Tuesday, October 21
4:30 pm-6:00 pm

712 How to Deal with Shareholders

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Faculty Biographies

Rhonda L. Brauer

Rhonda L. Brauer is a senior managing director, corporate governance, at Georgeson, a proxy solicitation firm in New York. Ms. Brauer's practice focuses on helping companies to enhance communications with their shareholders and third-party opinion-makers, and to analyze their current governance practices in light of the current corporate governance landscape and their own business developments.

Prior to joining Georgeson, Ms. Brauer held a variety of positions in the legal department of The New York Times Company, most recently serving as secretary and corporate governance officer and as a member of the company's senior management team. Her responsibilities included providing key support to senior management and the board on the development and implementation of appropriate corporate governance practices. Prior to working at The Times Company, Ms. Brauer was an associate lawyer with Cleary, Gottlieb, Steen & Hamilton in New York City and Brussels, Belgium, providing corporate legal advice to US and international clients and pro bono work in the area of human rights.

Ms. Brauer is a member of the Society of Corporate Secretaries and Governance Professionals, for which she has served as the chair of its corporate practices committee and as a member of its Media Awareness Group. In addition, Ms. Brauer is a member of the council of institutional investors and the Association of the Bar of the City of New York.

Ms. Brauer received an AB, magna cum laude and Phi Beta Kappa, from Cornell University and is a graduate, magna cum laude and Order of the Coif, of Indiana University School of Law.

David Lambert

David Lambert is deputy general counsel in finance/securities at TD Ameritrade Holding Corporation in Omaha, NE. TD Ameritrade is a leading provider of securities brokerage services and technology-based financial services to retail investors.

Prior to joining TD Ameritrade, Mr. Lambert was a partner at Kirkland & Ellis, in Washington, DC. He has also clerked for Judge J. Rich Leonard, United States Bankruptcy Court, E.D.N.C., in Raleigh, NC and for Judge Hugh A. Wells, North Carolina Court of Appeals, Raleigh, NC.

Mr. Lambert has served as an initial director of Friends of Rock Creek's Environment, a not-for-profit corporation organized to promote a healthy and sustainable Rock Creek watershed through conservation, education, and restoration.

Mr. Lambert received a BA from Duke University, his JD, summa cum laude, from North Carolina Central University School of Law, and holds a LLM in taxation from New York University School of Law.

John Seethoff

John Seethoff is vice president and deputy general counsel, finance and operations, at Microsoft Corporation in Redmond, WA where he manages a group of 66 professionals and staff providing legal support to the company's finance, human resources and operations functions. He is responsible for managing the corporate secretary function, providing legal support to the company's board of directors, overseeing the company's corporate governance policies and practices, and supervising securities law compliance.

Prior to joining Microsoft, Mr. Seethoff was a partner in the Seattle office of Kilpatrick & Lockhart Preston Gates & Ellis LLP.

Mr. Seethoff received a BS from the University of Washington and is a graduate of the University of California at Los Angeles School of Law.

Governance Issues: Say on Pay

- Non-binding SH ratification of NEO compensation
  - Britain since 2001
  - Australia since 2004
- Proponents
  - CalPERS
  - AFSCME

Governance Issues: Say on Pay

Say on Pay Adopters

- H&R Block
- Tech Data
- MBIA
- Littlefield
- RiskMetrics
- Par Pharmaceuticals
- Verizon
- Blockbuster
- Aflac

Governance Issues: Say on Pay

Examples

- H&R Block:
  - It shall be the practice of the Company to present at the annual meeting of shareholders a resolution calling for an advisory vote on overall executive compensation programs, including the linkage of overall pay to performance.
- Aflac:
  - Resolved, that the shareholders approve the overall executive pay-for-performance compensation policies and procedures employed by the Company, as described in the Compensation Discussion and Analysis and the tabular disclosure regarding named executive officer compensation (together with the accompanying narrative disclosure) in this Proxy Statement.

Governance Issues: Proxy Access

- SH access to company proxy statement for director nomination
  - Relieves SH of burden of filing a separate proxy statement
- SEC permits exclusion under Rule 14a-8(i)(8) of SH proposals that would require issuers to include SH nominees for director in proxy statement
  - Under 14a-8(i)(8), exclusion permitted if the proposal relates to an election for membership on the BOD

Governance Issues: Proxy Access

- AFSCME (American Federation of State, County & Municipal Employees) proposes SH access bylaw at AIG during 2005 proxy season
- SEC supported exclusion of SH access bylaw
- AFSCME sued AIG; SDNY ruled in favor of AIG
- AFSCME won on appeal
- SEC issued dueling proposals:
  - Status quo – continued exclusion of SH access proposals
  - SH access for 5% SHs not seeking to influence control

Activist Issues: Expense Reimbursement

- SH proposed bylaw amendment
- Response to lack of SH access to proxy
  - Expense reimbursement for BOD candidates if
    - Election for less than 50% of directors
    - 1 or more nominees are elected
    - No cumulative voting

Governance Issues: Proxy Access

- Dueling SEC proposals *both* approved by SEC for public comment
- SEC amends 14a-8(i)(8) to permit exclusion if the proposal relates to a nomination or election for membership on the BOD or a procedure for such nomination or election
- Lines are drawn starkly

Activist Issues: Expense Reimbursement

- Proposed bylaw made by AFSCME at CA, Inc.
  - Purpose: promote integrity of electoral process by facilitating nomination of director candidates by SHs
- CA sought no-action letter from SEC
  - DE law legal opinions supporting both positions
  - SEC certified 2 questions to DE Supreme Court:
    - Is the SH proposal a proper subject for action by SHs as a matter of DE law?
    - Would the SH proposal, if adopted, cause CA to violate DE law?

Activist Issues: Expense Reimbursement

- SH powers v. BOD management
  - DGCL §109(a) v. §141(a)
  - "efforts to distinguish by-laws that permissibly limit director authority from by-laws that impermissibly do so have failed to provide a coherent analytical structure, and the pertinent statutes provide no guidelines for distinction at all."
- Is the SH proposal a proper subject for action by SHs as a matter of DE law?
  - Process for decision-making or mandatory decision?
    - Process for electing directors
    - Expenditure of corporate funds will not by itself make it improper for SH action
    - Proper subject for SH action

Activist Issues: Expense Reimbursement

- Would the SH proposal, if adopted, cause CA to violate DE law?
  - Must consider any possible circumstance that BOD may be required to act under
    - To the extent a contract purports to require a BOD to act or not act as to limit the exercise of fiduciary duty, it is invalid and unenforceable. *Paramount Comm. v. QVC Network, Inc.*, 63 A.2d 34 (Del. 1994).
    - At least in 1 hypothetical, BOD would breach fiduciary duty
    - Mandatory expense reimbursement would violate DE law

Activist Issues: Derivative Securities

- HSR prior approval generally not required for acquisition
  - Exercise requires HSR prior approval
- Schedule 13D
  - Beneficial owner of 5% or more required to make disclosure within 10 days of acquisition
  - Purpose: to alert SHs of every large, rapid accumulation of stock, regardless of technique employed, that might represent a potential change in control
  - Economic (non-voting) interest not considered beneficial ownership under Rule 13d-3(a)
  - SHs acting together required to report as a member of a group

Activist Issues: Derivative Securities

- *CSX v. The Children's Investment Fund (TCI)*
  - Total returns swaps (TRS) used by activist to receive economic benefits of CSX shares without the right to vote
    - Activist takes long position, with the right to dividends and appreciation – no voting rights but has ability to receive shares
    - Counterparty takes a covered short position entitled to interest and protection on decrease in value of underlying security, with the right to vote
    - Activists had ~12% undisclosed ownership of CSX through TRS

Activist Issues: Derivative Securities

- *CSX v. The Children's Investment Fund*
  - SEC filed brief in support of activist not disclosing ownership
  - CSX sought to prevent TCI from voting shares and enjoin further disclosure violations
  - Beneficial Ownership
    - Court stated "there are substantial reasons for concluding TCI is the beneficial owner of the CSX shares held as hedges by its short counterparties."
    - Court found deemed beneficial ownership under Rule 13d-3(b) because TCI used TRS with "the purpose and effect of preventing the vesting of beneficial ownership of TCI as part of a plan or scheme to evade §13D."

Effectively Using Your Proxy Solicitor in Preparing for Shareholder Communications

- **Understand how your shareholder ownership breaks down**
- **Ensure you have correct proxy voting contacts for your shareholders**
- **Know:**
  - to which proxy advisory reports your shareholders subscribe
  - whether your shareholders historically follow the reports' recommendations
  - What, if any, internal proxy voting guidelines your shareholders have
- **Obtain:**
  - vote projections for upcoming shareholder meetings
  - recommended approaches for engaging your shareholders on given issues and proposals

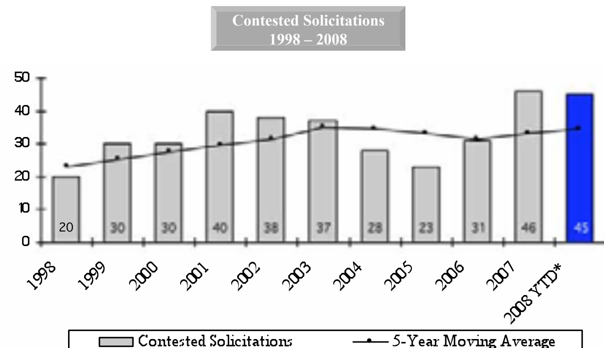
Communicating with Shareholders

- Shareholder activism is on the rise
- Dramatic increase in company-investor dialogues, at both the senior management and board levels on the company side
- Important to do not only during the proxy season, but also in the off-season

Pros and Cons of Director Dialogues with Investors

- **Pros:**
  - Enables investors to feel they have been heard at highest levels of a company
  - Can diffuse or resolve difficult issues
  - Can also be useful with proxy advisory firms
- **Cons:**
  - Time-consuming
  - Line-drawing when not possible for all shareholders
    - More likely an excuse, not the reality
  - Reg FD is also an excuse, not generally an issue, for directors prepared appropriately by management

2008 Proxy Fights and Hedge Funds Activism
Proxy Fights at Record Levels



As of June 2008

Proxy Fight Game: Overview

- **What are they asking for?**
  - Sales, Spin-offs, Buybacks, Dividends
  - Executive compensation and governance reform
  - Far fewer fights asking for control
- **Representation vs. Change-of-control**
  - Short slate solicitations far more common
- **The Players have changed**
  - Hedge funds act as catalysts (the “non-group group”)
- **Rumors of proxy fights can cause turnover in shareholder base**
- **Increased activity impacted by ease of e-proxy solicitations and electronic communications with and among shareholders**

Proxy Fights at Record Levels:
Withhold Campaigns as New Form of Proxy Contest

- **Withhold Campaigns as New Form of Proxy Contest**
  - 2004: Walt Disney/ Roy Disney
  - 2004: Safeway / State Pension Funds
  - 2005: Career Education / Steven Bostic
  - 2006: Houston Exploration / Jana Partners
  - 2007: Prudential Bancorp Inc of PA / Joseph Stillwell / The New York Times Co.
  - 2008: Axcelis Technologies Inc. / Sumitomo Heavy Industries Ltd.

Proxy Fight Game: Dissident Motivation

- Declining returns and increased competition between hedge funds force creativity and increased activity
- Growth in event-driven strategies: Short-term shareholder value enhancement
- Fewer companies maintain strong takeover defense profiles
- Activists are buoyed by recent successes

Proxy Fight Game: Dissident Techniques and Tactics

- **Parallel-Investing (a.k.a. “Wolf Pack Approach”)**
  - Hedge funds network extensively and often take follow-up positions in other funds’ initiatives
- **Corporate governance and other initiatives attract the support of other shareholders**
- **Hedge funds rarely seek control of target companies, but instead seek short-term gains in shareholder value**
- **Wide range of intensities:**
  - Low-intensity: simple information request, letter to board or management
  - Middle intensity: threats of proxy campaign, public relations initiative
  - High-intensity: full-blown proxy campaign

Proxy Fight Strategy Dealing with a Dissident - Negotiations

- **A dissident investor may be persuaded to discontinue proxy campaigns if certain concessions are granted by issuer:**
  - Board representation
    - 2008: 30 companies avoided contests by giving up one or more board seats*
  - Corporate governance reforms
  - Changes in business strategy
  - Reimbursement of campaign expenses
- **Points in timeline when settlements more likely:**
  - Filing of preliminary proxy statement with SEC by either side
  - Filing and mailing of definitive proxy statement with SEC by either side
  - Issuance of recommendations by proxy advisory firms
  - Public statements by significant shareholders not directly involved in fight
  - Day before shareholder meeting

* Data Source: Sharkrepellent.net (as of June 30, 2008)

Proxy Fight Strategy: Overview

- **Corporate Governance “Audit”**
- **Proper Due Diligence Early On**
  - Meet with dissident group
  - Nominating committee evaluations of dissident nominees
- **Establish Proxy Fight “Team”: Proxy Solicitor, Legal, Financial, and Public Relations Firm**
- **Review tentative “Proxy Fight Timeline” with Team**
- **Know Your Shareholder Base: Composition & Vote Projections**
- **Develop Comprehensive Message to Shareholders**
- **Institutional Road Shows, Fight Letters and other Communications**
- **Visit or Conference Calls with Proxy Advisory Firms**
- **Telephone calls to Registered and NOBO Holders**
- **Internet and Telephone Voting now permitted in contests**

Working with Proxy Advisory Firms: ISS Favors Minority Representation

- **When Seeking Board Control, Dissidents Need to Provide:**
  - A well-reasoned and detailed business plan (including strategic alternatives)
  - Explanation of why dissident plan is preferable
  - A transition plan that describes how the change in control will be effected
  - Identification of a qualified and credible new management team
  - ISS will compare dissident plan and nominees vs. current board
- **When Seeking Minority Representation:**
  - Detailed plan of action not required
  - Proof that dissident plan is preferable to the incumbents’ plan not required
  - Must show change is preferable to status quo
  - Must show that dissident slate will add value to board deliberations by considering the issues from a different and unique viewpoint

Working with Proxy Advisory Firms
ISS Focus Factors

- **Factors to Consider in Contested Elections**
  - Company performance relative to its peers
  - Strategy of the incumbents versus dissident strategy
  - Independence of directors/nominees
  - Experience and skills of board candidates
  - Governance profile of the company
  - Evidence of management entrenchment
  - Management Responsiveness to shareholders
  - Whether takeover offer has been rebuffed
- **In addition to ISS privately holding meetings with each side, there is the possibility of ISS-sponsored public webcasts in contested elections.**
- **ISS permits companies to fact-check proxy recommendation reports in non-contested situations.**

Working with Proxy Advisory Firms
Glass Lewis and Proxy Governance

- Glass Lewis & Co.
  - Possibility of "Proxy Talks" in contested situations
  - Companies are <u>not</u> given the opportunity to fact-check proxy recommendation reports in any situation
  - However, companies may provide ongoing updates to Glass Lewis throughout the year, provided they do not concern a specific proxy proposal
- Proxy Governance Inc.
  - Companies are given opportunities to (1) provide comments on proposed peer groups pre-proxy season; and (2) fact-check proxy recommendation reports before issuance
  - Will talk to both sides privately in contested situations

Working with Proxy Advisory Firms
Scenario 1: Recommending AGAINST Management
Results in Majority Withhold/Against Votes in Director Elections

XYZ, Inc.

Vote Projection 1

Proxy Contest

RiskMetrics & Glass Lewis Recommending Against Management

Shareholder Categories	Votes controlled as a % of outstanding	% of Votes controlled cast	Quorum	% of Votes cast as Supporting Management	Supporting Management as a % of outstanding	% of Votes cast as Supporting Dissident	Supporting Dissident as a % of outstanding
Institutional Investors	45.94%	90.00%	41.35%	15.00%	6.20%	85.00%	35.15%
Dissident	9.30%	100.00%	9.30%	0.00%	0.00%	100.00%	9.30%
Fidelity Investments	6.11%	100.00%	6.11%	100.00%	6.11%	0.00%	0.00%
T. Rowe Price & Associates	5.40%	100.00%	5.40%	0.00%	0.00%	100.00%	5.40%
Wellington Management Co.	5.10%	100.00%	5.10%	0.00%	0.00%	100.00%	5.10%
Brokers	20.32%	60.00%	12.19%	65.00%	7.92%	35.00%	4.27%
Officers and Directors	2.79%	100.00%	2.79%	100.00%	2.79%	0.00%	0.00%
Dividend Reinvestment Plan	0.20%	95.00%	0.19%	10.00%	0.02%	90.00%	0.17%
Company Plan Shares	1.04%	100.00%	1.04%	10.00%	0.10%	90.00%	0.94%
Registered Holders	3.79%	75.00%	2.84%	10.00%	0.28%	90.00%	2.56%
Total Percentage:	100.00%		86.32%		23.44%		62.88%

Summary	
Quorum	86.32%
Supporting Management as a % of outstanding	23.44%
Supporting Management as a % of Quorum	27.15%
Supporting Dissident as a % of outstanding	62.88%
Supporting Dissident as a % of Quorum	72.85%

Working with Proxy Advisory Firms
Scenario 2: Recommending FOR Management
Management Slate is elected in Director Elections

XYZ, Inc.

Vote Projection 2

Proxy Contest

RiskMetrics & Glass Lewis Recommending For Management

Shareholder Categories	Votes controlled as a % of outstanding	% of Votes controlled cast	Quorum	% of Votes cast as Supporting Management	Supporting Management as a % of outstanding	% of Votes cast as Supporting Dissident	Supporting Dissident as a % of outstanding
Institutional Investors	45.94%	90.00%	41.35%	85.00%	35.15%	15.00%	6.20%
Dissident	9.30%	100.00%	9.30%	0.00%	0.00%	100.00%	9.30%
Fidelity Investments	6.11%	100.00%	6.11%	100.00%	6.11%	0.00%	0.00%
T. Rowe Price & Associates	5.40%	100.00%	5.40%	100.00%	5.40%	0.00%	0.00%
Wellington Management Co.	5.10%	100.00%	5.10%	100.00%	5.10%	0.00%	0.00%
Brokers	20.32%	60.00%	12.19%	70.00%	8.53%	30.00%	3.66%
Officers and Directors	2.79%	100.00%	2.79%	100.00%	2.79%	0.00%	0.00%
Dividend Reinvestment Plan	0.20%	95.00%	0.19%	10.00%	0.02%	90.00%	0.17%
Company Plan Shares	1.04%	100.00%	1.04%	10.00%	0.10%	90.00%	0.94%
Registered Holders	3.79%	75.00%	2.84%	10.00%	0.28%	90.00%	2.56%
Total Percentage:	100.00%		86.32%		63.49%		22.83%

Summary	
Quorum	86.32%
Supporting Management as a % of outstanding	63.49%
Supporting Management as a % of Quorum	73.55%
Supporting Dissident as a % of outstanding	22.83%
Supporting Dissident as a % of Quorum	26.45%

Voluntary Company Disclosures

- Add to company web sites and proxy statements and by targeting special interest newsletters (e.g., Council of Institutional Investors, Riskmetrics/ISS and Global Proxy Watch)
- Enhances transparency of your business, executive compensation and corporate governance practices and decisions
- Provides companies with fuller credit for what they have done, with the proxy rating/advisory firms and with their shareholders

NYSE Rule 452 and Broker "Non-Votes" Overview

- **Reasons for Delay:**
  - Combined effect of Rule 452 modifications and majority voting
    - Shareholder "withhold" campaigns could be problematic
  - Inability to obtain quorum
  - Additional costs incurred with elimination
  - Full set of SEC commissioners were missing during past proxy season
- **Other Alternatives:**
  - Proportional Voting
    - Brokers vote proportionally to how directed shares are voted
    - Some brokers already have it in place
      - Merrill Lynch, Charles Schwab, TD Ameritrade, Goldman Sachs

NYSE Rule 452 and "Broker Non-Votes"

Discretionary Voting On Directors

Increases Quorum and vote "FOR" Directors

Scenario "A": With Discretionary Voting

Shareholder Component	% of Shares Outstanding	Projected Votes Cast	Voting "FOR" Directors Cast	"WITHHOLD" on Directors Cast
Registered Holders	10.0%	8.0%	7.5%	0.5%
Company Plans	8.0%	8.0%	7.8%	0.2%
RiskMetrics Institutions	30.0%	24.0%	22.5%	1.5%
Non- RiskMetrics Institutions	22.0%	16.5%	15.5%	1.0%
Brokers (individuals)	30.0%	**30.0%**	29.0%	1.0%
Projected Totals	100.0%	86.5%	82.3%	4.2%

NYSE Rule 452 and "Broker Non-Votes"

Elimination of Discretionary Voting

Significantly Reduces Quorum and Votes "FOR" Directors

Scenario "B": Without Discretionary Voting

Shareholder Component	% of Shares Outstanding	Projected Votes Cast	Voting "FOR" Directors Cast	"WITHHOLD" on Directors Cast
Registered Holders	10.0%	8.0%	7.5%	0.5%
Company Plans	8.0%	8.0%	7.8%	0.2%
RiskMetrics Institutions	30.0%	24.0%	22.5%	1.5%
Non- RiskMetrics Institutions	22.0%	16.5%	15.5%	1.0%
Brokers (individuals)	30.0%	**7.5%**	6.5%	1.0%
Projected Totals	100.0%	64.0%	59.8%	4.2%

Selected Shareholder Proposals
Majority Voting in Director Elections

- **Default Standard: Plurality Voting**
- **Movement Toward Majority Voting begins in 2004**
- **Over 66% of S&P 500 companies have adopted some form of majority voting***
  - 2005 & 2006 most Issuers adopt Majority Vote "policy" (i.e., original Pfizer Model)
  - 2007 & 2008 bring clear movement toward bylaw and charter amendments (i.e., Intel Model)
- **State law amendments facilitate Majority Voting**
  - Model Business Corporation Act (MBCA) amended to allow for Majority Voting
  - DE: amends DGCL §141(b) to make resignation policies irrevocable
  - CA: amends Cal. Corp Code §153 to allow for director "approval of the shareholders"
  - OH: passes law to allow for majority voting in July 2007
- **Debate has shifted from "should we" to "how do we"**
  - SEC won't issue No-Action letter if shareholder proposal requests bylaw amendment and issuer only has policy in place
  - Policy vs. By-Law vs. Charter Provisions
  - Is it better to adopt early or wait?
    - Early adoption allows issuer to craft bylaw to their liking

Data Source: Claudia H. Allen, Study of Majority Voting in Director Elections (as of October 2007)

Selected Shareholder Proposals
Majority Voting - If Director Resignation Required

- **Nominating and Governance Committee generally considers:**
  - Shareholder-stated reason for issuing withhold or against votes
  - Whether underlying cause for withhold is curable (e.g.: attendance issues)
  - Composition of Board
    - With and without resignation
    - Independence requirements
  - Director length of service and contributions
  - Availability of suitable replacement
- **Recent Cases:**
  - 2007: Gen-Probe Inc: Resignation not accepted. Board cited:
    - "unique qualifications, past contributions to the Board, her historical attendance and participation in Board meetings and communications, and her commitment regarding future attendance and scheduling"
  - 2008: Axcelis Technologies: Resignations not accepted. Board cited:
    - Experience and knowledge about the company, the Board would be left with only four remaining directors; at least one director sat on key committee.
    - Affected by unsolicited offer from Sumitomo Heavy Industries.

Negotiating a Majority Voting Policy
with a Shareholder Proponent

- **Decide whether or not to seek a "no-action" ruling from the SEC to try to exclude proposal from proxy statement**
- **Engage the proponent early and often and with straightforward transparency, with outside directors when feasible**
- **Sets stage for a mutually agreeable solution and successful outcome for both parties:**
  - Company perceived as pro-actively engaged in shareholder dialogue and pursuing best practices in corporate governance
  - Proponent perceived as having succeeded in its activist campaign
  - Experience can make both parties helpful to each other in the future

Status of Social Issues Proposals

	2006*	2007*	2008*
Filed	329	344	380
Omitted	51	62	60
Withdrawn	97	105	129
Voted On	177	175	184

- Average support was 14.7% over 147 meetings
- 49 proposals received over 15 percent favorable vote
- One proposal won majority support (sexual orientation anti-bias policy at Expeditors International)
- Record 129 resolutions have been withdrawn
- Increased support for resolutions asking companies to produce GHG emissions reports and to formulate goals for emission reduction
- Support fell for resolutions related to human rights, sexual orientation anti-bias policies, and employment reforms
- 5 individuals and 3 unions submitted 1/3 of proposals

** For meetings January 1 - June 30*

Social Responsibility – Environment

- Proponents
  - New York City pension funds
  - Calvert
  - Action Fund Management
  - Religious Investors
- Resolutions generally focused on three broad areas:
  - Climate action
  - Oil sands/toxics
  - Bioengineering
- Controversial SEC decision to allow omission of certain global warming resolutions that fall into the ordinary business category of internal risk assessment
- Proponents withdrew 21 resolutions on climate change due to company responsiveness
- Vote Results
  - Climate action (23% average support)
  - Oil sands/toxics (13.7% average support)
  - Bioengineering (8.1% average support)

Social Responsibility – Human Rights

- Proponents
  - John Harrington/Harrington Investments
  - Religious Investors
- Resolutions focus on two broad areas:
  - Establish a board committee on human rights
  - Establish or review policies related to human rights
- 8 proposals withdrawn due to company responsiveness
- Vote Results
  - Establish a board committee on human rights (3.2% support)
  - Establish or review policies related to human rights (3.6% support)

Social Responsibility – Sustainability

- Proponents
  - Social investment funds
  - New York City pension funds
  - Religious Investors
- Resolutions generally focused on two areas:
  - Report on sustainability
  - Establish a board committee
- Sustainability was the issue area with the most resolution withdrawals. Most of the 23 withdrawals involved company agreements to produce a sustainability report
- Vote Results
  - Report on sustainability (25.3% average support)
  - Establish a board committee (5.8% average support)

Social Responsibility – Equal Employment Policy

- Proponent
  - New York City pension funds
- Resolutions generally focused on two areas:
  - Expand/report on policies
  - Allow bias on sexual orientation
- For the first time this year, the SEC allowed no-action omissions of the “equity principles” resolution designed to promote the equal treatment of homosexual employees in the workplace
- Nearly half of the proposals withdrawn due to company responsiveness
- Vote Results
  - Expand/report on policies received (23.4% average support)
  - Allow bias on sexual orientation (6.1% average support)

IR magazine GUIDE NUMBER 3

Arming yourself against activists

Performing a governance checkup

Talking with activists

Monitoring the hot issues

Preparing for a proxy contest

Getting prepared

Know your shareholders

The better you understand your investor base, the better equipped you are to anticipate shareholder resolutions. One sign of trouble is the appearance in your stock of a well-known activist hedge fund. A proxy solicitor can keep you abreast of hedge funds moving in and out of your stock.

Trading patterns also bear watching. Greater volatility and turnover can signal dissident activity. Before a shareholder campaign, hedge funds tend to swarm into the stock sensing a shake-up, while long-term investors begin taking profits and trimming positions.

That said, it's difficult to predict the source of a shareholder proposal. In some cases, proponents may be large public pension or labor funds, but often they're small shareholders that don't necessarily raise eyebrows.

There's no magic bullet for determining whether you'll be targeted by activists based on your shareholder roster. But shareholder identification *can* help you project their reaction to a prospective proposal, and even extrapolate the outcome of a hotly contested proxy battle.

As activist investors, hedge funds and even some sophisticated retail shareholders raise their voices to ask companies to increase returns, they often demand sweeping changes in governance. What can IROs and other executives do to head off unwelcome shareholder resolutions before they're filed?

Entering into a frank dialogue with investors is one answer. Although the number of activist proposals has soared in the past few years, so has the number of settlements. In 2007, for instance, 665 shareholder proposals were submitted but only 375 reached a shareholder vote, according to Georgeson's 2007 annual corporate governance review.

An issue like majority voting epitomizes how this process works. Last year activists submitted almost 130 majority voting resolutions but just 37 wound up on final proxies. Most firms agreed to adopt some form of majority voting rather than having the proposal put to a show of hands.

Beginning a dialogue

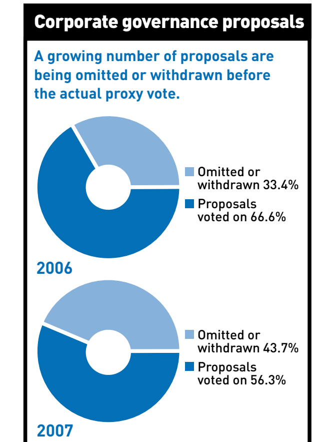
The rise in shareholder activism presents yet another excellent reason to maintain regular contact with key institutional investors. Shareholder conversations need not focus on specific issues; they can be friendly meetings or phone calls to invite feedback on a company's practices.

Outside of direct conversation, IROs can turn to perception and investor attitude studies or even the annual meeting to discover what investors are honestly feeling. Did they express dissatisfaction with your company? What aspects of your governance practices elicit the most questions? Research analysts are another trove of information. What are sell-side analysts publishing in their reports? And how has their outlook changed in the past months, or years?

Gone are the days when IROs could confine their conversations to large institutions and activists and hope to ward off shareholder proposals. Retail investors are also expressing their displeasure through the proxy.

Corporate governance proposals

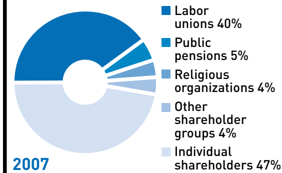
A growing number of proposals are being omitted or withdrawn before the actual proxy vote.



Following the hot issues

Sponsors of governance proposals, 2007

The lion's share of proposals was sponsored by labor funds and individual investors.



While communicating with individual retail holders is a daunting task, you *can* ensure they know what's afoot. By maintaining your corporate governance website, writing periodic updates in plain English and addressing any changes in governance in the annual report, you can bolster your relationship with all shareholders.

A governance checkup

Forward-looking firms have begun creating teams to discuss criticism they've received and strategize about possible activist campaigns. Typically, these teams meet every two weeks by telephone to swap insights and suggest responses to hypothetical shareholder initiatives. Sometimes the call lasts a few minutes; at other times, the team should be prepared for a long conversation.

This team should include a proxy solicitor, legal adviser, PR expert and perhaps your investment banker. Internally, the key players are the IRO, treasury department, corporate secretary and in-house counsel.

The team's function is to examine the company through an activist's eyes. To this end, the proxy solicitor can perform periodic strategic reviews, pointing out potential vulnerabilities. Plurality voting, a classified board, poison pills and a lack of mechanisms for shareholders to call special meetings might all raise red flags. Of course, knowing that a given provision could irritate shareholders doesn't mean you're necessarily going to make any changes.

A key part of the assessment is role playing: what would happen if a shareholder introduces a 'say on pay' resolution, for example? How well have such proposals fared at peer companies? Is there a modification that might appease investors without putting your pay practices to an advisory vote? This is also a good forum for discussing any forthcoming regulatory changes.

By setting aside time to plan, firms put themselves in a stronger position when shareholder proposals *do* hit. At the very least, when something happens, your response team will already be in place and you won't be scrambling to recruit members under pressure. Rather than reacting to what shareholders do, you'll have sketched out some responses and will be able to act with greater confidence.

Weighing the trade-offs

Modifying your company's corporate governance practices to be completely shareholder-friendly isn't always a winning strategy. Companies face several complicated trade-offs. For instance, management's desire for adequate defenses in case the company is targeted by activists is perfectly understandable. But poison pills, a classified board, super-majority voting and other such defenses also increase the likelihood activists will take aim in the first place.

In fact, in recent years, anti-takeover provisions have become the exception rather than the rule. From 2002 until 2006, the number of companies with poison pills dropped from 60 percent to 29 percent by year-end 2007, according to Georgeson.

Whenever possible, look at your governance initiatives against the backdrop of current practice and the examples set by your peer companies. Context matters: your governance practices will be viewed far differently if your financials are iffy than if performance is exemplary.

Say on pay

In 2007 and 2008 many companies faced a resolution calling for an advisory vote on pay, also known as say on pay. Among those targeted were Abbott Laboratories, Capital One, Lexmark, Wells Fargo and General Electric.

Say on pay is a non-binding referendum, significant because it gives investors an official outlet for voicing their opinions on pay practices. Although it's advisory, say on pay has generated considerable emotion. Anger is rampant over large payouts to ousted CEOs like Citigroup's Charles Prince (*Forbes* reports a $10 mn bonus, $28 mn in unvested stock options and $1.5 mn in yearly perks).

The issue has become political and may even be decided by Congress. In 2007 Barney Frank (D-MA), chairman of the House Financial Services Committee, introduced a say-on-pay bill in the House; it passed by a 269-134 margin but has yet to be introduced in the Senate.

As US capital markets waver and talk of a lengthy recession intensifies, activists will almost certainly redouble their efforts to reform executive compensation. And the measures are likely to resonate with shareholders.

In 2007 over three dozen proposals requesting a link between pay and performance received average shareholder support of almost 30 percent. At companies where compensation is viewed as egregiously high relative to shareholder returns, resolutions like 'say on pay' (see *Shareholders tackle social ills*, opposite) and even 'vote no' campaigns aimed at compensation committee members garnered success.

With regard to executive compensation, the best way to keep shareholder activists at bay is to improve the quality of your compensation disclosure and analysis (CD&A). The more disclosure you can provide without divulging proprietary information, the less likely you are to be slapped with an executive compensation resolution.

Many companies could do better in this area. In 2007 the SEC sent 350 companies comment letters, detailing weaknesses in their mandatory compensation disclosure, the most common of which was insufficient explanation of how pay is calculated.

Proper pay benchmarking is central to linking pay to performance, as are clear formulas for calculating compensation. Not only must you choose the proper peer groups to measure yourself against, but you should also include sufficient information to demonstrate that your pay is in line with your compensation principles. When your pay practices depart from the norm, offer plain-English explanations of what you do, and why.

Saying on pay

Within the CD&A, some aspects of pay are attracting particular scrutiny. Supplemental executive retirement plans (SERPs) and change in control or severance agreements have become lightning rods for shareholder discontent. Your best defense is to ensure your polices are well justified, clearly stated and consistently applied.

If your company has performance issues, expect pay to come under the microscope. Increasingly, shareholders are paying close attention to the financial deals executives receive in buyout situations. Some shareholders have even attempted to block mergers when they believed the company sweetened the change-in-control agreements for executives around the time of an offer, or that management wasn't holding out for the best financial offer it could negotiate.

In early March, Washington Mutual's board voted to exclude some mortgage and foreclosure losses from the metrics for calculating executive bonuses. This didn't sit well with WaMu shareholders who suffered

Preparing for a proxy contest

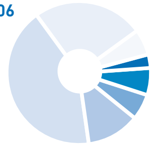
painful losses stemming from the subprime crisis.

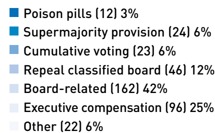
Activists continue to push to remake boards and corporate bylaws to give shareholders greater voice.

Corporate governance shareholder proposals

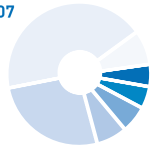
The number of executive compensation proposals grew dramatically in 2007.

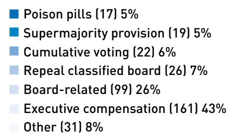
2006





2007





They have also reformed the ways in which votes are counted in corporate America. Under the old plurality voting standard, a director who received the most 'for' votes won because 'against' and 'withheld' votes were excluded from the tally. With a majority voting standard, a director must receive more votes in favor than withheld/against votes to secure or retain a seat.

Majority rules

Shareholders have scored numerous successes in spurring companies to move to majority voting. Research by Claudia Allen of Chicago law firm Neal Gerber & Eisenberg indicates that 66 percent of the S&P 500 had adopted some form of majority voting as of November 2007. IROs facing a majority voting proposal need to gauge the general proxy climate. Opposing the proposal may make you look retrograde, or even out of touch.

What's more, even though majority voting means more directors will get a higher percentage of withheld or against votes, few board members are being unseated for this reason. Only 15 directors at 11 S&P 1500 companies that held annual meetings in the first six months of 2007 had a director win less than a majority of the votes cast, according to Georgeson. Only one of these firms had adopted the majority voting standard and the director stayed on after she agreed to improve her meeting attendance (the primary reason given for withheld votes).

Shareholders tackle social ills

With climate change and labor issues seizing headlines, companies are beginning to pay closer attention to how their CSR practices are perceived.

Proxy solicitation firms say activists have demonstrated a willingness to engage with management on social and environmental issues. In this arena, simply coming to the table can sometimes be enough to quash a proposal.

At the same time, stonewalling can anger shareholders, leading to grave consequences. Activists recently waged a withhold vote campaign against Michael Boskin, chair of ExxonMobil's public issues committee, for refusing to meet with shareholders to discuss climate change strategy.

Often, opening the lines of communication makes a critical difference because shareholder proponents may not know about all of a company's programs in a given area. What's more, shareholders sometimes act as the proverbial canary in the coal mine, calling attention to a problem that's gone undetected.

A governance roadshow?

When facing a tough shareholder resolution, companies need to share their strategic objectives with investors in order to win votes. One way of doing this is an investor roadshow. You may consider going out on a series of meetings in key cities, allowing management to communicate with shareholders face-to-face in advance of a shareholder vote.

Investor roadshows require both time and true management commitment, but they can sometimes swing crucial proxy votes. A company's shareholder makeup will determine how feasible the idea is. For instance, if you have large holdings by international shareholders, this idea might be too difficult to execute. Proxy solicitation firms can help arrange the itinerary, pointing out key shareholders to visit and even scheduling meeting times.

Recently, some leading companies – including Nexen, based in Calgary, Canada – have launched corporate governance roadshows to engage investors and discuss pressing issues before trouble hits.

Almost everyone agrees: strong performance and an admirable governance record are your best defenses against an ugly shareholder campaign. If you're doing well relative to your peers, it's likely you'll be left alone.

Appraising your vulnerabilities isn't always easy and – ultimately – might not matter. Often, shareholder proponents decide they will file a fixed number of proposals on a particular issue; no matter how solidly you've performed, your company may still be selected as poster child for some general corporate ill.

It's therefore wise to consider how you'd handle shareholder resolutions on a variety of issues, even if there's no inkling of trouble.

Faced with a proposal, companies might decide acquiescence is the better part of valor. Typically, management receives far more credit for adopting a governance change proactively than for doing so under duress. When Aflac voluntarily agreed to hold a say-on-pay vote, the insurer generated enormous positive press. (The vote takes place at the company's annual meeting on May 5.) Par Pharmaceutical and Verizon Communications will also have say-on-pay votes in the near future.

At other times, management feels it has little choice but to fight a shareholder resolution. In these cases, it pays to know the array of options for maximizing your chances of a positive outcome.

First steps

Even if the initial rounds of conversation didn't succeed, it's worthwhile trying to engage proponents on resolutions that have been officially filed. Whenever you're speaking with the proponent, try to listen carefully for common ground. In the best cases, the discussions could lead to the withdrawal of the proposal. Failing that, there may be a compromise less drastic than the action proposed that will satisfy both sides.

Deciding who should speak with the shareholder activists may affect your chances of success. If someone within the organization – the IRO, the corporate secretary, or even the CFO or CEO – has an existing and friendly relationship with the proponent, that individual might be the right person to lead the discussion.

Often, shareholder activists appreciate the opportunity to speak to the board. A company's lead director or an independent board member might be the right representative for broaching areas of controversy.

When confronted with a shareholder resolution, almost all companies approach the SEC asking for a 'no action' determination. Because companies routinely ask the government to have shareholder proposals removed, this tactic is not viewed terribly negatively.

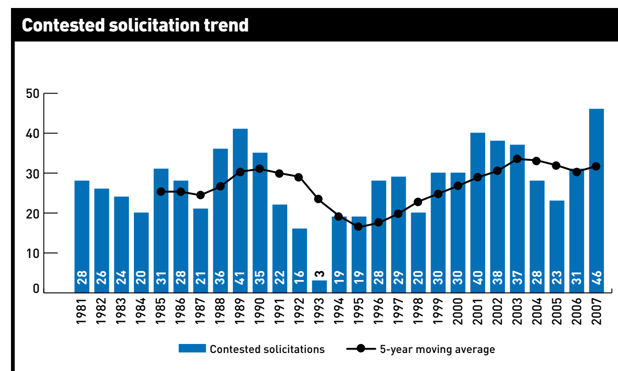
Sometimes relatively minor corporate decisions – like the record date for the season's proxy – can prove decisive. The record date freezes the shareholder roster for voting purposes so that only shareholders who own stock as of that specific date can vote a proxy. Sometimes, by setting the record date a little earlier or later, a company can ensure that arbs and/or other short-term players are either in or out of the stock for voting purposes.

Monitoring the vote

Once it's evident that a proposal will appear in the proxy, companies need to get a sharper picture of where shareholders stand. A knowledgeable proxy solicitation firm can tell you the most likely outcome were the vote to be held immediately. The solicitor can then design and execute calling campaigns and media initiatives, and even create internet sites designed to generate interest and support for management's position.

If a proxy contest is extremely important, management can take many steps to improve its odds of success. IROs can ask institutions to borrow back shares on loan for voting purposes. Management can also try to engage with major investors individually to discuss the central issues and try to sway shareholders' opinions.

All of these efforts take time, though. The earlier a company can form a clear picture of where specific shareholders stand in an upcoming proxy contest, the better able it is to take the steps necessary for garnering a majority of the vote.



Talk to opinion-makers

Increasingly, shareholders are taking their voting lead from proxy advisory firms like RiskMetrics, Proxy Governance and Egan-Jones. The analysis by RiskMetrics – the dominant player – can influence as much as or more than a quarter of the shares in a given stock. When a contentious issue is aired, it's important to engage proxy advisories early and to try to persuade them of your position.

In practice, establishing a relationship with RiskMetrics and the other proxy advisers should begin well before the hectic proxy season. Often, these firms will meet with 'clean' companies that have no discernible issues just to familiarize themselves with a company's governance practices and key players.

However, these meetings are usually initiated by the companies, not the advisory firm. Meetings like this can also help you better understand the types of issues looming on the proxy landscape and prepare for the future.

A new kind of conversation

Within the past several months a new sort of dialogue has begun taking place between companies and shareholders. On October 24, 2007, Pfizer spent a full day discussing its executive compensation and other governance practices with its largest shareholders. Members of the board were present, and all agreed it had been a very worthwhile exercise.

Not all companies can take this route. If too many firms adopted the Pfizer style of public forum, institutions, which have a limited bandwidth of time and attention, simply wouldn't have time to participate in all the meetings vying for attention.

At the same time, it is increasingly recognized that activist shareholders bring considerable expertise to a variety of challenges that public companies face, such as global warming, human rights challenges and safety issues. By sitting down and conversing with shareholders, companies can tap into alternative viewpoints and gain new ideas.

Engagement options

One possibility for generating future dialogue is electronic shareowner forums. These forums, which have yet to be fully tested, would allow shareholders and management an opportunity to exchange ideas.

Companies are waiting to see how these forums might develop. Will they become hotbeds of shareholder activism? Or will they evolve into useful tools for management and shareholders to exchange information on an ongoing basis?

Ironically, companies that have taken the most heat on controversial issues are emerging as leaders on how to deal with these problems. The Gap, which was vilified in the past for its child labor practices abroad, has developed a solid history of reporting and acting on labor issues in its supply chain. When a report recently uncovered children employed at one of its overseas factories, the company could point to numerous policies in place to prevent this situation, as well as the steps it routinely takes when a problem comes to light. What might have mushroomed into a major embarrassment was nothing more than a passing news story.

The bottom line? No company will ever be 100 percent perfect. For this reason, learning how to respond to criticism – and to act on well-meaning suggestions for change – can make you a far stronger and more resilient organization over time.

DEAL LAWYERS

Vol. 2, No. 4 July-August 2008

Distressed Debt Transactions: "Soup to Nuts"

By Michael Friedman, J. Bradley Boericke and Shirley Kuhlmann of Pepper Hamilton LLP[1]

A central feature of the ongoing credit crisis has been the decline in prices across all types of debt as the market has undertaken a radical repricing of risk. In response, a significant amount of capital is being raised by funds with a view to investing in debt. At the end of the first quarter of 2008, and in the midst of gloomy forecasts about how long the current market malaise will last, funds formed to purchase and manage distressed debt had raised over $24.6 billion.[2] Only a fraction of the funds raised have been invested to date, suggesting an imminent boom in distressed debt transactions.

From a variety of perspectives, and particularly in a climate where other alternative investment strategies are short-circuited by a lack of attractive financing and significant uncertainty, investments in distressed debt may have great appeal. But appeal does not come without risk, and purchasers of debt and their advisers need to be aware of the legal and practical pitfalls associated with distressed debt transactions. We examine the legal implications of transactions involving the sale and purchase of debt securities or syndicated bank debt. We use the generic "purchaser" throughout - but in some instances, we focus on issues that private equity funds in particular might encounter in the distressed debt arena.

1. **Preliminary Considerations**

Purchasers of debt in this environment may be acting with a variety of motivations and exit strategies. Is the purchaser seeking to purchase distressed debt for resale after the debt has been revalued? Or is the distressed debt purchase intended to be a variation on a loan-to-own transaction, whereby the purchaser anticipates becoming an active or controlling equity holder following an imminent bankruptcy or restructuring period?[3] Sometimes, the purchaser's strategy will be a hybrid of these two approaches, with different dominant strategies. The issues discussed in this Article need to be reviewed in light of the particular objectives of the purchaser.

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[2] *See, e.g.*, Matthew Sheahan, *Investors Warming Distressed Bench*, High Yield Rep., May 5, 2008.

[3] *See, e.g.*, Kelly DuPonte, *An Overview of the Private Equity Distressed Debt and Restructuring Markets*, The Guide to Distressed Debt and Turnaround Investing, 15.

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It is also important to keep in mind some distinctions relating to different kinds of debt. Generally, this article addresses both debt securities, which may have been publicly issued or privately placed (including so-called "144A for life" issuances), and syndicated "bank" debt, which is generally not treated as a security under the federal securities laws. We flag in the discussion below a number of areas where the differences in securities law treatment, and common practice relating to debt terms, may have a significant impact.

