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The Martha Duty: Protecting Shareholders from the Criminal Behavior of Celebrity Corporate Figures

In late December 2001, Martha Stewart sold her entire holding of ImClone stock.¹ Shortly afterward, government agencies discovered Stewart's sale during an investigation into possible insider trading involving sales of ImClone stock.² News of the investigation broke six months later.³ As a result, investors lambasted the share price of Stewart's company, Martha Stewart Living Omnimedia Inc. (MSO), causing MSO's market capitalization to decline by two-thirds.⁴ The government eventually obtained an indictment against Stewart for conspiracy, false statements to investigators, obstruction of justice, and securities fraud.⁵ In March 2004, Stewart was convicted on all counts but

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¹ Indictment, *United States v. Stewart*, ¶ 17 (June 4, 2003), available at <http://news.findlaw.com/legalnews/documents> (last visited July 1, 2004) [hereinafter Indictment]. Two months earlier, Stewart had divested her pension plan of ImClone shares. Will Swarts, *Lawyers Spar in Martha Case*, THE STREET.COM (Jan. 27, 2004), at <http://www.thestreet.com/pf/markets/willswarts/10139825.html>.

² Indictment, *supra* note 1, ¶ 22.

³ *Id.* ¶¶ 58-67.

⁴ *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961, 969 (Del. Ch. 2003), *aff'd*, 845 A.2d 1040 (Del. 2004). In the two months between June 6, 2002, when the Associated Press broke the story that the government was investigating Martha Stewart's ImClone sale, and August 9, 2002, MSO shares declined from \$19.01 per share to \$6.69 per share, a loss of \$12.32 per share. The share price settled in the \$10 range in the month following her March 5, 2004 conviction. See Yahoo! Finance, at <http://finance.yahoo.com/q/hp?s=MSO> for historical prices of MSO.

⁵ See generally Indictment, *supra* note 1.

securities fraud, which the judge dismissed.⁶

The massive decline in MSO market capitalization after allegations surfaced that founder-chairperson-CEO-corporate namesake Martha Stewart privately profited from insider trading illustrates the investment risk to shareholders of a corporation whose welfare is inextricably intertwined with the public image of a “celebrity corporate figure.”⁷ Whether it is a multi-billion dollar, publicly traded company or a local general partnership, a celebrity corporate figure’s private behavior may destroy a business’s value for other shareholders or partners alike.⁸ For example, shareholders of MSO lost over six hundred million dollars of market capitalization and faced uncertainty regarding the future value of the company as the market reacted to Stewart’s wrongdoing.⁹

Shareholders should not have to assume the risk that the private criminal behavior of celebrity corporate figures may damage shareholder value. Using Martha Stewart’s civil and criminal lawsuits as a backdrop,¹⁰ this Comment explores whether shareholders who suffer a loss in shareholder value due to a celebrity corporate figure’s private behavior can recover the loss under state law fiduciary duties or federal securities law, and, if not, whether shareholders should be able to recover for such injuries under a proposed new fiduciary duty for celebrity corporate figures. This Comment does not assert that all corporate figures

⁶ Jonathan D. Glater, *Stewart’s Lawyers Gambled with a Minimal Presentation*, N.Y. TIMES, March 6, 2004, at C1.

⁷ This Comment uses the term “celebrity corporate figure” to refer to individuals associated with a business in such a manner that the individuals and the business are thought of interchangeably. See discussion *infra* Part I.

⁸ Although this Comment focuses on corporation law, the discussions of traditional fiduciary duties, *infra* Part III.A, and the proposed new “Martha Duty,” *infra* Part V, sufficiently apply to other business entities such as partnerships, limited liability corporations and closed corporations.

⁹ MSO’s share price declined by \$12.32 per share in the two months following the Associated Press story of the Stewart investigation. See *supra* note 4. The \$12.32 per share loss multiplied by the approximately 49.62 million shares outstanding results in an approximate decline of six hundred million dollars. As owner of over sixty percent of the outstanding shares, Stewart was not immune from the losses her behavior caused. See Indictment, *supra* note 1, ¶ 59. See also Trends, Risks, and Uncertainties, Form 10-Q Quarterly Report for Martha Stewart Living Omnimedia, Inc. (Nov. 14, 2003), at <http://biz.yahoo.com/e/031114/mso10-q.html>.

¹⁰ *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961 (Del. Ch. 2003), *aff’d*, 845 A.2d 1040 (Del. 2004); *In re Martha Stewart Living Omnimedia, Inc. Sec. Litig.*, 02-CV-6273 (JES) (S.D.N.Y. filed Feb 3, 2002); *United States v. Stewart*, 305 F. Supp. 2d 368 (S.D.N.Y. 2004).

should be liable for all private behavior that harms shareholder value. Instead, it focuses on the behavior of celebrity corporate figures and a narrow range of private behavior.

The first part of this Comment defines the celebrity corporate figures from whom shareholders should be able to recover when the celebrity's private behavior harms shareholder value. The second part narrows the range of private behavior that should expose celebrity corporate figures to liability. Having identified the particular celebrity corporate figures at issue and the range of behavior that should generate liability, the third part analyzes the usefulness of state law fiduciary duties to trigger the celebrity corporate figure's liability to the shareholders. The fourth part analyzes the usefulness of federal securities law to remedy losses caused by the private behavior of these celebrity corporate figures. Concluding that existing state and federal law remedies do not sufficiently protect shareholders, the final part proposes a new fiduciary duty to be placed on celebrity corporate figures that would allow shareholders to recover when the celebrities' private behavior harms shareholder value.

I

IDENTIFYING WHICH CELEBRITY CORPORATE FIGURES SHOULD BE LIABLE FOR PRIVATE BEHAVIOR THAT CAUSES A DECLINE IN SHAREHOLDER VALUE

The private behavior of corporate figures can harm the businesses with which they are associated. After Kobe Bryant was charged with sexual assault, the companies that he endorsed suffered losses by abandoning their investment in Bryant as an endorser,¹¹ losing the goodwill associated with his ad campaigns,¹² or delaying Bryant-specific merchandise.¹³ Martha Stewart conspired to conceal the events that led to her private stock trade, obstructed justice, and made false statements to investigators, costing MSO shareholders hundreds of millions of dollars in market capitalization.¹⁴ John DeLorean's arrest for attempting to fi-

¹¹ See *Chocolate Maker Phasing Kobe Out*, NEWSDAY, Aug. 5, 2003, at A51; Corky Siemaszko, *Kobe Ad Career is Dribbling Off*, DAILY NEWS (N.Y.), Jan. 20, 2004, at 4.

¹² See Tamara E. Holmes, *Celebrities and Scandal* (Aug. 1, 2003), at <http://www.blackenterprise.com/ExclusivesekOpen.asp?id=436>.

¹³ See Natalie Zmuda, *Retail Debut of Kobe Shoe in Question*, FOOTWEAR NEWS, Oct. 20, 2003, at 2.

¹⁴ See *supra* note 9.

nance a drug deal was the death knell of the beleaguered DeLorean Motor Company.¹⁵

One could imagine similar situations in which a business would be harmed by the private behavior of a corporate figure. Yet, the average corporate figure likely does not put her business at risk through her private behavior. Perhaps the public sufficiently separates the average corporate figure from the company such that no confusion exists between the corporate figure's private behavior and the well-being of the business. More likely, the average corporate figure is anonymous to the public, and thus no risk accedes to the business from her private behavior. This Comment looks beyond the average corporate figure to a category of celebrity corporate figures to determine which corporate figures should be liable when their private behavior leads to a decline in shareholder value.

