

STEWART PROSECUTION IMPERILS BUSINESS CIVIL LIBERTIES

by

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The fallout from the Enron scandal, the collapse of WorldCom, the implosion of Global Crossing, and other recent events have created a hostile regulatory atmosphere for corporate executives. The public wants action, and prosecutors, regulators, and legislators are striving to meet the demand. As with any wave of excitement, however, there is a danger that careful distinctions will be brushed aside and settled expectations upset. Government lawyers must take care that the public's demand for "bread and circuses" does not result in petty offenders being thrown to the lions.

The Martha Stewart case is a disturbing sign that high-profile defendants are being disproportionately singled out for harsh treatment in the current environment for reasons of their celebrity, not reasons based on policy or law. Both the civil case and the criminal case against Stewart assert novel claims that push the edge of the envelope of securities law, while some of the more blatant wrongdoers responsible for Enron, WorldCom and other catastrophic financial failures, who are not household names, either have yet to be indicted or prosecuted with comparable zeal. Of course, there can be legitimate reasons for targeting a celebrity for an enforcement action, even when others who have committed similar offenses go unpunished. Given limited enforcement budgets, where two possible defendants have engaged in the same behavior, choosing the more famous of the two may make sense due to the greater deterrent effect it will have on others. This can be a particularly useful tactic when regulators seek to move existing law in a carefully considered manner to curb a new threat to investors, or reinforce an enforcement message in areas of settled law. But the legitimacy of celebrity prosecutions begins to break down when they are brought, not as part of a reasoned extrapolation of the law

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that has been building for some time, but rather as a publicity-driven effort to expand the law to fit the opportunity presented by the defendant's celebrity.

In the Martha Stewart case, the government's adventurous civil and criminal prosecutions have caused unwarranted damage not only to Ms. Stewart, but also to the shareholders of her own company, who are innocent bystanders in the media circus created and perpetuated by what may reasonably be seen as an improvident set of prosecutions.

For example, the civil case against Stewart is an unprecedented and unanticipated expansion of insider trading theory, one that gives every indication of having been crafted to snare Stewart rather than close an important interstice in the law. *See* Compl., *S.E.C. v. Stewart*, Case No. 03 CV 4070 (NRB) (S.D.N.Y. filed June 4, 2003), *available at* <http://www.sec.gov/litigation/complaints/comp18169.htm>. The SEC alleges that Stewart learned that her friend Samuel Waksal, the CEO of ImClone, was selling all of his stock in the company, and that based on this information, Stewart sold her ImClone stock as well. Insider trading theory has certainly evolved over the past thirty years, but this theory of culpability goes one step further than developed law. At first, insider liability was applied only to prevent corporate insiders from trading based on information about the corporation that they alone were privy to, *see S.E.C. v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968); later, it was extended to lawyers, accountants, and others who had access to inside corporate information, *see Chiarella v. United States*, 445 U.S. 222, 228 (1980). More recently, successful actions have been brought against persons who had no information from inside the corporation, but rather had advance knowledge of information *about* the corporation that would affect its stock price, such as the contents of the next issue of *Business Week*. *See United States v. Falcone*, 257 F.3d 226 (2d Cir. 2001).

The Stewart insider trading case, however, involves allegations not that Stewart knew any nonpublic facts about ImClone, or even that she knew nonpublic facts that would affect ImClone, but that she knew that her friend Waksal was selling his shares. In other words, Stewart allegedly knew that someone else knew material information, but she did not know what that information was, nor did she receive any recommendation to sell from the insider. It is possible that the SEC can build a case along these lines, but this would be the first time such a theory has ever been used in an insider trading case, and the connection between Stewart and any "misappropriated" inside information is tenuous at best. It is not unreasonable to speculate that had such a gamey theory been advanced against a non-celebrity at all, it would have been quickly followed by a relatively painless and low-key settlement. The charges against Stewart also raise the question of whether a shareholder overhearing a cell phone conversation, or learning that Warren Buffet was selling his shares in a particular company, is prohibited from following suit because Buffet or the stranger on the cell phone knew something not known to the public.

The SEC's aggressive interpretation of Rule 10b-5 went too far, even for the U.S. Attorney in the Southern District of New York, who refused to seek a criminal indictment for insider trading based on this theory. *See* Brooke A. Masters, *Stewart Prosecutor Balked at*

Insider-Trading Charges, WASH. POST, June 6, 2003, at E1. But the U.S. Attorneys' office deems to have also been attracted by the prospect of the low-hanging celebrity fruit represented by the prospects of a celebrity "perp-walk," shown over and over again on the network news and cable talk shows. The Department of Justice sought an indictment against Stewart for obstructing justice in the investigation of the insider trading allegations, the same allegations the U.S. Attorney refused to bring directly presumably because they were so weak. See Indictment, *U.S. v. Stewart* (S.D.N.Y. June 4, 2003), available at <http://news.findlaw.com/hdocs/docs/mstewart/usmspb60403ind.pdf>. Count Nine of the indictment goes beyond even the obstruction charge and accuses Stewart of securities fraud for falsely claiming her own innocence allegedly in order to prop up the stock of Martha Stewart Living Omnimedia ("MSLO"). This innovative theory of criminal culpability raises even more concerns of overreaching.