Finally, there are different ways in which distressed debt can be purchased, including open market purchases of publicly traded debt or other debt securities for which there is a liquid market (including many "144A-for-life" issues, traded in QIB markets); privately negotiated purchases of debt securities; standard purchases of bank debt in the secondary trading market; or negotiated portfolio acquisitions. Certain legal issues may be implicated by some forms of transactions and not others.

2. **Getting Started: Issues for Funds Planning to Invest in Debt**

In addition to all the conventional issues associated with formation of a new fund, there are certain issues that are particular to funds formed with a view to making investments in debt.

a. ERISA Investors

The distressed debt investment, because it often reflects a hybrid of trading and loan-to-own strategies, raises some issues regarding the types of entities eligible to participate. ERISA investors, and funds that include ERISA investors, need to assess whether there is likely to be sufficient control over the target—*i.e.*, the issuer of the acquired debt securities—for the fund to qualify under the venture capital operating company ("VCOC") exception to the ERISA "plan assets" regulations.

The VCOC exemption is available to funds that retain certain management rights over a minimum percentage of their portfolio investments.[4] In the case of funds raised exclusively to invest in distressed debt, the VCOC exemption may be available only if specific management rights are negotiated into an amended indenture; alternatively, these funds could avoid ERISA requirements by limiting their ERISA investors' aggregate investment to 25% of the fund.

b. Foreign Investors

While foreign investors do not pose the same eligibility issues as ERISA investors, tax treatment of investment returns may make certain distressed debt investments unattractive to foreign investors. A foreign fund, or a U.S. fund with foreign investors, will need to determine whether income from the debt instrument will be subject to U.S. tax. Interest will be exempt if it qualifies as "portfolio interest," provided that proper documentation is provided. Tax due diligence should include verifying that the debt instrument to be acquired meets the "registered form" requirements of applicable tax regulations and whether the debt provides for contingent payments. Certain contingent payments (such as payments contingent on the income or profits of the issuer) can disqualify a debt from the portfolio interest exception. Further, the portfolio interest exception is not available to persons who own, directly or by attribution, 10% or more of the issuer. If the fund is acquiring equity or warrants of the issuer (in addition to debt securities), the impact of the 10% ownership rule must be assessed. If the portfolio interest exception does not apply, then the interest paid by the U.S. issuer will be subject to 30% U.S. tax, unless an applicable tax treaty provides an exemption or a lower rate.

c. Proposed Regulation M Change

On July 1, 2008, the SEC issued proposed rules regarding the deletion of references to nationally recognized statistical ratings organizations ("NRSROs") in Regulation M, among other rules.[5] Rule 102 of Regulation M (which limits the ability of security holders who have an interest in the success of a particular offering to trade in issuer securities and thereby unfairly "condition" the market in anticipation of the offering) currently includes an exception for trading investment grade non-convertible securities.[6] Because the definition of "investment grade" securities is

[4] An advisory opinion issued by the Department of Labor in March of 2002 categorizes these requisite management rights into three groups: (1) delivery rights, which ensure the delivery of financial statements and other financial information to the investor (including a consolidated balance sheet within 120 days of the end of a fiscal year); (2) inspection and access rights, which include the right to receive copies of all documents, reports, financial data and other information reasonably requested; and (3) consultation and advisory rights, which entitle the investor to advise and consult with management relating all business affairs. Dep't. of Labor Advisory Opinion 2002-1A (Mar. 26, 2002).

[5] References to Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-58070 (July 1, 2008) (hereinafter, the "NRSRO Release").

[6] 17 CFR 242.102(d)(2).

based on NRSRO ratings,[7] and because the SEC wants to "reduce undue reliance" on such ratings, the proposed rule eliminates the exception for investment grade non-convertible securities in Rule 102(d)(2) and replaces it with an exception for all non-convertible securities issued by well-known seasoned issuers ("WKSIs").[8]

The use of the well-known seasoned issuer as a proxy for investment quality is particularly relevant in this market, in which the debt of many WKSIs is rated (belatedly) by the NRSROS as below investment grade. Should the proposed rule be adopted in substantially the form in the proposing release, the new rule may benefit investors with resale strategies that liberalize restrictions on their ability to trade non-investment grade securities.

3. **Due Diligence Review**

In connection with any purchase of debt, the purchaser will want to perform a due diligence review of the terms governing the debt, paying particular attention to the following:

a. Obligors and Relationship to Other Debt

A key characteristic of any debt is the identity of the obligor—who has the obligation to repay the debt. Often there will be multiple obligors, either as co-borrowers or as guarantors. In some cases, there may also be third party credit support (such as letters of credit or insurance) to take into account in evaluating the risks of non-payment.

Consideration should also be given to how the target debt fits with other indebtedness of those obligors and related parties. For example, structural subordination can exist for debt issued by a holding company, where other debt is incurred by a subsidiary that holds assets or operations. Since the claims of the holding company to the assets of the subsidiary exist by virtue of the holding company's equity ownership, the claims of debt holders of the subsidiary will have priority over claims of the holding company (and its creditors) with respect to the assets of that subsidiary.

In addition, cross default and cross acceleration provisions should be evaluated in light of the overall debt structure of the issuer to ensure that the holders of the debt to be purchased will not be substantially disadvantaged relative to other classes of debt.

b. Information Reporting

The Trust Indenture Act of 1939 (the "TIA") requires the issuer of public bonds to file with the indenture trustee all annual reports and other reports that the issuer is required to file with the SEC pursuant to Sections 13 or 15(d) of the Securities Exchange Act of 1934 (the "'34 Act"). As an overlay to the requirements of the TIA, financial reporting covenants in the indentures that govern these bonds generally come in one of two variations, which might be termed the "restrictive" and "flexible" forms.[9] The restrictive form of the reporting covenant requires the issuer to deliver the same information (*i.e.,* periodic reports on Forms 10-Q and 10-K), and within the same time frames, as would be required by the '34 Act, while the flexible form of the covenant requires delivery of SEC filings promptly after making such filings with the SEC.

Recent case law has generally confirmed (with an exception[10]) that the flexible version requires delivery of the information only as and when it is *actually* filed under the '34 Act—thus, under the flexible version, if an issuer is delinquent in its '34 Act reporting (*e.g.,* because of a restatement of financials), and belatedly delivers the delinquent report to the SEC and the trustee, there is no breach under the indenture so long as the delivery to the trustee closely follows the filing of the report with SEC.[11] However, the issue is not closed, as evidenced by the recent Finisar litigation. The Finisar litigation, now in the summary judgment phase, poses the same issue, but takes the inquiry a step further: after the litigation commenced, the delinquent SEC filings were made and subsequently furnished to the trustee, albeit after the 60 day period to cure a default under the indenture had

[7] 17 CFR 240.15c3-1.

[8] NRSRO Release, *supra* note 4, at 31—33.

[9] *See* Bruce C. Bennett, *Reflections on Indenture Remedies and Investor Protection*, 22 Insights 11, 15 (Feb. 2008).

[10] *See* Bank of New York v. BearingPoint, Inc., 824 N.Y.S. 2d 752 (N.Y. Sup. Ct. 2006) (holding that the issuer was in default due to its failure to perform the reporting covenant in the indenture).

[11] UnitedHealth Group, Inc. v. Cede & Co., No. 06-cv-4307 (D. Minn. Mar. 10, 2008); Affiliated Computer Services, Inc. v. Wilmington Trust Co., No. 06-cv-1770, 2008 WL 373162 (N.D. Tex. Feb. 12, 2008); Cyberonics, Inc. v. Wells Fargo Bank National Ass'n, No. H-07-121, 2007 WL 1729977 (S.D. Tex June 13, 2007). *See also* Bennett, *supra* note 3, at 16—18.

lapsed. One of the questions presented to the court is whether such action by the issuer cures the event of default (assuming such an event has occurred).[12]

c. Other Covenants

Debt documentation will almost always include a set of covenants imposing restrictions on various aspects of the operations of the issuer, but the nature and scope of these protections can vary significantly.

Historically, there has been a significant divide between debt securities and bank debt, with bank debt covenants set more restrictively (and waivers and amendments correspondingly commonplace). Bond covenants are usually focused on the issuer's prospective ability to incur debt and liens, and are "incurrence" covenants—financial ratio tests set criteria for determining the permissibility of additional debt or liens at a discrete point in time (the time of incurrence), and if those criteria are met at that time, then such debt and liens are permitted.

Covenants under bank loan documents are usually more concrete, imposing absolute financial maintenance covenants (*e.g.,* a requirement that the leverage ratio of debt to EBITDA not exceed a specified level at any time) and allowing only for set "baskets" of additional debt and/or liens. The "covenant lite" loans that surfaced in 2006 and into the first half of 2007 sought to import bond style incurrence-based covenants into bank loans. Though relatively few deals were completed under this model, the response of rating agencies clearly reflected their view that this represented a significant change in the risk profile of such debt.[13]

Broadly speaking, covenants provide protections against the issuer changing its risk profile as well as "early warning" triggers allowing a creditor to take steps before there are actual payment defaults. How much protection the covenants provide is an element to be evaluated before purchasing any particular debt issue. Where the covenants are less restrictive, the equity holders have much more freedom to operate the company with a view to maximizing equity value. If equity value has in effect been eliminated, this can amount to gambling the debt holder's money on a turn-around. In one report, S&P estimated that where there was no significant layer of debt that included meaningful maintenance covenants, the delay in lenders' ability to force an issuer to the table translated into recovery estimates that were an average of 8% —14% lower as compared to equivalent borrowers with full maintenance covenants.[14]

d. Mandatory and Optional Prepayments

Mandatory and optional prepayment terms should be evaluated for their potential effect on the return on an investment in debt. Debt purchasers should consider the degree to which certain material events will trigger mandatory prepayments—such as changes of control, equity issuances or material dispositions of assets. At the same time, debt purchasers should be mindful of the loss of yield that can result if prepayments (whether mandatory or optional) may be made without premiums or penalties.

e. PIK Toggles

The purchaser should identify whether any debt instruments, including the instrument relating to the debt being purchased, have issuer friendly features, such as payment-in-kind, or PIK, toggles. PIK toggles, which were a familiar part of the financing landscape just a few years ago, allow issuers to choose to pay interest on their debt by issuing more debt instead of making cash payments. Issuers are still subject to certain financial covenants that prevent them from taking on too much debt without lender consent, but those covenants did not stop seven companies from "flipping the switch" recently on their PIK-toggle bonds worth $2.4 billion.[15]

f. Equity Cure Rights

In bank loan documents that include financial ratio maintenance covenants, financial sponsors frequently bargain for an "equity cure" right—the ability to put additional equity into the debt issuer in a manner that would cure the covenant breach. In some cases, the equity cure right would be effected by an equity contribution that would be used to pay down debt, thereby adjusting the leverage ratio or other covenant measured against the issuer's debt

[12] Motion for Summary Judgment at 5, Finisar Corp. v. U.S. Bank Trust, No. 507-cv-04052 (N.D. Cal. Apr. 24, 2008)

[13] See *e.g.,* Standard & Poor's RatingsDirect CDO Spotlight (June 12, 2007), "*The Covenant-Lite Juggernaut is Raising CLO Risks—And Standard & Poor's is Responding,*" http://www2.standardandpoors.com/spf/pdf/fixedincome/CovenantLite_Juggernaut.pdf

[14] *See, e.g., Recovery Chances Lower for Covenant-Lite Loans-S&P*, July 18, 2008, *available at* http://uk.reuters.com/article/marketsNewsUS/idUKN1831469820070718 (citing the S&P report).

[15] Serena Ng, *PIK and Roll: Companies Seize on Perks of Loose Lending Terms*, Wall St. J., May 19, 2008, C-1 (citing a Standard & Poor's Leveraged Commentary & Data report).

levels. In other cases, the equity cure right was taken a step further: the lender's equity infusion was treated as the equivalent of earnings (increasing EBITDA).

While the infusion of additional equity is generally a positive event for debt holders, it bears mention that the allowance of an equity cure can delay the point at which the debt holders can bring the issuer to the table as discussed above in the context of "covenant lite" loans.

g. Assignability/Transfer Restrictions

Assignability and transfer restrictions should be reviewed and understood, not only for their impact on the proposed purchase but also as they affect the marketability of the debt in the event the purchaser desires to sell the purchased debt in the future.

Publicly traded debt securities will generally be unrestricted. In the case of debt securities issued though a private placement, including "144A-for-life" issuances, there will be limitations on the types of buyers and manner of sale.

Transfers of bank debt often require borrower consent to the assignment in the absence of any defaults under the loan documents.

4. **Insider Trading Rules**

The federal securities laws generally prohibit trading in securities while in possession of material non-public information relevant to those securities. This type of information might be acquired if the purchaser acquires a seat on the board of the issuer, exercises consulting or advisory rights with respect to the issuer, joins a creditors' committee as part of a bankruptcy proceeding, or simply through the communication of information by the issuer under conditions of confidentiality. In any of these circumstances, the purchaser may find itself subject to trading restrictions with respect to the purchased debt or other securities of the issuer.

In most syndicated bank facilities for companies with publicly traded securities, debt holders will often be given an opportunity to indicate whether they are public side or private side. If they wish to preserve their ability to trade in securities issued by the borrower or its affiliates, holders of the bank debt will indicate that they are public side holders and information otherwise required to be delivered under the loan documents but designated by the issuer as non-public will not be delivered to such public-side holders.

Some debt holders have sought to circumvent the restriction on trading by securing "big boy letters" from the parties to which they intend to sell their debt securities. A big boy letter amounts to an acknowledgement by the purchasing party that it is aware of the information asymmetry between itself and the seller, and waivers of future claims based on such asymmetry: the purchaser, despite being at an informational disadvantage, is willing and able to purchase the subject securities. However, recent cases—particularly the litigation between R^2 Investments and Salomon Smith Barney and the SEC action against Barclays, and one of its traders, Steven Landzberg—suggests that big boy letters are not panaceas for insider trading restrictions.[16]

Technically, the insider trading rules do not apply to trading in bank debt since bank debt is not treated as a "security" under the federal securities laws. Nonetheless, many active participants in the secondary loan market apply similar principals as a matter of good practice and consideration should be given to the reputational and other risks that would be entailed in trading on material non-public information.

5. **Tender Offer Rules**

The tender offer rules under the '34 Act impose certain disclosure and timing obligations on offers to purchase outstanding publicly traded securities; each of the parties to a distressed debt transaction may have incentives to structure the purchase of distressed debt to ensure that it is not subject to these obligations. Generally speaking, a debt purchase program will not be susceptible to categorization as a tender offer if it has a limited target audience, the purchase price does not represent a significant premium over the market price of the securities, and the target purchasers are sophisticated investors.[17] Although the jurisprudence relating to tender offers focuses on the offering of equity securities, it can provide meaningful comfort for parties involved in debt transactions: purchase programs relating to securities that involve fewer and more sophisticated holders—common characteristics of debt securities—are less likely to be recharacterized as tender offers.[18]

6. **Issuer Bankruptcy**

When an issuer of debt slips into bankruptcy, a debt holder will have to make a significant strategic decision about whether it will be closely involved in the bankruptcy proceedings.

If a debt holder takes a role as part of a creditors' committee it will become an "insider", thereby subjecting it to trading restrictions with respect to the debt securities as discussed above. Participation on an official creditors committee under the Bankruptcy Code necessarily entails responsibilities that would make the participant an insider. Where there is an ad hoc committee of holders, the bar to trading may be avoided for a while through the delegation of workout negotiations to attorneys and financial advisors and/or the designation of a steering committee of holders which will become restricted while the other holders remain free to trade. All of the holders will become restricted and receive confidential information when terms of a workout deal are ripe for consideration.[19]

For larger market participants, who might hold the debt through one group but have other groups involved in trading of other securities, it is possible to structure a Chinese wall. In this context it is crucial to abide by a set of specific criteria established by the court in connection with the bankruptcy of Federated Department Stores. These safeguards included: (1) requiring execution of a letter by employees with access to non-public information acknowledging their awareness that the information they receive may be material and non-public through their participation in or involvement with a creditors' committee, and that they are aware of ethical screen procedures; (2) establishing procedures to prohibit the dissemination (oral and written) of non-public information to employees not involved in the bankruptcy proceeding; (3) excluding employees that were privy to non-public information from communications that discuss imminent trading activity; and (4) maintaining compliance procedures to ensure that all trades comply with the above restrictions. These safeguards are similar to the requirements subsequently adopted in relation to more generally applicable insider trading policies under Rule 10b5-1(c) of the '34 Act.

7. **Equitable Subordination**

Equitable subordination, while not a remedy that is often approved by Bankruptcy Courts, has the ability to so undermine a creditor's investment that its specter continues to affect creditor behavior. To the extent that purchasers of distressed debt do not become fiduciaries of the issuer—by taking positions on the Board or otherwise creating a protected relationship with the issuer—they can take comfort in a 2006 ruling by the ninth circuit noting that a much higher burden of proof applies when claimants seek to an equitable subordination remedy with respect to a non-insider creditor.[20]

However, if the terms of the distressed debt transaction create a fiduciary relationship, the purchaser must pay careful attention to preventing even the appearance of impropriety, keeping in mind that disgruntled creditors or shareholders of the issuer in bankruptcy will only have to prove "substantial impropriety" to win their claim for equitable subordination in the absence of demonstrations of good faith and fair dealing on the part of the purchaser.

8. **Tax Issues**

a. Market Discount Rules

If a debt security is purchased at a discount from its face value, the purchaser will be subject to the tax rules concerning "market discount."[21] In general, the market discount rules require that the difference between the face amount of the debt and the purchase price be recognized as ordinary income, taxable at the highest applicable tax rates. Unlike the tax rules governing original issue discount, the market discount rules do not generally require that accrued market discount be taken into income currently.

[16] *See* Glenn E. Siegel & Davin J. Hall, *Confidentiality and Disclosure in Distressed Investing*, 24 Rev. of Banking & Fin. Serv. 1 (Jan. 2008).

[17] *See* Wellman v. Dickinson, 475 F. Supp 783 (S.D.N.Y. 1979) (describing eight factors indicating the presence of a tender offer, including (i) widespread solicitation of offers; (ii) solicitation representing a "substantial percentage" of securities; (iii) significant premium over market price; (iv) terms of offer are firm and nonnegotiable; (v) offers to purchase contingent upon the purchase of a minimum amount; (vi) offer was open for a limited time ; (vii) offerees were pressured to respond; and (viii) public announcements of a purchase program is followed by a rapid accumulation of the issuer's securities); Hanson Trust PLC v. SMC Corporation, 774 F.2d 47 (2d. Cir. 1985) (noting certain factors whose presence would indicate the *absence* of a tender offer, including, *inter alia*, (i) sophistication of the purchasers; (ii) no time limit within which to accept the offer to purchaser; and (iii) limited or nor advance solicitation or publicity of purchase program).

[18] *See, e.g., Client Alert: Navigating Debt Repurchases—Issues and Answers*, Latham & Watkins, March 31, 2008, *available at* http://www.lw.com/upload/pubContent/_pdf/pub2141_1.pdf.

[19] *See* Siegel & Hall, *supra* note 15.

[20] Henry v. Lehman Commercial Paper, Inc. (In re First Alliance Mortgage Co.), 471 F.3d 977 (9th Cir. 2006).

[21] An exception to this rule may exist in the case of deeply discounted bonds. Several cases support the view that if a recovery of a deeply discounted obligation is sufficiently speculative, principal payments on the bond should be treated first as a nontaxable return of basis.

Instead, market discount is taken into account as principal payments are made, or when the debt is sold, to the extent of the accrued market discount on the date of the sale or payment. In the case of a private equity fund purchaser, individual investors in the fund will recognize ordinary income taxable at maximum rates of 35% (rather than capital gain taxable at a 15% maximum rate) with respect to the market discount on debt instruments acquired by the purchaser.[22]

In general, market discount accrues using a ratable method. However, taxpayers can elect, on a bond-by-bond basis, to accrue interest using a constant interest method). Funds should consider the potential benefits of electing the constant interest method, which may reduce front-loading the market discount accrual. Funds should also be aware that a portion of the fund's interest deductions may be deferred if the purchase of market discount bonds is leveraged. The interest deduction deferral rules do not apply to taxpayers who elect to accrue market discount currently.

b. Debt Workouts and Modifications

The modification of a debt (for instance, a change in the interest rate, extension of the maturity date or change in security) may result in a "deemed exchange" for federal income tax purposes. Under some circumstances, the modification of a debt instrument purchased at a discount may result in the purchaser recognizing a taxable gain equal to the difference between the principal of the debt and the discounted purchase price. Deemed exchanges may also have adverse consequences for issuers of debt, including the potential to recognize income from the cancellation of indebtedness ("COD income"). In general, purchasers will be in a better position to avoid unintended adverse tax consequences if any debt modifications or workouts are completed prior to the acquisition of the debt instrument.

c. Restructuring Considerations

If the purchaser is (or becomes) a related party to the issuer, the purchase of the debt instrument at a discount may result in the issuer realizing cancellation of indebtedness income. In general, the threshold for related parties is 50% ownership or control. Distressed debt purchasers and issuers should consult their tax advisors if the purchase will, or may, result in the purchaser's acquisition of a greater than 50% interest in the issuer.

Conclusion

Warren Buffet compares taking on debt to driving with a spike sticking out of your steering wheel: All is well until you hit a bump in the road. Hitting a bump in the road, while no doubt painful for the impaled issuer in Buffet's analogy, can create great opportunities for purchasers to infuse cash and greater discipline into a struggling, or at least devalued, business while relieving debt holders who lack the resources to turn the business around. The challenge in investigating and structuring distressed debt transactions is dealing with multiple dynamic variables including investment strategy, market forces, and unknown and unpredictable co-creditors, but careful consideration and even more careful diligence—including investigation of the points described above—can help reap the rewards of a wise investment in distressed debt.

[22] An illustration: Corp X issued bonds in the amount of $1,000 on January 1, 2005. The bonds pay interest only at the rate of 6% and mature on December 31, 2011. On January 1, 2008, Fund acquires the bonds for $800. The Corp X bond has market discount of $200. Under the ratable method of accrual, approximately $50 of market discount will accrue each year through the maturity date of the bond. Assume that Fund sells the bonds after two years on December 31, 2009, for $950. Fund's gain of $150 is treated as ordinary income to the extent of the $100 accrued market discount and as long term capital gain for the remaining $50.

The SEC's Cross-Border Proposal: Top Four Ways Deals Would Change

By Frank Aquila and Melissa Sawyer, a Partner and Associate of Sullivan & Cromwell LLP[1]

As the global economy becomes more integrated and acquisitions are just as likely to be cross-border as they are cross-town, the U.S. cross-border rules have come under increasing scrutiny. The amendments recently proposed by the SEC seek to remedy recurring problems with the existing rules, making compliance easier and making enforcement more predictable.

What are the SEC's Cross-Border Proposals?

The SEC adopted its current cross-border business combination rules in 1999.[1] The 1999 rules were intended, among other things, to encourage acquirers of non-U.S. target companies to allow U.S. shareholders to participate in acquirers' tender and exchange offers. Although in many respects the 1999 rules have functioned well, the SEC regularly has been asked to grant case-by-case no-action, interpretive and exemptive relief to address certain recurring issues under the 1999 rules, including issues arising from conflicts between U.S. and non-U.S. requirements.

The amendments recently proposed by the SEC would largely codify the no-action, interpretive and exemptive relief that the SEC was provided on these issues.[2] As was the approach in the 1999 rules, the proposed amendments attempt to strike a balance between protecting U.S. investors and maintaining the U.S. capital markets' relevance in the face of the inescapable and unrelenting globalization of mergers and acquisitions. With globalization has come conflicts of law and customs, politics of protectionism and nationalism, new commitments to free markets, increasing risks of unregulated capital markets and increasing potential for enormous efficiencies and gains from synergies, consolidation, rationalization and capital flows that are unconstrained by national borders or local market practices.

For the parties to cross-border transactions, the proposed amendments would provide clearer guidelines about how to structure deals to allow U.S. holders to participate without subjecting the deal to the full range of U.S. requirements. This is significant to prospective acquirers since U.S. requirements could be costly and duplicative of the target's home country requirements, particularly when those requirements may already adequately protect U.S. investors. For U.S. holders, the proposed amendments reflect the SEC's ongoing efforts to ensure that they are less are less frequently excluded from participating in cross-border M&A transactions.

Top Four Ways Deals Would Change

Here is an overview of the four key ways in which the proposed amendments would modify the 1999 rules to minimize the need for case-by-case relief where the SEC has become aware of recurring conflicts and issues:

1. Easier Determination of U.S. Ownership

Prior to the 1999 rules becoming effective, U.S. security holders were regularly excluded from participating in transactions involving non-U.S. issuers if their participation was not otherwise necessary for the successful completion of the transaction. This was particularly true if their vote in favor of the transaction was not required or the buyer could conduct a tender offer and be assured of being able to squeeze out the U.S. holders without soliciting tenders from U.S. holders. By excluding U.S. holders, buyers were able to avoid having to comply with U.S. disclosure, procedural and substantive requirements. In some cases, U.S. requirements actually conflicted with home country requirements. In many cases, this resulted in substantial additional transaction costs and/or resulted in delays in completing deals.

The 1999 rules created exemptions for cross-border transactions that allowed buyers[3] to include U.S. holders in their acquisitions of foreign private issuers without complying with all of the U.S. requirements that would have been otherwise applicable. The lower the level of "U.S. interest" in a transaction, the fewer U.S. requirements apply to the transaction. "U.S. interest" was measured by the percentage of the target securities that are held by U.S. investors.

[1] SEC Release No. 33-7759 (Oct. 22, 1999).

[2] SEC Release No. 33-8917 (May 6, 2008).

[3] The exemptions apply equally to U.S. and non-U.S. buyers.

Under the 1999 rules, cross-border exemptions are structured as a two-tier system. Where no more than 10% of the target securities are held by U.S. holders, a qualifying cross-border transaction (a "Tier I transaction") will be exempt from most U.S. tender offer rules (including many of the disclosure, filing, dissemination, minimum offering period, withdrawal right and pro-ration requirements that are intended to provide holders with equal treatment and adequate time and information to make a decision whether to tender into an offer). Tier I transactions are also exempt from the registration requirements of Section 5 of the Securities Act of 1933.[4] Where more than 10% but no more than 40% of the target securities (on a class-by-class basis) are held by U.S. holders, a qualifying cross-border transaction (a "Tier II transaction") will be eligible for exemptions that provide targeted relief from some recurring areas of regulatory conflict, such as the prompt payment, extension and notice of extension requirements in Regulation 14E.[5]

Although the 1999 rules did in fact provide relief from certain U.S. requirements to buyers of foreign private issuers, there continues to be some uncertainty associated with determining eligibility for the Tier I and Tier II exemptions. That lack of clarity could result in the parties being unwilling to rely on the exemptions. In such situations, the parties often simply return to the pre-1999 practice of excluding U.S. holders from the transaction entirely, or choosing not to proceed with a transaction at all if the timing or uncertainty associated with having to comply with U.S. requirements would make the transaction impractical or uneconomic. Such a result was exactly what the 1999 rules were intended to eliminate. The proposed rules include several technical changes that should clarify the Tier I and Tier II eligibility standards.

(a) Calculating Ownership Requirements in Friendly Deals

Current Requirements—In a negotiated ("friendly") deal, the 1999 rules required calculation of the percentage of U.S. ownership by reference to the target's or issuer's non-affiliated "free" float. The calculation is required to exclude all holders of more than 10% of the target securities from both the numerator and the denominator of the calculation, but includes securities underlying American Depositary Receipts ("ADRs") and must be calculated based on beneficial ownership (rather than record ownership). The calculation is required to be measured as of the 30th day before commencement of a tender offer, as of the 30th day before the solicitation for other types of business combinations or as of the record date for a rights offering.

Issues with the Current Requirements—In many countries, it is impracticable or impossible to obtain share ownership information as of a precise date. In certain countries it takes longer than 30 days to collect the information. In addition, using the date of commencement of a tender offer to calculate share ownership (i) means that parties would have to sign and announce a transaction without knowing whether the deal will be eligible for the Tier I or Tier II exemptions, (ii) results in the calculation being affected by post-announcement share movements, which can be significant as arbitrageurs and hedge funds acquire shares and (iii) is inconsistent with Rule 14e-5, relating to purchases outside of a tender offer, which is triggered by the announcement of a deal (rather than commencement).

Proposed Amendments—The SEC has provided no-action relief in the past to permit certain buyers to calculate U.S. ownership as of a different time.[6] The proposed rules would largely eliminate the need for that no-action relief by allowing bidders in friendly deals to calculate U.S. ownership as of any day within the 60 days prior to public announcement of the transaction.[7] The SEC has also requested comment on whether to raise the 10% threshold for Tier I eligibility and/or whether to continue the exclusion of 10% holders from the calculation of the eligibility threshold.

(b) Calculating Ownership Requirements in Hostile Deals

Current Requirements—The Tier I and Tier II percentage-based eligibility thresholds are the same for friendly and hostile deals. However, since it can be more difficult to measure the ownership of a target's shares without the target's cooperation in a hostile deal, the 1999 rules permit bidders to assume the level of U.S. ownership based on the average daily trading volume of the relevant class of securities for a 12-calendar-month period ending 30 days before commencement of the offer. This "hostile presumption" is not available if the bidder knows or has "reason to know" that the actual ownership is different than the presumed ownership.

Issues with the Current Requirements—The requirement that the eligibility thresholds be calculated by reference to the commencement date is problematic in hostile deals for the same reasons as for friendly deals. There are two principal additional issues with the manner in which the thresholds are required to be calculated in hostile deals: (i) bidders have expressed uncertainty about what constitutes a "reason to know" that the level of U.S. ownership of the target exceeds the level indicated by trading volume, and whether rand to what extent they have an obligation to take affirmative action to seek out information about U.S. ownership levels; and (ii) it is unclear whether the "reason to know" carve-out applies only as of the measurement date or at any time through commencement.[8] Among other things, bidders have expressed concern that after announcement of a hostile transaction in reliance on one of the exemptions, a target could assert a level of ownership that would disqualify the bidder from relying on the relevant exemption as part of the target's strategy to defend itself against the hostile bid.

Proposed Amendments—The proposed rules would, consistent with the change for friendly deals, tie the reference date for measuring U.S. ownership to the public announcement of the transaction, rather than the commencement of the transaction. The proposed rules would also clarify that a bidder has "reason to know" publicly available information and information it receives from credible non-public sources, but is not required to take affirmative action to seek out information about U.S. ownership levels. Finally, the proposed rules would clarify that the determination of whether a bidder has "reason to know" of the target's U.S. ownership levels should be measured as of the date of public announcement of the transaction. The bidder is not required to take into account new information is receives from the target or otherwise after it announces the transaction. Each of these proposed changes would clarify a bidder's eligibility for using the Tier I and Tier II exemptions in a hostile transaction.

2. Fewer Conflicts between U.S. and Home Country Requirements

(a) Dual and Multiple Offers

Current Requirements—Rule 14d-10(a)(1) under the Exchange Act (the "all-holders rule") requires that all tender offers subject to Section 14(d) of the Exchange Act be held open to all holders of the target securities. Tender offers eligible for the Tier I exemption are not subject to the all-holders rule. Tender offers subject to the Tier II exemption are subject to the all-holders rule, but the Tier II rules permit the bidder to conduct two separate, parallel offers (one made only to non-U.S. security holders and the other made, on at least as favorable terms, only to the U.S. security holders). The purpose of allowing the dual-offer structure is to accommodate procedural differences between home country tender offer rules and the U.S. rules.

Issues with the Current Requirements—The Tier II exception to the all-holders rule is available only when there are two parallel offers. In some cases however, bidders must conduct multiple separate offers to comply with multiple jurisdictions' requirements. In addition, the all-holders exception requires a strict delineation between the offer for U.S. holders and the offer for non-U.S. holders, but in practice it can be difficult to observe that division. For example, non-U.S. holders of ADRs may trade the ADRs on U.S. securities exchanges. In addition, some non-U.S. jurisdictions do not permit the non-U.S. offers to exclude U.S. holders.[9]

Proposed Amendments—Consistent with no-action relief previously granted by the SEC's staff, the proposed amendments would permit more than two parallel offers, would allow the U.S. offer to include non-U.S. holders of ADRs and would allow the non-U.S. offers to include U.S. holders if required by the laws of the jurisdiction governing the non-U.S. offer and so long as the offer materials distributed to U.S. persons under the non-U.S. offer fully and adequately disclose the risks of participating in the non-U.S. offer as compared with the U.S. offer.

(b) Back-End Withdrawal Rights

Current Requirements—The Tier II exemptions currently allow a bidder to suspend withdrawal rights upon the expiration of the initial offering period and, therefore, not to offer rights to withdraw tendered securities

[4] Tier I status currently exempts the subject company from the filing, dissemination and procedural requirements of the U.S. tender offer rules and the heightened disclosure requirements applicable to going private transactions as defined in Rule 13e-3. It also exempts the target of a tender offer from the obligation to express and support a position with respect to the tender offer. For Tier I transactions, Rules 801 and 802 under the Securities Act of 1933 also provide relief from the registration requirements of Securities Act Section 5 for securities issued in rights offerings and business combination transactions.

[5] The Tier II exemptions do not currently provide relief from the registration requirements of Securities Act Section 5, nor do they include an exemption from the additional disclosure requirements applicable to going private transactions by issuers or affiliates.

[6] Equant N.V., SEC No-Action Letter, WSB File No. 0516200501 (CCH) (Apr. 18, 2004).

[7] In addition, the SEC asked for comment on whether the 10% threshold for Tier I eligibility should be increased and whether to continue the exclusion of 10% or greater holders from the eligibility calculations.

[8] Rio Tinto plc, SEC No-Action Letter, WSB File No. 0730200705 (CCH) (July 24, 2007).

[9] Royal Bank of Scotland Group plc, SEC No-Action Letter, WSB File No. 0813200710 (CCH) (July 23, 2007).

after the initial offering period has closed (so-called "back-end withdrawal rights")[10] only if: (i) the bidder announces the results of the initial offering period and pays for tendered securities in accordance with home country law and practice; and (ii) a subsequent offering period commences immediately thereafter.

Issues with the Current Requirements—In a number of jurisdictions, shares are tendered through multiple financial intermediaries rather than a single agent (like the U.S.). Consequently, in such jurisdictions, it can take several days after the expiration of the initial offering period to determine the tendered shares before the bidder pays for those securities. During that "counting" period, the U.S. rules would require that holders be permitted to withdraw their shares, but those withdrawals could make it difficult to get an accurate count and could make it impossible for the bidder to determine whether the offer's minimum acceptance condition is satisfied. This, in turn, can delay the bidder's ability to declare the offer unconditional and initiate a subsequent offering period.

Proposed Amendments—Consistent with existing staff no-action positions,[11] the proposed amendments would permit bidders in Tier II-eligible offers to suspend back-end withdrawal rights while tendered securities are being counted, even if the bidder ultimately does not provide for a subsequent offering period. Use of this relief however, would be subject to certain conditions that were typically included in the prior no-action relief relating to back-end withdrawal rights.[12] The SEC has also asked for comment as to whether bidders should be permitted to further suspend withdrawal rights through the announcement of the results of the tender offer.

(c) Subsequent Offering Periods

Current Requirements—The Tier II exemptions currently allow bidders to accept and pay for securities tendered during the initial offering period (but not during the subsequent offering period) in accordance with home country law and practice. Bidders who conduct subsequent offering periods remain subject to the U.S. requirements, which include limitations on the length of the period, prompt payment obligations, the obligation to immediately accept all securities tendered during the initial offering period, and an obligation to offer the same form and amount of consideration to holders in both the initial and the subsequent offering period.

Issues with the Current Requirements—Buyers have repeatedly asked the SEC for no-action relief with respect to the manner in which the current subsequent offering rules apply to Tier II transactions.[13] The U.S. rules often conflict with non-U.S. requirements in four significant areas: (i) length of the subsequent offering period; (ii) prompt payment requirements; (iii) use of mix-and-match offers and the ability to ensure that holders in a subsequent offering period receive the same form and amount of consideration as holders in the initial offering period; and (iv) ability to pay interest on securities tendered during a subsequent offering period.

Proposed Amendments—The proposed amendments would alleviate these subsequent offering period issues by permitting subsequent offering periods in Tier II-eligible transactions to extend for more than 20 business days, by modifying the prompt payment requirements to permit payment on a 14-day delayed rolling basis, and by codifying the SEC's prior no-action positions with respect to mix-and-match offers (specifically, by allowing a ceiling on a form of consideration and allowing separate proration pools for the initial offering period and the subsequent offering period). The amendments also would allow bidders to pay interest on securities tendered in a subsequent offering period in a Tier-II eligible offer to the extent required by applicable non-U.S. law.

3. More Flexibility for Non-U.S. Buyers to Purchase Securities Outside US Tender Offers

Rule 14e-5 under the Exchange Act prohibits the bidder and its affiliates and certain of its advisors (as well as the target and its affiliates and advisors in a friendly deal) from purchasing the target securities during the period from announcement of the tender offer until the offer expires. Tier I-eligible offers are exempt from Rule 14e-5, but Tier II-eligible offers are not.

[10] In contrast, in tender offers subject to Section 14(d) of the Exchange Act, bidders must permit tendering security holders to withdraw their securities at any point during the initial offering period or during the period that is within 60 days after commencement of the offer, even if the initial offering period has expired, up until the time that the bidder accepts and pays for the securities. The 60 day requirement is the source of back-end withdrawal rights in some cases.

[11] Scitex Corp. Ltd., SEC No-Action Letter, WSB File No. 0524200402 (CCH) (May 14, 2004).

[12] The conditions include that (i) the offer must include an initial offering period of at least 20 U.S. business days, during which withdrawal rights are provided, (ii) when withdrawal rights are suspended, all offer conditions must have been satisfied or waived except to the extent that the bidder is still counting tendered securities to determine if the minimum acceptance condition has been satisfied; and (iii) withdrawal rights are suspended only during the necessary centralization and counting process period and are reinstated immediately thereafter, unless the bidder declares the offer unconditional and immediately accepts the tendered securities.

[13] Barclays PLC, SEC No-Action Letter, WSB File No. 0910200701 (CCH) (Aug. 07, 2007); Rio Tinto plc, SEC No-Action Letter, WSB File No. 0730200705 (CCH) (July 24, 2007).

In the past, the SEC has granted case-by-case (and some class) exemptive relief for three types of purchases made outside of a Tier II-eligible offer: (i) purchases made pursuant to a non-U.S. tender offer where there are separate U.S. and non-U.S. offers; (ii) purchases made by offerors and their affiliates outside of the U.S.; and (iii) purchases made by financial advisors' affiliates outside of the U.S.[14]

The proposed amendments would codify the existing exemptive class relief previously granted for Tier II-eligible offers so long as certain disclosure requirements and a "most favored nation" treatment requirement for U.S. holders are met. In addition, the proposed amendments would permit certain additional purchases outside of a Tier II-eligible offer under certain circumstances.

For example, if the purchase is made by an affiliate of the bidder's financial advisor, availability of the additional relief would be subject to information barriers being in place to prevent the flow of information that may result in a violation of U.S. securities laws, the financial advisor must have a U.S.-registered broker-dealer affiliate, the purchases cannot be intended to facilitate the tender offer, and purchases for the purpose of risk arbitrage are expressly prohibited.[15]

4. Clarity When Applying the Rules

The SEC has proposed additional technical changes to the 1999 rules that would, among other things, exempt Tier I transactions for Rule 13e-3 with respect to a broader range of transaction structures. Previously, the Rule 13e-3 exemption only applied to tender offers and a limited number of other business combination structures commonly used outside of the U.S.

The rules did not cover the full range of structures commonly used in other jurisdictions, such as schemes of arrangement.[16] The limitations of the exemption resulted in the form of the transaction preventing otherwise-eligible parties from relying on the Tier I-exemption from Rule 13e-3. The additional technical changes would, among other things, also require parties to designate on the cover page of Schedule TO and Forms F-4 and S-4 their reliance on any of the applicable cross-border exemptions, and would permit non-U.S. institutional investors to use Schedule 13G instead of Schedule 13D (subject to certain conditions).

Last Words

The proposed amendments will standardize a number of the SEC's prior no-action relief grants, providing bright-line rules that will make the applicability of the U.S. rules more predictable. That predictability, in turn, will permit parties to better structure their deals to comply with both U.S. and non-U.S. requirements. The latter is becoming increasingly necessary as more and more deals involve multiple jurisdictions and more and more buyers are raising capital across national borders. In the past, in public speeches, members of the SEC staff have indicated that they routinely discuss areas of conflict between U.S. and non-U.S. requirements with regulators outside of the U.S.

The proposed amendments appear to reflect an attempt to reconcile these conflicting requirements, as well as a willingness to redress issues with the 1999 rules that came to light through recurring requests for no-action relief. Because neither non-U.S. nor U.S. requirements are static, it is likely that additional areas of conflict will emerge in the coming years and these conflicts may require additional amendments in the future.

(Endnotes)

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[14] Saipem SpA, SEC No-Action Letter, WSB File No. 0812200201 (CCH) (July 29, 2002) (reciting need to comply with French legal requirements to purchase shares in French offer); J.P. Morgan Securities Ltd., SEC No-Action Letter, WSB File No. 0304200226 (CCH), (Feb. 27, 2002) (reciting need for buyer's affiliate to make purchases in its capacity as a market maker).

[15] The proposed amendments do not extend relief to ordinary course trading activities by financial institution principles, nor is the SEC proposing any similar relief from Rules 101 and 102 of Regulation M (which prohibits purchases and arrangements to purchase shares of the offeror where those shares are being used as consideration in the offer).

[16] SUNDAY Communications Ltd., SEC No-Action Letter, WSB File No. 1113200613 (CCH) (Nov. 1, 2006); Equant N.V., SEC No-Action Letter, WSB File No. 0516200501 (CCH) (Apr. 18, 2004).

The SEC's New Cross-Border Guidance: Four "Don'ts" for Structuring Cross-Border Deals

By Frank Aquila and Melissa Sawyer, a Partner and Associate of Sullivan & Cromwell LLP

Even the most straight-forward cross-border M&A transactions are complex and require sophisticated deal structuring. In trying to develop new deal structures and "technologies" that comply with all of the (sometimes conflicting) applicable legal requirements, parties have stretched the limits of what is permissible under the U.S. rules on occasion. The SEC's recent release relating to proposed amendments to the cross-border rules (the "2008 Release") analyzes certain of these developments and reassert the SEC's view that some of the proposed structures and technologies run afoul of the U.S. tender offer rules.[1]

The interpretive guidance clarifies the SEC's position on several topics that arise in connection with cross-border deals. Specifically, aspects of the SEC's guidance present an analysis of the SEC's view of its jurisdiction over activities and security holders located outside of the U.S.[2]

It also signals a continued focus by the SEC on the adequacy of disclosures relating to business combinations and reinforces the conclusion that, although the SEC is willing to assist parties to cross-border transactions to rationalize their compliance with technical offering requirements across multiple jurisdictions, the SEC continues to believe that most security holders (whether U.S. or non-U.S.) are entitled to the substantive benefits of the U.S. antifraud rules. Set forth below is an overview of four areas where the SEC believes parties to cross-border transactions need to be more precise in the manner in which they structure their deals to comply with U.S. laws and regulations.

1. Don't Exclude Non-U.S. Holders

The 2008 Release includes several proposed amendments that would make it less costly for non-U.S. offerors to include U.S. holders in their offers. The SEC also indicated that it encourages its fellow international securities and takeover regulators to minimize the ability of bidders to exclude U.S. holders from business combination transactions. For that reason, the 2008 Release also includes guidance that suggests the SEC is willing to live by its own rules, by encouraging bidders for U.S. targets not to exclude non-U.S. holders from their offers.

Specifically, the SEC clarified that the all-holders provisions in Rules 14d-10 and 13e-4(f) apply equally to U.S. as well as non-U.S. shareholders. The SEC states that it views this guidance as merely reiterating is pre-existing position on this issue, but noted that it is aware that certain bidders have purported to exclude non-U.S. target security holders in tender offers subject to all-holders rule. The SEC also pointed out that the practice of asking target holders to certify that their tenders comply with local laws or that an exemption applies that allows such tenders is not appropriate. The SEC stated that it believes that target holders may not have the relevant facts regarding the bidder's actions and the requirements of local law to make that determination.

In a concession to the inherent difficulties of conducting a multi-jurisdictional exchange offer, the SEC did solicit comment on whether any amendments to the U.S. equal treatment provisions are necessary. The SEC also noted that the all-holders rule does not necessarily require bidders to mail offering materials into all non-U.S. jurisdictions.

2. Don't Purport to Exclude U.S. Holders While Still Accepting Their Tenders

The extent to which the SEC has jurisdictional means over non-U.S. offers that purport to exclude U.S. holders has become a more complicated question since the 1999 rules were adopted due to the prevalence of the Internet, among other factors. For example, does establishing a website containing links to copies of the offering materials that are accessible to U.S. holders constitute "providing a means to tender" to U.S. holders?

In the 2008 Release, the SEC noted that business combination transactions present heightened concerns as compared to capital-raising issuances because holders are already invested in the target company and are more likely proactively to seek out information about the proposed transaction. For that reason, the SEC indicated that bidders should take special precautions to avoid making the offer in the United States if they desire to exclude U.S. holders from the offer.

[1] SEC Release No. 33-8917 (May 6, 2008).

[2] This article is the second of a series of two articles that focuses on the 2008 Release. The first article was an overview of the four key ways in which the 2008 Release would modify the 1999 cross-border rules (SEC Release No. 33-7759 (Oct. 22, 1999)) to minimize the need for case-by-case relief where the SEC has become aware of recurring conflicts and issues.

