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Martha Stewart and Insider Trading

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The high profile nature of the Martha Stewart insider trading case led to prolific research and writing by academic and media professionals (Brinkley, 2008; Carpenter, Lacy, & Fico, 2008). This paper seeks to take both factual information about the case and existing academic investigation to discuss the central moral and ethical issues surrounding the case. In addition, the greater issue of insider trading will be examined and moral foundations for the issue will be established and discussed. Finally, the paper will conclude with a suggestion for the most consistent ethical approach to insider trading.

Background

Martha Stewart owned shares of a company called ImClone. In 2001 ImClone received notification that a new prescription drug, in which the company poured extensive money into research and development, would not receive approval by the Food and Drug Administration (Carroll & Buchholtz, 2006, p. 653). The CEO of ImClone, Sam Waskal, in an effort to avoid financial losses to his shares of ImClone, made a call to his stock broker to dump his shares of the company stock. The broker, who also served as a broker for Martha Stewart, notified Stewart that the CEO was liquidating the company stock and that it would be in her financial interest to follow suit by selling off her own shares of the company, which totaled almost 4,000 shares (Hoffman, 2007). The Securities and Exchange Commission noticed an unusual coincidence between the selling of mass amounts of shares by the CEO of ImClone and Martha Stewart and began an investigation to determine if Martha Stewart was guilty of insider trading.

Insider trading is defined by the SEC as “Illegal insider trading refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security” (U.S. SEC, 2009).

However, in an interesting legal technicality, Martha Stewart did not necessarily breach a fiduciary duty to the other investors, since she had no real obligation to inform other investors, which would be the case if she were an officer with the company (Hoffman, 2007). It is therefore possible that if Martha Stewart had initially confessed to her activities that she might not have been convicted of insider trading. However, that is not the course that Ms. Stewart took. She instead chose to collude with her broker in an attempt to fabricate a story about how there was a standing order for Ms. Stewart to sell her shares if the stock price fell below \$60 per share.

This dynamic in the case represents an important ethical distinction in the decisions made by Ms. Stewart up until this point. When Ms. Stewart initially received the information about the potential drop in the stock price of the ImClone stock and subsequently asked her broker to sell her shares, it is possible that she did not knowingly engage in illegal behavior. While there might be discussions as to whether or not insider trading is unethical or should be illegal (McGee, 2008), a topic that will be discussed later in this paper, the question of whether or not it is ethical to lie to federal investigators is blatantly illegal and unethical. By conspiring with her broker to defraud the Securities and Exchange Commission Ms. Stewart knowingly engaged in unethical behavior, for which no claim of ignorance would be credible.

In addition to bringing the situation to a new level ethically, the decision to collude with her broker to deceive the Securities and Exchange Commission brought the legal issues to a new level. In fact, the jail time and hefty fines, which were 4 times greater than the losses Stewart would have incurred had she kept her shares of the ImClone stock, were primarily a result of the court action related to the perjury and collusion charges of which Stewart was ultimately found guilty (Hoffman, 2007).

In addition to the charges that resulted from the selling of her shares of ImClone stock, Stewart also came under fire from investors in her own company, who alleged that Stewart, knowing that her company Martha Stewart Living Omnimedia Inc. would see a negative impact of stock price from the accusations associated with ImClone, sold many of her shares of the company to avoid additional financial loss (Carroll & Buchholtz, 2006). Stewart was also charged with manipulating the price of the stock of her own company by expressing her innocence to the charges, a charge that was later thrown out (McGee, 2008).

Ultimately, Martha Stewart was found guilty. However, as stated earlier, the primary legal issues arose from Stewart's conspiracy to defraud the investigators who were working the ImClone case. These issues could have been avoided had Stewart initially confessed to the decisions that led to the trading of the ImClone shares (Hoffman, 2007). The result of the guilty verdict was a fine and jail time. While the speculation might be that Stewart was too arrogant to admit to any wrong doing (Jennings, 2004), it is also a possibility that the government was seeking a high-profile scapegoat for the numerous corporate scandals that were prevalent at the time (Koch, 2004).

Moral Issues Associated With Insider Trading

While the Securities and Exchange Commission has determined that the activities associated with insider trading warrant specific laws and definitions, there are underlying moral laws that insider trading might violate. The basic issue associated with insider trading legality is that the executive has a fiduciary responsibility to the investors in the company. However, when an executive is privy to information that could negatively impact the stock price and therefore the investment of the shareholders is he morally obligated to share in that negative impact (McGee, 2008)?

