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**Business & Finance**

Business & Finance Magazine

February 23, 2007

**LENGTH:** 2501 words

**HEADLINE:** Martha Stewart : Criminal ?

**BODY:**

Martha Stewart: Criminal?

Martha Stewart personifies all that is right about the American dream and much that is wrong with American corporations.

Prof Geraldine Szott Moohr looks at the insider-dealing case which concluded last month.

The Martha Stewart case is emblematic of the state of white-collar criminal law statutes, their enforcement and the effects.

The case arose when Stewart's friend, Sam Waksal, sold his holdings in ImClone, the technology company he ran and had founded. When Stewart was told about Waksal's sales, she sold her shares in ImClone, Inc. The following day, when ImClone announced that the Food and Drug Administration (FDA) had not approved the company's cancer drug, the value of ImClone shares fell by 18%. By selling when she did, Stewart avoided a loss of about \$45,000.

Regulators soon suspected that sales of ImClone stock were based on unannounced information about the new drug, violating the United States insider-trading law. Waksal pleaded guilty to that offence and is now serving a seven-year prison term. During the initial investigation, Stewart was interviewed twice by investigators from three federal agencies, the Federal Bureau of Investigation, the Securities and Exchange Commission, and the local United States Attorney's Office. On both occasions, she offered information about her reasons for selling that a jury later found to be untrue.

Stewart and her broker, Peter Bocanovic, were eventually indicted for violating several federal criminal laws. A jury found them guilty and Stewart received a 10-month penalty, split between five months in prison and five months under house arrest. The case officially closed in January, 2006, when an appellate court rejected her appeals.

Each stage of her case, from investigation through sentencing, provides insights into white-collar criminal law in the US.

Investigation and indictment

The investigation began in February, 2002, and ended in June, 2003, when Stewart was indicted. This fact illustrates that investigations of white-collar crimes take a long time.

There are few witnesses to fraudulent conduct, so that investigators must painstakingly follow paper trails to determine whether a crime occurred. Such an investigation can set off harmful collateral consequences. Financial and business markets react to news of the investigation and to leaks regarding its progress. Investors sell, shareholders sue, clients withdraw, advertisers bail, and targeted firms soon encounter financial difficulties. Stewart's company, Martha Stewart Living Omnimedia, suffered these repercussions.

As a result of falling share prices and general uncertainty about Stewart's future role, corporate shareholders filed 13 civil suits against Stewart and her company.

During the investigation, Stewart was nominated to, and resigned from, the board of the New York Stock Exchange.

She also stepped down as CEO and chairwoman of her company. In addition to financial consequences, a social stigma attaches to the subject of an investigation, and arouses the suspicion of colleagues and friends as well as the government, with consequent loss of respect and status. The stigma of conviction begins long before a finding of guilt and is felt by the innocent as well as the guilty.

The decision to indict rests largely with the federal prosecutor in charge of the case. Stewart's celebrity status and the media attention that was given to the investigation argued for indictment. If the government had not indicted Stewart, prosecutors would be accused of giving a rich and famous person a break. Failing to indict would also indicate that the laws at issue were not worth enforcing. On the other hand, if she was charged, prosecutors would be seen as treating all offenders equally and all laws seriously.

Moreover, there is significant deterrent value to prosecuting a celebrity. When someone rich and famous is charged with a crime, the case attracts greater media attention than cases against ordinary defendants, and sends a message everyone notices. The message in the Martha Stewart case depends on the offences that are charged, decisions that are also a matter of prosecutorial discretion.

Absence of insider-trading charge Surprisingly, Stewart was not charged with insider-trading. Stewart sold her ImClone stock shortly after she was told that Waksal was selling his own shares. Thus, she had traded while in possession of nonpublic information that was arguably material to an ImClone investor. Why wasn't Stewart indicted for the crime of insider-trading?

The answer rests on the vagaries of insider-trading law which was developed by federal courts and is based largely on obligations of trust and confidentiality.

