

Nonprofits Under Increased Scrutiny:

Bishop Estate provides a cautionary tale about the dangers of mismanagement at charitable organizations

By Samuel P. King and Randall W. Roth

The five trustees of Bishop Estate, a 501(c)(3) charity, hired themselves as chief executives in designated areas of that charitable organization and paid themselves a million dollars a year, *each*. They had no job descriptions, no agreed-upon objectives, and no annual reviews. A trustee, asked during his deposition to explain who within the organization was responsible for holding him and the other self-appointed chief executives accountable, replied, “Nobody,” then changed his answer to “Us.” Either way, it amounted to power without accountability—a recipe for disaster.

And a disaster—or at least a debacle—it became. By the time the trustees had been removed from office, in a scandal that shook the State of Hawaii’s power structures to their foundation, the trustees of Bishop Estate had made an art out of charitable trust abuse.

They certainly had the resources for it. In 1995, the *Wall Street Journal* estimated that Bishop Estate was the nation’s wealthiest charity, with a financial value greater than the endowments of Harvard and Yale—combined.

For native Hawaiians, Kamehameha Schools—the multi-campus educational institution operated by Bishop Estate—has always been a beacon of hope. For others, Bishop Estate is the high-water mark for misconduct by insiders at a charitable organization—the Enron of charities.

A New Reality for Charitable Organizations

Other large charities (and many smaller ones, too) have had their own problems in recent years. Examples include United Way, American Red Cross, Princeton University, Smithsonian

Institution, and Getty Trust. The unifying theme is that charitable organizations are now coming under greater scrutiny.

All this comes at a time when there is a growing awareness of the central place charities occupy in contemporary American society. The Panel on the Nonprofit Sector reminds us that charities play a host of roles, from “offering relief from disasters, nurturing our spiritual and creative aspirations, caring for vulnerable people, protecting our natural and cultural heritage” to “finding solutions to medical and scientific challenges.” Charities also represent a rapidly growing sector of the economy.

The IRS has estimated that charitable organizations control more than \$8 trillion of the nation’s wealth. Each year they take in another trillion dollars in private donations, government grants, and service fees—all tax-free.

Most nonprofits are structured as corporations, but there also are a large number of trusts and unincorporated associations. No one structure is inherently superior to the others. Lawyers who specialize in nonprofit organizations frequently recommend incorporation (for very good reasons), yet Bill and Melinda Gates and Warren Buffet consciously chose to use trusts to distribute their largesse. The best legal structure in one set of circumstances can be the worst in another.

Individuals serving on the governing boards of nonprofit organizations—whether as directors or trustees or by some other name—are usually not paid. All of them are subject to fiduciary duties of care and loyalty anyway, although state statutes often lower the standard of care for uncompensated directors of nonprofit corporations.

Lawyers sometimes serve on such boards, but more typically provide independent legal counsel on behalf of either the charity or the board members acting in a fiduciary capacity (which is functionally similar to representing the charity). Unless a lawyer has been retained specifically to

represent board members personally, the interests of the charity must take precedence over those of its personnel, including board members.

To qualify for tax-exempt status under section 501(c)(3) of the Internal Revenue Code, a nonprofit organization must be organized and operated exclusively for charitable purposes; not provide benefits to its insiders (other than reasonable compensation for services actually rendered); limit any activities aimed at influencing legislation; and not participate in political campaigns.

Most organizations also must timely seek a determination letter from the IRS acknowledging that they qualify for tax-exempt status. Churches are exempt from this requirement, but their governing boards sometimes seek such a letter anyway, to assure prospective donors that their contributions will be tax deductible.

The public usually (and often, rightly) assumes the very best of charitable organizations and the people who govern them—an assumption called the “halo effect.” Yet, charitable organizations often lack proper internal controls, or fail to follow them, and the quality of oversight in the charitable sector historically has been suspect.

High-profile scandals like the one at Bishop Estate have prompted a reassessment of the current system of controls and oversight in the nonprofit sector, conducted by lawmakers in Congress and in state legislatures, and by the IRS, among others. The tentative conclusions draw an alarming picture of the state of oversight for charitable institutions. Those who are most concerned often have no power to act, and those who have the power and the responsibility too often lack the resources or the will.

While shareholders of companies in the for-profit sector and beneficiaries of private trusts have an enforceable right to meaningful information, a strong incentive to watch for insider abuse, and a legal means of getting evidence of wrongdoing in front of a judge, donors and intended

beneficiaries of nonprofits almost *never* have the legal standing needed to force insiders to provide reliable information, or to seek accountability when there is evidence of misconduct.