In defining the celebrity corporate figures who should be liable if declines in shareholder value are caused by their private behavior, this Comment departs from the narrow, conventional use of the term "celebrity" to describe famous entertainers and athletes. Such celebrities do play a role in the public image of businesses, typically as endorsers and sometimes as owners or management;¹⁶ however, such a narrow definition would leave out the individuals that put shareholders most at risk. Instead, celebrity corporate figure encompasses individual business owners or management whose public image is so inextricably intertwined with the businesses that the public makes little or no distinction between the individual and the business. Examples include Martha Stewart's relationship to MSO and Warren Buffett's relationship to Berkshire Hathaway Inc. National notoriety, though, is no prerequisite. Exclusively local businesses may also include celebrity corporate figures, if the local public image is such that the business is inextricably linked with owners or management.

As an initial matter, celebrities like Kobe Bryant, who serve solely as endorsers or spokespersons, should be excluded from the definition of celebrity corporate figures. Although there is

¹⁵ See Judith Cummings, *Ex-Auto Maker to Go on Trial After Long Wait*, N.Y. TIMES, Mar. 5, 1984, at A12.

¹⁶ One example is Earvin "Magic" Johnson, who started Johnson Development Corp. after retiring from professional basketball. See <http://www.johnsondevelopmentcorp.com>.

an undeniable public association of spokespersons to the business for which they endorse, holding spokespersons accountable to shareholders for the impact their private behavior has on shareholder value is inappropriate. Mainly, the connection between the spokesperson and the business does not typically rise to the level of being inextricable. In fact, celebrity endorsers and spokespersons are in demand precisely because of the careers they developed separate from the business. Often, these celebrities leverage their fame to endorse multiple businesses at the same time.¹⁷ Thus, the public can more readily separate these celebrities from the particular business for which they advertise. Furthermore, spokespersons are typically only tangentially related to the business. They are essentially employees of the marketing arm, not central decision-makers or strategists. Finally, employment contracts can effectively limit shareholders' exposure when a spokesperson's bad public behavior starts to affect shareholder value.¹⁸

Conversely, individuals like Martha Stewart, who convert their personal reputation or expertise into business success, are often inextricably intertwined with the businesses they have created,¹⁹ and therefore they must be included in the definition of celebrity corporate figures. Their private behavior is not as easily severable from the business as an endorser's or spokesperson's, primarily because the individual tends to be the product itself, manifested in magazines, towels, and color palettes. That individual's connection to the business, not the business's assets and infrastructure absent the individual, tends to dominate shareholder value.²⁰ Employment contracts are likely insufficient to

¹⁷ For example, Kobe Bryant endorsed McDonald's, Coca-Cola, and Nike. Chris Isidore, *Advertisers Worry: Who's Next?*, CNN/Money, at http://money.cnn.com/2003/07/21/news/companies/kobe_impact (July 22, 2003).

¹⁸ Spokesperson contracts can include a morality clause that allows the business to terminate spokespersons if they do anything to damage their reputation. E. Susan Vogt, *What to Consider When Signing Up a Celeb*, STRATEGY MAGAZINE, at <http://www.gowlings.com/resources/publications.asp?Pubid=781> (Feb. 11, 2002).

¹⁹ MSO's initial prospectus stated that "Martha Stewart, as well as her name . . . are integral to our marketing efforts and form the core of our brand name. Our continued success and the value of our brand name therefore depends, to a large degree, on the reputation of Martha Stewart." Prospectus, Martha Stewart Living Omnimedia, Inc. 12, at http://www.hoovers.com/mso/—ID_53053,ipage_870379—/free-co-secoutline.xhtml (Oct. 19, 1999).

²⁰ Morningstar analyst T.K. MacKay estimated MSO at \$7 per share without Stewart, at a time when the stock was trading at \$12 per share, down from the IPO price of \$40 per share and pre-indictment price of over \$19 per share. Dan Cook,

protect shareholders from the private behavior of these celebrity corporate figures because they typically are not only the commodity but also the dominant shareholder, and thus they are in a position to ransom a favorable contract in exchange for participation in the business venture.²¹ For example, although Stewart's employment contract contained a morality clause, the clause was a part of the definition of "cause" for termination, not a ground on which the company could sue for breach of contract.²² Also, absent converting the business into a new, celebrity-free entity, terminating the employment contract does little to limit the association between the celebrity and the business. To illustrate, Martha Stewart stepped down as chairwoman and CEO of MSO in June of 2003, but the market performance of the company was still tied to the outcome of Stewart's criminal trial.²³ This type of celebrity corporate figure should be held accountable for certain private behavior that harms shareholder value because of her inextricable connection to the business.

Also included in the definition of celebrity corporate figures who should be liable for private behavior that harms shareholder value are superstar CEOs and corporate namesakes. Unlike individuals who transform personal reputation into business success, both superstar CEOs and corporate namesakes derive their celebrity status from business acumen. Therefore, the connection between their private behavior and the company is not as intense. Still, these celebrity corporate figures can transcend the business in such a way that the welfare of the corporation is inextricably intertwined with the superstar CEO or corporate namesake's personal public image,²⁴ particularly when the celebrity is

Life Without Martha, CNN/Money, at http://money.cnn.com/2004/01/06/news/companies/martha_impact/index.htm (Jan. 24, 2004).

²¹ Stewart controlled over 94% of the voting power. See *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961, 978 (Del. Ch. 2003), *aff'd*, 845 A.2d 1040 (Del. 2004).

²² See generally Form of Employment Agreement, at <http://contracts.corporate.findlaw.com/agreements/martha/marthastewartemployagt.html> (last visited July 7, 2004).

²³ See Trends, Risks, and Uncertainties, Form 10-Q Quarterly Report for Martha Stewart Living Omnimedia, Inc. (Nov. 14, 2003), at <http://biz.yahoo.com/e/031114/mso10-q.html>. Furthermore, the huge decline in share price upon her conviction in the criminal case shows that the market continued to factor Stewart's presence into the worth of MSO. See David B. Wilkerson, *Stewart Shares Close With 23% Loss; Media Stocks Mixed*, at CBS.MarketWatch.com (March 5, 2004).

²⁴ A Wharton Business School study correlated a 10% change in CEO reputation with a 24% change in market capitalization. Leslie Gaines-Ross, *CEO Reputation:*

the namesake of the corporation. Employment contracts can more effectively limit the corporation's exposure to risk with these celebrity corporate figures than with dominant personalities such as Martha Stewart, but a similar power imbalance potentially exists that may dampen the contract's overall effect. Instead of foreclosing accountability to the shareholders for the private acts of superstar CEOs and corporate namesakes, corporate law should protect shareholders when the market determines that the superstar CEO or corporate namesake is so closely linked to the business that their private misbehavior harms shareholder value.

Essentially, celebrity corporate figures are individuals like Martha Stewart who transform personal reputations into business success, as well as superstar CEOs and corporate namesakes. The next step is to determine the type of private behavior for which celebrity corporate figures should be liable when the behavior harms shareholder value.

