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1989

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Marshall J. Breger

The Catholic University of America, Columbus School of Law

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Recommended Citation

Marshall J. Breger, Can Corporate Masters Afford to Become Public Servants, 71 BUS. & SOC'Y REV. 42 (1989).

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It's so tough to get good help in Washington these days.

Can Corporate Masters Afford to Become Public Servants?

by MARSHALL J. BREGER

THE AMERICAN PUBLIC has received a steady stream of reports about ethical lapses by public servants in the past several years. These reports have involved members of both the executive branch and Congress.

Not surprisingly, President Bush sought to put the "ethics in government" issue to rest early in his Administration, announcing on January 25, 1989, the formation of a President's Commission on Federal Ethics Law Reform and vowing to hold his Administration to "a higher ethical standard."

Nonetheless, within two weeks the President's Counsel, C. Boyden Gray, who had served Bush as ethics counselor during the transition and before as counsel to the Vice President, and Secretary of State James A. Baker, who had served as Bush's chief campaign adviser and earlier as chief-of-staff in the Reagan White House and Treasury Secretary, were criticized in the press for alleged ethical lapses.

How could this have happened? And if these two seasoned veterans — among George Bush's closest advisers — could not avoid allegations of impropriety, deserved or otherwise, how can any potential new appointee to a government position avoid such problems?

What one discovers upon a close reading of the newspaper accounts of these incidents is that neither man ever did anything wrong. Neither was charged with using his public office for private gain. Indeed, no evidence was cited even suggesting that might be the case. Rather, the allegations had to do with the extent of each man's compliance with federal conflict-of-interest laws designed to avoid even the appearance of a potential problem.

Central to both stories is Section 208 of Title 18 of the United States Code, which makes it a crime, punishable by fine or imprisonment, for an executive branch official to knowingly participate "personally and substantially" in any "particular matter" in which "he, his spouse, minor child, partner or 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, has a financial interest."

The breadth of this law was made clear by a 1987 Department of Justice opinion which concluded that it covers "all discrete matters that are the subject of agency action, *no matter how general their effect,*" including legislation and general policy, as long as there is a predictable, direct impact on the official's financial interests. Indeed, the official need never have considered the extent of this personal impact before taking the action in question. The mere participation in such a matter constitutes a violation of the criminal law — even if one's actions resulted in a financial loss.

While the primary focus in the Gary controversy was on his compensation service as chairman of Summit Communications, Inc., a large, family-owned communications company, a more general criticism

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Marshall J. Breger is chairman of the Administrative Conference of the United States.

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was made about his holdings in other communications companies and his possible participation in matters that may have affected those companies. The Baker case involved the appearance of a conflict between his multi-million-dollar stock holdings in Chemical New York Corporation — a bank holding company with $4.5 billion in loans to Third World nations — and Baker's participation as Secretary of State in this country's policy on Third World debt. Baker became the owner of Chemical New York stock after Chemical New York's takeover of Texas Commerce Bankshares, Inc., a holding company founded by Baker's grandfather.

In each case, these men took steps specifically to avoid violating Section 208's criminal prohibition, but the pundits still found them inadequate.

MR. SMITH GOES TO WASHINGTON

Consider what the Section 208 prohibition means to a businessman asked to take a job in Washington in the new administration. Let's take a fictional entrepreneur in the Houston area named John Smith. Smith had an interest in computers long before they were commonplace, and in the late 1960s he and a couple of friends started a business producing computer software. They incorporated and before long they expanded into computer installation and maintenance as well. While not Fortune 500, the company grew into a multi-million-dollar firm and went public. After a time, Smith tired of the CEO's life. He resigned as chairman but retained a 20 percent stock interest in the company.

Smith went back to his first love, the development of computer software, working mostly as a consultant or in small joint ventures. Money is no problem; he has numerous investments, not just in his old company but in other companies in the same field, and he serves as director on a couple of boards. Smith also became more involved in civic affairs and now sits on the board of a few nonprofit organizations. Eventually he began to dabble in politics and since the late 1970s has been a loyal supporter of George Bush.

