

**PROXY Governance, INC.**Contact: Alesandra Monaco  
Published: 06/16/2008**CSX CORP (NYSE : CSX)****Annual Meeting** | **Record Date:** 04/21/2008 | **Meeting Date:** 06/25/2008**Classification:** Russell 3000, S&P 500**Fiscal Year End:** 12/31/2007**Market Capitalization:** \$22.6B**Solicitor:** Innisfree M&A Incorporated**Shareholder Proposal Deadline:** 12/31/2008

- Investor Relations
- Proxy Statement
- SEC Filing 10k
- Company Description

**Meeting Agenda**

Management Agenda - Proxy Card Proposals			Recommendations		
			Management	PROXY Governance	
<b>MGT</b>	<b>1</b>	Elect Nominees	FOR	NONE	<b>Analysis</b>
	1.1	D.M. ALVARADO	FOR	NONE	
	1.2	E.E. BAILEY	FOR	NONE	
	1.3	SEN. J.B. BREAU	FOR	NONE	
	1.4	S.T. HALVERSON	FOR	NONE	
	1.5	E.J. KELLY, III	FOR	NONE	
	1.6	R.D. KUNISCH	FOR	NONE	
	1.7	J.D. MCPHERSON	FOR	NONE	
	1.8	D.M. RATCLIFFE	FOR	NONE	
	1.9	W.C. RICHARDSON	FOR	NONE	
	1.10	F.S. ROYAL	FOR	NONE	
	1.11	D.J. SHEPARD	FOR	NONE	
	1.12	M.J. WARD	FOR	NONE	
<b>MGT</b>	<b>2</b>	Ratify Appointment of Auditors	FOR	NONE	<b>Analysis</b>
<b>MGT</b>	<b>3</b>	Approve Shareholders' Right to Call Special Meeting	FOR	NONE	<b>Analysis</b>
<b>SH</b>	<b>4</b>	Allow Shareholders to Call Special Meeting	AGAINST	NONE	<b>Analysis</b>
<b>SH</b>	<b>5</b>	Repeal Bylaw Amendments Adopted by Board	AGAINST	NONE	<b>Analysis</b>

*MGT = Management, SH=Shareholder, SHB=Shareholder— binding proposal*

Dissident Agenda - Proxy Card Proposals			Recommendations		
			Dissident	PROXY Governance	
<b>MGT</b>	<b>1</b>	Elect Nominees	FOR	SPLIT	<b>Analysis</b>
	1.1	CHRISTOPHER HOHN	FOR	WITHHOLD	
	1.2	ALEXANDRE BEHRING	FOR	FOR	
	1.3	GILBERT H. LAMPHERE	FOR	FOR	
	1.4	TIMOTHY T. O'TOOLE	FOR	WITHHOLD	
	1.5	GARY L. WILSON	FOR	WITHHOLD	
	1.6	MGT NOM-D.M. ALVARADO	FOR	FOR	
	1.7	MGT NOM-SEN. JB. BREAU	FOR	FOR	
	1.8	MGT NOM-E.J. KELLY, III	FOR	FOR	
	1.9	MGT NOM-J.D. MCPHERSON	FOR	FOR	
	1.10	MGT NOM-D.M. RATCLIFFE	FOR	FOR	
	1.11	MGT NOM-D.J. SHEPARD	FOR	FOR	
	1.12	MGT NOM-M.J. WARD	FOR	FOR	
<b>SH</b>	<b>2</b>	Allow Shareholders to Call Special Meeting	FOR	AGAINST	<b>Analysis</b>
<b>MGT</b>	<b>3</b>	Approve Shareholders' Right to Call Special Meeting	AGAINST	FOR	<b>Analysis</b>
<b>SH</b>	<b>4</b>	Repeal Bylaw Amendments Adopted by Board	FOR	AGAINST	<b>Analysis</b>
<b>MGT</b>	<b>5</b>	Ratify Appointment of Auditors	NA	FOR	<b>Analysis</b>

*MGT = Management, SH=Shareholder, SHB=Shareholder— binding proposal*

---

## Table of Contents

---

### Comparative Performance Analysis

- Peer Companies
- Comparative Return to Shareholders
- Composite Performance Summary
- Performance Summary

### Governance Analysis

- Executive Compensation
- Board Profile
- Stock Ownership/Voting Structure
- State law/Charter/Bylaw Provisions
- Auditor Profile
- Vote Results

### Proposal Analysis

---

## Comparative Performance Analysis

---

PROXY Governance's Comparative Performance Analysis contains calculations and graphs that reflect a company's historical performance and that of its industry peers (listed below) based on certain key financial metrics generally over a five-year period.

[Comparative Performance Analysis](#)

---

### Peer Companies

---

For the Comparative Performance Analysis, generally up to 10 peer companies are selected primarily based on industry, but also considering market capitalization.

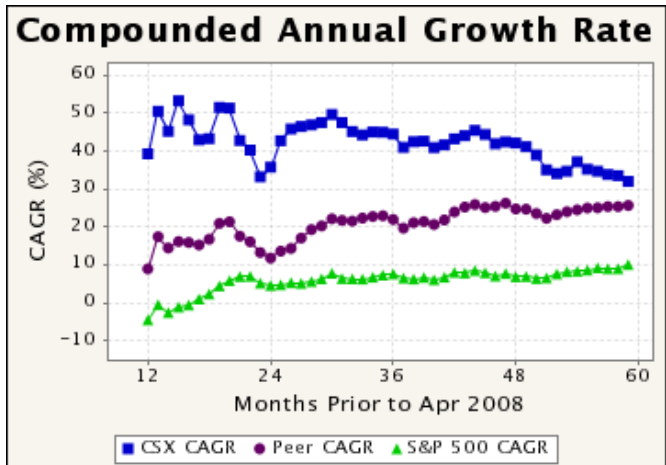
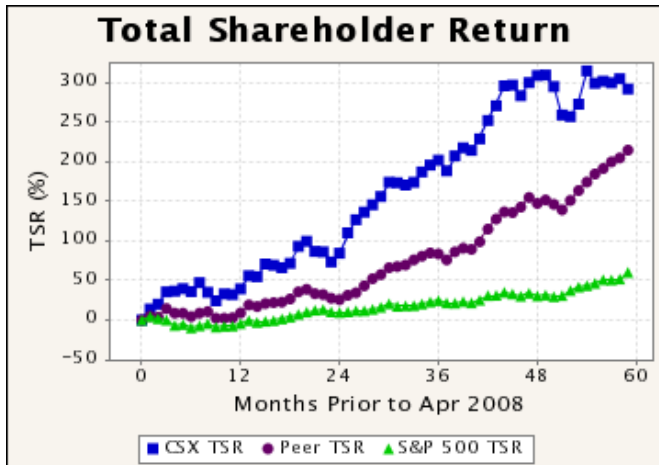
Peer Companies			
BURLINGTON NORTHERN SANTA FE	CANADIAN NATIONAL RAILWAY CO	CANADIAN PACIFIC RAILWAY LTD	GENESEE & WYOMING INC - CL A
GUANGSHEN RAILWAY LTD - ADR	KANSAS CITY SOUTHERN	NORFOLK SOUTHERN CORP	PROVIDENCE AND WORCESTER RR
UNION PACIFIC CORP			

[Comparative Performance Analysis](#)

