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Ethics

Allegations of a conflict of interest, or even an ''appearance'' of conflict, is enough to create a tactical advantage across a wide front of politics. Authors Robert Rizzi and Dianna Muth of Steptoe & Johnson note that one of the most effective traditional defenses to some charges of ethics violations is the insertion of a ''blind trust.''

As a matter of law, however, nominees rarely can avoid conflicts by establishing blind trusts. As a matter of optics, on the other hand the trusts retain their value—until, perhaps, they are challenged.

Blind Faith in Blind Trusts: Not as Solid an Ethical Shield as Many Believe

BY ROBERT RIZZI AND DIANNA MUTH

The government ethics statutory framework is now fully weaponized. The allegation of a conflict of interest, or even an ''appearance'' of conflict, is enough to create a tactical advantage across a wide front of politics. Members of both parties and virtually all factions have participated in these attacks and it is too late to retreat. Such is modern-day Washington.

Surprisingly, one of the most effective defenses to some charges of ethics violations is the insertion of a ''blind trust.'' For a number of reasons, the public and many prospective appointees appear to have confidence that, by placing their assets into a blind trust, attacks under color of the government ethics laws can be deflected. In our representation of well over 100 executive branch nominees through the confirmation process in the current and prior administrations, there is an almost universal interest in blind trusts. New clients ask: ''Why can't I just use a blind trust?'' In our experience, nominees rarely can avoid conflicts by establishing blind trusts. However, the belief that they are effective has become so entrenched that the actual law on the topic is often ignored in favor of the optics of blind trusts. This benefit should not be underestimated.

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Lifting the Veil

When a blind trust is established, the nominee transfers control and management of assets to an independent trustee who may not communicate with the nominee regarding the identity of the holdings in the trust going forward. The theory is that without knowledge of what specific assets are in the trust, the nominee could not be influenced in the performance of their official government duties.

That law, codified in the Code of Federal Regulations (5 CFR § 2634) and interpreted by the Office of Government Ethics (OGE), states that (i) financial conflicts can be prevented only by using a ''qualified blind trust'' (in turn subject to an array of special sub-rules), and (ii)

conflicted assets that are transferred into qualified blind trusts do not lose their taint and are still subject to conflict of interest restrictions until they are sold, because the government official who has contributed those assets to the trust still has sufficient knowledge of the assets to create possible conflicts with official duties.

First, the trust must meet the criteria to be ''qualified.'' For a blind trust to be qualified, OGE insists that the trustee be ''independent,'' to avoid the possibility for a ''back channel'' for the settlor to influence management of trust assets. Furthermore, at least for executive branch blind trusts, only ''institutional trustees,'' such as banks and other financial service companies, can meet the test for true independence.

This regulatory requirement is one of many reasons that qualified blind trusts are so rare. For example, during Mitt Romney's campaign, his limited disclosure of financial holdings was based in part on the fact that his assets were held in blind trust, even though the trustee was his personal lawyer and close friend, and therefore would have failed the OGE ''independence'' test. Whether based upon experience or upon market information, many high net worth individuals are not willing to entrust unfettered investment decisions to financial institutions as trustees. While a small number of such institutions have developed a lucrative bespoke practice acting as institutional blind trustees, the demand has been relatively modest.

The risks to settlors of ''defective'' blind trusts are often underappreciated.

Even if the burdensome requirements are met to establish a qualified blind trust, the act of transferring conflicted assets to the trust does not remove their taint. This law is logical—if the settlor of the blind trust knows what assets are initially transferred into the trust, that knowledge creates the potential for conflicts. The fact that day-to-day control is transferred to a trustee does not limit the conflict, under current law. Government ethics rules recognize this reality, and only later-acquired trust assets that are not disclosed to the settlor can avoid the risk.

In addition to the difficulties of meeting the onerous requirements for qualified blind trusts, the risks to settlors of ''defective'' blind trusts are often underappreciated. As a general matter, many of the financial conflict of interest rules are enforced through federal criminal law, Title 18 of the United States Code. A failure to avoid a financial conflict of interest is not simply a reputational problem (which may be significant enough), but could lead to a referral to the Department of Justice. Each year, OGE publishes a list of referrals under various criminal ethics laws, including under the relevant provisions of 18 USC § 208, and the prospect of appearing on that list is enough to cause many to proceed cautiously.

If a blind trust becomes defective by failing to meet the regulatory requirements—the blind trust is ''blown up''—the settlor is immediately exposed to the risk of a conflict of interest for the assets in the trust, and therefore to criminal liability.

An Alternative: Discretionary Trusts

The rules concerning blind trusts are distinct from parallel rules regarding ''discretionary trusts.'' Under a 2008 OGE ruling, assets held in discretionary trusts are not only immune from financial conflicts of interest, but are also exempt from the onerous disclosure rules that require government officials to list all of their financial holdings on a form (OGE Form 278) available to the public. Under the OGE ruling, discretionary trusts include arrangements that provide that a beneficiary can received only so much of the income and principal of the trust as the trustee in his uncontrolled discretion shall see fit, and that deny the beneficiary ''an enforceable right to payment.''

Once again, the logic of the ethics laws on discretionary trusts makes intuitive sense. An individual who is only a *potential* beneficiary of a discretionary trust, and who cannot compel an actual transfer of trust assets to herself, has no ''vested'' interest in the assets. She should no more be treated as having a financial interest in those assets than she might have in assets that she could at some point in the future inherit from her parents, who can always change their wills to allocate those assets to someone else.

