring "beneficial ownership" in 5 percent of CSX shares,[4] and (ii) the defendants failed to file required disclosures with the SEC within 10 days of forming a "group."[5] While the court issued an injunction restraining future violations of Section 13(d) and the rules thereunder by the defendants, it concluded as a matter of law that it could not enjoin the defendants from voting the CSX shares that they owned at the upcoming annual meeting.

Background and Decision

The case arose out of the defendants' plan to elect a slate of five nominees to CSX's 12-member board of directors, and a dispute between CSX and the defendants concerning the amount of CSX stock that the defendants

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[1] For example, it is noteworthy that Institutional Shareholder Services, a major proxy solicitation service, has recommended a vote in favor of four of the five nominees put forward by the dissidents in this case despite the court's ruling that the dissidents' disclosures violated the federal securities laws.

[2] The defendants were The Children's Investment Fund Management (UK) LLP (TCIF UK), The Children's Investment Fund Management (Cayman) Ltd., The Children's Investment Master Fund (TCI Fund), Christopher Hohn, Snehal Amin (collectively, "TCI"), and 3G Capital Partners Ltd., 3G Capital Partners, L.P., 3G Fund, L.P., and Alexandre Behring (collectively, "3G"). Hohn runs TCI, and Amin is a partner of TCIF UK. Behring runs 3G.

[3] Section 13(d) was adopted "to alert the marketplace to every large, rapid aggregation or accumulation of securities, regardless of technique employed, which might represent a potential shift in corporate control." *GAF Corp. v. Milstein*, 453 F.2d 709, 717 (2d Cir. 1971).

[4] Section 13(d)(1) provides in relevant part: "Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is registered pursuant to section 12 of this title, . . . is directly or indirectly the beneficial owner of more than 5 per centum of such class shall, within ten days after such acquisition, send to the issuer of the security at its principal executive office, by registered or certified mail, send to each exchange where the security is traded, and file with the Commission, a statement containing" the information required to be disclosed by Section 13(d)(1).

[5] Section 13(d)(3) provides: "When two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a 'person' for the purposes of this subsection."

Continued on page 2...

Federal Court Allows Activist Stockholders . . .

Continued from page 1...

beneficially owned. CSX accused the defendants of entering into total-return equity swaps referencing CSX shares,[6] and secretly coordinating efforts with respect to their interests in CSX as part of a plan to change or influence control of CSX by acquiring a large stake in CSX while evading the reporting requirements of the federal securities laws.[7] CSX argued that the defendants acquired beneficial ownership of the CSX stock referenced in the swap arrangements they entered into, but failed to accurately disclose this alleged beneficial interest. Specifically, CSX contended that TCI violated Section 13(d) by failing to disclose its beneficial ownership of CSX shares referenced in its swap arrangements,[8] and that the defendants violated Section 13(d) by failing to timely disclose the formation of a group.

CSX also asserted that the defendants violated Section 14(a) of the Exchange Act[9] by filing a preliminary proxy statement with the SEC that similarly failed to make these disclosures, and that Behring, Hohn, and Amin were personally liable for the violations of Sections 13(d) and 14(a) as control persons under Section 20(a) of the Exchange Act.[10] Finally, CSX argued that the defendants' Notice of Proposed Director Nominees and Bylaw Amendments (notice) failed to comply with CSX's Amended and Restated Bylaws (bylaws) because the notice failed to accurately identify the defendants' beneficial ownership of CSX stock despite the requirement in the bylaws that stockholders must disclose "the number of shares of capital stock of the Corporation that are owned beneficially and of record by such shareholder and such beneficial owner" in order to properly bring a nomination or other business before an annual meeting.

In response to CSX's claims, the defendants argued that they did not obtain beneficial ownership in CSX stock referenced in the swap arrangements they entered into, because they only obtained economic interests in CSX stock through the swap arrangements in contrast to any voting, investment, or dispositive control over any CSX stock.

The court held that TCI used the swap arrangements with the purpose and effect of preventing the vesting in TCI of beneficial ownership of the referenced CSX shares as part of a plan or scheme to evade the reporting requirements of Section 13(d), and thus TCI was deemed to beneficially own those shares based on Rule 13d-3(b). The court cited the following TCI actions as evidence that TCI should be deemed a beneficial owner of the CSX securities referenced in the swap arrangements: the chief financial officer of TCI Fund told its board that one of the reasons for using swap arrangements was "the ability to purchase without disclosure to the market or the company"; TCI emails discussed the need to make certain that its swap counterparties stayed below 5 percent share ownership in order to avoid triggering a disclosure obligation on the part of the counterparty; TCI admitted that one of its motivations in avoiding disclosure was to avoid paying a higher price for the shares of CSX that it expected would have occurred if its interests in CSX shares were disclosed to the market; and TCI acquired only 4.5 percent in physical CSX shares to remain safely below the 5 percent reporting requirement until it was ready to disclose its position.

