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Hedge Funds Agree to Settle Litigation Concerning
"Short-Swing" Profits Related to Derivative Positions

As part of the continuing confrontation between CSX Corporation and hedge funds holding CSX shares and equity swaps on CSX shares – and which earlier this year mounted a successful proxy fight, replacing four members of the CSX board of directors – the hedge funds have agreed to settle an action to recover "short-swing" profits pursuant to Section 16(b) of the Securities Exchange Act of 1934.

Section 16(b) provides that beneficial owners of more than 10% of the stock of publicly traded corporations (as well as officers and directors) are liable to disgorge to the corporation any profit derived from purchases and sales of the stock of the corporation within a period of less than six months. While the hedge funds which invested in CSX did not directly hold a position of more than 10% in CSX shares, their aggregate interest in the shares and the equity swaps – which involved matching positions in CSX stock by the banks which had written the swaps – together exceeded 10%. As we discussed in our memo of June 12th, in a separate litigation brought by CSX against the funds, Judge Kaplan of the U.S. District Court for the Southern District of New York held that the hedge funds were the beneficial owners of over 10% of CSX shares for purposes of SEC Rule 13d-3(b) on account of the shares they directly held and the swaps they entered into.

Following Judge Kaplan's decision, a CSX shareholder filed suit pursuant to Section 16(b) seeking to recover for the benefit of CSX short-swing trading profits achieved by the hedge funds while they beneficially held more than 10% of CSX stock directly and by virtue of their derivative positions. Rule 16a-1(a)(1) provides that a beneficial owner of more than 10% for purposes of Section 16 means any person who is deemed a beneficial owner pursuant to Section 13(d) and the rules thereunder. Based on the hedge funds' swaps and stock transactions, plaintiff and CSX identified potential recoverable damages from the hedge funds under Section 16(b) of approximately $138 million. The hedge funds agreed to pay $11 million to settle the Section 16(b) action. The amount of the settlement was reportedly influenced by, among other things, the fact that Judge Kaplan's decision regarding beneficial ownership is still pending appeal to the Second Circuit.

We have long advised that non-traditional economic and voting arrangements be approached with extreme caution. Such arrangements not only can have significant implications for investors' disclosure obligations under Section 13(d), but can also trigger shareholder rights plans, change-in-control provisions of commercial and employee contracts and compensation plans, and, as the CSX settlement makes clear, investors' "short-swing" profit repayment obligations under Section 16(b). We continue to urge the SEC to undertake comprehensive regulatory reform that addresses derivative arrangements in a clear and uniform manner, generally treating all such arrangements that are coupled with direct or indirect ownership of actual shares by counterparties as in all respects equivalent to actual ownership, and requiring appropriate disclosure of all such arrangements involving more than 5% economic equivalent ownership, whether long or short, and whether accompanied by underlying ownership positions or otherwise. In the meantime, it continues to be important for public companies and investors alike to consider all potential legal obligations and liabilities that may arise as a result of such economic ownership equivalent positions and to take appropriate action in that regard.

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