DO SHAREHOLDER ACTIVISTS VIOLATE FEDERAL PROXY SOLICITATION LAWS THROUGH INTERNET MESSAGE BOARDS?

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Dissident shareholders who use the Internet to organize stockholder revolts take heed! Internet-savvy cybersecurities lawyers and their corporate clients have discovered a new tool in their never-ending battle to fend off disruptive shareholder proposals.

Two closed-end management investment companies are alleging in recently-filed lawsuits that dissident shareholders have violated sections 13(d) and 14(a) of the Securities Exchange Act of 1934[1] by posting messages to an Internet message board devoted to discussions of closed-end funds.[2] Generally, the federal securities laws and rules cited in the suits prohibit: (1) the solicitation of more than 10 shareholders for their proxy votes unless a proposal is first filed with the SEC, (2) any proxy solicitation through false or misleading statements, and (3) certain types of concerted activity by beneficial owners of more than 5% of a company's shares without making advance filings with the SEC.

SAME SHAREHOLDER ACTIVIST INVOLVED IN BOTH SUITS

In both cases, the proxy battles involve a shareholder activist named Phillip Goldstein. Mr. Goldstein is President of Kimball & Winthrop, Inc., the general partner of Opportunity Partners L.P. He has been described as "the most visible of a new breed of closed-end-fund

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1 15 U.S.C.A § 78m(d) and 15 U.S.C.A. § 78n(a).

2 The actions are *The Emerging Germany Fund, Inc. v. Phillip Goldstein, Opportunity Partners L.P., Kimball & Winthrop, Inc., Ronald Olin and Deep Discount Advisors, Inc.*, 98 Civ. 2508 (S.D.N.Y., complaint filed April 8, 1998) and *Opportunity Partners L.P., and Great Neck Capital Appreciation Investment Partnership, L.P. v. The Emerging Mexico Fund, Inc., Gonzalo De Las Heras, Philip L. Bullen, Rodney B. Wagner, Edgar R. Fiedler and Richard S. Weiner*, No. 98 Civ. 4218 (WK) (S.D.N.Y., complaint filed June 16, 1998).

activist known as a fundbuster."[3] He is a retired New York City civil engineer who operates a $40 million hedge fund from the basement of his Brooklyn, New York home.[4]

The shares of many closed-end funds trade at deep discounts to their net asset values. Generally speaking, "fundbusters" such as Mr. Goldstein seek to buy shares at deep discounts and then maneuver to reduce the discounts, thereby increasing their overall returns vis-a-vis the funds' market performance. Such maneuvers may include submission of proposals to shareholders to remove the fund's investment advisers or to "open-end" the funds -- *i.e.*, to require the funds to redeem the shares on demand for cash equal to the net asset value of the shares.

THE EMERGING GERMANY FUND SUIT

Early this year, the Emerging Germany Fund scheduled its annual shareholders meeting on April 27. On March 27, Mr. Goldstein wrote to the fund's management advising of his plan to attend the meeting and to nominate himself and three others for election as directors of the fund. He also advised of his intention to submit four proposals for consideration by the shareholders, including proposals that essentially would require open-ending the fund and firing the fund's investment advisers.

During the course of this increasingly hostile battle, the Emerging Germany Fund and its lawyers discovered an intriguing fact. Mr. Goldstein was an active participant in electronic "discussions" that took place on the ICEFI Closed-End Funds Discussion Forum, an electronic message board accessible via the Internet.[5] Even more intriguing, some of the messages that Mr. Goldstein and others posted to the board allegedly addressed the very proposals that Mr. Goldstein wanted shareholders to consider at the annual shareholders meeting. The rest, as they say, is history.

On April 8, 1998, the fund withdrew its notice of the April 27 meeting and commenced a lawsuit against Mr. Goldstein, Opportunity Partners L.P., Kimball & Winthrop, Inc. and others.[6]

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[3] Leland Montgomery, *Closed-End Funds*, Worth Online, Feb. 1998 <http://www.worth.com/articles/Z9802F02.html>.

[4] Thomas Eaton, *Try Your Hand at Arbitrage*, Forbes.com, Sept. 8, 1997 <http://www.forbes.com/Forbes/97/0908/6005209a.htm>.