State regulators—usually the attorney general—have often failed to detect insider abuse of charitable organizations, or have failed to act in a timely and effective manner. Resources available for this function have tended to be quite limited, and few attorneys general have made charities a priority. Some appear to have been overly influenced at times by political considerations. Some have “looked the other way” when community leaders fell short in fulfilling their fiduciary duties, and others have used their regulatory role to score political points. For instance, when the trustees of the Hershey Trust tried to sell control of the Hershey Company to an out-of-state buyer, the Pennsylvania attorney general acted to protect the local economy—an illustration of the old saw that AG could also stand for “aspiring governor.”

The IRS has traditionally played a relatively minor role in regulating public charities (once an organization’s right to tax-exempt status initially has been determined), because that agency’s resources are small compared to its assigned duties, and for many years because it had only “nuclear weapons” in its arsenal. In those days, when it happened upon insider abuse, the IRS could either revoke the charity’s tax-exempt status—thereby hurting the charity’s intended beneficiaries—or do nothing. That all-or-nothing restriction, which punished the wrong people, changed with the 1996 enactment of a law that empowers the IRS to levy “intermediate sanctions,” finely graded penalties against insiders who abuse a public charity. This law benefits a charity in two specific ways: it reduces the chances that the IRS will impose the “ultimate” punishment, and it requires the abusers to reimburse the charity for their plunder (known in tax law as “excess benefits”).

Lawyers who represent charities also have oversight responsibility, but the exact nature of that responsibility tends to be unclear and controversial. Answers to key questions can vary by jurisdiction. Agency laws and ethics rules usually require counsel for an organization to report uncorrected insider misconduct to progressively higher authorities within the organization (“reporting up the ladder”) until the matter is addressed appropriately. If those at the highest level of governance fail to take appropriate action, the lawyer typically has the option under the applicable ethics rule to seek outside help, as necessary to protect the organization (“reporting out”). That is the approach currently taken in the Model Rules of Professional Conduct.

A lawyer in a state that has not adopted the model rules’ *discretionary* approach might be *required* to take action or *prohibited* from doing so, depending upon which state that lawyer is in. To complicate matters further, the jurisdiction’s laws regarding the duty of an agent (the lawyer) to protect its principal (the charity) might not be in synch with the ethics rule. And once the applicable law and rule have been determined, it is not uncommon that two lawyers will interpret one or both of them differently, or will disagree sharply on the implications to the facts at hand. This complexity and confusion helps to explain why it is so rare—almost unheard of—that a charity’s lawyer will report insider abuse to an outside agency.

Lessons from Bishop Estate

Scott McCue, immediate past-chairman of the American College of Trust and Estate Counsel’s committee on charities, called the Bishop Estate story “the most significant legal dispute of our times.” It demonstrates what can happen to a charity and its intended beneficiaries when internal controls are missing, insiders operate in secrecy, outside overseers fall short of their responsibilities, and lawyers maintain confidences in the face of egregious abuse.

Bishop Estate's fabled wealth came from Princess Bernice Pauahi Bishop, the great-granddaughter of King Kamehameha, a warrior who established the Hawaiian monarchy through conquest at the turn of the 18th century. In 1884, the childless Princess Pauahi, Kamehameha's last acknowledged descendant, devised her estate (which consisted primarily of crown lands) in charitable trust to erect and maintain two schools, “one for boys and one for girls ... to be known as and called the Kamehameha Schools.” Although the will does not require it, the original trustees decided as a matter of policy to admit only native Hawaiian children.

Over the course of the next century, Hawaii transformed in ways the princess could not have foreseen. The monarchy was deposed, and Hawaii became a part of the United States, a shift that touched off successive waves of trade, tourism, and immigration from both the American mainland and abroad. World War II and Hawaii's strategic importance to the U.S. military culminated in Statehood for the islands in 1959. The value of Bishop Estate land—described by *The New York Times* as “a feudal empire so vast that it could never be assembled in the modern world”—soared.

At the time of the scandal in the late 1990s and early 2000s, Bishop Estate was arguably the state's most powerful institution, with long arms stretching into all branches of Hawaii's government, and beyond; a few years before the scandal broke, a reporter wanting to investigate the Bishop Estate trustees for the Gannett-owned *Honolulu Advertiser* was told by its publisher to “back off.”