---

### Comparative Return to Shareholders

---



Source: FAME North American Pricing [NAP]

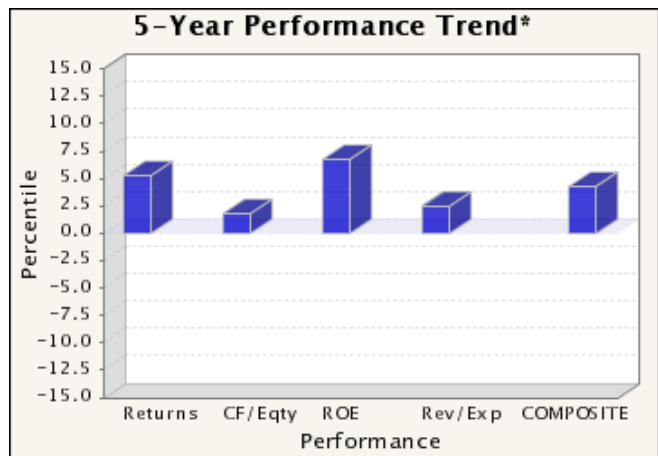
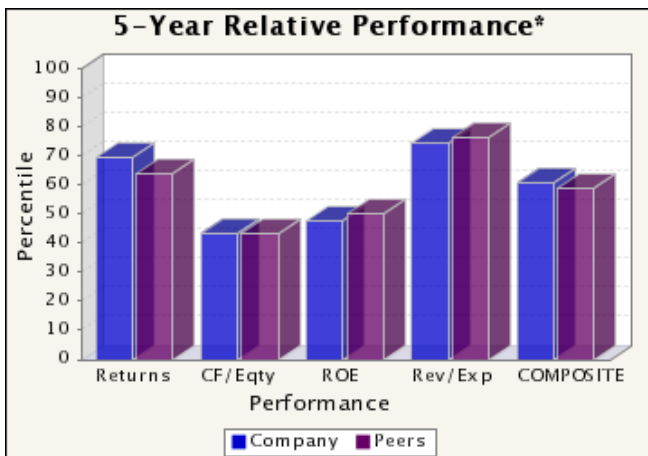
The graphs above depict total shareholder return and compounded annual growth rate at specific points in time over the past five years based on average monthly stock prices. The graphs should be read from left (present time) to right (60 months before present time). The graphs allow the user to determine either the company's total shareholder return or compounded annual growth rate to date based on an investment made at a specific point in time over the last five years. Assumes payment, but not reinvestment, of dividends.

Comparative Performance Analysis

### Composite Performance Summary

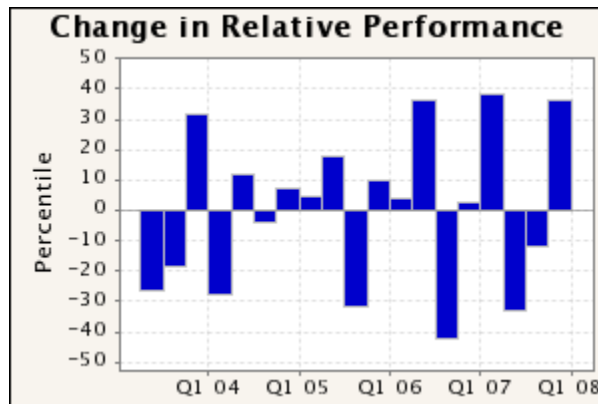
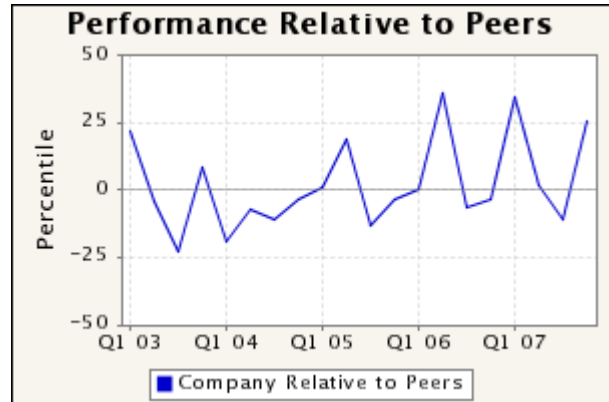
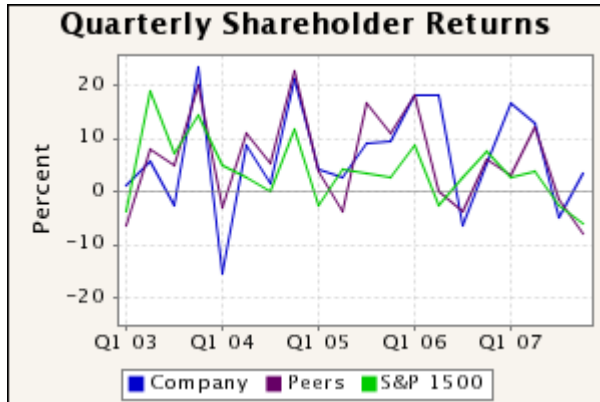
Composite Performance:

	Percentile relative to S&P 1500		Percentile Pts.
	Company	Peers	
<b>Composite:</b>			
Quarterly Shareholder Returns:	61	59	↑ 4
Cash Flow from Operations/Equity:	70	64	↑ 5
Return on Equity:	44	43	↑ 2
Revenue/Expenses:	48	50	↑ 7
	74	77	↑ 3

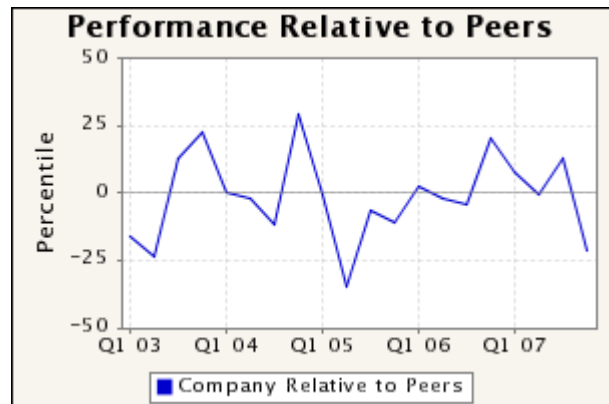
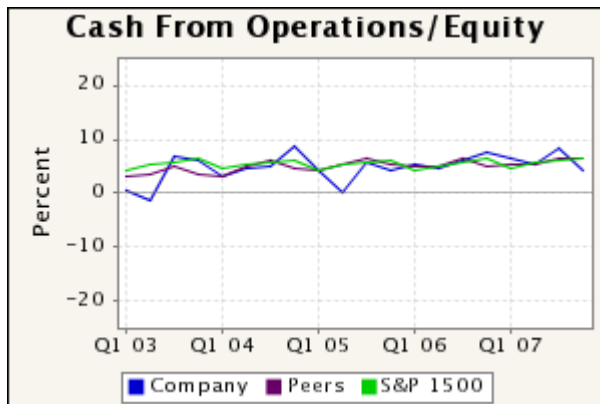