II

CELEBRITY CORPORATE FIGURES SHOULD BE LIABLE TO SHAREHOLDERS FOR LOSSES CAUSED BY PRIVATE CRIMINAL BEHAVIOR

Obviously, the range of private behavior that may garner negative public attention is endless; from political affiliation to religious habits, dietary decisions to extreme sport hobbies, drunken driving to insider trading. To hold a celebrity corporate figure liable for any private behavior that harms shareholder value would blur all distinction between that individual's private life and the corporation. As the judge in Martha Stewart's shareholder derivative suit noted, although important to MSO, Stewart was "not the corporation."²⁵

A rule restricting the entire range of private behavior is undesirable. Aside from constitutional concerns,²⁶ a rule limiting an individual's liberty to choose private activities in which to partici-

The New Factor in Shareholder Value, DIRECTORSHIP, Vol. 26, Iss. 5, at 4 (May 2000).

²⁵ *Beam*, 833 A.2d at 971.

²⁶ Any rule that restricted the entire range of personal behavior would at least raise First Amendment freedom of association and Fifth and Fourteenth Amendment equal protection concerns, but because the author narrows the personal behavior at issue to criminal behavior, a discussion of these constitutional concerns is beyond the scope of this Comment.

pate is inconsistent with American values. Such a rule would also lack predictability because the individual celebrity corporate figure may not know which private activities risked liability for shareholder losses until the market negatively responded to the activity. For example, the market might penalize the share price of an investment company whose elderly superstar CEO announced intentions to climb Mt. Everest, if the market determined that the danger associated with the CEO's mountain climbing was an unnecessary risk of an important company asset. However, the same announcement by the athletic CEO of an extreme sports outfitting company might not raise any clamor. Finally, investors do have responsibility to assess the various risk factors of an investment, including factoring the dependency of the corporation on the celebrity corporate figure's public image.

Alternatively, a rule that imposed liability on a celebrity corporate figure for the harm to shareholder value that derived from criminal behavior undertaken in the celebrity's private capacity would avoid the above concerns. Officers and directors already have a fiduciary duty to act legally in their corporate capacity.²⁷ The celebrity corporate figure could still choose any legal private behavior. The celebrity corporate figure could predict that legal behavior will be free from liability, regardless of how damaging the behavior might be to the company, leaving the onus on shareholders to value the business in accordance with the likelihood a celebrity figure would engage in private legal behavior harmful to the corporation.

Normally in corporate law, it is desirable to place the risk of loss on shareholders because they have an opportunity to assess risks and factor them into the valuation of a corporation. This approach assumes that the various disclosure and reporting requirements adequately inform investors of the information necessary to assess risk adequately. Additionally, individual investors are best suited to shoulder risk because they can reduce risk by diversifying their holdings. The business judgment rule exemplifies this approach by putting the risk of bad business decisions on the shareholders, not the directors making the decisions.²⁸

The presence of fiduciary duties, however, illustrates a legal rejection of a total "buyer-beware" approach that places all the

²⁷ See *infra* Part III.A.

²⁸ See discussion *infra* Part III.A.

risk on shareholders in every situation. Shareholders only assume the risk of bad business decisions and damages from the breach of a duty of care.²⁹ Shareholders do not assume the risk that directors lack good faith or act in a self-interested or disloyal manner.³⁰ Similarly, corporate law should not require shareholders to assume the risk that celebrity corporate figures will commit private criminal acts to the detriment of shareholder value.

Additionally, requiring shareholders to assume the risk that celebrity corporate figures might commit private criminal acts is bad policy. First, shareholders likely will not have access to information demonstrating a celebrity corporate figure's propensity for criminal activity, which is an important component in assessing the risk that a corporate figure's criminal acts would harm the value of a corporation. Also, courts typically shift risk to the party best able to shoulder it only in situations when they must allocate risk between innocent parties.³¹ When a celebrity corporate figure commits private criminal acts to the detriment of shareholder value, the responsibility should lie squarely on the celebrity. No allocation is necessary. Effectively, burdening shareholders with this risk can be analogized to the rules requiring boards to monitor employees to prevent them from violating the law. Courts have resisted requiring boards to monitor employees absent some reason for suspicion, stating "neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company's behalf."³² Similarly, shareholders should not be charged with liability for assuming the integrity of celebrity corporate figures absent some reason for suspicion.

The first two parts of this Comment have identified celebrity corporate figures as individuals who should be liable to shareholders when their private criminal behavior harms shareholder value. Having identified the individuals and behavior at issue, the next part discusses the applicability of traditional fiduciary duties to assess liability to corporate celebrity figures. This part

²⁹ DEL. CODE. ANN. tit. 8, § 102(b)(7) (2004).

³⁰ *See id.*

³¹ *See, e.g.,* DAN B. DOBBS, *THE LAW OF TORTS*, §334 (2000) (discussing the rationale behind the doctrine of vicarious liability, which assigns risk to an innocent employer on the justification that the employer is in a better position to absorb the loss and spread the risks than an innocent individual).

³² *In re Caremark, Inc. Derivative Litig.*, 698 A.2d 959, 969 (Del. Ch. 1996).

will use the example of celebrity corporate figure Martha Stewart, whose criminal activity destroyed much of MSO's shareholder value.

III

APPLYING STATE LAW FIDUCIARY DUTIES TO MARTHA STEWART'S IMCLONE STOCK TRADE

Martha Stewart's ImClone stock trade and the surrounding events provide an excellent, high-profile example of a celebrity corporate figure whose private criminal behavior harmed the shareholder value of her company. Although Stewart was acting in a private capacity when she traded her ImClone stock, the market penalized MSO.³³

According to the government's indictment, on December 27, 2001, Martha Stewart's stockbroker, Peter Baconovic, learned that ImClone CEO Sam Waksal and a family member urgently arranged to sell a large quantity of ImClone stock.³⁴ Baconovic then ordered his assistant, Douglas Faneuil, to inform Stewart of Waksal's sale.³⁵ Stewart, in turn, sold all her ImClone stock.³⁶ Within the following two days, ImClone publicly disclosed that the Food and Drug Administration (FDA) rejected ImClone's biologics licensing application for Erbitux.³⁷ By selling prior to the public disclosure of the FDA rejection, Stewart avoided losses of approximately \$50,000.³⁸

The Securities and Exchange Commission, Federal Bureau of Investigation, and United States Attorney's Office all investigated whether ImClone trades prior to the public disclosure of the FDA's rejection of Erbitux were based on material, nonpublic information.³⁹ According to the indictment, Stewart and Baconovic conspired to conceal the events leading to Stewart's sale of ImClone stock during the course of the investigation.⁴⁰ Specifically, Stewart was accused of altering her phone log from the date Baconovic informed her of Waksal's sale,⁴¹ falsely stat-

³³ See *supra* note 4 and accompanying text.

³⁴ Indictment, *supra* note 1, ¶ 13.

³⁵ *Id.* ¶¶ 15-16.

³⁶ *Id.* ¶ 17.

³⁷ *Id.* ¶¶ 19-20.

³⁸ *Id.* ¶ 21.

³⁹ *Id.* ¶ 22.

⁴⁰ *Id.* ¶ 23.