With this much power, it is not surprising that those trustees became arrogant. In a legal brief about water rights written in 1995, trustees argued that they were the rightful inheritors of the absolute power of Hawaiian royalty:

“Kamehameha I, by right of conquest, became lord paramount of these islands. He was an absolute monarch. His will was law. He was the lord of life and death. Then logically to the same extent, if not more, the trust of Bernice Pauahi, the legacy of the Kamehamehas, must be entitled to those traditional and customary prerogatives enjoyed by the Kamehameha [dynasty].”

An inflated sense of importance alone would not necessarily have weakened Bishop Estate's internal controls, but the trustees also introduced a deeply flawed governance structure. Effective internal controls include a significant degree of separation between management and an overseeing board of trustees or directors. Yet, individual “lead trustees” functioned at Bishop Estate like chief executives in designated areas, often making important decisions unilaterally. There was no one in a position to raise questions when the self-appointed chief executives neglected to produce a strategic plan; made investments based on “relationships” without proper due diligence work; failed to follow key provisions of the governing document; invested personal funds in business opportunities involving the trust; used trust funds to lobby extensively for changes in laws affecting their personal interests; involved the trust in state and federal political campaigns; nurtured a cozy relationship with the trust's long-time outside auditor; ordered staff accountants to improve financial results by using “creative” accounting adjustments; left the position of internal auditor vacant indefinitely; and demanded that trust counsel treat all sensitive matters as privileged.

Without a reliable reality check, the definition of a “sensitive matter” at Bishop Estate expanded until it covered anything that cast the trustees in a negative light.

In most jurisdictions, the governing insiders of a charitable organization cannot use the attorney-client privilege to deny relevant information about trust administration to an attorney general when the communications involve lawyers who represent either the governing members in

their fiduciary capacity or the charity itself. The judge in the Bishop Estate controversy, however, allowed the trustees to protect sensitive information even from the eyes of the attorney general.

A cult of secrecy developed within the Bishop Estate organization. The trustees routinely entered into confidential settlements of legal disputes involving their personal misconduct without telling any outsiders—not even the trust's insurance carriers—about either the dispute or its settlement.

When the head of risk management for the charity informed the outside auditor about these serious violations of fiduciary duty, word quickly got back to the trustees, who immediately fired the executive and obtained an injunction to prevent him from talking to others. A judge ruled that the would-be whistleblower could talk to the attorney general only about matters that were not covered by the trustees' claims of attorney-client privilege—which (because the trustees were allowed to use the privilege to withhold key documents even from the attorney general) doomed this effort to protect the charity.

One lesson from Bishop Estate is the need for laws that prohibit the secret use of charitable funds to settle allegations of personal wrongdoing. Transparency for charities is too important to be optional. Bishop Estate trustees demonstrated how easy it is to “bury the bodies” when no one is watching.

There will be times when confidentiality may be in the charity's best interests (for example, to protect its ability to raise money following embezzlement by a former insider), but the potential downside of allowing charities to operate below the radar is simply too great for it to be an acceptable fiduciary choice. To ensure public access to such information, Congress or state legislatures should enact a law that requires disclosure of such information not only to an appropriate outside agency, but also on the charity's tax return (Form 990).

Upon hearing about the Bishop Estate trustees' misconduct, a common response is, "So where were the lawyers?" In fact, they were everywhere—collecting millions of the charity's money. Despite viewing the insider abuse from front-row seats, none of the scores of lawyers is known to have reported to the court, or to any other appropriate outside agency, what we have described as a world record for breaches of trust. This is particularly difficult to explain in light of Hawaii's probate rule 42(c), which requires trust counsel to report any uncorrected nonfeasance directly to the court.

Lizabeth Moody, professor and dean emeritus at Stetson University, introduced a panel on these events at the 2006 ABA annual meeting with the words, "No case has been more revealing of the opportunities for evil by lawyers than Bishop Estate."

Some of Bishop Estate's lawyers contend that they performed legally and ethically, even honorably—that it would be a serious breach of their professional responsibility to divulge any confidential information. They also cite a policy-oriented consideration: Insiders at any organization—including a charity—who view lawyers as potential whistleblowers will not seek legal advice in difficult situations, and this eventually will prove to be detrimental to the organization.

This ignores that each member of a charity's governing board has a fiduciary duty to protect the organization's interests, even when they conflict with his or her personal interests. And that lawyers paid with charitable funds to represent the charity (or its insiders in their fiduciary capacity) are legally bound to put the charity's interests ahead of any fiduciary's personal interests (i.e., the organization, not its constituents, is the client).