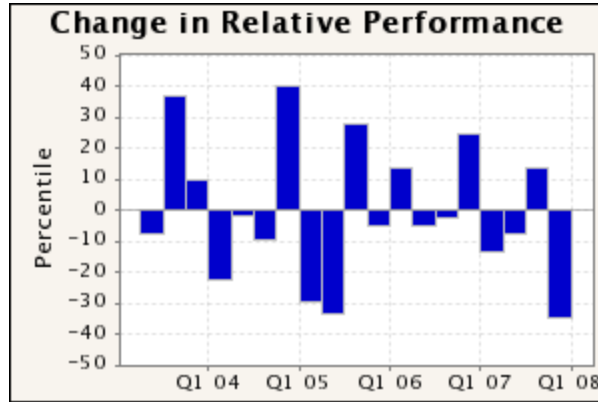
\*Based on five-year data when available

Performance Summary

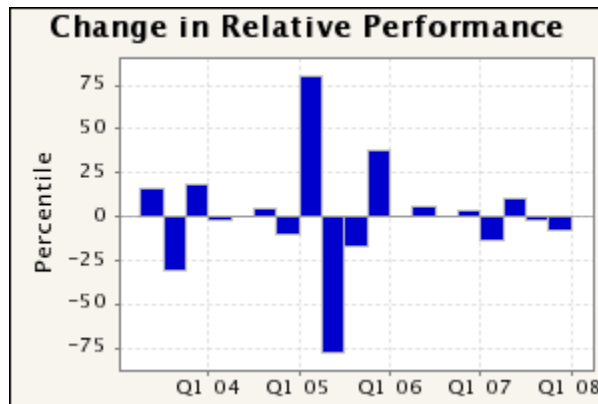
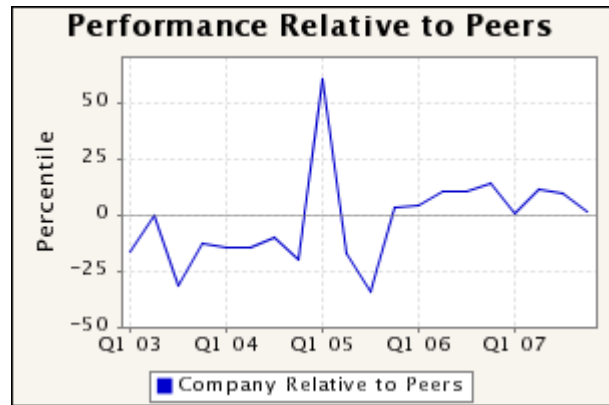
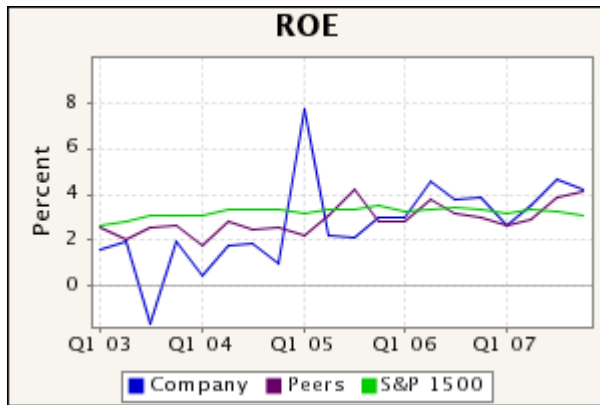


Source: Stock Price — North American Pricing [NAP]

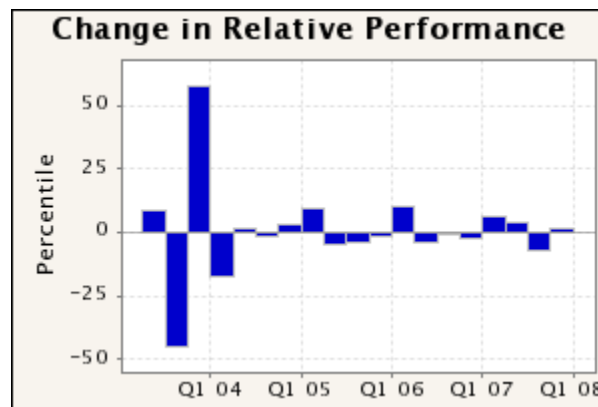
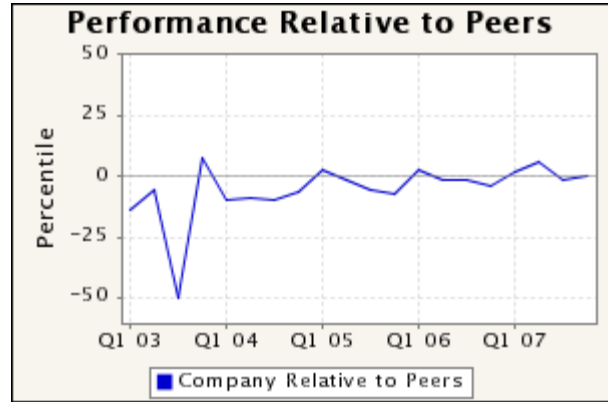
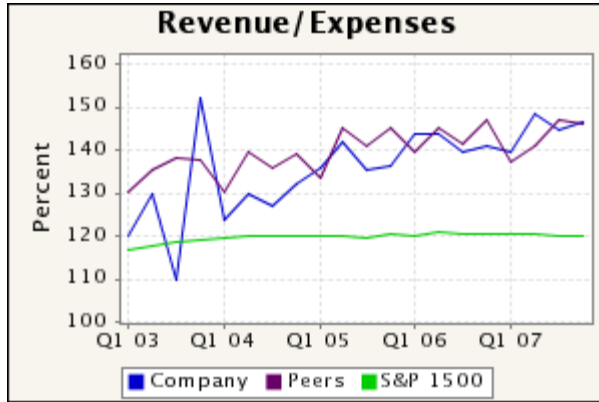




Source: Cash Flow/Equity — Compustat



Source: ROE — Compustat



Source: Revenues/Expenses — Compustat

## Governance Analysis

Governance Analysis

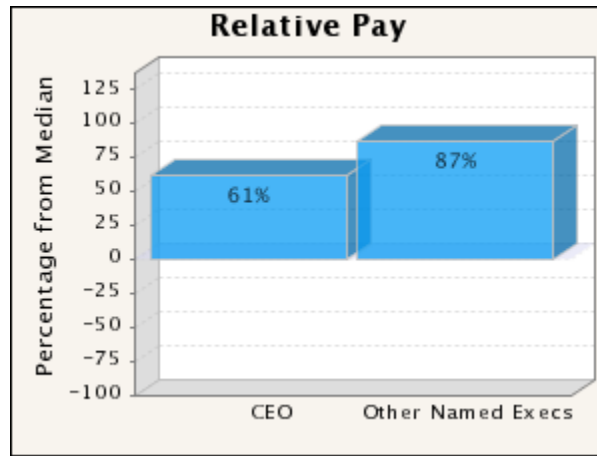
### Executive Compensation

PROXY Governance evaluates a company's executive compensation over the last three years, as available, and compares that to the median compensation paid by its peers over the same time frame. For our compensation model, generally 20 peer companies are selected based on similarity of market capitalization and broad economic sector using the GICS. Only U.S. and certain U.S. reporting companies that are incorporated offshore are included in this peer group.

The graph that follows shows:

- The average three-year CEO compensation paid by the company expressed as a percentage from median peer compensation.
- The average three-year compensation paid to the company's other named executives (excluding the CEO) as a percentage from median peer compensation.