⁴¹ *Id.* ¶ 26.

ing that she had a pre-planned sell strategy that required Baconovic to sell her ImClone shares when the price dipped below sixty dollars,⁴² denying she knew of Baconovic's message in her phone log,⁴³ and denying conversations where nonpublic information about ImClone was discussed.⁴⁴ Furthermore, after the Associated Press (AP) became the first to publicly report Stewart's ImClone trade on June 6, 2002, the government alleged that Stewart committed securities fraud when she made false and misleading statements regarding the sale in an effort to shore up the decline in MSO's share price that began after the AP's report.⁴⁵

All told, Martha Stewart was indicted for conspiring to obstruct justice, make false statements, and commit perjury; making false statements to investigators; obstructing justice; and committing securities fraud.⁴⁶ MSO shareholder Monica Beam brought a derivative action against Stewart and her board, alleging that Stewart breached her fiduciary duty to the corporation by engaging in insider trading, that the board failed to monitor Stewart's private affairs, and two other allegations not related to the ImClone transaction.⁴⁷ Attorneys also filed a class action complaint asserting securities fraud.⁴⁸

A. Fiduciary Duties Generally

Broadly speaking, corporate officers and directors owe fiduciary duties of loyalty, good faith, and care to the corporation.⁴⁹

⁴² *Id.* ¶ 27a, ¶ 36. Had Stewart implemented a strategy to sell ImClone prior to learning insider information, she would have had a defense to claims of insider trading because there would be no causal connection between her possession of the material non-public information and the stock sale. See 17 C.F.R. § 240.10b5-1(c); SEC v. Adler, 137 F.3d 1325, 1335 (11th Cir. 1998).

⁴³ Indictment, *supra* note 1, ¶ 27b.

⁴⁴ *Id.* ¶ 27e, ¶ 36a.

⁴⁵ *Id.* ¶¶ 58–67.

⁴⁶ See generally *id.*

⁴⁷ Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 833 A.2d 961 (Del. Ch. 2003), *aff'd*, 845 A.2d 1040 (Del. 2004). One of the allegations not related to the ImClone transaction included a breach of fiduciary duty of loyalty by usurping a corporate opportunity when Stewart sold shares of MSO to a combination of four interrelated business entities: ValueAct Partners, ValueAct Partners II, ValueAct International, and VA Partners. *Id.* at 970 n.9, 972. The other allegation was a breach of the fiduciary duty of care regarding MSO paying split-dollar insurance premiums, which might be a violation of the Sarbanes-Oxley Act. *Id.* at 975.

⁴⁸ *In re* Martha Stewart Living Omnimedia, Inc. Sec. Litig., 02-CV-6273 (JES) (S.D.N.Y. filed Feb 3, 2002).

⁴⁹ DENNIS J. BLOCK, ET AL., 1 THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 107 (5th ed. 1998); DEL. CODE. ANN. tit. 8,

Liability attaches on breach of these duties unless the business judgment rule protects the director.⁵⁰ Additional liability may attach under the doctrine of waste.⁵¹ Although claims for a breach of fiduciary duty and waste belong to the corporation,⁵² shareholders may bring a derivative suit to assert the corporation's claim, but only after making a demand on the board.⁵³ Failure to make a demand or allege facts that would show that the demand would have been futile results in a dismissal of the case.⁵⁴

The duty of loyalty "requires an undivided and unselfish loyalty to the corporation [so] that there shall be no conflict between duty and self-interest."⁵⁵ Director actions that implicate this duty are usually self-interested transactions, including usurping a corporate opportunity,⁵⁶ setting director and officer compensation,⁵⁷ using corporate powers to maintain control,⁵⁸ selling corporate control,⁵⁹ and engaging in a competitive enterprise.⁶⁰

The duty of care requires that the director or officer make decisions using ordinary good faith, due diligence, and skill and judgment under the circumstances.⁶¹ The duty applies to the director's decision-making process, not to the substance of the decision.⁶² Actions that implicate the duty of care include

§ 102(b)(7) (2004). Partners have similar duties, although to an even higher standard. WILLIAM E. KNEPPER AND DAN A. BAILEY, *LIABILITY OF CORPORATE OFFICERS AND DIRECTORS* §1-11 (6th ed. 1988); *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928). Whether good faith is subsumed within the duties of loyalty and care or a wholly separate duty is a matter of current debate. See Hillary A. Sale, *Delaware's Good Faith*, 89 *CORNELL L. REV.* 456, 463 (2004). This Comment treats good faith as being subsumed within the duties of loyalty and care.

⁵⁰ See discussion *infra* Part III.A.

⁵¹ See discussion *infra* Part III.A.

⁵² DENNIS J. BLOCK, ET AL., 2 *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* 1379-85 (5th ed. 1998); KNEPPER & BAILEY, *supra* note 49, § 3-14.

⁵³ DEL. CH. CT. R. 23.1.

⁵⁴ *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961, 977, 984 (Del. Ch. 2003), *aff'd*, 845 A.2d 1040 (Del. 2004).

⁵⁵ *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. Ch. 1939).

⁵⁶ See *id.*

⁵⁷ See *Wilderman v. Wilderman*, 315 A.2d 610 (Del. Ch. 1974).

⁵⁸ See *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988).

⁵⁹ See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

⁶⁰ See *Guth*, 5 A.2d at 514.

⁶¹ BLOCK ET AL., *supra* note 49, at 117-26.

⁶² BLOCK ET AL., *supra* note 49, at 126; see also *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000).

abdicated corporate governance,⁶³ failing to monitor the business and affairs of the corporation,⁶⁴ and turning a blind eye toward misconduct.⁶⁵

Proving a duty of care violation is difficult. Not wanting to subject directors or officers to liability simply for bad judgment, courts focus on whether directors used care in the decision-making process instead of the substance of the decision.⁶⁶ If the plaintiff cannot plead facts that show an absence of care in the decision-making process, the business judgment rule attaches and protects directors and officers from liability.⁶⁷ The business judgment rule “presumes that business decisions are made by disinterested and independent directors on an informed basis and with a good faith belief that the decision will serve the best interests of the corporation.”⁶⁸ However, the business judgment rule will not protect directors who cause the corporation to engage in illegal acts.⁶⁹ Even if a plaintiff shows an absence of care, directors and officers may still avoid liability if they relied on experts when making their decisions.⁷⁰ Additionally, corporate charters can limit director liability for monetary damages resulting from the breach of the duty of care,⁷¹ making the breach enforceable only by prospective, injunctive relief.

In addition to liability for breaches of fiduciary duties, directors and officers may be liable to the corporation for the waste or squandering of corporate assets.⁷² Although waste may be invoked in situations of unreasonable director compensation,⁷³ excessively low sales prices for corporate assets,⁷⁴ and corporate gifts,⁷⁵ courts rarely second guess directors’ or officers’ substan-

⁶³ See, e.g., *In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342 (Del. Ch. 1998).

⁶⁴ KNEPPER & BAILEY, *supra* note 49, §§ 3-9, 3-10.

⁶⁵ See, e.g., *In re Caremark, Inc. Derivative Litig.*, 698 A.2d 959, 969 (Del. Ch. 1996).

⁶⁶ See Brehm, 746 A.2d at 264; *In re Walt Disney Co.*, 731 A.2d at 362.

⁶⁷ BLOCK ET AL., *supra* note 49, at 110.

⁶⁸ BLOCK ET AL., *supra* note 49, at 4-5.

⁶⁹ See *Lewis v. Aronson*, 466 A.2d 375, 384 (Del. Ch. 1983).

⁷⁰ DEL. CODE ANN. tit. 8, § 141(e) (2004).

