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New Law Fails to Compel Justices to Sell Stock and Avoid Conflict of Interest

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WASHINGTON - A new law that makes it easier for federal judges to avoid recusals because of their stock holdings may not be having quite the impact that some people hoped, at least not at the U.S. Supreme Court.

In past years, a judge or justice would have been forced to take a financial hit, in the form of capital gains taxes, if he wanted to sell an individual stock to remove a conflict of interest and avoid sitting out a case. But not anymore.

Responding to years of lobbying by the judicial branch, Congress passed a law in 2006 that allows federal judges to sell stocks for conflict-of-interest reasons without paying taxes on their gains, provided they roll the money over into a mutual fund or other approved investment.

But despite the new incentive, the law hasn't always persuaded members of the Supreme Court to divest their holdings when they own shares in one of the litigants.

The issue has come up twice in the last two weeks.

Justice Samuel A. Alito Jr. received considerable attention last week for his absence in the closely watched Exxon Valdez case, concerning the legality of a $2.5 billion punitive damages award against Exxon for the massive 1989 oil spill off the coast of Alaska. From the tenor of the Feb. 27 oral argument, it appeared possible that the eight remaining justices might not be able to form a majority on certain issues in the case. Exxon Shipping Co. v. Baker, 07-219.

According to Alito's latest financial disclosure report, he owns between $100,000 and $250,000 worth of stock in ExxonMobil Corp.

And on Monday, an eight-member court minus Chief Justice John G. Roberts Jr. announced it was intractably split 4-4 over whether patients in Michigan could bring a product liability lawsuit against drug maker Warner-Lambert Co. for a diabetes drug that has since been taken off the market. Warner-Lambert v. Kent, 06-1498.

The court took the case to decide whether Michigan tort law, which strips drug makers of legal immunity if they deceive the Food and Drug Administration during the drug-approval process, is pre-empted by federal regulations.

Presumably, Roberts sat out the case because he owns between $15,000 and $50,000 worth of stock in Pfizer Inc., Warner-Lambert's parent company.

Justice Stephen G. Breyer, who has a large investment portfolio, also has been disqualified in recent cases because of his stock ownership.

The continuing recusals are puzzling to University of Pittsburgh law professor Arthur Hellman, who said it was troubling that the justices have not taken full advantage of a law designed to help them minimize their conflicts.

"It's a very serious situation when even a single important case is not decided by the court because of stock ownership by one of the justices," Hellman said.

"They have tremendous power, and with that power comes responsibility," he said. "It's hard to believe that their portfolios are so exquisitely balanced that there's any one stock they must have."

The situation is all the more frustrating, he said, because the justices do not explain their reasons for not participating.

Recusals at the Supreme Court are a particularly thorny problem because a disqualified justice, unlike a federal judge, cannot be replaced, leaving litigants without the benefit of a full nine-member court. Any time the court sits with just eight members, there's a chance that it will not be able to decide a case.

Admittedly, the court has not often split 4-4 in recent years because of a recused justice, and some of the recusals that did happen were not stock-related. It is not uncommon, however, for litigants to discover that they will not get consideration from a full bench because a justice has a financial conflict.

In the past year alone, justices have recused themselves in appeals involving companies like Bank of America Corp., Intel Corp., Microsoft Corp. and Wal-Mart Stores Inc.

Of all the recent Supreme Court recusals, Roberts' decision to sit out the Warner-Lambert case was particularly interesting because it contrasted with his actions in two other cases where he apparently sold his stock holdings to participate.

After disqualifying himself because of apparent financial conflicts, the chief justice decided to "unrecuse" himself in Stoneridge Investment Partners v. Scientific-Atlanta, 128 S. Ct. 761 (2008), a closely watched securities case that limited certain investor lawsuits, and in Credit Suisse Securities v. Billing, 127 S. Ct. 2383 (2007), which barred class actions alleging that major investment banks conspired to inflate stock prices during the dot-com boom of the late 1990s.

Roberts, through court spokeswoman Kathleen Arberg, declined to comment on why he divested his holdings and re-joined those cases, but did not do so in Warner-Lambert.

One possible explanation is that Roberts, a supporter of the new law on judicial divesting, re-joined Stoneridge and Credit Suisse because another justice was recused in each of those cases.

Had the chief justice not returned to the bench, those disputes would

have been decided by just a seven-member court. There was no such concern in Warner-Lambert.

Indiana University law professor Charles Geyh said although judges have the right to mange their portfolios as they see fit, such selective selling of stocks could raise questions because of the unknown motivation behind the differing decisions.

"Then the question is, Why not do it in all cases?" Geyh said. "I'm okay with giving judges the discretion to do this, but it can create a perception problem."

Despite the uncertainty surrounding Roberts' personal criteria for selling stocks to re-join cases, he seems to be the only justice to have done so. And according to his financial disclosure reports, he divested several stock holdings when he joined the court.

While some question why judges need to own individual stocks when they can invest in mutual funds without the same recusal risk, Geyh said judges already make sacrifices for their profession and should not be saddled with burdensome investment restrictions.

"When you don the robe, it doesn't mean you're planning to withdraw from the world and live like a hermit or a pauper," he said. "The price of occasionally getting a judge to disqualify himself is a price we can absorb."

As for the new law, Geyh said it may be easy for a judge to divest his holdings in some circumstances, but not in others. There are times when cashing out could be complicated for personal reasons, he said, or undesirable because it isn't a good time to sell.

"You don't want to force a situation where the judge is expected to take a financial bath," he said.

To obtain tax benefits, judges and justices are required to obtain a special certificate when they divest their holdings for conflict-of-interest reasons.

Lower court judges obtain those certificates from the U.S. Judicial Conference, the policymaking body of the federal courts. The Supreme Court has a separate internal procedure for reviewing stock sales by the justices.

There is no public record-keeping mechanism that would show how often judges are taking advantage of the new law, said David Sellers, a spokesman for the Administrative Office of the U.S. Courts.

Los Angeles tax attorney Dennis Brager of the Brager Tax Law Group said from a purely tax perspective, he did not see any hidden cost for judges who wanted to make use of the new tax provision.

"I don't see any reason, strictly from a tax standpoint, why there would be a downside to doing it," he said.

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