SECOND CIRCUIT ISSUES LONG-AWAITED OPINION IN CSX LITIGATION

On July 18, 2011, the U.S. Court of Appeals for the Second Circuit issued an opinion in the much-watched case of *CSX Corporation v. The Children's Investment Fund Management (UK) LLP, et al.* This case squarely presented the issue of whether a total return swap confers beneficial ownership of the underlying security for purposes of assessing whether a party is subject to the reporting requirements in Section 13(d) and the short-swing profit provisions in Section 16(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") – an important issue on which several industry organizations, including Willkie client Managed Funds Association, submitted amicus briefs. The Second Circuit, however, declined to resolve that question, explaining that the panel was unable to reach consensus.

This appeal arose out of a proxy fight over the board of directors of CSX Corporation ("CSX"). CSX sued The Children's Investment Fund Management (UK) LLP ("CIFM") and 3G Capital Partners Ltd. and sought an order precluding the defendants from voting their CSX shares due to, among other reasons, the failure by CIFM to disclose beneficial ownership of the CSX stock referenced in its swap transactions. The district court found that CIFM violated Section 13(d) by failing to file a Schedule 13D once its economic position in CSX, then held completely in swaps, exceeded 5 percent, but that the belatedly filed Schedule 13D was not materially misleading. While declining to enjoin defendants from voting their shares for that and other reasons, the district court issued a permanent injunction restraining future violations of Section 13(d).

On September 18, 2008, in an earlier decision, the Second Circuit affirmed the district court's denial of the voting injunction. The Second Circuit deferred decision at that time on defendants' cross-appeal, in which they challenged the district court's conclusion that they beneficially owned more than 5 percent of CSX's stock and should be enjoined from future violations of Section 13(d). The Second Circuit, in its decision issued this week, addressed those questions but stated that "the panel is divided on numerous issues" concerning whether and under what circumstances the long party to a total return swap may be deemed the beneficial owner of the underlying shares. Consequently, the Second Circuit limited its consideration to the issue of "group formation," and then vacated the district court's permanent injunction and remanded because the district court's factual findings as to the formation of a group were insufficient to warrant injunctive relief.

Although the panel did not reach the total-return-swap issue, one of its members, Judge Ralph K. Winter, Jr., authored a thoughtful 51-page concurring opinion explaining why, in his view, "cash-settled total-return equity swaps do not, without more, render the long party a 'beneficial owner' of such shares." According to Judge Winter, the district court based its decision to the contrary "in part on a flawed analysis of the economic and legal role of cash-settled total-return equity swap agreements." As an economic matter, as Judge Winter explained, absent an agreement between the long and short parties permitting the long party to acquire the hedge

stock or control its voting, such swaps do not indirectly facilitate control but, rather, permit parties to profit from efforts to cause public companies to adopt new policies that increase the value of the company. If the long party wishes to vote the underlying shares, it must unwind the swaps and buy stock at the open market price. As a legal matter, Judge Winter concluded that both "explicit legislation regarding swaps and Supreme Court decisions discussing statutory triggers involving 'beneficial ownership' of a firm's stock . . . foreclosed the conclusion reached by the district court."

Significantly, the Second Circuit's decision to leave unanswered the question of whether total return swaps confer beneficial ownership is not the last word on this subject. The Dodd-Frank Wall Street Reform Protection Act (the "Dodd-Frank Act") makes clear that, effective July 16, 2011, security-based total return swaps do not confer beneficial ownership for purposes of the Exchange Act unless the Securities and Exchange Commission (the "SEC") adopts a rule after consultation with the Secretary of the Treasury saying they do. The SEC has not done so and, as Judge Winter observed, at least going forward, total return swaps should thus not be treated "as rendering long parties subject to Sections 13 and 16 [of the Exchange Act] based on shares purchased by another party as a hedge."

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Willkie Farr & Gallagher LLP, in an amicus brief in the U.S. Court of Appeals for the Second Circuit on behalf of the Managed Funds Association, argued, as Judge Winter concluded, that total return swaps should not confer beneficial ownership over their underlying shares for purposes of the Exchange Act. If you have any questions about, or would like a copy of, the *CSX* decision please contact Roger D. Blanc (212-728-8206, rblanc@willkie.com), Martin B. Klotz (212-728-8688, mklotz@willkie.com), Jeffrey B. Korn (212-728-8842, jkorn@willkie.com), Daniel Schloendorn (212-728-8265, dschloendorn@willkie.com), Michael A. Schwartz (212-728-8267, mschwartz@willkie.com) or the Willkie attorney with whom you regularly work.

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