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New Internet Technology Permits New Proxy Contest Techniques

Novel techniques -- including use of message boards, websites and email -- are now available to activist shareholders to conduct a proxy contest over the Internet. The ability of dissidents to wage a web-based proxy solicitation suggests the need for target companies to adopt new methods in defending a corporate control contest.

by Eugene F. Cowell III

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Recent developments in technology have enabled more frequent, less costly communications by public companies with and among security holders. These technological changes, combined with the adoption by the Securities and Exchange Commission (SEC) of changes to the proxy rules in the last several years, have dramatically altered the techniques available to activist shareholders in mounting a proxy contest. Activists are now able to use the Internet to solicit votes for their directors in advance of, and in addition to, the formal proxy statement and other written materials traditionally mailed to shareholders.

An Internet-based solicitation strategy has recently led to the first successful proxy contest by an outside investor group. In the election contest led by Travis Street Partners LLC (TSP) for the board of directors of NASDAQ-traded ICO, Inc. in early 2001, TSP's "use of the Internet and its ability to rally investors online secured a victory in its fight to elect three directors to the board of ICO, Inc." and thereby to win "the first Internet proxy campaign."[1]

Technological Changes

Over the past several years, at the same time as message boards, websites and email have entered the mainstream of business communication, activist shareholders have increasingly used these tools to intensify and expand their communications with other shareholders during a proxy contest.[2]

First, dissidents have created special purpose websites shortly before or simultaneously with the launch of a proxy contest. A website serves not only to collect in one location all of the dissidents' communications regarding the proxy contest but also to intensify and increase the ability of the recipients to absorb the outsiders' message through use of modern Internet imagery, such as color, button devices, links and interactivity. A typical website may comprise:

- an "about us" page, which briefly explains the composition of the insurgent group and its plans;
- a home page, which features a frequent (typically daily) update describing the latest developments in the proxy contest;

- a FAQs page, which answers investor questions and concerns about the dissidents' platform;
- a "press releases" page, which collects all press releases disseminated by the dissidents;
- a "message board" page, which collects postings placed by the dissidents on the Company's Yahoo! or other Internet bulletin boards;
- an "SEC filings" page, which provides a convenient link into the target's SEC EDGAR database of all SEC filings relating to the target; and
- a "proxy materials" page, which provides ready access to the insurgent's most recently filed preliminary or definitive proxy statement.

Under SEC rules, a full copy of the website content is required to be filed with the SEC. Many investors have registered with various services that notify the investor when a new document regarding a company in which the investor has interest has been filed with the SEC. Consequently, since the website filing includes the web address, knowledge of the dissidents' website location soon spreads among all significant investors who generally follow the target company.

Second, dissidents recently have begun to use Yahoo! or other message boards to communicate with other investors about their proposals. Dissidents frequently use message board postings to make instantaneous announcement of proxy contest developments. More significantly, activist shareholders often post responses to questions of other message board participants or respond directly to participants who may express doubts about the dissidents' program. In this way, the challengers are able to expand their tools of communication by directly engaging potential supporters, much as candidates in the political arena have increasingly sought to garner votes by using the bilateral "town hall" format in addition to the more traditional unilateral communication tool of the "stump speech."

Finally, by encouraging a website visitor or message board participant to provide its email address to the dissidents by sending the address in to the dissidents' home page address posted on the website or specified in a message board posting, dissidents are able quickly to compile a comprehensive list of potential supporters. The dissidents are then able to use this list to communicate directly with shareholders on an instantaneous basis through email.

By contrast, prior to the Internet, dissidents had to rely on a cumbersome process of demanding a shareholders list from incumbent management, and then, once obtaining the list, seeking to "go behind" the list of largely corporate "street names" to discern the names of actual persons that would ultimately make the voting decision.

Moreover, pre-Internet, the timing and expense of communication always influenced whether and how communications would be disseminated. Even after the use of overnight courier services became commonplace, dissidents had no means to contact investors directly in response to developments in a proxy fight, and the cost of making a distribution (unlike free Internet communications) always needed to be considered.