Domestic Peer Companies			
BURLINGTON NORTHERN SANTA FE	DANAHER CORP	EATON CORP	FLUOR CORP
INGERSOLL-RAND CO LTD	ITT CORP	L-3 COMMUNICATIONS HLDGS INC	MCDERMOTT INTL INC
NORFOLK SOUTHERN CORP	PACCAR INC	PARKER-HANNIFIN CORP	PRECISION CASTPARTS CORP
ROCKWELL COLLINS INC	SOUTHWEST AIRLINES	TEXTRON INC	TYCO INTERNATIONAL LTD
UNION PACIFIC CORP	WASTE MANAGEMENT INC		



**Executive Compensation**

Executive	Salary	Bonus	Cash Incentive (Payout)	Equity Incentive (Target)	Stock Awards (GDV) <sup>1</sup>	Option Awards (GDV <sup>1</sup> )	Pension/Deferred Compensation	All Other	1-yr Pay	
<b>Michael J. Ward</b> Chairman/President/CEO	\$1,000,000	\$0	\$1,080,000	\$4,000,010	\$0	\$0	\$2,680,048	\$202,117	\$8,962,175	\$11
<b>Oscar Munoz</b> EVP/CFO	\$600,000	\$0	\$486,000	\$1,499,998	\$0	\$0	\$58,112	\$54,317	\$2,698,427	\$1
<b>Clarence W. Gooden</b> EVP/CCO	\$500,000	\$0	\$382,500	\$1,499,998	\$0	\$0	\$826,842	\$58,141	\$3,267,481	\$1
<b>Tony L. Ingram</b> EVP/COO CSX Transportation Inc.	\$525,000	\$0	\$448,000	\$1,499,998	\$0	\$0	\$117,910	\$39,129	\$2,630,037	\$1
<b>Ellen M. Fitzsimmons</b> SVP Law & Public Affairs/Corp. Sec.	\$450,000	\$0	\$324,000	\$1,000,013	\$0	\$0	\$230,086	\$48,806	\$2,052,905	\$1

<sup>1</sup>Options calculated using a Black-Scholes valuation model. GDV = Grant Date Value.

<sup>2</sup>Average pay is based on three-years of pay data, when available.

As disclosed for fiscal year end 2007.

Governance Analysis

**Board Profile**

Name	Nominee	Term Ends	Not Ind.	Position	Audit	Comp. Nom.	Age	Tenure	Other Board Seats	<75% Att.	No stock	Prev. yr. withhold votes	C
Donna M. Alvarado	<input checked="" type="checkbox"/>	2009	<input checked="" type="checkbox"/>		<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	59	2	1	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	3.3%	
Elizabeth E. Bailey PhD	<input checked="" type="checkbox"/>	2009	<input checked="" type="checkbox"/>		<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	69	19	1	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	5.5%	
John B. Breaux	<input checked="" type="checkbox"/>	2009	<input checked="" type="checkbox"/>		<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	64	3	1	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	3.4%	
Steven T. Halverson	<input checked="" type="checkbox"/>	2009	<input checked="" type="checkbox"/>		<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	54	2	--	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	3.3%	
Edward J. Kelly III	<input checked="" type="checkbox"/>	2009	<input checked="" type="checkbox"/>	Presiding Director	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	54	6	2	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	3.3%	
Robert D. Kunisch	<input checked="" type="checkbox"/>	2009	<input checked="" type="checkbox"/>		<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	66	18	--	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	5.5%	
John D. McPherson	<input checked="" type="checkbox"/>	2009	<input checked="" type="checkbox"/>		<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	61	0	--	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	--	
David M. Ratcliffe	<input checked="" type="checkbox"/>	2009	<input checked="" type="checkbox"/>		<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	59	5	1	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	4.3%	
William C. Richardson PhD	<input checked="" type="checkbox"/>	2009	<input checked="" type="checkbox"/>		<input checked="" type="checkbox"/>	Chair	67	16	2	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	5.5%	
Frank S. Royal	<input checked="" type="checkbox"/>	2009	<input checked="" type="checkbox"/>		<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	68	14	3	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	6.6%	
Donald J. Shepard	<input checked="" type="checkbox"/>	2009	<input checked="" type="checkbox"/>		Chair, Financial Expert	<input checked="" type="checkbox"/>	61	5	1	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	3.4%	
Michael J. Ward	<input checked="" type="checkbox"/>	2009	<input checked="" type="checkbox"/>	Chair, CEO, President	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	57	6	1	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	5.3%	

Independence	
Board	83.3%
Audit	100.0%
Compensation	100.0%
Nominating/Governance	100.0%

PROXY Governance believes that the Self-Regulatory Organizations' (SROs) standards of independence are satisfactory and does not support the use of an additional overlay of independence standards, which may vary among advisory services, institutional investors, and commentators. PROXY Governance believes that if the SROs standards are perceived to be inappropriate, interested parties should reopen the debate with the SROs or the SEC to have those standards adjusted.

Governance Analysis

### Stock Ownership/Voting Structure

Type of stock	Outstanding shares	Vote(s) per share
Common	404,783,890	1

Director & Officer Ownership
1.0%

Significant Shareholders
Deutsche Bank AG 9.1%

Governance Analysis

### State Law/Charter/Bylaw Provisions

State Law Statutory Provisions	
State of incorporation	Virginia
Business combination	<input checked="" type="checkbox"/>
Control share acquisition	<input checked="" type="checkbox"/>
Fair price provision	<input checked="" type="checkbox"/>
Constituency provision	<input type="checkbox"/>
Poison pill endorsement	<input checked="" type="checkbox"/>

Charter/Bylaws Provisions	
Classified board	<input type="checkbox"/>
Cumulative voting	<input type="checkbox"/>
Dual class/unequal voting rights	<input type="checkbox"/>
Blank check preferred stock	<input checked="" type="checkbox"/>
Poison pill	<input type="checkbox"/>
Directors may be removed only for cause	<input type="checkbox"/>
Only directors may fill board vacancies	<input type="checkbox"/>
Only directors can change board size	<input type="checkbox"/>
Supermajority vote to remove directors	<input type="checkbox"/>
Prohibit shareholders to call special meetings	<input type="checkbox"/>
Prohibit action by written consent	<input type="checkbox"/>
Fair price provision	<input type="checkbox"/>
Supermajority vote for mergers/business transactions	<input checked="" type="checkbox"/>
Supermajority to amend charter/bylaw provisions	<input type="checkbox"/>
Constituency provision	<input type="checkbox"/>
Directors - Majority Vote	<input checked="" type="checkbox"/>
Directors - Resignation policy	<input checked="" type="checkbox"/>

Governance Analysis

### Auditor Profile



Peer group includes companies listed under *Executive Compensation*.

Ernst & Young LLP serves as the company's independent auditors. The company did not disclose the year Ernst & Young LLP was first engaged as its auditors.

Audit Fees					
	Audit fees	Audit Related fees	Tax fees	Other fees	Total fees paid
CSX CORP	\$2,595,000	\$233,000	\$41,000	\$13,000	\$2,882,000

As disclosed for fiscal year end 2007.

