

# TO HAVE OR NOT TO HAVE—CONFLICTS OF INTEREST AND FINANCIAL PLANNING FOR JUDGES

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The canons of judicial ethics make clear that a judge should avoid putting himself in a position where he is likely to be faced with cases involving parties in which he is personally interested, and whenever such a case appears, he should decline to act.<sup>1</sup> This means, according to a formal opinion, that he should “not perform a judicial act, involving the exercise of judicial discretion, in a cause in which one of the parties is a corporation in which the judge is a stockholder.”<sup>2</sup> Although that prohibition against financial involvement in parties appearing before a judge is not new, the recent example of a Supreme Court Justice’s resignation under fire for external involvements and a Supreme Court nominee’s being rejected on financial conflict grounds<sup>3</sup> has increased our sensitivity on that issue.<sup>4</sup> That increased

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<sup>1</sup> ABA CANONS OF JUDICIAL ETHICS Nos. 4, 26, 29. Canon 4 states that a judge should avoid the appearance of impropriety. Canon 26 states that a judge should avoid personal investments in enterprises likely to appear in his court. Canon 29 states: “A judge should abstain from performing or taking part in any judicial act in which his personal interests are involved.” These three canons are linked together. It is improper for a judge to make investments in businesses which are likely to appear in his court because he would then be required to excuse himself. The appearance of evil stems from the connection between a judge’s “personal interest” and matters handled by his court. “Personal investment” and “personal interest” are equated. Further, Canon 27 permits a judge to be an executor or trustee, but repeats Canon 26’s prohibition on investments made in the judge’s fiduciary capacity. Thus, all investments owned in the judge’s name, whether for his own benefit or for the benefit of others, are treated alike.

<sup>2</sup> ABA COMM. ON PROFESSIONAL ETHICS, OPINIONS, No. 170 (1937). This strict position, that “any interest, no matter how small . . .” requires disqualification, is reflected in section 8(a) of the Interim Report of the ABA Special Committee on Standards of Judicial Conduct. By section 8(b), *see note 13 infra*, the parties may request a judge to proceed if his interest appears to be “insubstantial.” The federal statute requires that the judge disqualify himself only if his interest is “substantial.” 28 U.S.C. § 455 (1964).

<sup>3</sup> Justice Abe Fortas resigned from the Court on May 14, 1969, after disclosure that he had entered into an employment relationship with a private foundation set up by financier Louis Wolfson, who was thereafter indicted for selling unregistered securities. *See* 25 CONG. Q. ALMANAC 136-39 (1969); N.Y. Times, May 16, 1969, at 1, col. 6. The nomination of Judge Clement Haynsworth to be an Associate Justice of the Supreme Court was rejected by the Senate on November 21, 1969, after extensive hearings and debate had dwelt at length on his financial affairs. *See* 115 CONG. REC. S14886 (daily ed. Nov. 21, 1969); *Hearings on the Nomination of Clement F. Haynsworth, Jr., Before the Senate Comm. on the Judiciary*, 91st Cong., 1st Sess. (1969) [hereinafter cited as *Haynsworth Hearings*].

<sup>4</sup> Shortly after the Fortas resignation, the Judicial Conference was called into special session by Chief Justice Warren and on June 10, 1969, adopted new rules limiting off-bench activities of federal judges and requiring disclosure. *See* N.Y. Times, June 11, 1969, at 1, col. 3. Some of the rules were suspended on November 1, 1969, pending a study of the Canons of Judicial Ethics by an ABA Special Committee, and the disclosure rules were modified. *See* 38 U.S.L.W. 2271 (Nov. 11, 1969); N.Y. Times, Nov. 2, 1969, § 1, at 1, col. 2. Final disclosure rules and forms were adopted in March 1970, and require semiannual statements to be filed at stated places. 38 U.S.L.W. 2508 (March 24, 1970). In addition, two subcommittees of the Senate Committee on the Judiciary held hearings on the general subject of

sensitivity, in turn, tends to make life difficult for judges who have investments, and emphasizes a need for careful planning to avoid, or at least minimize, conflict problems. This paper attempts to conceptualize what elements make ownership of an investment into a conflict of interest and discusses planning techniques for dealing with those elements. While the focus is principally on members of the federal judiciary, the planning techniques are available for any judge, although the range of issues with which judges must deal varies with the jurisdiction of their courts, and this may indicate different considerations apply. It is worth noting that no simple arrangement for eliminating conflicts exists, and in the last analysis, the best protection against a conflict is the integrity of the individuals we select for judicial office.

## I

### THE PROBLEM IN CONTEXT

*A basic assumption.* Many individuals selected to be judges have accumulated some personal wealth which they have invested in various ways. The basic assumption made here is that judges should not be asked to forego investment in stocks and securities.<sup>5</sup> To do so would not only be unfair; it might also be counter-productive. Indeed, investment activity is so common in our society that there is little dispute about this proposition.<sup>6</sup> Otherwise, elevation to the bench might come to be regarded as imposing penalties on persons with accumulated wealth and thus discourage acceptance of judicial appointments.

*Identifying the conflict.* Financial conflicts of interest are matters of degree.<sup>7</sup>

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judicial conflicts of interest during that summer and fall. See 25 CONG. Q. ALMANAC 712-15 (1969). The extremely heavy attention paid to Judge Haynsworth's financial affairs was without doubt attributable to heightened sensitivity about ethics in the wake of the Fortas affair. See also Wall Street Journal, Oct. 20, 1970, at 1, col. 6.

<sup>5</sup> When Louis D. Brandeis was appointed to the Court in 1916, he is reported to have asked Chief Justice White whether he should dispose of his substantial investments. The Chief Justice is reported to have replied that Brandeis should not think of "disposing of the investments which you have made with such care." Letter from Edward D. White to Louis D. Brandeis, July 17, 1916, reported in A. MASON, *BRANDEIS: A FREE MAN'S LIFE* 512 (1946).

<sup>6</sup> Research has not revealed any writer who seriously contends that investment in stocks and securities is ipso facto improper. Rather the inquiry has been what particular stocks and securities are bad in particular situations. See, e.g., Edwards, *Commentary on Judicial Ethics*, 38 *FORDHAM L. REV.* 259, 264-68 (1969); Ritchie, *The Propriety of the Participation By a Judge In Non-Judicial Money-Making Activities*, 51 *CHI. B. RECORD* 70 (1969). For a discussion of the utility of diversified investing, see Smith, *Changing Concepts of Trust Investment Policy*, in 3 *LANDMARK PAPERS ON ESTATE PLANNING, WILLS, ESTATES AND TRUSTS* 1375 (A. Winard ed. 1968) [hereinafter cited as WINARD]. Requiring judges to limit their investments to government bonds would be one solution to the financial conflict of interest problem. The lack of significant support indicates that restriction to be too extreme for present acceptability, and no effort is made in this article to explore the merits of such a restriction.

<sup>7</sup> For an interesting discussion of this problem with respect to Congressional conflicts of interest, see *NEW YORK CITY BAR ASS'N SPECIAL COMM. ON CONG. ETHICS, CONGRESS AND THE PUBLIC TRUST* 34-51 (1970) [hereinafter cited as *ASS'N REP. ON CONG. ETHICS*]. While the American Bar Association's position categorically forbids any direct stock ownership when an act of judicial discretion is involved, see note 2 *supra*, it is not clear how far "personal interest" extends. Does it include ownership of stock

An investment owned by a judge becomes objectionable only as the relationship between it and the litigants in a specific case in which the judge is acting becomes direct and specific. For example, a judge owning 200 shares of General Motors Corporation stock should not, under the Bar Association's interpretation of Canon 29, decide a case involving a negligence claim against General Motors.<sup>8</sup> This conclusion is supported by state authority that *any* ownership of stock in one of the parties is a conflict of interest under state statutes requiring disqualification,<sup>9</sup> even though that stock may be a minor portion of the total outstanding stock of the corporation.<sup>10</sup> The federal statute is more flexible, requiring that the judge's interest be "substantial."<sup>11</sup> The conflict stems from two propositions: the judge's economic well-being might be affected by his decision in the case; and, because of his financial ties to management, he might identify himself as an owner and tend to favor management's decisions. There is a corollary: because the judge knows his personal interests are involved, he might try to be especially fair to the other side—a "reverse twist."

Let us suppose that the judge has arranged his affairs so that he does not know which *particular* stocks and securities he owns, but only that he does own some common stock. If, as a federal judge, he is called upon to decide a case involving the legitimacy of some rules of the stock exchange,<sup>12</sup> does he have a "conflict of interest"? The value of his holdings may be affected by his decision, although it is not clear how; and he knows that he is a "stockholder" and thus may identify

in a corporation which does business with a party to the litigation? If so, would even a small amount of business suffice? Judge Haynsworth's involvement in the *Darlington Mills* case brings this to mind; it was argued that his situation, where the business done seemed to be peripheral to the problem before the court, was not a conflict of interest. See, e.g., *Haynsworth Hearings*, *supra* note 3, at 108-36 (testimony of John P. Frank). In such situations, even a categorical rule does not answer some critical questions.

<sup>8</sup> But see Edwards, *supra* note 6, at 267.

<sup>9</sup> See, e.g., CAL. CIV. PRO. CODE § 170, cl. 2 (West Supp. 1970) ("holder or owner of any capital stock"); N.Y. JUDICIARY LAW § 14 (McKinney 1968) ("any matter in which he is interested"); TEX. REV. CIV. STAT. ANN. art. 15 (Supp. 1969) ("any case wherein he may be interested"). In statutes such as those of New York and Texas, the language is broad enough to permit a de minimus rule.

<sup>10</sup> See Annot., 25 A.L.R.3d 1331 (1969). See generally Frank, *Disqualification of Judges*, 56 YALE L.J. 605 (1947).

<sup>11</sup> 28 U.S.C. § 455 (1964). Compare *Kinnear-Weed Corp. v. Humble Oil & Refining Co.*, 403 F.2d 437 (5th Cir. 1968), with *Lampert v. Hollis Music, Inc.*, 105 F. Supp. 3 (S.D.N.Y. 1952). See *Bradford Audio Corp. v. Pious*, 392 F.2d 67 (2d Cir. 1968), for an interesting discussion of collateral attack on an order by a state court appointing a receiver on the ground that the judge owned 100 shares of stock of the corporation in receivership worth about \$300. The apparent categorical quality of state law is modified by the possibility of "waiver." A litigant may lose his right to assert disqualification if he fails to object seasonably. See N.Y. JUDICIARY LAW § 14 (McKinney 1968): "No judge shall be deemed disqualified from passing upon any litigation before him because of his ownership of shares of stock or other securities of a corporate litigant, provided the parties, in writing, or in open court upon the record waive any claim to disqualification of the judge." This provision seems to be an open invitation to adopt a disclosure and excuse rule. See text at notes 13-16 *infra*.

