Takeovers and Shareholder Communication Via the Internet

by **David J. Berger** and **Marthe LaRosiliere**

As the popularity of the Internet continues to explode,[1] the Internet and the World-Wide-Web have become an important avenue for shareholder communications amongst themselves and with management.[2] Approximately 85% of all major U.S. public companies now have corporate Web pages and regularly use these sites to communicate with their current and prospective shareholders, as well as with the market.[3] Shareholders can access a wide variety of information via the Internet, including a company's annual reports, public filings, press releases, financial data and other company and investor news. Some companies have gone even further, including experimenting with proxy voting via the Web and even holding their annual meetings on the Internet, thereby allowing investors from around the globe to attend and participate in these gatherings.

The Internet has also become a major factor in proxy contests and solicitations as well as shareholder communications and discussions on the subject. Proxy contestants (management and insurgents alike) and shareholders both large and small now include the World-Wide-Web as an integral part of getting their message across to shareholders. Further, shareholders frequently participate in "chat rooms" where common issues of concern are discussed and important questions can be debated.

It has also become increasingly common for shareholders to set up "chat rooms" to discuss the results of a particular company or group of companies. For example, shareholders of closed-end mutual funds have set up numerous chat rooms to discuss why particular funds trade at discounts to their net asset values. Stockholders of numerous public companies, including Apple, Cirrus and Microsoft have set up similar rooms to discuss important issues relating to these companies.

The Internet also has played a major role in takeover battles. For example, the Web played a major role in the takeover battle involving Conrail, CSX and Norfolk Southern. In their effort to garner shareholder support for their proposed merger, CSX and Conrail had a joint Web site with links to their individual home pages. The joint site included news releases, detailed background citing the benefits of the merger, a question and answer section as well as corporate profiles of the two companies. In the first few minutes after the

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[1] **David J. Berger** is a partner, and **Marthe LaRosiliere** is an associate, at Wilson Sonsini Goodrich & Rosati, Palo Alto. A recent survey estimated that approximately 58 million adults in the United States and Canada use the Internet. G. Christian Hill, *Adult Users of the Net in the U.S. and Canada Put at 58 Million,* WALL ST. J., Dec. 11, 1997.

[2] *See* Boris Feldman & Ignacio E. Salceda, *Shareholder and Investor Relations in the Electronic Age,* published in SECURITIES IN THE ELECTRONIC AGE, § 5.02 (discussing the benefits and possible perils of a corporate home page as well as the preventive measures companies should consider).

[3] The National Investor Relations Institute estimates that 95% of all companies with over 1.5 billion in market capitalization have a corporate Web page. United States Securities and Exchange Commission Report to Congress: *The Impact of Recent Technological Advances on the Securities Markets,* September 1997, § I (C)(2)(a) (hereafter "SEC Report to Congress").

merger announcement, the joint site received 4800 "hits" and continued to receive approximately 2000 visitors an hour during the ensuing twelve hours. CSX and Conrail also used the Web to monitor chat rooms and newsgroups in order to gage how Norfolk Southern's hostile bid was being perceived.[4]

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Not to be outdone, Norfolk Southern used its Web site to help derail the merger and take over Conrail. Along with copies of relevant press releases and articles, the site displayed two detailed maps: one showing the routes of a merger between Norfolk Southern and Conrail and one illustrating the routes covered by a Conrail-CSX merger. All three contestants also allowed shareholders to subscribe and receive immediate news on the merger via e-mail.

Electronic Communication among Shareholders

Shareholders have also recognized the value of the Internet as numerous sites dedicated to corporate governance and democracy have been created in the past few years. These cites provide links to various corporations' and institutional investors' Web sites as well as bulletin boards allowing shareholders to communicate directly with each other. Many of them also include their target list of companies who are under performing.[5] Moreover, most investor relations Web sites permit e-mails to be sent from them to the corporation, allowing shareholders to express their views immediately and with little cost or effort.