⁷¹ *Id.* § 102(b)(7) (2004).

⁷² 18B AM. JUR. 2D *Corporations* § 1687. “A transaction constitutes a ‘waste of corporate assets’ if it involves an expenditure of corporate funds or a disposition of corporate assets for which no consideration is received in exchange and for which there is no rational business purpose.” AMERICAN LAW INSTITUTE, 1 PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.42 (1994).

⁷³ See, e.g., *Rogers v. Hill*, 289 U.S. 582, 591 (1933).

⁷⁴ See, e.g., *Telxon Corp. v. Bogomolny*, 792 A.2d 964 (Del. Ch. 2001).

⁷⁵ See, e.g., *Kahn v. Sullivan*, 594 A.2d 48 (Del. 1991).

tive business decisions, confining waste to only unconscionable cases.⁷⁶

B. *The Beam Suit*

The *Beam* plaintiffs alleged that Stewart breached her fiduciary duty to the corporation by engaging in insider trading, that the board failed to monitor Stewart's private affairs, and two other allegations not related to the ImClone transaction.⁷⁷ However, the suit settled only the issue of whether the MSO board owed a fiduciary duty to shareholders to prohibit her from engaging in criminal acts that could harm shareholder value. The court dismissed the claim that the board violated its fiduciary duties to monitor Martha Stewart to ensure that her private behavior did not harm the company for failure to state a claim.⁷⁸ The court also dismissed without prejudice the claim that Stewart individually breached her fiduciary duty to the company because the plaintiff failed to make a demand on the board or adequately plead why a demand would be futile, as required by Delaware Court of Chancery Rule 23.1.⁷⁹ Thus, whether Stewart's private actions constituted a breach of her fiduciary duties remains an open question.

As explained above, the failure to monitor the business and affairs of the corporation is an example of the breach of the duty of care.⁸⁰ Normally, a claim of failure to monitor arises when the directors have been negligent in monitoring the affairs of the company, with corporate liability resulting.⁸¹ However, "that the Board has a duty to monitor the [private] affairs of an officer or director is quite novel."⁸² The court required Beam to allege

⁷⁶ *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000).

⁷⁷ See *supra* note 47. *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961 (Del. Ch. 2003), *aff'd*, 845 A.2d 1040 (Del. 2004). One of the allegations not related to the ImClone transaction included a breach of fiduciary duty of loyalty by usurping a corporate opportunity when Stewart sold shares of MSO to a combination of four interrelated business entities: ValueAct Partners, ValueAct Partners II, ValueAct International, and VA Partners. *Id.* at 970 n.9, 972. The other allegation was a breach of the fiduciary duty of care regarding MSO paying split-dollar insurance premiums, which might be a violation of the Sarbanes-Oxley Act. *Id.* at 975.

⁷⁸ *Id.* at 972.

⁷⁹ *Id.* at 976.

⁸⁰ See discussion *supra* Part III.A.

⁸¹ *Beam*, 833 A.2d at 971; see also *In re Caremark*, 698 A.2d 959 (Del. Ch. 1996); *In re Baxter Int'l Inc. Shareholders Litig.*, 654 A.2d 1268 (Del. Ch. 1995).

⁸² *Beam*, 833 A.2d at 971.

facts that suggested both that the board had a reason to monitor Stewart and that the board had a duty to monitor her private affairs.⁸³

“[A]bsent a cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.”⁸⁴ Beam failed to allege facts that suggested a cause for suspicion prior to the publication of the story detailing the investigation and her involvement in the ImClone sale.⁸⁵ However, even if Beam had shown cause for suspicion, the court was not willing to place a duty to monitor private affairs upon the board unless the plaintiff cited a case to support the duty.⁸⁶ Prior case law characterized the cause for suspicion in terms of “wrongdoing by the corporation.”⁸⁷ Although she was important to the company, Stewart was not the corporation.⁸⁸ No duty existed to monitor Stewart’s private affairs, so the claim was dismissed.⁸⁹

Importantly though, the court did not foreclose the claim that Stewart breached her fiduciary duties individually when she sold shares of ImClone.⁹⁰ Instead, the court dismissed the claim because Beam failed to make a demand on the board or allege facts that demonstrated that a demand would have been futile.⁹¹ The

⁸³ *Id.* at 971-72.

⁸⁴ *Id.* at 971 (quoting *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963)). In *In re Caremark*, the court surmised that *Graham*’s holding, quoted in *Beam*, would likely require updating in light of subsequent developments in Delaware corporate law, stating:

[I]t would . . . be a mistake to conclude that our Supreme Court’s statement in *Graham* concerning “espionage” means that corporate boards may satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation’s compliance with law and its business performance.

In re Caremark 698 A.2d at 970. Even under *Caremark*’s updated interpretation, it is doubtful a court would require “information and reporting systems” to provide timely feedback about the personal affairs of management or employees.

⁸⁵ *Beam*, 833 A.2d at 971.

⁸⁶ *Id.* at 971-72.

⁸⁷ *Id.* at 971.

⁸⁸ *Id.*

⁸⁹ *Id.* at 972.

⁹⁰ *Id.* at 977.

⁹¹ *Id.* at 984.

court excused the demand requirement against Stewart and the other inside director, but no facts suggested that the four outside directors were incapable of considering the demand.⁹² How the court may have decided the claim that Stewart individually breached her fiduciary duties is discussed next.

*C. Stewart's Actions Analyzed Under Traditional
Fiduciary Duties*

Beam alleged that “[t]o the detriment of the Company and in complete disregard [of] her fiduciary duties of loyalty and care, Stewart [had] jeopardized the future financial health of the Company by placing her own interests before those of the Company and its shareholders.”⁹³ Stewart’s actions, however, cannot easily be characterized as a breach of loyalty or care when analyzed under the existing legal framework and case law. Furthermore, Stewart’s ImClone sale and the ensuing damage to MSO’s corporate reputation does not fit the definition of waste.

A claim that Stewart breached her duty of loyalty likely would fail. Stewart’s ImClone stock sale was self-interested in that she acted to avoid \$50,000 in personal losses. However, the duty of loyalty does not apply to every private action simply because it was undertaken in the director’s best interest. Instead, the duty of loyalty implicates self-interested transactions in which the director’s interest runs contrary to that of the corporation.⁹⁴ The stock sale was a private decision solely in Stewart’s interest, with no connection to MSO. None of the typical duty of loyalty situations apply: the Stewart facts do not describe a director compensation issue, the usurping of a corporate opportunity, use of corporate powers to maintain control, sale of corporate control, or engaging in competitive enterprise.

One may argue that Stewart breached her duty of loyalty by proceeding with her self-interested transaction despite the risk that any illegality in the transaction could tarnish her public reputation and damage the value of the company. When framed in this manner, Stewart’s interest in avoiding losses ran contrary to the corporation’s interest in maintaining her public reputation. No precedent exists to support this argument just as no prece-

⁹² *Id.* at 977-78.

⁹³ Appellant’s Opening Brief at 1, *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040 (Del. 2004) (No. 501, 2003).

