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# Court sides with hedge funds on CSX vote

**By Floyd Norris**
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**NEW YORK:** A U.S. federal judge has ruled that two hedge funds seeking to win a proxy fight at CSX violated securities laws by not disclosing their positions and intentions many months before they did.

But Judge Lewis Kaplan of U.S. District Court in New York nonetheless ruled Wednesday that there was nothing effective that he could do. He refused to bar the hedge funds from voting their shares at an annual meeting on June 25, as CSX, one of the largest railroad companies in the United States, had requested.

"Some people deliberately go close to the line dividing legal from illegal if they see a sufficient opportunity for profit in doing so," Kaplan wrote in his 115-page decision. "A few cross that line and, if caught, seek to justify their actions on the basis of formalistic legal arguments even when it is apparent that they have defeated the purpose of the law. This is such a case."

The two hedge funds - the Children's Investment Fund of Britain and 3G Capital Partners, a Brazilian fund - are backing a dissident slate of five directors at the CSX meeting. The funds own 8.7 percent of the company's shares, and have positions in equity swaps - a form of derivative contract - that amount to another 12.3 percent of the shares.

Kaplan all but invited CSX to appeal his decision to the Second U.S. Circuit Court of Appeals. The judge said he believed that he could not stop the funds from voting their shares, largely because of a Second Circuit precedent. If he could have done so, the judge said, he would have issued such an injunction.

The judge did bar the funds from future violations of the securities laws, but said no new disclosures were required, because all relevant facts were now public. "Any penalties for defendants' violations must come by way of the Securities and Exchange Commission or the Department of Justice," the ruling said.

That put the ball squarely in the SEC's court. Evidence in the case showed that CSX had been trying for months, without success, to persuade the SEC to act. The only public role of the SEC so far came when a staff member, responding to a request from the court, sent a legal interpretation that largely agreed with the position of the hedge funds.

The case drew attention far beyond the ranks of those who care whether the hedge funds can win the fight and gain board representation. While that would not give the funds control, it would give them a place inside the company to push for management changes.

A former member of the SEC, Joseph Grundfest, who is a law professor at Stanford University, argued that a victory by the hedge funds "would render compliance" with the disclosure requirements "essentially voluntary."

Wall Street lined up behind the hedge funds, arguing that it could create chaos if the disclosure requirements were broadened.

Central to the case is the nature of equity swaps, in which one party - typically a brokerage firm - promises to pay the other - in this case a hedge fund - all the economic rewards of owning a stock, and the fund promises to compensate the firm if the stock loses value.

There are reasons to buy swaps aside from evading disclosure rules.

A fund can use more leverage, and a foreign-based fund can avoid paying withholding taxes on dividends.

An equity swap holder does not have voting rights. Normally, the brokerage firm that writes the swap will buy the stock, but it does not have to do so, if it is willing to take the risk or in the unlikely event that it has another customer who wants to use a swap to short the same stock.

That lack of voting rights was critical, in the view of the hedge funds. U.S. securities laws require that "beneficial ownership" be disclosed, and define such as including both voting rights and economic benefits.

CSX argued that the brokerage firms, which nominally own the shares although they have no economic stake in the company, had good business reasons to vote as the hedge funds wish. If they did not do so, such firms would risk losing business from the hedge funds.

Kaplan said there were "persuasive reasons" for concluding that the funds "beneficially owned at least some and quite possibly all" of the shares bought by the brokerage firms to hedge their swap positions. But, he said, there was no need for him to rule on that issue.

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