Governance Analysis

### Vote Results of Last Annual Meeting

Proposals	% FOR Votes <sup>1</sup>	For Votes	Against Votes	Abstentions	Broker Non-Votes
MGT Elect directors <sup>2</sup>	93.4% - 96.7%				
MGT Ratify Appointment of Auditors - Ernst & Young LLP	97.3%	339,564,515	9,563,593	3,170,664	0
SH Limit Executive Compensation	9.2%	24,200,164	237,775,492	4,984,098	85,339,018
SH Adopt Majority Vote to Elect Directors	57.0%	149,741,267	112,772,878	4,445,609	85,339,018
SH Allow Shareholder Approval of Severance Agreements	61.5%	161,412,593	101,136,663	4,410,498	85,339,018
SH Allow Shareholders to Call Special Meeting	69.6%	182,361,577	79,753,885	4,844,292	85,339,018

<sup>1</sup> As a % of votes cast for and against; may not reflect passage of proposal. <sup>2</sup> Low — High director votes.

**Note:** See the Board Profile for individual director votes.

### Proposal Analysis

Management

#### 1 Elect Nominees

**PROXY Governance Vote Recommendation: SPLIT**

**Proposal:**

To elect the following 12 nominees to the board: D. Alvarado, E. Bailey PhD, J. Breaux, S. Halverson, E. Kelly III, R. Kunisch, J. McPherson, D. Ratcliffe, W. Richardson PhD, F. Royal, D. Shepard, M. Ward

**Analysis:**

- Board size: 12
- New directors since last year: 1
- Independent directors: 10
- Non-Independent directors: 2

Non-independent directors: Chairman and CEO M. Ward. D. Ratcliffe is chairman and CEO of the Southern Co., from which the company receives revenue exceeding the NYSE threshold for director independence.

Unless there is evidence of a breakdown in board monitoring or effectiveness -- such as poor corporate performance relative to peers, excessive executive compensation, noncompliance with SEC rules or SRO listing standards, a lack of responsiveness to legitimate shareholder concerns, or various other factors -- we presume that the board is properly discharging its oversight role and that it is adequately policing itself in terms of board organization, composition and functioning.

**Performance:** According to PROXY *Governance's* performance analysis, the company has performed **in line** with peers over the past five years; the company ranks at the 61st percentile relative to the S&P 1500.

**Compensation:** The average three-year compensation paid to the CEO is 61% above the median paid to CEOs at peer companies and the average three-year compensation paid to the other named executives is 87% above the median paid to executives at peer companies.

### **Proxy Contest – Background**

The Children's Investment Fund Management LLP (TCI) began accumulating its 4.4% of shares in April 2007. Several times over the next six months, the fund requested private meetings with CSX management and directors to discuss the company's performance and governance, which resulted in one face-to-face meeting with CFO Munoz and the company's internal and external counsel. In October, the fund issued a public letter to the board outlining several recommendations it believed were in shareholders' interest; a month later the board responded, also in a public letter, with its view that the recommendations were not in shareholders' best interests. Over the same seven-month period, 3G Capital Partners Ltd. (3G), which began accumulating its 4.3% of shares in February 2007, engaged in "limited discussions" with the company's senior management on its own recommendations for increasing shareholder value.

During much of 2007, principals of the two funds also discussed the company with each other, though the funds assert they did not discuss potential share purchases, shareholder activist strategies, or whether or how to pursue control of the company. On Dec. 12, 2007, the two funds entered into an agreement to coordinate their efforts to influence the company and notified the company they intended to nominate a dissident slate of directors. A week later, the group issued a press release identifying its dissident nominees and disclosing its collective ownership stake (then 8.3%) as well as its cash-settled equity swap positions collectively representing an economic exposure to an additional 11.8% of shares. While the funds disclaimed beneficial ownership of any shares purchased by their counterparties to hedge the swaps, that issue, as well as certain other assertions of the funds' 13D filings in regard to the proxy contest, have since been contested in court (see "Legal and Regulatory Issues" below).

Beginning in January 2008, the company and the funds attempted to reach a negotiated solution to avert a proxy contest. The company proposed to replace four incumbent directors with three of the dissident nominees – TCI Managing Director C. Hohn, 3G Managing Director A. Behring, and G. Lamphere – plus a fourth mutually-acceptable independent director with industry experience. There the negotiations stalled, however, over the multi-year term of the standstill agreement which the company would have required the dissidents to sign (after initially resisting any standstill, the dissidents proposed a one-year term), and the issue of splitting the roles of chairman and CEO.

At the 2007 annual meeting, shareholders approved a non-binding shareholder proposal that the bylaws be amended to allow shareholders to call a special meeting. In late January 2008, after negotiations to avert a proxy contest broke down, the funds introduced binding proposals for the annual meeting which would allow shareholders representing 15% of shares outstanding to call special meetings (Proposal 2) and repeal any bylaw amendments approved by the board between Jan. 1, 2008, and the date of the 2008 annual meeting (Proposal 4). In early February, the board approved an amendment to the bylaws – also subject to shareholder approval at the annual meeting – which would allow shareholders representing 15% of shares outstanding to call a special meeting, but which included several "procedural safeguards to protect the resources of the company and shareholders' investment from the substantial administrative and financial burdens, and disruptive effects, that serial shareholder meetings on the same matter would impose on the company." (Proposal 3).

### **Proxy Contest – Dissident View**

The dissidents contend that while the company's share price has generally performed significantly better than the S&P 500 for the past several years, these results were largely due to powerful macroeconomic developments such as railroad capacity constraints, comparatively higher trucking prices driven by fuel economics, a resurgence of coal and agricultural product shipping volumes, and the growth of intermodal shipping. Even at a 27% annualized total return rate for the period 2004 through 2007 (a period prior to the public announcement of the proxy contest), the dissidents note the company is only slightly above the industry average of 25%.

In the dissidents' view, the more compelling questions for shareholders surround improvement in operational metrics and

financial performance which are within management's control, and which will ultimately determine whether the company can continue strong financial performance once the rising macroeconomic tide, now lifting all boats, begins to recede. The dissidents calculate that 88% of the company's improvement in EBIT between 2003, when the current management team came on board, and 2007 is due to pure pricing, driven primarily by improving industry economics. Inflation (including fuel surcharges) and volume netted another 6% of EBIT growth, leaving just 6% of growth from productivity – the one lever which management does control.

Moreover, the dissidents argue, the company lags its peers on “nearly every operational metric.” Productivity has been declining since 2005, but unit costs (excluding fuel) have grown at the second-fastest rate in the industry and nearly twice the industry's 3% compounded annual cost growth rate (CAGR) from 2000 through 2007. In a peer group of five major North American railroads (CSX, Burlington Northern Santa Fe Corp., Union Pacific Corp., Canadian National Railway Co., and Norfolk Southern Corp.), the company ranks third on dwell time and accident rate, fourth on metrics of cost inflation, and last on velocity and on labor expense as a percentage of total revenues. In recent customer surveys conducted by Morgan Stanley and Credit Suisse, the dissidents note, the company also ranked fourth among the five railroads for its ability to deliver cargo when expected and last in a holistic rating of service quality. Fifty four percent of customers – 17 percentage points more than the fourth-place competitor – rated the company's service quality either “fair” or “poor”.