⁹⁴ See discussion *supra* Part III.A.

dent supported the duty to monitor claim in the *Beam* suit.⁹⁵

The claim that Stewart breached her duty of care suffers because Stewart's decision was a private decision not typically covered by the duty of care. The duty of care requires directors to use care and good faith in making *business* decisions related to the corporation they direct. Extending the duty to private decisions would require massive doctrinal changes to the duty of care. First, the court would have to expand the predicate decision to include both business and private decisions. Then, to avoid a court's substituting its judgment for that of private individuals, the court would have to recognize a private judgment rule akin to the business judgment rule to protect private, informed decisions made in good faith.⁹⁶ Instead of drastically changing the duty of care, a court would likely do as the *Beam* court did and dismiss the claim for lack of precedential support.

Finally, framing Stewart's ImClone sale as waste also falls outside traditional legal analysis. Although Stewart's reputation was an important asset to her company,⁹⁷ tarnishing her reputation by making an allegedly illegal stock sale hardly amounts to a wasteful expense of corporate assets. At most, any harm to her reputation was collateral to the ImClone sale. Furthermore, courts only invoke waste in unconscionable situations involving director compensation, excessively low sales prices for stock or control, and corporate gifts.⁹⁸

Even if the *Beam* court had reached the merits of the claim that Stewart breached her state law fiduciary duties, success on the claim would have been unlikely. The duties do not extend to private behavior that is outside the director's corporate capacity. State law has not developed to redress the harm to shareholder value caused by the private criminal behavior of celebrity corporate figures. As described in the next part, the shareholders in the class action suit have similar challenges to recovery under federal law.

⁹⁵ *Beam*, 833 A.2d at 961.

⁹⁶ See the discussion of the business judgment rule, *supra* Part III.A.

⁹⁷ See *supra* note 23.

⁹⁸ See discussion *supra* Part III.A.

IV
APPLYING FEDERAL SECURITIES LAW TO PROTECT
SHAREHOLDERS FROM CELEBRITY CORPORATE FIGURES’
PRIVATE CRIMINAL BEHAVIOR

In the appropriate situation, federal securities law may allow shareholders to recover the decline in shareholder value caused by some private criminal behavior of celebrity corporate figures. Section 10(b) of the Securities Exchange Act outlaws fraud or manipulation in connection with the purchase or sale of a security.⁹⁹ Even if the criminal behavior had no connection to securities, shareholders still might be able to recover if the celebrity corporate figure acted to mislead investors regarding the criminal behavior for the purpose of boosting the share price.

A. *Elements of Securities Fraud*

Under the authority of section 10(b), the Securities and Exchange Commission promulgated Rule 10b-5 that specified categories of behavior that, in connection with a purchase or sale of any security, constitute securities fraud. The behaviors include:

- (a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person¹⁰⁰

Once a plaintiff alleges facts that fit these categories, the plaintiff still must show the typical elements of fraud, including scienter,¹⁰¹ materiality,¹⁰² causation,¹⁰³ reliance,¹⁰⁴ and damages.¹⁰⁵

The plaintiff can only meet Rule 10b-5’s scienter requirement by “stat[ing] with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”¹⁰⁶

⁹⁹ 15 U.S.C. § 78j (2000).

¹⁰⁰ 17 C.F.R. § 240.10b-5 (2003).

¹⁰¹ Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

¹⁰² Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988).

¹⁰³ *Id.* at 241.

¹⁰⁴ *Id.* at 243.

¹⁰⁵ *See id.*

¹⁰⁶ 15 U.S.C. § 78u-4(b)(2) (2000). Circuit courts have interpreted this pleading requirement in three ways. The easiest standard, used in the Second and Third Circuits, allows the plaintiff to show a strong inference of scienter by alleging evidence of motive and opportunity to commit fraud or recklessness. *Novak v. Kasaks*, 216

Materiality is present “if there is a substantial likelihood that a reasonable shareholder would consider [the misstatement or omission] important.”¹⁰⁷ Causation is split into transaction causation and loss causation, with liability attaching only when the plaintiff can show that the defendant’s conduct caused both the plaintiff’s transaction and resulting loss.¹⁰⁸ Transaction causation is similar to “but for” causation, describing the conduct that induced the purchase or sale of the securities,¹⁰⁹ whereas loss causation is similar to proximate cause, describing the conduct that caused the economic harm.¹¹⁰ Finally, the plaintiffs must show reliance. To some degree, reliance is analogous to transaction causation.¹¹¹ Reliance provides the link between the investor’s actions and the defendant’s actions.¹¹² Reliance on misstatements and omissions is presumed because the market rapidly incorporates any public material misrepresentation into the market price.¹¹³ The standard of proof in a private securities fraud action is the civil standard, preponderance of the evidence.¹¹⁴

F.3d 300, 310-11 (2d. Cir. 2000); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534-35 (3d. Cir. 1999). Important factors include that the defendant: “(1) benefitted in a concrete and personal way from the purported fraud . . . ; (2) engaged in deliberately illegal behavior . . . ; (3) knew facts or had access to information suggesting that their public statements were not accurate . . . ; or (4) failed to check information they had a duty to monitor.” *Novak*, 216 F.3d at 311 (citations omitted). The Ninth Circuit rejects the motive and opportunity position in favor of a stricter standard. *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 979 (9th Cir. 1999). Instead, the plaintiff must show the defendant acted with “deliberate or conscious recklessness.” *Id.* Several circuits require recklessness “akin to conscious disregard.” *In re Comshare Inc. Sec. Litig.*, 183 F.3d 542, 550 (6th Cir. 1999), takes a middle ground approach that finds motive and opportunity to be relevant to, but not determinative of, scienter. *Id.* at 551; *see also* Fla. State Bd. of Admin. v. Green Tree Fin. Corp., 270 F.3d 645 (8th Cir. 2001); *Nathenson v. Zonagen Inc.*, 267 F.3d 400 (5th Cir. 2001); *Philadelphia v. Fleming Cos.*, 264 F.3d 1245 (10th Cir. 2001); *Greebel v. FTP Software, Inc.*, 194 F.3d 540 (1st Cir. 1999); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271 (11th Cir. 1999).

¹⁰⁷ *Basic*, 485 U.S. at 231 (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

¹⁰⁸ *AUSA Life Ins. Co. v. Ernst & Young*, 206 F.3d 202, 209 (2d Cir. 2000).

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² *Basic*, 485 U.S. at 243.

¹¹³ *Id.* at 247 (explaining the fraud-on-the-market theory).

¹¹⁴ *United States v. Stewart*, 305 F. Supp. 2d 368, 369 (S.D.N.Y. 2004).

*B. Applying Securities Fraud to Martha Stewart's
ImClone Sale*

Martha Stewart's ImClone sale provides a framework to determine how using federal securities law could protect shareholders from losses caused by a celebrity corporate figure's private criminal behavior. Stewart's stock sale, by itself, would not normally expose her to a securities fraud action from MSO shareholders. Even if she indeed acted on insider information, she was not "employing a device, scheme, or artifice to defraud" MSO shareholders as described in Rule 10b-5(a). Nor was she engaging "in any act, practice, or course of business which operates" as a fraud on MSO shareholders as described in Rule 10b-5(c). ImClone shareholders might have claims against Stewart under those parts of the rule, but MSO shareholders would not be interested parties.