Regulatory Framework

By way of background, it is important to recognize that the federal proxy rules are premised on one simple regulatory concept. They focus on disclosure, mandating that, before any vote, or "proxy," is "solicited," [3] a shareholder must receive a document, called a "proxy statement,"[4] containing specified disclosures intended to provide him or her with an opportunity

to make an informed voting decision. The only exception to the proxy statement delivery rule that is generally available to shareholders is Rule 14a-2(b)(2) under the Securities Exchange Act of 1934, which permits shareholders to solicit proxies from up to 10 persons, without delivering any proxy statement thereto or, except for antifraud requirements, otherwise complying with the proxy rules.

To ensure that the "definitive" proxy statement contains the appropriate disclosures, Rule 14a-6(a) requires that the proxy statement be provided to the SEC staff for review, in preliminary form, at least 10 days before the definitive proxy statement is sent or given to shareholders. So long as a proxy statement in preliminary form has been filed 10 days in advance, the proxy rules do not technically require receipt of an SEC "order" or like imprimatur before the definitive proxy statement may be disseminated to shareholders.

Nonetheless, although the SEC staff technically has no formal power to "clear" or pre-approve a definitive proxy statement before its dissemination, securities law practitioners universally advise soliciting parties not to print the definitive proxy statement and commence collecting proxies until the SEC staff has indicated that it will have no more comments on the most recent preliminary proxy statement on file. Consequently, as a practical matter, the need to obtain "clearance" by the SEC staff of a preliminary proxy statement before using that document as a definitive proxy statement has resulted in a customary review period extending over a period from as short as 10 days to as long as six to eight weeks after filing of the initial preliminary proxy statement. During this SEC review period, one or more drafts of the preliminary proxy statement are prepared by counsel and filed with the SEC, and the SEC staff provides comments until the staff is satisfied with the disclosures in the proxy statement.

Prior Restrictions on Pre-Definitive Proxy Statement Communications

Given the need to receive clearance from the SEC staff before the definitive proxy statement may be distributed and votes obtained, the degree to which activist shareholders may communicate about the election and the dissidents' program with other shareholders in advance of receiving clearance is a key factor in how an election contest is conducted.

Prior to the adoption of revisions to the proxy rules in 1992, participants in a solicitation were generally permitted to engage in a solicitation prior to dissemination of the definitive proxy statement only by use of so-called "stop, look and listen" materials disseminated pursuant to Rule 14a-11(b). Under the proxy rules in effect before l992, materials disseminated pursuant to Rule 14a-11(b) had to be filed with and pre-cleared with the SEC.[5] In order to obtain speedy SEC clearance, materials distributed under Rule 14a-11(b) typically contained no substantive information that might require extended SEC analysis and thus merely warned investors to refrain from making a voting decision until the proxy statement was received; as a result, those materials came to be referred to as "stop, look and listen" materials.

In 1992, the SEC comprehensively amended the proxy rules.[6] As a result of these changes, before adoption of revised Rule 14a-12 in early 2000, participants in an election contest could communicate with other shareholders before the definitive proxy statement was distributed through use of not only Rule 14a-11(b) but also two additional mechanisms.

Under Rule 14a-11(b), after the 1992 rule changes, activists were permitted to disseminate materials in advance of the definitive proxy statement without any requirement of prior SEC clearance. The requirement remained, however, that the soliciting parties deliver the definitive proxy statement to any solicited persons "at the earliest practicable date." Consequently, at least some uncertainty appears to have existed whether Rule 14a-11(b) could properly be used to commence a proxy solicitation substantially in advance of SEC clearance of

the definitive proxy statement or at least the filing with the SEC of a preliminary proxy statement in substantially complete form.

In any event, instead of relying on Rule 14a-11, most soliciting parties conducting pre-definitive proxy statement solicitations after 1992 and before the early 2000 rule changes used a mechanism made possible by revisions to Rule 14a-3(a). Under Rule 14a-3(a), as revised in 1992, participants could solicit a shareholder if (but only if) the shareholder had received a physical copy of the preliminary proxy statement on file with the SEC and were not furnished the proxy card.

The Rule 14a-3(a) mechanism, however, necessitated a period of no solicitation at all until a preliminary proxy statement had been prepared and filed with the SEC. Moreover, even after the preliminary proxy statement was on file, the delivery requirement resulted in delays in using email communications to solicit shareholders to whom a preliminary proxy statement had not yet been sent. In addition, unless limited access mechanisms were used to ensure prior receipt of the preliminary proxy statement, this rule could not be used to communicate through websites or message boards prior to the delivery of the definitive proxy statement.