The motivation that an insider has to sell or buy stocks based on information that is not publicly available is that the insider seeks to make or avoid the loss of money. However, does this activity come at the expense of any shareholders (Engelen & Liedekerke L, 2007)? First of all, the relationship between the shareholder and the executive must be examined.

The executive essentially is an employee by the shareholders, since the shareholders are actually part owners of the company (Thompson & Edelman, 2009). The shareholder invests money into the company with the hope that the executives that are running the company will be able to make decisions that increase profits for the company and therefore increase the value of the shares owned by the investor (Salov, 2008). In the Martha Stewart case the information about the FDA rejection of the medication was not a decision that was made by the executive, however it would result in the loss of shareholder money. While the CEO of ImClone did sell a large portion of his shares in order to avoid financial loss, did his sale affect the value of the other shareholder's stock? One could argue that those who purchased the sales that the CEO sold were the most harmed by the insider trading, but those are stocks that would have been bought anyway, regardless of whether or not the CEO sold them or if they were sold by another investor, so the lower stock price was not directly related to the insider trading (McGee, 2008). Insider trading may result in a lower level of loss for the insider, but it does not appear to come at the expense of a shareholder. If this is a crime of theft or fraud, where is the victim? What individual is in a worse financial position as a direct result of the insider trading?

Another issue that surrounds insider trading is whether or not the insider breached a contract when he or she engaged in insider trading. For example, if the executive or insider shared confidential information that was patented or trademarked by the company and this resulted in the buying or selling of stock by another individual, then the insider would be guilty

of violating a confidentiality agreement with the company (McGee, 2008). However, in this case it is not the selling of stock that is the true ethical violation, but the use of confidential information for any purpose outside of the context of the company.

The use of information to advance personal goals, which is at the heart of insider trading, may sound very bad, but after examining the concept we are able to see that it is not. Moore (1990) uses the following analogy:

Suppose I am touring in Vermont and come across an antique blanket chest in the barn of a farmer, a chest I know will bring \$2,500 back in the city. I offer to buy it for \$75, and the farmer agrees. If he had known how much I could get for it back home, he probably would have asked a higher price—but I failed to disclose this information. I have profited from an informational advantage...I am not morally obligated to tell those who deal with me *everything* that it would be in their interest to know. (p. 172)

Although the previous quotation is a bit dated, the analogy still holds true. There are countless areas in our everyday life where one individual benefits from having more information than someone else.

In addition to the difficulty in finding a victim in an insider trading situation, there is an argument that could be made that it actually serves to benefit the shareholder in many situations (Engelen & Liedekerke, 2007). For example, if investors are able to access public information regarding the position of the company stock that is held by the CEO the investors are able to more accurately access the direction that the CEO feels the company is going. In essence, the purchasing or selling of company stock allows for the executive to “put her money where her mouth is” and therefore provide investors with a more accurate picture of future performance. If the CEO makes public statements about the company’s bright future, but is selling his or her own

shares, the investors will know that something is going on and that the CEO is privy to inside information and the investor can react in like manner (McGee, 2008). This prevents a “do as I say, not as I do” dynamic from appearing.

Conclusion

Based on the issues raised in this paper it is at least debatable that insider trading is unethical and should be illegal. What is not debatable is that it is currently illegal and therefore any executive is ethically bound by the shareholders and society to follow the law. As discussed in the Martha Stewart case, simply denying that insider trading is wrong is not a defensible position.

However, there are steps that a company can take to help executives avoid the potentially murky ethical waters of insider trading. For example, the company can set up systems that allow for instant notification to shareholders when any individual above a certain organizational level buys or sells stock in the company. This would help the executives hold to their fiduciary responsibility to the shareholders, but without keeping them from acting on information that might benefit them, or at least reduces financial loss.

In addition to instant notification of shareholders, there could be a waiting period for the buying or selling of stock by any executive above a certain organizational level (Olson, 1987). This would prevent situations such as ImClone where the CEO was able to execute a trade before information became public. If there were a 48 hr waiting period in place it might prevent such situations from occurring.

At the very least it is incumbent on the executive and his or her stock broker to be aware of the laws and precedents regarding insider trading so that he or she is effectively able to

maintain adherence to the laws, for the sake of the individual and for the sake of the shareholders in the company.

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