The SEC reiterated that legends that indicate that the offer is not being made into the U.S. are not sufficient to exclude U.S. holders. The SEC guidance indicates that bidders should take affirmative steps to monitor and restrict tenders from U.S. holders. For example, bidders may require a representation or certification from tendering holders that they are not U.S. holders. Bidders could also ask offshore nominees to certify that tenders are not being made on behalf of U.S. holders. The bidder should also ensure there are no indicia that would or should put the bidder on notice that the tendering holder is a U.S. investor. For example, bidders should focus on holders who desire to receive payment from a U.S. bank and holders who provide U.S. taxpayer identification numbers.

3. Don't Lock Holders into a Modified Deal without Adequate Disclosure

Under the general U.S. rules, if a bidder makes a material change to the terms of its tender offer, the bidder must both keep the offer open for a set period of time after providing notice of the material change and must provide withdrawal rights during the extension period. The purpose of the rule is to permit security holders time to learn of and react to information about material changes (whether to tender in response to the new information, or withdraw securities previously tendered).

The general U.S. extension/withdrawal rule frequently conflicts with rules and practices in other jurisdictions, specifically as applied to waivers or reductions in minimum acceptance conditions. For example, in certain other jurisdictions, bidders may need to reduce the minimum acceptance condition in order to declare the offer wholly unconditional, thereby permitting the participation of certain institutional holders that are prohibited by their charters from tendering into conditional offers. For that reason, under the 1999 rules, the SEC provided that a bidder meeting the conditions of the Tier II exemptions may waive or reduce the minimum acceptance condition in a tender offer without providing additional withdrawal rights.

The availability of the 1999 rules' "minimum acceptance condition" exception from the general "extension/withdrawal rights" rules is conditioned on the bidder's meeting certain conditions designed to ensure that the waiver/reduction is adequately communicated to holders, among other things. In the 2008 Release, however, the SEC indicated that this exception was intended to be relied upon only where required by home country law or practice. The SEC also indicated that when it was crafting the 1999 rules, the SEC had analyzed the exception principally in the context of cash offers, not exchange offers (where pro forma financial statements are generally required) or competing bid transactions (where the minimum acceptance condition can have important implications for the success or failure of a competing bid).

For those reasons, in the 2008 Release, the SEC clarifies that additional conditions must also be satisfied in connection with relying on the exception. Specifically, a bidder in a Tier II-eligible offer may only waive or reduce the minimum acceptance conditions without extending the offering period or providing withdrawal rights if: (1) extending the offering period and providing withdrawal rights would conflict with a home country law or practice requirement; (2) the bidder has fully disclosed and discussed all implications of any potential waiver or reduction in the offering materials, including, where material, providing alternate sets of pro forma financial statements to reflect the consequences of different potential levels of ownership; and (3) the bidder does not waive or reduce the minimum acceptance condition to a level that could result in the bidder holding less than a majority of the class of subject securities.

4. Don't Conduct Vendor Placements in a Tier II Transaction

In cross-border transactions that qualify for the Tier I exemptions, bidders are permitted to offer cash consideration to U.S. holders in lieu of offering securities (even if non-U.S. holders would receive securities), so long as the bidder has a reasonable basis for believing that the amount of cash is substantially equivalent to the value of the consideration offered to non-U.S. holders. This exemption generally allows bidders to avoid having to register securities in the U.S. Where the exemption is not available, some bidders who are conducting exchange offers have sought to avoid having to register securities in the U.S. by conducting vendor placements. In a vendor placement, the bidder generally employs a third party to sell in offshore transactions the securities to which tendering U.S. security holders are entitled in the offer.

The 2008 Release makes clear that the SEC believes vendor placements are only permissible in a limited number of circumstances. The SEC points out that the amount of cash to be received in a vendor placement is determined by reference to the market value of the underlying security, such that the recipients should still be entitled to the protections of the Securities Act in most cases. The SEC reiterated the limited conditions in which an exception from Securities Act registration may be appropriate for a vendor placement.

A critical factor in this "Section 5" analysis is whether "the market for the bidder securities to be issued in the exchange offer and sold pursuant to the vendor placement procedure is highly liquid and robust and the number of bidder securities to be issued in the exchange offer and for the benefit of tendering U.S. holders is relatively small compared to the total number of bidder securities outstanding."[3] The SEC also said it would consider the timing of the vendor placement process as compared to the closing of the offer; whether the bidder announces material information before the process is complete; and whether the vendor placement involves special selling efforts by brokers or others acting on behalf of the bidder.

Even if a vendor placement is permissible as a Securities Act matter, the vendor placement may still run afoul of the all-holders and best-price requirements of Rule 14d-10, which suggests that vendor placements have very limited utility for Tier II offers. The 2008 Release states very clearly that offering cash under a vendor placement arrangement to some U.S. holders and bidder securities to others (such as institutions) is not permitted in tender offers subject to the all-holders rule. A bidder seeking to use a vendor placement structure for a Tier II offer must seek an exemption from the all-holders rule, and the SEC will only grant relief where "it is in the interests of U.S. investors".[4]

* * *

The SEC's interpretive guidance in the 2008 Release reasserts the SEC's authority over, and scrutiny of, various practices that have been used in connection with cross-border transactions. Together with the proposed amendments contained in the 2008 Release, the interpretations lend additional clarity to the ways in which parties can structure cross-border transactions to comply with both U.S. and non-U.S. requirements. As we indicated in the first article in this series, because neither non-U.S. nor U.S. requirements are static and because deal technologies continue to evolve, it is likely that additional areas of conflict will emerge in the coming years and these conflicts may require additional amendments in the future.

[3] Supra, note 1 at 133.

[4] Supra, note 1 at 135.

Follow-Up: How to Do a Deal Without Shareholder Approval: The "Financial Viability Exception"

Here is a clarification for the article in our last issue on the "Financial Viability Exception": For Nasdaq, the process does not typically start with a Listing of Additional Shares filing, but rather with a call either to the company's Listing Qualifications analyst, or sometimes to David Compton, Director, Corporate Governance Interpretations (David.Compton@nasdaqomx.com or 301.978.8026). During the call, the Nasdaq Staff will talk through the issues to help the company decide whether it would be worthwhile to proceed with a formal written request. To provide transparency, the Nasdaq has a set of FAQs posted on its website that explains the written application process in depth.

Regarding the timing of Nasdaq's response, the process can take a week or two, but the Nasdaq Staff is very aware of the urgency of these situations and makes every effort to respond as quickly as possible. Typically, delays result from incomplete company submissions or the Staff's need to ask follow-up questions. That's why the FAQs are important; they provide a good roadmap to companies as to what to include in the written submission. If the submission is complete, they can usually respond within a few days.

Hedge Fund Attacks: Eight Lessons Learned from the In-House Perspective

By Dave Lambert, Deputy General Counsel—Finance/Securities, TD Ameritrade Holding Corporation[1]

Hedge fund activism is an arena every public company may be forced to enter because: (1) hedge fund capital has reached $1.5 trillion, (2) hedge funds face increased competition for returns and (3) any public company can have governance processes challenged or underperform. The mainstream business media regularly reports on the activities of hedge funds and the responses of their targets, such as TD Ameritrade. I offer eight lessons below from the in-house legal perspective based on my recent experience.

The Hedge Fund Attack and the Response

On May 29, 2007, the Board of Directors of TD Ameritrade received a letter from two hedge funds, JANA Partners and S.A.C. Capital Advisors. In this letter, JANA and SAC informed TD Ameritrade that their funds had "an economic interest" in approximately 50 million shares of TD Ameritrade, amounting to 8.4% of the outstanding stock. JANA and SAC also informed TD Ameritrade that they were seeking regulatory approval to acquire additional shares in excess of $600 million. In their letter to the board, these hedge funds stated they believed that TD Ameritrade could dramatically increase long-term shareholder value though a combination with E*Trade Financial or Charles Schwab but that representatives of the largest shareholder may have been standing in the way of this benefit because of "glaring and untenable conflicts of interest."

On June 5, 2007, TD Ameritrade responded to the letter by filing an 8-K, which included a copy of the May 29, 2007 letter. On June 8, 2007, JANA and SAC responded in the form of a public letter to the board, further claiming "glaring conflicts of interest on the Board . . . standing in the way of maximum value creation for shareholders" and posted to the web a presentation entitled "TD Ameritrade: Maximum Value Creation Through Consolidation," detailing the financial analysis supporting their proposal. On June 28, 2007, TD Ameritrade received a demand to inspect books and records related to all strategic transactions. On July 2, 2007, TD Ameritrade disclosed on Form 8-K that the mergers and acquisitions committee was reconstituted to be comprised of solely outside independent directors. On July 6, 2007, TD Ameritrade filed an 8-K disclosing it would not comply with the books and records demand because it failed to comply with Delaware law. On July 17, 2007, JANA and SAC relinquished the books and records demand

By the end of 2007, E*Trade's share price had fallen 86%, as a result of its large portfolio of real estate assets, and JANA and SAC had sold the bulk of their positions in TD Ameritrade, marking the official conclusion to their unsuccessful activist campaign.

Lessons Learned

Here's a list of practical lessons—from an in-house counsel's perspective—from this experience.

1. First Salvo—The initial contact from activist investors may not be a letter to the board, but rather a notice required to be given under the antitrust laws. Approval from the Federal Trade Commission and Department of Justice is required under the Hart-Scott-Rodino Act prior to certain large, non-passive share purchases. Under HSR, the target is also required to make a filing with the FTC and DOJ. Activist hedge funds often need to receive HSR approval before purchasing common stock or exercising derivative securities, but HSR approval generally is not required for the acquisition of derivative securities (see #5 below for a tie-in to Schedule 13D filings). Hedge funds seeking to maintain the secrecy of the investment will not seek early termination of the 30-day period for HSR approval, because the FTC publishes the names of the target and the purchaser when early termination is granted.
2. Books & Records Inspection—Prepare for a possible books and records inspection demand under DGCL §220 by getting the board and committee minutes in order: exhibits may need to be appended to the minutes, which themselves may need to be filed in the minute books. More importantly, ensure that the board's regular consideration and review—with appropriate outside advice—of the long-term strategies,

[1] Obligatory footnote. TD Ameritrade, Inc., member FINRA (www.finra.org) /SIPC (www.SPIC.org). The author wouldn't be a member of any organization that would accept him. TD AMERITRADE, Inc. is a subsidiary of TD AMERITRADE Holding Corporation. TD Ameritrade is a trademark jointly owned by TD Ameritrade IP Company, Inc. and The Toronto-Dominion Bank. © 2008 TD Ameritrade IP Company, Inc. All rights reserved for an 8pm table for 2. Used with permission after having been very politely and repeatedly asked. Id. Ego. See, I told you so.

strategic opportunities and balance sheet management is reflected in the minutes of the meetings of the board of directors.

3. Team Building—When you receive notice under HSR or see an activist become a shareholder, start building your team from the inside out, starting with senior management, corporate communications and investor relations. Experienced outside advisors, including investment bankers, proxy solicitors, legal counsel and a public relations firm, are a crucial component to the team. In particular, a public relations firm experienced in hedge fund activism brings insight and advice that internal corporate communications and investor relations can leverage when creating and communicating messages.
4. Scenario Planning—Consider all possibilities the activists may employ, such as shareholder proposals, takeover bid, share repurchase, asset sale and proxy contest. Assess vulnerabilities under charter, bylaws and governance guidelines to proxy contests and shareholder proposals and review alternatives to close gaps, including bylaw amendments to force disclosure of short positions and hedges. Be prepared for a negative (personal) public relations campaign against management and the board and for litigation, as part of the fundamental strategy or the demand to inspect books and records.
5. Intelligence Gathering—Be familiar with your shareholder base so that you can recognize significant stock purchases and possible activist owners. Scenario planning can be informed by the tactics previously employed by the hedge fund and its investment approach, reputation (activist leader or event-driven) and ownership position. Monitor the shareholder base closely. But don't expect current ownership information to come from a Schedule 13D or Form 13F. JANA and SAC never filed a Schedule 13D, maintaining that their "economic interest" did not make them a beneficial owner under Rule 13d-3. Changes in hedge fund tactics and reporting requirements are possible in light of the recent holding in CSX Corp. v. The Children's Investment Fund involving cash-settled equity swaps. Form 13F is a lagging indicator because it's filed 45 days after the end of the quarter. Use the PR firm to monitor and compile news and analyst reports at least daily to keep apprised of all storylines.
6. Responding—Carefully review and analyze the proposal and understand the activist's desired outcome. Measure shareholder and analyst reaction to the proposal. Respond in due course. Acknowledge and co-opt good ideas, rebut fallacies and ignore personal attacks. Keep the tone neutral. Clear, concise writing helps the team understand the legal and business issues and develop effective message points
7. Messaging Matters—Typical internal corporate communications and investor relation strategies and messages don't translate into the activist arena. Activist hedge funds are sophisticated users of public relations machinery, who are willing to refute (and embarrass) the company in ways that the internal communications teams may be unaccustomed to. The advice received from an outside PR firm can be invaluable in crafting messages and preparing for analyst meetings.
8. Trading Blackout and Regulation FD—The securities trading and disclosure issues arising for all significant corporate events apply in the case of activist hedge funds. Review your trading policy and issue blackouts as material information is communicated. Talk through the application of Regulation FD with your internal investor relations and corporate communications team.

As preparation for possible engagement with an activist hedge fund, consideration of the broader policy concerns—the role of shareholders in corporate governance, economic rationale for hedge fund activism and possible regulatory changes to the covert accumulation of stock—can be of practical use in confronting hedge funds. My reading included:

- Brav, Alon, Jiang, Wei, Thomas, Randall S. and Partnoy, Frank, "Hedge Fund Activism, Corporate Governance, and Firm Performance" (November 2006). ECGI—Finance Working Paper No. 139/2006, available at SSRN: http://ssrn.com/abstract=948907.
- Bainbridge, Stephen M., "Shareholder Activism and Institutional Investors" (September 2005). UCLA School of Law, Law-Econ Research Paper No. 05-20, available at SSRN: http://ssrn.com/abstract=796227.
- Hu, Henry T.C. and Black, Bernard S., "Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership." Journal of Corporate Finance, vol. 13, pp. 343-367, 2007, available at SSRN: http://ssrn.com/abstract=874098.
- *CSX Corp. v. The Children's Investment Fund Management (UK) LLP, et. al.* (S.D.N.Y. June 11, 2008).

Jumping Over Standstills

By Clifford Neimeth of Greenberg Traurig LLP[1]

When undertaking a public M&A sale transaction, the use of confidentiality and standstill agreements ("CSA") to initiate a pre-sign market check, auction or one-on-one negotiation, and to facilitate a buyer-candidate's due diligence investigation, is often considered a routine matter. Some may view much (if not all) of the agreement as uncontroversial, "plain vanilla," "boilerplate" and "standard."

Although sometimes bi-lateral (or mutual), depending on the transaction structure (*e.g.,* a stock deal or MOE), the CSA generally benefits the seller by (i) requiring that all "Evaluation Material" (as defined in the CSA) made available to the buyer in the course of its pre-sign diligence, is used strictly in furtherance of the potential "Transaction" (as defined in the CSA) and (ii) including either a detailed or less specific standstill covenant to ensure that any Transaction will be consensual *ab initio*—(*i.e.,* negotiated with the company directly through its board or, depending on the context, a special committee thereof) and promoting an orderly sales process.

Of course, nothing is ever that simple and there are myriad tactical decisions made by the buyer and seller in the course of negotiating a CSA which directly impact the foreseeable (and sometimes unforeseeable) ways in which the CSA interrelates with the deal protection provisions of the definitive merger agreement. Moreover, the scope and tone of the standstill and other provisions of the CSA can shape the pre-sign auction or market check process (*i.e.,* determine who enters the bidding or submits a bona fide indication of interest or offer) and can have dynamic consequences in the case of an interloper's topping bid during the window shop (and/or go-shop) period following the execution and announcement of the merger agreement.

The intensity of negotiations over standstill clauses and the exceptions thereto has increased of late as a function of market driven conditions and the relative shift in buyside and sellside bargaining power and in view of recent judicial decisions further explicating the way boards properly discharge their fiduciary duties in a sale of control. The recent litigation surrounding the sale of Sunrise Senior Living illustrates well some of the foregoing CSA features and implications.

Background of the Sunrise Senior Living Litigations

In a noteworthy—but somewhat "below the radar"—pair of recent decisions of the U.S. District Court, Western District of Kentucky (the "Kentucky Federal Court"), and the Ontario Court of Appeals (the "Canadian Appellate Court"), the Kentucky Federal Court declined to grant defendant-Health Care Property Investor Inc.'s ("HCPI") motion to dismiss plaintiff-Ventas, Inc.'s ("Ventas") complaint against HCPI for, among other things, alleged tortious interference with Ventas' agreement to purchase substantially all the assets of Sunrise Senior Living Real Estate Investment Trust ("Sunrise REIT"), an Ontario public REIT listed on the Toronto Stock Exchange ("TSE"), for approximately $ 15 per outstanding REIT unit (or $ 1.14 billion, in the aggregate). In parallel, the Canadian Appellate Court, which was petitioned to interpret the deal protection package in the purchase agreement—specifically, the no shop covenant and window shop exceptions thereto—ruled that Sunrise REIT was required to enforce the standstill agreement contained in its CSA with HCPI.

The lawsuits arose out of a formal auction conducted in Q4 2006 by Sunrise REIT and the special committee's financial advisor, TD Securities. HCPI and Ventas participated in the auction and signed CSAs with Sunrise REIT. The CSAs precluded HCPI and Ventas, for a period of 18 months from, among other things, (i) making or publicly announcing any unit or asset acquisition, merger or business combination transaction involving Sunrise REIT or its subsidiaries outside of the auction process without Sunrise REIT's written consent and (ii) seeking any waiver or amendment of the CSAs. However, the Ventas CSA contained a termination clause in the event Sunrise REIT entered into an agreement to sell more that 20% of its equity securities, assets or operations to a third party or if Sunrise REIT's trustees did not reject an unsolicited tender or exchange offer prior to the 15th day after its commencement. This termination provision in the Ventas CSA was unknown to HCPI until the litigations ensued. HCPI's CSA contained no such exception.

Out of seven initial expressions of interest, HCPI and Ventas were the two auction finalists, but only Ventas successfully negotiated a property management agreement with Sunrise Senior Living, Inc. ("SSLI"). SSLI was

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Sample "Express Standstill"Clause

In addition to the standstill covenant (which, if agreed to by the buyer-candidate, is more typically set forth at length, and less preferably from the seller's point of view, is sometimes expressed more casually by defining the proposed Transaction as one negotiated directly with the company), the parties to a CSA negotiation will usually focus on the breadth of the definition of Evaluation Material and who such material may be furnished to (*e.g.,* debt and equity financing sources and a finite "need to know" list of the buyer's outside professional advisors) and under what circumstances; no (employee) poach covenants (in the case of a direct competitor or any strategic-buyer candidate); restrictions on the formation of "clubs" and consortiums in order to promote a broad field of competitive financial-buyer candidates; the expiration date of the buyer's covenants (*e.g.,* 12-24 months in the case of an express standstill provision or no-poach clause); the procedures and standards for disclosure of all or a portion of the Evaluation Material in the case of a judicial proceeding or when otherwise required by applicable law; and other nuances in the CSA with respect to waivers, mutuality, and the like.

One iteration of an express standstill clause, may read:

You agree that, without the prior written consent of the Company or its Board of Directors (or any duly constituted committee thereof composed entirely of independent directors), from and after the date hereof until the second anniversary of the date hereof, neither you nor any of your "Affiliates" or "Associates" (as such terms are defined in Rule 12b-2 under the Securities Exchange Act of 1934, as amended (the "Exchange Act")), directly or indirectly, shall:

(i) acquire, offer to acquire, or agree to acquire, whether by means of purchase or otherwise, any (x) securities (or any interest therein or right thereto) having statutory, organic or contractual voting power, whether or not contingent ("Voting Securities"), of the Company or of any successor to or person in "control" (as such term is defined in Rule 12b-2 under the Exchange Act) thereof, or (y) assets of the Company or of any subsidiary, division or operating unit of the Company or of any successor to or control person thereof;

(ii) enter into any contract, arrangement, understanding, plan, arrangement or commitment in respect of any Derivative Securities;

(iii) seek or propose to influence, change or control the management, policies or affairs of the Company or make or in any way participate in any "solicitation" of "proxies" or "consents" (as such terms are used in the rules and published interpretations of the Securities and Exchange Commission ("SEC")) to vote (or to withhold in respect of or abstain from voting), or seek to advise or influence any person with respect to the voting of (or the withholding of or abstention from voting), any Voting Securities;

(iv) make any public announcement with respect to, or submit to the Company or any of its Affiliates, Representatives or any other person, any proposal, expression of interest or offer (with or without conditions) providing for, in a single transaction or in any series of related transactions, any merger, consolidation, acquisition, business combination, recapitalization, reorganization, divestiture, spin-off, cash or property distribution or other extraordinary transaction involving the Company or any of its subsidiaries or any of the Company's or any of its subsidiaries' securities or assets;

(v) engage in, enter into or participate in any discussions, negotiations, contracts, arrangements, understandings, plans or commitments with any person with respect to any of the matters described in clauses (i) through (iv) above, or otherwise form, join or in any way engage or participate in any discussions relating to the formation of, any "group" (within the meaning of Section 13(d)(3) of the Exchange Act), in connection with any of the matters described in clauses (i) through (iv) above; or

(vi) request the Company or its Board of Directors (or any committee thereof) to, or communicate with any of the Company's Representatives with respect to, any amendment to or waiver of any of the terms or provisions of this paragraph __ (including, without limitation, this clause (vi)).

You hereby acknowledge that you and your Representatives have been advised by respective legal counsel, and that you and that your Representatives are aware, that U.S. federal securities Laws prohibit any person who is in possession of material, non-public information about a person from purchasing, selling or otherwise trading in the securities of such person.

For purposes of this paragraph __, "Derivative Securities" means any securities that are the subject of any derivative or other transaction entered into by any person, which gives such person the economic equivalent of ownership of an amount of such securities due to the fact that the value of the derivative is determined by reference or in relation to the price or value of such securities, irrespective of whether (i) such derivative conveys or confers to any person, or otherwise has ascribed to it, any voting rights or voting power or (ii) the derivative is capable of being or required to be settled by the payment of cash or through the delivery of such securities.

Sunrise REIT's property manager and the owner of certain minority interests in Sunrise REIT's facilities and properties. (The original CSA's precluded any communication with SSLI, but these provisions were waived by Sunrise REIT to permit Ventas and HCPI, respectively, to engage in talks with SSLI to help formulate their second-round bids once it became apparent that SSLI was not bidding for Sunrise REIT).

HCPI withdrew from the final round of the auction process and Ventas, having successfully worked out the necessary commercial arrangements with SSLI, submitted its definitive $ 15 per unit offer and subsequently negotiated, executed and announced with Sunrise REIT a definitive purchase agreement on January 15, 2007 (the "Purchase Agreement"), providing for the $ 15 per unit acquisition. This represented an approximately 35.7% premium over Sunrise REIT's unaffected unit price.

The Purchase Agreement contained a reasonably comprehensive "U.S.-style" deal protection package, including, among other things, a no shop covenant; window shop exceptions for unsolicited, bona fide Acquisition Proposals which reasonably could be expected to result in a Superior Proposal; a fiduciary termination right (under defined circumstances); a five-day match period and tolling rights for Ventas in the case of the proposed withdrawal by Sunrise REIT's trustees of their deal recommendation or in the case of the trustee's proposed approval of an agreement providing for a Superior Proposal; the requirement to recommend the deal with Ventas and the specific circumstances under which the trustees could withdraw the same; information furnishing "parity requirements" in the case of holding discussions with a third party pursuant to an unsolicited, bona fide, topping bid; a $39.8 million break up fee payable to Ventas if the Purchase Agreement was terminated in favor of a Superior Proposal; Sunrise REIT's covenants to solicit unitholder approval of the transaction and convene the special meeting of unitholders; negotiated definitions of "Acquisition Proposal" and "Superior Proposal"; and (as part of the no shop covenant), an express prohibition against Sunrise REIT's ability to amend or waive any of the standstill agreements contained in CSAs entered into with pre-sign auction participants, including the HCPI CSA.

On January 17, 2007, representatives of Sunrise REIT informed HCPI that HCPI remained bound by the terms of the HCPI CSA and that HCPI was required to return to Sunrise REIT all confidential Evaluation Materials. HCPI subsequently returned the materials.

In mid-February 2007 (pending unitholder approval of the Purchase Agreement at the special meeting scheduled therefor), HCPI submitted to Sunrise REIT a topping bid at $ 18 per unit (representing a 20% "jump premium"), conditioned on reaching an acceptable property management agreement with SSLI. HCPI also publicly announced

Sample Carve-Out to Standstill Clause

One iteration of a "carve out" to a standstill clause, that a seller and a buyer-candidate may seek to negotiate, may read:

The provisions of [the standstill paragraph] shall be inoperative and of no force or effect if (and only if), from and after the date hereof: (a) any person or group shall have acquired or entered into a binding definitive agreement that has been approved by the Board of Directors of the Company (or any duly constituted committee thereof composed entirely of independent directors) to acquire more than 50% of the outstanding Voting Securities of the Company or assets of the Company or its subsidiaries representing more than 50% of the consolidated earnings power of the Company and its subsidiaries, taken as a whole, (b) any person commences a tender or exchange offer which, if consummated, would result in such person's acquisition of Beneficial Ownership of more than 50% of the outstanding Voting Securities of the Company, and in connection therewith, the Company files with the SEC a Schedule 14D-9 with respect to such offer that does not recommend that the Company's stockholders reject such offer; or (c) the Company's Board of Directors (or any duly constituted committee thereof composed entirely of independent directors) shall have determined in good faith, after consultation with outside legal counsel, that the failure to waive, limit, amend or otherwise modify [the standstill paragraph], would be reasonably likely to be inconsistent with the fiduciary duties of the Company's directors under applicable law; provided, however, that with respect to clauses (a), (b) and (c) of this sentence, you shall not have solicited, initiated, encouraged or taken any action to facilitate or assist or participate with any such other person or group in connection with any of the transactions contemplated by clauses (a), (b) and (c) of this sentence.

its intention to make the bid. HCPI announced that, apart from the substantially higher price, the terms of its bid otherwise were identical to the terms of the Purchase Agreement and requested Sunrise REIT's trustees, "in a proper exercise of their fiduciary duties," to respond immediately and affirmatively to its topping bid.

Ventas informed Sunrise REIT that the HCPI CSA and the Purchase Agreement prohibited communications between SSLI and HCPI, and similarly informed SSLI that it could not have discussions or meet with HCPI. Sunrise REIT informed Ventas that the standstill in the HCPI CSA had been waived and asked Ventas to concur that, in doing so, Sunrise REIT did not breach the terms of the Purchase Agreement. Ventas disagreed and demanded that Sunrise REIT comply with the terms of the Purchase Agreement and the HCPI CSA. Ventas took the position that the no shop covenant in the Purchase Agreement precluded Sunrise REIT from permitting or facilitating any communications between SSLI and HCPI and that none of the fiduciary outs or definitional exceptions thereto were apposite.

Sunrise REIT publicly announced that it treated HCPI's $ 18 per unit topping bid as an unsolicited third-party Acquisition Proposal under the window shop fiduciary clause in the Purchase Agreement, but in view of the property management agreement condition to HCPI's topping bid, Sunrise REIT's trustees could not conclude whether HCPI's bid constituted a Superior Proposal or one that reasonably could be expected to lead to the same. This led to the commencement of the Canadian declaratory relief action involving all constituent parties (described below).

At the unitholders' special meeting to consider and vote on the deal, the Purchase Agreement was rejected by Sunrise REIT's unitholders, in view of HCPI's published 20% premium topping bid and because of unitholder rumbling over the auction process. Ultimately, Ventas increased its purchase price to $ 16.50 per unit to win unitholder approval of an amended Purchase Agreement entered into with Sunrise REIT. Payment of the increased $ 1.50 per unit led to Ventas' filing the Kentucky Federal Court tortious interference action against HCPI (described below).

In the Canadian declaratory judgment action (filed originally in the Ontario Superior Court of Justice and upheld unanimously on appeal by the Canadian Appellate Court), Sunrise REIT sought a judicial interpretation of Section 4.4 of the Purchase Agreement (the no shop covenant and its exceptions) and the binding effect of the waivers of the provisions of the CSAs precluding contact and communications with SSLI. The Canadian Appellate Court held, among other things, that Sunrise REIT was required to enforce the standstill agreement contained in the HCPI CSA because the fiduciary exceptions contained in Section 4.4 were inapplicable and that because HCPI's topping bid was made in breach of the HCPI CSA, it could not constitute a "bona fide" Acquisition Proposal (as required by the express language of the window shop exception to Section 4.4.). The Court based this conclusion on a cumulative reading of the HCPI CSA and the Purchase Agreement with Ventas.

What the Courts Said

Much like some of the recent MAC out, specific performance remedy and financing covenant decisions of the Delaware Chancery Court and other state courts, the Canadian Appellate Court opinion sets forth an excellent analyses of contract drafting and construction principles in a context (*i.e.,* deal protection covenants and exceptions) that inherently contains multi-layered provisions, replete with double provisos, cross-references, defined terms, "notwithstanding the foregoing" overrides and "subject to" supremacy clauses. Thus, the Court admonished: unless there is an intentional commercial objective to obfuscate terms or a practical need to move past a negotiating point to get a deal done, it is best to just unequivocally "say what you mean and mean what you say." (Here in fact, Ventas seemingly was quite deliberate in negotiating and drafting precisely the protection the winner of an auction would want against prior auction participants who are not allowed a second "bite at the apple" to jump its deal; whereas Sunrise REIT and HCPI were left with strained arguments as to the collective and individual meaning of various exceptions-to-exceptions and other carve out language).

The Kentucky Federal Court, in a very brief opinion, observed that HCPI breached its CSA and concluded that it failed to abide by the "rules of the game" and had no justification or privilege to excuse its conduct. Accordingly, it held that HCPI's actions could be tortious and that a motion to dismiss was inappropriate at the time. Although the Kentucky Federal Court decision is short on analyses, the Court was compelled to address the issues set forth in plaintiff's complaint in the procedurally narrow context of HCPI's motion to dismiss for failure to state any theory of law upon which relief could be granted to Ventas.

Obtrusively absent from the decisions of the Kentucky Federal Court and the Canadian Appellate Court is any specific third party beneficiary discussion, although the Kentucky Federal Court observed that "no special tort duty was owed [by HCPI to Ventas] due merely to the existence of [HCPI's] Standstill Agreement with Sunrise REIT," and the Ontario Appellate Court (and lower Ontario court) flatly rejected HCPI's argument that the benefit of the HCPI CSA was "assigned" to Ventas without HCPI's consent.

Neither the Kentucky Federal Court decision nor the Ontario Appellate Court (or lower Canadian court) decisions delve (apart from dicta) into the fiduciary aspects of the decisions and processes undertaken by Sunrise REIT's trustees. One can come away with different takes of that after reading the facts and the underlying pleadings and submissions to the Courts.

Lessons Learned

From an M&A practitioner's perspective, the litigations raise numerous practical questions for future consideration, including whether:

1. Merger agreements (at least in a sale of control) should contain a clearly articulated fiduciary out to waive CSAs entered into with past market check or auction participants and, if such a provision is successfully bargained for by the target or the CSA itself contains such fiduciary out; whether this necessarily would operate to lower the contract price put on the table by the buyer;
2. Standstill agreements should contain a "self-destruct" clause if a third party not otherwise under a standstill or similar restriction (x) commences an unsolicited tender offer and the target's board either recommends acceptance or takes a neutral 14D-9 position or, irrespective of the target board's recommendation or position, whether the standstill should terminate if the offer is substantially unconditional and fully financed at a high premium or (y) enters into a definitive sale of control agreement with the target (as opposed to, perhaps, a true business combination, an "at the market" MOE or other M&A transaction not animating Revlon duties);
3. It is appropriate to qualify the window shop language in a sale of control merger agreement allowing the target's board to furnish information to the proponent of an unsolicited, bona fide "Acquisition Proposal" only via a CSA no more favorable to the interloper than the CSA entered into with the purchaser under the merger agreement (because that often can have adverse implications not envisioned by the parties at the outset);
4. There are circumstances where standstills should not contain a prohibition against the counterparty's ability to request the target board for a waiver to propose a bona fide transaction, and whether waivers should be addressed only in the window shop provisions of the definitive merger agreement;
5. In view of the Canadian Appellate Court and Kentucky Federal Court litigations, CSAs should contain express third-party beneficiary disclaimers;
6. As articulated in the recent published decision of the Delaware Chancery Court , In re Topps Company Shareholders' Litigation, previously executed standstills should be suspended or terminated all together during a go-shop period; and
7. CSAs should expressly define what constitutes a "bona fide" or "permissible" offer to avoid a subsequent judicial determination of the issue.

These decisions also serve to remind M&A practitioners and deal principals that while, on the one hand, courts (as in the recent United Rentals-Cerberus case) sometimes are compelled to interpret ambiguous provisions susceptible to more than one reasonable interpretation and look at extrinsic evidence to determine the intentions of the parties, on the other hand, the courts will tread lightly when requested to superimpose a fiduciary out upon, set aside or reform complex and largely unambiguous deal protection provisions negotiated by sophisticated parties which do not operate as a commercial absurdity and which could have been expressly bargained for.

The Shareholder Activist Corner: Spotlight on Shamrock Activist Value Fund

By Brandon Meyer and Robin Mayns Cowles, Senior Vice Presidents of ICR[1]

Recently, FactSet SharkWatch reported that the level of shareholder activism is at historic levels. The first quarter of 2008 saw a record volume in proxy fight announcements and overall activism against U.S. companies is at its highest since at least 2004. During the quarter, activist investors obtained board seats at 32 companies (two won via a vote at a proxy fight; ten to settle a proxy fight; thirteen granted as part of other activist campaigns; and seven granted to prominent activists that were Schedule 13D filers, but did not publicly agitate). This is the first in a series of articles that will delve into the specific tactics and strategies of specific activist investors.

1. Who Shamrock Is—Shamrock Activist Value Fund has been an activist investor in public companies for over two decades, investing over $1.3 billion in 39 companies. Shamrock currently has $1 billion of committed capital. In early July, Dennis Johnson, Director of Corporate Governance for CalPERS (who also served as the Chair of the Council of Institutional Investor's board), joined Shamrock as a Managing Director.

Shamrock's activism relies on the commonly-held theory that significant shareholders should have the ability to influence corporate decisions. Its Fund has developed a four-step process to implement its activist investment philosophy:

1. *Find "Deep Value" Targets:* Shamrock uses financial analysis to identify companies that have a trading value that is discounted to the intrinsic value of the underlying business.
2. *Assess Activist Elements:* Shamrock analyzes potential targets to identify those companies that might benefit from its influence by considering the corporation's business strategy, structure, governance, and shareholder base.
3. *Develop a Strategy:* Shamrock formulates a plan to accumulate an ownership position in the target company as well as a strategy to unlock value.
4. *Execute the Plan:* Shamrock uses various acquisition strategies to achieve an influential position in the target and attempts to work with the company to implement Shamrock's plan.

Shamrock Funds that have been part of an activist situation include:

- Shamrock Partners Activist Value Fund LLC
- Shamrock Activist Value Fund, LP
- Shamrock Activist Value Fund II, LP
- Shamrock Activist Value Fund III, LP
- Shamrock Holdings
- Trefoil International III
- Trefoil Capital Investors LP
- Shamrock Activist Value Fund GP, LLC

2. Shamrock's History of Activism—Since 1984, Shamrock has sought changes at companies via activism through 32 campaigns at 30 separate companies. In five of these campaigns, Shamrock escalated their activism to a proxy fight—and in an additional three campaigns, the Fund threatened escalation to a proxy battle.

Shamrock tends to pursue activism in order to maximize shareholder value. In nine of their 32 campaigns, they have sought to maximize shareholder value through a series of operational and or transactional changes. In most of their activist campaigns, they publicly release letters they have sent to the target company's board. Occasionally, they also have sent letters directly to other shareholders in order to educate the broader shareholder community and to build support for their campaign. Shamrock has been a successful activist having only five campaigns turn into proxy contests and in each of those five contests, Shamrock and the target company have either settled or the company was sold.

3. What Shamrock Has Done Recently—Hedge funds attract investors by ensuring them that they will produce higher, abnormal returns over other investment vehicles. Current market conditions have resulted in fewer "good" companies for funds to target and produce these abnormal returns. As a result, we anticipate seeing an increase in the aggressiveness and tenacity of the activism driven by Shamrock and other funds. So far this year, Shamrock has targeted two companies with proxy contests.

In March of this year, Shamrock initiated a public phase of activism with Coinstar. Shamrock met with the company's Nominating and Governance Committee and requested they consider adopting good corporate governance practices, including declassifying the board, adopting majority voting requirements for director elections, canceling its poison pill and increasing stock ownership requirements for directors. Coinstar's board adopted all of the governance changes, with the exception of declassifying the board.

The next day, Shamrock notified the board of its intention to nominate three persons for election to the seven-person board at the 2008 annual meeting, stating that it believed the company would not voluntarily add investor representatives to the board without a proxy fight and felt the board needed new perspectives to maximize shareholder value. Shamrock also filed numerous amendments to its Schedule 13D providing details of the meetings with Coinstar management and describing its dissatisfaction with management's performance. Subsequently, the company announced plans to add additional independent directors from its largest shareholders following the annual meeting. Then shortly before the meeting, Coinstar settled with Shamrock announcing that they would add one Shamrock nominee to the Board and an additional independent director by March 2009. Shamrock terminated the proxy contest and agreed to standstill provisions lasting until the completion of the 2010 annual meeting.

Here is another example: earlier this year, Shamrock converted its Schedule 13G to a Schedule 13D and notified the board of Reddy Ice Holdings of its intent to nominate two directors citing the need for the company's board to focus on improving financial and operational performance, managing the company's balance sheet, seeking growth through "strategic tuck-in acquisitions" and its belief that new leadership is necessary to institute governance reform. Through a number of discussions in advance of their annual meeting, Reddy Ice and Shamrock announced a settlement resolving the proxy fight. The agreement resulted in the addition of both Shamrock nominees to the board, beginning the search for a new CEO and Shamrock agreeing to support the board until December of 2009.

How Much Will Hedge Fund Activism Cost a Target?

ICR's informal tracking of the costs incurred by target companies solely for defense against a proxy contest makes it clear that a proactive evaluation of potential weaknesses and the adoption of appropriate defenses against such an attack should be on the mind of every management team and board. From our estimates, a company will need to spend anywhere from $225,000 to $7 million to defend themselves—whether successfully or not—against such an attack.

(Endnotes)

[1] ICR is a leading financial communications consulting firm specializing in investor relations and corporate communications. ICR has set a new standard for financial communications with a business model driven by deep, capital-markets expertise provided by a team of former Wall Street and corporate professionals, including senior sell-side analysts, portfolio managers, chief financial officers and investment bankers. Their perspective is combined with that of senior PR, media and corporate communications professionals to provide an integrated service offering rooted in industry knowledge and first-hand capital markets experience.

The Implications of *CSX*: Beneficial Ownership Reporting Through Total Return Swaps

By Edward Best and Laura Richman of Mayer Brown LLP, Chicago, Illinois

The United States District Court for the Southern District of New York recently held in *CSX Corporation v. The Children's Investment Fund Management (UK) LLP*,[1] a case involving the proxy fight between two activist investment funds and CSX Corporation, that the funds had violated Section 13(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), by failing to disclose beneficial ownership of CSX shares in which the funds had economic interests through total return swaps.

The court sidestepped ruling on the central issue in the case—whether total return swaps confer beneficial ownership on the "long" party to the swap—and instead decided the case based on a finding that the total return swaps in which the investment funds participated were part of a plan or scheme to evade the reporting requirements of Section 13(d) and, thus, conferred on the funds beneficial ownership of the shares underlying the swaps.

How the Case Arose

The case arose out of a proxy contest in which two groups of investments funds and related parties, one affiliated with The Children's Investment Fund Management (UK) LLP (the "TCI Funds") and one affiliated with 3G Capital Partners Ltd. (the "3G Funds"), were seeking, among other things, to elect their nominees to five of the twelve seats on the CSX board of directors.

The TCI Funds acquired their first investment exposure to CSX in October 2006 through total return swaps.[2] Ultimately, the TCI Funds acquired approximately 4 percent of CSX's outstanding shares and had an economic exposure to approximately an additional 11 percent through total return swaps. The TCI Funds contacted CSX's management following the TCI Funds' initial investment in CSX and at various times thereafter, disclosing their economic interest in CSX and suggesting various alternatives for enhancing the value of CSX's shares, including a possible leveraged buyout. In August 2007, the TCI Funds began working on plans for a proxy contest at CSX's 2008 annual stockholders' meeting at which they would propose a "short slate" of two directors.

The 3G Funds made their initial investment in CSX in February 2007, acquiring nearly 2 percent of CSX's outstanding shares. The 3G Funds ultimately acquired ownership and economic exposure (through total return swaps) in an aggregate of over 4 percent of CSX's outstanding shares. The 3G Funds sought to meet with CSX's management, but to no avail. In October 2007, the 3G Funds began working on their own plans for a proxy contest at CSX's 2008 annual stockholders' meeting at which they would propose to elect one director.

On December 19, 2007, a group (collectively the "Group"), comprised of the TCI Funds, the 3G Funds and three individuals which had agreed to become nominees to serve on CSX's board of directors, filed a Schedule 13D with the Securities and Exchange Commission (the "SEC"). The filing disclosed that the members of the Group had entered into an agreement to coordinate certain of their efforts with regard to the purchase and sale of CSX shares and that the Group intended to conduct a proxy solicitation. The filing also disclosed that the Group collectively owned 8.3 percent of CSX's outstanding shares, that the TCI Funds had cash-settled swaps with respect to approximately 11 percent of CSX's outstanding shares and that the 3G Funds had similar swaps with respect to 0.8 percent of CSX's outstanding shares. Both the TCI Funds and the 3G Funds disclaimed beneficial ownership of the shares underlying their respective swaps.

On March 10, 2008, the Group filed its preliminary proxy statement with the SEC. The Group proposed to elect five directors and to amend CSX's by-laws to permit holders of 15 percent of CSX's shares to call a special stockholders meeting. The preliminary proxy statement noted that the Group collectively held 35.1 million shares, representing approximately 8.7 percent of CSX's outstanding shares, as well as the swap arrangements and the aggregate percentage of CSX shares subject to the swaps.

CSX filed suit against the Group contending, among other things, that the TCI Funds had violated Section 13(d) of the Exchange Act by failing to disclose their beneficial ownership of the shares of CSX subject to the total return swaps, and that the TCI Funds and the 3G Funds violated Section 13(d) by failing timely to disclose the formation of a group. Among the remedies sought by CSX, it asked the court to enjoin the TCI Funds and the 3G Funds from voting any of their CSX shares.

The Court's Decision

Section 13(d) of the Exchange Act requires any person who acquires "beneficial ownership" of 5 percent or more any class of equity security registered under the Exchange Act to publicly disclose that fact in a filing with the SEC. Rule 13d-3(a) under the Exchange Act, which defines what constitutes "beneficial ownership," provides that:

> 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.

The *CSX* court observed that the question of whether a total return equity swap confers beneficial ownership under this rule was one of first impression. The court first noted that the SEC intended Rule 13(d)-3(a) to provide a broad definition of "beneficial ownership," and that this determination required "[a]n analysis of all relevant facts and circumstances in a particular situation . . . in order to identify each person possessing the requisite voting power or investment power."[3] In the *CSX* matter, factors the court considered included:

- A total return equity swap placed the funds in the same economic position as though they owned the referenced shares outright.
- With respect to investment power, while counterparties are not obligated to hedge their positions with purchases of the underlying shares, they inevitably do so.
- Although a total return equity swap may be designed to settle in cash, the parties to the swap contract may consent to settlement in the form of delivery of the underlying shares.
- The funds had influence over the voting of the shares in question when the counterparties hedged their position in the total return equity swap contracts by purchasing the underlying shares. The voting policies of the counterparties vary: some will not vote them, or will not vote them in a contested matter, which would prevent these shares from being voted against the position that the funds were taking in a related proxy contest. Additionally, some counterparties may vote in accordance with the desires of the funds. The court also speculated that counterparties that claim to vote such shares in their own discretion, may be influenced in their voting to vote as the funds would like in the hopes of attracting new business from their clients.

While in this case, the court found the arguments for treating cash-settled total return equity swaps as conferring beneficial ownership for the purposes of Section 13(d) persuasive, the court ultimately found it unnecessary to make a ruling on that point. Instead the court relied on Rule 13d-3(b), which provides that:

> 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 of 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 (g) of the Act shall be deemed for purposes of such sections to be the beneficial owner of such security.

[1] (08 Civ. 2764 (LAK) June 11, 2008). The decision can be found at http://www1.nysd.uscourts.gov/cases/show.php?db=special&id=79.

[2] Under the terms of the total return swaps, the "short" party" (*i.e.,* the financial institution counterparties) agreed to pay the "long" party (*i.e.,* either the TCI Funds or the 3G Funds) (1) any cash distributions on the underlying CSX shares, and (2) an amount equal to the market appreciation in the value of the CSX shares over the term of the swap. In turn, the long party agreed to pay the short party the interest that would have been payable had the long party actually borrowed the CSX shares plus any decrease in the market value of the CSX Shares. Under the terms of the swaps, the long party did not have the right to vote the referenced CSX shares or to direct the short party as to how to vote the shares nor did it have the right to acquire the underlying CSX shares.

[3] It is interesting to note that the SEC's Division of Corporation Finance submitted an *amicus* letter (this letter was not from the Commission itself), in response to a request by the judge, stating that "a standard cash-settled equity swap agreement, in and of itself, does not confer on a party, here the investment funds, any voting power or investment power over the shares a counterparty purchases to hedge its position. In our view, the conclusion is not changed by the presence of economic or business incentives that the counterpart may have to vote the shares as the other party wishes or to dispose of the shares to the other party."