[5] *See* <http://www.linkindia.com/icefi/wwwboard/index.html>.

[6] *See supra*, n.2. *See also* The Emerging Germany Fund Inc., *The Emerging Germany Fund Inc. Amends ByLaws, Will Reschedule Annual Meeting, and Commences Litigation Against Stockholders for Violation of Securities Laws*, Apr. 8, 1998 <http://ww2.newswire.ca/releases/April1998/08/c2145.html> (press release).

The suit alleges that various of the defendants, including Mr. Goldstein, used an Internet "chat-Line to evade . . . proxy solicitation rules."[7]

According to the complaint, on March 28 Mr. Goldstein posted a message informing message board viewers that Opportunity Partners had notified the fund's management of its intention to nominate four directors and to submit its proposals at the upcoming shareholders meeting.[8] The complaint alleges that the "communication was false and misleading in that it failed to disclose facts material to a shareholder's assessment of the qualifications of the four directors."[9] The complaint further alleges that one message board participant posted a message on March 30 indicating that at his instruction, his broker already had "contacted Phil to provide him with a proxy covering" his shares and that "[a]ll it took was a two minute phone conversation and follow-up fax."[10]

Interestingly, the complaint makes much of an alleged posting by Mr. Goldstein that reportedly read as follows:

> "We are not filing a proxy with the SEC and we intend to solicit proxies from only 10 persons as described in my prior postings. Unless a stockholder votes at the meeting himself or gives (or has his broker give) someone else a proxy to be voted at the meeting, his shares will not be voted for our nominees or on these proposals."

According to the fund, this message demonstrates that Mr. Goldstein already was aware that earlier postings violated the SEC proxy solicitation rules.

The fund claims that such postings violated Section 14(a) of the Securities Exchange Act of 1934 and SEC Rules 14a-3 through 14a-6 promulgated under that section of the statute.[11] Absent exemption, those provisions generally require the filing of a preliminary or final proxy statement with the SEC and the distribution of copies of such proxy statements to all solicited

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7 *See* Complaint at 22, 23-26. The allegation was technically erroneous. The Web site involved is an electronic message board -- an electronic bulletin board to which messages are posted and remain accessible to viewers for weeks at a time. A "chat room" -- not "chat-line" -- involves exchange of real time communications by persons who exchange live messages while on-line.

8 Complaint ¶ 58, at p. 23.

9 *Id.* at pp. 23-24.

10 *Id.* ¶ 60, at p. 25.

11 *See id.* ¶¶ 63-68, at pp. 26-27.

persons. The fund also alleges that certain postings were false and misleading and omitted material facts in violation of Section 14(a) of the act and SEC Rule 14a-9.[12]

The fund further claims that Opportunity Partners and others violated Section 13(d)(1) of the Securities Exchange Act of 1934 and SEC Rule 13d-5(b)(1) promulgated under that section of the statute.[13] Those provisions essentially bar coordinated activity by the beneficial owners of more than 5% of a company's shares for the purpose of acquiring, holding, voting and disposing of securities without first making certain filings with the SEC.

The defendants have denied the allegations and moved to dismiss the claims against them. They argue, among other things, that the communications posted to the message board did not rise to the level of proxy solicitations and, instead, were the equivalent of permissible "meetings among shareholders who are of all the same mind." Moreover, the defendants argue that even if the communications are found to be proxy solicitations, the allegations against them are deficient because they do not demonstrate that the communications were made to more than ten shareholders of the fund. According to the defendants, the complaint describes purportedly responsive messages from eleven anonymous persons who posted to the board, but fails to allege that those eleven persons were also shareholders of The Emerging Germany Fund. Finally, the defendants argue that the allegations that they acted collectively for the purpose of acquiring, holding or disposing of registered equity securities are insufficiently specific and, thus, must be dismissed.

The defendants' motion to dismiss is awaiting determination by the Judge in the case. In the meantime, the Judge has directed the parties to schedule a settlement conference some time in September.