First, Stewart was not affiliated with ImClone and did not owe fiduciary duties to ImClone shareholders. She could not be charged under the classic theory of insider-trading which bars executives and other insiders from trading on non-public information about the company.

Nor was she a tippee who received information from an insider who had breached a duty by disclosing the information. Faneuil, her broker's assistant and an employee of Merrill Lynch, told Stewart that Waksal was selling, but he did not owe fiduciary duties to ImClone shareholders. Nor could Stewart be charged for misappropriating information and then trading.

She had not betrayed a confidential relationship to the assistant or to Merrill Lynch, the source of the information. It could be argued, however, that Faneuil had misappropriated information that belonged to Merrill Lynch, thus betraying his confidential relationship with, and obligations to, the firm.

The problematic issue was whether Stewart had committed insider-trading when she traded on information that had been misappropriated by Faneuil. An insider-trading charge on this theory implicates two related but distinct doctrines: tippee liability, a species of classic insider trading; and misappropriation liability. Prosecutors may have hesitated to establish a new criminal offence in a high-profile criminal case. This non-charge again illustrates the prosecutor's discretion, this time in declining to charge a defendant:

In contrast, the Securities and Exchange Commission, apparently believing that this gap in insider-trading laws ought to be closed, brought a civil enforcement action against Stewart based on the tippee/misappropriation theory.

Stewart eventually settled this claim, neither denying nor admitting wrongdoing. The enforcement action reminds us that civil regulatory actions often overlap with criminal prosecutions as the same conduct can result in civil or criminal charges, or both. The only distinctions between civil and criminal liability in many statutes involve the accused's felonious intent and the prosecution's burden to prove all elements of the crime beyond a reasonable doubt.

This convergence of civil and criminal law can blur the distinction between the standards for each cause of action, often leading courts to expand the scope of the criminal provision. In insider-trading cases, courts have applied essentially civil standards - which were designed to compensate victims in criminal cases - where the purpose is to punish.

Another perturbing aspect of the overlap between civil and criminal law is the possibility of parallel and multiple legal proceedings against defendants. Stewart faced three proceedings that emanated from her infamous trade: civil suits by shareholders, regulatory action by the SEC, and criminal action by the justice Department.

A three-front defence effort, even when one court stays its proceeding in deference to another, presents significant procedural challenges for defendants.

Yet the phenomenon of parallel or multiple proceedings is not unusual in white-collar criminal law, where the threat of criminal charges strengthens the government's position in the civil matter. Securities fraud charge In contrast to the decision not to charge Stewart with insider-trading, prosecutors indicted Stewart for another form of securities fraud. Stewart was charged with fraudulently misleading investors in Omnimedia, not ImClone investors, but shareholders of her company.

After news reports disclosed Stewart's sale and Waksal's arrest, Stewart made public statements aimed at her company's shareholders. Among other things, she denied any wrongdoing and explained her reason for selling: when the price of ImClone fell to \$60 per share, she executed a pre-arranged decision to sell her shares. Prosecutors charged that Stewart's statements had affirmatively misrepresented her reason for selling in order to influence the price of her company's stock and to protect her own wealth.

According to the government, her deceptive statements fraudulently misled investors and affected their decisions to buy or sell shares of her company.

Commentators almost immediately identified several problems with this unusual charge. Fraud requires more than deception: the deception must relate to a material matter. Stewart's statements were arguably not material because they referred to a personal transaction that did not concern business at Omnimedia.

Securities law also requires that the deception is connected to the purchase or sale of a security. In the end, the judge acquitted Stewart of securities fraud. The securities fraud charge shows how federal white-collar criminal laws use broad, undefined terms that prosecutors can apply to a wide range of conduct.

Congress delegated to the courts the task of defining these terms, but judicial interpretations can vary. A statute may offend the constitution if it is so unclear that citizens "of common intelligence must necessarily guess at its meaning and differ as to its application". The standard is particularly pertinent in white-collar crimes because not all unethical or immoral conduct is criminal.