A popular use of the Internet among shareholders is to garner support for their sponsored proposals. Currently, Rule 14a-8 places a 500 word limitation on the length of a shareholder's proposal and the accompanying supporting statement. Consequently, many shareholders use the Web to post additional information, including graphics, about their proposals. CalPERS and the Florida Retirement System Trust Fund, for instance, issued their solicitation materials on their Web sites in support of their shareholder proposal to amend Archer-Daniels-Midland's bylaws for board member independence.

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The use of the Internet as a campaigning tool has not been limited to institutional investors. For example, Putnam Premier Income Fund's bylaws required that it submit to its shareholders a proposal to convert from a closed-end mutual fund to an open-ended one, a proposal opposed by management. An individual shareholder who supported the opening up of the fund, created a Web site specifically to encourage other shareholders to vote in favor of the proposal. The shareholder's site created a link to Putnam's Web page and encouraged shareholders to share their opinions with the company via e-mail.[6]

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[4] *Web Used to Communicate CSX-Conrail Merger As Well as Norfolk's Southern's Bid to Derail It* Interactive PR (WESTLAW), Nov. 4, 1996.

[5] The California Employees' Retirement System ("CalPERS"), for example, not only posts its annual lists of target companies on its Web site, it also identifies companies that exemplify best practices and improve shareholder value. *See* <http://www.calpers.ca.gov>.

[6] Howard M. Friedman, *Proxy Solicitations and the Cyberspace Revolution,* Insights, Dec. 1997 at 9.

SEC Requirements for Electronic Delivery

The Securities Exchange Commission ("SEC") has generally taken a very favorable view towards the expanded use of the Internet[7] and has been a major factor in the rapid growth of the Internet in the corporate communication and governance process. EDGAR, the SEC's database system which allows for electronic filing of public disclosure documents, is viewed by many as the start of the technological revolution in the securities market. EDGAR was launched as a pilot project in 1984 and in 1996, the SEC mandated that all public disclosure documents be filed electronically through EDGAR. All of the documents filed through EDGAR are readily available on the SEC's Web site, <http://www.sec.gov>. As noted by the SEC, "[t]he ready access to [EDGAR] made possible by the Internet, both through the Commission's own Web site and other sources, forms the core of the new body of corporate information now available on-line."[8]

In October 1995, the SEC issued a release, addressing the procedural requirements a company must follow when forwarding proxy statements, annual reports, proxy cards and any other mandatory disclosure documents (collectively, the "Mandatory Disclosure Documents") to shareholders via any electronic medium.[9] Another SEC interpretive release followed in May 1996, addressing the use of electronic media by broker-dealers and investment advisors.[10] Neither of these Releases alter the substantive laws in any way and the liability provisions such as 10b-5 and 14a-9 "apply equally to electronic and paper-based media."[11]

The SEC has generally taken a favorable view towards the use of the Internet.

Despite the SEC's encouragement and favorable view of this new technology, the Commission has stated that, as of yet, a company may not eliminate entirely the "traditional paper-based system."[12] Thus, a company must still continue to make all of their Mandatory Disclosure Documents available on paper for those shareholders who want them. In addition, a company must first receive a shareholder's "informed

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[7] *See* SEC Report to Congress, § I(A) (SEC listing the benefits of increasing use of technology in the securities markets).

[8] *Id*.

[9] *Use of Electronic Media for Delivery Purposes,* SEC Release 7233, [1995 Tr. Binder] FED. SEC. L. REP. (CCH) ¶ 3200 at 3128 (Oct. 6, 1995) (hereafter the "Oct. 1995 Release"). In both its 1995 Release and its 1997 Report to Congress, the SEC was quick to note that electronic media encompasses "not only the Internet, but also audiotapes, videotapes, facsimiles, CD-ROM, electronic mail and proprietary computer networks." SEC Report to Congress, § I(A)3. *See also* Oct, 1995 Release, n. 9 (broad definition of the term "electronics").

[10] *Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisors for Delivery of Information,* SEC Release No. 7288, [1996 Tr. Binder] FED. SEC. L. REP. (CCH) ¶ 3201 at 3131-12 (May 9, 1996) (hereafter "May 1996 Release").

[11] Oct. 1995 Release, n. 11. *See also* SEC Report to Congress, § I(B)(3) (securities law liability provisions apply to electronic delivery and Web content just as they apply to paper versions); May 1996 Release at 3131-13 (electronic transmission of documents "does not affect the rights and responsibilities of any party under the federal securities laws").