<sup>12</sup> See, e.g., *Thill Securities Corp. v. N.Y. Stock Exch.*, 5 TRADE REG. REP. (1970 Trade Cas.) ¶ 73,306 (7th Cir. Aug. 27, 1970); *Kauffman v. Dreyfus Fund, Inc.*, 5 TRADE REG. REP. (1970 Trade Cas.) ¶ 73,333 (3d Cir. Sept. 24, 1970).

with other stockholders. Hence, he does have a financial interest in the subject matter of the case before him.

Initially, it seems nonsensical to treat the latter situation as a conflict of interest. If it were so treated, not much has been accomplished by permitting a judge to invest in common stocks generally because no matter what his specific investments entailed he would be forced to excuse himself. Further, effect on value and identification of interest are more remote. It is not clear whether changes in stock exchange rules, including such things as the type and amount of commissions to be charged, will have any effect on the value of common stocks in general. At most, the effect would be indirect. Moreover, even if a judge did identify himself as a stockholder, he would not be led to favor one side of the case or the other by that fact alone. Some investors would deplore a rules change which others would applaud. More important, any predisposition on the issue is a function of attitudes already developed by the individual through his previous experience as an investor, and that obviously is not within the control of any conflict of interest planning.

The conflict to be avoided is a direct and specific financial relationship to one party in a proceeding before the judge, thereby placing his financial interests at stake in the decision. The type of interest referred to here is not limited, however, to ownership of an interest in a named party. It should include actions involving the interests of a distinct industry in members of which the judge owns stock and knows that he does. Although a particular company in which a judge has invested may not be involved directly, the impact of the issue for decision may be equally severe on all members of the industry. Therefore, if the concern is an individual judge's ability to identify his specific financial interests, then knowledge of the industry in which the investment is made is just as vital as the names of the particular companies.

## II

### MEANS OF DEALING WITH CONFLICTS

There are two basic approaches in dealing with conflicts: (1) resolving a conflict after it has been discovered by some mechanism for determining whether or not a judge should excuse himself from a pending case; (2) in some way separating a judge from his investments so that conflicts will not occur. This paper deals primarily with the latter method, but, because of the prevalence of the former, some discussion of it is necessary.

*Disclosure and excuse.* In a clear case, when a judge is aware that he has a financial interest in one of the litigants in a case pending before him, he can recuse himself and refuse to proceed further with the case. If the case is not so clear, he could disclose the existence of the conflict, and give the parties involved, or an officer of the court, the opportunity to object to his continu-

ing with the case.<sup>13</sup> This procedure would be formalized for federal judges by the proposed Judicial Reform Act.<sup>14</sup> The Act would penalize a judge who participates in a case knowing that he, or a relative or associate, has a financial interest in one of the parties. Exceptions would be made for cases when the interest is insubstantial, or when the judge discloses the interest to a named judicial officer and receives a "ruling" that the interest is "unlikely to affect the integrity" of the decision.<sup>15</sup> Moreover, testimony in the hearings on the Act revealed support for more complete public disclosure of a judge's financial interests, in contrast to the limited disclosure technique proposed in the Act.<sup>16</sup>

The problem with the disclosure method can be illustrated by a recent Fifth Circuit proceeding, *Southern Louisiana Area Rate Cases v. FPC*.<sup>17</sup> At issue was the propriety of an order by the Federal Power Commission reducing rates for natural gas produced from offshore oil fields, and numerous oil companies were parties to the action. During argument before a panel of the Fifth Circuit, on

<sup>13</sup> See *Lampert v. Hollis Music, Inc.*, 105 F. Supp. 3 (S.D.N.Y. 1952); text at note 17 *infra*. See also ABA SPECIAL COMM. ON STANDARDS OF JUDICIAL CONDUCT, INTERIM REPORT § 8(b) [hereinafter cited as ABA INTERIM REP.]: "When . . . disclosure indicates that a judge's interest is insubstantial, he may upon written request by all parties to the proceeding withdraw his disqualification and participate in the proceeding."

<sup>14</sup> S. 1506, 91st Cong., 1st Sess. (1969). See *Hearings on S. 1506, The Judicial Reform Act, and Related Bills, Before the Subcomm. on Improvements in Judicial Machinery of the Senate Comm. on the Judiciary*, 91st Cong., 1st Sess. (1969) [hereinafter cited as 1969 *Hearings*]. Similar proposals were made in the 90th Congress. See *Hearings on S. 3055, The Judicial Reform Act, and Related Bills, Before the Subcomm. on Improvements in Judicial Machinery of the Senate Comm. on the Judiciary*, 90th Cong., 2d Sess. (1968) [hereinafter cited as 1968 *Hearings*]. The two sets of hearings have similar testimony. In addition, there were hearings on November 26 and December 4, 1969, including a statement by Judge Ainsworth on the position of the Judicial Conference, but at this writing these hearings have not been published.

<sup>15</sup> A similar procedure is provided for an executive employee who may apply for a "written determination" by the "Government official responsible for his appointment" that "the [financial] interest is not so substantial as to be deemed likely to affect the integrity of the services the Government may expect from . . . such employee." 18 U.S.C. § 208(b)(1) (1964). An alternative is publication in the *Federal Register* of a general rule that a certain type of interest is "too remote or too inconsequential."

<sup>16</sup> 428 F.2d 407 (5th Cir. 1970). See 1969 *Hearings, supra* note 14, at 117-18 (testimony of Judge Craven), 148-49 (testimony of Senator Case), 163-64 (testimony of Judge Biggs). The disclosure rules of the Judicial Conference do not require disclosure of investments except when the judge has participated in a case knowing that he, his spouse, or a member of his immediate family had a financial interest in any of the named parties. A judge is also requested to disclose whether he engaged in transactions involving the securities or other property of a party of a case pending before him, and to state why he thought it was proper to proceed under such circumstances. See 38 U.S.L.W. 2508, Report Form, questions IV A & B (Mar. 24, 1970). This disclosure occurs only after the fact and appears to be an effort to check the propriety of each judge's actions while leaving the initial decision whether or not to proceed with the case up to his discretion. Exec. Order 11,222, pt. IV, requires the reporting of financial interests by government employees and delegates the authority to issue regulations to the Civil Service Commission. Agency heads are directed to supplement existing standards with their own regulations. Exec. Order No. 11,222, §§ 402, 702, 3 C.F.R. 306, 309, 311 (1965). See 5 C.F.R. § 735, subpart D, for the Civil Service Commission's general regulations. The various department regulations are modelled on their regulation.

<sup>17</sup> 428 F.2d 407 (5th Cir.), *petition for cert. filed*, 39 U.S.L.W. 3104-05 (U.S., Sept. 9, 1970) (Nos. 669, 681-85, 691-92).

October 6, 1969, Judge Warren L. Jones, a member of the panel, disclosed that his wife held stock in oil companies which were parties to the action; he offered to excuse himself should any of the parties object.<sup>18</sup> None did, and the argument proceeded. Subsequently, however, Chief Judge Brown, a second member of the panel, was also found to own oil stocks. On October 10, a letter was sent to all counsel disclosing the interests involved, again inquiring whether there were any objections. Apparently after further discussion among members of the Fifth Circuit bench, the panel excused itself without waiting for objection from any of the parties.<sup>19</sup> Reargument was heard on December 17, 1969, and the case was decided in March.

In a close case, there are two conflicting pressures. On the one hand, there is the desirability of avoiding disruption of a pending case. In the Louisiana rate-making case, the disruption resulted from the need to schedule a second argument on the appeal, with delay to the court and probable increased expense to the parties. The effect would be especially serious in that case because of the voluminous record and the large number of parties participating in the appeal. On the other hand, there is a possibility that the decision in the case will be tainted by the presence of a conflict of interest. Again, the direct financial interest of two of the three judges on the panel in a case of such wide-reaching importance to the oil industry would cause at least the appearance of impropriety. That would be so regardless of whether the individual judges were aware of the existence of the conflict, or were convinced that the fact that they owned some securities in such widely owned concerns would not affect their judgment.

These pressures create a tension which becomes stronger as the disclosure of the conflict comes later in the proceeding, and the disruption becomes greater. In addition, there are strong inhibitions on an attorney to object to the judge's continuing participation in the case, and thereby cast doubt on the judge's fairness. In effect, the judge by announcing from the bench his intention to participate unless a party objects may seem to be declaring that he thinks the conflict is not "substantial" and thus will not affect his impartiality. There are few judges, and it is therefore difficult for an attorney to avoid future contact with that judge. It is not surprising then, that the disclosure and excuse method does not seem to be a satisfactory way of coping with conflicts of interest.<sup>20</sup>

<sup>18</sup> N.Y. Times, Oct. 14, 1969, at 1, col. 2. Reputedly, Chief Judge Brown stated that he hoped no one would object as Judge Jones was the only member of the panel who had read the record.

<sup>19</sup> N.Y. Times, Oct. 22, 1969, at 21, col. 7. Replies to the October 10th letter were requested by October 21st, but the order for reassignment was dated October 17th. Although the *Times* reported that there had been no objections, the court evidently changed its mind without waiting to find out if anyone would object.

<sup>20</sup> One area where the disclosure and excuse system seems to work fairly well is in the area of arbitration. The rules of the American Arbitration Association provide that either party to an arbitration may reject the arbitrator selected by the Association. AM. ARBITRATION ASS'N, COMMERCIAL ARBITRATION R. § 18 (1964); see M. DOMKE, COMMERCIAL ARBITRATION §§ 21.03-04 (1968). Hence, it is easy to eliminate any conflict of interest which might affect the impartiality of an arbitration. Objection to an arbitrator is not analogous to objection to a judge, even when the precise identity of the objector is

Nor is resolution of the problem measurably advanced by conferring responsibility for the decision on an impartial judicial officer, as the Judicial Reform Act would do. The same competing pressures bear on his decision; the chore of deciding whether a colleague's impartiality might be affected by the existence of a conflict, even if by appearance only, seems most unpleasant.

The disclosure method is not designed to prevent conflicts of interest, but to deal with them when they occur. To minimize occurrence, reliance must be placed on the judge's good sense in avoiding investments where a conflict is likely to occur. This depends in turn on the foreseeability of conflicts, and except for obvious situations<sup>21</sup> most financial conflicts cannot be anticipated.

The problem of predicting which investments are likely to result in conflicts is compounded by some other factors. Holdings by a judge in the capacity of trustee, or holdings by close relatives and associates fall within the scope of anti-conflict of interest principles.<sup>22</sup> Since a judge is not apt to be thinking about investments owned by or on behalf of others, the existence of a conflict involving such an investment may not be discovered until late in the proceedings.<sup>23</sup> Even for investments owned by the judge, discovering the existence of a conflict may be very difficult. Corporate conglomerates make corporate ownership arduous to trace; a judge may not know that he is financially interested in a corporation involved in litigation before him because he owns stock in another and seemingly unrelated corporation.<sup>24</sup>

confidential for the simple reason that there are only a limited number of judges. Once an arbitrator has been excused on the request of a party, neither party, nor their attorneys, need have anything more to do with him; this is not true of a judge, who may appear frequently in the affairs of an attorney, or even one of the parties. The latter problem obviously inhibits objections to a judge's participation, in a way very different to objections to an arbitrator.