In addition to the Rule 14a-13(a) procedure, under Rule 14a-3(f), so long as a definitive proxy statement was on file with the SEC, participants could solicit by means of certain general communications consisting of:

> one or more speeches in public forums, press releases or published or broadcast opinions, statements, or advertisements appearing in a broadcast media, newspaper, magazine or other bona fide publication disseminated on a regular basis.

This exception was of limited utility, however, since it applied only during the short period after SEC clearance of the definitive proxy statement was obtained and before the definitive proxy statement was printed and distributed. Moreover, the types of general communications enumerated in Rule 14a-3(f) did not literally include websites or message boards.

Rule 14a-12 Revisions

The scope of electronic communications permitted before a definitive proxy statement could be distributed under the pre-2000 regulatory regime was therefore relatively narrow. By contrast, as a result of the SEC's adoption of revisions to Rule 14a-12 in early 2000,[7] websites, message boards and email communications may be freely used in conducting an election contest, including even before a preliminary proxy statement is filed with the SEC. Under Rule 14a-12 as now in effect, both written and oral solicitations are permitted before the definitive proxy statement has been cleared by the SEC and provided to investors, so long as three conditions, discussed below, are satisfied.

First, under Rule 14a-12(b), any written communication made before delivery of the definitive proxy statement to security holders must be filed with the SEC no later than the date of first use. Apart from preparing a one-page cover sheet, the rule requires no preparation of a summary of the contents of the communication or other prepatory work in order to make the Rule 14a-12 filing. In order to comply with this requirement, participants in a solicitation need only be certain to have counsel ready to file the document on EDGAR simultaneously with the first use of the soliciting material.[8]

Second, Rule 14a-12(a)(1) requires that any written communication[9] to shareholders before delivery of the definitive proxy statement contain two written disclosures. First, the communication must disclose the identity of the participants and a description of their interests,

or a legend clearly advising investors where such information may be obtained. Second, the communication must advise shareholders to read the proxy statement itself after it becomes available and that the proxy statement and other relevant documents are available on the SEC's website. These two disclosure requirements are easily satisfied by a boilerplate legend inserted at the end of all communications as a matter of course.[10]

Finally, Rule 14a-12(a)(2) requires that before any proxy is furnished to or requested from any shareholder that has been solicited under Rule 14a-12 by any written or oral communication, the soliciting party must deliver a definitive proxy statement to such security holder. The rule requires that a definitive proxy statement be delivered only to "security holders" solicited under Rule 14a-12 and not to all persons who may have received or viewed any of the dissidents' communications regarding the proxy contest. Consequently, any party that uses Rule 14a-12 to solicit prior to clearing a definitive proxy statement with the SEC can satisfy this condition simply by delivering the definitive proxy statement to every person to whom a proxy is ultimately furnished or from whom a proxy is ultimately requested.

The application of Rule 14a-12(a)(2) only to "security holders" greatly simplifies compliance for soliciting parties who use the Internet. First, a soliciting party that uses email to solicit investors before a definitive proxy statement is available need not keep records of all persons to whom email communications have been made. Second, a soliciting party that solicits using Yahoo! postings or websites is not required to install "limited access" mechanisms or other procedures to prevent a user from viewing posted material unless the soliciting party has first obtained the user's name and address.

Compliance with the conditions of Rule 14a-12 is purely ministerial and places no substantial burdens on the soliciting parties. Consequently, assuming the conditions are satisfied, activist shareholders have free rein to use all forms of Internet communication to seek to convince other shareholders of the need for change not only during the period of SEC review of the proxy statement in preliminary form but even before the initial filing with the SEC.

Significantly, unlike Rule 14a-11(b), revised Rule 14a-12 contains no "as soon as practicable" timing requirement regarding delivery of the definitive proxy statement to the persons solicited. Consequently, pre-definitive proxy statement solicitation can be commenced weeks, or even months, before the definitive proxy statement is ready for distribution or a preliminary form is filed with the SEC, so long as, before any proxy card is requested, the security holders receive the definitive proxy statement.