[12] *See* SEC Report to Congress, § I(B)(3).

consent" to receiving all corporate information exclusively in electronic form before relying solely on this method of delivery.[13] Therefore, a hard copy consent form must first be mailed to all shareholders.[14]

For consents to be considered "informed," the company must specify: (i) the specific medium of delivery (such as the company's Web site); (ii) the potential that shareholders may incur costs when accessing the information in this manner (such as on-line time); and (iii) the period during which the consent will be effective.[15] The scope of the consent (i.e., whether the company is seeking consent to provide all necessary documents or only selected documents electronically) must also be disclosed.[16] It is important to note that even shareholders that have specifically consented to receiving all corporate information in electronic form are entitled to the paper version if they request such a version or if they revoke their consent.[17]

The SEC allows a company to infer the consent of its employee-shareholders to receiving documents electronically (unless they specifically request a paper version) if such employees use or have access to the company's e-mail system in the ordinary course of their employment.[18] The procedural requirements of notice, access and evidence of delivery (*see infra*) must also be satisfied. Thus, the e-mail must attach the actual document or announce the availability of the materials and include information as to how to access the information on the company's intranet or local area network.[19] The e-mail must also "prominently" state that a paper version is available upon request.[20]

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[13] *Id.* A company may rely on consents provided to a brokerage firm or other record holders of stock. Oct. 1995 Release, n. 29.

[14] Intel Corporation, for example, in 1997, offered its record holders the option of receiving its annual report and proxy statement via the Internet. The company first mailed a Notice and Request for Consent to these holders with their fourth quarter dividend check. Those record holders who returned the consent form then received another notice by mail notifying them of the Web site address and availability of the annual report and proxy statement. Included with this second notification was a proxy card and a postage prepaid return envelope. Of Intel's 110,000 record holders, 11,000 consented to this form of electronic delivery. SEC Report to Congress, n. 65 (citation omitted).

[15] Oct. 1995 Release, n. 29.

[16] *Id.*

[17] *Id.* at n. 27 and accompanying text. *See also* May 1996 Release, n. 17 (shareholder's revocation of consent is not a prerequisite to requesting a paper copy of a document).

[18] May 1996 Release, Example 1; SEC Report to Congress, § I(C)(2)(c).

[19] In 1997, Hewlett-Packard sent its 60,000 employee-shareholders an e-mail that it was planning to put its annual report on its Web site and would not distribute hard copies of the report to employees unless they replied to the message and requested a paper copy. Only 5,000 employees chose the paper version. The remaining 55,000 employees subsequently received another e-mail which informed them that the report was available. The message included an icon that, when clicked, switched directly to the company's annual report. The experiment was so successful that Hewlett-Packard plans on expanding the electronic option to the rest of its registered shareholders in the next proxy season. *See* D. Craig Norland, *Electronic Communication with Shareholders,* INSIGHTS, July 1997 at 8 (Hewlett-Packard's assistant general counsel discussing the company's experience with electronic communication with its employee-shareholders).

[20] May 1996 Release, Example 1.

The SEC's two Releases have focused on an issuer satisfying its delivery requirements. In order for electronic transmission to be considered "delivered," three requirements must be satisfied: (i) notice; (ii) access; and (iii) evidence of delivery.

Notice

Electronic communication must provide "timely and adequate" notice to shareholders that information for them is available.[21] The act of posting a document on a Web site, does not, in and of itself, constitute adequate notice. According to the SEC:

> If an electronic document itself is provided – for example, on computer disk, CD-ROM, audio tape, videotape, or e-mail – that communication itself should generally be sufficient notice. If the document is provided on an Internet Web site, however, separate notice would be necessary to satisfy the delivery requirements unless the issuer can otherwise evidence that delivery to the investor has been satisfied ....[22]

Thus, when placing any Mandatory Disclosure Document on the Internet, a company must first provide a separate notice to its shareholders via another medium such as regular mail or e-mail (assuming that the shareholder has consented to this form of communication), informing them that the Mandatory Disclosure Materials are available on-line. Alternatively, a company must be able to demonstrate that delivery of the document has actually been satisfied. An e-mail receipt or confirmation that a shareholder has accessed a Web site should satisfy as evidence of receipt.