<sup>21</sup> This would seem to include such investments as ownership of public utility stock by judges before whom rate-making cases occur frequently. See Edwards, *supra* note 3, at 266. The dilemma this poses for judges on courts where industry problems are often litigated is again illustrated by the Fifth Circuit situation, where thirty-seven oil companies were parties to the litigation. Oil companies are likely to be large diversified enterprises; their stocks may be good investments. Yet, it seems desirable for judges on the Fifth Circuit to avoid investment in oil company stocks. Otherwise, it might be difficult to obtain a panel to hear a case like the *Southern Louisiana Rate Cases*.

<sup>22</sup> See ABA INTERIM REPORT, *supra* note 13, at §§ 4(c), 8, including ownership in the capacity of trustee, and ownerships by persons closely related or associated with the judge. The Judicial Reform Act includes the judge's "spouse, minor child, creditor, partner, organization in which he is serving as officer, director, trustee, partner or employee, or any person or organization with whom he is negotiating or has any arrangement concerning prospective employment . . ." S. 1506, 91st Cong., 1st Sess. § 401(a) (1969). Executive conflict of interest statutes likewise include the employee, "his spouse, minor child, partner or employee, or any person or organization with whom he is negotiating or has any arrangement concerning prospective employment . . ." 18 U.S.C.A. § 208(a) (Supp. 1970). See B. MANNING, FEDERAL CONFLICT OF INTEREST LAW 132 (1964); Perkins, *The New Federal Conflict of Interest Law*, 76 HARV. L. REV. 1113, 1131-34 (1963).

<sup>23</sup> Judges are very busy people, and occasionally cannot be aware of all potential conflicts of interest. This recalls Judge Haynsworth's purchase of stock in the Brunswick Corporation after argument and apparently after the decision how to dispose of the case, but before the decision was announced. See *Haynsworth Hearings*, *supra* note 3, at 236-47 (testimony of Hon. Harrison L. Winter). The investment was made on the advice of his investment advisor some time after Judge Haynsworth's active participation in the case had ended, preparation of the opinion having been assigned to Judge Winter. As Judge Haynsworth said, the case "did not enter [his] mind." *Id.* at 270-72.

<sup>24</sup> The "Public Report" form for disclosure to the Judicial Conference provides: "This statement re-

Once a conflict has been identified in time to do something about it without causing major delay, there is a further problem. There does not seem to be much authority supporting the categorical rule inferred from the ABA's interpretation of Canon 29;<sup>25</sup> what authority exists seems to be based on a specific statute rather than a general imperative.<sup>26</sup> To some persons a categorical rule makes little sense, and a *de minimus* exception appears necessary for cases when the judge's financial interest is so minor that it could not affect the integrity of his decision.<sup>27</sup> But where is the dividing line? Trying to decide whether a relatively small interest in a large corporation is substantial or not, or, as the Reform Act would have it, is "not of such a nature as will affect the integrity of any ruling by such judge" is rather difficult. More important, a judge has a duty not to recuse himself unless he is disqualified.<sup>28</sup> Thus, a judge may not avoid sitting without legal excuse even though doing so would be difficult or unpleasant. The judge's duty to perform his office is not diminished because the parties may object. A judge may feel that he should not excuse himself when the financial conflict appears to be minor. Given the time pressures of today's judicial business, the judge may be left to decide the question for himself.<sup>29</sup>

Thus, there are numerous problems with the disclosure technique. On top of this, some judges may feel uncomfortable in disclosing their investments—even to another member of the judicial conference in which they sit. That finding is reported in another paper in this symposium.<sup>30</sup> It is understandable that planning

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lating to 'participation' is in terms of 'knowingly participated' for the following reason: The Conference recognizes that because of the existence of many mutual and diversified investment funds, large conglomerates and trusts having a wide range of investments and affiliates, there may be cases in which a 'named party' may own interests in a corporation, but which ownership is not known to the judge who (or whose spouse or family member in his household) may also be a stockholder of such corporation. The Conference recognizes that without knowledge of such stock ownership by the party, the judge's action could not be affected by this fact. Thus, the report to be made under this requirement relates only to the 'knowing' participation by the judge." 38 U.S.L.W. 2508 (Mar. 24, 1970).

<sup>25</sup> ABA CANONS OF JUDICIAL ETHICS No. 29. See note 1 *supra*.

<sup>26</sup> See, e.g., *Tatum v. Southern Pacific Co.*, 250 Cal. App. 2d 40, 58 Cal. Rptr. 238 (1967) (judge owned stock in defendant corporation as trustee of a testamentary trust). The Canons of Judicial Ethics, and the Formal Opinions of the ABA Committee on Professional Ethics, are more guides to conduct than binding rules. It is unlikely that they would serve as the basis for a reversal on the grounds of judicial misconduct.

<sup>27</sup> See, e.g., *Edwards*, *supra* note 6, at 264-68; UNIVERSITY OF CHICAGO LAW SCHOOL, CONF. ON JUDICIAL ETHICS 14-16 (comment of Hon. Thomas E. Fairchild), 17-24 (comment of Robert L. Stern) (1965).

<sup>28</sup> See, e.g., *Walker v. Bishop*, 408 F.2d 1378 (8th Cir. 1969); cases in *Haynsworth Hearings*, *supra* note 3, at 122 (statement of John P. Frank).

<sup>29</sup> In cases involving disqualification because of alleged personal bias, *Wolfson v. Palmieri*, 396 F.2d 121 (2d Cir. 1968), or because of personal relationship, *Weiss v. Hanna*, 312 F.2d 711 (2d Cir. 1963), *cert. denied*, 374 U.S. 853 (1964), the courts hold that disqualification is properly left to the discretion of the individual judge. The statutory language of section 455 with respect to financial conflicts of interest is not so flexible, although interpretation of "substantial" leaves a lot of room for the exercise of judgment.

<sup>30</sup> See Saeta, *Analysis of a Survey of the Opinions of Trial Court Judges*, 35 LAW & CONTEMP. PROB. 171 (1970).



which minimizes many of the problems discussed above and protects privacy would seem attractive to our judges.

*The barrier technique.* The second technique in dealing with conflicts of interest is to erect a barrier between a judge and his investments to shield him from potential conflicts. The essential ingredient to be screened out is knowledge; if a judge does not know that he is financially interested in the case before him, his judgment cannot be affected.<sup>31</sup> Hence, planning is directed at blinding the judge to his investments. Trusts are the most useful vehicle for this planning because of the flexibility they offer and the existence of a body of law defining the obligations of trustees. Trusts used for this purpose are called "blind trusts."

Simply creating a trust to manage a judge's investments without the additional "blindness" feature does not help in dealing with conflicts. If a judge is financially interested in a party involved in litigation before him, and knows of the interest, it does not matter that his interest is through direct ownership or through a beneficial interest in a trust under which the trustee owns the investment in question.<sup>32</sup> Putting investment decisions in someone else's hands may have significant effects for the grantor; he need no longer concern himself with the active management of his investments, nor need he worry about corporate problems that sometimes come with such investments. For example, he would not take part as a stockholder in the management of the corporations in which he owns stock. But neither that nor the fact that another decided to purchase stock should make a difference if the judge knows that he is beneficially interested in a corporation appearing before him as a party. He stands to benefit from a favorable decision just as much as if he personally had made the investment choice. Of course, the use of a trust for estate planning purposes is often desirable, but such considerations are beyond the scope of this paper.<sup>33</sup>

<sup>31</sup> It may seem self-evident that lack of knowledge prevents the occurrence of a conflict of interest even though the judge does actually own a financial interest in one of the parties to a case before him. The Judicial Conference takes this view, see note 16 *supra*, and the New York Bar Association studies seem to agree. See ASS'N REP. ON CONG. ETHICS, *supra* note 7, at 62-63. However, in the earlier statute on executive conflicts of interest, section 434, there was no explicit requirement of knowledge, and a respectable argument could be made that knowledge was irrelevant. See *Hearings on the Nomination of Robert S. McNamara Before the Senate Comm. on Armed Services*, 87th Cong., 1st Sess. 11-18 (1961) [hereinafter cited as *McNamara Hearing*] (memorandum of John C. Herberg). The present statute, section 208(a), explicitly requires knowledge for disqualification. See MANNING, *supra* note 22, at 133. The federal statute on disqualification of federal judges makes no specific mention of knowledge, and possibly might be interpreted similarly to section 434. Nevertheless, that argument is not likely to be seriously advanced, especially since, in the "blind" barrier technique, neither the judge nor the parties would know of the existence of a conflict, and thus neither could take advantage.

<sup>32</sup> The disclosure rules of the Judicial Conference, see note 24 *supra*, the interim report of the ABA Special Committee, see ABA INTERIM REP., *supra* note 13, at § 8(a), and the federal statute on executive conflicts of interest all include beneficial interests as well as direct interest. Section 208(a) refers only to "a financial interest," and it is assumed that beneficial interests through trusts are included. See MANNING, *supra* note 22; Exec. Order No. 11,222, § 203(a), 3 C.F.R. 306, 307 (1965) (referring to "indirect" interests); and, e.g., 5 C.F.R. §§ 1300.735-24(a)(i)-(iii) (1970) (Standards of Conduct for Bureau of the Budget).

<sup>33</sup> See generally J. FARR, AN ESTATE PLANNER'S HANDBOOK 91-114, 133-64 (3d ed. 1966); J. TRACHT-

Investment in mutual funds has many of the characteristics of setting up a simple trust. Authority to make investments is delegated to a person independent of the judge, who retains only the right to receive the income from his interest in the fund and has the right to cash in his shares. In addition, mutual funds are required by law to report semiannually to shareholders the investments in its portfolio and the changes made in those investments.<sup>34</sup> Suppose the judge owns \$20,000 worth of the stock of mutual fund X, which has invested one per cent of its portfolio in General Motors stock. Why is that interest different from direct ownership of \$200 worth of General Motors stock, assuming that we would be concerned by a conflict involving that amount of stock?<sup>35</sup>

If the judge knows the value of his interest in the fund can be affected by his decision in a case involving one of the companies in which the fund has invested, then clearly there would be a conflict, and we should treat the situation exactly as we would a simple trust. Yet, the executive regulations on conflicts of interest do recognize a difference,<sup>36</sup> some of them specifically permitting investment in mutual funds as a means of avoiding possible disqualification. The ABA Special Committee on Standards of Judicial Conduct recognizes the see-through characteristic of the mutual fund, but it would treat interests held through a mutual fund as a conflict only if the *fund's interest* in the company involved in litigation before the judge was "substantial."<sup>37</sup>

The rationale for different treatment may rest on the character of mutual fund management. A fund manager makes his decisions based on concern for a much larger fund. His decisions, that is, are not made with the judge's interests in mind, which would be true in the case of a personal trust. The impersonal character of the mutual fund is heightened by the fact that investing in mutual funds is an activity engaged in by a vast number of persons. In this sense, that of activity shared with many others, the mutual fund purchase seems comparable to the purchase of un-

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MAN, ESTATE PLANNING 195-99 (1965); Bush, *The Utility of Discretionary Trusts in Estate Planning*, N.Y.U. 26TH INST. ON FED. TAX. 1305 (1968); Casner, *Estate-Planning—Avoidance of Probate*, 60 COLUM. L. REV. 108 (1960); Sharpe, *The Irrevocable Trust: Some Benefits and Risks Compared with Revocable Trust: How to Provide for the Possibility of Statutory and/or Administrative Changes*, N.Y.U. 28TH INST. ON FED. TAX. 941 (1970).