It is now 1989 and the new Secretary of Commerce is staffing his department. The Secretary needs an assistant secretary for import policy. Computer imports is a major trade concern, and he is advised that John Smith would be ideal for the job. After discussions with the White House, Smith is offered the job. Smith jumps at the chance to join the new team in Washington. But wait. It's not that easy. What must Smith undertake in light of the criminal prohibition on taking any action that might affect a government official's financial interest?

• *Public financial disclosure.* The first thing Smith discovers about being ethical in Washington is that all high-level government officials and nominees to those positions are required by the Ethics in Government Act of 1978 to make extensive public disclo-

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sures regarding their personal finances. A federal official must disclose, for instance, any interest that the official (or his spouse or minor child) has in a trade or business or any asset held for investment or production of income if it exceeds $1,000; any transactions in real property or securities that exceed $1,000; any liabilities that exceed $10,000, excluding a home mortgage and certain personal loans; and the identify of all positions held in any capacity in any business enterprise, nonprofit organization, or other institution. About the only thing Smith does not have to disclose are positions held in religious, social, fraternal, or political organizations.

"Civilians must be able to leave their private pursuits to temporarily serve their country."

All of Smith's information is reported on Standard Form 278, which then becomes available to any member of the public who asks for it. The report will be used by the White House and the United States Office of Government Ethics to determine whether Mr. Smith has property and interests that pose a problem under Section 208.

Because of Section 208's prohibition against taking action that may affect one's financial interests, there is no way that Smith can become the next Assistant Secretary for Import Policy without taking steps to avoid an appearance of a conflict of interest. The options for Smith are to (1) seek a waiver from the Section 208 prohibition, (2) agree to not participate — in legalese, to "rescue" himself — in particular matters or decisions affecting his financial interests, (3) place his problem assets in a blind trust, or (4) sell or "divest" those assets that pose a potential appearance of conflict with his government responsibilities. Smith will find major drawbacks to all of these options.

• *Waivers.* Congress recognized the breadth of Section 208 and provided in that statute certain waivers from prohibition. A waiver may be granted to an official when the President, agency head, or other appointing official issues a written decision finding that the official's financial interest is "not so substantial" as to be likely to affect the integrity of the official's government services. In addition, the statute gave federal agencies authority to publish general rules exempting certain financial interests that the agency determines are "too remote or too inconsequential" to affect the integrity of their employees' services. The standards of "not so substantial" and "too remote or too inconsequential" to affect the integrity of an individual's services are not going to be of much help to Smith. While government agency practice varies in granting such waivers, agencies generally are reluctant to grant them.

The James Baker episode illustrates why this may be the case. While Treasury Secretary in the Reagan administration, Baker obtained a waiver from President Reagan which allowed him to participate in general policy decisions that did not specifically relate to Chemical New York, on the understanding that he would refrain from participating in matters that did. Upon becoming Secretary of State in the Bush Administration, Mr. Baker announced an intention to follow the same course with respect to actions he might take with respect to Third World debt: He would not participate in any matter specifically involving Chemical New York, and he would seek a presidential waiver to allow him to participate in general matters where, while his decisions might affect Chemical New York's interests, they would not affect them any differently than the interests of other U.S. financial institutions holding Third World loans. The judgment of the pundits: not good enough! *The New York Times* scored his ill-advised insistence on holding the stock and greeted as a "welcome reversal" his subsequent decision to sell off all his bank holdings.

Smith's holdings in the computer field cannot be characterized as "insubstantial," "remote," or "inconsequential." Clearly, Smith will find no relief in the statutory waiver provisions.