Additional Solicitation Restrictions

In addition to the conditions required for compliance with Rule 14a-12, a soliciting party conducting a election contest needs to be aware of several other rules. First, notwithstanding the changes to Rule 14a-12, any activist shareholders beneficially owning 5% or more of the relevant company's stock who constitute a "group" under Rule 13d-3 must comply with the requirements of Schedule 13D, in addition to the proxy rules. Once a Schedule 13D has been filed that describes the group's general plans regarding the election contest, however, so long as the plans with respect to the company do not change, each additional communication effected under Rule 14a-12 by the group generally would not require an amendment to the Schedule 13D.

Second, notwithstanding the broad sanctioning of shareholder communications prior to delivery of the definitive proxy statement effected by the Rule 14a-12, the changes do not eliminate the antifraud restrictions of Rule 14a-9, which apply to all proxy communications. Rule 14a-9 in general prohibits any false or misleading statements in connection with both written and oral communications in connection with a proxy solicitation. In particular, the SEC

note to Rule 14a-9 states, that, depending on the circumstances, material that impugns the character or integrity, or alleges improper conduct, of an election candidate or that states results of a solicitation before the meeting itself may be "misleading" within the meaning of Rule 14a-9.

As noted above, all written soliciting material used before the definitive proxy statement is disseminated must be filed with, and therefore is subject to review by, the SEC. Moreover, in a corporate control contest, company counsel typically reviews all Rule 14a-12 filings by the dissidents and frequently may invoke the assistance of the SEC staff to obtain a "toning down" or outright retraction of the dissidents' communications by delivering a list of complaints directly to the SEC staff in the form of a so-called "whine" letter filed on a confidential basis. The SEC staff then in turn, or in some cases, on its own initiative, may, if it deems appropriate, deliver a so-called "bedbug" letter to the dissident shareholder group requesting the soliciting parties to modify future disclosures or, in cases of egregious violations of Rule 14a-9, publicly retract prior communications. Consequently, activist shareholders typically have counsel review each written communication to confirm that such communication complies on its face with the antifraud strictures of Rule 14a-9 before it is sent to investors.

Finally, oral communications effected under Rule 14a-12 are not required to be reduced to writing for filing with the SEC. Consequently, revised Rule 14a-12 opened the door to essentially unlimited telephonic or other oral communications, without any filing requirement or other restriction, except of course, the antifraud provisions of Rule 14a-9.

Management Outlook

Given the dramatic broadening in the types and timing of communications now permitted in an election contest under revised Rule 14a-12, management of public companies should consider carefully, both before and during a potential proxy contest, whether any changes in strategy are appropriate.

First, to give the company an edge in communicating with shareholders if a proxy contest were to ensue, management needs to assemble and keep current a list of email addresses for the principals at each of the institutions or other persons beneficially holding a significant portion of the company's stock. Moreover, management should consider the extent to which such addresses may be assembled in a manner, or retained in a form, that would not require disclosure to an activist shareholder requesting a copy under either the stockholder list or books and records examination provisions of the applicable corporate statute. For example, if email addresses are collected with assurances of non-disclosure and non-use other than by the company or, as a formal matter, are not maintained as part of the company's stock transfer records of actual registered holders, the applicable corporate statute may not require delivery of the email addresses to an outside shareholder upon demand.

Moreover, although Rule 14a-7 requires an issuer either to provide a requesting shareholder with a list of the names and addresses of shareholders or to mail the requesting shareholder's proxy materials to shareholders on behalf of the requesting shareholder, in an election contest, the issuer selects which alternative will apply. Consequently, even if Rule 14a-7 were otherwise to require disclosure of email addresses, an issuer may avoid doing so simply by electing to mail an activist shareholders' materials rather than to provide the list.