<sup>34</sup> Investment Company Act of 1940, § 30(d), 15 U.S.C. § 80a-30(d) (1964); 17 C.F.R. § 270.30d-1 (1970).

<sup>35</sup> See text at notes 7-11 *supra*.

<sup>36</sup> By section 208(b) of the executive conflicts statute, a type of investment may be exempted from the conflict of interest rule by publication of a general rule in the *Federal Register*. See note 15 *supra*. Departments publishing such a rule exempting interests held through mutual funds include Defense, 32 C.F.R. § 40.735-15(a)(3) (1970); HEW, 45 C.F.R. § 73.735-501(a) (1970); Justice, 28 C.F.R. § 45.735(b) (1970) (but only if the fund's interest in the corporation does not exceed 1 per cent of the value of the fund's assets); Labor, 29 C.F.R. § 0.735-12 (1970) (similar 1 per cent rule); and Transportation, 49 C.F.R. § 99.735, app. A, ¶(a)(1) (1970). An implication of approval may be seen in the confirmation hearing on Douglas Dillon's nomination to be Secretary of the Treasury, when the Finance Committee approved his investment in a regulated investment company. See *Hearing on the Nomination of Douglas Dillon Before the Senate Comm. on Finance*, 87th Cong., 1st Sess. (1961).

<sup>37</sup> ABA INTERIM REP., *supra* note 13, at § 8(b).

identified common stock.<sup>38</sup> There is the further consideration, of course, that a large purchase of stock by the fund may be a very small percentage of the fund's assets—although quite possibly greater than one per cent, the rule of thumb adopted by some executive departments.

It is hard to be categorical about mutual funds. If a judge owns only a moderate amount of any particular fund, then the conflict problem does not appear to be serious, and the judge could plan his investments in mutual funds to stay away from conflicts. Unfortunately, that still requires considerable care in selection and continuing knowledge of what each fund is doing. It may just be too bothersome. Further, if a judge holds a large amount of one fund, so that even small changes in asset values produce significant changes in the value of his holding, the conflict is sufficiently serious to treat the mutual fund the same as a personal trust, regardless of the substantiality of the fund's investment in a particular corporate litigant.

### III

#### THE "BLIND TRUST" FORM

##### *The Objective.*

A "blind trust" is intended to prevent the occurrence of conflicts of interest by preventing knowledge, even though the judge's financial interest may in fact be at stake in the decision. This automatically eliminates some of the difficult problems associated with disclosure—foreseeability, identification, and the necessity of determining the "substantiality" of the conflict. While the judge need no longer be sensitized to the possible existence of a conflict, he must pay a price for that freedom from worry. As will be shown presently, the device is cumbersome and expensive, and carries some unresolved legal questions. Further, it seems inconsistent for the judge who sets up a blind trust not to give up whatever role he may have had as financial adviser and trustee to his family. Otherwise, he retains all of the problems with respect to potential conflicts in their investments which he has attempted to avoid for himself. The avoidance of the family financial role may seem to be a serious detriment when the newly appointed judge had previously been relied upon for advice and direction, and for whom there are no obvious replacements. Naturally, nothing would prevent a judge from using a blind trust for his own investments while he continues to manage some family affairs, but that arrangement disserves the purpose of a blind trust to free the judge from concern over conflicts of interest.

More important, the means by which the blind trust accomplishes its objective is secrecy, which is fundamentally at odds with the ideas supporting disclosure. In the latter situation, if the important persons<sup>39</sup> know what the conflict is, they may

<sup>38</sup> See ASS'N REP. ON CONG. ETHICS, *supra* note 7, at 62.

<sup>39</sup> This statement need not imply general disclosure. "Important person" could include only a judge or other officer of the court from whom a determination might be requested that the conflict is so insubstantial that disqualification is not warranted. See Judicial Reform Act, S. 1506, 91st Cong., 1st Sess.

judge for themselves the extent of the risk that the judge's impartiality might be affected. In the former situation, nobody knows whether there might in fact be a conflict of interest because nothing is revealed.<sup>40</sup> There is no way of checking on the extent of the judge's financial involvement, it being assumed that checking is unnecessary.<sup>41</sup> This is a basic difference in policy, and runs against the grain of current notions of reform, where the emphasis has been on disclosure.

A further assumption is implicit in the use of blind trusts: if no one knows whether a conflict exists, the appearance of evil is avoided as much as the fact. Yet a blind trust is not impervious; it must be administered by people, and people do from time to time disclose confidential information. If the losing party in a case decided by the judge subsequently discovered that the judge had, through his blind trust, a substantial financial interest in the winning party, would he believe that the judge really did not know of that interest? For the blind trust to work, the judge must be ignorant of his investments, yet here a stranger has discovered the existence of the conflict. The feeling that the losing party and the public might have been deceived may actually harm confidence in the integrity of the judicial process more than would a policy of full disclosure.

The conflict between disclosure and secrecy is basic. How is the confidence of our people in their judges best to be maintained—by playing the cards on the table, or by keeping them secret? The question is unanswerable within the confines of this paper since the acceptability of secrecy depends on our willingness to trust our judges and on our readiness to interpret the use of blind trusts as an honest endeavour to avoid accidental conflicts of interest.

### *Some Assumptions and Limitations.*

*Outright gifts.* The initial assumption is that the judge needs to retain the economic benefit of his investments—that is, some means must be found of insulating him from his investments and at the same time permitting him to enjoy the income from them and to retain certain claims to principal. If an outright gift is made, or an irrevocable trust is created for the benefit of others, then the type

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§ 401(a) (1969). Or, in the more general type of disclosure and excuse, the parties to the action. Where disclosure to the parties occurs, there may be general publicity, as happened in the *Southern Louisiana Rate Cases*. See note 18 *supra*. In the latter situation, the cards are laid on the table and the relevant parties can feel confident that they understand what influences may be at work on the judge.

<sup>40</sup> Thus, the really unscrupulous might in fact be helped by the cloak of secrecy thrown around their affairs. Compare the discussion of the impact of disclosure on the affairs of some corrupt federal judges in the testimony on the Judicial Reform Act. 1969 *Hearings*, *supra* note 14, at 105-14.

<sup>41</sup> Lest secrecy be overemphasized, it should be observed that use of a "blind" trust is not inconsistent with requiring disclosure to a specified officer. Thus, the trustee could be asked to file confidential reports with an officer designated to receive them. This permits a limited disclosure policy as suggested by both the Judicial Reform Act and the Judicial Conference. See Judicial Reform Act, S. 1506, 91st Cong., 1st Sess. § 401(a) (1969); 38 U.S.L.W. 2271 (Nov. 1, 1969) (resolution of Judicial Conference to require filing of reports). The panels to review the reports were appointed early in December. See N.Y. Times, Dec. 6, 1969, at 1, col. 5. Authorizing trustees to file these reports would be consistent with current executive practice. See note 16 *supra*.

of planning discussed here can be simplified. The judge's financial interests would no longer be directly at stake and supervision of the property would be transferred to another, without the need for a cumbersome trust. From the context of the discussion,<sup>42</sup> it is clear that an outright transfer does not by itself solve the conflict of interest problem, particularly where the transferee is a close personal relation. Thus, where the property is not readily saleable—such as stock in a family corporation—and the judge does not expect the transferee to dispose of the property, giving it away to wife or children will leave the conflict in a case involving the corporation just as real as if the judge had not given it away. Naturally, in such a situation, the judge would be expected to excuse himself even though his financial interests are no longer directly involved.

While it may be true that outright gifts simplify conflict of interest planning, they frequently do violence to good estate planning.<sup>43</sup> A future change in circumstances, such as serious illness, may make the prospective transferor dependent on his principal. Or a change in personal relationships within the family, or the death of a member of the family, may dictate a change in the ultimate disposition of the judge's estate. Hence, despite substantial tax savings obtainable by inter vivos transfers,<sup>44</sup> it is generally more desirable to retain claims to or control over property to protect against unforeseen changes in circumstance. As a corollary to the basic assumption stated at the beginning of this paper, a judge should not be compelled to forego sound estate planning to reduce the possibility of conflicts of interest.

*Benefits retained and other dispositive provisions.* The principal benefit retained by the judge would be the right to receive the income from the assets transferred to the trust. Furthermore, he should have the right to demand principal at his option by requesting a sum stated in dollars. Other controls over the dispositive provisions of the trust, such as the power to amend and a testamentary general power of appointment, are desirable, especially since the planning under discussion here does not permit the saving of income or estate taxes. In that light, it is not necessary that the trust itself contain dispositive provisions other than a direction to transfer principal on termination, usually the time of the judge's death. Proliferating the trusts through which one's estate will pass may not be a good idea,<sup>45</sup> but the blind trust

<sup>42</sup> See note 22 *supra*.

<sup>43</sup> For typical warnings, see FARR, *supra* note 33, at 99-100; TRACHTMAN, *supra* note 33, at 173.

<sup>44</sup> The federal gift tax rates are three-fourths of the federal estate tax rates. Further, the two tax systems are independent, which means that a well-devised program of lifetime giving can take advantage of two sets of exclusions and exemptions, as well as two independent sets of rates. In effect, a life-time gift may be a transfer from the highest estate tax bracket to a much lower gift tax bracket. This effect may be compounded by a transfer of potential appreciation from the grantor's estate to those of his beneficiaries. This ignores the impact of state taxes, which may also offer substantial savings. See also Yoblen, *An Effective Gift Program: What to Give and When to Give It*, 24 J. TAX. 355 (1966).

<sup>45</sup> Sometimes multiple trusts are useful for tax reasons. See Bush, *Multiple Trusts: Still a Valid and Valuable Estate Planning Tool*, N.Y.U. 28TH INST. ON FED. TAX. 923 (1970). The suggestion in the text refers to simplicity of a person's estate plan. It is too easy to forget provisions in trust instruments incorporated by reference.

serves such a specialized function that a more familiar form of trust may be a more comfortable means of providing for ultimate disposition of the estate.