Access

A shareholder's ability to access electronic communication must be "comparable" to that provided by regular mail. In short, the electronic medium should be easily accessible or, to borrow the words of one commentator, "a shareholder should not have to be a computer expert to locate and read the information."[23]Placing a document on a system which would require a shareholder to go through a series of confusing or complicated steps before accessing the information may be considered so burdensome that access is effectively denied.[24] Furthermore, shareholders must have the ability to either download the information or have on-going access to the materials for as long as the applicable delivery requirements dictate. Specifically, with respect to corporate elections, all proxy-related materials along with the company's annual report must remain on a company's Web site until the meeting is adjourned. If votes are allowed to be submitted after the adjournment of the meeting, the electronic materials must remain on the Internet until such time when voting is no longer permitted.

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[21] Oct. 1995 Release at 3131-2.

[22] *Id.*

[23] Gloria Santona, *More Corporations are Using the 'Net' to Reach Investors,* NAT'L L. J., July 14, 1997 at B16.

[24] *See* Oct. 1995 Release at 3131-2.

Evidence of Delivery

A company must have "reasonable assurance" that each of its shareholders has received the electronic documents.[25] The underlying principle behind this requirement is to ensure that issuers and other market participants are not relying on electronic delivery to shareholders who do not have access to computers or who choose not to receive these materials electronically.[26] Evidence of electronic delivery include:[27]

- obtaining an informed consent from a shareholder to receive the information through a particular electronic medium coupled with assuring appropriate notice and access;
- obtaining evidence that a shareholder actually received the information, such as by e-mail return receipt or confirmation of accessing, downloading or printing;
- dissemination via facsimile to a shareholder who has requested that the information be faxed to it and has provided the telephone number of a fax machine;
- a shareholder's ability to access a document by using hyperlinks to a required document; and
- a shareholder's use of forms or other material obtained by accessing the electronic information.

Electronic Transmission of Specific Documents and **Information**

Electronic Annual Reports

A growing list of companies, including Adobe Systems, Oracle Corporation, Intel and RR Donnelly & Sons, now make their annual reports available electronically, usually via their Web home pages or on a CD-ROM. The SEC currently allows a company's electronic annual report to contain information not included in the paper version of the report.[28] Consequently, some annual reports on the World-Wide-Web contain video presentations by senior management and interactive applications to enable shareholder feedback and other companies, such as Microsoft, provide an Excel spreadsheet on their Web site annual report, allowing viewers to analyze the company's financial results for themselves.

Electronic Delivery of Proxy Materials

A number of companies also are delivering their proxy statements and solicitation materials via the Internet. Since federal law requires that companies forward all proxy materials to the beneficial owners, electronic delivery of proxy materials is complicated by the fact that the majority of stock in public companies

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[25] SEC Report to Congress, § I (B)(3)(c).

[26] *Id.*

[27] *See* Oct. 1995 Release, Examples 1-12, 23-52, for examples of sufficient and insufficient delivery.

[28] SEC Report to Congress, n. 54-55 and accompanying text.

are held in "street names" and companies may not know the identity of many of their beneficial owners.[29] Thus, what has traditionally been done is that record holders seek voting instructions from the beneficial owners or "pass through" the vote to these owners by giving them a signed proxy, a process which may prove not to be cost effective or time efficient if done electronically.

To alleviate this problem, the Depository Trust Company (under the supervision of the SEC), launched a pilot direct registration program in November 1996. Participating shareholders may have their shares registered through book-entry form directly on the books of the issuer and receive a statement of ownership in lieu of a stock certificate. These shareholders receive proxy materials directly from the company and subject to state law requirements, may vote their shares without going through an intermediary. It is estimated that since the pilot's launch, there have been approximately fifty companies that have participated in the program.[30]

Electronic Voting

In 1997, the Internet's role in proxy contests was further expanded as a number of companies allowed their shareholders not only to receive their proxy materials on-line, but to submit their proxies electronically. Aside from the federal rules and statutes, a company must also be mindful of the governing state laws before instituting electronic voting as proxy voting remains, for the most part, regulated by individual states. Currently, a handful of states (including Delaware, California and New York), allow shareholders to return a proxy vote without a signature or specifically authorize electronic proxies.