Additionally, Stewart's false proclamations of innocence to the public, by themselves, would not normally amount to securities fraud. However, Rule 10b-5(b) encompasses misleading statements or omissions connected with the purchase or sale of a security. If Stewart's statements were made with the intent of protecting or boosting MSO's share price, those statements might be converted into securities fraud. In Stewart's criminal trial, the court dismissed this theory of securities fraud because the government failed to present sufficient evidence to show scienter.¹¹⁵ The holding was predicated on the heightened standard of proof used in a criminal trial when assessing the sufficiency of the evidence.¹¹⁶ The plaintiffs in the civil securities fraud class action filed against Stewart will test a similar theory under the lower civil standard of proof.¹¹⁷ They allege that, in the months following the public disclosure of the investigation into Stewart, MSO and Stewart issued several statements proclaiming her innocence

¹¹⁵ *Id.* at 376. Additionally, many commentators dismissed as quite novel the government's characterization that Stewart committed securities fraud by proclaiming her innocence because the misstatements were made about Stewart's personal affairs, not a security or business. See, e.g., Paul Thomasch & Gail Appleson, *Stewart Wins Key Ruling on Fraud Charge*, at http://www.boston.com/business/articles/2004/02/15/stewart_wins_key_ruling_on_fraud_charge (Feb. 14, 2004).

¹¹⁶ *Stewart*, 305 F.Supp 2d at 376. The criminal court did not analyze any other elements of securities fraud, so the question of whether the evidence against Stewart would be enough to impose liability in a civil trial remains open. *Id.* at 378 n.5.

¹¹⁷ Consolidated and Amended Class Action Complaint ¶ 61, *In re Martha Stewart Living Omnimedia, Inc. Sec. Litig.* 02-CV-6273 (JES) (S.D.N.Y. filed Feb. 3, 2002).

in order “to protect the price of MSO stock from declining and to minimize the harm news of the government’s investigation would have on Stewart’s reputation and the Company’s business.”¹¹⁸

In addition to the claim that Stewart’s proclamations of innocence amounted to securities fraud, the plaintiffs in the civil class action also allege several events prior to publication of the AP report that, if true, likely amount to a more traditional application of Rule 10b-5(b)’s provision against misstatements or omissions. Prior to the AP report, the complaint alleges a Rule 10b-5(b) material omission when the MSO board failed to disclose information regarding the government’s investigation into Stewart’s ImClone sale.¹¹⁹ Normally, a material omission is not actionable under Rule 10b-5 unless a duty to disclose arises. Directors in possession of material nonpublic information have a duty to disclose the information unless they refrain from trading in the stock.¹²⁰ According to the complaint, the directors’ duty to disclose arose when they became aware of the nonpublic information regarding the investigation and its likely negative impact on MSO, and then proceeded to sell significant amounts of their personally-held stock.¹²¹ Also, during the period between the start of the investigation and the public disclosure, the complaint alleges Rule 10b-5(b) material misstatements when Stewart issued a press release accompanying the fourth-quarter and year-end reports that MSO was a “*smoothly run business with no hidden surprises*.”¹²² The company’s SEC filings during the period also failed to mention the investigation despite including the risk statement that damage to Stewart’s public image would harm the share price.¹²³

The class-action plaintiffs who bought MSO shares between the time Stewart learned of the investigation and the time Stewart’s claims of innocence were proven false at the conclusion of the criminal trial would meet Rule 10b-5’s threshold requirement of alleging fraud in connection with the purchase or sale of a security. Additionally, the plaintiffs would likely prove scienter for all the alleged events because they would only have to meet the

¹¹⁸ *Id.* ¶ 73.

¹¹⁹ *Id.* ¶ 61.

¹²⁰ See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968).

¹²¹ *In re Martha Stewart Living Omnimedia, Inc. Sec. Litig.* 02-CV-6273 (JES) ¶ 66, 69.

¹²² *Id.* ¶ 79 (alteration in original).

¹²³ *Id.* ¶ 79-83.

Second Circuit's pleading standard of motive and opportunity or recklessness by a preponderance of the evidence.¹²⁴ Stewart and the board clearly had motive and opportunity. Stewart owned over sixty percent of MSO shares, having much of her personal wealth tied to MSO's share price.¹²⁵ MSO's board members also owned MSO stock, selling over \$5 million dollars worth of stock during the period prior to the AP report.¹²⁶ Because Stewart's reputation was a significant factor in MSO's success, she had motivation to not disclose the investigation and to defend her reputation through the false claims of innocence after the AP report broke.¹²⁷ In terms of the factors the Second Circuit deems important,¹²⁸ Stewart and the board benefited in a concrete and personal way by preventing the share price decline and, as alleged, knew facts suggesting that her public statements were not accurate. Unlike in Stewart's criminal case,¹²⁹ the plaintiffs in the civil suit could likely plead the requisite scienter because of the lower evidentiary standard in civil cases. Although the plaintiffs could successfully allege fraud in connection with a security and scienter for all the events described in the complaint, the analysis of whether the plaintiffs could meet the elements of materiality, causation, reliance, and damages differs for plaintiffs who purchased MSO prior to the AP report and those who purchased MSO after the report.

The plaintiffs who purchased MSO prior to the AP report could likely prove all the fraud elements for the pre-AP-report misstatements and omissions. The statements that MSO had no foreseeable problems were false if, as alleged, the board had discussed the negative impact the news of the investigation would have had on the stock. Additionally, a duty to disclose the omissions arose when the board members failed to abstain from trading on the information.¹³⁰ The misstatements and omissions were material because a reasonable investor would likely have found the news of the investigation important because of the potential effect on Stewart's reputation. The immediate and precipitous decline in the share price post-disclosure evidences that

¹²⁴ See *supra* note 106.

¹²⁵ Indictment, *supra* note 1, ¶ 59.

¹²⁶ See *supra* note 121 and accompanying text.

¹²⁷ See *supra* note 23.

¹²⁸ See *supra* note 106.

¹²⁹ See *supra* note 116 and accompanying text.

¹³⁰ See *supra* note 120 and accompanying text.

investors indeed found the information important. Furthermore, MSO had already conceded the materiality of harm to Stewart's reputation in its prospectus and later SEC filings.

Additionally, pre-AP-report plaintiffs could establish transaction causation because those who purchased MSO stock prior to the disclosure of the investigation could argue that they were induced to purchase by the omission of news of the investigation or the positive misstatements that no hidden surprises lurked for MSO. Loss causation could be shown because the eventual disclosure of the misstated and omitted information caused the immediate decline in share price. Reliance would be presumed, since the market price of MSO reflected all the public knowledge available at the time any individual purchased MSO shares.¹³¹ Even though the plaintiffs that purchased MSO shares prior to the AP report likely would satisfy all the elements of securities fraud and, thus, could recover for any damages suffered, pinpointing the damages would be a challenge because determining exactly when the share price decline ceased to be related to the misstatements and omissions would be difficult.

Conversely, those plaintiffs who purchased MSO after the AP report likely would fail to prove materiality, causation, reliance, and damages. Materiality would be difficult to prove because a reasonable investor would not have found Stewart's claims of innocence particularly important. Instead, declaring innocence is the expected response to criminal accusations, whether guilty or not. The continued decline in the share price after Stewart made the statements indicates reasonable investors, in fact, did not believe Stewart's statements.

As for causation, those who purchased MSO stock after the AP report based on Stewart's claims of innocence could argue transaction causation was met because she induced them to buy on the belief that the share price was undervalued given her innocence. However, loss causation would be difficult to establish because the continual decline in MSO's share price was a result of the earlier misstatements, not her claims of innocence. The decline would have occurred whether or not she claimed innocence. Because plaintiffs who bought MSO after the AP report based on Stewart's claims of innocence would be unlikely to prove materiality and loss causation, the questions of reliance and damages are moot.