Based on the facts in question, the court found that the hedge funds were amassing their swap positions as part of a plan or scheme to avoid disclosure that would have been required if they had bought the shares outright, and so deemed the hedge funds to be the beneficial owners of CSX stock represented by the swap.[4] In addition to the facts discussed above, the court was particularly persuaded by the fact that the hedge funds had spread their swap transactions among numerous counterparties in an attempt to avoid disclosure of the position they were building in CSX stock.

As noted above, CSX filed suit against the funds contending, among other things, that the funds violated Section 13(d) by failing timely to disclose the formation of a group. In this regard, the Court observed that whether individuals or entities can be deemed to act as a group does not depend on the existence of a formal agreement. Rather, the agreement "may be formal or informal, and need not be expressed in writing." Nor do the parties need to commit to a defined set of terms as long as they share a common objective. In the instant case, the Court disagreed, noting that the long-standing relationship between TCI and 3G, 3G's pattern of dramatically increasing its holdings in CSX directly following meetings with TCI, and preparations by both entities to engage in a proxy fight, among other things, indicated that defendants had formed a group early as February 2007.

CSX sought, among other things, injunctive relief to preclude the investment funds from voting their shares at the upcoming annual meeting as a penalty for these violations of Section 13(d). The court concluded it could only apply this remedy if it found that the CSX shareholders would suffer irreparable injury because of the violations of Section 13(d). The court noted that "private plaintiffs usually are unable to establish an irreparable harm once the relevant information has been made available to the public" unless the defendant has obtained "a degree of effective control" as a result of purchases made before it had complied with Section 13(d). In light of the fact that the Group ultimately filed a Schedule 13D, which the court did not find was false, misleading or otherwise inadequate as to any material fact, the court was unable to find irreparable injury and the relief granted was limited to a permanent injunction restraining future violations of Section 13(d). The court did state that "[w]ere the Court free as a matter of law, however, to grant such an injunction, whether on the basis that such relief is warranted to afford deterrence or on another basis, it would do so."

Implications of the Case

Before discussing the implications of the case, we should remind readers of the old adage "bad facts make bad law." Total return swaps have many legitimate uses, including allowing an investor to leverage its capital, allowing an investor uninterested in waging a proxy fight to obtain a significant ownership interest in a company and thus a "seat at the table" to push for changes and allowing a non-US fund to gain economic exposure to a US company without having to pay withholding taxes on dividends. Total return swaps can also be used to gain significant economic exposure to a company without reporting. In the *CSX* case, the court found that the investment funds used total return swaps to intentionally circumvent the disclosure requirements of Section 13(d) and that they did so in a particularly flagrant manner. It is unclear whether the court would have reached the same conclusion had it been presented with less flagrant conduct.

While the court did not decide whether *all* long counterparties of cash-settled total return equity swaps, or even the investment funds in this case, should be considered beneficial owners of the referenced shares under Rule 13d-3(a) of the Exchange Act, the analysis clearly signals the court's receptiveness to such an argument on similar facts. Absent a reversal of the decision on appeal[5] or clarifying rulemaking by the SEC, investors and counterparties may want to consider reviewing existing positions, and updating their procedures for future transactions, to determine if they could be deemed to have significant influence over voting or dispositive transactions of others. This would presumably take into account the various relationships, including investment banking and prime brokerage relationships, proprietary trading and other derivatives transactions, between the investor and the counterparty.

[4] The SEC Staff's *amicus* letter stated that "[i]n the Division's view, the long party's underlying motive for entering into the swap transaction generally is not a basis for determining whether there is a 'plan or scheme to evade' Rule 13d-3. . . We believe that the mental state contemplated by the words 'plan or scheme to evade' is generally the intent to enter into an arrangement that creates a false appearance." The court disagreed with the SEC's position stating "An appearance of non-ownership cannot be false unless one in fact is at least a beneficial owner. That beneficial ownership would satisfy Rule 13d-3(a), thus making Rule 13d-3(b) superfluous. In consequence, Rule 13d-3 as a whole is inconsistent with any view that a false appearance of non-ownership is a prerequisite to application of Rule 13d-3(b)."

[5] Both CSX and the investment funds have filed notices of appeal.

commentators have expressed the concern that the *CSX* court's interpretation could extent to even passive investors. While it does not appear to us that this is likely absent additional guidance from an appellate court, passive investors might consider a defensive filing using Form 13G that includes a disclaimer of beneficial ownership.

Because a significant benefit to activist shareholders of using cash-settled total return equity swaps is to avoid disclosure of their positions, the *CSX* decision, which appears to take away that advantage, at least under certain circumstances, will likely considerably reduce the use by activist shareholders of cash-settled total return equity swaps. The inability to shield themselves from disclosure may dissuade activist stockholders from taking positions in companies in the first instance.

A perhaps unanticipated consequence of the *CSX* case is on reporting of beneficial ownership and liability for short-swing profits under Section 16 of the Exchange Act. Rule 16a-1 references Section 13 for the initial determination of whether a person is deemed to be the beneficial owner of more than ten percent of any class of registered equity security. If a person is deemed to be a "ten percent stockholder" under Section 16, he would be required to report his beneficial ownership of shares of the subject company and would be liable for any "profits" on any purchases and sales within six months of each other.

The *CSX* decision will also have implications for financial institutions acting as the short party on total return swaps. In order to avoid reputational and other risks, financial institutions may decide that, under appropriate circumstances, they will want to confirm, among other things, that their customers or counterparties have legitimate business reasons for entering into the transactions other than avoiding the reporting requirements of Section 13(d), the total cash and derivative exposures to the reference entity, that they are not spreading their exposure across multiple dealers and that they are complying with all applicable laws.

In light of some of the comments made by the *CSX* court regarding the influence counterparties may have over the institutions voting and other policies, financial institutions should consider reviewing their policies and documentation with respect to voting shares underlying swaps and passing through execution, pricing or timing to the counterparty or otherwise providing consultation rights to counterparties.

Public companies may see in this ruling a potential new defense for safeguarding themselves against activist shareholders. However, given the court's asserted inability to provide any meaningful sanctions once proper disclosure is made, it is unclear whether this new weapon has any teeth.

Finally, given both the professional and popular interest in this case and in the treatment of derivative securities under Federal securities laws and in light of the court's disagreement with the position expressed in the SEC's general counsel's letter, it seems likely the SEC will respond with new or revised rules.

IN THE SUPREME COURT OF THE STATE OF DELAWARE

CA, Inc., a Delaware corporation,	§	
	§	No. 329, 2008
Petitioner Below,	§	
Appellant,	§	On Certification of Questions
	§	of Law from the United States
v.	§	Securities and Exchange
	§	Commission
AFSCME Employees Pension Plan,	§	
	§	
Respondent Below,	§	
Appellee.	§	

Submitted: July 9, 2008
Decided: July 17, 2008

Before **STEELE**, Chief Justice, **HOLLAND**, **BERGER**, **JACOBS**, and **RIDGELY**, Justices, constituting the Court *en Banc*.

Upon Certification of Questions of Law from the United States Securities and Exchange Commission. **CERTIFIED QUESTIONS ANSWERED**.

Raymond J. DiCamillo, Blake Rohrbacher, and Scott W. Perkins, Esquires, of Richards, Layton & Finger, P.A., Wilmington, Delaware; Of Counsel: Robert J. Giuffra, Jr. (argued), David B. Harms, William B. Monahan, and William H. Wagener, Esquires, of Sullivan & Cromwell LLP, New York, New York; for Appellant.

Jay W. Eisenhofer, Stuart M. Grant, Michael J. Barry (argued), and Ananda Chaudhuri, Esquires, of Grant & Eisenhofer P.A., Wilmington, Delaware; for Appellee.

JACOBS, Justice:

This proceeding arises from a certification by the United States Securities and Exchange Commission (the "SEC"), to this Court, of two questions of law pursuant to Article IV, Section 11(8) of the Delaware Constitution[1] and Supreme Court Rule 41. On June 27, 2008, the SEC asked this Court to address two questions of Delaware law regarding a proposed stockholder bylaw submitted by the AFSCME Employees Pension Plan ("AFSCME") for inclusion in the proxy materials of CA, Inc. ("CA" or the "Company") for CA's 2008 annual stockholders' meeting. This Court accepted certification on July 1, 2008, and after expedited briefing, the matter was argued on July 9, 2008. This is the decision of the Court on the certified questions.

I. *FACTS*

CA is a Delaware corporation whose board of directors consists of twelve persons, all of whom sit for reelection each year. CA's annual meeting of stockholders is scheduled to be held on September 9, 2008. CA intends to file its definitive proxy materials with the SEC on or about July 24, 2008 in connection with that meeting.

AFSCME, a CA stockholder, is associated with the American Federation of State, County and Municipal Employees. On March 13, 2008, AFSCME

[1] Article IV, Section 11(8) was amended in 2007 to authorize this Court to hear and determine questions of law certified to it by (in addition to the tribunals already specified therein) the United States Securities and Exchange Commission. 76 *Del. Laws* 2007, ch. 37 § 1, effective May 3, 2007. This certification request is the first submitted by the SEC to this Court.

submitted a proposed stockholder bylaw (the "Bylaw" or "proposed Bylaw") for inclusion in the Company's proxy materials for its 2008 annual meeting of stockholders. The Bylaw, if adopted by CA stockholders, would amend the Company's bylaws to provide as follows:

> RESOLVED, that pursuant to section 109 of the Delaware General Corporation Law and Article IX of the bylaws of CA, Inc., stockholders of CA hereby amend the bylaws to add the following Section 14 to Article II:
>
> The board of directors shall cause the corporation to reimburse a stockholder or group of stockholders (together, the "Nominator") for reasonable expenses ("Expenses") incurred in connection with nominating one or more candidates in a contested election of directors to the corporation's board of directors, including, without limitation, printing, mailing, legal, solicitation, travel, advertising and public relations expenses, so long as (a) the election of fewer than 50% of the directors to be elected is contested in the election, (b) one or more candidates nominated by the Nominator are elected to the corporation's board of directors, (c) stockholders are not permitted to cumulate their votes for directors, and (d) the election occurred, and the Expenses were incurred, after this bylaw's adoption. The amount paid to a Nominator under this bylaw in respect of a contested election shall not exceed the amount expended by the corporation in connection with such election.

CA's current bylaws and Certificate of Incorporation have no provision that specifically addresses the reimbursement of proxy expenses. Of more general relevance, however, is Article SEVENTH, Section (1) of CA's Certificate of Incorporation, which tracks the language of 8 *Del. C.* § 141(a) and provides that:

> The management of the business and the conduct of the affairs of the corporation shall be vested in [CA's] Board of Directors.

It is undisputed that the decision whether to reimburse election expenses is presently vested in the discretion of CA's board of directors, subject to their fiduciary duties and applicable Delaware law.

On April 18, 2008, CA notified the SEC's Division of Corporation Finance (the "Division") of its intention to exclude the proposed Bylaw from its 2008 proxy materials. The Company requested from the Division a "no-action letter" stating that the Division would not recommend any enforcement action to the SEC if CA excluded the AFSCME proposal.[2] CA's request for a no-action letter was accompanied by an opinion from its Delaware counsel, Richards Layton & Finger, P.A. ("RL&F"). The RL&F opinion concluded that the proposed Bylaw is not a proper subject for stockholder action, and that if implemented, the Bylaw would violate the Delaware General Corporation Law ("DGCL").

On May 21, 2008, AFSCME responded to CA's no-action request with a letter taking the opposite legal position. The AFSCME letter was accompanied by an opinion from AFSCME's Delaware counsel, Grant & Eisenhofer, P.A. ("G&E"). The G&E opinion concluded that the proposed Bylaw is a proper

[2] Under Sections (i)(1) and (i)(2) of SEC Rule 14a-8, a company may exclude a stockholder proposal from its proxy statement if the proposal "is not a proper subject for action by the shareholders under the laws of the jurisdiction of the company's organization," or where the proposal, if implemented, "would cause the company to violate any state law to which it is subject." *See* 17 C.F.R. § 240.14a-8.

subject for shareholder action and that if adopted, would be permitted under Delaware law.

The Division was thus confronted with two conflicting legal opinions on Delaware law. Whether or not the Division would determine that CA may exclude the proposed Bylaw from its 2008 proxy materials would depend upon which of these conflicting views is legally correct. To obtain guidance, the SEC, at the Division's request, certified two questions of Delaware law to this Court. Given the short timeframe for the filing of CA's proxy materials, we concluded that "there are important and urgent reasons for an immediate determination of the questions certified," and accepted those questions for review on July 1, 2008.

II. *THE CERTIFIED QUESTIONS*

The two questions certified to us by the SEC are as follows:

1. Is the AFSCME Proposal a proper subject for action by shareholders as a matter of Delaware law?

2. Would the AFSCME Proposal, if adopted, cause CA to violate any Delaware law to which it is subject?

The questions presented are issues of law which this Court decides *de novo*.[3]

[3] *B.F. Rich & Co., Inc. v. Gray,* 933 A.2d 1231, 1241 (Del. 2007).

III. *THE FIRST QUESTION*

A. Preliminary Comments

The first question presented is whether the Bylaw is a proper subject for shareholder action, more precisely, whether the Bylaw may be proposed and enacted by shareholders without the concurrence of the Company's board of directors. Before proceeding further, we make some preliminary comments in an effort to delineate a framework within which to begin our analysis.

First, the DGCL empowers both the board of directors and the shareholders of a Delaware corporation to adopt, amend or repeal the corporation's bylaws. 8 *Del. C.* § 109(a) relevantly provides that:

> After a corporation has received any payment for any of its stock, the power to adopt, amend or repeal bylaws shall be in the stockholders entitled to vote…; provided, however, any corporation may, in its certificate of incorporation, confer the power to adopt, amend or repeal bylaws upon the directors…. The fact that such power has been so conferred upon the directors…shall not divest the stockholders…of the power, nor limit their power to adopt, amend or repeal bylaws.

Pursuant to Section 109(a), CA's Certificate of Incorporation confers the power to adopt, amend or repeal the bylaws upon the Company's board of directors.[4] Because the statute commands that that conferral "shall not divest the stockholders

[4] Article SEVENTH Section (2) of CA's Certificate of Incorporation provides that "[t]he original By Laws of the corporation shall be adopted by the incorporator. Thereafter, the power to make, alter, or repeal the By Laws, and to adopt any new By Law, except a By Law classifying directors for election for staggered terms, shall be vested in the Board of Directors."

…of…nor limit" their power, both the board and the shareholders of CA, independently and concurrently, possess the power to adopt, amend and repeal the bylaws.

Second, the vesting of that concurrent power in both the board and the shareholders raises the issue of whether the stockholders' power is coextensive with that of the board, and vice versa. As a purely theoretical matter that is possible, and were that the case, then the first certified question would be easily answered. That is, under such a regime any proposal to adopt, amend or repeal a bylaw would be a proper subject for either shareholder or board action, without distinction. But the DGCL has not allocated to the board and the shareholders the identical, coextensive power to adopt, amend and repeal the bylaws. Therefore, how that power is allocated between those two decision-making bodies requires an analysis that is more complex.

Moving from the theoretical to this case, by its terms Section 109(a) vests in the shareholders a power to adopt, amend or repeal bylaws that is legally sacrosanct, *i.e.*, the power cannot be non-consensually eliminated or limited by anyone other than the legislature itself. If viewed in isolation, Section 109(a) could be read to make the board's and the shareholders' power to adopt, amend or repeal bylaws identical and coextensive, but Section 109(a) does not exist in a vacuum. It must be read together with 8 *Del. C.* § 141(a), which pertinently provides that:

> The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.[5]

No such broad management power is statutorily allocated to the shareholders. Indeed, it is well-established that stockholders of a corporation subject to the DGCL may not directly manage the business and affairs of the corporation, at least without specific authorization in either the statute or the certificate of incorporation.[6] Therefore, the shareholders' statutory power to adopt, amend or repeal bylaws is not coextensive with the board's concurrent power and is limited by the board's management prerogatives under Section 141(a).[7]

Third, it follows that, to decide whether the Bylaw proposed by AFSCME is a proper subject for shareholder action under Delaware law, we must first

[5] As earlier noted, CA's Certificate of Incorporation fully empowers the board of directors, in language that tracks Section 141(a), to manage the business and affairs of the Company.

[6] *See, e.g., McMullin v. Beran*, 765 A.2d 910, 916 (Del. 2000) ("[o]ne of the fundamental principles of the Delaware General Corporation Law statute is that the business affairs of a corporation are managed by or under the direction of its board of directors."); *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281, 1291-92 (Del. 1998) ("One of the most basic tenets of Delaware corporate law is that the board of directors has the ultimate responsibility for managing the business and affairs of a corporation.[…] Section 141(a)...confers upon any newly elected board of directors *full* power to manage and direct the business and affairs of a Delaware corporation.") (emphasis in original) (internal citations omitted); *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984) ("[a] cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation.").

[7] Because the board's managerial authority under Section 141(a) is a cardinal precept of the DGCL, we do not construe Section 109 as an "except[ion]…otherwise specified in th[e] [DGCL]" to Section 141(a). Rather, the shareholders' statutory power to adopt, amend or repeal bylaws under Section 109 cannot be "inconsistent with the law," including Section 141(a).

determine: (1) the scope or reach of the shareholders' power to adopt, alter or repeal the bylaws of a Delaware corporation, and then (2) whether the Bylaw at issue here falls within that permissible scope. Where, as here, the proposed bylaw is one that limits director authority, that is an elusively difficult task. As one noted scholar has put it, "the efforts to distinguish by-laws that permissibly limit director authority from by-laws that impermissibly do so have failed to provide a coherent analytical structure, and the pertinent statutes provide no guidelines for distinction at all."[8] The tools that are available to this Court to answer those questions are other provisions of the DGCL[9] and Delaware judicial decisions that can be brought to bear on this question.

[8] Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 TUL. L. REV. 409, 444 (1998); *Id.* at 416 (noting that "neither the courts, the legislators, the SEC, nor legal scholars have clearly articulated the means of…determining whether a stockholder-adopted by-law provision that constrains director managerial authority is legally effective."). *See also* Randall S. Thomas & Catherine T. Dixon, ARANOW & EINHORN ON PROXY CONTESTS FOR CORPORATE CONTROL, § 160.5 (3d ed. 1998) ("At some point the broad shareholder power to adopt or amend corporate by-laws must yield to the board's plenary authority to manage the business and affairs of the corporation…. The difficulty of pinpointing where a proposal falls on this spectrum of sometimes overlapping authority is exacerbated by the absence of state-law precedent demarcating this boundary."); John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837, 889 (1994) ("Symptomatically, persuasive Delaware authority is simply lacking that draws boundaries between the shareholder's right to amend the bylaws and the board's right to manage."); William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861, 1932 n.274 (1995) ("[S]tate lawmakers have never had occasion to draw a clear line between board management authority and shareholder by-law promulgation authority. As a result, the extent to which a by-law may constrain…management authority is not clear.").

[9] *Keeler v. Harford Mut. Ins. Co.*, 672 A.2d 1012, 1016 (Del. 1996) ("In determining legislative intent…we find it important to give effect to the whole statute, and leave no part superfluous.").

B. *Analysis*

1.

Two other provisions of the DGCL, 8 *Del. C.* §§ 109(b) and 102(b)(1), bear importantly on the first question and form the basis of contentions advanced by each side. Section 109(b), which deals generally with bylaws and what they must or may contain, provides that:

> The bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees.

And Section 102(b)(1), which is part of a broader provision that addresses what the certificate of incorporation must or may contain, relevantly states that:

> (b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters:
>
> (1) Any provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors and the stockholders, or any class of the stockholders….; if such provisions are not contrary to the laws of this State. Any provision which is required or permitted by any section of this chapter to be stated in the bylaws may instead be stated in the certificate of incorporation.

AFSCME relies heavily upon the language of Section 109(b), which permits the bylaws of a corporation to contain "any provision…relating to the…rights or powers of its stockholders [and] directors…." The Bylaw, AFSCME argues,

"relates to" the right of the stockholders meaningfully to participate in the process of electing directors, a right that necessarily "includes the right to nominate an opposing slate."[10]

CA argues, in response, that Section 109(b) is not dispositive, because it cannot be read in isolation from, and without regard to, Section 102(b)(1). CA's argument runs as follows: the Bylaw would limit the substantive decision-making authority of CA's board to decide whether or not to expend corporate funds for a particular purpose, here, reimbursing director election expenses. Section 102(b)(1) contemplates that any provision that limits the broad statutory power of the directors must be contained in the certificate of incorporation.[11] Therefore, the proposed Bylaw can only be in CA's Certificate of Incorporation, as distinguished from its bylaws. Accordingly, the proposed bylaw falls outside the universe of permissible bylaws authorized by Section 109(b).[12]

Implicit in CA's argument is the premise that *any* bylaw that in *any* respect might be viewed as limiting or restricting the power of the board of directors

[10] *Harrah's Entm't v. JCC Holding Co.*, 802 A.2d 294, 310 (Del. Ch. 2002).

[11] 8 *Del. C.* § 102(b)(1) pertinently provides that the "the certificate of incorporation may also contain…any provision…limiting…the powers of…the directors."

[12] Although CA advances this argument in its Brief in connection with the second question, *i.e.*, as a reason why the Bylaw, if adopted, would violate Delaware law, we view the argument as also properly bearing upon the first question, namely, whether the proposed Bylaw is a proper subject for shareholder action.

automatically falls outside the scope of permissible bylaws. That simply cannot be. That reasoning, taken to its logical extreme, would result in eliminating altogether the shareholders' statutory right to adopt, amend or repeal bylaws. Bylaws, by their very nature, set down rules and procedures that bind a corporation's board and its shareholders. In that sense, most, if not all, bylaws could be said to limit the otherwise unlimited discretionary power of the board. Yet Section 109(a) carves out an area of shareholder power to adopt, amend or repeal bylaws that is expressly inviolate.[13] Therefore, to argue that the Bylaw at issue here limits the board's power to manage the business and affairs of the Company only begins, but cannot end, the analysis needed to decide whether the Bylaw is a proper subject for shareholder action. The question left unanswered is what is the scope of shareholder action that Section 109(b) permits yet does not improperly intrude upon the directors' power to manage corporation's business and affairs under Section 141(a).

It is at this juncture that the statutory language becomes only marginally helpful in determining what the Delaware legislature intended to be the lawful scope of the shareholders' power to adopt, amend and repeal bylaws. To resolve that issue, the Court must resort to different tools, namely, decisions of this Court

[13] Section 109(a), to reiterate, provides that the fact that the certificate of incorporation confers upon the directors the power to adopt, amend or repeal bylaws "shall not divest the stockholders …of the power…, nor limit their power to adopt, amend or repeal bylaws."

and of the Court of Chancery that bear on this question. Those tools do not enable us to articulate with doctrinal exactitude a bright line that divides those bylaws that shareholders may unilaterally adopt under Section 109(b) from those which they may not under Section 141(a). They do, however, enable us to decide the issue presented in this specific case.[14]

2.

It is well-established Delaware law that a proper function of bylaws is not to mandate how the board should decide specific substantive business decisions, but rather, to define the process and procedures by which those decisions are made. As the Court of Chancery has noted:

> Traditionally, the bylaws have been the corporate instrument used to set forth the rules by which the corporate board conducts its business. To this end, the DGCL is replete with specific provisions authorizing the bylaws to establish the procedures through which board and committee action is taken.… [T]here is a general consensus that bylaws that regulate the process by which the board acts are statutorily authorized.[15]

[14] We do not attempt to delineate the location of that bright line in this Opinion. What we do hold is case specific; that is, wherever may be the location of the bright line that separates the shareholders' bylaw-making power under Section 109 from the directors' exclusive managerial authority under Section 141(a), the proposed Bylaw at issue here does not invade the territory demarcated by Section 141(a).

[15] *Hollinger Intern., Inc. v. Black*, 844 A.2d 1022, 1078-79 (Del. Ch. 2004) (internal footnotes omitted), *aff'd*, 872 A.2d 559 (Del. 2005). *See also*, *Gow v. Consol. Coppermines Corp.*, 165 A. 136, 140 (Del. Ch. 1933) ("[A]s the charter is an instrument in which the broad and general aspects of the corporate entity's existence and nature are defined, so the by-laws are generally regarded as the proper place for the self-imposed rules and regulations deemed expedient for its convenient functioning to be laid down.").

* * *

> … I reject International's argument that that provision in the Bylaw Amendments impermissibly interferes with the board's authority under § 141(a) to manage the business and affairs of the corporation. Sections 109 and 141, taken in totality,….make clear that bylaws may pervasively and strictly regulate the process by which boards act, subject to the constraints of equity.[16]

Examples of the procedural, process-oriented nature of bylaws are found in both the DGCL and the case law. For example, 8 *Del. C.* § 141(b) authorizes bylaws that fix the number of directors on the board, the number of directors required for a quorum (with certain limitations), and the vote requirements for board action. 8 *Del. C.* § 141(f) authorizes bylaws that preclude board action without a meeting.[17] And, almost three decades ago this Court upheld a shareholder-enacted bylaw requiring unanimous board attendance and board approval for any board action, and unanimous ratification of any committee

[16] *Id.* at 1080 n.136.

[17] *See also, e.g.,* 8 *Del. C.* § 211(a) & (b) (bylaws may establish the date and the place of the annual meeting of the stockholders); § 211(d) (bylaws may specify the conditions for the calling of special meetings of stockholders); § 216 (bylaws may establish quorum and vote requirements for meetings of stockholders and "[a] bylaw amendment adopted by stockholders which specifies the votes that shall be necessary for the election of directors shall not be further amended or repealed by the board of directors."); § 222 (bylaws may regulate certain notice requirements regarding adjourned meetings of stockholders).

action.[18] Such purely procedural bylaws do not improperly encroach upon the board's managerial authority under Section 141(a).

The process-creating function of bylaws provides a starting point to address the Bylaw at issue. It enables us to frame the issue in terms of whether the Bylaw is one that establishes or regulates a process for substantive director decision-making, or one that mandates the decision itself. Not surprisingly, the parties sharply divide on that question. We conclude that the Bylaw, even though infelicitously couched as a substantive-sounding mandate to expend corporate funds, has both the intent and the effect of regulating the process for electing directors of CA. Therefore, we determine that the Bylaw is a proper subject for shareholder action, and set forth our reasoning below.

Although CA concedes that "restrictive procedural bylaws (such as those requiring the presence of all directors and unanimous board consent to take action) are acceptable," it points out that even facially procedural bylaws can unduly intrude upon board authority. The Bylaw being proposed here is unduly intrusive, CA claims, because, by mandating reimbursement of a stockholder's proxy expenses, it limits the board's broad discretionary authority to decide whether to grant reimbursement at all. CA further claims that because (in defined

[18] *Frantz Mfg. Co. v. EAC Indus.*, 501 A.2d 401 (Del. 1985). *See also Hollinger*, 844 A.2d at 1079-80 (shareholder-enacted bylaw abolishing a board committee created by board resolution does not impermissibly interfere with the board's authority under Section 141(a)).

circumstances) the Bylaw mandates the expenditure of corporate funds, its subject matter is necessarily substantive, not process-oriented, and, therefore falls outside the scope of what Section 109(b) permits.[19]

Because the Bylaw is couched as a command to reimburse ("The board of directors shall cause the corporation to reimburse a stockholder"), it lends itself to CA's criticism. But the Bylaw's wording, although relevant, is not dispositive of whether or not it is process-related. The Bylaw could easily have been worded differently, to emphasize its process, as distinguished from its mandatory payment, component.[20] By saying this we do not mean to suggest that this Bylaw's reimbursement component can be ignored. What we do suggest is that a bylaw that requires the expenditure of corporate funds does not, for that reason alone,

[19] CA actually conflates two separate arguments that, although facially similar, are analytically distinct. The first argument is that the Bylaw impermissibly intrudes upon board authority because it mandates the expenditure of corporate funds. The second is that the Bylaw impermissibly leaves no role for board discretion and would require reimbursement of the costs of a subset of CA's stockholders, even in circumstances where the board's fiduciary duties would counsel otherwise. Analytically, the first argument is relevant to the issue of whether the Bylaw is a proper subject for unilateral stockholder action, whereas the second argument more properly goes to the separate question of whether the Bylaw, if enacted, would violate Delaware law.

[20] For example, the Bylaw could have been phrased more benignly, to provide that "[a] stockholder or group of stockholders (together, the 'Nominator') shall be entitled to reimbursement from the corporation for reasonable expenses ('Expenses') incurred in connection with nominating one or more candidates in a contested election of directors to the corporation's board of directors in the following circumstances…." Although the substance of the Bylaw would be no different, the emphasis would be upon the shareholders' entitlement to reimbursement, rather than upon the directors' obligation to reimburse. As discussed in Part IV, *infra*, of this Opinion, in order for the bylaw not to be "not inconsistent with law" as Section 109(b) mandates, it would also need to contain a provision that reserves the directors' full power to discharge their fiduciary duties.

become automatically deprived of its process-related character. A hypothetical example illustrates the point. Suppose that the directors of a corporation live in different states and at a considerable distance from the corporation's headquarters. Suppose also that the shareholders enact a bylaw that requires all meetings of directors to take place in person at the corporation's headquarters. Such a bylaw would be clearly process-related, yet it cannot be supposed that the shareholders would lack the power to adopt the bylaw because it would require the corporation to expend its funds to reimburse the directors' travel expenses. Whether or not a bylaw is process-related must necessarily be determined in light of its context and purpose.

The context of the Bylaw at issue here is the process for electing directors—a subject in which shareholders of Delaware corporations have a legitimate and protected interest.[21] The purpose of the Bylaw is to promote the integrity of that electoral process by facilitating the nomination of director candidates by stockholders or groups of stockholders. Generally, and under the current

[21] *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 660 n.2 (Del. Ch. 1988) ("Delaware courts have long exercised a most sensitive and protective regard for the free and effective exercise of voting rights."); *Id.* at 659 ("[W]hen viewed from a broad, institutional perspective, it can be seen that matters involving the integrity of the shareholder voting process involve consideration[s] not present in any other context in which directors exercise delegated power."); *See also Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1378 (Del. 1995); *MM Cos., Inc. v. Liquid Audio, Inc.,* 813 A.2d 1118 (Del. 2003); and 8 *Del. C.* § 211 (authorizing a shareholder to petition the Court of Chancery to order a meeting of stockholders to elect directors where such a meeting has not been held for at least 13 months).

framework for electing directors in contested elections, only board-sponsored nominees for election are reimbursed for their election expenses. Dissident candidates are not, unless they succeed in replacing the entire board. The Bylaw would encourage the nomination of non-management board candidates by promising reimbursement of the nominating stockholders' proxy expenses if one or more of its candidates are elected. In that the shareholders also have a legitimate interest, because the Bylaw would facilitate the exercise of their right to participate in selecting the contestants. The Court of Chancery has so recognized:

> [T]he unadorned right to cast a ballot in a contest for [corporate] office…is meaningless without the right to participate in selecting the contestants. As the nominating process circumscribes the range of choice to be made, it is a fundamental and outcome-determinative step in the election of officeholders. To allow for voting while maintaining a closed selection process thus renders the former an empty exercise.[22]

* * *

The shareholders of a Delaware corporation have the right "to participate in selecting the contestants" for election to the board. The shareholders are entitled to facilitate the exercise of that right by proposing a bylaw that would encourage candidates other than board-sponsored nominees to stand for election. The Bylaw would accomplish that by committing the corporation to reimburse the election

[22] *Harrah's Entm't v. JCC Holding Co.*, 802 A.2d 294, 311 (Del. Ch. 2002) (quoting *Durkin v. Nat'l Bank of Olyphant,* 772 F.2d 55, 59 (3d Cir. 1985)).

expenses of shareholders whose candidates are successfully elected. That the implementation of that proposal would require the expenditure of corporate funds will not, in and of itself, make such a bylaw an improper subject matter for shareholder action. Accordingly, we answer the first question certified to us in the affirmative.

That, however, concludes only part of the analysis. The DGCL also requires that the Bylaw be "not inconsistent with law."[23] Accordingly, we turn to the second certified question, which is whether the proposed Bylaw, if adopted, would cause CA to violate any Delaware law to which it is subject.

IV. *THE SECOND QUESTION*

In answering the first question, we have already determined that the Bylaw does not facially violate any provision of the DGCL or of CA's Certificate of Incorporation. The question thus becomes whether the Bylaw would violate any common law rule or precept. Were this issue being presented in the course of litigation involving the application of the Bylaw to a specific set of facts, we would start with the presumption that the Bylaw is valid and, if possible, construe it in a manner consistent with the law.[24] The factual context in which the Bylaw was challenged would inform our analysis, and we would "exercise caution [before]

[23] 8 *Del. C.* § 109(b).

[24] *Frantz Mfg. Co. v. EAC Indus.*, 501 A.2d 401, 407 (Del. 1985).

invalidating corporate acts based upon hypothetical injuries…."[25] The certified questions, however, request a determination of the validity of the Bylaw in the abstract. Therefore, in response to the second question, we must necessarily consider any possible circumstance under which a board of directors might be required to act. Under at least one such hypothetical, the board of directors would breach their fiduciary duties if they complied with the Bylaw. Accordingly, we conclude that the Bylaw, as drafted, would violate the prohibition, which our decisions have derived from Section 141(a), against contractual arrangements that commit the board of directors to a course of action that would preclude them from fully discharging their fiduciary duties to the corporation and its shareholders.[26]

This Court has previously invalidated contracts that would require a board to act or not act in such a fashion that would limit the exercise of their fiduciary duties. In *Paramount Communications, Inc. v. QVC Network, Inc.*,[27] we invalidated a "no shop" provision of a merger agreement with a favored bidder (Viacom) that prevented the directors of the target company (Paramount) from communicating with a competing bidder (QVC) the terms of its competing bid in an effort to obtain the highest available value for shareholders. We held that:

[25] *Stroud v. Grace*, 606 A.2d 75, 79 (Del. 1992).

[26] *Paramount Communications, Inc. v. QVC Network, Inc*., 63 A.2d 34 (Del. 1994); *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998).

[27] 637 A.2d 34 (Del. 1994).

> The No-Shop Provision could not validly define or limit the fiduciary duties of the Paramount directors. To the extent that a contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable. [...] [T]he Paramount directors could not contract away their fiduciary obligations. Since the No-Shop Provision was invalid, Viacom never had any vested contract rights in the provision.[28]

Similarly, in *Quickturn Design Systems, Inc. v. Shapiro*,[29] the directors of the target company (Quickturn) adopted a "poison pill" rights plan that contained a so-called "delayed redemption provision" as a defense against a hostile takeover bid, as part of which the bidder (Mentor Graphics) intended to wage a proxy contest to replace the target company board. The delayed redemption provision was intended to deter that effort, by preventing any newly elected board from redeeming the poison pill for six months. This Court invalidated that provision, because it would "impermissibly deprive any newly elected board of both its statutory authority to manage the corporation under 8 *Del. C.* § 141(a) and its concomitant fiduciary duty pursuant to that statutory mandate."[30] We held that:

> One of the most basic tenets of Delaware corporate law is that the board of directors has the ultimate responsibility for managing the business and affairs of a corporation. [...] The Quickturn certificate of incorporation contains no provision purporting to limit the authority of the board in any way. The Delayed Redemption Provision, however, would prevent a newly elected board of directors from *completely* discharging its fundamental management duties to the corporation and its stockholders for six months. While the Delayed Redemption Provision limits the board of directors' authority in only one respect, the suspension of the Rights Plan, it nonetheless restricts the board's power in an area of fundamental importance to the shareholders—negotiating a possible sale of the corporation. Therefore, we hold that the Delayed Redemption Provision is invalid under Section 141(a), which confers upon any newly elected board of directors *full* power to manage and direct the business and affairs of a Delaware corporation.[31]

Both *QVC* and *Quickturn* involved binding contractual arrangements that the board of directors had voluntarily imposed upon themselves. This case involves a binding bylaw that the shareholders seek to impose involuntarily on the directors in the specific area of election expense reimbursement. Although this case is distinguishable in that respect, the distinction is one without a difference. The reason is that the internal governance contract—which here takes the form of a bylaw—is one that would also prevent the directors from exercising their full managerial power in circumstances where their fiduciary duties would otherwise require them to deny reimbursement to a dissident slate. That this limitation would be imposed by a majority vote of the shareholders rather than by the directors themselves, does not, in our view, legally matter.[32]

[28] *Paramount v. QVC*, 637 A.2d at 51.

[29] 721 A.2d 1281 (Del. 1998).

[30] *Quickturn*, 721 A.2d at 1291.

[31] *Id.* at 1291-92 (italics in original, internal footnotes omitted).

[32] Only if the Bylaw provision were enacted as an amendment to CA's Certificate of Incorporation would that distinction be dispositive. *See* 8 *Del. C.* § 102 (b)(1) and § 242.

AFSCME contends that it is improper to use the doctrine articulated in *QVC* and *Quickturn* as the measure of the validity of the Bylaw. Because the Bylaw would remove the subject of election expense reimbursement (in circumstances as defined by the Bylaw) entirely from the CA's board's discretion (AFSCME argues), it cannot fairly be claimed that the directors would be precluded from discharging their fiduciary duty. Stated differently, AFSCME argues that it is unfair to claim that the Bylaw prevents the CA board from discharging its fiduciary duty where the effect of the Bylaw is to relieve the board entirely of those duties in this specific area.

That response, in our view, is more semantical than substantive. No matter how artfully it may be phrased, the argument concedes the very proposition that renders the Bylaw, as written, invalid: the Bylaw mandates reimbursement of election expenses in circumstances that a proper application of fiduciary principles could preclude. That such circumstances could arise is not far fetched. Under Delaware law, a board may expend corporate funds to reimburse proxy expenses "[w]here the controversy is concerned with a question of policy as distinguished from personnel o[r] management."[33] But in a situation where the proxy contest is

[33] *Hall v. Trans-Lux Daylight Picture Screen Corp.*, 171 A. 226, 227 (Del. Ch. 1934); *See also Hibbert v. Hollywood Park, Inc.*, 457 A.2d 339, 345 (Del. 1983) (reimbursement of "reasonable expenses" permitted where the proxy contest "was actually one involving substantive differences about corporation policy.").

motivated by personal or petty concerns, or to promote interests that do not further, or are adverse to, those of the corporation, the board's fiduciary duty could compel that reimbursement be denied altogether.[34]

It is in this respect that the proposed Bylaw, as written, would violate Delaware law if enacted by CA's shareholders. As presently drafted, the Bylaw would afford CA's directors full discretion to determine what *amount* of reimbursement is appropriate, because the directors would be obligated to grant only the "reasonable" expenses of a successful short slate. Unfortunately, that does not go far enough, because the Bylaw contains no language or provision that would reserve to CA's directors their full power to exercise their fiduciary duty to decide whether or not it would be appropriate, in a specific case, to award reimbursement at all.[35]

* * *

In arriving at this conclusion, we express no view on whether the Bylaw as currently drafted, would create a better governance scheme from a policy

[34] Such a circumstance could arise, for example, if a shareholder group affiliated with a competitor of the company were to cause the election of a minority slate of candidates committed to using their director positions to obtain, and then communicate, valuable proprietary strategic or product information to the competitor.

[35] *See Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998) ("Although the fiduciary duty of a Delaware director is unremitting, the exact course of conduct that must be charted to properly discharge that responsibility will change in the specific context of the action the director is taking with regard to either the corporation or its shareholders."). A decision by directors to deny reimbursement on fiduciary grounds would be judicially reviewable.

standpoint. We decide only what is, and is not, legally permitted under the DGCL. That statute, as currently drafted, is the expression of policy as decreed by the Delaware legislature. Those who believe that CA's shareholders should be permitted to make the proposed Bylaw as drafted part of CA's governance scheme, have two alternatives. They may seek to amend the Certificate of Incorporation to include the substance of the Bylaw; *or* they may seek recourse from the Delaware General Assembly.

Accordingly, we answer the second question certified to us in the affirmative.

QUESTIONS ANSWERED.

24

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK
- x
CSX CORPORATION,

Plaintiff,

-against- 08 Civ. 2764 (LAK)

THE CHILDREN'S INVESTMENT FUND
MANAGEMENT (UK) LLP, et al.,

Defendants,

-against-

MICHAEL J. WARD,

Additional Counterclaim
Defendant
- x

OPINION

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LEWIS A. KAPLAN, *District Judge.*

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 actions 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. The defendants – two hedge funds that seek extraordinary gain, sometimes through "shareholder activism" – amassed a large economic position in CSX Corporation ("CSX"), one of the nation's largest railroads. They did so for the purpose of causing CSX to behave in a manner that they hoped would lead to a rise in the value of their holdings. And there is nothing wrong with that. But they did so in close coordination with each other and without making the public disclosure required of 5 percent shareholders and groups by the Williams Act, a statute that was enacted to ensure that other shareholders are informed of such accumulations and arrangements. They now have launched a proxy fight that, if successful, would result in their having substantial influence and perhaps practical working control of CSX.

Defendants seek to defend their secret accumulation of interests in CSX by invoking what they assert is the letter of the law. Much of their position in CSX was in the form of total return equity swaps ("TRSs"), a type of derivative that gave defendants substantially all of the indicia of stock ownership save the formal legal right to vote the shares. In consequence, they argue, they did not beneficially own the shares referenced by the swaps and thus were not obliged to disclose sooner or more fully than they did. In a like vein, they contend that they did not reach a formal agreement to act together, and therefore did not become a "group" required to disclose its collaborative activities, until December 2007 despite the fact that they began acting in concert with respect to CSX far earlier. But these contentions are not sufficient to justify defendants' actions.

The question whether the holder of a cash-settled equity TRS beneficially owns the referenced stock held by the short counterparty appears to be one of first impression. There are persuasive arguments for concluding, on the facts of this case, that the answer is "yes" – that defendants beneficially owned at least some and quite possibly all of the referenced CSX shares held by their counterparties. But it ultimately is unnecessary to reach such a conclusion to decide this case.

Rule 13d-3(b) under the Exchange Act[1] provides in substance that one who creates an arrangement that prevents the vesting of beneficial ownership as part of a plan or scheme to avoid the disclosure that would have been required if the actor bought the stock outright is deemed to be a beneficial owner of those shares. That is exactly what the defendants did here in amassing their swap positions. In consequence, defendants are deemed to be the beneficial owners of the referenced shares.

As for the question whether defendants made prompt disclosure after they formed a "group" within the meaning of Section 13(d) of the Exchange Act, the evidence, as in virtually all such cases, is circumstantial. But it quite persuasively demonstrates that they formed a group many months before they filed the necessary disclosure statement. Their protestations to the contrary rest in no small measure on the premise that they avoided forming a group by starting conversations by stating that they were not forming a group and by avoiding entry into a written agreement. But the Exchange Act is concerned with substance, not incantations and formalities.

1 17 C.F.R. § 240.13d-3(b).

This is not to say that CSX is entitled to all of the relief that it seeks. The Williams Act was intended not only to prevent secret accumulation and undisclosed group activities with respect to the stock of public companies, but to do so without "tipping the balance of regulation either in favor of management or in favor of the person making the takeover bid."[2] It must be applied, especially in private litigation, with due regard for the principle that the purpose of private equitable relief is "to deter, not to punish."[3] Moreover, the Court's ability to formulate a remedy is sharply constrained by precedent. Accordingly, while the Court will enjoin defendants from further Section 13(d) violations, it may not preclude defendants from voting their CSX shares and declines to grant any of the other drastic relief that CSX seeks. Any penalties for defendants' violations must come by way of appropriate action by the Securities and Exchange Commission ("SEC") or the Department of Justice.

Background

I. Parties

Plaintiff CSX Corporation ("CSX") is incorporated in Virginia and headquartered in Jacksonville, Florida. Its shares are traded on the New York Stock Exchange, and it operates one of the nation's largest rail systems through its wholly owned subsidiary, CSX Transportation, Inc. Its chairman, president, and chief executive officer is Michael J. Ward, who is named here as an additional defendant on the counterclaims.

2 *Rondeau v. Mosinee Paper Corp.,* 422 U.S. 49, 58-59 (1975) (quoting S. REP. NO. 550, 90th Cong., 1st Sess., 3 (1967)).

3 *Id.* at 61 (quoting *Hecht Co. v. Bowles,* 321 U.S. 321, 329 (1944)).

Defendants The Children's Investment Fund Management (UK) LLP ("TCIF UK") and The Children's Investment Fund Management (Cayman) LTD. ("TCIF Cayman") are, respectively, an English limited liability partnership and a Cayman Islands company. Defendant The Children's Investment Master Fund ("TCI Fund") also is a company organized under the laws of the Cayman Islands and is managed by both TCIF UK and TCIF Cayman. These entities are run by defendant Christopher Hohn, who is managing partner and a controlling person of TCIF UK and the sole owner and a controlling person of TCIF Cayman. Defendant Snehal Amin is a partner of TCIF UK. These five defendants are referred to collectively as TCI.

Defendants 3G Fund L.P. ("3G Fund") and 3G Capital Partners L.P. ("3G LP") are Cayman Islands limited partnerships. Defendant 3G Capital Partners Ltd. ("3G Ltd.") is a Cayman Islands company and the general partner of 3G LP, which in turn is the general partner of 3G Fund. They are run by defendant Alexandre Behring, also known as Alexandre Behring Costa, who is the managing partner of 3G Ltd. These four defendants are referred to collectively as 3G.

II. Proceedings

TCI and 3G currently are engaged in a proxy fight in which they seek, *inter alia,* to elect their nominees to five of the twelve seats on the CSX board of directors and to amend its by-laws to permit holders of 15 percent of CSX shares to call a special meeting of shareholders at any time for any purpose permissible under Virginia law. The CSX annual meeting of shareholders, which is the object of the proxy fight, is scheduled to take place on June 25, 2008.