Some control over the actions of the trustee may also seem desirable. Thus, the judge could retain the power to revoke the trust, or some more limited power such as the power to substitute trustees. Retention of such a broad power would not compromise the security of the trust unless exercised, and then the judge should be required to inform some interested party of his intention to exercise any of the powers.<sup>46</sup> That would require disclosure of the termination of the trust arrangement. Because of tax expense, as well as other expense, revocation of a blind trust is not a good idea if the judge intends to establish a new blind trust.

*A caveat.* The blind trust is not a cure-all. It can only be used under certain circumstances, the most important of which is the existence of a balanced portfolio which can be reinvested with relative ease. A large asset which cannot be disposed of, and which the judge knows will probably be retained by the trustee, would defeat the purpose of a blind trust. That is, the blind trust is not simply a segregation of assets by a peculiar form of trust vehicle; it connotes the judge's ignorance of *both* the assets originally comprising the trust principal *and* the trustee's reinvestment decisions.

A blind trust is also a complicated and expensive arrangement. When a judge does not have many assets, or they are mainly non-liquid, such as real estate, a blind trust may be a bad idea. In that case, investment in selected mutual funds may be more desirable. The conflict of interest problem would still exist for that judge as for the others, but the blind trust may simply be too expensive to be worth it. It is a planning technique and should be carefully considered in light of each judge's particular situation before a decision to use it is made.

#### *Background—Executive Practice.*

When matters of personal financial interest are involved, the executive conflict of interest statute specifically requires knowledge before the employee can be penalized for acting on matters in which he is interested.<sup>47</sup> As some authorities have suggested,<sup>48</sup> and as federal regulations imply,<sup>49</sup> a blind trust might be a satis-

<sup>46</sup> When this problem arose in the hearing on the confirmation of Robert McNamara's nomination to be Secretary of Defense, the Senate Armed Services Committee requested a provision in the trust instrument requiring notification of the Committee of any alteration or the revocation of the trust. See *McNamara Hearing*, *supra* note 31, at 5-6.

<sup>47</sup> See note 31 *supra*.

<sup>48</sup> See N.Y.C. BAR ASS'N SPECIAL COMM. ON THE FEDERAL CONFLICT OF INTEREST LAWS, CONFLICT OF INTEREST AND FEDERAL SERVICE 249-50 (1960); ASS'N REP. CONG. ETHICS, *supra* note 7, at 62; Perkins, *supra* note 22, at 1134.

In a press conference on the nomination of Judge Haynsworth to be an associate justice of the Supreme Court, President Nixon specifically referred to blind trusts: "I don't happen to think that blind trusts, particularly in the public mind, are going to remove [conflict of interest] questions." 5 WEEKLY COMP. PRES. DOC., No. 43, at 1445 (Oct. 27, 1969).

<sup>49</sup> Although knowledge of a conflict of interest is necessary for a violation of section 208(a) to occur, Executive Order No. 11,222, and the Civil Service regulations thereunder, require disclosure of all

factory method for executive employees to cope with statutory inhibitions on their investments. While there appears to have been some experience with blind trusts for executives,<sup>50</sup> such trusts are not very often used.<sup>51</sup> The reasons for such a limited experience include the expense and inconvenience of setting up a blind trust, as well as the nature of the job and the predictability of investments which are likely to produce conflicts.

If a man is hired to work in a specific department, he can fairly accurately foresee the type of company with which he is most likely to be involved in his official capacity. This means that he can set an investment policy which may effectively avoid conflicts, without the need for planning devices such as blind trusts. Further, the executive acts in a policy-making area; he is often selected for his expertise in the area of concern<sup>52</sup>—and sometimes, perhaps, also for the views he has previously

financial interests. See note 16 *supra*. However, alternative filing of financial information by persons other than the employee, such as the trustee of a blind trust, is permitted, although a "blind trust" is not referred to by name: "In the event any information required to be included in a statement required by . . . this part is not known to the person required to submit such statement but is known to other persons, the person concerned shall request such other persons to submit the required information on his behalf." Exec. Order No. 11,222, § 403(b), 3 C.F.R. 306, 309 (1965). See also, e.g., 31 C.F.R. § 0.735-77 (1970) (Treasury Department). The Department of Transportation specifically approves "blind trusts" by name, 49 C.F.R. § 99.735-15(h) (1970), but requires the trustee to file the necessary information. 49 C.F.R. § 99.735-39 (1970).

<sup>50</sup> Apparently, the first reference to use of a trust to avoid or mitigate conflicts of interest is found in the confirmation hearings of John McCone to be Chairman of the Atomic Energy Commission in 1958. See *Hearings on the Nomination of John A. McCone Before the Senate Section of the Joint Comm. on Atomic Energy*, 85th Cong., 2d Sess. 3-7, 19-21 (1958). That trust was not a blind trust, but rather was intended to remove Mr. McCone from voting control of companies whose stock he could not sell. In this respect it resembles the trust set up by David Packard for control of his interest in Hewlett-Packard Corp., which of course was not a blind trust either, since there never was any intention to have the trustee sell any of the Hewlett-Packard stock. See *Hearings on the Nominations of Laird, Packard, and Darden Before the Senate Comm. on Armed Forces*, 91st Cong., 1st Sess. 42-47 (1969). Mr. McNamara's trust was "blind" except for certain tax information. See *McNamara Hearing*, *supra* note 31, at 11-12. Since that time, there have been occasional references to conflict of interest arrangements in confirmation hearings—see, e.g., *Hearings on Nominations Before the Senate Comm. on Finance*, 87th Cong., 1st Sess. 7-8 (1961)—without any indication of the terms of the trust. Only one blind trust was found (for Henry Kearns, President of the Export-Import Bank). *Hearings on the Nominations of Carlos C. Villarreal, Henry Kearns, and Preston Martin Before the Senate Comm. on Banking and Currency*, 91st Cong., 1st Sess. 9-27 (1969) [hereinafter cited as *Kearns Hearings*].

<sup>51</sup> The writer made an informal check of various law firms in Washington, D.C., and New York City to discover whether there was much experience with blind trusts. The firms covered were relatively few in number but were likely to have had some experience with estate planning for public officials. With one exception, the response was negative. Moreover, a rapid check of executive confirmation hearings in 1969 turned up no blind trusts other than the Kearns trust. It may be that some executive employees not subject to the confirmations process have used blind trusts, or that the hearings on others did not report the terms of the trusts. Some Washington banks reported that they did handle blind trusts for executive employees but not many. This hasty and incomplete survey could not give an accurate count of the actual number of blind trusts in use, but it does emphasize their rarity. It is also worth noting that research did not uncover anything written to date, even in the treatises, which focuses on blind trusts.

<sup>52</sup> This is the justification for confirming the nomination of men like Mr. Packard, who, despite his generous gift of the income from, and the appreciation in the value of, his Hewlett-Packard stock, did remain interested in the stock. It is clear from the hearing, and the debate in the Senate, that principal reliance was placed on Mr. Packard's integrity, rather than on the efficacy of his avoiding

expressed. A judge has to be impartial, and thus has less tolerance in coping with conflicts of interest.

A blind trust established for an executive employee would in some ways parallel the type of trust usable for judges. Thus, the trust instrument would declare its purpose to be the entrusting of investment decisions to the trustee, and would direct the trustee not to disclose to the grantor any of the assets in the trust, notwithstanding any contrary rule.<sup>53</sup> The trustee is required to prepare and file the grantor's personal income tax returns, withholding from distributions of the trust's net income amounts sufficient to pay the grantor's tax, and further to participate in the audit of the grantor's tax returns during the term of the trust with the authority to compromise the grantor's tax liability.<sup>54</sup> Since an executive employee is in office usually for a limited time, the trust would terminate at the end of the grantor's term of office, at which time the trustee would render a final accounting.

The most significant difference between the situation of an executive employee and that of a judge is length of the term of office. An executive officer usually serves only a limited time, but the appointment of a judge is indefinite. Thus, many of the trust problems can be glossed over in executive trusts, particularly the provision for an accounting. These problems cause increasing concern as the term of office—and of the trust—lengthens.

#### IV

##### PROBLEMS IN BLIND TRUSTS FOR JUDGES

No case was uncovered in which a blind trust was actually established for a judge, although they may very well exist. The reasons for this are many. Apart from the emphasis on disclosure as the means of coping with judicial conflicts of interest, the trust requires considerable personal inconvenience. After all, who likes to give another a blank check to file his tax returns for the indefinite future, let alone control investments, and so on? Use of the trust is also expensive. To these objections must be added questions about the legal validity of a blind trust and its adequacy to accomplish the purpose assigned to it.

potential conflicts of interest through his trust, which perhaps is as it should be. 115 CONG. REC. 1673-84 (1969).

<sup>53</sup> The trust for Henry Kearns appears to be a representative example of what such a trust would be. See *Kearns Hearings*, *supra* note 50, at 24-27. Item 4 of the trust gives the trustee discretion to determine whether any of the assets originally transferred to the trustee are to be sold, and if so, when. Informally, I was advised that the general policy on such matters was not to sell the original assets unless doing so would be consistent with the trustee's investment policy. Of course, the grantor would not know when any such sale took place because the transaction would be reported on an income tax return prepared and filed by the trustee. Nevertheless, the position taken in this paper is that the policy of retention is not consistent with the use of a blind trust, particularly where the assets contributed to the trust were blue chip stocks and the grantor knew the amount of income expected from them. See text at notes 57-61 *infra*. The trustee's powers in the Kearns trust appear to be standard trustee's powers.

<sup>54</sup> The preparation and filing of tax returns would be done under a power of attorney. See *Treas. Reg. § 31.6011(a)-7(a)* (1960). The authorization to file returns would include filing reports on financial interests in connection with executive employment. See note 49 *supra*.



Successful use of a blind trust to avoid conflicts of interest involves three major problem areas: (1) complete reinvestment of the judge's portfolio; (2) lodging broad discretion in a trustee to make reinvestments of the trustee's choice without informing the judge, let alone giving him any controls over investment decisions of the trustee; and (3) finding some means of satisfying the trustee's duty to account. Apart from the basic legal and practical problems these requirements present, the tax situation is a further complication when the judge is the primary beneficiary of the trust.<sup>55</sup> There are two types of tax problems to be discussed: (1) the tax cost of creating and operating the trust and (2) the question of disclosure for the purpose of filing tax returns. The former is a question of whether the judge is willing to pay the cost of using the device, while the latter increases the difficulty in preserving the "blindness" of the trust. The tax problems will be discussed in the context of the other problem areas.