Thus, government officials who are beneficiaries of discretionary trusts are insulated from virtually all financial conflicts of interest. However, under a special qualification in the 2008 ruling, settlors of such trusts are not covered by the exemption. As a result, discretionary trusts, while a potential defense for individuals whose ancestors were foresighted enough to set aside assets in trust and grant sole discretion to the trustee, are not a substitute for blind trusts.

Watching the Watchdogs

Interesting questions arise as to how such conflicts are revealed, and to what extent good-government ''watchdogs'' or other parties can play a role in enforcement of the government ethics statutes. Political appointees are required to file annual financial disclosures (OGE Form 278), as well as periodic transaction reports (OGE Form 278-T). It is these reports that allow both government ethics officials and the public to monitor potential conflicts of interest.

Because the criminal conflict of interest statute only requires two elements—knowledge that one holds of a financial interest, and participation by the holder in a ''particular matter'' (the term of art for official actions involving, for example, an adoption of a regulation)—government officials who have disclosed their portfolios to the public are at risk that some well-meaning government reformers, or not so well-meaning opposition researchers from some political faction will allege a connection to a ''particular matter,'' and therefore bring allegations against the official within the penumbra of a criminal statute. The blind trust, of course, serves as a shield by allowing the appointee to disclaim knowledge of the financial interest.

The consequences of conflicts of interest can reach beyond criminal liability for the appointee and disparaging press coverage.

In *United States v. Mississippi Valley Generating Co.*, the Supreme Court, in an opinion by Chief Justice Earl Warren, held that a flagrant conflict of interest permitted the government to disavow a tainted contract, and

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left the counterparty without recourse and with substantial out-of-pocket costs. The case involved a mid-level bank officer of First Boston (now Credit Suisse), who had volunteered to help the Bureau of the Budget (now OMB) analyze bond financing for a utilities privatization transaction, where the bank was to be paid a fee by the utility in connection with the same transaction.

Even though neither the bank nor the individual employee ultimately profited from his overlapping activities, and although the government had participated in all aspects of the transaction and knew about the role of the bank officer, the Court decided that voiding the contract was necessary to send a message that ''no man can serve two masters'' (the Biblical admonition was actually used in the opinion). The price of a later-discovered conflict of interest can be substantial.

Despite these risks and drawbacks, confidence in blind trusts continues virtually unabated, through election cycles and scandals.

What Accounts for this Blind Faith?

There are number of possible explanations for the blind faith in blind trusts. Historically, blind trusts were widely used, and prior to the promulgation of the Ethics in Government Act, such arrangements were a routine solution to avoid conflict of interests. Faith in blind trusts has been reinforced by high-profile examples of politicians who have used such trusts in the past. Mitt Romney carried on a long tradition of presidential candidates, including Ronald Reagan, who famously held assets in a blind trust throughout his presidency.

The use of presidential trusts, and the widespread publicity they receive, no doubt reinforces the popular perception that such measures ''work.'' Presidential blind trusts are themselves ironic, because by statute, both the president and the vice president are exempt from the criminal conflict of interest statutes. Presidential blind trusts are largely ceremonial.

Another possible explanation is that faith in blind trusts reflects the views of successful high net-worth individuals from the private sector (i.e., many of the nominees with possible exposure to financial conflicts) that these devices ''should'' work. Based on our experience, many wealthy investors who actively manage their own portfolios may assume that, if their ability to buy and sell is eliminated, that should be enough to avoid potential conflicts once in government. Many of these individuals in particular tend to equate active management with potential conflicts.

For example, it is quite common for potential nominees to make sharp distinctions between limited partners and general partners who participate in private investment funds—they are well aware that the deal struck in such funds is that, as limited partners, they will delegate control over investment decisions, in return for a (hopefully) higher than market yield at the end of the fund's term. To suggest that they might make decisions in government that could affect their limited partner investments does not comport with their basic understanding of how such funds work. A similar logic would apply to decisions made by trustees of blind trusts.

Finally, most of the individuals entering government service from successful private-sector careers do not envision staying in government forever. The use of a blind trust to hold assets only while the settlor spends a couple of years in Washington comports with this view. This view also highlights the difficulty of matching expectations with government ethics laws, which in a given case may impose a permanent reallocation of investment assets for individuals entering government service, even if their tenure will be temporary.

It is also possible that the popular confidence in blind trusts derives from a lack of familiarity with how such vehicles actually operate. Although simple ''family'' trusts are becoming increasingly common as a means of avoiding costs of probate administration, complex trusts are not a common feature of Middle American portfolios, and the concept of a privately operated ''blind'' trust vehicle can be comforting to a public generally suspicious of the conduct of government officials. A similar confidence often attaches to law firm ''ethical walls'' to address potential legal conflicts in large law firms. In both cases, the ''blind'' vehicle operates reasonably well and permits a degree of flexibility in the system, blessed in each case by lawyers.

Will the Cynics Notice?

Like most matters of faith, respect should be shown, and the mystical confidence in the ability of blind trusts to defend against conflict of interest charges must be acknowledged. The fact that the general public continues to believe in these exotic vehicles as protections against conflicts of interest reinforces one of the main objectives of the government ethics laws, that is, promoting ''trust in government'' by combatting even the appearance of conflicts of interest, and seems to counteract the general cynicism concerning Washington.

Despite the fact that there is almost no basis for that faith in the law, officials may well continue to use blind trusts to avoid politically-charged attacks couched in terms of alleged violations of government ethics laws. Under these circumstances, blind trusts serve a purpose, even if they do very little actually to prevent conflicts of interest.

Blind trusts formed for purposes of persuading the public that government officials took formal steps to avoid conflicts may be the next evolution in battles over government ethics.