Moreover, vague statutes may not effectively deter criminal conduct by others. When the law is unclear, persons who are considering some action may not realise that they are in danger of violating criminal laws. This point is particularly relevant in the white-collar context where conduct often involves ethical lapses, betrayals of trust and deceptions that are not always crimes.

#### Cover-up charges

Stewart told investigators that she had sold her ImClone stock because its price had fallen to her predetermined \$60 limit. Based on these and other statements, she was charged with making false statements to investigators, obstructing justice, and conspiring to commit those offences. Aply referred to as cover-up crimes, these free-standing, independent offences are not related to the target offence under investigation. A cover-up offence may be brought even when the target offence, such as insider-trading or securities fraud, is not a crime or could not be proven.

The cover-up charges remind us again of the breadth of federal statutes. For example, the false statement provision prohibits misleading virtually any government official, even when not under oath or in formal circumstances. The cover-up charges against Stewart also illustrate the depth of the federal criminal code.

The code reportedly contains at least 100 false statement statutes and over 325 fraud statutes, giving prosecutors a wide choice of specific charges.

Crimes like false statements, perjury and obstruction overlap, so the same conduct results in three different violations. When another person is involved, these offences also suggest conspiracy, and Stewart and Bocanovic were also charged with agreeing to violate the false statement and obstruction statutes. The conspiracy statute adds an extra layer of depth because co-conspirators are liable for the actions of their cohorts when that action furthers the conspiracy. Thus, Stewart was also charged with, and found guilty of, her broker's independent perjury in his testimony before the SEC.

The use of cover-up charges obscures the substantive crime that is under investigation. The government need never explain why the conduct that was "covered up" was a crime. We are left, in Stewart's case, wondering whether willfully trading on a tip of misappropriated information is a crime.

Trial, sentence and lessons learnt By one index, Stewart's case is unique - she actually went to trial.

In the federal criminal justice system, roughly 95% of defendants plead guilty. In other senses, Stewart's trial was typical of federal criminal trials. Stewart was tried jointly with her broker, Bacanovic, who was also accused of conspiracy. What does a conspiracy trial tell us about white-collar crime?

First, the strategy of a joint trial shows that prosecutors are now as committed to winning white-collar cases as they are to winning cases in the war on drugs.

Stewart's trial also reminds us a joint trial on conspiracy charges offers the government several benefits. In addition to procedural advantages, a jury may not view defendants as individual actors when they are linked together in the courtroom.

In trying Stewart, the government relied on a co-operating witness, the assistant who told her about Waksal's sales. After pleading guilty to a lesser charge in exchange for agreeing to help the government, Faneuil testified against Stewart. Even though such witnesses provide crucial evidence for the government, the strategy is troubling.

Faneuil is arguably as liable as Stewart. By his own testimony, he was aware of the insider-trading issue at the time of the trade and yet he facilitated the sale. He supported Stewart's story for six months. Those who believe in the moral basis of criminal law may wonder whether allowing a morally culpable actor to avoid trial is a just result. Those who justify criminal laws and punishment because they deter others may question the efficacy of a tactic that can lead to widespread cynicism about criminal enforcement.

Stewart was sentenced as a first offender convicted of a non-violent crime that did not cause financial harm. She received a five-month prison term, a five-month term of house arrest, two years of probation, and a \$30,000 fine.

Bocanovic received the same term of incarceration and a \$4,000 fine. Faneuil was ordered to pay a fine of \$2,000. The sentences in this case tell us that prison terms for similar conduct are often inconsistent. Faneuil, at a minimum, conspired in the trade and the subsequent cover-up. Yet, on the prosecutors's recommendation, he avoided a prison term.

Public indictment, trial, and sentencing create a public record that educates the public and deters, to some degree, others from committing similar crimes.

As the Stewart matter reveals, however, certain aspects of white-collar criminal laws and their enforcement are problematic. If Martha Stewart's case, involving a wealthy, well-educated business executive with experienced defence counsel, is any example, we should be very concerned about ordinary offenders.

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**LOAD-DATE:** March 4, 2007