By contrast, the dissidents note, Canadian National consistently ranks first or second on all operating metrics, and held 2007 unit cost growth (excluding fuel) to 1.4% – less than half the 3% industry average. Canadian National, the dissidents contend, has achieved that leadership – and begun to reshape the terms of competition in the industry – by developing a new operating model it calls the “scheduled precision railroad.” By focusing on the railcar, rather than the train, as the most meaningful measure of operating efficiency, Canadian National has driven improvements in velocity (12%), handlings per carload (44%), dwell time (22%), and loading time (25%), and has increased train length by 23%. The consequence of these operating efficiencies has been an increase, beyond the commonly-accepted rate of 10%, in the percentage of time during which the railcar is moving, effectively increasing system capacity without any corresponding increase in capital spending. The operating improvements of a scheduled precision railroad, the dissidents calculate, would deliver \$1.8 billion in additional annual EBIT at CSX. Along with certain other operating changes, such as negotiating more efficient maintenance outsourcing agreements, optimizing scheduling to increase labor productivity, and optimizing for fuel consumption, the dissidents estimate the total annual EBIT improvement could be as much as \$2.2 billion. Even realizing a part of that opportunity, the dissidents conclude, would be “hugely valuable” for shareholders.

In presentations to investors, the dissidents detail productivity opportunities in scheduling, locomotives, fuel, labor productivity and safety, as well as corresponding metrics and targets, to help drive the company toward a scheduled precision railroad model. In addition, the dissidents believe the company has suboptimized its capital allocation – capital spending has increased 50% since 2006, when the company began basing its executives' incentives on its operating ratio rather than free cash flow – and capital structure. “Each incremental turn of leverage,” the dissidents calculate, “creates \$12 per share in value.” Finally, the dissidents would drive the company to explore additional revenue opportunities through such strategies as congestion and yield management pricing, as well as basic pricing opportunities versus such direct competitors as Norfolk Southern. The dissidents agree that other U.S. railroads would likely benefit from implementing many of the principles of a scheduled precision railroad as well. By contrast to their experience with CSX, the dissidents say, management at such competitors as Union Pacific, in which the dissidents also own shares and with which the dissidents have also discussed similar changes, has generally been more receptive, and “will get there on their own” – making a proxy contest unnecessary.

The dissidents have also identified several governance concerns, such as the board's lengthy inaction on the 2007 shareholder vote on the right to call special meetings, which suggest the board is insufficiently responsive to the interests of shareholders. To drive the operating improvements which will deliver increased shareholder value, the dissidents contend, the company requires a board which is more responsive to shareholder interests, and both able and more willing to challenge the CEO on the range of what is possible. The dissidents have targeted five incumbent directors, including the only four directors with greater than five years tenure who are standing for re-election:

- E. Bailey, 69, is a professor at the Wharton School of the University of Pennsylvania, a director on one other public company
- R. Kunisch, 66, is a special partner and senior advisor at ABS Capital Partners, was formerly chairman and CEO of PHH Corp. and vice chairman of Cendant Corp., and has served as a CSX director for 17 years.
- W. Richardson, 67, was formerly CEO of the Kellogg Foundation and President of Johns Hopkins University, is currently a director of two other public company boards, and has served as a CSX director for 15 years.
- F. Royal, 68, is a physician in private practice, a director on three other public company boards, and has served as a CSX director for 14 years.
- S. Halverson, 54, is CEO of The Haskell Co., a director of one other public company board, and has served as a CSX director for 1 year.

To replace them, the dissidents have proposed five nominees:

- C. Hohn, 41, is co-founder and managing partner of The Children's Investment Fund Management (UK) LLP.
- A. Behring, 41, is managing director of 3G Capital Partners Ltd., and was previously CEO of Latin American railroad and logistics company América Latina Logística, where he remains a member of the Management Committee of the board.
- G. Lamphere, 55, founded and is managing director of Lamphere Capital Management, and has served as a director

of 12 companies, including Canadian National Railway, Illinois Central Railroad, and railroad and real estate firm Florida East Coast Industries Inc.

- T. O'Toole, 52, is managing director of the London Underground, and was previously president and CEO of Conrail Inc.
- G. Wilson, 68, is currently a private investor, and previously held executive positions with The Walt Disney Co. and Marriott Corp. Wilson currently serves on two public company boards and has previously served as a director of Progress Rail Services Corp. and as chairman of Northwest Airlines Corp.

### **Proxy Contest – Management View**

The company asserts that its share price has significantly outperformed not only the S&P 500, but the railroad industry itself, for the one-, two-, three-, four-, and five-year periods through June 2008 (a series of timeframes which include the period since the public announcement of the proxy contest, which may have had an effect on price performance, but also includes market response to the company's Q4 2007 and Q1 2008 financial results). On a comparable diluted basis, EPS from continuing operations increased at an industry-leading 39% CAGR between 2004 and 2007. In Q1 2008, the company's operating margin was tied for first place among U.S. railroads. Its earnings guidance, the company notes, leads the industry: through 2010 it has set CAGR targets of 13 – 15% for operating income and 18 – 21% for EPS, and the company expects its operating margin to approach 30% by 2010. Free cash flow, which has already enabled the company to nearly triple its dividend since 2005, repurchase nearly \$3 billion in stock since 2006, and target repurchase of an additional \$3 billion by 2009, is forecasted to reach \$1 billion annually by 2010.

This performance trajectory, the company argues, began with groundwork laid as the current management team began to take shape in 2003. Key "foundational initiatives" included:

- Refocusing the company through the strategic sale of \$1.4 billion in terminals, lines, and other assets.
- Streamlining the organization, including a 20% reduction in management which netted \$100 million in cost savings, and implementing a pay-for-performance philosophy to improve execution across the organization.
- Significant operating improvements on key metrics such as safety (50% improvement, to a record now second best in the industry) and on-time originations and arrivals (60% improvement, to what the company asserts is "industry leading service").
- Significant headway on core financial metrics such as productivity cost savings (\$500 million realized to date, with an additional \$400 million in the pipeline through 2010), "industry-leading price gains" (6% annually on what the company terms "same store sales"), and improved contribution and operating margins through network restructurings, business mix improvements, and innovations such as capacity-based pricing to balance traffic flows.

Sustaining the performance trends of the past five years, the company asserts, will depend on many of the same strategic priorities, particularly those which align operating capabilities with customer needs, high-return technology projects, and investments in port and intermodal infrastructure.

By contrast, the company contends, the dissident slate not only "has provided no business plan or strategic insight," but "will interrupt the value creation from CSX's strategic plan." The dissidents' proposals – including one suggestion prior to the proxy contest that the company consider a leveraged buyout – have "a consistent theme of increased leverage for CSX" which would "destroy prudent flexibility and capital markets access." By contrast, the company asserts, in achieving the "lowest long-term cost of capital" while simultaneously repurchasing nearly \$3 billion in shares during 2007 and tripling the dividend since 2005, the company has demonstrated "an aggressive approach to leverage and return of capital." Whereas the dissident nominees "fail to represent the best interests of all shareholders," the company itself continues to have "an active and ongoing dialogue with [its] investor base," as evidenced by more than 220 individual investor meetings in 2007, and both the board and the executive management team "review and discuss [external] feedback regularly."