¹³¹ See *supra* note 113.

Under federal law, at least some MSO shareholders could recover for the damage caused by Stewart's private behavior. However, using federal securities law to protect shareholders from celebrity corporate figures whose private criminal behavior harms shareholder value would only work in very limited factual circumstances and for a limited class of shareholders. Like state law fiduciary duties, the law in this area does not clearly cover a situation where the celebrity corporate figure harms shareholder value through private criminal behavior. To fill this gap, courts should recognize a new fiduciary duty as outlined in the next part.

V

THE MARTHA DUTY: A CORPORATE CELEBRITY FIGURE'S FIDUCIARY DUTY TO AVOID CRIMINAL PRIVATE BEHAVIOR THAT HARMS SHAREHOLDER VALUE

Shareholders of a company with a corporate celebrity figure face additional risk not present in a company without such figures. Courts should impose a special duty on celebrity corporate figures to address the additional risk. Creating a new fiduciary duty to address special, uncommon situations would not be unprecedented. For example, the *Unocal* duty addresses directors' defensive conduct in the special situation of a takeover by subjecting the directors' decisions to a stricter substantive review by courts prior to applying the business judgment rule.¹³² In a situation in which there is a change of corporate control, directors must follow the *Revlon* duty to earn the highest price for shareholders.¹³³ The duty of a celebrity corporate figure to avoid private criminal behavior could be called the "Martha Duty."

A. *Elements of the Martha Duty*

A plaintiff asserting the Martha Duty would have to prove that the defendant: (1) was a celebrity corporate figure; (2) committed a criminal act, and; (3) caused damages to the corporation. Initially, the plaintiff would need to prove facts that suggest that the corporation is so inextricably intertwined with the public image of the defendant that the defendant qualifies as a celebrity corporate figure. Relevant facts could include admissions by the

¹³² See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

¹³³ See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

company to investors that the reputation of the celebrity is a risk factor of the investment. Additionally, the market's reaction to news of the celebrity corporate figure's private criminal behavior would indicate that the market views the corporation and celebrity as inextricably bound. Finally, when the celebrity corporate figure is the namesake of the corporation, a rebuttable presumption could exist that the company is inextricably linked to the celebrity's image.

Next, the plaintiff would need to prove that the celebrity corporate figure committed a criminal act.¹³⁴ As discussed in Part II, this Comment's concern is private criminal behavior that harms shareholder value. Clearly, the plaintiff could meet this burden by pointing to a conviction or plea. Absent a conviction or plea, the plaintiff would have to allege facts that could prove the criminal behavior by a preponderance of the evidence.

Finally, the plaintiff would have to prove damages. Event study methodology could be used to determine any decline in shareholder value related to the celebrity corporate figure's criminal behavior. Essentially, event study methodology starts with an efficient market hypothesis that a security's price reflects the present value of the future cash flow from a company's assets given all available information about the company. New information leads to changes in the security price. A change in the price after an event reflects the market's unbiased value of that event.¹³⁵ This unbiased value would equal the damages shareholders suffered.

B. Applying the Martha Duty to Martha Stewart's ImClone Sale

The plaintiffs could prove that Martha Stewart was inextricably intertwined with MSO. From the release of the prospectus forward to the most recent 10-Q, MSO has consistently pointed to Stewart's public image as a risk factor for investors. Addition-

¹³⁴ I intentionally fail to distinguish between the different degrees of crimes, such as misdemeanors or felonies, that would trigger the Martha Duty. Instead, the duty should trigger upon the commission of any crime with the market determining what weight, if any, to put on a particular crime.

¹³⁵ Event study methodology has been used to determine the economic effects of the change of a company's name, the release of a new product, use of celebrity spokespersons, product recalls, and adverse regulations or rulings. See, e.g., Jagdish Agrawal & Wagner A. Kamakura, *The Economic Worth of Celebrity Endorsers: An Event Study Analysis*, 59 JOURNAL OF MARKETING 56 (July 1995).

ally, the market reaction to the initial disclosure of the investigation,¹³⁶ as well as the reaction to the dismissal of the securities-fraud claim in Stewart's criminal trial,¹³⁷ indicates that the market viewed Stewart and MSO as inextricably bound. Finally, Martha Stewart is the namesake of MSO, allowing plaintiffs to argue for the presumption that the company is inextricably intertwined with her. Stewart would not likely defeat this element, but could attempt to do so by showing that MSO has transcended her reputation by building a successful business model that went beyond her talent, imagination, and reputation.¹³⁸

The plaintiffs could also prove the private criminal behavior, pointing to the conviction in her criminal case. Had she prevailed in her criminal case, the plaintiffs could still attempt to prove the very same issues using the lower burden of proof in civil trials.

Finally, the plaintiffs likely would prove damages. The precipitous decline in stock price immediately following the public disclosure of the ImClone investigation, coupled with the absence of other MSO news to explain the decline, allows an inference that the market decline was based solely on the damage to her public image. The more interesting question would be determining when the event ceased. Plaintiffs would argue that it ceased on the date the stock price hit the lowest mark, thereby allowing for the most damages. Stewart would argue for a much shorter timeline, minimizing her liability.

A court would likely find that Stewart violated the Martha Duty. Given that the criminal jury found the alleged facts surrounding her ImClone sale to be true,¹³⁹ this is the correct result. Stewart built a personal fortune by enticing investment in a corporation that leveraged her personal reputation. Although investors could assess the likelihood Stewart would fall out of public favor, they could not assess, and therefore should not be forced to assume, the risk of her criminal behavior. Existing fi-

¹³⁶ See *supra* note 9.

¹³⁷ MSO shares surged 11% the day charges were dismissed. Jonathan D. Glater, *Most Serious Charge Against Stewart is Dismissed*, N.Y. TIMES, Feb. 28, 2004, at A1.

¹³⁸ Compare MSO with other companies such as Dell Computers. While MSO is still trying to evolve the Stewart brand beyond the Stewart personality, Dell Computers has a proven business model and capable management team that transcends founder Michael Dell. Alan Brew, *MSO Must Find Life After Stewart for Company to Survive*, PR WEEK (U.S.), March 1, 2004, at 8.

¹³⁹ See *supra* note 6 and accompanying text.

duciary duties make clear that investors are not expected to assess the risk that directors lack good faith or act in a self-interested manner. Similarly, shareholders valuing MSO stock should not be expected to factor in the likelihood that Stewart would commit private criminal acts that would harm shareholder value. The proposed Martha Duty allocates the responsibility to the person most responsible for the damages, Martha Stewart.

CONCLUSION

Investing in a company whose public image is inextricably intertwined with that of a celebrity corporate figure includes an investment risk that the private behavior of the celebrity will harm shareholder value. While individual investors are often best suited to assess risk and price investments accordingly, corporate law should not require investors to assume the risk that these celebrity corporate figures will commit private criminal acts to the detriment of shareholder value. Traditional state law fiduciary duties do not adequately allow shareholders to recover from a celebrity corporate figure whose private criminal behavior has reduced shareholder value. Similarly, federal securities law is not well-suited to remedy these losses. Therefore, courts should recognize a special fiduciary duty under which celebrity corporate figures owe a duty to avoid criminal behavior in their private lives that could lead to a decline in shareholder value.