• *Recusal.* Depending on the scope of his responsibilities as Assistant Secretary for Import Policy and the contents of his investment portfolio, Smith might be able to avoid violating Section 208's criminal prohibition by entering into an agreement to not participate in matters that relate to the property he owns — the so-called recusal agreement. Such agreements are standard practice. Recall that to avoid violating Sec-

Politics American Style

"Texas chicken processor Lonnie Pilgrim added a surprise to the information packages he passed out in the Texas state Senate chambers. Pilgrim handed blank checks for $10,000 to 10 Senators (of 31) who were the swing votes on workers' compensation reform. The gifts apparently broke no law, but only 2 of the 10 Senators said they would cash the checks. And the Senate torpedoed reform anyway."

—*Business Week*
July 24, 1989

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tion 208, Baker sought to use a combination of a waiver for general policy matters and recusal for particular matters potentially affecting his financial interests. This approach, combined with public financial disclosure, was approved by the Office of Government Ethics during Baker's tenure as Secretary of the Treasury in the Reagan administration.

Recusals, however, are no panacea. Too frequent resort to recusals will mean that Smith, the new Assistant Secretary for Import Policy, will not be making the important policy decisions he was selected to make. Most likely some career bureaucrat will have to make those decisions. This situation runs afoul of the very notion of political accountability. The problem with the use of recusals is most acute for people like Smith, who are selected for a government position in a specialized area — computer technology imports — precisely because of their intimate knowledge of the field based on a lifetime in the business. Consequently, it appears that recusal agreements also are not going to be of much help to Smith.

• *Blind trusts.* Well, one might ask, why not have Smith place his assets in a "blind trust"? We frequently hear references to these arrangements, and the concept sounds good. The problem historically with blind trusts is that the veil of secrecy between the trustee and the individual placing assets in such a trust is too easily pierced. If an individual's portfolio consists of a few large holdings, especially closely held assets, a prudent trustee will be loathe to sell them outright except under business conditions that demand it. Then, too, information about the income of a trust is needed for tax purposes, and even if the income is not attributed to specific transactions, the individual will have a pretty good idea whether or not his major properties were sold during the year. Perhaps most important, if the trustee is a friend or associate of the individual who places assets in a blind trust, a question is raised about how blind the trust really is.

For these reasons, the Ethics in Government Act of 1978 includes requirements designed to guarantee that so-called blind trusts are actually blind to the official involved. The Act allows for the establishment of two types of trusts' a "qualified blind trust" and a "qualified diversified blind trust."

The requirements for the establishment of a qualified diversified blind trust are much stricter with respect to the type of assets that can be placed in the trust and the types of assets that the trustee can acquire during the duration of the trust. The most important requirement for this type of blind trust is that the trust must have a "well-diversified portfolio" as defined by regulations and approved by the Office of Government Ethics. That Office also must certify that the trustee is "independent," again as defined by regulation. Assets placed in a diversified blind trust are immediately deemed not to be financial interests of the government official.

By contrast, a qualified blind trust is one in which the assets placed in trust are gradually "blinded" as the independent trustee sells property and reinvests the proceeds in some other property or asset. In other words, assets placed in a qualified blind trust are treated as assets of the government official for purposes of Section 208 until the trustee notifies the official that the trustee has disposed of the assets — at that point, the trust is blinded with respect to the reinvestment.

"A businessman is very likely to conclude that the price of being an 'ethical' government servant is too high."

Smith will have to think very hard before opting for either type of blind trust. In either case, he will be reluctant to place everything he has acquired over a lifetime into the hands of a truly independent trustee in order to serve a two- or four-year stint in the Bush Administration. And if assets aren't truly "blinded," as in the case of initial assets placed into a qualified blind trust and not yet sold, they will still be deemed Smith's financial interests until they are totally sold off and reinvested by the trustee — precluding Smith from legally participating in the initial development of policies that he was selected to design.

Perhaps most important, assets reinvested and placed in a qualified diversified blind trust or sold by the trustee of a qualified blind trust are likely to produce significant taxable gains because the stock Smith holds in the company he founded was acquired at a very low price compared to its current value.