### **Legal and Regulatory Issues**

In March 2008, alleging violations of Rule 13D-3 disclosure requirements, the company sued to prevent the funds from voting their shares at the annual meeting. The funds, the company contended, had in fact formed a group to influence the company's actions much earlier than disclosed in the 13D filing, and had also failed to declare beneficial ownership of an additional 11.8% of shares which, the company believed, the funds controlled through their equity swap positions. In asserting that the cash-settled equity swaps – which do not generally have voting rights and are not currently subject to the same SEC reporting standards for institutional investors as a long equity position – effectively made the funds beneficial owners of the shares used by their counterparties to hedge the swap, the case took on much broader significance for the securities and derivatives markets generally. At the court's request, the SEC's Division of Corporation Finance filed an amicus brief on the disputed legal issues regarding the establishment of beneficial ownership. Recognizing "the significant policy issues raise by the well-publicized use of equity swaps by investors, particularly in the context of business combinations or other change of control transactions," the SEC asserted that "Rule 13D-3, properly construed, is narrower in coverage" than the company contended, and that "economic or business incentives, in contrast to some contract, arrangement, understanding or relationship concerning voting power or investment power between the parties to an equity swap, are not sufficient to create beneficial ownership under Rule 13D-3." The International Swaps and Derivative Association Inc. and the Securities Industry and Financial Markets Association also filed an amicus brief arguing that requiring the long party in such swaps to claim beneficial ownership of underlying shares "would create substantial uncertainties in the securities and derivatives markets and could chill legitimate and desirable commercial activity."

In his opinion of June 11, 2008, U.S. District Judge Lewis Kaplan found “that TCI created and used the [equity swaps] 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 13D,” and that “under the plain language of Rule 13D-3, [TCI] thus is deemed to be a beneficial owner of the shares held by its counterparties to hedge their short exposures.” At the same time, Kaplan noted, “the 13D disclosed the entirety of defendants’ position in CSX and the manner in which it was held,” and therefore “the Court has not found that the defendants’ Schedule 13D disclosure is false, misleading, or otherwise inadequate as to a material fact.” Both funds had also violated Rule 13D-3, Kaplan ruled, by effectively forming a group much earlier than December, when the group filed its 13D disclosure.

Because there was “no proxy rule violation or material misstatement or omission in the Schedule 13D that belatedly was filed,” Kaplan noted, the law allowed for no effective remedy for the 13D violations, including the company’s requested remedy of barring the funds from voting their shares in the proxy contest. “Were the court free as a matter of law, however, to grant such an injunction,” Kaplan concluded, “whether on the basis that such relief is warranted to afford deterrence or on another basis, it would do so.” On June 12, Kaplan denied the company’s request for interlocutory appeal.

In a separate development on June 3, six U.S. senators (Evan Bayh of Indiana, Sherrod Brown of Ohio, Jim Bunning of Kentucky, Thomas Carper of Delaware, Mel Martinez of Florida, and Robert Menendez of New Jersey) requested that Treasury Secretary Henry Paulson initiate a review, via the Committee on Foreign Investment in the United States (CFIUS), of the funds’ acquisition of CSX shares. An inter-agency committee chaired by Paulson, CFIUS is charged with evaluating the national security implications of foreign acquisitions of U.S. companies or operations; in March 2008, CFIUS objections related to a proposed minority ownership stake by a Chinese firm eventually scuttled the proposed sale of technology firm 3Com Corp. to Bain Capital Partners, LLC. Echoing some of CSX’s legal arguments regarding disclosure, the senators noted that the hedge funds’ “investment, through share ownership and derivative securities, concerns us because the investment devices being used lack transparency, leaving the ownership and control of critical U.S. infrastructure in the hands of unknown investors.” The company is “the exclusive rail provider to 13 major military bases and ocean terminals,” the senators noted, and in 2007 “shipped over 300 carloads of nuclear material” to the Department of Energy’s Savannah River site. By June 12, Paulson had made no public response to the senators’ letter.

### **Summary**

In arguing that a company which has delivered a 27% annualized total return over the past four fiscal years has actually underperformed its potential, the dissidents have set themselves no mean task. Chairman and CEO Ward, who took office in January 2003, completed building his management team in early 2004; it seems difficult to believe that the change in management was merely coincidental with the long trend of share price increases which took root that year, and has yet to end. In that same four-year period, the company actually outperformed Canadian National, which posted only a 24% annualized total return. This is not a management team unable to deliver results or a company which is “broken”.

Neither, however, is it a company which is outperforming peers – and what is most compelling in the dissidents’ argument is the vision of how it might and the open question – which is at the core of this proxy contest – of why it is not.

In comparing the performance of the five peer railroads over the past 10 years (a period which puts the effects of more recent macroeconomic trends into context), the performance of Canadian National shares is spectacular. While CSX shares increased by approximately 51% – lowest among the group – Canadian National improved by 485%, or nearly triple the improvement of the second strongest competitor. During the first six years of that period, moreover – before the favorable macroeconomic trends took root – Canadian National shares improved 171%, more than 10 times the improvement of the second strongest competitor, while CSX shares, which lost 34%, again performed worst among the five peers. Looking at the 10-year share price performance for the five railroads, it is certainly conceivable, as the dissidents have concluded, that one competitor has begun changing the rules of the game.

While the dissidents’ argument is not bullet-proof – on the same Morgan Stanley survey which ranked the company fourth on its ability to deliver cargo when expected, railroad customers actually ranked Canadian National fifth – the breadth of the dissidents’ vision and depth of supporting data is powerful. Perhaps even more important is that the dissidents’ plan evinces a deep understanding of the industry and the company’s operations which will be crucial for a board driving such deep change – and that, by contrast with the company’s current non-management directors, a number of the dissident nominees have operating experience in the industry on which to rely. Finally, we note that the two hedge funds – whose holdings in CSX represent their single largest economic exposure – have a compelling incentive to deliver increases in shareholder value. At the same time, however, we recognize that the current board and its management team have delivered strong results over the past four years, and remain unconvinced the dissidents have argued a case sufficient to support replacing nearly half the incumbent directors. We therefore recommend shareholders elect two of the five dissident nominees – A. Behring and G. Lamphere – on the grounds that those two nominees together bring both the commitment of a substantial ownership stake and credibility of industry experience, including Lamphere’s board experience with Canadian National during its transformation.

### **Rationale/Conclusion:**

While we recognize that the current board and its management team have delivered strong results over the past four years, and do not believe the dissidents have argued a case sufficient to support displacing five of twelve incumbent directors, we do find that the dissidents have made a convincing argument that the company could be doing even better, and that adding a

greater degree of railroad operating experience to the board would make it more informed. We also take note of the fact that, given the money they have invested in CSX stock, the dissidents have a very substantial economic incentive to increase shareholder value. We therefore recommend shareholders elect the two dissident nominees – A. Behring and G. Lamphere – who together bring both the commitment of a substantial ownership stake and credibility of industry experience, including Lamphere’s board experience with Canadian National during its transformation.

[\[back to top\]](#)

**Shareholder**

**2 | Allow Shareholders to Call Special Meeting**

**PROXY Governance Vote Recommendation: AGAINST**

**Proposal:**

Amend the bylaws to allow one or more shareholders having beneficial ownership of 15% or more of the company's common stock to call a special meeting of the shareholders for any purpose allowed under the laws of Virginia.

**Proponent:**

The Childrens' Investment Fund

**Shareholder View:**

The proponents note that corporate laws of thirty-two states provide that beneficial owners of only 10% of shares may call a special meeting, absent a contrary provision in the charter or bylaws. Prominent institutional investors and organizations support a shareholder right to call special meetings, and the proxy voting guidelines of many public employee pension funds also favor the right. Additionally, at the company’s 2007 annual meeting, shareholders approved by a ratio of more than two to one a nonbinding proposal requesting that the board amend the bylaws to give holders of at least 10% to 25% of shares the power to call a special shareholder meeting.