THE EMERGING MEXICO FUND SUIT

Mr. Goldstein's battle with The Emerging Mexico Fund began somewhat earlier than his fight with the Emerging Germany Fund. In December 1997, Mr. Goldstein allegedly arranged submission of shareholder proposals to five funds, including the Emerging Mexico Fund, proposing to fire the funds' investment advisers. For example, Opportunity Partners submitted a proposal to terminate the Emerging Mexico Fund's adviser. Mr. Goldstein's wife, Judith, reportedly submitted a proposal to convert the fund to an open-end fund.

All five fund companies sought no-action letters from the SEC, arguing that the proposals violated the 1940 Investment Company Act in one fashion or another. The Emerging Mexico Fund argued, among other things, that Mr. Goldstein orchestrated both shareholder proposals submitted to it and, thus, had violated the one proposal per proponent limit

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[12] *Id.* ¶¶ 76-81, at pp. 29-30.

[13] *See id.* ¶¶ 69-75, at pp. 27-29.

permitted under SEC Rule 14a-8(a)(4). Thus, according to the fund, it was entitled to omit the proposals from its 1998 proxy soliciting materials.

To the surprise of the entire industry, the companies lost their bids to block the substance of the proposals. In a series of SEC No-Action letters made publicly available on May 8, 1998, the SEC Staff rejected the funds' arguments and refused to give assurance that it would not recommend enforcement action to the Commission if the proposals were omitted from the funds' 1998 proxy soliciting materials.[14]

According to Mr. Goldstein, the Emerging Mexico Fund and its management included the disputed proposals, but did not do them justice in the proxy solicitation materials sent to the fund's shareholders. Thus, it was Mr. Goldstein who commenced suit this time. On June 16, 1997, he filed a suit against the Emerging Mexico Fund and the fund's directors alleging, among other things, violations of federal proxy solicitation laws and breaches of fiduciary duties.

The fund's lawyers struck back quickly. On June 22, 1998, the fund and its directors answered the complaint with a counterclaim. They allege that Mr. Goldstein, Opportunity Partners and Kimball & Winthrop had violated the same proxy solicitation laws as those at issue in the Emerging Germany Fund suit with postings, once again, to the ICEFI Closed-End Funds Discussion Forum message board. According to the allegations of the counterclaim, on June 1, 1998, Mr. Goldstein posted a message entitled "MEF Voting Strategy" in which he urged shareholders to refrain from sending the company their proxies and "[i]f you can't attend the meeting, cross out management's nominees for director and write in Phillip Goldstein and Steve Samuels, my partner and indicate you wish to vote for us as directors. . . . Watch this space for future developments."[15]

On July 30, Mr. Goldstein and the other counterclaim defendants moved to dismiss the counterclaims against them in the Emerging Mexico Fund suit on essentially the same grounds as those they asserted in their motion to dismiss the Emerging Germany Fund. Their motion remains pending and awaits decision by the Court.

WHAT ABOUT THE SHAREHOLDER PROPOSALS?

Unlike the Emerging Germany Fund, which withdrew its notice of annual shareholder's meeting after receipt of Mr. Goldstein's proposals, the Emerging Mexico Fund annual

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[14] *See The Emerging Mexico Fund, Inc.*, SEC No-Action Letter, 1998 WL 229590 (S.E.C.) (May 8, 1998). *See also Clemente Global Growth Fund, Inc.*, SEC No-Action Letter, 1998 WL 229593 (S.E.C.) (May 8, 1998); *Scudder Spain & Portugal Fund, Inc.*, SEC No-Action Letter, 1998 WL 229585 (S.E.C.) (May 8, 1998); *The New Germany Fund, Inc.*, SEC No-Action Letter, 1998 WL 229598 (S.E.C.) (May 8, 1998); *The INVESCO Global Health Science Fund*, SEC No-Action Letter, 1998 WL 229602 (S.E.C.) (May 8, 1998).