Having determined that TCI was a beneficial owner of the CSX shares referenced in the swap arrangements under Rule 13d-3(b) due to its evasive behavior, the court decided not to rule on the legal question of whether TCI was the per se beneficial owner of the shares referenced in swap arrangements under Rule 13d-3(a). However, the court did state that there were substantial reasons for concluding that TCI was the beneficial owner of the CSX shares referenced in the swap arrangements under Rule 13d-3(a). Specifically, the court believed that TCI manifestly had the economic ability to cause the investment banks with which it entered into the swap arrangements to buy and sell CSX shares, and that there was reason to believe that TCI was in a position to influence the investment banks with respect to the exercise of their voting rights. The court criticized TCI's argument that it did not have beneficial ownership of the shares because it

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[6] These swap arrangements were sophisticated derivative transactions between the defendants and investment-bank counterparties that gave the defendants all of the indicia of stock ownership except that the defendants did not have record ownership of the referenced CSX shares and did not have the legal right to vote those shares, both of which remained with the investment banks.

[7] When the defendants first filed a Schedule 13D disclosing that they had formed a group, they also publicly disclosed for the first time that they already had amassed ownership of approximately 8.3 percent of the outstanding CSX shares, and that they had entered into swap arrangements that referenced approximately an additional 11.8 percent of the outstanding CSX shares.

[8] "Beneficial ownership" is defined by Exchange Act Rule 13d-3, which provides in relevant part: "(a) For the purposes of sections 13(d) and 13(g) of the Act a beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares: (1) Voting power which includes 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, such security. (b) Any person who, directly or indirectly, creates or uses a trust, proxy, power of attorney, pooling arrangement or any other 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) or 13(g) of the Act shall be deemed for purposes of such sections to be the beneficial owner of such security."

[9] Section 14(a) and Rule 14a-9 thereunder govern the disclosures made in proxy statements.

[10] Section 20(a) provides: "Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."

Continued on page 3...

Continued from page 2...

had no legal right to direct the investment banks to buy or sell shares or to vote them as exalting form over substance: "The securities markets operate in the real world, not in law school classrooms. Any determination of beneficial ownership that failed to take account of the practical realities of that world would be open to the gravest abuse."[11]

The court then turned to the question of whether the defendants violated Section 13(d) because they failed to timely disclose that they had formed a group. The court noted that the touchstone of a group within the meaning of Section 13(d) is that the members combined in furtherance of a common objective. The court analyzed the defendants' activities and motives throughout the relevant period, and found that they had formed a group under Section 13(d) by as early as February 13, 2007—nine months prior to the time that they filed a Schedule 13D with the SEC disclosing that they had formed a group. The court noted that all of the following had occurred prior to or on February 13, 2007: TCI and 3G had a close relationship for years; one of 3G's funds was an investor in TCI; Hohn and Behring discussed TCI's investment in CSX, including its approximate size; 3G began buying CSX shares shortly after the conversation between Hohn and Behring; and Hohn and Behring spoke about CSX as a result of market excitement regarding CSX attributable in whole or part to 3G's heavy buying of CSX shares.[12] The court held that these circumstances all suggested that the defendants' activities were products of concerted action notwithstanding the defendants' denials.[13]

The court proceeded to analyze CSX's claims concerning the notice. The court found unpersuasive CSX's argument that the notice was deficient because the defendants did not include in their statement of beneficial ownership the shares referenced in the swap arrangements, even though they disclosed those swap positions in an annex to the notice. The court stated that CSX was focusing on form over substance by disregarding the fact that the defendants disclosed the swap arrangements, albeit without characterizing them as giving the defendants beneficial ownership. The court ruled that the defendants complied with the notice requirements in substance if not in all trivial particulars, because it satisfied the essential purpose of the notice to provide disclosure of the defendants' interest. The court also advised that CSX drafted its own bylaws and could have defined beneficial ownership in a manner that would have required the precise disclosure that it contended was required.