In the context of the pushing-the-envelope insider trading claims, the securities fraud charge is a particularly frightening example of misplaced prosecutorial zeal. The statements at issue by Martha Stewart were not the typical stuff of securities fraud actions: false statements about earnings, or revenue, new product lines, or issuance of government licenses or approvals. Rather, Stewart merely responded to allegations in the press in June 2002 that she had engaged in insider trading in ImClone stock. Stewart buttressed her denials with modest factual claims: that she had a pre-existing agreement with her broker; that she did not have any inside information about ImClone; and that she had cooperated with investigators. Stewart made these statements not under oath, nor to investigators, but in a press release, at a conference, and in one case, to news reporters through her attorneys. In essence, Stewart stands accused of securities fraud for defending herself against allegations of securities fraud. Notably, the stock she is accused of "manipulating" isn't even the stock she sold, supposedly on the basis of "inside" information, but the stock of her own Martha Stewart Living Omnimedia.

The bootstrapping nature of the criminal securities fraud charge is the least of its disturbing aspects. More troubling is the fact that nothing limits the prosecution's theory to statements made in the press during an investigation. Under the prosecution's theory, Stewart may face additional charges for every "false" public statement she or her lawyers make. Stewart's "not guilty" plea, for example, is a public statement of fact that is either true or not true, and was perhaps at least in part intended to bolster her company's stock price, or if believed by investors, would have that effect. (Of course, Stewart may argue that such typical self-serving protestations of innocence are simply *de rigueur*, and only a simpleton would seriously allege that it could have any measurable market impact.)

Her lawyers' opening and closing statements in both trials will no doubt present Stewart's side of the story, as will many of the motions and briefs they file. Worse still, nothing limits the prosecution's theory to investigations involving alleged securities fraud. Should this theory gather traction for future prosecutions, prominent executives and their lawyers may have to watch what they say in defending themselves of any allegation of wrongdoing — for example drunk and disorderly conduct or even lying on a résumé — lest their statements be deemed

“false” by a prosecutor and result in a securities fraud charge because they are the CEO or serve on the board of a publicly traded company.

If the securities fraud charge is ultimately successful, the result will be that executives’ ability to defend themselves against allegations of wrongdoing will be severely compromised and the wholly ordinary issuance of reassuring press releases which may turn out to contain inaccuracies or contested facts, whether or not known or intended (or which may merit Fifth Amendment protection), could create risk. A conviction for securities fraud carries with it a maximum prison term of ten years – quite a disincentive for typically risk-averse corporate leaders. The most natural response will be to attempt to avoid any speech at all – in or out of court – that could implicate securities fraud liability. No defense counsel can adequately represent his client if he cannot state the facts of the case in the most positive way possible. Nor can an executive adequately exercise her right to free speech if any exculpatory factual claims made in response to allegations in the press carry with them the threat of lengthy imprisonment based solely on making the statement. Simply put, Ms. Stewart’s expressed belief that her conduct did not violate any securities law, if proven wrong, could be used as evidence of yet additional securities violations. It is an issue pregnant with potential constitutional problems under the First, Fifth and Sixth Amendments.

Nor is there any compelling countervailing interest in enforcement here that balances out these potential dangers. Prosecutors and regulators have more than enough arrows in their quiver to protect against efforts to game the system. False statements can be dealt with through obstruction of justice charges or prosecution for perjury. If out-of-court statements threaten to jeopardize the fairness of a trial, the judge may enter a gag order prohibiting *all* parties from making public statements. But unlike the typical gag order, the threat of securities fraud charges would have an entirely one-sided effect: prosecutors and regulators would be free to discuss allegations with the press, but the corporate executive will not be able to respond, even through his or her lawyers, for fear of criminal prosecution on top of everything else.

The criminal securities fraud charge against Stewart is wholly unnecessary in order to protect investors. The securities laws presume that investors are able to dismiss “puffery” – vaguely optimistic statements about the future – and to anticipate obvious risks that are part and parcel of the business they are investing in. The overall goal of the securities laws is only to ensure that the investing public has adequate and untainted information available concerning publicly traded securities. Even assuming that Stewart’s response to the insider trading allegations was material to an investor in MSLO, which world would that investor rather inhabit: one in which he or she has no idea what Stewart’s defense might be, or one in which the investor can evaluate Stewart’s proffered explanation, weigh it against the government’s very public circulation of the indictment and decide for herself what the status of things are? If more information is better, then knowing in June 2002 that Stewart will claim that she had a pre-existing agreement with her broker is better than having to wait for trial for that same information. The securities fraud charge against Stewart may actually harm investors by limiting the information available to them about executive misconduct.

The harms involved in allowing securities fraud charges for defending against allegations of securities fraud in the press far outweigh the rather dubious benefits. Martha Stewart will have her day in court, but she should not be forced to have another day in court for every previous day.