[15] Defendants' Answer and Counterclaim dated June 22, 1998 ¶ 14, at p. 28.

shareholder meeting went forward. The meeting was held on June 24 and was reconvened on June 26 to announce the results of the votes.[16] According to the company, nearly 5.8 million shares voted in favor of opening the fund, while more than 2.3 million shares voted against the proposal. The company treated the proposal as a non-binding advisory proposal and announced that it would be up to the board to decide whether the fund would convert. The shareholders defeated the proposal to terminate the investment advisory agreement with the fund's investment adviser.[17]

LESSONS TO BE LEARNED

What lessons may be learned from the funds' claims against Mr. Goldstein and the others? Perhaps the most important lesson is that proxy solicitation do's and dont's are varied and complex. Consequently, the propriety of communications about proxies and proxy battles should not simply be assumed in the relatively extemporaneous environments of message boards, chat rooms and Usenet news groups. Even the pros can fall victim to allegations of misconduct.

Additionally, if nothing else, these two suits show that companies and their lawyers are growing increasingly savvy about searching and monitoring the Internet for evidence that might be used in lawsuits against their opponents. Those who choose to use the Internet as a communications tool for so-called "financial-chat" must remain ever-aware that their comments are public, may be recorded and likely will be quoted back to them in the event of a dispute.

Yet, it must be emphasized that there is nothing inappropriate or illegal about using the Internet for proxy solicitation. It simply must be done in compliance with applicable statutes and SEC rules. For example, the SEC has made clear that proxy soliciting materials may be delivered via the Internet if certain procedures are followed.[18]

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16 *See* The Emerging Mexico Fund, Inc., *Company Press Release: Emerging Mexico Fund Makes Announcement on Shareholder Vote*, Yahoo! Finance PR Newswire, June 24, 1998 <http://biz.yahoo.com/prnews/980624/ny_emerg_m_1.html>.

17 *See* Dow Jones Newswires, *Emerging Mexico Fund Holders Vote To Keep Mgr Santander*, Wall St. J. Interactive Ed., June 26, 1998 (available via search at <http://www.wsj.com>).

18 *See Use of Electronic Media for Delivery Purposes*, Securities Act Release No. 33-7234, Exchange Act Release No. 34-36346, Investment Company Act Release No. 21,400, 1995 WL 588462 at *11-*13 (S.E.C.) (Oct. 6, 1995) (also available via <http://www.sec.gov/rules/proposed/33-7234.txt>).

Moreover, companies are not the only ones who can use the Internet in connection with proxy battles. As one commentator has written, "[d]issidents and shareholder activists were among the first to recognize the potential of the Internet" in this context.[19]

Nor is there anything about the proxy solicitation laws that proscribes individual shareholders from simply voicing their opinions about management via the Internet. For example, "[w]ithout submitting their own proposals, dissidents may use their own Web sites to encourage shareholders to vote against management's proposals at the annual meeting."[20] Indeed, when Putnam Premier Income Fund was required to submit to shareholders a proposal to convert to an open-end fund structure, management opposed the conversion. A long-time dissident shareholder put up a Web site to encourage shareholders to reject management's recommendation and to vote to open-up the fund.[21]

Finally, instances such as those alleged in the suit are likely to occur with increasing frequency as more investors trade via the Internet and increasingly turn to that medium for investment information. Indeed, as one author recently has emphasized, the Internet provides an opportunity for "investor empowerment" particularly in the context of proxy solicitations and the opportunity for "far more sophisticated and current intra-investor communications."[22]

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[19] John C. Wilcox, *Shareholder Communications: Electronic Communication and Proxy Voting: The Governance Implications of Shareholders in Cyberspace*, Insights, March 1997, at 8, 11. Indeed, the most celebrated instance of the use of the Internet in proxy solicitations involved Bennett LeBow and the Brooke Group who fought a proxy battle against RJR Nabisco by posting all their proxy materials and communications on the home page of their proxy solicitation firm. *See id.*

[20] Howard M. Friedman, *Technology: Proxy Solicitations and the Cyberspace Revolution*, Insights, Dec. 1997 at 9, 11.

[21] *Id.* (citing Kathryn Haines, *Putnam Premier Income Shareholder "Tells All" On Internet*, Dow Jones News Service, March 13, 1997).

[22] John C. Coffee, Jr., *Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation*, 52 Bus. Law. 1195, 1197 (Aug. 1997).

The SEC and other securities regulators must continue to remain sensitive to the tensions inherent in the rules regarding proxy solicitation materials and the need to permit free and easy communications among shareholders who now have access to a medium that permits virtually instantaneous electronic publication to countless other inquisitive investors.

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