*Reinvestment.* The basic precept of the blind trust is the beneficiary's lack of knowledge of the trust assets. If the beneficiary is also the settlor and knows what has been contributed to the trust, this precept is violated at the outset. Hence, it is not enough that the judge be ignorant of the trustee's investment policy; he must also understand that the trustee is expected to sell the trust assets promptly—if the judge has not done so prior to creating the trust—and reinvest the proceeds.<sup>56</sup> Yet, this produces an initial cost which clearly inhibits the use of these devices and may seem to many to be an unwarranted penalty for the honor of assuming public office.

In the first place, if the assets have appreciated in value, there will be a tax to pay on the gain.<sup>57</sup> Since the trust would be a grantor trust, the tax increases the grantor's own tax liability, even when the assets are sold by the trustee after creation of the trust. Indeed, changes by the Tax Reform Act of 1969 in the treatment of capital gains increase this cost still further in situations where there is none of the tax avoidance potential at which the Reform Act was directed.<sup>58</sup> If the assets

<sup>55</sup> For tax purposes, the grantor of a trust is treated as the owner of the assets held by the trustee if the income "is, or, in the discretion of the grantor or a nonadverse party, or both, may be . . . distributed to the grantor . . ." INT. REV. CODE OF 1954 § 677(a)(1). In tax jargon, the trust is a "grantor trust." Items of income and deduction attributable to trust property must be reported on the grantor's individual income tax return. INT. REV. CODE OF 1954 § 671.

<sup>56</sup> There is a further problem in assuring confidentiality in making investments. The stock exchange requires its members to know the identity of their customers. N.Y. Stock Exch. R. Nos. 405, 406, 2 CCH N.Y. STOCK EXCH. GUIDE ¶¶ 2405, 2406. Rule 406(1) permits transactions to be made by numbered account if the broker has on file a record of the identity of the client. Thus, confidentiality of the trust can be preserved if the trustee makes arrangements for a numbered account.

<sup>57</sup> In the usual case, if the investment had been held for more than six months, the tax would be a capital gains tax. This discussion of tax liabilities focuses exclusively on federal taxes, because federal taxes are more significant than state taxes and because federal tax provisions are more complex. Of course, there is often a state income tax cost to be paid as well. For a good summary, see Committee on Taxation of Trust Income, ABA Section of Real Prop., Prob., & Trust Law, *State Taxation of Trust Income*, 2 REAL PROP., PROB. & TRUST J. 141 (1967).

<sup>58</sup> Under the 1969 amendments, the maximum capital gains tax on gains of individuals in excess of \$25,000 during any one year (or \$50,000 on a joint return) is increased. The increased tax is computed

have decreased in value, resulting in a net loss on sale, there may still be a tax cost. Capital losses are not deductible in full, and deductions for capital losses are subject to annual limitations which may cause loss of any tax benefit for some of the losses.<sup>59</sup> Further, a rollover of depreciated assets will reduce the grantor's tax basis—even if the trustee reinvests the proceeds in similar investments<sup>60</sup>—and possibly increase tax liabilities in the future.

Apart from the tax cost, there may be a financial deterrent when an investment is sold. This may result from a sale of a security at the wrong time—when, for example, the security has reached the bottom of a price decline. In other words, the basic requirement of the blind trust forces reinvestment decisions which may be unwarranted given the condition of the securities market, or, at the least, unnecessary from a financial planning standpoint.<sup>61</sup> Even when balanced portfolios are involved, forced reinvestment decisions will always generate some cost. There are brokers' commissions, transfer taxes, trustees' fees, and related charges to be paid, not to mention the potential tax liability. It is no wonder that prominent persons in this position are reluctant to wade into a blind trust.

*Trustee discretion.* Whenever assets are transferred in trust to a trustee, the trustee assumes the burden of making investments. While his authority stems from the trust instrument, the law imposes duties on him, particularly, for our purposes, the duty to care for the trust property as would a prudent person with respect to

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without the benefit of an alternative capital gains tax (with its 25 per cent maximum rate), although the alternative tax is retained for the first \$25,000 of capital gains (or \$50,000 as the case may be). INT. REV. CODE OF 1954, §§ 1201(b)-(c). For a discussion of the mechanics, see Hariton, *Capital Gains and Losses: Act Sections 511, 513-516*, N.Y.U. 28TH INST. ON FED. TAX. 41, 48-52 (Tax Reform Act Supp. 1970). In addition, the section 1202 deduction (50 per cent of long term capital gain) is a tax preference item. INT. REV. CODE OF 1954, § 57(a)(9)(A). Both of these provisions can materially increase the tax on large capital gains realized in one taxable year by an individual. The purpose in enacting such provisions was to inhibit tax avoidance by wealthy persons who could convert income into capital gains. See, e.g., S. REP. No. 552, 91ST CONG., 1ST SESS. 190-92 (1969).

<sup>59</sup> A capital loss is deductible only from capital gains, or from ordinary income to the extent of \$1000, or the amount of the short term loss plus one-half the long term loss, whichever is less. INT. REV. CODE OF 1954, § 1211(b)(1). The nondeductible loss may be carried forward and treated as capital losses in future years, but in those years it is subject to the same limitations on deductibility. INT. REV. CODE OF 1954, § 1212(b). Thus, a large loss might never be deductible or at least, the tax benefit derived from deductibility would be postponed.

<sup>60</sup> If the stock or securities acquired are "substantially identical" to the stock or securities sold, and the acquisition takes place within 30 days preceding the sale or within 30 days following the sale, the transactions is a "wash sale." The loss is disallowed, and the basis of the acquired stock or securities is the same as that of the stock or securities sold, adjusted for differences in price. INT. REV. CODE OF 1954, § 1091. In the loss situation, the trustee may consider making a "wash sale" deliberately to prevent reduction in basis when the asset could be held with reasonable prospects for its appreciation in value, and when the loss could not be absorbed by gains in the near future. Query whether this would comply with a direction in the trust instrument to sell and reinvest or with the purpose to camouflage the assets in the trust. If a "wash sale" were in the best interests of the trust, and affected only a portion of the assets originally contributed to the trust, it would seem that the trustee could do it.

<sup>61</sup> A reasonable period of time for making reinvestments could prevent or minimize such losses as well as permit lengthening the holding period for tax purposes to six months and is certainly consistent with the purposes of the trust. In most cases, haste would not be important, although there should be, in fact, reinvestment of the original assets.

his own affairs and to make the trust assets productive.<sup>62</sup> A trustee failing in this duty may be surcharged for losses incurred on investments which were improper when made or which were retained by the trustee past the time when a prudent man, acting as he would in his own affairs, would have sold them. The possibility of liability and imposition of legal restrictions on the making of investments has led generally to a conservative investment policy, with some concern for ways of broadening investment considerations.<sup>63</sup> The grantor may modify the trustee's duty to confer discretion in making a wider range of investments<sup>64</sup> and in a trust with an indefinite term, such as the blind trusts under discussion here, it is usually wise to give the trustee discretion to make a variety of investments.

The risk of making investments is always placed on the trustee. That risk may be minimized in various ways, such as by broadening the trustee's discretion, by conferring the authority to make investment decisions on someone other than the trustee, or by providing an exculpatory provision against certain kinds of liability.<sup>65</sup> Nevertheless, the duties imposed by law cannot be abrogated if the transfer was

<sup>62</sup> See RESTATEMENT (SECOND) OF TRUSTS §§ 174, 181, 227 (1959); G. BOGERT, TRUSTS & TRUSTEES §§ 611-12 (2d ed. Supp. 1970) [hereinafter cited as BOGERT]; W. NOSSAMAN, TRUST ADMINISTRATION AND TAXATION §§ 27.02, -21 (Supp. 1969) [hereinafter cited as NOSSAMAN]; A. SCOTT, TRUSTS, §§ 174, 181, 227 (3d ed. Supp. 1970) [hereinafter cited as SCOTT]. The writing on the duties of trustees is voluminous, and only generalized statements are possible in the context of this article. Indeed, a great deal of law on control over trustee investments is statutory. See BOGERT §§ 615-63. For summary of the various duties imposed on trustees under general principles, see Subcomm. on Trust Administration and Accountability of Trustees, ABA Section of Real Prop., Prob., and Trust Law, *Outer Limits of Trustee Powers* (1962), in 3 WINARD, *supra* note 6, at 1017. Application of the "prudent man" rule might require the trustee to diversify the assets of the trust. See RESTATEMENT (SECOND) OF TRUSTS § 228 (1959); BOGERT 414-18; Annot., 24 A.L.R.3d 730-64 (1969). Hence, trust law, even in the absence of specific directives in the trust, might require the trustee to achieve one purpose of a "blind trust"—to maintain a balanced portfolio. Indeed, if a trustee with special investment skill is appointed, such as an investment management firm, a special standard of skill commensurate with the professional standing of the trustee might be required. See RESTATEMENT (SECOND) OF TRUSTS § 174, comment *d*, at 227 (1959); SCOTT § 174.1; NOSSAMAN § 27.21 [2].

<sup>63</sup> See 61 MICH. L. REV. 1545 (1963); authorities cited note 62 *supra*. Some recent developments in the statutory area seem to be relaxing restrictions on trustees' powers. See Berall, *Fiduciary Powers Statutes*, 108 TRUSTS & ESTATES 243 (1969); Haskell, *Some Problems with the Uniform Trustees' Powers Act*, 32 LAW & CONTEMP. PROB. 168 (1967).

<sup>64</sup> See, e.g., RESTATEMENT (SECOND) OF TRUSTS § 227(c), comments *q-w* (1959); SCOTT § 227.14. Generally, it is said that a trustee has only such powers as are conferred on him by the terms of the trust. RESTATEMENT (SECOND) OF TRUSTS § 186(a) (1959). The grantor may make the terms as broad as he wishes, conferring complete discretion on the trustee in their exercise. This does not abrogate the restrictions imposed by law on what a trustee can do, but limits control by the courts to abuse of discretion. See RESTATEMENT (SECOND) OF TRUSTS § 187 (1959).