Finally, the court addressed CSX's requests for relief for the defendants' violations of Section 13(d). While the court enjoined the defendants from committing further violations of Section 13(d), it refused to grant CSX's request for an injunction prohibiting the voting of any CSX shares owned by the defendants at the upcoming annual meeting. The court held that as a matter of law a threat of irreparable injury was essential to obtain an injunction sterilizing any of the defendants' voting rights, and that CSX had failed to establish such a threat. The court found that the alteration of the corporate electorate arguably affected by the defendants' action, which did no more than increase their likelihood of prevailing in the current proxy contest, could not be regarded as irreparable injury that would properly be remedied by preventing the voting of the defendants' stock, regardless of whether the stock was acquired while the defendants were in violation of Section 13(d).[14] The court did state, however, that it would have enjoined the defendants from voting the shares they acquired while in violation of Section 13(d) if it were free to do so as a matter of law, but that any penalties for the defendants' violations must come by way of appropriate action by the SEC or the Department of Justice.

Analysis

Judge Kaplan's ruling is a clear warning to activist shareholders that attempts to avoid disclosure of ownership through hedges, swaps, and other indirect ownership transactions may not be tolerated by courts. However, the SEC may not share the concerns and views expressed in the court's opinion. In a June 4, 2008, letter to the court, the staff of the SEC's Division of Corporation Finance (staff) responded to two questions posed to the SEC by Judge Kaplan regarding (i) whether TCI had beneficial ownership of CSX shares held by their swap counterparties, and (ii) "what mental state is required to establish the existence of a plan or scheme within the meaning of Rule 13d-3(b)." The staff's response supported the defendants' arguments. First, the staff stated that "a standard cash-settled swap agreement does not confer on a party" any voting power or investment power of the shares held by the counterparty, and that such swap arrangements "are not sufficient to create beneficial ownership." Concerning the court's second question, the staff concluded that the significant consideration was not the person's motive, but whether "the person knew or was

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[11] The court also stated: "Some people deliberately go close to the line dividing legal from illegal if they see a sufficient opportunity for profit in doing so. A few cross that line and, if caught, seek to justify their action on the basis of formalistic arguments even when it is apparent that they have defeated the purpose of the law. This is such a case."

[12] The court also considered "the frequent lack of credibility of Hohn, Amin, and Behring," and that "the parties went to considerable lengths to cover their tracks" in its analysis of whether the defendants formed a group with respect to CSX earlier than they claimed.

[13] The court also found that it was undisputed that Hohn and Behring controlled TCI and 3G and that their actions plainly induced the Section 13(d) violations. As a result, the court found that Hohn and Behring were jointly and severally liable under Section 20(a) for the violations of Section 13(d).

[14] The court granted CSX's request to recover the costs of the action from the defendants. The court denied all of the other claims and requests of the parties.

Continued on page 4...

Federal Court Allows Activist Stockholders . . .

Continued from page 3...

reckless in not knowing that the transaction would create a false appearance." The staff then stated that "taking steps with the motive of avoiding reporting and disclosure generally is not a violation of Section 13(d) unless the steps create a false appearance."

Given the court's ruling, it would be advisable for investors with economic interests of more than 5 percent in a company to consider publicly disclosing their interests. However, given the current regulatory scheme, the views of the staff summarized above, and the lack of a meaningful remedy available to courts to punish violators of Section 13(d), activist shareholders may continue to acquire significant interests in companies without disclosing such interests until disclosure serves their own goals. In order to provide themselves with some protection, companies should carefully review and, if necessary, revise the notice provisions of their bylaws to require disclosure of all economic interests in the company's stock.

This ruling comes on the heels of recent decisions by the Delaware Chancery Court that also dealt with the efforts of activist stockholders.[15] Companies should review all of their corporate documents to ensure that the documents adequately address the concerns raised in this time of increased stockholder activism. In addition, companies should be aware of who their stockholders are and be diligent and careful in their communications with stockholders. Similarly, boards of directors should be informed of their fiduciary duties when faced with the various tactics employed by activist stockholders, and consider the legal and policy issues raised by having potentially large "investors" in the company who are not shareholders.

Should you have any questions about this case or any of these issues, please feel free to contact David J. Berger or Elizabeth M. Saunders in Wilson Sonsini Goodrich & Rosati's litigation department.

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[15] Our WSGR Alerts from April 2008 entitled "Delaware Chancery Court Issues a Trio of Opinions Reminding Boards and Corporate Counsel to Carefully Review Corporate Contracts and Documents" and "Delaware Chancery Court Allows Activist Stockholder to Nominate Director Candidates without Complying with Advance-Notice Provision of Bylaws" analyzed these decisions.