CSX brought this action against TCI and 3G on March 17, 2008. The complaint alleges, among other things, that defendants failed timely to file a Schedule 13D after forming a

group to act with reference to the shares of CSX and that both the Schedule 13D and the proxy statement they eventually filed were false and misleading.[4] It seeks, among other things, an order requiring corrective disclosure, voiding proxies defendants have obtained, and precluding defendants from voting their CSX shares. TCI Master Fund, 3G Fund, 3G LP, and 3G Ltd. filed counterclaims against CSX and Ward asserting various claims under the federal securities laws.[5]

With the consent of the parties, the Court consolidated the preliminary injunction hearing with the trial on the merits.[6] Following the conduct of a great deal of expedited discovery, the case was tried on May 21 to 22, 2008. The Court subsequently has had the benefit of more than 500 pages of post-trial submissions by the parties, two *amicus* briefs, an *amicus* letter on behalf of the Division of Corporation Finance of the SEC, and two lengthy letters by professors, one of whom is a former commissioner of the SEC.

The parties have urged the Court to render a decision by this week in order to permit an expedited appeal prior to the meeting. This opinion contains the Court's findings of fact and conclusions of law.[7]

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[4] Docket item 1.

[5] Docket items 26-27.

[6] Docket item 9.

[7] In addition to the findings set forth in this opinion, the Court adopts proposed findings 11.3 - 11.5, 11.17, 11.19-11.22, 12.2, 12.4-12.9, 13.2-13.5, and 13.7-13.10 set forth in docket item 62.

III. Total Return Swaps

A. The Basics

The term "derivative," as the term is used in today's financial world, refers to a financial instrument that derives its value from the price of an underlying instrument or index. Among the different types of derivatives are swaps, instruments whereby two counterparties agree to "exchange cash flows on two financial instruments over a specific period of time."[8] These are (1) a "reference obligation" or "underlying asset" such as a security, a bank loan, or an index, and (2) a benchmark loan, generally with an interest rate set relative to a commonly used reference rate (the "reference rate") such as the London Inter-Bank Offered Rate ("LIBOR").[9] A TRS is a particular form of swap.[10]

The typical – or "plain vanilla" – TRS[11] is represented by Figure 1.[12]

[8] Expert Report of Marti G. Subrahmanyam ("Subrahmanyam Report") ¶ 62.

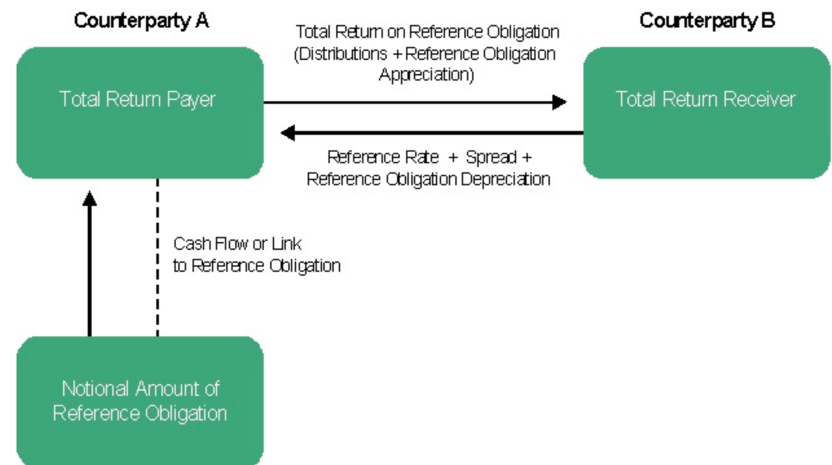
[9] *Id.*

[10] *Id.*

[11] The terms of a plain vanilla TRS frequently follow a framework established by the International Swaps and Derivatives Association, Inc. ("ISDA"). The ISDA master agreement is "a standard form that . . . includes basic representations and covenants," DX 149 (Partnoy Report) ¶ 46, that parties supplement with modifications to account for their specific interests. Subrahmanyam Report ¶ 68; DX 150 (Partnoy Surrebuttal) ¶ 20 n.26. For example, counterparties may negotiate such terms as the reference obligation that underlies the agreement or the rights of each party to terminate the swap. It is these contract-specific terms "that determine the value of the transaction." Subrahmanyam Report ¶ 68.

[12] Subrahmanyam Report, at 19.

Figure 1



Counterparty A – the "short" party – agrees to pay Counterparty B – the "long" party – cash flows based on the performance of a defined underlying asset in exchange for payments by the long party based on the interest that accrues at a negotiated rate on an agreed principal amount (the "notional amount"). More specifically, Counterparty B, which may be referred to as the "total return receiver" or "guarantor," is entitled to receive from Counterparty A the sum of (1) any cash distributions, such as interest or dividends, that it would have received had it held the referenced asset, and (2) either (i) an amount equal to the market appreciation in the value of the referenced asset over the term of the swap (if the TRS is cash-settled) or, what is economically the same thing, (ii) the referenced asset in exchange for its value on the last refixing date prior to the winding up of the transaction (if the

TRS is settled in kind). Counterparty A, referred to as the "total return payer" or "beneficiary," is entitled to receive from Counterparty B (1) an amount equal to the interest at the negotiated rate that would have been payable had it actually loaned Counterparty A the notional amount,[13] and (2) any decrease in the market value of the referenced asset.[14]

For example, in a cash-settled TRS with reference to 100,000 shares of the stock of General Motors, the short party agrees to pay to the long party an amount equal to the sum of (1) any dividends and cash flow, and (2) any increase in the market value that the long party would have realized had it owned 100,000 shares of General Motors. The long party in turn agrees to pay to the short party the sum of (1) the amount equal to interest that would have been payable had it borrowed the notional amount from the short party, and (2) any depreciation in the market value that it would have suffered had it owned 100,000 shares of General Motors.

In practical economic terms, a TRS referenced to stock places the long party in substantially the same economic position that it would occupy if it owned the referenced stock or security. There are two notable exceptions. First, since it does not have record ownership of the referenced shares, it does not have the right to vote them. Second, the long party looks to the short

[13] The notional amount typically is the value of the referenced asset at the time the transaction is agreed and may be recalculated periodically. Subrahmanyam Report ¶ 63. The difference between the reference rate and the negotiated interest rate of the swap depends on (1) the creditworthiness of the two parties, (2) characteristics of the underlying asset, (3) the total return payer's cost of financing, risk, and desired profit, and (4) market competition. *Id.* ¶ 64.

[14] *Id.* ¶ 63; DX 149 (Partnoy Report) ¶ 25.

The payments occur on "refixing dates" that recur throughout the duration of the TRS as specified by the contract.

party, rather than to the issuer of the referenced security for distributions and the marketplace for any appreciation in value.

The short party of course is in a different situation. It is entitled to have the long party place it in the same economic position it would have occupied had it advanced the long party an amount equal to the market value of the referenced security. But there are at least two salient distinctions, from the short party's perspective, between a TRS and a loan. First, the short party does not actually advance the notional amount to the long party. Second, it is subject to the risk that the referenced asset will appreciate during the term of the TRS. As will appear, the institutions that make a business of serving as short parties in TRSs deal with this exposure by hedging, a fact pivotal to one of CSX's claims here.

The swap agreements at issue in this case are cash-settled TRSs entered into by TCI with each of eight counterparties, most significantly Deutsche Bank AG ("Deutsche Bank") and Citigroup Global Markets Limited ("Citigroup"), and by 3G with Morgan Stanley.[15]

B. *The Purposes of TRSs*

The goals of those who enter into TRSs vary.

[15] TCI's other counterparties are Credit Suisse Securities (Europe) Limited ("Credit Suisse"), Goldman Sachs International ("Goldman"), J.P. Morgan Chase Bank ("J.P. Morgan"), Merrill Lynch International ("Merrill Lynch"), Morgan Stanley & Co. International plc ("Morgan Stanley") and UBS AG ("UBS"). TCI's swap agreements can be found at PX 230 (TCI and Citigroup), PX 231 (TCI and Credit Suisse), PX 232 (TCI and Deutsche Bank), PX 233 (TCI and Goldman), PX 234 (TCI and J.P. Morgan), PX 235 (TCI and Merrill Lynch), PX 236 (TCI and Morgan Stanley), and PX 238 (TCI and UBS). 3G's swap agreement with Morgan Stanley can be found at PX 237.

1. Short Parties

As a generic matter, a short party may be motivated to enter into a TRS simply to obtain the cash flow generated by the long party's payment of the negotiated rate on the notional amount over the term of the swap. But the *quid pro quo* for that cash flow is the exposure to the risk of market appreciation in the referenced security.

As a matter of theory and on occasion in practice, a short party may accept that exposure either because it thinks the risk of appreciation is small – in other words, it is making its own investment decision with respect to the referenced security – or because it has a more or less offsetting long exposure that it wishes to hedge. But that is not what we are dealing with in this case.

The defendants' counterparties in this case are major financial service institutions that are in the business, among others, of offering TRSs as a product or service and seeking an economic return via the pseudo-interest, if it may be so called, that they receive on the notional amount and from other incidental revenue sources. They are not, in this aspect of their endeavors, in the business of speculating on the market fluctuation of the shares referenced by the TRSs into which they enter as short parties. Accordingly, they typically hedge their short exposures by purchasing the referenced securities in amounts identical to those referenced in their swap agreements.[16]

[16] An incidental consequence of their doing so is to enable them to generate additional revenue by lending the shares, for a fee, to short sellers. Subrahmanyam Report ¶¶ 65-66.

Institutions that hedge short TRS exposure by purchasing the referenced shares typically have no economic interest in the securities.[17] They are, however, beneficial owners and thus have the right to vote the referenced shares.[18]

Institutional voting practices appear to vary. As noted below, some take the position that they will not vote shares held to hedge TRS risk. Some may be influenced, at least in some cases, to vote as a counterparty desires. Some say they vote as they determine in their sole discretion. Of course, one may suppose that banks seeking to attract swap business well understand that activist investors will consider them to be more attractive counterparties if they vote in favor of the positions their clients advocate. In any case, however, the accumulation of substantial hedge positions significantly alters the corporate electorate. It does so by (1) eliminating the shares constituting the hedge positions from the universe of available votes, (2) subjecting the voting of the shares to the control or influence of a long party that does not own the shares, or (3) leaving the vote to be determined by an institution that has no economic interest in the fortunes of the issuer, holds nothing more than a formal interest, but is aware that future swap business from a particular client may depend upon voting in the "right" way.

[17] A notable exception would occur if the long party to the TRS became insolvent and thus unable to perform its obligation to hold the short party harmless against any decline in the value of the referenced security.

[18] This decoupling of the economic and voting interests is discussed, among other places, in Henry Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006).

2. Long Parties

A long party to a TRS referencing equity in a public company gains economic exposure to the equity. In other words, it is exposed to essentially the same potential benefits and detriments as would be the case if it held the referenced security, and it gains that exposure without the need for the capital to fund or maintain such a purchase directly. This may permit such investors to operate with greater leverage or a lower cost than might be the case if they bought the security directly.[19] But those are by no means the only reasons motivating long parties to engage in TRSs. There can be tax advantages. Most importantly for purposes of this case, if the long party to a cash-settled TRS is not the beneficial owner of the referenced shares – a question hotly contested here – one interested in amassing a large economic exposure to the equity of a registered company may do so without making the public disclosure that is required when a person or group acquires 5 percent or more of the outstanding shares.

The avoidance of public disclosure can confer significant advantages on the long party. By concealing its activities, it may avoid other investors bidding up the referenced stock in anticipation of a tender offer or other corporate control contest and thus maximize the long party's profit potential. Second, it permits a long party who is interested in persuading an issuer to alter its policies, but desirous of avoiding an all-out battle for control, to select the time of its emergence to the issuer as a powerful player to a moment of its choosing, which may be when its exposure is substantially greater than 5 percent. In other words, it permits a long party to ambush an issuer with a holding far greater than 5 percent.

---

[19] Subrahmanyam Report ¶ 70.

One other point bears mention here. TRSs, like all or most derivatives, are privately negotiated contracts traded over the counter. Their terms may be varied during their lives as long as the counterparties agree. In consequence, a TRS that in its inception contemplates cash settlement may be settled in kind – i.e., by delivery of the referenced shares to the long party – as long as the parties consent.

This confers another potential advantage on a long party that contemplates a tender offer, proxy fight, or other corporate control contest. By entering into cash-settled TRSs, such an investor may concentrate large quantities of an issuer's stock in the hands of its short counterparties and, when it judges the time to be right, unwind those swaps by acquiring the referenced shares from those counterparties in swiftly consummated private transactions. Moreover, even if such TRSs were settled in cash, the disposition by the short counterparties of the referenced shares held to hedge their swap exposures would afford a ready supply of shares to the market at times and in circumstances effectively chosen and known principally by the long party. The long party therefore likely would have a real advantage in converting its exposure from swaps to physical shares even if it does not unwind the swaps in kind.

IV. The Events of Mid-2006 Until Late 2007

The events preceding this lawsuit are best understood by first considering the conduct of TCI and 3G separately. The Court then will analyze the relationship between TCI and 3G and their conduct in order to determine whether they in fact acted independently.

A. TCI

1. TCI Develops a Position in CSX

TCI began to research the United States railroad industry in the second half of 2006 and rapidly focused on Norfolk Southern and CSX, the two largest railroads in the eastern portion of the country. It decided to concentrate on CSX because it "had more legacy contracts that were below market value prices" and, in TCI's view, "ran less efficiently" than did Norfolk.[20] In short, it felt that changes in policy and, if need be, management could bring better performance and thus a higher stock price. That insight, if insight it was, however, would be worthless or, at any rate, less valuable if CSX did not act as TCI thought appropriate. So TCI embarked on a course designed from the outset to bring about changes at CSX.

TCI made its initial investment in CSX on October 20, 2006, by entering into TRSs referencing 1.4 million shares of CSX stock.[21] By the end of that month, it was party to TRSs referencing 1.7 percent of CSX shares.[22]

TCI almost immediately contacted CSX and informed it that TCI had accumulated approximately $100 million of CSX stock. Two weeks later, it advised CSX that it had $300 million invested in CSX, "with the potential to scale that further," and sought a meeting with senior

[20] DX 145 (Amin) ¶¶ 3-5, 10-11; DX 144 (Hohn) ¶¶ 8-9. Legacy contracts are "long-term contracts that have not been repriced to current market prices." DX 145 (Amin) ¶ 10.

[21] PX 206.

[22] Subrahmanyam Report Ex. C.1.

management at the Citigroup Transportation Conference,[23] which was scheduled to take place on November 14, 2006.

In the meantime, TCI continued accumulating TRSs referencing CSX throughout November, engaging in seventeen swap transactions with various financial institution counterparties. By the middle of the month, it had increased its exposure to approximately 2.7 percent.[24]

On November 14, 2006, TCI's Hohn and Amin attended the Citigroup conference. During the course of the day, they approached CSX representatives, including David Baggs, the assistant vice president of treasury and investor relations. Amin later told Baggs that TCI's swaps, the only type of investment exposure TCI then had in CSX, could be converted into direct ownership at any time.[25]

Following the conference, TCI continued to build its position through additional swaps throughout December, reaching 8.8 percent by the end of 2006.

2. TCI's Leveraged Buyout Proposal

TCI's belief that it could profit substantially if it could alter CSX's policies or, if need be, management manifested itself when, during December 2006, it began to investigate the possibility of a leveraged buyout ("LBO"). It explored this possibility with Goldman Sachs, sending

[23] PX 267 (Munoz) ¶¶ 3-4; PX 133; PX 136.

[24] Subrahmanyam Report Ex C.1.

[25] PX 268 (Baggs) ¶¶ 5-6. The Court does not credit Amin's denial of any such statement. *See* DX 145 (Amin) ¶¶ 20-21.

its LBO model.[26] Its email "re-iterate[d]" the need to keep the communication highly confidential, as TCI "ha[d] not taken the idea to anyone else, nor [was its] holding publicly disclosed so any leakage of our conversations with you would be damaging for our relations with the company."[27]

On January 22, 2007, by which date TCI had amassed TRSs referencing 10.5 percent of CSX,[28] TCI met with one of CSX's financial advisors, Morgan Stanley, to discuss the LBO proposal.[29] It noted during its presentation that a "'perfect storm' of conditions makes a private equity bid [for a major U.S. railroad] nearly inevitable" and that "CSX [was] logically the prime candidate" because of its "valuation, size, [and] quality of franchise." TCI urged Morgan Stanley to back the plan and suggested that CSX "formally hire an investment bank to proceed urgently."[30]

Morgan Stanley relayed the substance of its conversation to CSX.[31] TCI then approached CSX directly about the issue on February 8 at an investor conference organized by J.P. Morgan.[32] Amin asked Baggs for CSX's views on the LBO proposal. Baggs confirmed that Morgan Stanley had relayed the proposal but said that CSX was not in a position to respond.

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[26] PX 20, at TCI0159800-02.

[27] *Id.* at TCI0159799.

[28] Subrahmanyam Report Ex. C.1.

[29] PX 37; PX 267 (Munoz) ¶ 8. Hohn indicates that he requested that Deutsche Bank analyze the LBO possibility as well. He places this request in early 2007. DX 144 (Hohn) ¶ 17.

[30] PX 37, at TCI0153575.

[31] PX 267 (Munoz) ¶¶ 8-9.

[32] PX 268 (Baggs) ¶ 11; DX 145 (Amin) ¶ 30.

3. January through March 2007

TCI continued to build its TRS position in CSX. In the meantime, CSX was not idle. On February 14, 2007, it filed a Report of Form 8-K in which it announced a plan to buy back $2 billion worth of its common stock.[33]

By February 15, 2007, the date of the BB&T Transportation Conference, which was attended by CSX, TCI, and others, TCI had increased its position, still entirely via TRSs, to 13.6 percent.[34] At the conference, Amin approached Baggs and Oscar Munoz, CSX's chief financial officer, to inquire as to how CSX intended to conduct its share repurchase program. Baggs and Munoz declined to discuss the specifics in light of Regulation FD under the securities laws.[35] During the course of the brief conversation, however, Amin stated that TCI "owned" 14 percent of CSX.[36]

Following the BB&T Transportation Conference, TCI began to contact other hedge funds about CSX. Hohn told Mala Gaonkar, a partner of Lone Pine Capital, to "[t]ake a look" at

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[33] JX 6. Share repurchases often are made by companies facing control contests.

[34] Subrahmanyam Report Ex. C.1.

[35] 17 C.F.R. § 243.100 *et seq*. "In general terms, Regulation FD prohibits a company and its senior officials from privately disclosing any material nonpublic information regarding the company or its securities to certain persons such as analysts or institutional investors." *SEC v. Siebel Sys., Inc.*, 384 F. Supp. 2d 694, 696 (S.D.N.Y. 2005). If the company makes selective disclosure of material nonpublic information, it must disclose the same information publicly.

[36] PX 268 (Baggs) ¶ 12; PX 267 (Munoz) ¶ 10. The Court does not credit Amin's testimony that he did not speak to Baggs or Munoz at the conference.

CSX[37] and Vinit Bodas, managing director of Deccan Value Advisors, that "csx is the best to us. keep this confidential [*sic*]."[38] On March 2, 2007, Hohn told Bodas to "[b]uy csx [*sic*]."[39]

These contacts, the Court finds, were intended to promote the acquisition of CSX shares by hedge funds that TCI regarded as favorably disposed to TCI and its approach to CSX in an effort to build support for whatever course of action it ultimately might choose with respect to the company. Moreover, the evidence convinces the Court that it is likely that TCI made similar approaches to other such funds. Hohn contended in his witness statement that he had conversations with hedge funds such as Deccan Value Advisors, Lone Pine Capital, 3G, Seneca, Icahn, TWC, and Atticus, but only concerning the railroad industry generally, not CSX in particular.[40] Given the evidence to the contrary regarding Hohn's discussions with Deccan Value and Lone Pine, the Court's assessment of Hohn's credibility, and TCI's clear interest in doing so, the Court finds that Hohn did not limit his conversations with other hedge funds to industry-level topics. He suggested, in one way or another, that they buy CSX shares and alerted them to the fact that CSX had become a TCI target.

Up to this point, TCI had not acquired directly even a single share of CSX stock. But it decided to begin such acquisitions to place more pressure on the company and to lay the groundwork for a proxy fight.

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37 PX 45; Tr. (Hohn) at 172-73.

38 PX 46.

39 PX 53; Tr. at 174-75, 189.

40 DX 144 (Hohn) ¶ 22.

On March 2, 2007, TCI filed a premerger notification report under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 ("HSR Act")[41] in which it stated that it intended to acquire an undetermined number of CSX common shares in an amount that would meet or exceed $500 million.[42] A few days later, Amin advised CSX of the filing by letter.[43]

TCI, in the meantime, had not abandoned the idea of taking CSX private in an LBO. Moreover, the circumstances suggest, and the Court finds, that it continued to discuss its interest in CSX and this and other possibilities for altering CSX's practices in a manner that TCI believed would cause its stock to rise,[44] at least at some level of specificity, with other like-minded hedge funds.

The record demonstrates that TCI in March was invited by Austin Friars, a Deutsche Bank proprietary hedge fund, to listen in on a phone call that Austin Friars had arranged with John Snow, a former CSX chief executive officer, to review a list of questions that Austin Friars had compiled for him, and to submit questions of their own. This of course suggests, and the Court finds, that TCI had made Austin Friars aware of its investment in and interest in provoking basic change at CSX, else Austin Friars would have been unlikely to extend this invitation.

Among the questions proposed by Austin Friars for Mr. Snow was whether railroad

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41 *See* 15 U.S.C. § 18a.

42 PX 55; DX 145 (Amin) ¶ 34; DX 144 (Hohn) ¶ 21.

43 DX 10; DX 145 (Amin) ¶ 35. CSX asserts that it received such notice on March 15. *See* Tr. (Hohn) at 166.

44 An LBO of course would have afforded a different route to the big profit that TCI sought.

companies could "lend themselves to being ru[n] by private equity."[45] TCI responded that this, among other questions, was "great," thus making clear to Austin Friars, even if it had not specifically done so earlier, that TCI was looking at the possibility of trying to take CSX private. And this was not its only interaction with Deutsche Bank on the subject. It subsequently enlisted Deutsche Bank to analyze its LBO proposal, and Deutsche Bank concluded that CSX was a "terrific LBO candidate."[46]

TCI continued to exert pressure on CSX management through the end of March. They met in New York on March 29, at which time Amin criticized management for failing to take certain actions and pressed it to implement TCI's proposals. He indicated that TCI held up to 14 percent of CSX's stock, the bulk of it in swaps that could be converted to physical shares, and that there were "no limits" to what TCI would do absent CSX's acquiescence in its demands.[47] The day after the meeting, March 30, TCI entered into additional swaps that brought its economic exposure to approximately 14.1 percent.

45 PX 57.

46 PX 65, at TCI0962472; PX 64. Hohn contends that Deutsche Bank approached TCI to market its various banking services and performed the LBO analysis for no compensation. DX 144 (Hohn) ¶ 17.

47 PX 269 (Fitzsimmons) ¶¶ 11-14; PX 267 (Munoz) ¶ 12.

4. TCI Begins Preparing for a Proxy Fight

In early April, TCI sent its LBO model to Evercore, another CSX advisor,[48] and reached out to Hunter Harrison, the chief executive officer of Canadian National, a Class I railroad like CSX, to inquire whether "he would be interested in coming in as CEO of CSX."[49] By the middle of the month, Amin wrote that TCI was not "going to get what we want passively."[50] At more or less the same time, TCI began to unwind some of its swaps and to purchase CSX stock with a goal of keeping its exposure to CSX "roughly constant."[51] It is relevant to consider why TCI decided to shift some of its position into shares.

Certainly there is no persuasive evidence that any economic factor that led TCI to choose swaps in the first place had changed. In other words, if financing considerations made swaps more attractive at the outset, that advantage persisted. So the explanation lies elsewhere. And it is, in the circumstances, obvious. TCI saw the payoff on its CSX investment, if there was to be one, resulting from a change in CSX policies and, if need be, management. But CSX had rebuffed all of

48 PX 71.

49 PX 36; PX 75. Amin explained at trial that TCI sought only to determine whether Harrison was interested, but that it was not TCI's intention "to necessarily have him as CEO of CSX." Tr. (Amin) at 200. Assuming (but not finding) that to be so, the incident nevertheless would confirm the Court's view that TCI was determined to force changes in CSX's policies and, if need be, to bring about a change in control.

50 PX 83, at TCI0254261.

51 DX 145 (Amin) ¶ 37.

By April 18, its combined economic exposure to CSX common, including both its directly owned shares and its swap position, reached 15.1 percent. Subrahmanyam Report Ex. C.1.

TCI's overtures for substantive high level meetings and shown little interest in an LBO. So TCI by this time understood that a proxy fight likely would be required to gain control of or substantial influence over CSX. Holding shares that it could vote directly had an advantage over swaps because the votes of shares held by swap counterparties were less certain. They depended upon TCI's ability to influence those counterparties to vote the shares as TCI wished. This advantage, however, was not enough to cause TCI to dump a large part of its TRS position.

5. CSX Files Its 10-Q and Discloses that TCI Has an Economic Position

On April 18, 2007, CSX filed its Form 10-Q for the period ending March 30, 2007, in which it disclosed that it had

> "received notice from The Children's Investment Fund Management (U.K.) LLP that it had made a filing under the Hart-Scott-Rodino Antitrust Improvements Act to acquire more than $500 million of CSX stock. That firm has also advised CSX that it currently holds a significant economic position through common stock ownership and derivative contracts tied to the value of CSX stock."[52]

Following this disclosure, TCI essentially paused its trading activities. But it continued and, perhaps, stepped up its efforts to lay the groundwork for a proxy contest and to induce like-minded investors to buy CSX shares. On May 8, Amin attended the Bear Stearns Transportation Conference where he gave a heavily attended speech. He set forth TCI's (1) interest in CSX, (2)

52 There is some disparity as to when the Form 10-Q actually became publicly available. The document is dated April 17, 2007, but the SEC notes that it was filed on April 18. *See* http://www.sec.gov/Archives/edgar/data/277948/000119312507083489/d10q.htm. The difference matters only insofar as it affects the analysis of TCI's April 18 swap and stock purchase activity. Notwithstanding this disparity, it is clear that TCI made no additional stock purchases after April 18, and engaged in only one swap unwind between April 19 and August 23.

proposals to improve CSX, and (3) view that management was unresponsive to those proposals.[53] The next day, TCI, among others, emailed CSX to ascertain the outcome of the shareholder vote, taken at the annual meeting on May 2, on a non-binding resolution concerning shareholders' ability to call special meetings.[54]

CSX subsequently had little contact with TCI between the Bear Stearns Conference and August. TCI, however, met again with Evercore to express frustration that neither CSX management nor its board had been willing to meet to discuss TCI's proposals to improve operations and governance at the company. TCI informed Evercore that it directly owned 4 percent of CSX shares and had entered into swaps referencing over 10 percent of the company's shares.[55]

6. Proxy Fight Preparations Continue

TCI claims to have begun reconsidering its position in CSX as it entered August 2007 because (1) it was reevaluating its entire portfolio in light of turmoil in the credit and equity markets and (2) it perceived a heightened risk of re-regulation of the railroad industry.[56] As we shall see, it in fact reduced its exposure by nearly 2 million shares. Nevertheless, on August 2, TCI met with D.F.

53 DX 145 (Amin) ¶ 39; PX 268 (Baggs) ¶ 18; *see* PX 96.

54 PX 207; PX 268 (Baggs) ¶ 19 (noting that this "was the first instance in my experience of having investors calling about the outcome of a particular shareholder proposal.").

55 PTO ¶ 13; DX 145 (Amin) ¶ 42; DX 144 (Hohn) ¶ 27.

56 DX 145 (Amin) ¶ 43.

King, its proxy solicitation firm, to discuss the mechanics of a proxy contest.[57] D.F. King advised that success in a proxy contest was more likely if TCI proposed a "short slate" of two director-nominees, rather than a control slate, because Institutional Shareholder Services ("ISS")[58] would be more willing to endorse that approach than to endorse a control slate at a company with a record of success vis-à-vis share price performance.[59]

Hohn expressed his professed concern over re-regulation to CSX on August 23, stating that the proposed legislation was "a death threat to returns in the industry." He recommended that the railroad industry threaten to "cut all growth capex [i.e., capital expenditure]" because it would be "impossible to justify growth capex if this bill is passed."[60]

CSX held an analyst/investor conference in New York on September 6. TCI attended. Following the conference, Hohn met with CSX advisors Evercore and Morgan Stanley and again expressed disappointment with and criticism of CSX.[61] TCI then contacted Heidrick & Struggles, an executive search firm, and asked it to locate one or two potential nominees to the board.[62]

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[57] PX 116.

[58] ISS is an organization that, among other things, advised institutional investors with respect to voting in proxy fights. *See* http://www.issproxy.com/serve/index.html.

[59] PX 117; PX 118.

[60] PX 121, at CSX CORP 00007174.

[61] PTO ¶ 15.

[62] PX 137, at TCI0512741-42.

On September 20, TCI informed D.F. King that it was "likely to proceed in a proxy contest,"[63] although Amin expressed skepticism that a minority slate of directors could accomplish what TCI wished to achieve. He therefore inquired as to the feasibility of running a slate of nominees for half the board, an idea that D.F. King thought would be unsuccessful because it would not command support by ISS.[64] TCI continued other preparations as well. It identified Tim O'Toole as a potential director nominee at the end of September, and Amin contacted him on October 6 to arrange a meeting between him and Hohn.[65] After the meeting, Amin put O'Toole in touch with an attorney at Schulte Roth, TCI's counsel, "to discuss what a process may look like."[66]

TCI continued to press CSX. It sent an open letter to the board on October 16 in which it stated that it owned 4.1 percent of CSX's shares as a "long-term investor." Hohn and Amin reiterated demands that the board (1) "[s]eparate the [c]hairman and CEO roles," (2) "[r]efresh the [b]oard with new independent directors," (3) "[a]llow shareholders to call special shareholder meetings," (4) "[a]lign management compensation with shareholder interests," (5) "[p]rovide a plan to improve operations," (6) "[j]ustify the capital spending plan," and (7) "[p]romote open and constructive relations with labor, shippers and shareholders."[67] They requested also that the board

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[63] PX 128; Tr. (Behring) at 107.

[64] PX 135, at TCI0955614.

[65] PX 192; Tr. (Behring) at 136.

[66] PX 139.

[67] PX 140, at CSX CORP 00007180-81.

freeze growth investment until the fate of any regulatory legislation becomes more apparent.[68] Hohn and Amin concluded that they "sincerely hope[d that CSX would] act now – and act voluntarily – to address the serious issues facing CSX."[69] TCI followed with a second open letter on October 22 in which it criticized CSX's response to its first letter as "pandering to Washington" and its management's statements to lawmakers as "reckless and "irresponsible."[70]

7. TCI Concentrates its Swaps in Deutsche Bank and Citigroup

As the likelihood of a proxy fight increased, TCI began to address the matter of its voting power.

From the inception of its TRS acquisitions in October 2006 until the end of October 2007, TCI carefully distributed its swaps among eight counterparties so as to prevent any one of them from acquiring greater than 5 percent of CSX's shares and thus having to disclose its swap agreements with TCI. On October 30, 2007, however, TCI began unwinding its TRSs with Credit Suisse, Goldman Sachs, J.P. Morgan, Merrill Lynch, Morgan Stanley, and UBS and replacing them with TRSs with Deutsche Bank and Citigroup. Ultimately, it shifted exposure equal to approximately 9 percent of CSX from other counterparties into Deutsche Bank and Citigroup.

TCI contends that it did this for two reasons. It claims first that it was motivated by the credit market crisis, believing that Deutsche Bank and Citigroup, as commercial banks backed by

[68] *Id.* at CSX CORP 00007192.

[69] *Id.* at CSX CORP 00007193.

[70] DX 52, at CSX_00001013-14.

governmental central banks, would reduce TCI's exposure to counterparty credit risk. Perhaps so. But there was another and, from TCI's point of view, far more important reason for this move. The likelihood of its counterparties voting the hedge shares with TCI was very much on its mind. Indeed, Hohn stated that he and Amin

> "discussed whether picking Deutsche Bank and Citigroup would be beneficial in terms of a potential vote of any hedge shares in a potential proxy fight. With respect to Deutsche Bank, we speculated that it might be helpful that a hedge fund within Deutsche Bank, Austin Friars Capital, also had a proprietary position in CSX."[71]

But Hohn was modest. As the record demonstrates, TCI and Austin Friars had been working together, at least to some degree, on the CSX project for some time. TCI had consulted Deutsche Bank about its LBO proposal. And, as we shall see, there is additional reason to believe that Deutsche Bank was exceptionally receptive, to say the least, to TCI's goals and methods.

8. TCI Enters into Agreements with Two Director-Nominees

TCI had met with Tim O'Toole in October to gauge his interest in being nominated for the CSX board. On December 6, 2007, O'Toole purchased 2,500 shares of CSX stock, which qualified him for election, and on December 10 entered into a formal agreement to be a nominee for the board.[72] The next day, and after a two week negotiation, Gary Wilson also agreed to be a nominee for TCI's slate of directors.[73]

[71] DX 144 (Hohn) ¶ 30; DX 145 (Amin) ¶¶ 46-47.

[72] PTO ¶ 31; DX 61.

[73] DX 64.

B. 3G

1. 3G Develops a Position in CSX

3G began to analyze the investment potential of the North American railroad industry during 2005 and 2006 but began to focus on CSX only toward the end of 2006 and beginning of 2007.[74] It claims that it perceived CSX to be 3G's best investment opportunity because it thought that (1) the share price of CSX was "less likely to decrease and more likely to appreciate over time as compared with other railroads," (2) "CSX had a large proportion of legacy contracts at below-market prices that would expire and could then be re-priced over time" to increase revenues, and (3) "CSX had substantial upside potential from improving operational efficiency."[75]

During the first week of February, Daniel Schwartz of 3G contacted CSX's investor relations department to inquire about the company.[76] He then emailed Behring on February 7 to indicate that the deadline had passed for CSX shareholders to submit proposals to be included in the company's proxy materials, including board nominations, for that year's annual general meeting. As 3G was not then a shareholder of CSX – indeed, it had no investments in or exposure to it of any kind – this demonstrates its interest in a proxy fight right from the outset.[77]

74 DX 146 (Behring) ¶¶ 16-19.

75 *Id.* ¶ 21.

76 PTO ¶ 17.

77 Its denial of this at trial was not credible.

3G made its first investment in CSX on February 9, purchasing 1.7 million shares of common stock.[78] In the week ended February 16, it amassed 8.3 million shares, or 1.9 percent of shares outstanding.[79] 3G then sold 17,340 shares and temporarily stopped trading.[80]

Behring wrote to CSX's Ward on February 27 to request a meeting. He explained that his interest stemmed from his ownership of approximately 2 percent of CSX shares.[81] Baggs responded on Ward's behalf, stating that he was available to discuss the railroad industry and CSX, but indicating that the J.P. Morgan investor/analyst conference, scheduled in the middle of March, might be a convenient time for Behring to meet with Ward.[82] Behring attended the conference and introduced himself to Ward, who agreed to arrange a meeting with 3G representatives.[83]

78 PX 206; Subrahmanyam Report Ex. C.2. Behring asserted in his witness statement that this purchase was made on February 8, *see* DX 146 (Behring) ¶ 22, but agreed at trial that it actually occurred on February 9. Tr. (Behring) at 97, 140.

79 PX 206; Subrahmanyam Report Ex. C.2.

3G's sudden and high volume trading in CSX shares raised interest at UBS, one of 3G's prime brokers. A UBS representative asked 3G why it had focused on CSX, and observed that its CSX holdings represented "a very sizeable position and not something that fit[] into [its] regular trading patterns." PX 63.

80 PX 206; Subrahmanyam Report Ex. C.2.

81 DX 11, at CSX_00007286-87.

82 *Id.* at CSX_00007285-86.

83 DX 146 (Behring) ¶ 30. This meeting never occurred.

2. 3G Resumes Buying CSX Shares

On March 29, 2007, 3G began to purchase shares of CSX stock at a rapid rate. Between that date and April 17, it acquired 11.1 million shares, bringing its holdings to 4.4 percent of the company's outstanding stock.[84] Its April 2 purchases alone represented 89.6 percent of the total daily volume of trading in CSX stock.[85] But it stopped buying as abruptly as it began and made no further investments in CSX between April 17 and August 15.[86]

3G nevertheless remained very much interested in CSX. It attended the Bear Stearns Conference on May 8 and heard Amin's speech, which Schwartz characterized as "an amazing speech, ripping into csx mgmt!!!! [*sic*]."[87] It monitored the price of CSX stock during the speech and noted that it rose to $46.50, up 1.3 percent.[88] On May 9, 2007, Schwartz telephoned CSX to find out the results of votes conducted at the May 2 annual general meeting on various shareholder proposals.[89] He called again on May 17 to seek a meeting between 3G and CSX, a meeting that CSX

84 PX 206; Subrahmanyam Report Ex. C.2.

85 Docket item 61 ¶ 80.

86 PX 206.

87 PX 94.

88 *Id.*

89 PX 268 (Baggs) ¶ 19.

refused to have. The two parties ultimately[90] agreed to arrange a June visit to CSX's Jacksonville headquarters.[91]

3. 3G's Hart-Scott-Rodino Filing

Baggs and Munoz met with 3G at its New York offices on June 11. Behring told CSX that 3G would be making a Hart-Scott-Rodino premerger notification filing, which it subsequently did on June 13.[92] In a subsequent letter to CSX confirming the filing, 3G indicated that it intended to acquire shares of CSX common stock in excess of $500 million and that it might acquire more than 50 percent.[93]

4. 3G Sells Some Shares

Notwithstanding its Hart-Scott-Rodino filing, 3G did not change its investment position in CSX for nearly four months after its purchase on April 17. Starting in the middle of August, however, it began once again to increase its holdings, purchasing about 493,000 shares on August 15 and then entering into its first TRSs, which referenced 1.7 million CSX shares, on August

90 CSX initially declined to meet without documentation of 3G's holdings. *See* Tr. (Baggs) at 52. 3G then had Morgan Stanley write to CSX and state that 3G held 19,407,894 shares of CSX common stock in an account there. DX 30.

91 DX 146 (Behring) ¶¶ 34, 41.

92 PTO ¶¶ 20-21.

93 PX 105.

16.[94] Between August 24 and September 14, however, it sold 8.3 million CSX shares, over 40 percent of its position.[95] The Court deals with those sales below.

5. 3G Rebuilds its Investment in CSX

By September 15, 3G held 11.6 million shares and swaps referencing 1.7 million shares, giving it economic exposure to just over 3 percent of the shares outstanding, and had stopped reducing its exposure. On September 26, 3G reversed course again and began increasing its direct position. By October 15, it had purchased 5.2 million shares and held 3.8 percent of the shares outstanding. Together with its swaps, it had economic exposure to 4.2 percent of the shares outstanding.

6. 3G Prepares for a Proxy Fight

During this period, 3G also began to pursue possible nominees for the CSX board. It identified Behring as one potential candidate and focused on Gil Lamphere, a former director of Canadian National Railway, as another.[96] Following an October 12 meeting, Lamphere put together

94 The counterparty for these swaps was Morgan Stanley. PX 206; Subrahmanyam Report Ex. C.2.

95 PX 206; Subrahmanyam Report Ex. C.2.

96 DX 146 (Behring) ¶¶ 44-45. Schwartz contends that Behring identified Lamphere by reviewing annual reports. *See* Docket item 61 ¶ 106.5.

an operating plan for CSX entitled "Project Improve."[97] On November 2, Lamphere met with 3G's lawyers at Kirkland & Ellis.[98] He then purchased 22,600 shares of CSX stock, thus qualifying for election to the board, and, on December 10, 2007, entered into a formal agreement to be a board nominee.[99]

3G simultaneously acquired more shares and entered into more swaps. On November 1, it increased its physical holdings in CSX by 421,300 shares.[100] Between November 1 and 8, it entered into TRSs referencing an additional 1.58 million CSX shares.[101] On November 8, the final day on which 3G's CSX position changed, it held 4.1 percent of the shares outstanding and had swaps referencing 0.8 percent of shares outstanding, for an aggregate economic exposure of 4.9 percent of the company.[102]

97 PX 142. The Court does not credit Lamphere's deposition testimony that Schwartz created the document.

98 PX 194, at LAM 0000237; PX 145.

99 PTO ¶ 30.

100 PX 206; Subrahmanyam Report Ex. C.2.

101 *Id.*

102 *Id.*

C. The Relationship Between TCI and 3G

TCI and 3G have had a long-standing relationship. Synergy, a fund under the 3G umbrella, has been an investor in TCI since its beginning.[103] TCI and 3G thus are well known to and communicate regularly with each other. Moreover, TCI is widely regarded as an "activist" hedge fund. This was of considerable interest to 3G, which regarded itself as inexperienced in playing such a role. Behring therefore sought out Hohn for the purpose of educating himself in this area.[104]

1. 3G Learns of TCI's Interest in CSX

In the early part of 2007, Synergy received a letter from TCI disclosing the industries in which TCI was invested. The report showed a very large holding in "U.S. transportation."[105]

Behring contacted TCI to inquire as to what this meant, He was particularly interested in TCI's holdings in the railroad industry.[106] Hohn told him that TCI had "an interest in CSX," the size of which could be deduced from TCI's overall position in the railroad industry. While Hohn professes not to recall having told Behring of TCI's exact holdings in the company,[107] it would have been entirely natural for him to have disclosed at least the approximate size of TCI's holding. The Court finds that he did so.

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[103] Docket item 61 ¶ 15.

[104] Tr. (Behring) at 122-23.

[105] Tr. (Hohn) at 159.

[106] *Id.* at 160.

[107] *Id.* at 160-61.

2. 3G and TCI Discuss Activity in CSX

As discussed above, 3G purchased its first shares of CSX on February 9 and made additional purchases on February 12. These were no piddling acquisitions. Its purchases over these two days constituted approximately 24 percent of the total market volume for CSX shares.[108] Moreover, its purchasing continued through February 16, by which time 3G had accumulated 8.3 million shares of CSX. In addition, 3G entered into some CSX credit default swaps ("CDS") on February 13 and 14.[109]

These events coincided with an email that Hohn sent to Amin on February 13 with the subject line "Re: Arcelor Brasil MTO - urgent." The first paragraph stated that Hohn wanted to discuss communications that Amin had had with a third party regarding Arcelor Brasil. In the next paragraph, however, Hohn raised a new subject. He wrote that "[i]ncreased activity in csx cds [*sic*] has caused excitement in the stock. I want to also discuss our friend alex [*sic*] of Brazil."[110]

Hohn admitted that he spoke with Behring in relation to this email and that the conversation occurred at about the time the email was sent. At trial, however, he denied that his interest in discussing his "friend Alex" with Amin, or his conversation with Behring that occurred at this time, related to CDS activity in CSX.[111]

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[108] Docket item 61 ¶ 53.

[109] PX 274.

[110] PX 42.

[111] Tr. (Hohn) at 156 ("If you read the email, again, you see the title is Arcelor Brasil. It does not say that I wanted to speak to him about CDS swaps. In fact, I wanted to speak to him about Arcelor Brasil, which was a $500 million position for us where we were engaged in

This testimony is not credible except perhaps in an extremely literal sense. 3G was interested in CSX no later than January 2007 and Hohn knew it. 3G purchased a very large volume of CSX shares in the open market immediately before the email. Its CDS transactions, on the other hand, were a handful of private contracts that were characterized by defense counsel as "a tiny minuscule hedge," costing only $10,000 a year, "of what became an over billion dollar equity position."[112] The likelihood therefore is that Hohn's email "misspoke" in referring to 3G's *CDS* transactions, the intention being to refer to its *stock* purchases. But whether the reference was intended to be to CDSs or shares, the real "excitement" concerned the volume of trading in CSX shares, not a few private CDS transactions. The Court infers that Hohn wanted to discuss his "friend Alex" with Amin because he was concerned that 3G was acting in a manner that risked having the marketplace become aware of the accumulation of a position that might presage a control battle.

3. 3G and TCI Meet on March 29

This conclusion dovetails with the fact that 3G made no investments in CSX from February 22 until March 29. On the latter date, Behring met with Amin in New York.[113] Each

an issue with the Brazilian SEC ruling on a minority buyout. I wanted to get Alex's views on whether the Brazilian SEC, how they would deal with the situation."). His reasoning, however, is not credible, as a discussion with Behring arose only after Hohn focused on CSX. Moreover, Hohn's current explanation is undermined by his deposition testimony, in which he claimed that he did not know that "friend Alex of Brazil" referred to Alex Behring. *See* Docket item 61 ¶ 55.

[112] Tr., June 9, 2008, at 53.

[113] PX 66.

claimed not to recall attending that meeting,[114] but both testified, unpersuasively, that they did not discuss their respective holdings in CSX.[115] On that very day, however, 3G resumed purchasing CSX stock, buying 11.1 million more shares by April 18. In addition, during this period, the waiting period resulting from TCI's HSR Act filing expired, and TCI also began purchasing CSX common stock, accumulating 17.6 million shares by April 18.

4. TCI and 3G Inquire of CSX Regarding a Shareholder Vote

TCI and 3G, along with many other investors and CSX, attended the Bear Stearns Transportation Conference on May 8, 2007, at which Amin made his speech about TCI's position and interest in CSX.

The next day, TCI contacted CSX to inquire about the results of shareholder voting at the CSX annual general meeting held one week earlier.[116] 3G made the same inquiry, as did several other investors.[117] According to Baggs, who had been the vice president of investor relations for over

[114] Tr. (Behring) at 99; *id.* (Amin) at 196. Behring, however, admitted that he met with Amin from time to time and that he could have met with him around March 29, *see id.* (Behring) at 102, and Amin testified that he had no reason to believe that the meeting did not occur. *Id.* (Amin) at 196.

[115] *Id.* (Behring) at 102; (Amin) at 197.

[116] PX 207.