<sup>65</sup> These matters are interrelated. As the trustee's discretion is broadened, the matters covered by the exculpatory clause are also broadened. See RESTATEMENT (SECOND) OF TRUSTS § 222, comment *c* (1959); SCOTT § 222.1. It has been observed that the prevailing attitude is to disparage exculpatory clauses, and attempt to find means of avoidance. See, e.g., Comm. on Trust Administration and Accounting, ABA Section of Real Prop., Prob., and Trust Law, *Exculpatory Clauses—Their Legal Significance*, 1 REAL PROP., PROB. & TRUST J. 530 (1966) [hereinafter cited as *Report on Exculpatory Clauses*]. One technique is to find an action by the trustee not to be within the powers granted to him in the trust instrument, and therefore not covered by the exculpatory clause. See *Ripsey v. Denver United States Nat'l Bank*, 273 F. Supp. 718 (D. Colo. 1967) (private sale of minority interest in *Denver Post*); BOGERT § 542.

really intended to be in trust.<sup>66</sup> Therefore, protection of the trustee—and the beneficiaries—lies in the method of supervision and approval, a matter dealt with below. This problem is not different from that raised by ordinary, visible trusts, except that the grantor-beneficiary cannot discern what is occurring in the management of the trust. Investment guidelines can be set forth in the trust instrument, but the basic point is the grantor's inability to supervise personally the management of the trust assets.<sup>67</sup>

Another method of retaining some control over investment policy is to require the trustee to accept the direction of some third person.<sup>68</sup> The "investment advisor" might, for example, be a trusted friend or relative whose advice the grantor had valued before the trust was established. There are problems with giving a power of control to someone other than the trustee, including a complicated question of liability.<sup>69</sup> The trustee would have the duty of checking to see if the directions of the advisor, not beneficially interested in the trust, are appropriate; further, the advisor, who would be a fiduciary, also has duties not unlike those of a trustee with respect to the making of investments. This requires careful drafting to define the separate responsibilities of trustee and advisor. The problems adverted to above make it inadvisable to use advisors except for some special purpose, and where management of a balanced portfolio is concerned, resort to an advisor may not be worth the trouble.

On the other hand, the fact that two fiduciaries are responsible for the investment decisions may prove to be a benefit where the grantor-beneficiary is precluded by the purpose of the trust from exercising any degree of supervision over management of the trust assets. Thus, the duty of the trustee to check on the decisions of the advisor may give added confidence to the grantor that the fund is being adequately managed. This, coupled with perhaps special confidence in the person selected as advisor, might overcome the clumsiness of an arrangement that requires two persons to act on each investment decision.

Regardless of the techniques available for keeping some control over investment policy, there is precious little the grantor can do to supervise the investment of his resources. That situation is not palatable for most persons.<sup>70</sup> It deprives the grantor-

<sup>66</sup> See, e.g., BOGERT § 542, at 471-73.

<sup>67</sup> For example, guidelines of this type were inserted in the trust for Robert McNamara because of the Senate Committee's concern that lack of knowledge would not prevent application of the conflict of interest statute. Hence, the trustee was directed not to invest in defense industries. See *McNamara Hearing*, *supra* note 31, at 9-10.

<sup>68</sup> For discussions of the duties and liabilities of investment advisors, see Comm. on Trust Administration and Accountability of Trustees, ABA Section of Real Prop., Prob., and Trust Law, *Responsibility of Investment Advisors*, 103 TRUSTS & ESTATES 1002 (1964), reprinted in 3 WINARD, *supra* note 6, at 1354; Brennan, *Trustee and Investment Advisor*, 100 TRUSTS & ESTATES 243 (1961); Note, *Directory Trusts and the Exculpatory Clause*, 65 COLUM. L. REV. 138 (1965); Note, *Trust Advisors*, 78 HARV. L. REV. 1230 (1965). The McNamara trust required the trustee to follow the directions of an investment advisor. See *McNamara Hearing*, *supra* note 31, at 10-11.

<sup>69</sup> See, e.g., *Report on Exculpatory Clauses*, *supra* note 65, at 536-39; Brennan, *supra* note 68.

<sup>70</sup> See, e.g., 100 TRUSTS & ESTATES 93-94 (1961).

beneficiary of flexibility in arranging his financial affairs and gives that function to someone else who may not share the same objectives, however carefully those objectives may be set forth in the trust instrument. Where balanced portfolios are concerned, this problem may not be too serious financially—and in some cases it may even be a better course of action as a matter of financial planning—but it is a psychological detriment for the grantor to be placed at such a disadvantage with respect to his own personal wealth. It is one thing to receive investment advice from one whose skill is respected; it is quite another to give up all possibility of correcting or controlling decisions made on the basis of such advice.

*The duty to account.* One of the basic duties of a trustee is the duty to account—the duty to disclose to those persons who are beneficially interested in the trust the actions taken by the trustee.<sup>71</sup> This duty serves two purposes: (1) it enables the beneficiaries to supervise the activities of the trustee and (2) it provides the trustee with the means to obtain release from liability for the period of time covered by the accounting. Discharge of the duty rests on disclosure; concealment simply cannot satisfy either purpose.<sup>72</sup> Yet disclosure to the beneficiary, who is also the judge, defeats the purpose of the trust. For the blind trust to work, then, some means must be found to satisfy the duty to account.

There are two aspects of the problem. In the first place, it may be possible to reduce the liability of the trustee through broadening his discretion and through exculpatory clauses in the trust instrument.<sup>73</sup> Under general principles, clauses completely relieving the trustee of liability—and therefore of the duty to account—are contrary to public policy.<sup>74</sup> In that case, the trustee could do exactly as he pleased, with no worry about supervision, an arrangement which can scarcely be called a “trust.”<sup>75</sup> Yet, it also seems clear that a trustee may be relieved of liability for certain kinds of fault. Clauses providing that the trustee would not be liable except for loss due to gross negligence, fraud, and concealment have been held to be effective so long as the grantor’s intention to exculpate

<sup>71</sup> RESTATEMENT (SECOND) OF TRUSTS § 172 (1959); BOGERT § 961; NOSSAMAN § 27.26; SCOTT §§ 172, 172.1, 173; Comm. on Trust Administration and Accountability of Trustees, ABA Section of Real Prop., Prob., and Trust Law, *Settling the Trustee's Accounts: Why, When, How, and Where* (1963), in 3 WINARD, *supra* note 6, at 1387.

<sup>72</sup> See, e.g., RESTATEMENT (SECOND) OF TRUSTS § 216(2)(b) (1959); SCOTT §§ 216.3, 219.2. See generally BOGERT § 974; Subcomm. of Comm. on Trust Administration and Accounting, ABA Section of Real Prop., Prob., and Trust Law, *Limiting Future Actions After Trust Account Approval*, 2 REAL PROP., PROB. & TRUST J. 503 (1967) [hereinafter cited as *Report on Trust Accounts*].

<sup>73</sup> See note 65 *supra*. Exculpatory clauses are discussed also in NOSSAMAN § 28.21; Cronin, *Effectiveness of Exculpatory Clauses*, 98 TRUSTS & ESTATES 1147 (1959); Note, *Directory Trusts and the Exculpatory Clause*, 65 COLUM. L. REV. 138 (1965).

<sup>74</sup> RESTATEMENT (SECOND) OF TRUSTS § 222(2), comment *b* (1959); BOGERT § 542, at 471; SCOTT § 222.3.

<sup>75</sup> See BOGERT § 973, at 252-53: “A settlor who attempts to create a trust without court accountability in the trustee is contradicting himself. A trust necessarily means rights in the cestui, enforceable in equity. If the trustee cannot be called to account, the cestui cannot force the trustee to any particular line of conduct with regard to the trust property or sue for breach of trust. The trustee may do as he likes with the property, and the cestui is without remedy.”

the trustee is absolutely clear, and the grantor was aware of the nature of the clause when he created the trust.<sup>76</sup> Thus, there is a range within which the trustee can be relieved of liability, but great care must be taken to assure the effectiveness of such a clause.

In the second place, the duty to account for inter vivos trusts may be satisfied in informal ways.<sup>77</sup> If the method is set forth in the trust instrument, a trustee may disclose the transactions he has made to the beneficiaries without the necessity of a court action, and obtain release from liability. One purpose for using an informal method is to avoid the expense and publicity which may result from a judicial proceeding. Certainly, the latter problem in a blind trust would be a compelling reason for using an informal accounting.

There is some question about the efficacy of informal accountings, however, particularly when not all beneficiaries know of the accounting or the transactions reported therein.<sup>78</sup> Since silence does not imply approval, written releases or some other affirmance from the beneficiaries is important to protect the trustee from future actions dealing with transactions taking place during the period for which an informal accounting is made.<sup>79</sup> Where a release is sought from one beneficiary, it may well be binding on the others where that beneficiary has the power to terminate the trust, or has a general power of appointment.<sup>80</sup> The reasoning would be that the beneficiary in question has the power to dispose of the trust principal, and a release for transactions in which loss has occurred is a form of disposition. That reasoning is more compelling if the beneficiary is also the grantor, and the trust instrument clearly states the grantor's intention to permit informal settlement of accounts.<sup>81</sup> Hence, if the release is effective to bind the grantor, it should also bind the other beneficiaries.

Discussions of informal accountings focus on accountings made with beneficiaries of the trust. Suppose, however, that an unrelated third party is appointed, or hired by the grantor, to make the accountings on his behalf. Serious questions are raised whether this arrangement could effectively settle the trustee's accounts.<sup>82</sup> A third

<sup>76</sup> See *Dill v. Boston Safe Deposit & Trust Co.*, 343 Mass. 97, 175 N.E.2d 911 (1961); RESTATEMENT (SECOND) OF TRUSTS § 222, comment *d* (1959); SCOTT § 222.4; *Report on Exculpatory Clauses*, *supra* note 65, at 540.

<sup>77</sup> RESTATEMENT (SECOND) OF TRUSTS § 172, comment *d* (1959). See *Report on Trust Accounts*, *supra* note 72, at 512-23; Chaffin, *Some Problems in Providing for Nonjudicial Settlement of the Trustee's Accounts*, 3 GA. STATE B.J. 417 (1967); Westfall, *Nonjudicial Settlement of Trustees' Accounts*, 71 HARV. L. REV. 40 (1957).

<sup>78</sup> A beneficiary is not bound by an accounting of which he has no notice, nor of transactions not disclosed by the trustee's report. See authorities cited note 72 *supra*; BOGERT § 941, at 389-93, § 942, at 401-04.

<sup>79</sup> See *Report on Trust Accounts*, *supra* note 72, at 515-17.

<sup>80</sup> RESTATEMENT (SECOND) OF TRUSTS § 216, comments *g-h* (1959); SCOTT § 216.2. But see *Report on Trust Accounts*, *supra* note 72, 517-20, reporting considerable doubt on the matter.

<sup>81</sup> See RESTATEMENT (SECOND) OF TRUSTS § 216 comment *i* (1959).

<sup>82</sup> See *Report on Trust Accounts*, *supra* note 72, at 518; Westfall, *supra* note 77. As Professor Westfall observes, the typical situation occurs when the beneficiary is a minor and the non-beneficiary some close relative. When the relationship between the grantor-beneficiary and the non-beneficiary auditor is gov-

party would have no interest in enforcing the trust, and this might result in losses to a beneficiary without his ever being able to object. That result runs against the grain of existing trust principles, yet if appointment of a surrogate serves some strong objective—maintaining the security of a trust the only justification for the existence of which is its “blindness”—and the surrogate is beholden to the grantor-beneficiary who has retained the power to terminate the trust, what purpose is served by forbidding the effectiveness of the arrangement in protecting the trustee?