Second, in the event an election contest does arise, management should consider carefully whether it too should actively use the Internet to counter the message of the activist shareholders. Of course, in some circumstances, such as where management considers its position with the shareholders solid and strong, a policy of deliberate disregard may be the most effective approach. Management needs to recognize, however, that the era of a proxy fight commencing

in earnest only upon dissemination of the definitive proxy statement, as was typically the case before revised Rule 14a-12 was adopted, has ended. Today, under revised Rule 14a-12, outside shareholders will have the opportunity to deliver their message to potential supporters during the entire SEC review period, through email communications, press releases and website and message board postings. A management that ignores the activist group and its communications may find that it has waited too long, and allowed the failings of incumbent management alleged by the activist shareholders to become so ingrained in the minds of shareholders, that whatever message management eventually does articulate when the definitive proxy statement and related "fight" letters are distributed falls on deaf ears.

To the contrary, a creative and well executed Internet-based defense could well prove more successful than such traditional strategies as a policy of deliberate disregard or a print-media campaign of newspaper advertisements and mail-delivered "fight letters." Indeed, a defensive strategy that fails to seize the opportunity of the communicative power of the Internet in defending a proxy contest could even suggest to investors a failure of management to be prepared to use modern technology in its day-to-day business dealings as well.

Rule 14a-12 is as available for use by a target company as it is for use by dissidents, in solicitations made through email, websites or message board postings. To be sure, Regulation FD, which applies to a public company itself but not to dissident shareholders even where the dissidents constitute a Rule 13d "group," requires that any material nonpublic information, including information that might be revealed in a solicitation, be disclosed to all shareholders. The required disclosure may be effected either (1) by filing a Form 8-K disclosing that information with the SEC or (2) by disseminating the information through another method "that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public." Since use of Rule14a-12 for web-based communications is conditioned in the first place on filing such information with the SEC under Rule 14a-12(b), the public availability requirement of Regulation FD is ordinarily satisfied[11] when Rule 14a-12 is used.[12]

Finally, even if management chooses not to respond publicly to each communication of an activist group during the SEC review period, management should carefully monitor all materials filed by the outsiders with the SEC. In this way, if appropriate, by use of "whine" letters or other communications, management may invoke the assistance of the SEC staff in assuring that the communications by the activist group comply with Rule 14a-9 and thereby do not threaten the fairness of the election contest itself.

Conclusion

Recent changes in SEC proxy rules have enabled activist shareholders to easily wage a corporate control contest over the Internet. The days are numbered when newspapers fight ads and written materials mailed to shareholders on their own form the backbone of a successful activist proxy campaign or a winning defensive strategy. Instead, activist shareholders and incumbent management teams will increasingly find it not only advantageous but also necessary in corporate control contests to supplement, if not largely replace, more traditional forms of communication with the Internet tools of emails, message boards and websites.

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[1] Charles Raymond, *Proxy Fights and Shareholder Activism, Travis Street's Attack on the Web,* April 20, 2001, Dow Jones Newswire, *available at* http://www.dowjonesnews.com; *See also* Fourneret, Jessica, "Follow-Up: Just Deserts at Luby's," 4(2) Corporate Board Member 14 (Summer 2001) ("[TSP] won...the first successful proxy battle fought in cyberspace"). "Although such shareholder revolts have been nurtured on the Internet before, [the TSP] proxy contest is unique as a structured and deliberate effort to secure shareholder support online while still conforming to securities laws," Columbia University law professor John Coffee said. Riva Richmond, *Travis Street*

Takes on ICO Inc., Proxy Fight, January 18, 2001, Dow Jones Newswire, *available at* http://www.dowjonesnews.com.

[2] The recent contested board elections for such companies as The Pioneer Group, Inc. (May 2000); Luby's Inc. (January 2001); ICO, Inc. (April 2001); and Goldfield (June 2001) have all involved significant use of Internet technology by activist shareholder groups. Information concerning contested board of directors elections can be found at http://www.messages.Yahoo!.com/Yahoo!/business/finance/index.html on each company's individual message board.

[3] "Solicitation" is defined broadly in Rule 14a-1(a)(l) to include, subject to exceptions, "any request for a proxy whether or not accompanied by or included in a form of proxy."

[4] Rule 14a-1(g) defines "proxy statement" as the document containing the information specified in Regulation 14A that is required to be delivered to shareholders at or prior to obtaining a proxy (voting card) from such shareholders.

[5] Use of Rule 14a-11(b) to distribute materials in advance of the proxy statement also required that (1) the materials contain certain background information regarding the soliciting parties and (2) the soliciting parties deliver the definitive proxy statement to all solicited persons "at the earliest practicable date" and not to deliver a proxy (voting card) to such persons until they had received the definitive proxy statement.