When initially retained to provide legal services on behalf of a charity, a lawyer would be wise to make clear to members of the governing board that the lawyer, like those board members, is

there to serve the charity. Under the Model Rules of Professional Responsibility, the organization's lawyer can be ethically obligated to make sure that the charity's agents understand that the lawyer is *not* representing their personal interests.

The Bishop Estate trustees spent millions of dollars in charitable funds to defend their personal interests, and were never required to reimburse the charity. Any member of a charity's governing board who wants a lawyer to represent his or her *personal* interests should be required to pay for such legal services personally. If circumstances arguably warrant a different approach, or reimbursement later, a judge should decide that in open court.

Because of structure problems with effective oversight in the charitable sector, lawyers who are paid with charitable funds perhaps should be required by law or ethics code, or both, to report all material breaches of fiduciary duty by agents of charities to an appropriate agency—once reasonable efforts have been made to correct the problem internally. This is arguably consistent with standard agency law (i.e., the organization rather than its constituents is the principal, and agents are generally required to take reasonable steps to protect a principal from harm), but would require modification to the ethics rules in most jurisdictions. For example, the Model Rules of Professional Conduct currently include a duty to “report up,” but only the discretion to “report out.”

Unless a lawyer is representing insiders personally, the right to assert attorney-client privilege “belongs” to the organization. This is clear when the charity is a corporation or similar entity, but sometimes is uncertain in the case of a charitable trust. Judges in Hawaii have stated in dicta that a former trustee controls the privilege. Many states do not have a clear rule on this. Clarification is in order: the law should state unequivocally that the current trustees or directors control the attorney-client privilege even with respect to communications between former trustees

or directors and any lawyer who at the time of the communication was representing either the charity or the individuals in their fiduciary capacity.

Particularly important lessons from Bishop Estate are that the public cannot always rely upon the courts to protect charities from insider abuse, and that public involvement can be critically important in protecting a charitable organization—which further supports the call for greater transparency.

Hawaii's attorneys general and probate judges never seemed to notice the many improprieties at Bishop Estate until alumni from Kamehameha Schools publicly protested the trustees' actions and it became clear that the public would support—perhaps demand—an investigation. Even then, the attorney general found her efforts repeatedly frustrated by a state judiciary that had close ties to the insiders.

Although a lower court normally fills vacancies on a charitable trust's governing board (when the trust document does not provide for another mechanism), Princess Pauahi's will had given that power to the “majority of the justices of [Hawaii's] supreme court,” who later ruled unanimously (on several occasions), that when selecting Bishop Estate trustees, they were functioning unofficially.

This trustee-selection power turned the lucrative trusteeships into prized political chits, and appeared, in turn, to influence the process of judicial selection. (Seven of the nine members of Hawaii's Judicial Selection Commission are selected by the Chief Justice, House Speaker, Senate President, and Governor. Over the decades of abuse at Bishop Estate, the justices filled trustee vacancies with a Chief Justice, a House Speaker, a Senate President, and a Governor's closest advisor, who was also, coincidentally, Chairman of the Judicial Selection Commission.) The five

justices, while acting officially, did not hesitate to rule on legal controversies involving the trustees they had selected while acting “unofficially.”

These ties between Bishop Estate and the state judiciary severely hampered accountability during the Bishop Estate investigation. For example, the trustees had used trust funds to buy liability insurance with “insured vs. insured” clauses that purported to deny coverage to the charity if successor trustees ever tried to hold predecessor trustees accountable for harm to the trust. Rather than declare it against public policy for trustees to attempt to tie the hands of their successors in that way, the judge accepted the provision on face value.

One of the trust's insurance carriers eventually paid out the \$25 million policy limit to facilitate an out-of-court settlement on the many charges of fiduciary malfeasance. Although court-appointed masters had earlier recommended that the trustees be ordered to reimburse millions for legal fees that should not have been paid with trust funds, and to pay millions more in surcharges, the settlement terms did not require the trustees to pay any of their own money to anyone. The trustees did not even have to admit to any wrongdoing. The judge who encouraged and approved this settlement said he was doing so in the interests of “closure” and “healing.”

By failing to hold these trustees accountable in a meaningful way, the courts sent the wrong message to fiduciaries elsewhere who may occasionally be tempted to abuse their positions of trust.