Suppose that an auditor is employed by the grantor for the purpose of receiving the accounts of the trustee and approving them. The auditor should probably be a professional—a firm of certified public accountants would be satisfactory—and should be independent of the trustee. This would assure careful supervision and continuity, and naturally the grantor could retain the authority to fire the auditor should relations become strained between them. The trust instrument would specifically require the trustee to file accounts on a regular basis with the auditor, and would provide that the approval of the auditor would constitute a full release of the trustee from liability for the transactions disclosed in the trustee’s report. The employment relationship would be negotiated independently from the trust, and would call for compensation to be paid by the grantor. This leaves three questions: will it be legally effective, what happens if the auditor finds something wrong, and what is the duty of the auditor?

The suggestion appears to be novel. It may be that in prior situations, substitution of a third person for the real beneficiary was not done for strong enough reasons. An analogy may be seen in the method for protecting the interests of persons who are not sui juris—the appointment of a guardian.<sup>83</sup> This method is court supervised, and is intended to prevent the overreaching of persons who are not able to protect themselves. Thus, appointment of guardians might be thought necessary because the person whose interest is to be protected could not effectively choose his own representative. The employment of the auditor for a blind trust is not exactly analogous to the appointment of a guardian, but no reason appears for holding it to be ineffective when it is done for an important purpose, voluntarily, and by one who is capable of protecting himself. Nevertheless, the validity of the surrogate device should be regarded as an open question.

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erned by an explicit employment agreement, it would seem that the argument in favor of validity would be even stronger. Compare *Hillman v. Second Bank-State Street Trust Co.*, 338 Mass. 15, 21, 153 N.E.2d 651, 653 (1958): “The possession of the power [to approve the trustee’s accounts] does not make the person who possesses it a trustee, a party to the trust instrument, or even an advisor whose advice must be sought in advance with respect to all matters affecting the trust.” The “auditor” in that case, appointed in a testamentary trust for a mentally ill minor child, was held not to have standing for a declaratory judgment action construing the trust.

<sup>83</sup> While a guardian is not a trustee, many of the guardian’s powers and duties are similar. See RESTATEMENT (SECOND) OF TRUSTS § 7 (1959); BOGERT § 13. Guardianships are regulated by statute—see, e.g., CAL. PROB. CODE §§ 1440-44 (West Supp. 1970); N.Y. SUR. CT. PRO. ACT §§ 1701-23, 1750-55 (McKinney Supp. 1970)—although they may be appointed by deed.

If the auditor discovers something improper in the trustee's accounts, he should be empowered to deal directly with the trustee, and, if necessary bring an action to protect the trust on the grantor's behalf. No reason appears why the grantor could not employ an agent for this purpose. If the auditor can discharge the liability of the trustee because of his relationship to the grantor, why not also enforce the trust? The answer to this question seems to follow from the answer to the first question.

There are other means of handling the enforcement problem, but these are less satisfactory. It might be possible to require the auditor to report directly to the grantor whether he found any irregularities in the trust account, and to disclose the value of the assets in the trust. If the grantor were unhappy with the result, or if the auditor reported some wrongdoing, the grantor could revoke the trust and proceed against the trustee. In the latter case, if judicial proceedings are required, the security of the trust may well have been breached anyway, even though the grantor might not bring the action himself, because of the publicity that normally attends court hearings.

Since the auditor is in a confidential relationship with the grantor, he would probably be treated as a fiduciary. His position may not be too much different from that of an investment advisor,<sup>84</sup> who is subject to such duties as the duty of loyalty, and the duty to use reasonable care and skill in the performance of his function. Further, the employment agreement could relieve the auditor from liability for acts other than gross negligence or more egregious misconduct.<sup>85</sup> It would be important not to make the exculpatory clause too broad, since it would not be possible or desirable to release the auditor from every conceivable form of wrongdoing.<sup>86</sup> But a clear statement of the purpose for hiring the auditor, and of the grantor's intent to rely on the auditor's judgment, should be effective to preclude liability in the absence of serious overreaching of the grantor, particularly in light of the narrow definition of the auditor's duties. If the conclusion seems somewhat less than clear—that an auditor would be legally effective in protecting both the interest of the grantor and of the trustee—it is because existing trust principles have never had to be applied to such a specialized purpose. Yet, the use of trusts is flexible, depending on the ingenuity of the draftsman and adequate protection for the interests of the beneficiaries, and it should be possible to persuade a court of its validity. Even so, the auditor device is complicated—it requires a second arrangement with a second professional; it is expensive—the grantor must pay both trustee's fees and the auditor's fees; and it is likely to inhibit the trustee's investment decisions—with one pro-

<sup>84</sup> See RESTATEMENT (SECOND) OF TRUSTS § 185, comment *h* (1959); SCOTT § 185, at 1475-81.

<sup>85</sup> See *Report on Exculpatory Clauses*, *supra* note 65, at 537-40; Note, *Trust Advisors*, 78 HARV. L. REV. 1230, 1235-37 (1965); Note, *Directory Trusts and the Exculpatory Clause*, 65 COLUM. L. REV. 138, 146-48, 149-50 (1965).

<sup>86</sup> See notes 74, 75 *supra*.



fessional seeking to satisfy the judgment of another. The blind trust should be used only when thought to be necessary.

*Penetration of the trust—Income tax returns.* As pointed out earlier, the blind trust discussed in this paper is a "grantor trust" for federal income tax purposes, with the result that all items of income and deduction are reported on the grantor's personal income tax return, as if the transfer to the trust had never taken place.<sup>87</sup> Reporting requirements for tax purposes require such information as the specific payors of interest and of dividends, and the details of transactions producing realized gain or loss.<sup>88</sup> If the judge files his own tax return, and observes these reporting requirements, he obviously learns a great deal about the trustee's investment activity.

One alternative is to give someone else, such as the trustee or the auditor, the authority to prepare, file, and deal with an audit of the judge's personal income tax returns. This would be consistent with executive practice; the trust for Henry Kearns seems to be representative.<sup>89</sup> In the judicial blind trust, set up to last for a longer period of time, this further relinquishment of contact with one's personal financial affairs may not seem to be trivial. Yet the deprivation is relatively minor compared to the other impositions of a successful blind trust.

Another alternative, which seems to have been used in Robert McNamara's trust,<sup>90</sup> is to require disclosure to the judge of net amounts of ordinary income, and of the details of transactions producing realized gain or loss. In the latter situation, since the asset disclosed has been sold, one can argue that nothing of substance has in fact been disclosed. The latter alternative might be acceptable if the identity of particular investments then held by the trustee could be kept confidential, but the reporting requirements on their face appear to be rigid.<sup>91</sup> Even if the Internal Revenue Service would accept a return which did not show the required details,<sup>92</sup> considerable security and perhaps confidence has been lost.

<sup>87</sup> See note 55 *supra*; Treas. Reg. §§ 1.671-3, -4 (1956). According to the reporting requirements, the trustee of a grantor trust files a blank Form 1041 with a schedule attached to the Form showing the items of income, deduction, and credit to be reported on the grantor's tax return. If the trust is a valid trust under state law, it apparently must obtain an employer identification number for reporting purposes and file the blank return. See Rev. Rul. 63-178 (question 5), 1963-2 CUM. BULL. 609, 611.

<sup>88</sup> See Internal Revenue Service Form 1040, Schedules B & D (1970).

<sup>89</sup> See *Kearns Hearings*, *supra* note 50, at 25 (items 2 & 3 of the trust).

<sup>90</sup> See *McNamara Hearing*, *supra* note 31, at 12 (item (5)(c) at top of page).

<sup>91</sup> The Secretary of the Treasury has authority to prescribe the manner of reporting. INT. REV. CODE of 1954 § 6011(a). The statute provides: "Every person required to make a return . . . shall include therein the information required by such forms or regulations." The regulations state that a return which does not set forth the information required is not acceptable. Treas. Reg. § 1.6011-1(b) (1959). Of course, for individuals like our judge the required form is the 1040. Treas. Reg. § 1.6012-1(a)(6) (1959):

<sup>92</sup> There might be problems in correlating the information attached to the trustee's Form 1041 with the individual's Form 1040. It would seem, however, that there would be few enough of these arrangements that some special dispensation could be made to take care of the tax reporting problem. For example, the individual could prepare his return and give it to the trust auditor, who would check it for accuracy and file it along with the trust's return.

## V

## CONCLUSION

This paper has discussed alternative planning arrangements to cope with the conflict of interest problem for judges under rather limited assumptions. The blind trust, for all its problems, might be the simplest method for those judges who do not want to be bothered by unexpected conflicts in a time of extreme sensitivity to that issue. Those who use the blind trust have to remember the degree to which they will have to give up control over their financial affairs. These matters should be resolved in advance; it is not a good idea to try the blind trust "on for size," with the intention of abandoning it if it proves too uncongenial.

In setting up such a trust, two points should be remembered:

(1) There is no substitute for clarity in drafting. The purpose of the trust should be clearly stated. The validity of some necessary provisions might rest on their service in the conflict of interest purpose. Further, the trustee should clearly understand his function in the dissemination of information and his relationship to a supervisory auditor if there is one. He should be directed to keep the affairs of the trust in confidence except for reports to the auditor and except for necessary disclosure to effect investment decisions or file returns required by the government.

(2) The critical problem in operating such a trust is supervision. Since the grantor-beneficiary cannot do it, he must find someone who will. Both the trustee and the auditor can be protected from liability, and if both are professionals, they will probably insist on such protection. However, the auditor's employment agreement and the exculpatory clauses in that agreement and in the trust instrument should be carefully drawn to accomplish the purpose of the trust, it being understood that certain matters such as fraud or gross negligence cannot be disclaimed.

This article is not a survey of all of the problems and choices open to judges in their financial planning. Such basic matters as, for example, choice of trustee are no different from estate planning problems which face the rest of us, and thus such a discussion is beyond the scope of the article. Nor is it a survey of all problems which might crop up in the management of a blind trust. Resolution of the difficult problem of the scope of protection afforded trustees and supervisory auditors will have to await potential future developments.

It is difficult to form a judgment about the worth of blind trusts in solving the conflict of interest dispute. It is possible to set up an adequate blind trust, but the success of the venture seems to come back to a more basic proposition—the integrity of our judges. Obviously, a judge comes to his work with previously acquired attitudes which are unaffected by all of the conflict of interest planning we can ever do. Much of the present dispute over who should sit on the Supreme Court seems to reflect choices between such attitudes as revealed by the work of the individuals concerned. Why, then, so much concern over the judge's financial in-

terests? Perhaps for the protection of the system of justice—protection of confidence in it. If so, and if the barrier technique is thought to be a valid way of protecting against conflicts, then much more can be done. For example, judicial supervision of blind trusts, perhaps through officers specifically appointed for that purpose, would substantially reduce the supervision problem. In any event, the success of any method of handling conflicts depends also on our success in choosing persons worthy of being judges.