[117] *See* PX 268 (Baggs) ¶ 19; PX 101.

three years and with the company for over twenty, this "was the first instance in [his] experience of having investors calling about the outcome of a particular shareholder proposal."[118]

5. The August-September Pause

We have seen already that TCI began professing concern about the risk of reregulation of railroads in August 2007. And for a period of about two weeks, TCI and 3G evidenced that concern. Both reduced their positions. Between August 23 and August 31, TCI reduced its exposure to CSX by nearly 2 million shares.[119] Indeed, Amin told Hohn on September 12, 2007 that he wished that TCI had sold CSX "10 dollars ago."[120] And over almost the same period – August 24 to September 14 – 3G sold 8.3 million CSX shares, over 40 percent of its position.[121] But this change of heart was temporary.

6. TCI and 3G Ramp Up Again

On September 20, just six days after 3G completed the sales referred to above, TCI informed D.F. King that it likely would go ahead with a proxy contest and began looking for suitable

118 PX 268 (Baggs) ¶ 19.

119 Subrahmanyam Report Ex. C.1.

120 PX 126, at TCI0017049

121 PX 206; Subrahmanyam Report Ex. C.2.

director-nominees. During that same time period, 3G contemplated proposing Behring as a director-nominee.[122]

Amin and Behring met again on September 26. Although both parties deny that they discussed anything related to the purchase of CSX common stock, they both admitted that the topic of CSX likely arose and that each knew that the other had an investment position in the company.[123] And just as occurred on March 29, the date of an earlier Amin-Behring meeting, 3G again began buying CSX holdings on the day of this September 26 meeting.[124] By October 15, it had purchased over 5 million shares, bringing its physical holdings to 16.8 million shares.

7. TCI and 3G Search for Director Nominees

TCI and 3G both began searching for director-nominees during the same time period. TCI identified Tim O'Toole as a potential candidate and contacted him on October 6 to arrange a meeting. Hohn and O'Toole met in London on October 8.

By October 5, Behring, he says, was reviewing annual reports to identify suitable director candidates. He identified Lamphere around that time and met with him in New York on October 8.

122 DX 146 (Behring) ¶ 44.

123 Tr. (Behring) at 124-27; *id.* (Amin) 197. The Court does not credit Amin's testimony that they never discussed buying or selling CSX stock.

124 PX 206; Subrahmanyam Report Ex. C.2.

Behring met with Lamphere again on October 12 and then met with Amin on October 17. He denied having told Amin during that meeting that 3G was searching for nominees and that it had met twice with a potential candidate.

V. The Proxy Contest

A. TCI and 3G Disclose the Formation of a Formal Group

On December 10, 2007, Lamphere[125] and O'Toole[126] entered into nominee agreements with 3G and TCI, respectively, and on December 11, Gary Wilson agreed with TCI to be a nominee.[127]

On December 19, 2007, TCI, 3G, Lamphere, O'Toole, and Wilson (the "Group") filed a Schedule 13D with the SEC. The filing disclosed that they had "entered into an agreement to coordinate certain of their efforts with regard [*sic*] (i) the purchase and sale of [various shares and instruments] and (ii) the proposal of certain actions and/or transactions to [CSX]."[128] It stated that the Group disclosed that it collectively owned 8.3 percent of CSX shares outstanding, all of which were said to have been "originally acquired . . . for investment in the ordinary course of business" save for the 25,100 purchased by Lamphere and O'Toole in connection with becoming director

125 DX 70.

126 DX 61.

127 DX 145 (Amin) ¶ 60.

128 JX 8 (Item 5).

nominees.[129] The Group disclosed that it "intend[ed] to conduct a proxy solicitation" but "ha[d] no present plan or proposal that would relate to or result in any of the matters set forth in subparagraphs (a) - (j) of Item 4."[130] The Group reserved the right to take future action that it deemed appropriate.

The 13D disclosed also that TCI had cash-settled equity swap arrangements with eight counterparties that gave it economic exposure to approximately 11 percent of CSX's shares outstanding. 3G similarly disclosed its swap economic exposure to 0.8 percent, all of which was held with Morgan Stanley. Both disclaimed beneficial ownership of the underlying shares referenced by their TRSs.[131]

B. The Group Files Its Notice of Intent to Nominate Directors

Pursuant to CSX's amended and restated bylaws, the Group filed a "Stockholder Notice of Intent to Nominate Persons for Election as Directors of CSX Corporation" ("Notice") on January 8, 2008.[132]

129 *Id*. (Item 4). TCI had paid $762,251,613, including commissions, to acquire the 17,796,998 shares that it held and 3G had paid $707,588,338, including commissions, for its 17,232,854 shares. *Id.* (Item 3).

130 *Id.* (Item 4).

131 *Id.* (Item 6).

132 DX 72.

C. CSX and TCI Attempt to Negotiate a Resolution

Edward Kelly, the presiding director of the CSX board, met with Hohn in January to see whether a proxy contest could be avoided. CSX expressed a willingness to nominate three of the Group's director nominees, including Hohn and Behring, and a fourth mutually acceptable candidate.[133] But Kelly and Hohn were unable to agree on a fourth candidate.[134]

Hohn's efforts in the negotiations were not limited to seating directors on the board. On January 14, he demanded that (1) he be able to interview the current directors, dictate which directors the Group's three nominees would replace, and determine which committees they would be seated on, (2) the roles of CEO and chairman be split, (3) the board's size not be increased without approval of the shareholders or 80 percent of the board, and (4) shareholders controlling 10 or 15 percent of the outstanding shares of voting stock be permitted to call a special meeting at any time and for any legally permissible purpose.[135] Hohn told Kelly that he would create a dissident board and make things unpleasant for Kelly. Moreover, he told Kelly that if TCI were successful in electing

[133] PX 266 (Kelly) ¶ 23; DX 144 (Hohn) ¶ 45; PX 161, at TCI0874906.

[134] *See* PX 157, 158, 161, 163.

[135] PX 266 (Kelly) ¶ 23; PX 165. Amin noted that it was "very unfortunate[]" that Hohn articulated his demands in an email. *See* PX 275, at TCI0959364; Tr. (Amin) at 208. He claims to have said that because he thought such matters were "better discussed in person so that there is no confusion about what's being requested." Tr. (Amin) at 208. This testimony, which borders on the absurd, is patently incredible.

its five directors, Ward's future would be "bleak."[136] Kelly responded on January 16 that he was "concerned about [Hohn's] apparent interest in gaining effective control."[137]

The two sides met the next day, and Kelly inquired as to whether Hohn would be interested in a standstill agreement.[138] Hohn was not receptive to the idea so, on January 18, Kelly informed Hohn that the differences between CSX and TCI would be "impossible to bridge," particularly because of Hohn's position that a standstill agreement, no matter its contents, would not be acceptable.[139]

Three days later, the Group supplemented its Notice to include its intent to present a proposal that would amend the CSX bylaws to allow shareholders holding at least 15 percent of all shares outstanding the ability to call a special meeting.[140]

[136] PX 266 (Kelly) ¶ 25.

[137] PX 167.

[138] DX 306, at CSX_00035073.

[139] PX 169.

[140] PTO ¶ 33; JX 9. The Group filed an additional supplemental notice on January 25 proposing to repeal any bylaws passed by the board from January 1, 2008, onward. JX 10. The effect of this proposal would be to repeal the board's February 4, 2008, amendment to the bylaws that permitted shareholders of fifteen percent or more of a class of stock to call a special meeting.

D. CSX and The Group File Proxy Materials

1. CSX

CSX filed a preliminary proxy statement on February 21 and a revised version on February 22, 2008. It urged shareholders to vote for the board's proposed directors and not to vote for any nominees offered by the Group.[141] It stated also that the shareholders would be presented with three proposals concerning their ability to call a special meeting: one supported by CSX, one by TCI, and a third.

CSX proposed amending the bylaws to permit holders of 15 percent of the company's outstanding shares to require the board to call a special meeting unless the proposed topic of the meeting had been voted on within the previous year or would be voted on at the annual meeting within the next ninety days.[142] It urged that its proposal provided safeguards against the use of such meetings as a mechanism for disruption or delay that were lacking in the other proposals.[143]

2. The Group's Proxy Statement

The Group filed its preliminary proxy statement on March 10, 2008. It proposed Hohn, Behring, Lamphere, O'Toole, and Wilson for election to the board and advocated its proposal to permit investors holding at least 15 percent of CSX stock to call a special meeting for any purpose permissible under Virginia law. The materials noted that the Group collectively held 35.1 million

[141] JX 3, at third page.

[142] *Id.* at page 57.

[143] *Id.* The third proposal ultimately was withdrawn.

shares, representing approximately 8.7 percent of those outstanding, and that the value of its investment in CSX exceeded $1.65 billion.[144] It disclosed its members' swap arrangements and the aggregate percentage of CSX shares to which they provided economic exposure.[145] It disclosed also that Deutsche Bank beneficially owned 36.7 million shares of CSX, or 9.1 percent of the common stock.[146]

VI. The Positions of the Parties

CSX contends that (1) TCI violated Section 13(d) of the Exchange Act by failing to disclose its beneficial ownership of shares of CSX common stock referenced in their TRSs and (2) TCI and 3G violated Section 13(d) by failing timely to disclose the formation of a group. It argues further that TCI and 3G violated Section 14(a) of the Exchange Act because their proxy statements were materially false and misleading. Its state law claim contends that defendants' notice of intent to nominate directors failed to comply with CSX's bylaws in violation of Section 13.1-624 of the Virginia Stock Corporation Act.[147]

Defendants contend first that CSX and Ward violated Section 14(a) of the Exchange Act because the CSX proxy statement is materially false and misleading concerning (1) executive compensation and director stock awards, and (2) the defendants and their intentions. They allege also

[144] JX 12, at fourth page.

[145] *Id.* at page 15.

[146] *Id.* at page 17. This fact was disclosed in CSX's proxy materials as well.

[147] PTO, at 92-93.

that a bylaw amendment passed by CSX on February 4 concerning shareholder special meetings violates Section 13.1-680 of the Virginia Stock Corporation Act.[148]

Discussion

I. Section 13(d)

The Williams Act, which enacted what now is Section 13(d) of the Exchange Act, was passed to address the increasing frequency with which hostile takeovers were being used to effect changes in corporate control.[149] Section 13(d) in particular 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."[150]

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148 *Id.* at 93-94.

149 *See* Act of July 29, 1968, Pub. L. No. 90-439, § 2, 82 Stat. 454 (1968). Senator Williams opened the hearings on the legislation by stating that filling the large gap in the disclosure requirements of the securities laws, a step already taken at that point by several other countries, would ensure that

> "[a]ll will be able to deal in the securities markets knowing that all of the pertinent facts are available. This is the premise under which our securities markets are supposed to work. Following this premise they have thrived and prospered over the years. Now is the time to eliminate the last remaining areas where full disclosure is necessary but not yet available."

Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids: Hearing Before the Subcomm. on Securities of the S. Comm. On Banking and Currency, 90th Cong., 1st Sess. 2-3 (1967) (statement of Sen. Williams, Chairman, Senate Subcomm. on Securities).

150 *GAF Corp. v. Milstein*, 453 F.2d 709, 717 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972).

The core of the statute for present purposes is Section 13(d)(1), which provides in relevant part that

> "Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is registered pursuant to section 78*l* 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 such of the following information, and such additional information, as the Commission may by rules and regulations, prescribe as necessary or appropriate in the public interest or for the protection of investors–
>
> "(A) the background, and identity, . . . and the nature of such beneficial ownership by, such person and all other persons by whom or on whose behalf the purchases have been or are to be effected;
>
> * * *
>
> "(C) if the purpose of the purchases or prospective purchases is to acquire control of the business of the issuer of the securities, any plans or proposals which such persons may have to liquidate such issuer, to sell its assets to or merge it with any other persons, or to make any other major change in its business or corporate structure;
>
> "(D) the number of shares of such security which are beneficially owned, and the number of shares concerning which there is a right to acquire, directly or indirectly, by (i) such person, and (ii) by each associate of such person, giving the background, identity, residence, and citizenship of each such associate . . . ."[151]

In order to prevent circumvention of Section 13(d)(1), Section 13(d)(3) further provides that "[w]hen two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose

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151 15 U.S.C. § 78m(d)(1).

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."[152]

The heart of the dispute presently before the Court concerns whether (1) TCI's investments in cash-settled TRSs referencing CSX shares conferred beneficial ownership of those shares upon TCI, and (2) TCI and 3G formed a group prior to December 12, 2007.

A. Beneficial Ownership

The concept of "beneficial ownership" is the foundation of the Williams Act and thus critical to the achievement of its goal of providing transparency to the marketplace.[153] Although Congress did not define the term, its intention manifestly was that the phrase be construed broadly.[154]. The SEC did so in 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.

152 *Id*. § 78m(d)(3).

153 *See Takeover Bids: Hearing Before the Subcomm. on Commerce and Finance of the H. Comm. on Interstate and Foreign Commerce*, 90th Cong., 2d Sess. 40-41 (1968) (statement of Manuel F. Cohen, Chairman, Securities and Exchange Commission) ("[B]eneficial ownership is the test. [The acquiring entity] might try to get around it, and that would be a violation of law, but the legal requirement is beneficial ownership.").

154 *See, e.g., Wellman v. Dickinson,* 682 F.2d 355, 365-66 (2d Cir. 1982) (rejecting narrow construction of § 13(d)(3) in light of legislative history), *cert. denied* 460 U.S. 1069 (1983).

> "(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 of [*sic*] 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 (g) of the Act shall be deemed for purposes of such sections to be the beneficial owner of such security."[155]

The SEC intended Rule 13d-3(a) to provide a "broad definition" of beneficial ownership so as to ensure disclosure "from all those persons who have the ability to change or influence control."[156] This indeed is apparent from the very words of the Rule. By stating that a beneficial owner "includes" rather than "means" any person who comes within the criteria that follow, it made plain that the language that follows does not exhaust the circumstances in which one might come within the term.[157] The phrases "directly or indirectly" and "any contract, arrangement, understanding, relationship, or otherwise" reinforce that point and demonstrate the focus on substance rather than on form or on the legally enforceable rights of the putative beneficial owner. It therefore is not surprising that the SEC, at the very adoption of Rule 13d-3, stated that the determination of beneficial ownership under Rule 13d-3(a) requires

155 *See* 17 C.F.R. § 240.13d-3.

156 Filing and Disclosure Requirements Relating to Beneficial Ownership, Exchange Act Release Nos. 33-5925, 34-14692, 43 Fed. Reg. 18,484, 18,489 (Apr. 28, 1978); Interpretive Release on Rules Applicable to Insider Reporting and Trading, Exchange Act Release No. 34-18114, 46 Fed. Reg. 48,147 (Oct. 1, 1981) (indicating that the concept of beneficial ownership under Section 13(d) "emphasizes the ability to control or influence the voting or disposition of the securities.").

157 *See, e.g., Fed. Land Bank of St. Paul v. Bismarck Lumber Co.*, 314 U.S. 95, 99-100 (1941); *United States v. Huber*, 603 F.2d 387, 394 (2d Cir. 1979), *cert. denied* 445 U.S. 927 (1980); *W. 79th St. Corp. v. Congregation Kahl Minchas Chinuch*, No. 03 Civ. 8606 (RWS), 2004 WL 2187069, at *5 (S.D.N.Y. Sept. 29, 2004).

> "[a]n analysis of all relevant facts and circumstances in a particular situation . . . in order to identify each person possessing the requisite voting power or investment power. For example, for purposes of the rule, the mere possession of the legal right to vote securities under applicable state or other law . . . may not be determinative of who is a beneficial owner of such securities inasmuch as another person or persons may have the power whether legal, economic, or otherwise, to direct such voting."[158]

Nor does Rule 13d-3(a) exhaust the Commission's efforts to cast a very broad net to capture all situations in which the marketplace should be alerted to circumstances that might result in a change in corporate control. Rule 13d-3(b) was adopted so that Rule 13d-3(a) "cannot be circumvented by an arrangement to divest a person of beneficial ownership or to prevent the vesting of beneficial ownership as part of a plan or scheme to evade the reporting requirements of [S]ection 13(d)."[159]

With these considerations in mind, the Court turns to CSX's contentions. It first considers whether TCI had beneficial ownership, within the meaning of Rule 13d-3(a), of the shares of CSX stock referenced by its swap agreements and held by its counterparties by considering the facts and circumstances surrounding those contracts. It then turns to the question of whether TCI, assuming it were not a beneficial owner of the hedge shares under Rule 13d-3(a), nevertheless would be deemed a beneficial owner under Rule 13d-3(b) because it used the TRSs as part of a plan or scheme to evade the disclosure requirements of Section 13(d) by avoiding the vesting of beneficial ownership in TCI.

158 Adoption of Beneficial Ownership Disclosure Requirements, Exchange Act Release Nos. 33-5808, 34-13291, 42 Fed. Reg. 12,342, 12,344 (Mar. 3, 1977)(emphasis added).

159 *Id.*

1. Rule 13d-3(a)

The contracts embodying TCI's swaps did not give TCI any legal rights with respect to the voting or disposition of the CSX shares referenced therein. Nor did they require that its short counterparties acquire CSX shares to hedge their positions. But the beneficial ownership

> "inquiry focuses on any relationship that, as a factual matter, confers on a person a *significant ability to affect* how voting power or investment power will be exercised, because it is primarily designed to ensure timely disclosure of market-sensitive data about changes in the identity of those who are able, as a practicable matter, to influence the use of that power."[160]

It therefore is important to consider whether TCI's TRSs contemplated that its counterparties would hedge their positions with CSX shares and, if so, whether TCI had "a significant ability to affect how voting power or investment power will be exercised."

a. Investment Power

TCI acknowledges, as it must, that its swaps contemplated the possibility that the counterparties might – indeed would – hedge by acquiring physical shares. It emphasizes, however, that they were under no contractual obligation to do so and, indeed, had other means of hedging their short positions. Moreover, TCI asserts that it had no influence over how its counterparties disposed

160 *SEC v. Drexel Burnham Lambert Inc.*, 837 F. Supp. 587, 607 (S.D.N.Y. 1993) (internal quotation marks and emphasis omitted), *aff'd sub nom. SEC v. Posner*, 16 F.3d 520 (2d Cir. 1994), *cert. denied,* 513 U.S. 1077 (1995) (emphasis added). *Accord* Filing and Disclosure Requirements Relating to Beneficial Ownership, Exchange Act Release Nos. 33-5925, 34-14692, 43 Fed. Reg. 18,484, 18,489 (Apr. 28, 1978) (Rule 13d-3(a) requires disclosure "from all those persons who have the ability to change *or influence* control") (emphasis added); Interpretive Release on Rules Applicable to Insider Reporting and Trading, Exchange Act Release No. 34-18114, 46 Fed. Reg. 48,147 (Oct. 1, 1981) (indicating that the concept of beneficial ownership under Section 13(d) "emphasizes the ability to control or *influence* the voting or disposition of the securities.") (emphasis added).

of physical shares used to hedge a swap, if any, at the time of termination. TCI therefore maintains that it had no investment power over any shares used to hedge its swaps.

TCI correctly describes the legal instruments constituting the swaps. They do not require the counterparties to hedge their positions by purchasing CSX stock and do not in terms address the question of how the counterparties will dispose of their hedges at the conclusion of the swaps. But the evidence is overwhelming that these counterparties in fact hedged the short positions created by the TRSs with TCI by purchasing shares of CSX common stock. As the charts set forth in Appendix 1 show, they did so on virtually a share-for-share basis and in each case on the day or the day following the commencement of each swap.[161]

This is precisely what TCI contemplated and, indeed, intended. None of these counterparties is in the business, so far as running its swap desk is concerned, of taking on the stupendous risks entailed in holding unhedged short (or long) positions in significant percentages of the shares of listed companies. As a practical matter, the Court finds that their positions could not be hedged through the use of other derivatives.[162] Thus, it was inevitable that they would hedge the TCI swaps by purchasing CSX shares.

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161 Four of the counterparties – Citigroup, Deutsche Bank, Morgan Stanley, and UBS – purchased shares to hedge its corresponding swap short position every time they and TCI entered into a TRS. *See* Subrahmanyam Rebuttal Report, at 12. Deutsche Bank in each case did so on the same day on which the TRS was transacted. *See id*. at 12. Merrill Lynch hedged fifteen of its sixteen swaps by purchasing an equivalent number of matching shares, all on the same day as the swap transaction, and Credit Suisse hedged fourteen of its sixteen swaps in the same manner, all on the same day as the swaps. *Id.* (No data were provided for Goldman or J.P. Morgan.)

162 *See* Subrahmanyam Report ¶¶ 87-102 (explaining why alternative instruments used to hedge risk were not economically practical for the bank counterparties).

TCI knew that the banks would behave in this manner and therefore sought at the outset to spread its TRS agreements across a number of counterparties so as to avoid pushing any counterparty, individually, across the 5 percent threshold that would have triggered an obligation on the counterparty's part to disclose its position under Regulation 13D.[163] This would have been a cause for concern only if TCI understood that its counterparties, although not legally obligated to do so, in fact would hedge by purchasing CSX shares equal or substantially equal to the shares referenced by the TCI swaps.[164]

Moreover, TCI understood that there were advantages to TCI of its short counterparties hedging with physical shares. The fact that these are nominally cash-settled TRSs does not necessarily mean that they all will be settled for cash. TCI and its counterparties have the ability to agree to unwind the swaps in kind, i.e., by delivery of the shares to TCI at the conclusion of each transaction, as indeed commonly occurs.[165] That simple fact means that the hedge positions of the counterparties hang like the sword of Damocles over the neck of CSX. Once the Hart-Scott-Rodino waiting period expired, nothing more was required to move the legal ownership of the hedge shares from the banks to TCI than the stroke of a pen or the transmission of an email. This greatly enhances TCI's leverage over CSX, even if it never settles any of the TRSs for cash, as indeed has been the case to date. And TCI so views the realities as evidenced by Amin's statement to CSX that TCI's swap

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163 *See* PX 30, at TCI0929168; PX 22; PX 27.

164 Mr. Amin's testimony that TCI could not and did not assume that each counterparty would hedge the swaps by purchasing a corresponding number of physical shares, *see* Tr. (Amin) at 202-03, 205-06, simply is not credible.

165 Henry Hu & Bernard Black, 79 S. CAL. L. REV. at 868.

position could be converted to shares at any time as well as his assertion on February 15, 2007, that TCI "owned" a quantity of shares that clearly included the shares held by its counterparties.

The corollary to the bank's behavior at the front end of these transactions, viz. purchasing physical shares to hedge risk, is that the banks would sell those shares at the conclusion of the swaps (assuming cash settlement) so as to avoid the risk that holding the physical shares would entail once the downside protection of the swap was removed. And that is exactly what happened here. With very minor exceptions, whenever TCI terminated a swap, the counterparty sold the same number of physical shares that were referenced in the unwound swap and it did so on the same day that the swap was terminated.[166] Citigroup, Credit Suisse, Deutsche Bank, Goldman, and Morgan Stanley did precisely this, as did Merrill Lynch and UBS save that (1) Merrill Lynch's sales on a few occasions involved slightly different numbers of shares, and (2) UBS on five occasions sold on the day following the termination of a swap.[167]

To be sure, there is no evidence that TCI explicitly directed the banks to purchase the hedge shares upon entering into the swaps or to sell them upon termination. Nor did it direct the banks to dispose of their hedge shares by any particular means. But that arguably is not dispositive.

On this record, it is quite clear that TCI significantly influenced the banks to purchase the CSX shares that constituted their hedges because the banks, as a practical matter and as TCI both knew and desired, were compelled to do so. It significantly influenced the banks to sell the hedge shares when the swaps were unwound for the same reasons.

166 *See* Subrahmanyam Rebuttal Report Exs. 4.1 to 4.7.

167 *Id.*

b. Voting Power

There is no evidence that TCI and any of its counterparties had explicit agreements that the banks would vote their hedge shares in a certain way.[168] Moreover, the policies and practices of the counterparties with respect to voting hedge shares vary.[169] But these are not the only pertinent considerations.

(1) Deutsche Bank

Between October and November 2007, TCI moved swaps referencing 28.4 million and 18.0 million shares into Deutsche Bank and Citigroup, respectively, while leaving swaps referencing 1,000 shares with each of its remaining six counterparties.[170] Hohn offered two reasons for doing so.

First, he said that he felt that commercial banks, which are backed by governmental institutions, entailed less credit risk than investment banks. Second, he conceded that he picked

168 *See, e.g.*, DX 149 (Partnoy Report) ¶ 50.

169 Some appear to have policies that preclude its swap counterparties from influencing any votes on proprietary shares purchased to hedge swaps. Others, notably Deutsche Bank, do not prohibit swap counterparties such as TCI from influencing the manner in which it votes hedge shares. Still others appear to lack any uniform policies. Citigroup views the shares it purchases to hedge swaps as exclusively under its control and as "a matter of practice" does not vote those shares, but admitted that it "might vote" them. Kennedy Dep. at 19, 24. UBS refers "[a]ny request by a swap counterparty relating to voting of a [UBS proprietary share]" to its legal department. DX 149 (Partnoy Report) ¶¶ 49(c).

170 TCI left swaps in each of its six other counterparties to obscure the identities of its principal counterparties. Tr. (Amin) at 204-06; Docket item 70, at 64-65 ¶ 39.

Deutsche Bank and Citigroup – as opposed to other commercial banks – because he thought that "would be beneficial in terms of a potential vote of any hedge shares in a potential proxy fight."[171]

Hohn's credit risk argument is not entirely persuasive. Assuming *arguendo* that the commercial banks in general were safer than investment banks, it was by no means clear in November 2007 that Citigroup was not a credit risk, notwithstanding its backing by the Federal Reserve.[172] But it is unnecessary to pause on that point, as it is entirely clear that the move into at least Deutsche Bank was made substantially out of Hohn's belief that he could influence the voting of the shares it held to hedge TCI's swaps. As an initial matter, Hohn was well aware that Austin Friars, a hedge fund within Deutsche Bank, held a proprietary position in CSX common stock. From at least March 2007, when Austin Friars invited TCI to submit questions for and listen in on the John Snow call, the two funds shared a common interest in taking a railroad private. Nor was this the first time that they had shared detailed information about positions or plans. Hohn believed that TCI could exploit this relationship to influence how Austin Friars, and in turn how Deutsche Bank, voted its CSX shares.[173] But there is considerably more to the Deutsche Bank situation than Austin Friars.

CSX initially set the record date for voting at its annual meeting as February 27, 2008.[174] Immediately before that record date, Deutsche Bank owned 28.4 million shares to hedge its

171 DX 144 (Hohn) ¶ 30.

172 *See, e.g.*, Carrick Mollenkamp, *HSBC, the Subprime Seer: Sanguine View Isn't Likely*, WALL ST. J., Nov. 12, 2007, at C1 (noting that Citigroup was expected to announce potential write-downs of nearly $11 billion in the fourth quarter of 2007).

173 Amin's testimony to the contrary, *see* Tr. (Amin) at 218, is not credible.

174 PX 264 (Ward) ¶ 25.

short position created by its TCI TRSs.[175] Immediately preceding and following the record date, there were large and aberrant movements of CSX shares into and out of Deutsche Bank's hands.[176] CSX argues that these movements show that Deutsche Bank (1) had sought to boost revenues by loaning the shares in its hedge positions, presumably to short sellers, (2) recalled the loans so that it would own the shares on the record date and thus be entitled to vote them, (3) wished to vote those shares pursuant to an arrangement with TCI, and (4) then reloaned the shares immediately after the record date.

TCI would have the Court reject this scenario as speculative. It argues that the record date for voting coincided closely[177] with the record date determining the right to receive dividends and that it would have been quite natural for Deutsche Bank to have acted to ensure its receipt of those funds. Moreover, it argues that Deutsche Bank witnesses denied that any recall occurred.[178]

TCI's argument falls considerably short. For one thing, CSX adjourned its annual meeting and changed the record date after the record date for payment of a dividend had passed.[179] There is no evidence that the record date for the dividend was changed. Nevertheless, a similar influx

175 Subrahmanyam Rebuttal Report Ex. 4.3.

176 PX 270 (Miller) ¶¶ 16-19, 26, 28, 34; Tr. (Miller) at 76-77.

177 The coincidence was not exact. There was a two day difference. PX 16, at CSX CORP 00008177-78; PX 17, at CSX CORP 00008181.

178 Tr., June 9, 2008, at 28:18-29:5.

179 The record date for payment of dividends was February 29. The new record date for the adjourned shareholders meeting was set on March 14. PX 17, at CSX CORP 00008181; PX 18, at CSX CORP 00008206.

and outflow of shares took place around the adjourned record date.[180] In consequence, the desire to receive the dividend is not a likely explanation for what transpired. Moreover, the bank witnesses upon whom TCI relies in fact lacked any personal knowledge of the material facts.[181]

In the last analysis, the question whether there was an agreement – explicit or implicit – between Deutsche Bank and TCI with respect to the voting of the shares is a close one. In view of the grounds on which the Court ultimately disposes of this case, however, it is unnecessary to make a finding on the point.

(2) All of the Counterparties

The Court is not persuaded that there was any agreement or understanding between TCI and any of the other banks with respect to the voting of their hedge shares. But the SEC has made plain that a party has voting power over a share under Rule 13d-3(a)(1) if that party has the "ability to control *or influence* the voting . . . of the securities."[182] So the question of influence must be considered with respect to all of the banks.

As an initial matter, TCI, which knew that the banks would hedge the swaps by purchasing physical shares, could and at least to some extent did select counterparties by taking their

[180] Tr. (Miller) at 84.

[181] *See* Arnone Dep. at 39-40, 51-54; Busby Dep. at 24, 28-30, 34. In fact, TCI cites to the deposition of Arnone, *see* docket item 59, at 33, without disclosing that the pages referenced record not testimony, but a statement by counsel. *See* Arnone Dep. at 54-48.

[182] Interpretive Release on Rules Applicable to Insider Reporting and Trading, Exchange Act Release No. 34-18114, 46 Fed. Reg. 48,147 (Oct. 1, 1981) (emphasis added). *See also Wellman,* 682 F.2d at 365 n.12 (beneficial ownership not defined by Rule 13d-3 "solely as present voting power").

business to institutions it thought would be most likely to vote with TCI in a proxy contest. D.F. King's "Preliminary Vote Outlook" presentation concerning the proxy contest indicates that certain types of investors adhere to particular voting patterns in contested elections and are influenced by the recommendations made by institutional proxy advisory firms such as RiskMetrics (formerly ISS).[183] Although D.F. King was clear that it could not guarantee the manner in which a particular investor would vote, patterns of behavior made it possible for TCI to predict the likelihood of that vote and place its swap transactions accordingly.

Further, some of the banks' policies gave TCI the power to prevent a share from being voted. Credit Suisse, for example, appears to follow a policy of not voting its hedge shares if it is solicited by its counterparty in a contested situation.[184] In such instances, then, TCI could ensure that that bank's hedge shares would not be voted against it by the simple expedient of soliciting its counterparty. Thus, by entering into a TRS with Credit Suisse, TCI was in a position to ensure that Credit Suisse would purchase shares that otherwise might have been voted against TCI in a proxy fight and then to ensure that those shares would not be so voted. While this would not be as favorable a result as dictating a vote in its favor, it would be better than leaving the votes of those shares to chance.

Finally, the fact that TCI thought it could influence Citigroup at least suggests that its relationship with Citigroup permitted it to do so. Nevertheless, the proof on this point is not sufficient to find that TCI in fact had that ability.

[183] *See* PX 160, at TCI0891561-62.

[184] DX 149 (Partnoy Report) ¶ 49(a).

c. Synthesis

In the last analysis, there are substantial reasons for concluding that TCI is the beneficial owner of the CSX shares held as hedges by its short counterparties. The definition of "beneficial ownership" in Rule 13d-3(a) is very broad, as is appropriate to its object of ensuring disclosure "from all . . . persons who have the ability [even] to . . . influence control."[185] It does not confine itself to "the mere possession of the legal right to vote [or direct the acquisition or disposition of] securities,"[186] but looks instead to all of the facts and circumstances to identify situations in which one has even the ability to influence voting, purchase, or sale decisions of its counterparties by "legal, economic, or other[]" means.[187]

On this record, TCI manifestly had the economic ability to cause its short counterparties to buy and sell the CSX shares. The very nature of the TRS transactions, as a practical matter, required the counterparties to hedge their short exposures. And while there theoretically are means of hedging that do not require the purchase of physical shares, in the situation before the Court it is perfectly clear that the purchase of physical shares was the only practical alternative. Indeed, TCI effectively has admitted as much. It did so by spreading its swap transactions among eight counterparties to avoid any one hitting the 5 percent disclosure threshold and thus triggering its own reporting obligation – a concern that was relevant only because TCI knew that the counterparties were hedging by buying shares. And it did so in closing argument, where its counsel said that the banks'

185 Note 156, *supra.*

186 Note 158, *supra.*

187 *Id.*

purchases of CSX shares were "the natural consequence" of the swap transactions.[188] Thus, TCI patently had the power to cause the counterparties to buy CSX. At the very least, it had the power to influence them to do so. And once the counterparties bought the shares, TCI had the practical ability to cause them to sell simply by unwinding the swap transactions. Certainly the banks had no intention of allowing their swap desks to hold the unhedged long positions that would have resulted from the unwinding of the swaps.

The voting situation is a bit murkier, but there nevertheless is reason to believe that TCI was in a position to influence the counterparties, especially Deutsche Bank, with respect to the exercise of their voting rights.

TCI nevertheless argues strenuously against a finding that it has beneficial ownership of the shares, focusing heavily on the fact that it had no legal right to direct its short counterparties to buy or sell shares or to vote them in any particular way, indeed at all.[189] Some *amici,* more

188 Tr., June 9, 2008, at 27:33.

189 Defendants rely on an SEC interpretive release in which the Commission took the position that "[a] purchaser of a cash-settled security future (*i.e.,* a security future that, by its terms, must be settled by a cash payment) would not count the equity securities underlying the contract for purposes of determining whether he or she is subject to the Regulation 13D reporting requirements, because he or she does not have the right to acquire beneficial ownership of the underlying security." Commission Guidance on the Application of Certain Provisions to Trading in Security Futures Products, 67 Fed. Reg. 43,234, 43,240 (June 27, 2002) (listed as an interpretive release at 17 C.F.R. pts. 231 and 241).

As an initial matter, no one suggests that this interpretation resolves the question before this Court. The interpretive release involved only cash-settled securities futures, which are impersonal exchange traded transactions, and at least to that extent, unlike cash-settled equity swaps. Moreover, there is no evidence that the Commission intended this guidance to apply outside the context of cash-settled securities futures. In any case, in view of the fact that the matter is being decided on other grounds, this interpretation need not be addressed at greater length.

cautiously, urge that any finding of beneficial ownership be rooted in unique facts of this case to avoid upsetting what they say is the settled expectation of the marketplace that equity swaps, *in and of themselves,* do not confer beneficial ownership of the referenced shares. They contend that a broader ruling could have extensive implications and that the subject therefore is dealt with more appropriately by administrative agency rule making than case-by-case adjudication. And the SEC Division of Corporation Finance argues – perhaps inconsistently with some of the Commission's past statements about the breadth of the definition of beneficial ownership[190] – that there is no beneficial ownership where the short counterparties buy, sell, or vote their hedge shares as a result of their own economic incentives and not pursuant to legal obligations owed to their long counterparties, although it does not comment on the facts of this case. The Division, moreover, suggests that a contrary ruling would be novel and upset settled expectations of the market.

The focus on TCI's legal rights under its swap contracts, while those rights certainly are relevant, exalts form over substance. The securities markets operate in the real world, not in a law school contracts classroom. Any determination of beneficial ownership that failed to take account of the practical realities of that world would be open to the gravest abuse. Indeed, this Court is not alone in recognizing that abuses would be facilitated by a regime that did not require disclosure of the sort that would be required if "beneficial ownership" were construed as advocated by CSX.[191]

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190 The statements referred to, *e.g.,* note 156, *supra,* were not made in the specific context of swaps or other derivatives.

191 *See, e.g.,* Henry Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions,* 156 U. PENN. L. REV. 625, 735-37 (2008) (assuming that equity swaps do not give the long party beneficial ownership, they can be used to secure effective control without disclosure otherwise required by § 13(d)).

Moreover, the Court is inclined to the view that the Cassandra-like predictions of dire consequences of holding that TCI has beneficial ownership under Rule 13d-3(a) have been exaggerated.[192] For one thing, there is no reason to believe that there are many situations in which the 5 percent reporting threshold under Section 13(d) would be triggered by such a ruling. The overwhelming majority of swap transactions would proceed as before without any additional Regulation 13D or G reporting requirements. The issue here, moreover, is novel and hardly settled. And markets can well adapt regardless of how it ultimately is resolved. Indeed, the United Kingdom reportedly now requires disclosure of economic stakes greater than 1 percent in companies involved in takeovers and is considering requiring disclosure at the 3 percent level in other companies, levels lower than would be required to trigger Section 13(d), assuming that the TRSs here fall within Rule 13d-3(a).[193] Yet there is no reason to believe that the sky has fallen, or is likely to fall, in London.

Nor do potentially broad implications or any supposed advantage of administrative rule making over adjudication permit a court to decline to decide an issue that must be decided in order

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Similarly, professor and former SEC commissioner Joseph Grundfest and other academics have written that "[i]n the context of this case, the . . . integrity of the stock market was undermined and an uneven playing field was created." *See* Letter from Joseph Grundfest, Henry Hu, and Marti Subrahmanyam to Brian Cartwright, General Counsel of the SEC (June 2, 2008), at 13.

192 A major proponent of the hypothesis that dire consequences will ensue from a determination of beneficial ownership in this case is defendants' expert Frank Partnoy. Having considered Partnoy's positions and Marti Subrahmanyam's responses, the Court believes Partnoy's views are exaggerated and declines to accept them. In addition, Partnoy's views in this respect are unpersuasive because his failure to engage with the specific circumstances of this case renders his generalizations suspect.

193 Robert Cyran, *Policing Equity Derivatives,* WALL ST. J., June 7, 2008, at B14.

to resolve a case before it. But it is equally true that courts should decide no more than is essential to resolve their cases.

In this case, it is not essential to decide the beneficial ownership question under Rule 13d-3(a). As is discussed immediately below, TCI used the TRSs with the purpose and effect of preventing the vesting of beneficial ownership of the referenced shares in TCI as part of a plan or scheme to evade the reporting requirements of Section 13(d). Under Rule 13d-3(b), TCI, if it is not a beneficial owner under rule 13d-3(a), therefore is deemed – on the facts of this case – to beneficially own those shares. The Court therefore does not rule on the legal question whether TCI is a beneficial owner under Section 13d-3(a).

2. Rule 13d-3(b)

In construing any statute or rule, the Court is governed by well-established principles. It first must examine "the language of the provision at issue,"[194] which governs "'unless that meaning would lead to absurd results.'"[195] In addition, the provision "should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant, and so that one section will not destroy another unless the provision is the result of obvious mistake or error."[196]

We begin with the language. Rule 13d-3(b) provides:

194 *Resnik v. Swartz*, 303 F.3d 147, 151-52 (2d Cir. 2002).

195 *Forest Watch v. United States Forest Serv.*, 410 F.3d, 115, 117 (2d Cir. 2005) (quoting *Reno v. Nat'l Transp. Safety Bd.*, 45 F.3d 1375, 1379 (9th Cir. 1995)).

196 *APWU v. Potter*, 343 F.3d 619, 626 (2d Cir. 2003) (internal citation omitted).

> "Any person who, directly or indirectly, [1] creates or uses a trust, proxy, power of attorney, pooling arrangement or any other contract, arrangement, or device [2] with the purpose of [*sic*] effect of divesting such person of beneficial ownership of a security or preventing the vesting of such beneficial ownership [3] as part of a plan or scheme to evade the reporting requirements of section 13(d) or (g) of the Act shall be deemed for purposes of such sections to be the beneficial owner of such security."[197]

Thus, the Rule by its plain terms is triggered when three elements are satisfied:

- the use of 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) or (g).

It is undisputed that TCI's cash-settled TRSs are contracts. The first element therefore concededly is satisfied.

The evidence that TCI created and used the TRSs, at least in major part, for the purpose of preventing the vesting of beneficial ownership of CSX shares in TCI and as part of a plan or scheme to evade the reporting requirements of Section 13(d) is overwhelming. Joe O'Flynn, the chief financial officer of TCI Fund told its board, albeit not in the specific context of CSX, that one of the reasons for using swaps is "the ability to purchase without disclosure to the market or the company."[198] TCI emails discussed the need to make certain that its counterparties stayed below 5

197 *See* 17 C.F.R. § 240.13d-3(b).

198 PX 19, at TCI0011386; *see also* Subrahmanyam Report ¶ 72.

percent physical share ownership,[199] this in order to avoiding triggering a disclosure obligation on the part of a counterparty. TCI admitted that one of its motivations in avoiding disclosure was to avoid paying a higher price for the shares of CSX, which would have been the product of front-running that it expected would occur if its interest in CSX were disclosed to the market generally.[200] Indeed, TCI acquired only approximately 4.5 percent in physical CSX shares to remain safely below the 5 percent reporting requirement until it was ready to disclose its position.

To be sure, there is evidence that TCI argues points in the opposite direction. It did disclose to CSX the fact that it had exposure to its stock well before it made a Schedule 13D filing. But that does not carry the day. Telling an issuer that an investor has exposure to its stock is quite a different matter than timely disclosing to the marketplace generally the details of the investor's position, its plans and intentions, its contracts and arrangements with respect to the issuer's securities, and its financing and then keeping that information up to date as Regulation 13D requires. For one thing, the market in general does not necessarily know even what the issuer knows. And the issuer is left to guess as to many of the important matters that compliance with Regulation 13D requires. Here, TCI's limited disclosure to CSX and its concealment of broader, more timely, and more accurate information from the marketplace served its objectives. It exerted pressure on CSX, a pressure that was enhanced by the lack of complete information. And it kept the marketplace entirely and, after CSX filed its Form 10-Q, largely in the dark, thus serving TCI's interest in permitting it to

199 PX 22, 27-30; *see also* Subrahmanyam Report Exs. D, D.1-D.7.

200 DX 144 (Hohn) ¶ 22; Tr. (Hohn) at 188-90.

build its position without running up the price of the stock. In all the circumstances, the Court finds that each of the elements of Rule 13d-3(b) is satisfied here.

This outcome is supported by the views of the SEC's Division of Corporation Finance as the Court understands them. While the Division did not comment upon or attempt to analyze the facts of this case in light of governing legal standards, its *amicus* letter appears to take two positions. First, it states the view that "the long party's underlying motive for entering into the swap transaction generally is not a basis for determining whether there is 'a plan or scheme to evade.'"[201] It goes on to say that it believes "that the mental state contemplated by the words 'plan or scheme to evade' is generally the intent to enter into an arrangement that creates a false appearance." It states that "a person who entered into a swap would be a beneficial owner under Rule 13d-3(b) if it were determined that the person did so with the intent to create the false appearance of non-ownership of a security." But it adds that it "cannot rule out the possibility that, in some unusual circumstances, a plan or scheme to evade the beneficial ownership provisions of Rule 13d-3 might exist where the evidence does not indicate a false appearance or sham transaction."[202] Having said that, however, the letter concludes that "as a general matter, a person that does nothing more than enter into an equity swap should not be found to have engaged in an evasion of the reporting requirements."[203]

As an initial matter, no one suggests that TCI did "nothing more than enter into an equity swap." At a minimum, it entered into the TRSs rather than buying stock for the purpose,

201 Letter from Brian Breheny, Deputy Director of the Division of Corporation Finance, to Judge Kaplan (June 4, 2008), at 3.

202 *Id.*

203 *Id.* at 4.

perhaps among others, of avoiding the disclosure requirements of Section 13(d) by preventing the vesting of beneficial ownership in TCI.

Passing on to its other point, the Division's assertion that "a person who entered into a swap would be a beneficial owner under Rule 13d-3(b) if it were determined that the person did so with the intent to create the false appearance of non-ownership of a security" suffers from some degree of ambiguity. On the one hand, the statement may be intended merely to illustrate a specific intent that would satisfy the test, without intending to exhaust the possibilities. On the other, it may intend to convey the thought that an intent to create a false appearance of non-ownership is indispensable to a Rule 13d-3(b) finding. Two considerations persuade the Court that the former is the case.

First, the Division declined to "rule out the possibility that . . . a plan or scheme to evade . . . might exist [without] a false appearance or sham transaction." It follows that it cannot be saying that, in its view, a false appearance of non-ownership is a necessary condition for application of Rule 13d-3(b).

Second, reading Rule 13d-3(b) as requiring an intent to create a false appearance of non-ownership would violate a fundamental principle of statutory construction. An appearance of non-ownership cannot be false unless one in fact is at least a beneficial owner. That beneficial ownership would satisfy Rule 13d-3(a), thus making Rule 13d-3(b) superfluous. In consequence, Rule 13d-3 as a whole is inconsistent with any view that a false appearance of non-ownership is a prerequisite to application of Rule 13d-3(b).

This leaves us with the Division's more likely position, viz. that Rule 13d-3(b) is satisfied only where the actor intends to create some false appearance, albeit not necessarily a false appearance of non-ownership. But false appearance of what?

The goal of Section 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."[204] In consequence, the natural reading is that the Division refers to a false appearance that no such accumulation is taking place. Put another way, Rule 13d-3(b) applies where one enters into a transaction with the intent to create the false appearance that there is no large accumulation of securities that might have a potential for shifting corporate control by evading the disclosure requirements of Section 13(d) or (g) through preventing the vesting of beneficial ownership in the actor.

If that is what the Division means, then its proposed standard is more than satisfied in this case. TCI intentionally entered into the TRSs, with the purpose and intent of preventing the vesting of beneficial ownership in TCI, as part of a plan or scheme to evade the reporting requirements of Section 13(d) and thus concealed precisely what Section 13(d) was intended to force into the open. And if this is not what the Division means, the Division's argument would be unpersuasive.[205] After all, there is not one word in Section 13(d) or in Rule 13d-3 that supports a

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204 *Treadway Cos., Inc. v. Care Corp.,* 638 F.2d 357, 380 (2d Cir.1980) (internal citation omitted).

