

# Equity and Debt Decoupling: Derivative Instruments Challenge Fundamental Assumptions of Corporate and Bankruptcy Law

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The rapid growth in derivatives as hedging instruments, particularly through equity swaps, credit default swaps (“CDS”) and loan credit default swaps (“LCDS”), has challenged fundamental assumptions underlying corporate governance law, federal shareholder disclosure requirements and bankruptcy law. Corporate law has long relied on a “one share one vote” model, which presumes that a shareholder’s economic interests in a corporation are inextricably linked to their voting power. Federal securities laws require significant shareholders to disclose their percentage ownership stakes, on the assumption that they are likely to vote their interests and that other shareholders are entitled to know who the major stakeholders are. Similarly, bankruptcy law has assumed a creditor will act rationally in regard to a debtor and other similarly situated creditors in order to maximize their recovery.

The markets have rendered these assumptions obsolete. We face a period of re-thinking of these paradigms, as the recent phenomena of “equity decoupling” and “debt decoupling” continue to create uncertainty in corporate, federal securities and bankruptcy law. Our clients will need to be aware of these issues over the next few years as practical and legal effects of these phenomena become more evident.

## Equity and Debt Decoupling—What They Are

“Equity decoupling” refers to the disassociation of voting and economic interests in a corporation.<sup>1</sup> An equity total-return swap provides the clearest example: The long party to the swap agreement has a direct economic interest in the referenced equity securities and, hence, the underlying corporation itself. However, the long party has no vote in the affairs of the company, since the long party does not own the equity securities. Conversely, the short party to the swap typically hedges its position by acquiring the equity shares, which gives the short party a voting stake in the corporation but no real economic interest. Thus, the economic and voting interests inherent in the shares have been “decoupled.”

Similarly, “debt decoupling” refers to creditors’ ability to transfer away the risk of economic loss while still retaining the legal right to recover from the debtor and to participate in the debtor’s restructuring. Increasingly, creditors use CDS or LCDS contracts to transfer default risk to their hedge counterparties while retaining their legal rights under the original note or facility.

Below, we discuss specific issues that highlight the importance of equity and debt decoupling in today’s business environment.

<sup>1</sup> For an in-depth discussion of debt and equity decoupling, we recommend Henry Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. Pa. L. Rev. 625 (2008). We have relied on the insights of Professors Hu and Black when preparing this memorandum.

## Memorandum

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The recent phenomena of equity and debt decoupling—the separation via derivatives of economic interests from voting or legal rights—have challenged basic tenets of corporate, federal securities and bankruptcy law.

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## **Equity Decoupling: New Issues for Derivatives Holders**

The core issues of equity decoupling—the disengagement of economic interests and voting rights through derivatives—have spurred concern and commentary in the context of corporate governance and takeover matters. Shareholders may hold significant voting rights in corporations in which they lack any economic interest because of hedging positions. Conversely, derivatives holders may acquire economic interests in corporations that, if converted into direct ownership of the shares, would require disclosure under the federal securities laws. Because such derivatives holders may not be required to disclose their positions, however, they can accumulate their stakes without alerting other investors or management. A swift conversion of such an undisclosed economic interest into actual ownership can confer a significant advantage to a player in a change-of-control, takeover or proxy battle.

An example of the issues raised by equity decoupling through equity derivatives is provided by the *CSX Corporation v. The Children’s Investment Fund Management (UK) LLP* litigation in the United States District Court for the Southern District of New York.<sup>2</sup> CSX is presently engaged in a proxy contest with two hedge funds (The Children’s Investment Fund (“TCI”) and 3G Capital Partners (“3G”). In the litigation, CSX contended that, as long parties to cash-settled equity swaps that referenced CSX stock, the hedge funds were, in reality, “beneficial owners” of the CSX shares acquired by the short counterparties (investment banks) as hedges to the swaps. Therefore, CSX contended that TCI and 3G (i) violated Section 13 of the Securities and Exchange Act (the “Exchange Act”) by failing to disclose their beneficial ownership of the counterparties’ positions and (ii) violated Section 14 of the Exchange Act by making materially false and misleading statements in the proxy statement. Based on these alleged

violations, CSX sought injunctive relief, among other things, to prohibit TCI and 3G from voting their shares.

In response, TCI, 3G and securities industry groups (including ISDA and SIFMA, as *amici*) contended that the hedge funds did not own the underlying shares of CSX, could not vote them, and had no control over their voting or disposition. Thus, while the hedge funds were economically interested in CSX, their voting interests (through other shares they held directly) were below the threshold requiring federal disclosure. ISDA and SIFMA were particularly concerned about the uncertainty that might arise in the derivatives markets if the Court were to find otherwise.

On June 11, 2008, the Court issued its decision. The Court strongly credited CSX’s argument that TCI and 3G were the “beneficial owners” of the CSX Corporation stock, but declined to reach the ultimate issue. The Court wrote:

The question whether the holder of a cash-settled equity [total-return swap] 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.

Instead, the Court held that the hedge funds should be “deemed” to be beneficial owners of the shares because they had engaged in “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[.]” The Court then held that the defendants had violated Section 13(d) of the Exchange Act and enjoined them from future violations of the Act.