Delaware and some other states, however, require that there be evidence that an electronic vote has been properly authorized before it can be counted.[31] To comply with this requirement, companies are providing their shareholders with a traditional proxy card which includes a personal identification number ("PIN") or other identifying information as well as the Web site address indicating where they can cast their vote. These shareholders then log on to the appropriate Web site and punch in their PIN number. After the shareholder's identity is confirmed, a computer program displays the information set out on the printed proxy card and allows a shareholder to mark the appropriate boxes on the electronic ballot.[32]

This procedure also has been used to permit shareholders to cast their vote via voice mail with the use of a touch tone telephone. Instead of a Web address, companies opting for the voice mail method, list a phone

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[29] *See* Rule 14a-13 (requiring companies to send proxy materials to beneficial owners through the respective record holder) and Rules 14b-1 and 14b-2 (requiring brokers, banks and other custodians of securities for the benefit of others to transmit all proxy materials to beneficial owners upon assurance of reimbursement for reasonable expenses).

[30] SEC Report to Congress, n. 62.

[31] *See, e.g.*., Del. Gen. Corp. Code § 212; Cal. Corp. Code §178.

[32] Bell & Howell, the company who, in 1996, pioneered the broadcasting of its annual meeting over the Internet used this procedure to allow its record holders to vote via e-mail, through a secure client-server at the company's Web site as late as the morning of its 1997 annual meeting. It was reported that approximately 25% of the company's outstanding shares were by proxy over the Internet. *Bell & Howell Adds New Twist to Annual Meeting Proxy Voting on the Web*, PR NEWSWIRE, May 14, 1997 (LEXIS). By halting electronic voting at the start of the meeting, Bell & Howell also sidestepped the difficult issue as to whether a shareholder attending the meeting electronically is present for the purposes of voting. *See Cyberspace Revolution*.

number on the proxy card and shareholders, after punching in their PIN number, follow the recorded instructions to submit their proxies.[33]

An alternative to the PIN procedure is digital signature technology. A digital signature is an encryption code that certifies the identity of the author of an electronic document or message. With digital signature technology, an electronic message or document is encrypted with the sender's unique encryption code, known as a "key." In order to take advantage of this technology, shareholders must first obtain a pair of "keys" — one key is private and the other public. The shareholder would sign the electronic proxy using its private encryption code and then transmit the proxy along with its public key to the intended recipient, which the recipient would then use to decrypt the message. The recipient can also verify the sender's identity by checking with third party certification authorities who can confirm whether or not a particular person is the holder of the "public key" that decrypted the transmission.

Although no public company has reported using this technology, it is believed by some to be more secure than the current PIN procedure since it not only authenticates the identity of the sender of the message, it also assures that the contents of the message have not been altered after the original transmission.[34] This may prove to be particularly helpful where there are multiple levels of electronic submissions (i.e., the company's transfer agent to the record holder, the record holder to the beneficial holder, the beneficial holder to the record holder and finally, the record holder to the company's transfer agent) or in a contentious battle where challenges to proxies are likely. Digital signature technology also does away with the need to mail a printed proxy card to shareholders. However, it would require that shareholders obtain digital signatures as well as require the participation of yet another entity in the proxy solicitation and voting process: the third-party certification authorities.

Conclusion

The growing use and popularity of electronic media, including the Internet, have made communications with and among shareholders faster, easier and relatively inexpensive. As the popularity of electronic technology increases, the importance of the Internet in takeovers, proxy contests, shareholder communications and the entire corporate governance process will also grow. This growth, in general, will have substantial benefits for all shareholders and other participants in the corporate governance process.

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[33] A few companies, such as Compaq Computer and Intel are providing their shareholders with both options (along with the traditional method) in 1998.

[34] For a discussion of the possible use of digital signature technology in the context of a proxy contest, *see* Friedman, *supra*, n. 6.