205 As a staff interpretation, the Division's views are entitled to no greater weight than flows from their persuasive qualities. *See United States v. Mead Corp.*, 533 U.S. 218, 234-35 (2001); *Skidmore v. Swift & Co.*, 323 U.S. 134, 139-40 (1944); *see also Gryl ex rel. Shire Pharms. Group PLC v. Shire Pharms. Group PLC*, 298 F.3d 136, 145 (2d Cir. 2002), *cert. denied* 537 U.S. 1191 (2003).

requirement of an intent to create a false appearance of non-ownership if that term requires anything more than concealment of the sort of secret market accumulations that went on here.

Undaunted, TCI argues that it did not trigger Rule 13d-3(b). It relies in part on a letter from Professor Bernard Black to the SEC in which the professor argued that "it must be permissible for an investor to acquire equity swaps, rather than shares, in part – or indeed entirely – *because* share ownership is disclosable under § 13(d) while equity swaps are not."[206] He bases this argument on the premise that "the underlying [i.e., evasive] activity must involve holding a position which is 'beneficial ownership' under the *statute* (Exchange Act § 13(d) or (g)), but would otherwise fall outside the *rule* – outside the SEC's effort to define the concept of beneficial ownership elsewhere in Rule 13d-3."[207] With respect, the Court finds the argument unpersuasive.

As an initial matter, the SEC, in the Court's view, has the power to treat as beneficial ownership a situation that would not fall within the statutory meaning of that term. Section 23(a) of the Exchange Act[208] grants the Commission the "power to make such rules and regulations as may be necessary or appropriate to implement the provisions of this chapter for which [it is] responsible

206 Letter from Bernard Black to Brian G. Cartwright, General Counsel of the SEC (May 29, 2008), at 4-5 (emphasis in original).

207 *Id.* at 5 (emphasis in original).

208 15 U.S.C. § 78w(a).

. . . ."[209] The validity of a rule or regulation promulgated under such a grant of authority will be sustained so long as it is "reasonably related to the purposes of the enabling legislation."[210]

The purpose of Section 13(d) is to alert shareholders of "every large, rapid aggregation or accumulation of securities, regardless of technique employed, which might represent a potential shift in corporate control."[211] Rule 13d-3(b) was promulgated to further this purpose by preventing circumvention of Rule 13d-3 with arrangements designed to avoid disclosure obligations by preventing the vesting of beneficial ownership as defined elsewhere[212] – in other words, where there is accumulation of securities by any means with a potential shift of corporate control, but no beneficial ownership. As Rule 13d-3(b) therefore is reasonably related to the purpose of the statute, it is a perfectly appropriate exercise of the Commission's authority even where it reaches arrangements that otherwise would not amount to beneficial ownership.

209 *Id.* § 78w(a)(1).

210 *See* Amendments to Tender Offer Rules; All-Holders and Best-Price, Exchange Act Release Nos. 33-6653, 34-23421, 51 Fed. Reg. 25,873-01, 25,875 (July 11, 1986); *see also Mourning v. Family Publ'ns Serv., Inc.*, 411 U.S. 356, 369 (1973) (quoting *Thorpe v. Housing Auth. of City of Durham*, 393 U.S. 268, 280-81 (1969)); *Polaroid Corp. v. Disney*, 862 F.2d 987, 994-95 (3d Cir. 1988) (sustaining All Holders Rule as within the SEC's rulemaking authority).

211 *GAF Corp. v. Milstein*, 453 F.2d 709, 717 (2d Cir. 1971), *cert. denied* 406 U.S. 910 (1972).

212 Adoption of Beneficial Ownership Disclosure Requirements, Exchange Act Release No. 33-5808, No. 34-13291, 42 Fed. Reg. 12,342, 12,344 (Mar. 3, 1977).

Second, while it may be debated whether the term "beneficial ownership" as used in the Williams Act is broader than or coextensive with the same language as used in Rule 13d-3(a),[213] one thing is quite clear. If Rule 13d-3(b) reaches only situations that involve beneficial ownership, then it reaches only situations that are reached by Rule 13d-3(a). Professor Black's view thus would render Rule 13d-3(b) superfluous.

* * *

In sum, the Court finds that TCI created and used the TRSs with the purpose and effect of preventing the vesting of beneficial ownership in TCI as part of a plan or scheme to evade the reporting requirements of Section 13(d). Under the plain language of Rule 13d-3(b), it thus is deemed to be a beneficial owner of the shares held by its counterparties to hedge their short exposures created by the TRSs.

B. *Group Formation*

CSX contends that TCI and 3G violated Section 13(d) because they failed timely to disclose that they had formed a group. TCI and 3G contend that they did not form a group until

213 The language of the Rule defines the term "[f]or the purposes of sections 13(d) and 13(g) of the Act." 17 C.F.R. § 240.13d-3(a). While the use in the Rule of the term "includes," *inter alia,* makes clear that Rule 13d-3(a)(1) and (2) are not the only criteria that define "beneficial ownership," Rule 13d-3(a) as a whole appears quite plainly to reflect the Commission's intent to define the term exhaustively for purposes of the statute. Curiously, however, the Division's *amicus* letter, without citation of authority, states that the Division "believes that Rule 13d-3, properly construed, is narrower in coverage than the statute."

December 12, 2007, and therefore satisfied their disclosure obligations when they filed a Schedule 13D on December 19, 2007.[214]

Section 13(d)(3) provides that "[w]hen 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."[215] The existence of a group turns on "whether there is sufficient direct or circumstantial evidence to support the inference of a formal or informal understanding between [members] for the purpose of acquiring, holding, or disposing of securities."[216] Group members need not "be committed to acquisition, holding, or disposition on any specific set of terms. Instead, the touchstone of a group within the meaning of Section 13(d) is that the members combined in furtherance of a common objective."[217] In this respect, an allegation that persons have formed a group "is analogous to a charge of conspiracy" in that "both assert that two or more persons reached an understanding, explicit or tacit, to act in concert to achieve a common goal."[218] The requisite agreement "may be formal or

214 JX 8.

215 15 U.S.C. § 78m(d)(3).

216 *Hallwood Realty Partners, L.P. v. Gotham Partners, L.P.,* 286 F.3d 613, 617 (2d Cir. 2002) (internal quotation marks omitted).

217 *Wellman*, 682 F.2d at 363; *see Morales v. Quintel Entm't, Inc.*, 249 F.3d 115, 124.

218 *Hallwood Realty Partners, L.P. v. Gotham Partners, L.P.*, 95 F. Supp. 2d 169, 176 (S.D.N.Y 2000), *aff'd,* 286 F.3d 613.

informal, and need not be expressed in writing."[219] The likelihood that any agreement in this case would be proved, if at all, only circumstantially is perhaps greater than usual because the parties went to considerable lengths to cover their tracks.[220]

The Court already has made detailed findings concerning the defendants' activities and motives throughout the relevant period. The most salient points are summarized and, to a large extent, conveniently depicted on the timeline included in Appendix 2:[221]

- TCI and 3G have had a close relationship for years, in part because 3G's Synergy Fund is an investor in TCI.
- January 2007 - Hohn and Behring discuss TCI's investment in CSX, including its approximate size.
- February 2007 – 3G begins buying CSX shortly after Behring's January conversation with Hohn.

[219] *Hallwood Realty Partners*, 286 F.3d at 617; *see Rounseville v. Zahl*, 13 F.3d 625, 632 (2d Cir. 1994) ("[C]onspiracies are by their very nature secretive operations that can hardly ever be proven by direct evidence.").

[220] Hohn testified that he was "particularly sensitive to the issue of groups and knowledgeable about when a group is formed and when it is not formed," Tr. (Hohn) at 180, and claims often to have begun conversations with other hedge funds, including 3G, by saying that the two parties were not a group. *Id.* (Behring) at 120. Furthermore, when TCI approached the line between non-group and group behavior as it viewed it, it sought to limit any paper trail. *See, e.g.*, PX 84; *see also* PX 46, at TCI0345190 ("we cannot be in a group so we are careful on sending models").

[221] The timeline in the original and official copy of this opinion is in color and larger than the standard 8.5 x 11 inch page. A reduced, black and white copy is included in the electronically filed version.

- On or about February 13, 2007 – Hohn speaks to his "friend Alex" Behring about CSX as a result of market excitement regarding CSX attributable in whole or part to 3G's heavy buying.
- At about the same time, Hohn begins tipping other funds to CSX, which continues for some time. This is an effort to steer CSX shares into the hands of like-minded associates.
- March 29, 2007 – Amin and Behring meet.
- March 29, 2007 – 3G resumes CSX purchases after hiatus.
- March 29, 2007 through April 18, 2007 – TCI increases its overall (shares plus swaps) position by 5.5 million shares, or 1.2 percent of CSX. 3G increases its position by 11.1 million shares, or 2.5 percent of CSX.
- August to September 2007 – Hohn becomes concerned about possible reregulation. Both 3G and TCI reduce their CSX exposures, although 3G to a proportionately greater extent than TCI.
- Late September - October 2007 – TCI tells D.F. King it probably will mount proxy contest. Hohn and Behring meet on September 26, 2007. Both TCI and 3G resume increasing their positions in the wake of the meeting. Both begin looking for director nominees.

These circumstances – including the existing relationship, the admitted exchanges of views and information regarding CSX, 3G's striking patterns of share purchases immediately following meetings with Hohn and Amin, and the parallel proxy fight preparations – all suggest that the parties' activities from at least as early as February 13, 2007, were products of concerted action

notwithstanding the defendants' denials. Defendants nevertheless argue strenuously that they did not form a group until December 2007.

Perhaps their most significant point is the assertion that 3G's sale of 40 percent of its holdings in August to September 2007 is inconsistent with concerted action because TCI did not act accordingly. But the argument ultimately is unpersuasive for at least two reasons.

First, while it is true that TCI did not reduce its exposure by a like proportion (40 percent), TCI and 3G in that period shared misgivings about being as heavily exposed to CSX as they then were. TCI also reduced its exposure, albeit by a smaller percentage. The difference may be characterized as static. Moreover, what is most striking about this period is not that the two entities reduced their exposure asymmetrically. It is that 3G began increasing its exposure again less than a week after TCI decided to launch a proxy fight and on precisely the same day that Amin and Behring met – September 26, 2007. In other words, the parties shared misgivings in August-September when they were reducing their positions, but they got back on the track, so to speak, that they had been on previously by late September.

Second, even assuming, for the sake of argument, that 3G's August-September sales were, in whole or in part, not within the mutual contemplation of the defendants, that would not necessarily foreclose a finding that they acted as a group. Co-conspirators and members of cartels act on their own from time to time. While this is a fact entitled to be considered in determining whether an agreement existed and, if so, its terms and duration, the weight to be given to it depends upon the circumstances.[222]

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222 *See, e.g.*, *United States v. Beaver*, 515 F.3d 730, 739 (7th Cir. 2008) ("It is not uncommon for members of a price-fixing conspiracy to cheat on one another occasionally, and evidence

Defendants rely heavily also on the Court's bench opinion in *Hallwood Realty Partners, L.P. v. Gotham Partners, L.P.*[223] and, in particular, on its observations that relationships and communications among people and parallel investments in the same company, even where coupled with a motive to avoid discovery, do not *necessarily* require the conclusion that the actors formed a group. That of course is true. Equally true, however, is that these and other factors all are relevant to the question.[224] Each case presents the issue whether the trier of fact is persuaded by a preponderance of the evidence that the defendants before it formed a group. Each turns on its own facts. So *Hallwood Realty* does not decide this case, although it certainly is pertinent.

In the last analysis, the question comes down to whether this trier of fact, having considered all of the circumstantial evidence – including the frequent lack of credibility of Hohn, Amin, and Behring and the inferences to be drawn therefrom – is persuaded that TCI and 3G formed a group with respect to CSX securities earlier than they claim. It finds that they did so no later than February 13, 2007.

C. Alleged Schedule 13D Deficiencies

CSX contends that the TCI-3G Schedule 13D was materially false and misleading because it (1) failed accurately to disclose their beneficial ownership of CSX common stock by falsely

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of cheating certainly does not, by itself, prevent the government from proving a conspiracy.").

223 No. 00 Civ. 1115 (LAK) (S.D.N.Y. dated Feb. 23, 2001), *aff'd, Hallwood Realty Partners, L.P.,* 286 F.3d 613.

224 *Id.; see Wellman,* 682 F.2d at 363-65 (relying, *inter alia,* upon communications and common objectives among putative members to sustain "group"finding).

disclaiming beneficial ownership of the shares referenced in the swaps, (2) misrepresented the date of group formation and the beneficial ownership of the group's holdings, (3) failed to disclose information concerning contracts, arrangements, understandings, or relationships among group members and others, and (4) failed to disclose plans or proposals as to CSX's business or corporate structure.

1. Legal Standard

A beneficial owner of greater than 5 percent of a class of any equity security is required to disclose, within ten days of acquiring that position, the information contained in Section 13(d)(1)(A) - (E) on a Schedule 13D.[225] "A duty to file under [Section] 13(d) creates the duty to file truthfully and completely."[226] Section 13(d) is violated only to the extent that any misstatement or omission is material, viz. "there is a substantial likelihood that a reasonable shareholder would consider it important in making an investment decision."[227]

2. Beneficial Ownership

CSX contends that defendants' Schedule 13D is materially misleading because it (1) fails to include the shares referenced in the TRSs in the aggregate of shares beneficially owned and

[225] 15 U.S.C. § 78m(d)(1).

[226] *United States v. Bilzerian*, 926 F.2d 1285, 1298 (2d Cir.), *cert. denied,* 502 U.S. 813 (1991).

[227] *Id.* (citing *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (noting that to satisfy the materiality requirement, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.").

(2) disclaims beneficial ownership over those shares. Whether because TCI and 3G beneficially own those shares under Rule 13d-3(a), which the Court does not decide, or because they are deemed to beneficially own them under Rule 13d-3(b), as the Court has held, the 13D in fact was misleading. Nevertheless, the 13D disclosed the entirety of defendants' position in CSX and the manner in which it was held. It therefore was not materially so. In any case, the facts now are widely disseminated.

3. Group Formation

CSX asserts that the Schedule 13D is materially misleading because defendants fail to disclose (1) the correct date on which the group was formed, and (2) an accurate number of shares beneficially owned by the group.

The latter contention fails for the reason discussed above. And although the failure to file a Schedule 13D disclosing the existence of a group within ten days of its formation violated Section 13(d), the information that was material when the Schedule 13D belatedly was filed was the existence of the group, not the date of its formation. No reasonable investor, aware of the existence of a group, would find the date on which the group was formed to be important in making an investment decision.[228]

[228] *See Standard Metals Corp. v. Tomlin,* 503 F. Supp. 586, 603-04 (S.D.N.Y. 1980) (disclosure of the existence of a group renders the date of formation "relatively immaterial").

4. Contracts, Arrangements, Understandings, or Relationships

Item 6 of Schedule 13D mandated disclosure of any contracts, arrangements, understandings, or relationships with respect to any CSX securities. CSX contends that defendants failed to disclose material terms of their swap agreements, the number of shares referenced in each, and the aggregate number of shares referenced in all of their swaps, and failed to file the swap agreements under Item 7. Moreover, CSX asserts that 3G failed to disclose the material terms of its credit default swaps.

Defendants disclosed that (1) they had swaps and the counterparties to those swaps, (2) the aggregate percentage of shares that were referenced in those swaps, and (3) 3G had credit default swaps. Moreover, they disclosed in Item 5 that they had calculated the percentages of their holdings based on the assumption that CSX had 420,425,477 shares outstanding.[229] While defendants might have disclosed more, what they omitted was not material. Further, assuming *arguendo* that defendants should have included the actual swap agreements in Item 7, their failure to do so was *de minimis*.[230]

5. Plans or Proposals

The statement in the 13D that defendants "originally acquired Shares for investment in the ordinary course of business because they believed that the Shares, when purchased, were

229 JX 8 (Items 5 and 6).

230 The Court doubts whether any reasonable investor would have found those agreements, some of which exceeded 100 pages, important in making an investment decision.

undervalued and represented an attractive investment opportunity"[231] was accurate in a limited sense but was false and misleading because it misrepresented the fact that TCI intended from the outset to bring about changes in the policies and, if need be, management of CSX. Nevertheless, defendants' present plans and intentions are plain from the additional paragraphs in Item 4 and the letters attached as Exhibits 2 and 3 and incorporated by reference into Item 4. In light of these disclosures, the false statement concerning defendants' reasons for originally acquiring shares therefore would be unlikely to have any significant impact on shareholders.[232] The misstatement therefore is not material.

II. Section 14(a)

CSX contends that defendants made materially false and misleading statements in their preliminary and definitive proxy statements filed on March 10, April 15, and April 28, 2008,[233] (collectively the "Proxy Filings") in violation of Section 14(a) of the Exchange Act[234] and Rule 14a-9 thereunder.[235] Specifically, it asserts that defendants (1) failed to disclose the true extent of their beneficial ownership of CSX shares of common stock by falsely disclaiming beneficial ownership of shares associated with TRSs, (2) misrepresented the date upon which the TCI-3G group was formed and the number of shares it beneficially owned, (3) failed adequately to disclose the contracts

231 JX 8 (Item 4).

232 *See Int'l Banknote Co., Inc. v. Muller*, 713 F. Supp. 612, 621 (S.D.N.Y. 1989).

233 JX 12, JX 17, JX 19.

234 15 U.S.C. § 78n(a).

235 17 C.F.R. § 240.14a-9.

with swap counterparties, (4) misrepresented TCI's position with respect to a settlement of the proxy fight, and (5) set forth a false two-year history of the insurgents' respective transactions in CSX securities because they failed properly to disclose the swap transactions.

Section 14(a) makes it unlawful to solicit proxies "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."[236] Rule 14a-9 prohibits the solicitation of proxies "containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading."[237] A fact is material in a proxy solicitation "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[238]

As an initial matter, CSX's first three bases for contending that the Proxy Filings are materially false and misleading mirror the challenges it levied against defendants' Schedule 13D filing. They fail for the same reason.

CSX next asserts that TCI's statements that it "made many concessions with the hope of being able to reach an amicable resolution with CSX that would avoid a proxy contest" and, during the January 2008 negotiations, "indicated willingness to sign a one year stand-still

[236] 15 U.S.C. § 78n(a).

[237] 17 C.F.R. § 240.14a-9(a).

[238] *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1090 (1991); *Resnik v. Swartz*, 303 F.3d 147, 151 (2d Cir. 2002).

agreement"[239] were materially false and misleading. It contends that TCI (1) mischaracterizes Mr. Hohn's approach to the negotiations and (2) fails to mention that Mr. Hohn expressed willingness to enter into a standstill agreement only after negotiations were terminated.

None of these statements is materially false or misleading. TCI did make concessions during negotiations, a fact demonstrated by Mr. Ward's notes,[240] notwithstanding Mr. Hohn's original position that he wanted all five of his candidates seated on the board. Moreover, although it is true that Hohn expressed willingness to agree to a standstill only after negotiations had terminated, it is not clear that he knew they had been terminated or that they could not have been resuscitated by such a concession.

Finally, CSX contends that TCI failed to disclose its history of swap transactions over the preceding two years. Item 5(b)(1)(vi) of Schedule 14A requires that the filing party "[s]tate with respect to all securities of the registrant purchased or sold within the past two years, the dates on which they were purchased or sold and the amount purchased or sold on each such date."[241] This does not require disclosure of swap transactions. Notwithstanding that fact, both 3G and TCI disclosed the swap agreements in which they were counterparties.[242]

Accordingly, defendants made no materially misleading statements or omissions in its Proxy Filings and therefore are not in violation of Section 14(a) or Rule 14a-9.

[239] JX 19, at page 5.

[240] *See* DX 306.

[241] 17 C.F.R. § 240.14a-101.

[242] JX 19, at 18.

III. Section 20(a)

Section 20(a) of the Exchange Act provides:

> "Every person who, directly or indirectly, controls any person liable under any provision of [the Exchange Act] 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 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."[243]

CSX claims that Messrs. Hohn and Behring are jointly and severally liable for the violation of Sections 13(d). It is undisputed that Messrs. Hohn and Behring, respectively, controlled these entities. The only possible remaining question as to their personal liability relates to their individual culpability.

There is a lively debate in this Circuit as to whether culpable participation is an element of a plaintiff's *prima facie* case under Section 20(a) or, instead, whether lack of culpability is an affirmative defense that must be pleaded and proved by a controlling person in order to escape liability for violations by a controlled person. This Court holds the latter view,[244] which in this case is fatal to the individual defendants because they have neither pleaded nor proved the affirmative defense. In this case, however, the controversy is beside the point. CSX would prevail on this point even if it bore the burden of proving culpable participation.

243 15 U.S.C. § 78t(a).

244 *E.g., In re BISYS Sec. Litig.,* 397 F. Supp. 2d 430, 450-52 (S.D.N.Y. 2005); *In re Parmalat Sec. Litig.,* 375 F. Supp. 2d 278, 307-10 (S.D.N.Y. 2005); *In re NTL, Inc. Sec. Litig.,* 347 F. Supp. 2d 15, 37 n.127 (S.D.N.Y. 2004)

Hohn was involved in the day-to-day oversight of the swap agreements from the beginning of TCI's investment in CSX. His focus included ensuring that TCI did not push any counterparty across the five percent reporting threshold. He engaged in discussions with Behring regarding TCI's investments and precipitated the conversation on or about February 13 by which – and probably during which – TCI and 3G formed a group regarding CSX. He was responsible for making a filing under the HSR Act in which TCI said that TCI "intend[ed] to try to influence management in how the company is run,"[245] and he signed the October 16 letter to the CSX board.[246] Hohn signed also the Schedule 13D filed on December 19, 2007.[247]

Behring similarly controlled the day-to-day investment activities of 3G. He spoke with TCI frequently and formed a group with Hohn. He attempted at various times to meet with CSX management and signed a letter to them indicating that 3G had made a Hart-Scott-Rodino filing.[248] He met with Amin on several occasions, during which time the two spoke about their respective investment plans for their TCI holdings and then directed purchases or sales to be made thereafter. Behring also signed the Schedule 13D.

In all the circumstances, Hohn and Behring quite plainly induced the Section 13(d) violations. Hohn nevertheless argues that he relied upon the advice of counsel and therefore acted

245 PX 87A, at TCI0418758.

246 PX 140.

247 JX 8.

248 PX 105.

in good faith.[249] The argument relies exclusively on his trial testimony that TCI retained counsel before it made investments, followed their advice as to what was permissible, and was "aware that if you held more than 5 percent of a company in physical shares, . . . then derivative positions where you had economic interests but no voting benefit had to also be disclosed."[250] The implication is that he was advised that TCI was not obliged to disclose its derivative position before becoming the beneficial owner of more than 5 percent of the physical shares. The argument, however, is not appropriately considered and in any case unpersuasive.

During pretrial discovery, CSX sought disclosure, including production of documents, concerning the legal advice that TCI had obtained. TCI and Hohn responded by asserting the attorney-client privilege to block disclosure.[251] CSX objects to their now relying on the belatedly and incompletely disclosed advice of counsel.

The Court agrees with CSX. Having blocked discovery of the existence and nature of any legal advice it sought, Hohn will not now be heard to assert that his actions were consistent with the advice of counsel and therefore in good faith.[252] In any case, Hohn's attempt to rely on the

249 *See* Docket item 59, at 56-57.

250 Tr. (Hohn) at 187-88.

The fact that the testimony that TCI relies upon came in response to a question by the Court is beside the point. It would be fundamentally unfair for TCI now to assert that it relied upon the advice of counsel after having prevented CSX from inquiring into what advice was sought and on what factual predicate, and what advice in fact was given.

251 *See, e.g.,* Docket item 89, at 3-7.

252 *E.G.L. Gem Lab Ltd. v. Gem Quality Inst., Inc.,* 90 F. Supp. 2d 277, 296 n.133 (S.D.N.Y. 2000), *aff'd,* 4 Fed. Appx. 81 (2d Cir. 2001) (affirming judgment and finding of bad faith); *Trouble v. Wet-Seal, Inc.,* 179 F. Supp. 2d 291, 304 (S.D.N.Y. 2001) (party waives advice

advice of counsel is not convincing given that he has failed to offer evidence sufficient to permit the Court to find that TCI fully disclosed all material facts to counsel, that any failure to do so did not make Hohn's reliance unreasonable, and that Hohn and TCI conformed their actions in all respects to the advice they received. In fact, Hohn testified at his deposition that TCI did not even ask counsel whether it needed to disclose its swaps because it thought it already knew the answer.[253]

Accordingly, the Court finds that Hohn and Behring are jointly and severally liable for the violations of Section 13(d).

IV. Notice of Proposed Director Nominee and Bylaw Amendment

As noted, TCI on January 8, 2008, submitted to CSX a Stockholder Notice of Intent to Nominate Persons for Election as Directors in which it proposed its slate of candidates for the board. Later in January, it sent two supplemental notices regarding its intent to propose an amendment of the bylaws to allow holders of 15 percent or more of all outstanding CSX shares to call a special meeting for any purpose permissible under Virginia law. The January 8 notice,[254] which in

of counsel defense by failing to disclose intention to assert that defense during discovery); *In re Buspirone Antitrust Litig.,* 208 F.R.D. 516, 521-24 (S.D.N.Y. 2002) (similar); *In re Worldcom, Inc. Sec. Litig.,* No. 02 Civ. 3288 (DLC), 2005 WL 600019 (S.D.N.Y. Mar. 15, 2005) (denying leave to amend to assert advice of counsel defense given lack of notice during discovery); *In re Worldcom, Inc. Sec. Litig.,* No. 02 Civ. 3288 (DLC), 2005 WL 627721 (S.D.N.Y. Mar. 16, 2005) (same); *see Bilzerian,* 926 F.2d at 1292.

253 Docket item 90, Ex. 15, at 139:19-140:5.

254 PX 159.

this respect was incorporated into the supplemental notices,[255] avowed that TCI beneficially owned 8.3 percent of CSX's shares, a figure that did not include the shares referenced under its TRSs.

Article I, Section 11(a)(i), of CSX's bylaws provides in substance that any shareholder of record as of the appropriate date may nominate persons for election and propose business to be considered by the shareholders provided, in relevant part, that the shareholder "complies with the notice procedures set forth in . . . Section 11."[256] Section 11(c)(i) makes clear that "[o]nly such persons who are nominated in accordance with the procedures set forth in . . . Section 11 shall be eligible . . . to serve as directors and only such business shall be conducted at a meeting of shareholders as shall have been brought before the meeting in accordance with the procedures set forth in . . . Section 11."[257] Section 11(a)(ii) states in pertinent part that a shareholder's notice:

> "shall set forth . . . (C) as to the shareholder giving the notice and the beneficial owner, if any, on whose behalf the nomination or proposal is made . . . (2) the class and number of shares of capital stock of the Corporation that are owned beneficially and of record by such shareholder and such beneficial owner."[258]

CSX's position is simplicity itself. Defendants, it argues, beneficially owned the shares referenced by their TRSs. Accordingly, it argues, defendants' statement in the notice that they beneficially owned 8.3 percent of CSX's shares did not accurately disclose their beneficial ownership

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255 JX 9, 10.

256 JX 30, at 4.

257 *Id.* at 7.

258 *Id.* at 5.

in compliance with the bylaws in consequence of which the notice was deficient. The response to this argument is equally simple.

Assuming for purposes of discussion that the defendants were beneficial owners of the shares referenced by their TRSs within the meaning of Rule 13d-3, and assuming further that the definition of the term "beneficial owner" in the bylaws is coextensive with that in the Rule, the fact remains that the defendants' swap positions were disclosed in Annex E to the notice. Under Virginia law, corporate bylaws are construed in accordance with principles used in construing statutes, contracts, and other written instruments.[259] The essential purpose of the notice provision having been satisfied by the defendants' disclosure of their interest, they have complied with its requirements in substance if not in all trivial particulars.[260] That is all that was required. Moreover, it ill behooves CSX, which asks the Court to focus on substance rather than form in determining whether defendants' swaps gave them beneficial ownership of the referenced shares held by their counterparties, to exalt form over substance in construing defendants' notice by disregarding the fact that defendants disclosed the swap positions, albeit without characterizing those positions as giving them beneficial ownership. This is especially so because CSX drafted its own bylaw and thus could have defined beneficial ownership in a manner that would have required the precise disclosure that it here contends was required.

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259 *Virginia High Sch. League, Inc. v. J.J. Kelly High Sch.,* 254 Va. 528, 531 (1997).

260 *See, e.g.*, *Akers v. James T. Barnes of Washington, D.C.*, 227 Va. 367, 370-71 (1984) ("Substantial compliance with reference to contracts, means that although the conditions of the contract have been deviated from in trifling particulars not materially detracting from the benefit the other party would derive from a literal performance, he has received substantially the benefit he expected, and is, therefore, bound to pay.") (emphasis removed).

Accordingly, CSX's attack on defendants' notice is without merit.

V. Counterclaims

Defendants have asserted counterclaims against CSX and Ward. They allege that CSX's proxy solicitations are materially false and misleading in violation of Section 14(a) and that Ward is liable for this violation under Section 20(a). They claim also that a by-law amendment adopted by the CSX board on February 4, 2008 (the "Amendment") violates Virginia law. They seek declaratory and injunctive relief.

A. Section 14(a) Claim

Section 14(a) of the Exchange Act prohibits the solicitation of proxy materials in contravention of rules and regulations prescribed by the SEC.[261] Rule 14a-9 prohibits proxy solicitation:

> "by means of any proxy statement . . . containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading . . . ."[262]

Thus, an "omission of information from a proxy statement will violate [Section 14(a)] if either the SEC regulations specifically require disclosure of the omitted information in a proxy statement, or

261 15 U.S.C. § 78n(a).

262 17 C.F.R. § 240.14a-9(a).

the omission makes other statements in the proxy statement materially false or misleading."[263] "In the context of a proxy solicitation, a statement is material 'if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.'"[264]

1. Target Awards Under the Long Term Incentive Plan

Defendants argue that the CSX proxy statement is incomplete and misleading in its disclosure of the long term incentive compensation awarded to executives and employees.

On May 1, 2007, CSX's compensation committee submitted and the board adopted the CSX 2007-2009 Long Term Incentive Plan ("LTIP"), which set target awards for covered executives and employees. The target awards are measured in CSX shares. They are not grants of shares, but establish the possibility of future compensation. Actual awards may be adjusted depending, *inter alia*, on performance. The target award, measured in CSX shares, however, serves as the benchmark for any adjustments. The value of CSX shares on the date of the target awards therefore affects the range of potential actual awards.

263 *See Resnik v. Swartz*, 303 F.3d 147, 151 (2d Cir. 2002).

264 *Resnik*, 303 F.3d at 151 (quoting *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1090 (1991)).

The CSX compensation committee and the board possessed material non-public information at the time it set the target awards.[265] However, the board did not coordinate setting the target awards with the disclosure of material non-public information.[266]

The CSX proxy describes the timing of the performance grants as follows:

> "Beginning with the 2006-2007 and 2006-2008 [LTIP], the [Compensation] Committee adopted the practice of granting target awards at the May meeting of the Committee, which is the first regular meeting following receipt in April by the Committee and the Board of the Company's business plan for the upcoming three-year period . . . ."[267]

Defendants argue that this is inadequate because it does not disclose that the company set the performance grants while in possession of material non-public information.

SEC rules require that a proxy statement "explain all material elements of the registrant's compensation of the named executive officers," including the information specified in Item 402 of Regulation S-K.[268] Regulation S-K explains that "[h]ow the determination is made as to when [compensation] awards are granted, including awards of equity-based compensation," may be a material element of compensation.[269] An SEC release further explains that under these regulations, a company should disclose if it had or intends to have "a program, plan or practice to select option grant dates . . . in coordination with the release of material non-public information. . .

[265] *See, e.g.,* PX 4 at 5; PX 267 (Munoz) ¶ 21; PX 265 (Richardson) ¶ 13.

[266] PX 265 (Richardson) ¶¶ 12, 14.

[267] JX 5, at 27.

[268] 17 C.F.R. § 240.14a-101 (Item 8).

[269] 17 C.F.R. § 229.402(b)(2)(iv).

."[270] Thus, if CSX had a program, plan or practice to coordinate the timing of the grants with the release of material non-public information, that practice should have been disclosed in the proxy materials. But there is no convincing evidence that CSX had such a practice. Furthermore, disclosure of the fact that the compensation committee possessed material non-public information at the time they set the target awards is not necessary to make other statements not false or misleading.

2. *The CSX Board's Compliance With CSX Insider Trading Policy*

Defendants argue that the CSX proxy statement is materially misleading because it fails to disclose that the board violated the company's insider trading policy.

CSX's policy provides that "[n]o CSX officer, employee or director . . . may purchase, sell or otherwise conduct transactions in any CSX security while he or she is aware of material nonpublic information about CSX."[271] It further prohibits any officer, employee, or director from

[270] Executive Compensation and Related Person Disclosure, Exchange Act Release Nos. 33-8732A, 34-54302A, 71 Fed. Reg. 53,158, 53,163-64 (Sept. 8, 2006). CSX argues that the performance grants are not options and thus fall outside of this regulation. But the SEC release makes clear that this disclosure should be made with regard to "the award of stock options and other equity-based instruments." *Id.* at 53,165. The SEC's Division of Corporation Finance confirms this. SEC, Item 402 of Regulation S-K - Executive Compensation, Questions & Answers of General Applicability, Question 3.01, http://www.sec.gov/divisions/corpfin/guidance/execcomp402interp.htm. That the performance grants are subject to later adjustment is immaterial because the trading price on the date of the grant determines the number of shares that can be earned. If the grants were made just prior to the release of material non-public information that increased the trading price, then the monetary value of the grants would appear artificially small. It is this type of timing, if done as part of a program, plan, or practice, that should be disclosed under the regulation and guidance.

[271] JX 27, at 1.

engaging in transactions in CSX securities during certain "blackout periods."[272] The policy defines "CSX security" broadly to include "any derivative instrument (including, but not limited to contracts, swap agreements, warrants and rights), the value of or return on which is based on or linked to the value of or return on any CSX security."[273]

As described above, on May 1, 2007, the compensation committee and the board set the target awards for the 2007-2009 LTIP while in possession of material non-public information. In addition, on December 12, 2007, the board granted 5,000 shares of common stock to each non-employee director,[274] pursuant to the CSX Stock Plan for Directors, which allows directors to grant themselves shares on a discretionary basis at any time and upon such terms as the board deems fit.[275] The size and timing of this grant was consistent with discretionary grants made in prior years, and did not depend on the market value of the shares on the day of the grant.[276] The board's December 12, 2007, grants were made during a blackout period as defined by the insider trading policy.

Defendants argue that the board violated CSX's insider trading policy by (1) setting the 2007-2009 LTIP target awards while in possession of material non-public information, and (2) making discretionary share grants to directors during a blackout period. Defendants argue that the proxy statement is materially misleading because it does not disclose these violations.

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272 *Id.* at 3.

273 *Id.* at 1.

274 PX 14, at 8.

275 JX 5, at 15.

276 PX 269 (Fitzsimmons) ¶ 10.

The Court is not persuaded that the insider trading policy, which by its terms applies to transactions of an officer, employee or director, applies also to transactions of the board when it acts as a board. Furthermore, assuming *arguendo* that these transactions violated the insider trading policy, the defendants do not articulate how the omission of this fact renders any statement in the proxy statement materially false or misleading. It is not sufficient that defendants characterize a violation of the insider trading policy as a breach of the board's fiduciary duty. "[N]o general cause of action lies under § 14(a) to remedy a simple breach of fiduciary duty."[277]

In any case, the proxy statement discloses the facts and circumstances of these transactions. Defendant's complaint is merely that CSX should have described the transactions as violations of its insider trading policy. But the disclosure rules do not oblige CSX to describe these transactions in pejorative terms.[278]

The Court is not persuaded that the transactions by the board violated CSX's insider trading policy. But assuming, *arguendo*, that these transactions constitute breaches of the board's fiduciary duties, the Court concludes that the CSX proxy statement is not materially false or misleading by its failure to disclose those breaches.

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277 *Koppel v. 4987 Corp.*, 167 F.3d 125, 133 (2d Cir. 1999); *see Va. Bankshares*, 501 U.S. at 1098 n.7 ("Subjection to liability for misleading others does not raise a duty of self-accusation; [rather] it enforces a duty to refrain from misleading.")

278 *In re: PHLCORP Sec. Tender Offer Litig.*, 700 F. Supp. 1265, 1269 (S.D.N.Y.1988) (stating, in a § 14(e) case, that as long as the relevant underlying facts are disclosed, the securities laws do not require insiders to characterize conflict of interest transactions with pejorative nouns or adjectives); *see GAF Corp. v. Heyman*, 724 F.2d 727, 740 (2d Cir. 1983).

3. CSX's Belief that TCI Seeks Effective Control

Defendants argue that CSX's statements that it believed that TCI was seeking "effective control" of the board[279] are materially false and misleading.

TCI has nominated only five candidates for election to a twelve-member board.[280] Although this would not be a majority, TCI told CSX that it would use this position to influence the work of the board.[281] Based on this and other experiences with TCI,[282] CSX honestly believed that TCI was seeking effective control.[283]

Statements of opinion may be materially false and misleading if the opinion is both objectively and subjectively false.[284] The defendants argue that CSX could not have believed that TCI was seeking effective control of the board because TCI has nominated only a minority slate of directors. Thus, the defendants seek to define effective control as being nothing less than a majority of the board. This is not the natural implication of the phrase as used by CSX in these

279 Such statements were made in the Board's February 14, 2008, letter to Hohn (DX 79) and in CSX's March 17, 2008, press release (DX 86). CSX has filed both of these documents as additional solicitation material pursuant to Rule 14a-12.

280 JX 17, at 1.

281 PX 266 (Kelly) ¶ 25 (Kelly understood Hohn to have threatened to create a dissident board that could disrupt the operation of the board).

282 *See, e.g.*, PX 108 (indicating that TCI might attempt to replace the entire board); PX 111 (same).

283 PX 266 (Kelly) ¶ 27.

284 *Virginia Bankshares*, 501 U.S. at 1095-96; *Bond Opportunity Fund v. Unilab Corp.*, No. 99 Civ. 11074 (JSM), 2003 WL 21058251, at *5 (S.D.N.Y. May 9, 2003); *In re: McKesson HBOC, Inc. Sec. Litig.*, 126 F.Supp.2d 1248, 1260, 1265 (N.D.Cal. 2000).

circumstances.[285] Indeed, the February 14, 2008, letter acknowledges specifically that TCI had nominated only a minority slate before concluding that TCI sought effective control. Because effective control often is understood to mean something considerably less than a majority position, there is no conflict between CSX's knowledge that TCI has nominated a minority slate and its opinion that TCI hopes to use that position to exert effective control. Accordingly, the Court concludes that these statements are not materially false or misleading.

4. TCI's Proposal Regarding Capital Expenditures

Defendants argue that Michael Ward's statement[286] that "one hedge fund . . . actually demanded that CSX freeze investment in its rail system" is materially false and misleading. It has suggested, it says, only that CSX freeze all *growth* investment pending congressional action on a re-regulation bill.[287]

CSX argues that Ward's statement is true because Ward believed and continues to believe that it is true. But Ward's belief is not relevant – this statement is one of fact, not opinion. Ward's statement inaccurately represents that TCI suggested that CSX freeze all as opposed to a particular type of investment. But this does not get defendants where they want to go.

285 For example, TCI's proxy solicitor, D.F. King, expressed the opinion that "the loss of confidence expressed by shareholders in electing a short-slate dramatically alters long-standing board alliances and creates opportunities for change." PX 135.

286 This statement was made in a March 11, 2008, opinion article by Michael Ward published in the *Washington Times*. DX 184. CSX filed the article as additional soliciting material.

287 *See, e.g.*, DX 47, 83, 82 at 99, 152-54; PX 96, 121.

In order to violate Rule 14a-9, a misleading statement must be made with respect to a material fact. The relevant question therefore is whether there is "a substantial likelihood that a reasonable investor would consider [TCI's position on non-growth investment] important in deciding how to vote."[288]

Whether this is a material fact in the context of this proxy fight is a close question. One of the matters that shareholders will be asked to decide is whether to vote for the minority slate nominated by TCI. The directors' recommendation about how to vote is likely to be material to such a decision, and the directors' reasons for a recommendation also may be material.[289] When the Supreme Court evaluated the materiality of false statements in *Virginia Bankshares*, it observed that "[n]aturally . . . the shareowner faced with a proxy request will think it important to known the directors' belief about the course they are recommending and their specific reasons for urging the stockholders to embrace it."[290]

An argument for finding materiality in this case is that Ward, by describing TCI's proposal inaccurately, was able to make the board's recommendation to vote against the TCI slate more persuasive. Faced with a somewhat similar circumstance, the D.C. Circuit concluded that it

[288] *Resnik*, 303 F.3d at 151 (quoting *Virginia Bankshares*, 501 U.S. at 1090).

[289] *See Virginia Bankshares*, 501 U.S. at 1090-91 ("We think there is no room to deny that a statement of belief by corporate directors about a recommended course of action, or an explanation of their reasons for recommending it, can [be material].")

[290] *Id.* at 1091.

would be intolerable to allow someone to claim that a fact is immaterial after relying on that fact to make a decision appear well informed.[291]

While such an outcome might be troubling, it does little to explain whether a fact is material. A trivial fact does not become material merely because it is related to a material fact. For example, if a false reason is given for a decision but the false reason is trivial, then it is unlikely that it did much to make the decision appear well reasoned and it remains a trivial fact.

In the circumstances of this case, the Court is not persuaded that there is a substantial likelihood that a reasonable investor would consider this important in deciding how to vote. Accordingly, Ward's statement did not violate the law.

5. The CSX-TCI Negotiations

In a March 17, 2008, CSX press release, CSX's lead director, Mr. Kelly is quoted as saying: "In an effort to avoid the disruption and expense of a proxy contest [CSX has] spoken with TCI on a number of occasions in an attempt to find common ground."[292] Defendants claim this statement is materially false and misleading.

The CSX board asked Kelly, as presiding director of the CSX board, to meet with Hohn to assess whether a proxy contest could be avoided.[293] Early in the negotiations, Ward

[291] *Berg v. First Am. Bankshares, Inc.*, 796 F.2d 489, 496 (D.C. Cir. 1986).

[292] DX 86.

[293] PX 266 (Kelly) ¶ 21.

encouraged Kelly to end the negotiations and kill any agreement.[294] But the CSX board asked Kelly to continue negotiations with Hohn, which he did.[295] As the negotiations proceeded, both sides discussed possible concessions.[296] Ultimately, the negotiations ended without an agreement.[297]

Defendants claim that CSX had no intention of finding common ground with TCI, and that its statement to the contrary therefore is materially false and misleading. TCI provides no evidence to support this claim. Defendants focus on Ward's intention to end the negotiations and CSX's post-negotiation strategy to win the proxy contest,[298] but neither of these facts suggest that CSX approached the negotiations in January with no intent to find common ground.

There is no evidence that CSX had no intention of finding common ground with TCI. Defendants, therefore, cannot establish that Kelly's statement is materially false or misleading.

[294] Tr. (Ward), at 13:9-14; 13:21-23; 16:21-24.

[295] PX 15, at 2-3; PX 266 (Kelly) ¶¶ 21-22.

[296] *See, e.g.*, PX 266 (Kelly) ¶ 23; DX 144 (Hohn) ¶¶ 45-47.

[297] *See* PX 169.

[298] Although Ward admits that CSX's current plan is to "deploy offense and defense with the goal of zero dissidents," there is no evidence that CSX adopted this plan while the negotiations with TCI were ongoing. *See* Tr. (Ward) at 22:2-23:7; DX 307 (notes from meeting that occurred after end of negotiations).

6. CSX's Purposes in Bringing this Lawsuit

CSX's March 17, 2008, press release quotes Mr. Ward as saying that "[CSX] filed this suit . . . to ensure that all of our shareholders receive complete and accurate information."[299] Defendants argue that this statement is materially false and misleading.

Speaking bluntly, this contention does not warrant a serious response. If the American people do not know that not every protestation of high motive, made in a contested election, can be taken literally, there is not much hope for any of us.

B. Declaratory Relief Regarding By-Laws Amendment

On February 4, 2008, the CSX board adopted an amendment to the CSX bylaws under which shareholders of record representing at least fifteen percent of the outstanding shares of CSX's stock may call a special meeting for certain limited purposes.[300] The Amendment does not allow special meetings to be called to elect or remove directors.[301] CSX management is seeking shareholder ratification of the Amendment at the upcoming shareholder meeting.[302]

[299] DX 86.

[300] JX 5, at 54; JX 30, at Art. I, § 2(b) (the amendment).

[301] Although the Amendment does not preclude specifically the use of special meetings for the election or removal of directors, its terms achieve that effect. *See* DX 266 (Kelly ¶ 7).

[302] JX 5, at 54.

CSX's Articles of Incorporation do not limit the circumstances in which directors may be removed.[303] Its shareholders thus have the power to remove directors with or without cause,[304] although "[a] director may be removed . . . only at a meeting called for the purpose of removing the director."[305]

Defendants argue that the Amendment is void because it prevents shareholders from calling a special meeting to remove a director without cause and therefore prevents the shareholders from exercising their right to remove directors without cause. This argument is flawed. First, Virginia law does not guarantee shareholders the right to call special meetings.[306] Second, the Amendment does not change shareholders' ability to call special meetings to remove directors – they were not able to call a special meeting to remove directors before its adoption. Finally, although the Amendment does not allow shareholders to call a special meeting for the purpose of removing a director, others are authorized to do so.[307]

303 *See* DX 98.

304 VA. CODE § 13.1-680.

305 *Id.*

306 Rather, shareholders are only able to call a special meeting if the articles or bylaws of the corporation authorize it. VA. CODE § 13.1-655.