The proponents note that the board has recently amended the bylaws to enable holders of 15% of outstanding shares to call a special meeting, and is requesting shareholder approval for that amendment (Proposal 3). Under management's proposed amendment, however, the proposals that may be brought to a vote at a special meeting are restricted to those that have not been brought within 12 months after any annual or special meeting of shareholders at which the “same matter” was included on the agenda, or if the “same matter” will be included on the agenda at an annual meeting to be held within 90 days after the receipt by the company of such request. The current bylaws, the proponents argue, define “same matter” to preclude a special meeting to be held for the purpose of electing directors proposed by shareholders or removing directors.

The current shareholder proposal, the proponent asserts, would amend the bylaws to ensure that the intent of the 2007 proposal, providing for special meetings without conditions or limitations, is implemented.

**Management View:**

The board notes that it has recently amended the bylaws to allow holders of 15% of shares to call a special meeting, is seeking shareholder approval of that amendment at this meeting (Proposal 3), and believes this proposal is therefore unnecessary.

**Analysis:**

Because we support management's proposed amendment (see analysis of Proposal 3) to enable shareholders with 15% of outstanding shares to call a special meeting of shareholders, we do not support this proposal to repeal it.

**Rationale/Conclusion:**

Because we support management's proposed amendment (Proposal 3) to enable shareholders with 15% of outstanding shares to call a special meeting of shareholders, we do not support this proposal to repeal it.

[\[back to top\]](#)

**Management**

**3 | Approve Shareholders' Right to Call Special Meeting**

**PROXY Governance Vote Recommendation: FOR**

**Proposal:**

Approve amendments to the company's bylaws to permit holders of 15% of the company's outstanding voting stock to require the board to call a special meeting of the shareholders. The amendment precludes shareholders from taking action earlier than the one-year anniversary of a meeting which addressed the same item, even if circumstances arise within that period that cause holders of 15% of the company's outstanding voting stock to wish take such action. However, shareholders would be able to request a special shareholder meeting with respect to an item that has not been voted on within one year

**Management View:**

On February 4, 2008, the board adopted amendments to the company's bylaws to permit holders of 15% of outstanding shares to call a special meeting of the shareholders. The board believes this action addresses the views of shareholders on this topic as reflected in the vote at the 2007 annual meeting on a nonbinding proposal recommending this change which, the board notes, did not preclude any procedural elements in the bylaw amendment.

Under the amended bylaws, if shareholders have voted upon an item within one year, or will vote on an item at an annual meeting within the next 90 days, then certain procedural safeguards of the bylaws allow for delay. The 90-day time restriction could result in the board's decision, after receipt of the request for a special meeting, to add an item to the agenda of the annual meeting to avoid having two meetings within a short time period. The effect is essentially to allow for all items of special interest to the shareholders to be voted upon annually, as all shareholders meeting the eligibility requirements in Section 11 of Article I of the company's bylaws are free to submit proposals for consideration at the annual meeting. Such a procedural safeguard, the board contends, would give the shareholders substantial input without the high costs and distraction of repeated votes on the same matters within months. The board asserts that these safeguards are lacking in the shareholder-proposed special shareholder meeting proposal (Proposal 2).

The board believes that this is a balanced approach to providing shareholders with an important right and opportunity to decide matters concerning the company, without creating a constant vote and election cycle.

**Analysis:**

PROXY Governance generally supports proposals giving shareholders the right to call a special meeting. We note that the restrictions management has introduced, while uncommon, are neither unprecedented nor particularly onerous, and that their most obvious effect will be to ensure that the right will not be used to call repeated special meetings in order to remove incumbent directors. As the company's board is not classified, and all directors must stand for re-election each year, we believe shareholders have sufficient opportunity to address any perceived issues with the boards' stewardship, and that the the amendment as proposed is therefore both reasonable and responsive to shareholders' concerns.

**Rationale/Conclusion:**

PROXY Governance generally supports proposals giving shareholders the right to call a special meeting, and notes that the restrictions management has introduced on the exercise of this right, while uncommon, are neither unprecedented nor particularly onerous. As the company's board is not classified, and all directors must stand for re-election each year, we believe shareholders have sufficient opportunity to address any perceived issues with the boards' stewardship, and that the the amendment as proposed is therefore both reasonable and responsive to shareholders' concerns.

[back to top]

**Shareholder**

**4 | Repeal Bylaw Amendments Adopted by Board**

**PROXY Governance Vote Recommendation: AGAINST**

**Proposal:**

Repeal any amendment or modification to the bylaws as of Sept. 12, 2007 by the board from Jan. 1, 2008 through the date of this annual meeting, and stipulate that any repealed amendments or modifications may not be reinstated without the approval of the shareholders.

**Proponent:**

The Childrens' Investment Fund

**Shareholder View:**

This proposal, paired with Proposal 2, would replace the board's proposed bylaw amendment allowing shareholders to call a special meeting with a proposed shareholder amendment to allow shareholders to call a special meeting. See Proposal 3 for discussion of the contested terms in management's proposed amendment.

**Analysis:**

Because we support management's proposed amendment to enable shareholders with 15% of outstanding shares to call a special meeting of shareholders, we do not support this proposal to repeal it.

**Rationale/Conclusion:**

Because we support management's proposed amendment (Proposal 3) to enable shareholders with 15% of outstanding shares to call a special meeting of shareholders, we do not support this proposal to repeal it.

[\[back to top\]](#)

**Management**

**5 Ratify Appointment of Auditors**

**PROXY Governance Vote Recommendation: FOR**

**Proposal:**

The Audit Committee has selected Ernst & Young LLP as the company's independent auditors for the next fiscal year.

**Analysis:**

Barring circumstances where there is an audit failure due to the auditor not following its own procedures or where the auditor is otherwise complicit in an accounting treatment that misrepresents the financial condition of the company, PROXY Governance recommends the company's choice of auditor. PROXY Governance believes that concerns about a corporation's choice of auditor and the services performed (e.g., high non-audit fees) should be directed through withhold votes from the members of the audit committee, which is responsible for retaining and compensating the auditor.

**Rationale/Conclusion:**

We believe that, in this circumstance, the board/audit committee should be accorded discretion in its selection of the auditor.

[\[back to top\]](#)

© 2008 by PROXY Governance, Inc.™ All Rights Reserved. The information contained in this proxy analysis is confidential, for internal use only in accordance with the terms of the subscriber's subscription agreement, and may not be reproduced or redistributed in any manner without prior written consent from PROXY Governance, Inc. All information is provided "as is" and without any warranty to accuracy, is not intended to solicit votes, and has not been submitted to the Securities and Exchange Commission for approval. The information should not be relied on for investment or other purposes. Proponents and issuers written about in PROXY Governance research reports may be subscribers to PROXY Governance's proxy voting and/or research services. Although PROXY Governance often confers with both proponents and issuers to ensure the accuracy of data, and to obtain an in-depth understanding of matters and positions, neither proponents nor issuers are involved in the preparation of the report or voting recommendations and PROXY Governance independently prepares such reports and recommendations.