<sup>2</sup> *CSX Corporation v. The Children’s Investment Fund Management (UK) LLP et al.*, 08 Civ. 2764 (LAK) (S.D.N.Y.).

The CSX decision frames in stark terms the dramatic consequences that can result when equity swaps are used as a proxy for equities. This firm will be providing specific guidance based upon the case with respect to its impact on requirements for the disclosure of such interests.

The CSX opinion does not address the voting issue with respect to the shares held by the swaps dealers as a hedge, who are economically disinterested (“empty voters”). However, commentators have suggested various corporate voting reforms—such as adjusting record dates and reducing empty voters’ ability to vote by compelling share lenders to recall their shares from otherwise economically disinterested share borrowers so that the lenders can vote their shares—that will significantly alter the conduct of corporate governance, merger approvals and proxy contests.<sup>3</sup>

**Debt Decoupling: Managing a Bankruptcy in a Post-CDS Era**

Historically, the restructuring process has relied on the assumption that the interests of the debtor and its creditors are aligned in favor of the firm’s survival—principally, because the creditors’ likelihood of recovery was tied to the firm’s continued generation of cash to pay down its debt. Consistent with this presumption, bankruptcy rules grant creditors standing, permit them to serve on committees and entitle them to vote on bankruptcy plans on the basis of the amounts owed to them.

However, creditors who have entered into CDS and LCDS contracts to hedge their loan exposure to the debtor firm may be economically disinterested in the survival of the firm. Creditors may calculate that a default by the debtor will trigger a higher recovery on the swap instruments than the creditor could achieve through a restructuring or bankruptcy. Thus, the creditors may be motivated to let the debtor fail. Similarly, a creditor that has hedged its indebtedness may be entitled as a matter of law to a significant role

in the bankruptcy, despite its lack of economic exposure to the debtor.

Corporate executives and their advisers who are trying to restructure a firm’s debt now face a new set of issues and complications that arise out of hedging with CDS or LCDS contracts:

First, the debt holders may not be responsive during the pre-filing period when time is of the essence. In a restructuring, the debtor firm must be able to communicate swiftly and efficiently with its creditor constituencies, especially secured lenders, to effectuate an out-of-court restructuring or, if a bankruptcy is imminent, to address debtor-in-possession (DIP) financing and/or § 363 sale issues in order to maximize recoveries to the creditors. However, if the debt holders are completely hedged through CDS or LCDS contracts, they will have little incentive to respond to the debtor. Indeed, where the derivative is cash settled, the creditor may decide that the recovery on the contract will exceed recoveries in a bankruptcy and will certainly be more expedient, and will have an incentive to allow the debtor to default.

Second, where the swap has been physically settled, the loan will be held by the protection seller, who may be completely unknown to the debtor. The debtor may find that, at a crisis moment, its long-term lender has disappeared and it is negotiating with a new creditor, who may have little interest or ability to provide DIP financing or respond to the debtor’s attempts to enter into an out-of-court restructuring. The protection seller and new debt holder may advocate a prompt § 363 sale to recover on the loan, rather than support the debtor in bankruptcy.

Third, the debtor may find the bankruptcy more difficult to manage, since different hedging positions taken by its creditors may eliminate otherwise common interests among the creditor group and make it difficult to reach an agreement with such creditor group.

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<sup>3</sup> Significantly, the Court permitted TCI and 3G to vote their shares in the proxy contest, which turned the decision into a Pyrrhic victory for CSX. The Court’s decision was based on settled principle that disenfranchisement of the stock for Section 13(d) violations is only warranted if, absent injunction, there would be irreparable harm to the interest which Section 13(d) seeks to protect, i.e. “aler[ting] investors to potential changes in corporate control.” Although TCI and 3G “may have contributed to creating a corporate electorate that is materially different today than it was before” they made the purchases of CSX shares in violation of Section 13(d), the Court appeared compelled to hold that there was no irreparable harm because corrective disclosure had been made.

Finally, the debtor may face voting constituencies in the bankruptcy that, while alleged to be powerful, actually have little or no economic interest in the debtor's reorganization. Such parties may simply decline to vote on a bankruptcy plan, making plan approval more difficult.

It is therefore important that all constituencies in a distressed company or in a bankruptcy proceeding take into account the implications of creditors entering into CDS or LCDS contracts to hedge their debt exposure. It is even possible for trade creditors to purchase CDS-like protection on their claims prior to an obligor's default. Debt and claim holders should be aware that creditors who would normally be considered allies given their position in the debtor's capital structure, or even fellow credit facility syndicate members, may in reality have conflicting economic interests because of their hedging positions. Debt and claim holders may find that such similarly situated creditors are acting unpredictably due to these undisclosed hedges.

In addition, creditors seeking to become active in a bankruptcy proceeding by joining an *ad hoc* committee may find themselves under increasing pressure from both debtors and other adverse constituencies to reveal their actual economic stake in the debtor including all hedge positions. Even creditors who simply want to appear in a case as an interested party should seek legal advice to the extent they are making any representations to the Court either in writing or at a hearing as to their aggregate debt holdings and do not mention any offsetting hedge positions.

RK&O will continue to report on issues relating to equity and debt decoupling, including the important disclosure and compliance issues highlighted by the CSX opinion, as they arise in the coming weeks.

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