• *An outright sale or "divestiture."* Smith may prefer to sell his assets outright rather than place them in the hands of an independent trustee. Certainly this would solve the conflict-of-interest problem. Again, the tax consequences of such a decision are likely to make him think twice. Since the Tax Reform Act of 1986 eliminated the preferences given to long-term capital gains, any gain on the sale of Smith's 20 percent interest in the computer company and other assets will be taxed at rates applied to ordinary income. He very likely is going to conclude that the price of being an "ethical" government servant for two to four years is just too high for him and his family.

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In June 1988, the Administrative Conference of the United States, an independent federal advisory agency, proposed a remedy for people like Smith, and the idea has been rapidly catching on. The Conference's proposal was simple: Congress should amend the Internal Revenue Code to permit entering government officials to sell or divest the property in question, reinvest the proceeds in a neutral investment vehicle (such as Treasury obligations), and defer realization of gains until the proceeds in the neutral vehicle are sold. In other words, people like Smith would be able to make a "tax neutral" decision whether to accept a presidential appointment.

This is by no means a radical notion. The Internal Revenue Code already provides that no gain or loss will be realized on an exchange of investment property for other investment property "of like kind." The owner's basis in the original property is simply carried over to the new purchase. Realization of the capital gain is not eliminated; it is postponed until the individual ultimately disposes of the reinvestment property. But this Code provision does not apply to securities. What the Conference proposes doing is simply extending this tax-neutral exchange arrangement to those individuals who are legally obliged to sell off their securities in order to accept the call to government service.

Absent the negative tax consequences, divestiture of assets is likely to be a much more attractive option for an appointee to a high-level government position who has extensive interests in the private sector. Divestiture is also the most effective way to avoid actual or apparent conflicts of interest. At the same time, care must be taken to restrict the opportunity for a tax-free "rollover" of assets only to those situations in which there is a genuine need for divestiture to avoid conflicts of interest.

The Conference's proposal, therefore, would not permit Smith to decide on his own whether this option is necessary. A nominee or government official would have to be ordered or advised by a superior, independent authority to divest property to avoid a violation of conflict-of-interest statutes. In addition, the person ordering divestiture would have to approve the reinvestment vehicle.

There is a reason for Smith to be encouraged. The President's Commission on Federal Ethics Law Reform released its report in March and adopted the Conference's recommendation. The Commission declared that "divestiture of troublesome assets and reinvestment in neutral holdings is the single most important device we have encountered to eliminate completely or at least mitigate greatly subsequent conflicts of interest." The Ethics Commission's report was followed by the report of the National Commission on the Public Service — chaired by Paul A. Volcker, former chairman of the Federal Reserve Board — which similarly endorsed the Conference's recommendation.

On April 12, President Bush sent to Congress proposed legislation — the Government-Wide Ethics Act of 1989 — which adopted the Administrative Conference's recommendation for deferral of tax liability where government nominees and officials are required to divest assets in order to avoid conflicts of interest.

What's to Know?

"Casey, 29, an employee of Nevada's Mustang Ranch brothel, explaining how she feels about investing in the ranch, which recently announced a public stock offering:
" 'I'd have to know a lot more about the ins and outs of the business.' "

—Reno Gazette-Journal

PUBLIC BENEFITS

All Americans should care whether Mr. Smith goes to Washington. The so-called revolving door between the private sector and government service, and back again, has been strongly criticized by some people, including the influential citizen group, Common Cause. While I recognize the evils associated with the revolving-door phenomenon, I believe the tradition of Cincinnatus — of civilians willing to leave their private pursuits to temporarily serve their country — is worth preserving. Keeping the door of government service open to businessmen and -women like Mr. Smith will involve costs — principally the cost of regulating the evils of pernicious lobbying for preferential treatment. Nevertheless, I would be reluctant to trade our system, with all its warts, for a government entirely staffed by a separate civil service, as in Great Britain and elsewhere. Indeed, the importance of recruiting people like Mr. Smith to serve in government has grown as both the functions of government and the technological complexity of governmental decisions has increased.

The chances of Mr. Smith being able to go to Washington will improve greatly if Congress removes the tax barrier to divestiture of conflicting property. If this does not happen, the price to Mr. Smith of public service may simply be too high. ☐

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