The IRS was the unexpected hero in the Bishop Estate scandal. At a time when the state attorney general's investigation was hopelessly bogged down, and it looked as though Hawaii's judiciary would never take definitive action, senior IRS officials made it known that they had decided to revoke the charity's tax exemption retroactively, a move that would cost the charity (and its intended beneficiaries) nearly \$1 billion up front, with untold additional costs down the road. Equally shocking, the IRS officials refused even to discuss the matter with the trustees or their

representatives because of irreconcilable conflicts between the interests of the trustees and those of the charity, including the trustees' use of trust funds for legal representation of their personal interests.

The IRS officials then got word to the state court that they would be willing to reconsider the decision to revoke the charity's tax-exempt status, but only if a list of non-negotiable conditions were met—the first of which was the immediate resignation or removal of all five trustees.

The trustees and their lawyers complained bitterly about this heavy-handed approach, calling it “extortion,” but it worked. Under these circumstances the local court had no real choice but to remove the trustees.

It took a heavy hand to break the legal logjam in this particular case, and that fact has not been lost on lawmakers and regulators in their consideration of proposed measures to better protect charities from insider abuse.

Lawmakers in New York and Massachusetts have considered proposed legislation that would impose significant new regulatory requirements on nonprofits. The California legislature enacted the Nonprofit Integrity Act of 2004, which focuses on disclosure, organizational governance, and auditing reforms, including requirements for independent audits and audit committees.

Congress, in part because the prior law prevented the IRS from sharing with Hawaii's attorney general the fruits of its investigation of the Bishop Estate trustees, included a provision in the Pension Protection Act of 2006 permitting the IRS to provide taxpayer information to state-level regulators of charities. Unfortunately, the new law misses the intended target. Hugh Jones, president-elect of the National Association of Charity Regulators, has described that new provision as “totally flawed,” because it severely hamstrings attorneys general and other regulators from

using the information once received. The IRS, whether to force corrective measures itself, or merely to support state-level efforts, needs to be more of an active player in the regulation of charities—especially when local politics complicate the situation.

While the problem of insider abuse at nonprofit organizations is real, and changes at the local and federal levels are happening now (with more to come), there is also reason to be concerned about overkill. At the 2006 ABA panel session on the impact the Bishop Estate scandal is having on the nonprofit sector, Stephen Merrill, a former attorney general and former governor of New Hampshire, described leaders in the nonprofit community as being “fearful” of the Senate Finance Committee Chairman. Merrill, now president of the Bingham Consulting Group, was referring to Republican Senator Grassley, who has since been replaced by Democratic Senator Baucus, but those two Senators appear to be very much on the same wavelength. Merrill’s point was that recent oversight problems in the nonprofit sector may prompt Congress to overreact with new laws that would be overly burdensome to the vast majority of charities that routinely operate on tight budgets and whose board members and other insiders are stretched thin personally and doing the very best they know how to do. Few charities have access to the level of resources and expertise currently required by for-profit companies to comply fully with the requirements of the Sarbanes-Oxley Act.

A moderate approach would make sense. There are elements of Sarbanes-Oxley that could be extended to the nonprofit sector without unnecessary burden. For example, a charity’s highest-ranking officer could be required to sign and certify the charity’s Form 990, and its board members obliged to review it.

The IRS recently added a number of new disclosure requirements. Because charities are already obligated to make their Form 990s available to the public, meaningful information there

could help inform members of the public who are motivated to watch out for the interests of a particular charity. A user-friendly description of a charity's financial resources, and how the charity used those resources during the preceding year to further its charitable mission, would be a major step forward.

Industry groups such as the Panel on the Nonprofit Sector also worry about overkill, but even they have expressed concerns about the status quo and have called for targeted increases in federal funding to enable the IRS to step up its enforcement and oversight activities, and new funding to help states establish or increase oversight and education programs for charitable organizations.

The simplest and potentially powerful of all the above concepts deals with the lawyer's duty to report uncorrected insider abuse to an appropriate outside agency. There already is a list of requirements that organizations must fulfill to get and maintain tax-exempt status, and among these should be the willingness of each charity's governing board, and of any lawyer paid with charitable funds, to memorialize in writing that the lawyer's duty is to the charity, not to its insiders, and that this requires the lawyer to report clear-cut, serious breaches of duty to an appropriate outside agency, such as the state attorney general or the IRS—after making reasonable efforts to resolve the matter internally. Congress could achieve this at a stroke by making it a part of the Internal Revenue Code.

Good people can make a bad system work well, and bad people will eventually find ways around even good systems. But the legal profession can and should assist in efforts to make it harder to abuse the trust that the public places in charities and in the people who run them.