307 VA CODE § 13.1-655 provides that "[a] corporation shall hold a special meeting of shareholders . . . [o]n call of the chairman of the board of directors, the president, the board of directors . . . ."

VI. Relief

CSX seeks several forms of injunctive relief, some of it far reaching.

In considering its request, it is well to bear in mind that courts in this circuit have found an implied private right of action for issuers – such as plaintiff – to bring claims for injunctive relief for violations of Sections 13(d) and 14(a)[308] on the premise that the "congressional purpose was furthered by providing issuers with the right to sue 'to enforce [the] duties created by [the] statute.'"[309] Allowing an issuer to seek injunctive relief "furthers the object of § 13(d) by increasing honest disclosure for the benefit of investors without placing incumbent management in a stronger position than aspiring control groups."[310] This principle informs the scope of relief available to an issuer-plaintiff like CSX.

In private actions under the securities laws, relief is "determined according to traditional principles. Thus, [CSX] must succeed on the merits and 'show the absence of an adequate remedy at law and irreparable harm if the relief is not granted.'"[311] Further, to obtain an injunction

308 *See, e.g.*, *GAF Corp. v. Milstein*, 453 F.2d 709, 720 (2d Cir. 1971) (§13(d)), *cert. denied,* 406 U.S. 910 (1972)); *Capital Real Estate Investors Tax Exempt Fund Ltd. P'ship v. Schwartzberg*, 929 F.Supp. 105, 108-09 (S.D.N.Y. 1996) (§ 14(a)). *See also Rondeau,* 422 U.S. at 62-63 (securities laws generally); *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366, 371 (6th Cir.1981) (§ 14(a)), *cert. denied*, 455 U.S. 982, 102 S.Ct. 1490, 71 L.Ed.2d 691 (1982).

309 *Hallwood Realty Partners, L.P.*, 286 F.3d at 620.

310 *Id.* at 620-21.

311 *Roach v. Morse*, 440 F.3d 53, 56 (2d Cir. 2006) (quoting *N.Y. State Nat'l Org. for Women v. Terry*, 886 F.2d 1339, 1362 (2d Cir.1989) (citing *Rondeau*, 422 U.S. at 57)). The Court applies the standard for a permanent injunction because this case was tried on the merits, pursuant to FED. R. CIV. P. 65(a)(2).

based on a violation of Section 13(d), the irreparable harm must be to those interests which that section seeks to protect.[312]

A. Success on the Merits

The Court has found that the defendants violated Section 13(d) in that (1) TCI did not file the required disclosure within 10 days of acquiring beneficial ownership in 5 percent of CSX shares, and (2) TCI and 3G failed to file the required disclosure within 10 days of forming a group.[313] But the Court has not found that the defendants' Schedule 13D disclosure is false, misleading, or otherwise inadequate as to a material fact.

Nor has the Court found that the defendants violated Section 14(a) or Rule 14d-9. Accordingly, injunctive relief is evaluated in light of the two 13D violations.

The fact that the Court has found no proxy rule violation or material misstatement or omission in the Schedule 13D that belatedly was filed disposes of several of CSX's prayers for relief. There is no basis for ordering corrective disclosure or for voiding proxies that defendants have obtained. Thus, the only remedies within the range of reasonable consideration are sterilization of

[312] *ICN Pharm., Inc. v. Khan,* 2 F.3d 484, 489 (2d Cir. 1993) ("[A]n injunction will issue for a violation of § 13(d) only on a showing of irreparable harm to the interests which that section seeks to protect" (quoting *Treadway Cos.,* 638 F.2d at 380); *Capital Realty Investors Tax Exempt Fund Ltd. P'ship v. Dominium Tax Exempt Fund L.L.P.,* 944 F. Supp. 250, 258-599 (S.D.N.Y. 1996) (§ 14); *ONBANCorp, Inc. v. Holtzman,* 956 F. Supp. 250, 256 (N.D.N.Y. 1997) (§ 14); *E. H. I. of Fla., Inc. v. Ins. Co. of N. Am.,* 499 F.Supp. 1053, 1066 (D.C.Pa. 1980) (§ 14). Moreover, when assessing irreparable harm for 13(d) claims, the court is not concerned with the shareholder who already has sold shares at a depressed price. *E.ON AG v. Acciona, S.A.*, 468 F.Supp.2d 537, 557 (S.D.N.Y. 2006) (citing *Rondeau*, 422 U.S. at 59).

[313] The Court has found also that Hohn and Behring are personally liable for the violations of TCI and 3G respectively.

the shares that defendants acquired during the period when they were out of compliance with Section 13(d), which amounts to about 6.4 percent of CSX's outstanding shares,[314] and an injunction against future disclosure violations.

B. Share Sterilization

Plaintiff seeks an injunction prohibiting the voting of any CSX shares owned by the defendants or members of their group at the 2008 annual meeting. It contends that this relief is warranted for two reasons. CSX's shareholders, they maintain, would be harmed irreparably in its absence. In any case, they argue, sterilization of this stock is required to avoid permitted defendants to retain the fruits of their violations and to deter future violations.

1. Irreparable Harm

CSX's irreparable injury argument sweeps too broadly. It offers no persuasive reason to prevent defendants from voting shares that they acquired before they breached any disclosure obligation, so the only proper focus is on the 6.4 percent of CSX shares that they purchased during the period in which they had not satisfied their disclosure obligations. Moreover, any present shareholders who have purchased for the first time after defendants filed their 13D knew what they were getting into and could not be injured in any cognizable way by allowing defendants to vote all their shares. Those current shareholders who have held shares throughout the period, however, may be in a different position. Defendants' actions may have contributed to creating a corporate electorate

[314] Defendants most recently held 8.3 percent of CSX's shares. Of that total, 1.9 percent were acquired by 3G before its disclosure obligation arose upon the expiration of 10 days following the formation of a group with TCI no later than February 13, 2007.

that is materially different today than it was before defendants made those purchases. Those who are content with present management and unconvinced by defendants' blandishments may be in a weaker position than they might have occupied had defendants made full and timely disclosure.[315] That all of the facts now have been disclosed does not alter this prospect. So the question is whether foreclosing defendants from voting the shares they acquired during their violations would avert irreparable injury that otherwise would occur.

In *Rondeau v. Mosinee Paper Corp.*,[316] the Supreme Court addressed the irreparable harm that a private plaintiff must show in order to obtain injunctive relief for a Section 13(d) violation. Rondeau did not file a Schedule 13D until three months after he had acquired more than 5 percent of the issuer's outstanding stock. He acquired an additional 2.5 percent of the outstanding stock before disclosing his position. Although Rondeau admitted violating Section 13(d), the district court found no irreparable harm and denied injunctive relief.[317]

The Court of Appeals reversed. It found irreparable harm because Mosinee Paper "'was delayed in its efforts to make any necessary response to' [Rondeau's] potential to take control." In any case, it concluded, Mosinee "'need not show irreparable harm as a prerequisite to obtaining permanent injunctive relief . . . .'" It remanded with instructions to enjoin Rondeau from voting the shares acquired while in violation of Section 13(d). "It considered 'such an injunctive decree

315 Had defendants made full and timely disclosure, it is likely that the price of CSX shares would have risen on the prospect of a battle for control.

316 422 U.S. 49.

317 *Id.* at 51-54.

appropriate to neutralize [Rondeau's] violation of the Act and to deny him the benefit of his wrongdoing.'"[318]

The Supreme Court reversed. In evaluating the claimed harm, it focused on whether "the evils to which the Williams Act was directed ha[d] occured . . . ." It concluded that "[o]n this record there is no likelihood that [Mosinee's] shareholders will be disadvantaged should petitioner make a tender offer, or that [Mosinee] will be unable to adequately place its case before them should a contest for control develop."[319]

Rondeau does not foreclose the possibility relief such as sterilization for Section 13(d) violations, but it does make clear that a prerequisite to such relief is a showing of irreparable harm. Moreover, the determinative question is whether, absent an injunction, there would be irreparable harm to the interests which Section 13(d) seeks to protect – viz. "alert[ing] investors to potential changes in corporate control."[320] In consequence, private plaintiffs usually are unable to establish an irreparable harm once the relevant information has been made available to the public. Second Circuit cases go so far as to suggest, in *dicta*, that irreparable harm can not be established once corrective disclosure is made.[321]

318 *Id.* at 56-57.

319 *Id.* at 59.

320 *Kamerman v. Steinberg*, 891 F.2d 424, 430 (2d Cir. 1989) (quoting *GAF Corp.*, 453 F.2d at 720).

321 *ICN Pharm.*, 2 F.3d at 489 ("'[A]n injunction will issue for a violation of § 13(d) only on a showing of irreparable harm to the interests which that section seeks to protect. Those interests are fully satisfied when the shareholders receive the information required to be filed.'" (citations omitted) (quoting *Treadway Cos.*, 638 F.2d at 380)); *Treadway Cos.*, 638 F.2d at 380 ("Since the informative purpose of § 13(d) had thereby been fulfilled, there was

Nonetheless, the Second Circuit in *Treadway* left open the possibility of finding irreparable harm despite corrective disclosure, observing that it would not rule out the possibility that "'disenfranchisement or divestiture may be appropriate'" where a defendant has obtained "'a degree of effective control' as a result of purchases made before it has complied with § 13(d) . . . ."[322] It did not resolve the issue, however, because it regarded the defendants' 31 percent holding of the outstanding shares as insufficient to confer "a degree of effective control."[323] *Treadway* thus stands for the proposition that acquisition of a 31 percent block, partially during a period of noncompliance with Section 13(d) is insufficient to threaten irreparable injury on the remaining shareholders because control has not passed at that level.

It is questionable whether a bright line rule that appears to foreclose the existence of "a degree of effective control" in the absence of a stock holding larger than 31 percent is consistent with commercial realities. One need look no farther than Hohn's threat to Kelly that election of his slate of a minority of directors would permit him to render Ward's future "bleak" and be disruptive in the CSX boardroom[324] to see why that is so. Moreover, courts have recognized that minority

no risk of irreparable injury . . . .").

322 *Treadway Cos.,* 638 F.2d at 380 n.45 (quoting *Fin. Gen'l Bankshares, Inc. v. Lance,* No. 78-0276, 1978 WL 1082, at *13 (D.D.C., Apr. 27, 1978)).

323 This conclusion is consistent with the district court case to which the Circuit cited. In *Financial General Bankshares Inc.*, the Court observed that enjoining any future stock acquisition "might be appropriate if defendants had obtained effective control . . . as a result of purchases made while not complying with section 13(d)." The Court concluded that the defendants had not obtained effective control despite acquiring approximately an additional 15 percent of the outstanding shares. *Fin. Gen'l Bankshares, Inc.*, No. 78-0276, 1978 WL 1082, at *13 (D.D.C. Apr. 27, 1978).

324 PX 266 (Kelly) ¶ 25.

shareholdings or board representation may confer a degree of control, at least in some circumstances.[325] But *Treadway* is the law of our Circuit, and this Court is obliged to follow it. Indeed, plaintiffs have cited no case, in or out of our Circuit, in which irreparable harm was found because a defendant had obtained a degree of effective control.[326] It necessarily follows that the alteration of the corporate electorate arguably effected by defendants' actions, which did no more than increase its likelihood of prevailing in the current contest, cannot be regarded as irreparable injury that properly may be remedied by preventing the voting of the stock acquired while defendants were in violation of Section 13(d).[327]

325 *See, e.g., Dan River, Inc. v. Unitex Ltd.*, 624 F.2d 1216, 1225 (4th Cir. 1980) (20 percent "frequently is regarded as control of a corporation"); *Standard Fin., Inc. v. LaSalle/Kross Partners, L.P.*, No. 96 C 8037, 1997 WL 80946, at *4-*5 (N.D. Ill. Feb. 20, 1997) (intention to obtain two board seats and to influence company evidenced purpose to exercise control); *Saunders Leasing Sys., Inc. v. Societe Holding Gray D'Albion, S.A.*, 507 F. Supp 627, 633-34 (N.D. Ala. 1981) (intention to acquire 25 percent of issuer "controlling").

326 *E.g., Raybestos-Manhattan, Inc. v. Hi-Shear Indus.*, 503 F.Supp. 1122, 1133 (E.D.N.Y. 1980) (quoting *Treadway*, but not finding degree of effective control); *Drobbin v. Nicolet Instrument Corp.*, 631 F.Supp. 860, 913 n.3 (S.D.N.Y. 1986) (same).

327 Other courts have observed that the disadvantage to management or to a tender offeror that may result from a shift in the corporate electorate does not an irreparable harm. *See, e.g.*, *Gearhart Indus., Inc. v. Smith Intern., Inc.*, 741 F.2d 707, 715 (5th Cir. 1984) ("Insofar . . . as the injunction is made to rest on disadvantage created to . . . management's resistance to the takeover, the Williams Act does not support it."); *E.ON AG v. Acciona, S.A.*, No. 06 Civ. 8720 (DLC), 2007 WL 316874, at *9 (S.D.N.Y. Feb. 5, 2007) (fact that defendant's substantial stock holdings may make tender offer more difficult does not constitute irreparable harm); *Fin. Gen'l Bankshares, Inc.*, No. 78-0276, 1978 WL 1082, at *12 (no irreparable injury based "unlawful headstart [tender offerors] have obtained in their surreptitious efforts to seize control. . . .").

2. *Deterrence*

Other courts have suggested that relief beyond corrective disclosure is appropriate, at least in some circumstances, in order to deter violations.[328] In the main, they have done so in reliance on arguments made by the SEC in an *amicus curiae* brief to the First Circuit where the Commission suggested that, "in determining whether more than corrective disclosure is called for, [a court] should . . . consider (1) whether a substantial number of shares were purchased after the misleading disclosures and before corrective disclosure, (2) whether the curative disclosure occurred simultaneously with or on the eve of a tender offer, and (3) whether the violation was egregious'"[329] and argued that "[a]bsent a remedy beyond ordering corrective disclosure, a person will have little incentive to comply with the statute."[330]

The difficulty with this argument is that it is foreclosed by *Rondeau*, where the Supreme Court rejected the contention that the relief ordered in that case was justified, notwithstanding the lack of threatened irreparable injury, by the "public interest" in enforcing the disclosure requirements.[331] "[T]he fact that [a plaintiff] is pursuing a cause of action which has been generally recognized to serve the public interest," it said, "provides no basis for concluding that it is

328 *See, e.g., San Francisco Real Estate Investors v. Real Estate Inv. Trust of Am.*, 701 F.2d 1000, 1009 (1st Cir. 1983); *Am. Carriers, Inc. v. Baytree Investors, Inc.*, 685 F.Supp. 800, 812-13 (D. Kan. 1988); *Hanna Mining Co. v. Norcen Energy Resources Ltd.*, 574 F.Supp. 1172, 1202-03 (N.D.Ohio 1982).

329 *San Francisco Real Estate Investors*, 701 F.2d at 1009.

330 Brief for the SEC as *Amicus Curiae*, *San Francisco Real Estate Investors v. Real Estate Inv. Trust of Am.*, 701 F.2d 1000 (1st Cir. 1983) [DI 61, Add. B]; *see also Gen. Steel Indus., Inc. v. Walco Nat'l Corp.*, SEC Litig. Release No. 9533, 1981 WL 315222 (Dec. 21, 1981).

331 *Rondeau,* 422 U.S. at 62, 65.

relieved of showing irreparable harm and other usual prerequisites for injunctive relief."[332] While a footnote in *Piper v. Chris-Craft Industries, Inc.,*[333] decided two years after *Rondeau,* suggests that deterrence "possibly" is an appropriate consideration in formulating relief "with respect to the most flagrant sort of [securities law] violations which no reasonable person could consider lawful,'"[334] this *dictum* is insufficient to overcome *Rondeau's* square holding that threatened irreparable injury is a *sine qua non* of the sort of relief that CSX seeks here.[335]

Accordingly, this Court holds that a threat of irreparable injury is essential to obtain an injunction sterilizing any of defendants' voting rights and that plaintiff has failed to establish such a threat. Were the Court free as a matter of law, however, to grant such an injunction, whether on the basis that such relief is warranted to afford deterrence or on another basis, it would do so.

C. *Enjoining Further Disclosure Violations*

CSX seeks an injunction against further violations of the securities laws.

332 *Id.* at 64-65.

333 430 U.S. 1 (1977).

334 *Id.* at 40 n.26.

335 Plaintiff cites two post-*Rondeau* cases in which shares were sterilized despite corrective disclosure. *Champion Parts Rebuilders, Inc. v. Cormier Corp.*, 661 F.Supp. 825 (N.D.Ill. 1987*);General Steel Indus., Inc. v. Walco Nat. Corp.*, No. 81-1410-C, 1981 WL 17552, at *3 (E.D.Mo. Nov. 24, 1981). Both, however, relied on considerations that are inappropriate in light of *Rondeau*.

The SEC is authorized by statute to seek such an injunction.[336] But it "must demonstrate that there is a substantial likelihood of future [securities] violations . . . ."[337] In evaluating whether there is a substantial likelihood of future violations, a court considers

> "the fact that the defendant has been found liable for illegal conduct; the degree of scienter involved; whether the infraction is an 'isolated occurrence;' whether defendant continues to maintain that his past conduct was blameless; and whether, because of his professional occupation, the defendant might be in a position where future violations could be anticipated."[338]

Of course, when the SEC appears before the Court seeking an injunction against further violations, it "appears . . . not as an ordinary litigant, but as a statutory guardian charged with safeguarding the public interest in enforcing the securities laws."[339] The SEC therefore is "relieved . . . of the obligation, imposed on private litigants, to show risk of irreparable injury or the unavailability of remedies at law."[340] CSX, a private litigant, however, must demonstrate a threat of irreparable injury to the interests which Section 13(d) seeks to protect.[341]

[336] 15 U.S.C. § 78u(d).

[337] *SEC v. Cavanagh*, 155 F.3d 129, 135 (2d Cir. 1998) (citing *SEC v. Unifund SAL*, 910 F.2d 1028, 1040 (2d Cir.1990)).

[338] *Cavanagh*, 155 F.3d at 135 (quoting *SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90, 100 (2d Cir.1978)).

[339] *SEC v. Mgmt. Dynamics, Inc.*, 515 F.2d 801, 809 (2d Cir. 1975).

[340] *Unifund SAL*, 910 F.2d at 1036 (citations omitted); *also Mgmt. Dynamics, Inc.*, 515 F.2d at 808-09.

[341] *Rondeau,* 422 U.S. at 57 (addressing, *inter alia,* injunction against future violations); *Wininger v. SI Mgmt. L.P.*, 33 F. Supp. 2d 838, 847 (N.D.Cal. 1998) (concluding that plaintiff's request for a permanent injunction was not futile because the Court could issue a permanent injunction on a showing of irreparable harm).

1. Probability of Future Violations

In this case, defendants have committed two violations of Section 13(d) of the Exchange Act. Both failed to make a timely filing after forming a group. TCI failed to file within 10 days after being becoming, or being deemed to have become a beneficial owner of more than 5 percent of CSX's shares.

These violations were not products of ignorance. There is evidence that the use of derivatives such as those at issue here is "a standard technique [in the hedge fund industry] to avoid disclosure of these big stakes."[342] In any case, TCI deliberately evaded disclosure obligations. Both defendants were more than cognizant of the obligation to file promptly upon forming a group and, in this Court's view, knew full well, or recklessly disregarded the substantial likelihood, that they had formed a group, this notwithstanding Hohn's incantations and the lack of a formal written agreement.

Both continue to maintain that their actions were blameless and, indeed, testified falsely in a number of respects, notably including incredible claims of failed recollection, to avoid responsibility for their actions. Both, moreover, are engaged in lines of endeavor in which future violations are far more than a speculative possibility.

In all the circumstances, the Court finds a substantial likelihood of future violations. Defendants have sought to control CSX for over a year. As obstacles to control surfaced, they adapted their strategy for achieving control, making disclosures only when convenient to their strategy. Defendants' latest strategy for control will be tested at the annual shareholder meeting. And

[342] U.S. Securities and Exchange Commission, *Unofficial Transcript of the Roundtable Discussion on Proxy Mechanics* May 24, 2007 (remarks of Prof. Henry Hu). (Unfortunately, the document is not paginated.)

if this strategy is not successful, the Court perceives a substantial likelihood that the defendants would craft a new strategy for control without regard to their disclosure obligations.

2. Irreparable Injury

The fact that future violations are probable absent an injunction is highly pertinent to the irreparable injury question. Defendants' past violations have advanced significantly the achievement of their objectives. They likely were able to acquire a larger position in CSX for a price lower than would have been required had all of the facts been disclosed as and when required. The motive for building on that position through concealment remains. The battle for CSX may not end with the June 25 annual meeting. Further Section 13(d) violations could allow defendants to increase their position to a point of working control. Remaining shareholders in that event would find themselves with shares in a corporation with a controlling shareholder and thus deprived of the opportunity to gain a control premium for their shares. Corrective disclosure could not remedy that harm because it would come too late. In any case, the legal remedy, if any, manifestly would be inadequate because it would be impossible to determine with any accuracy the price that the remaining shareholders could have realized if that fact that defendants were in the process of obtaining working control. A permanent injunction against future Section 13(d) injunctions therefore is appropriate.[343]

[343] *See, e.g., E.On AG v. Acciona, S.A.,* No. 06 Civ. 8720 (DLC), 2007 WL 316874, at *10 (S.D.N.Y. Feb. 5, 2007).

Conclusion

For the foregoing reasons, plaintiff is entitled to a permanent injunction restraining future violations of Section 13(d) of the Exchange Act and the rules thereunder. The counterclaims are dismissed. The Court has concluded that it is foreclosed as a matter of law from enjoining defendants from voting the 6.4 percent of CSX's shares that they acquired between the expiration of to10 days following the formation of the group no later than February 13, 2008 and the date of the trial. If, however, it were free to grant such relief, it would exercise its discretion to do so.

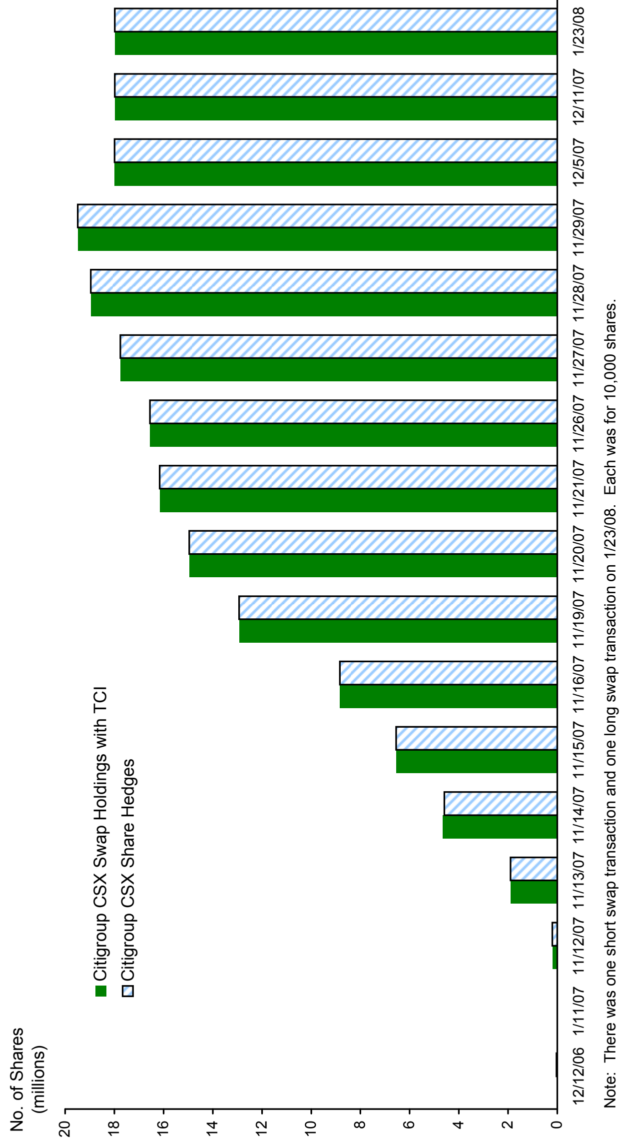
Counsel shall notify the Court no later than 11 a.m. on June 12, 2008 whether an application will be made to this Court for relief pending appeal. In the event that they wish to do so, any application will be heard orally that day in Courtroom 12D at 2:15 p.m.

SO ORDERED.

Dated: June 11, 2008
Issued at: 3:05 p.m.

Lewis A. Kaplan
United States District Judge

(The manuscript signature above is not an image of the signature on the original document in the Court file.)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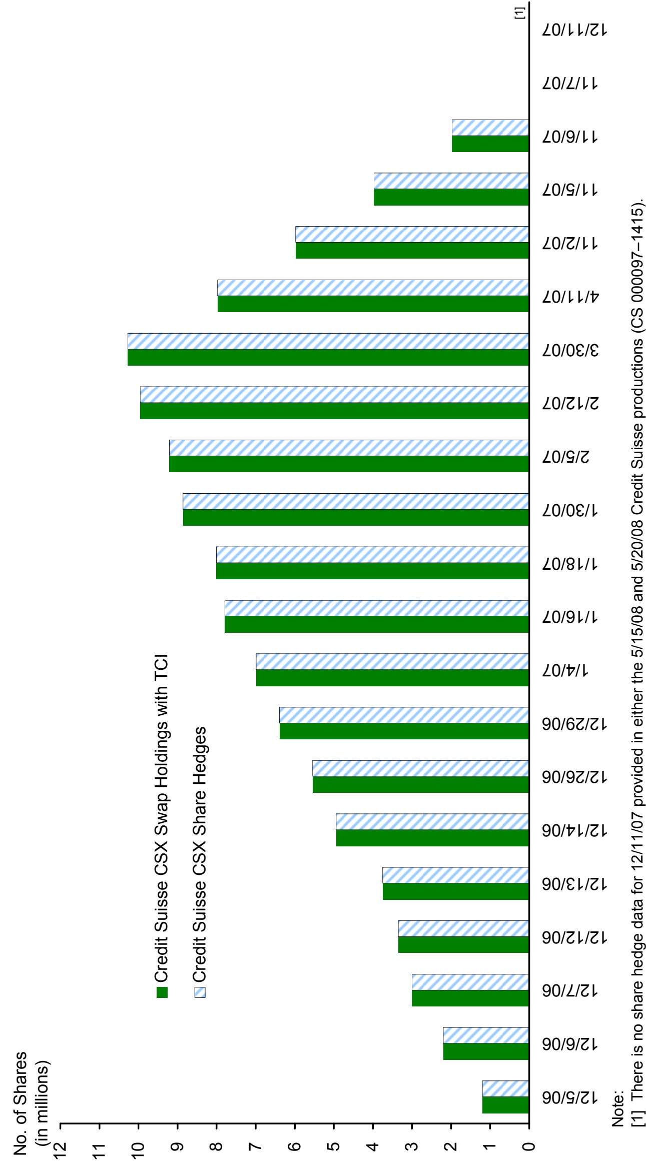
Citigroup Inc.: Holdings of CSX Swaps with TCI and CSX Share Hedges
12/12/06 – 1/23/08
No. of Shares
(millions)
20
18
16
14
12
10
8
6
4
2
0
Citigroup CSX Swap Holdings with TCI
Citigroup CSX Share Hedges
12/12/06
1/11/07
11/12/07
11/13/07
11/14/07
11/15/07
11/16/07
11/19/07
11/20/07
11/21/07
11/26/07
11/27/07
11/28/07
11/29/07
12/5/07
12/11/07
1/23/08
Note: There was one short swap transaction and one long swap transaction on 1/23/08. Each was for 10,000 shares.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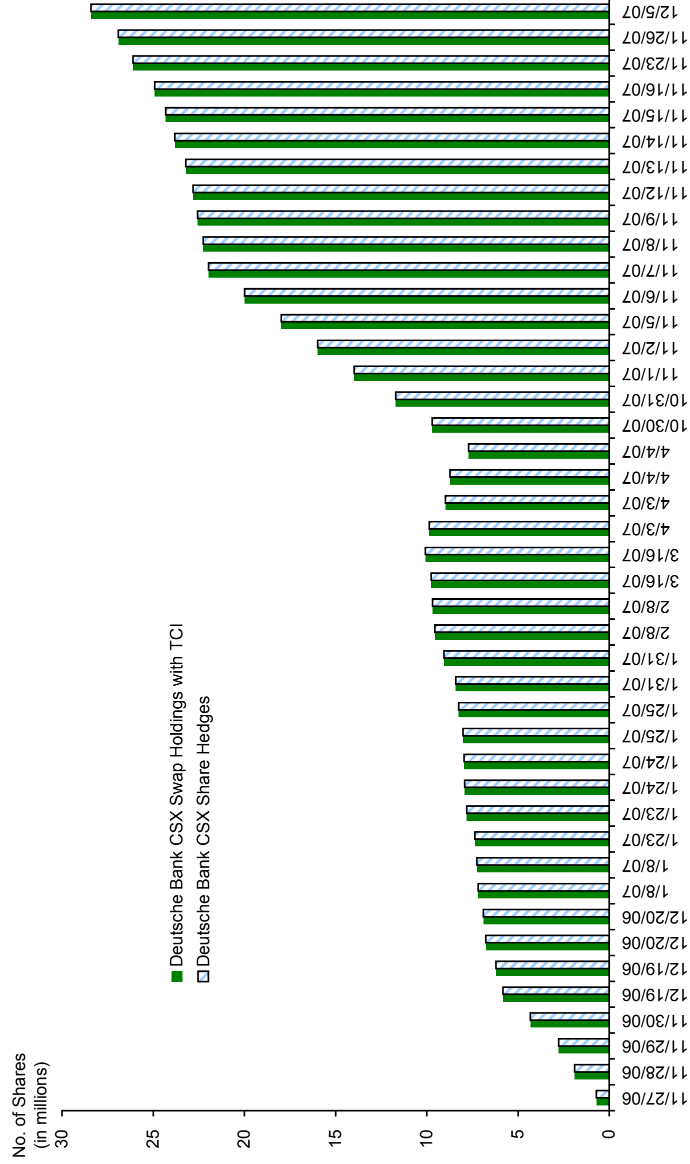
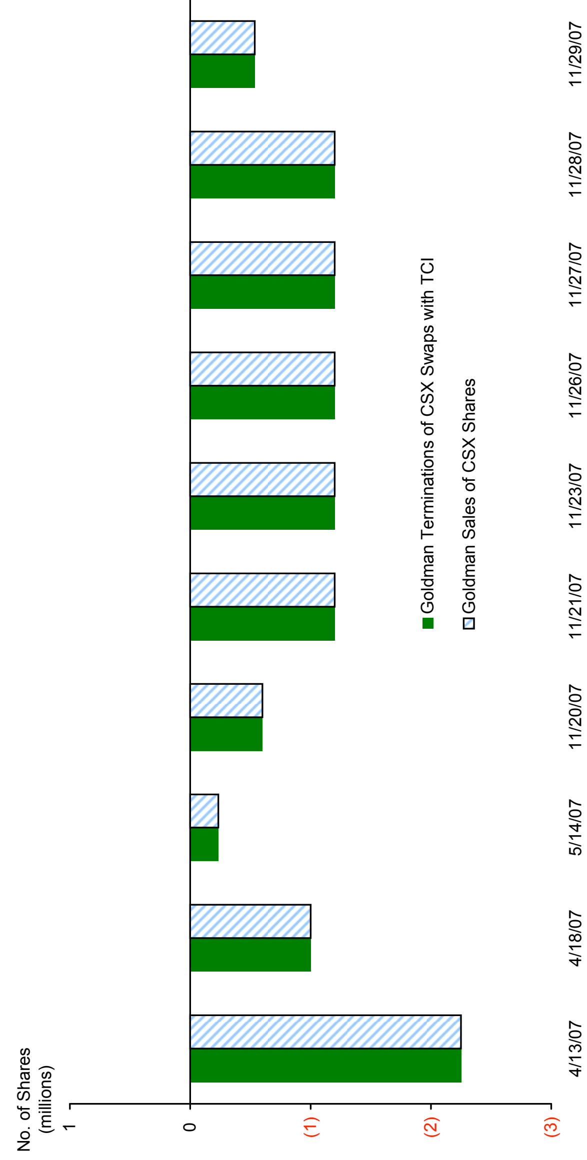
Credit Suisse: Holdings of CSX Swaps with TCI and CSX Share Hedges
12/5/06 – 12/11/07
No. of Shares
(in millions)
12
11
10
9
8
7
6
5
4
3
2
1
0
Credit Suisse CSX Swap Holdings with TCI
Credit Suisse CSX Share Hedges
12/5/06
12/6/06
12/7/06
12/12/06
12/13/06
12/14/06
12/26/06
12/29/06
1/4/07
1/16/07
1/18/07
1/30/07
2/5/07
2/12/07
3/30/07
4/11/07
11/2/07
11/5/07
11/6/07
11/7/07
12/11/07
[1]
Note:
[1] There is no share hedge data for 12/11/07 provided in either the 5/15/08 and 5/20/08 Credit Suisse productions (CS 000097–1415).

Deutsche Bank AG: Holdings of CSX Swaps with TCI and CSX Share Hedges
11/27/06 – 12/5/07



Goldman Sachs Group, Inc.: Terminations of CSX Swaps with TCI and Sales of CSX Shares
4/13/07 – 11/29/07



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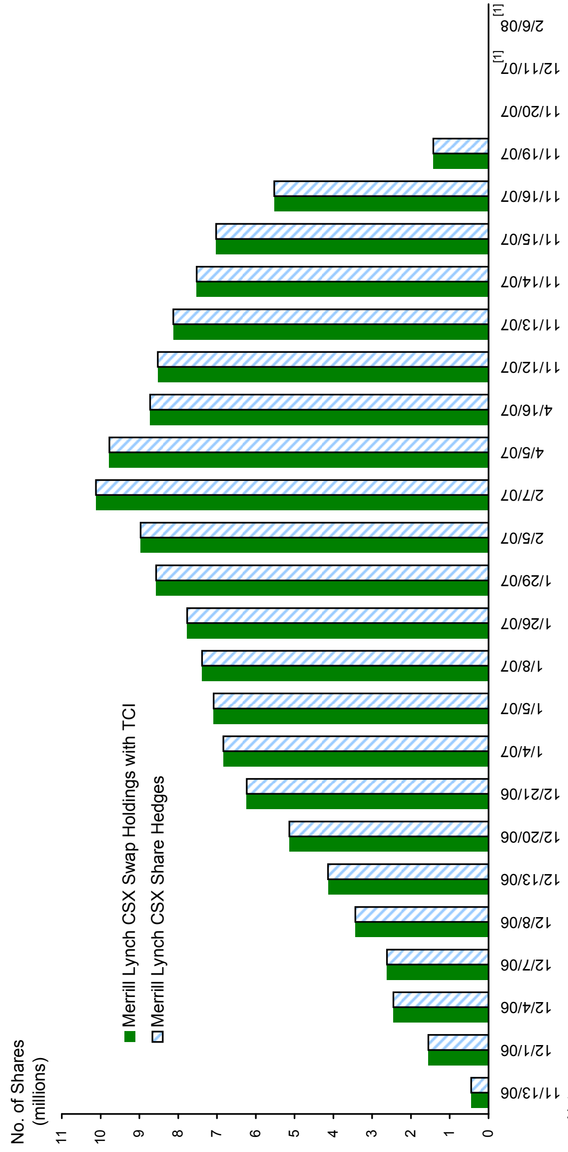

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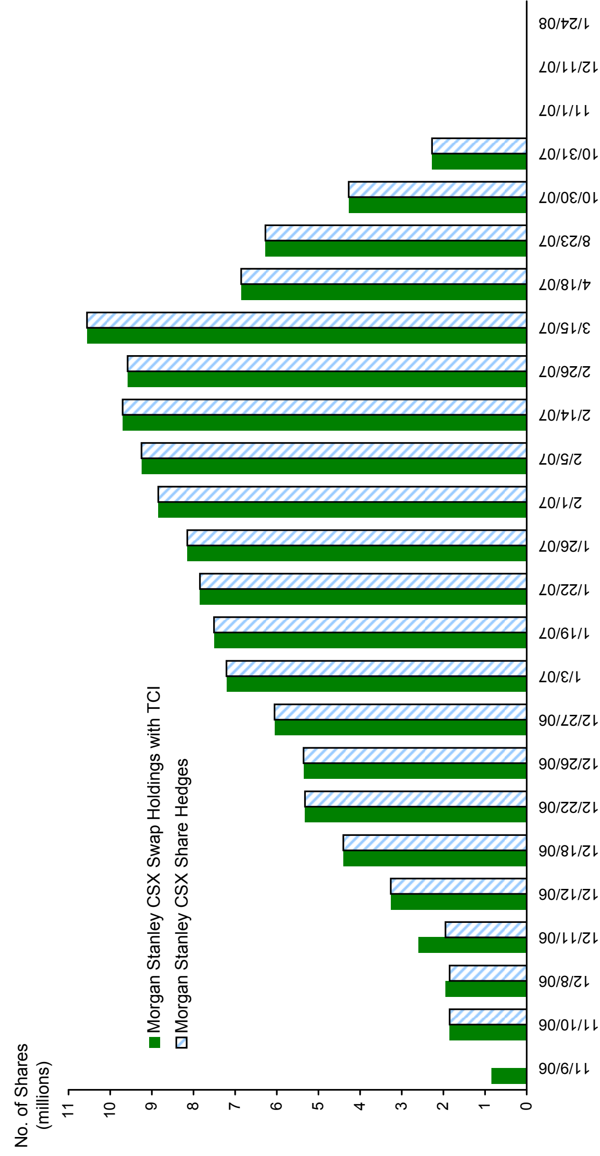

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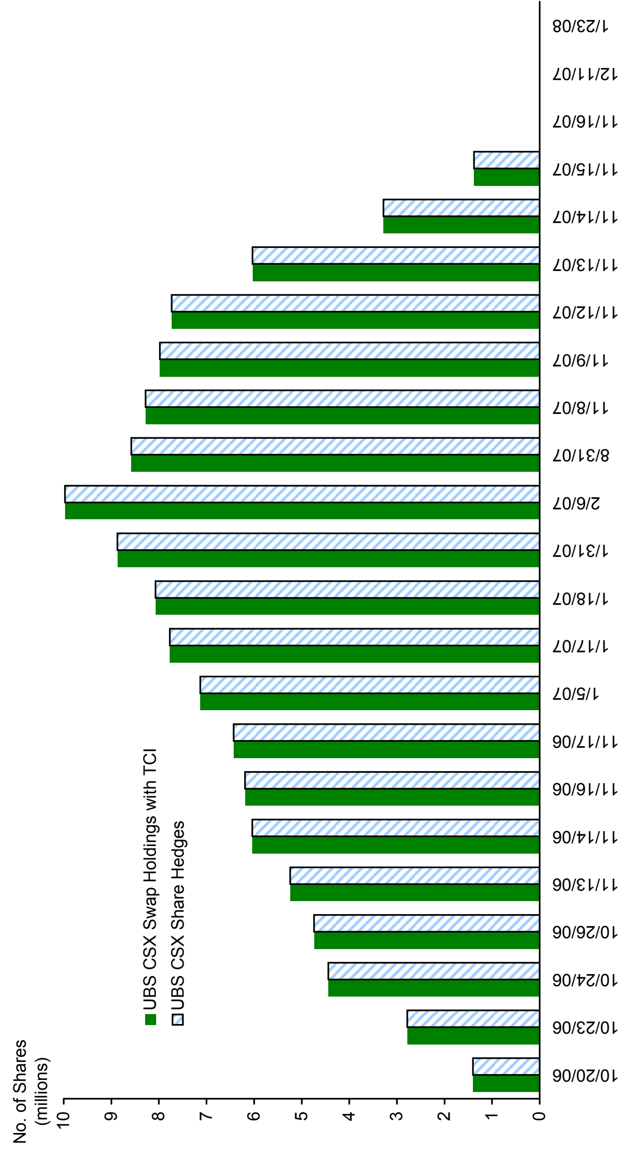
UBS AG: Holdings of CSX Swaps with TCI and CSX Share Hedges 10/20/06 – 1/23/08



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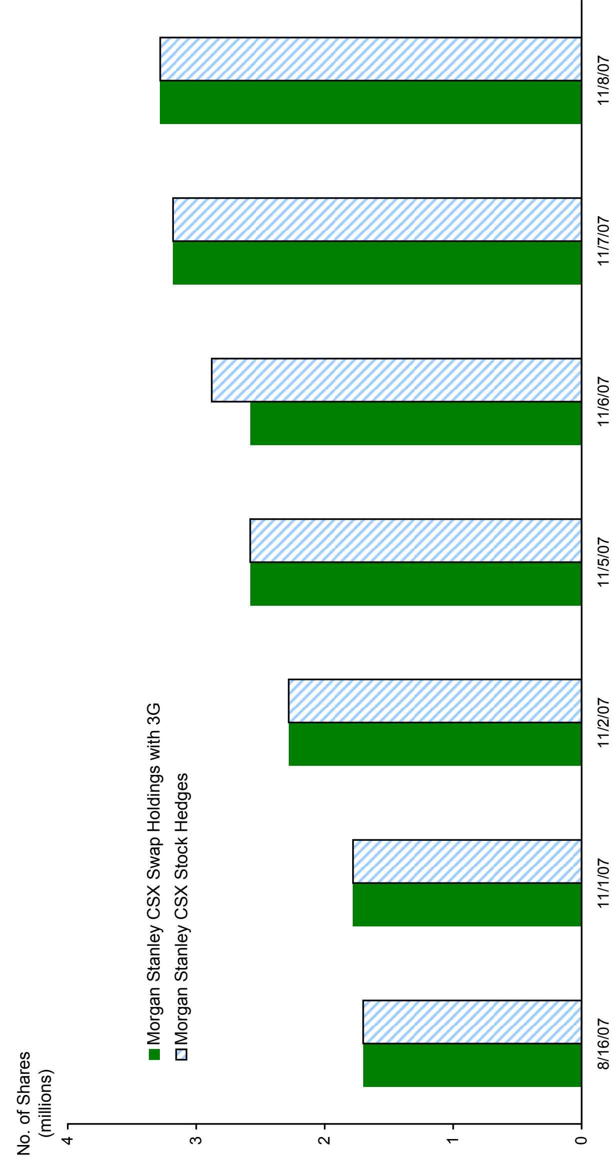
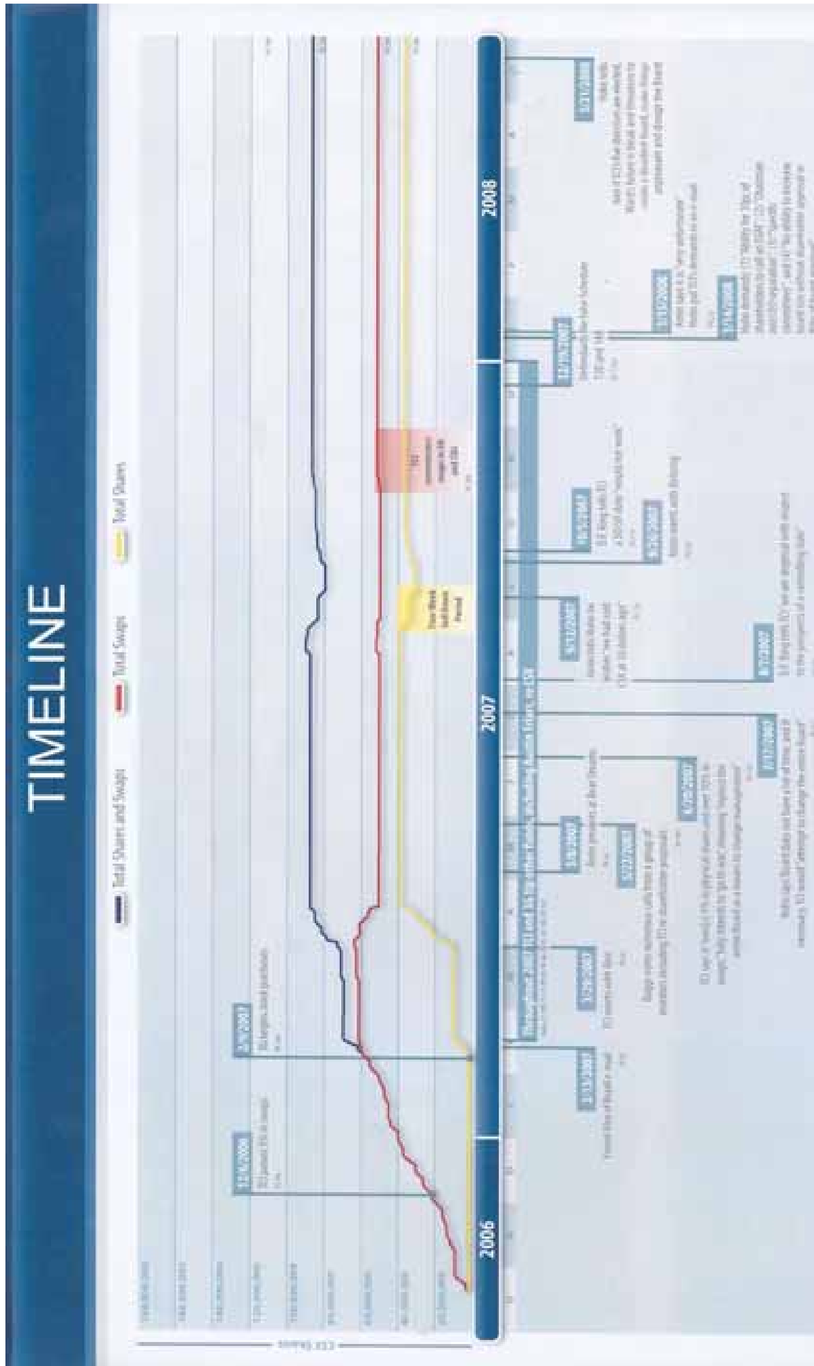
Morgan Stanley: Holdings in CSX Swaps with 3G and CSX Share Hedges 8/16/07 – 11/8/07





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