[6] SEC Exchange Act Release No. 31326 [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,051 (October 16, 1992)

[7] SEC Exchange Act Release No. 42055 [1999-2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,215 (October 22, 1999) The relevant SEC rule changes adopted in early 2000 comprise both (1) the expansion of Rule 14a-12 to cover all solicitations, not just solicitations regarding shareholder nonelection proposals (as had formerly been the case) and (2) the elimination of Rule 14a-11, the substance of which, as revised, is now contained in Rule 14a-12.

[8] Of course, as has long been the case, once the definitive proxy statement is furnished to investors, any other written soliciting material must continue to be filed with the SEC, but under Rule 14a-6(b), not Rule 14(a)-12.

[9] Under Rule 14a-12, participants who communicate in person or over the telephone without using any written materials are not required to recite orally to shareholders either the participant disclosure or the definitive proxy statement warning required to be included on written communications.

[10] In the solicitation by Travis Street Partners, LLC for the 2001 annual meeting for ICO, Inc., to satisfy the two disclosure requirements of Rule 14a-12(a)(1), during the seven-week period between TSP's first filing of a preliminary proxy statement with the SEC on January 5, 2001 and the TSP's delivery of its definitive proxy statement to investors on March 5, 2001, TSP included substantially the following legend on each separate Yahoo! posting, each separate page of TSP's website and each email communication, as well as all press releases:

CERTAIN ADDITIONAL INFORMATION

> The participants in the proposed solicitation of proxies ("Participants") are TSP; the following persons who are, or have funded capital contributions of, members of TSP: Chris N. O'Sullivan, Timothy J. Gollin, Christopher P. Scully, A. John Knapp, James D. Calaway, Charles T. McCord, III, a joint venture between McCord and Calaway, John V. Whiting, Freeman Capital Management LLC, Robert Whiting, Randall Grace, R. Allen Schubert, Stephen F. Martin and Global Undervalued Securities Master Fund, L.P. ("Global"); and the following affiliates of Global: Global Undervalued Securities Fund, L.P., Global Undervalued Securities Fund, Ltd., Global Undervalued Securities Fund (QP), L.P., Kleinheinz Capital Partners LDC, Kleinheinz Capital Partners, Inc., John B. Kleinheinz and J. Kenneth Phillips. In aggregate, the Participants beneficially own 1,639,300 shares of ICO's common stock or 7.23% of such shares outstanding (based on ICO's Annual Report on Form 10-K for the fiscal year ended September 30, 2000). TSP has filed a preliminary proxy statement with the Securities and Exchange Commission (SEC) in connection with a proposed solicitation that the Participants may make with respect to shareholder proxies for the 2001 Annual Meeting of Shareholders of ICO. The Preliminary Proxy Statement contains important information, including additional information about the views and members of TSP as well as the individuals that TSP intends to nominate for election to the ICO Board of Directors. You should read the Preliminary Proxy Statement in its entirety. It can be obtained at no charge on the SEC's web site at (http://www.sec.gov) or by requesting a copy from MacKenzie Partners, Inc., (212) 929-5500 (call collect) or (800) 322-2885 (toll-free).

On its communications before TSP first filed a preliminary proxy statement with the SEC, TSP used essentially the same legend, but simply indicated its intention to file a preliminary proxy statement and cautioned investors to read "any such proxy statement when it is available." *Available at* http://messages.Yahoo!.com/bbs?action=+&type=r&board=7082494&sid=7082494.

[11] *Regulation FD–Question 5*, SEC Division of Corporate Finance: Manual of Publicly Available Telephone Interpretations (October 2000 – 4th Supplement] *available at* http://www.sec.gov/offices/corpfin/phonitsy.htm. The interpretation (cautions that "[i]n considering whether that disclosure is sufficient, however, companies must take care to bring the disclosure to the attention of readers of the document, must not bury the information, and must not make the disclosure in a piecemeal fashion throughout the filing").

[12] Unlike dissidents, however, under Regulation FD, who have no filing obligation with respect to oral communications, a target company must limit the content of its oral communications with security holders to public information or information that is simultaneously made available to the public generally.