UNIVERSITY OF HAWAI'I LAW REVIEW

VOLUME 21

1999

University of Hawai'i Law Review

Volume 21 / No. 2 / Winter 1999

SYMPOSIUM ISSUE ON THE BISHOP ESTATE CONTROVERSY

Foreword
Edward C. Halbach, Jr. i
A Note on the Sources xiii

ARTICLES

Limiting Dead Hand Control of Charitable Trusts: Expanding the Use of the *Cy Pres* Doctrine
Alex M. Johnson, Jr. 353

Of Princesses, Charities, Trustees, and Fairytales: A Lesson of the Simple Wishes of Princess Bernice Pauahi Bishop
Judge Robert Mahealani M. Seto and Lynne Marie Kohm 393

Nonprofit Compensation and the Market
Peter Frumkin and Alice Andre-Clark 425

Endangering Individual Autonomy in Choice of Lawyers and Trustees—Misconceived Conflicts of Interest Claims in the Kamehameha Schools Bishop Estate Litigation
James R. McCall 487

Understanding the Attorney-Client and Trustee-Beneficiary Relationships in the Kamehameha Schools Bishop Estate Litigation: A Reply to Professor McCall
Randall W. Roth 511

Comment on Professor Roth's Reply
James R. McCall 531

A Taxing Time for Bishop Estate: What is the I.R.S. Role in Charity Governance?
Evelyn Brody 537

Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law
Susan N. Gary 593

Why the Justices Should Stop Appointing Bishop Estate Trustees
Hazel Beh 659

Copyright © 1999 by University of Hawai'i Law Review

Appendix A: Chronology of Events in the Kamehameha Schools Bishop Estate Controversy 673
Appendix B: Will of Bernice Pauahi Bishop; Codicil No. 1; Codicil No. 2 679
Appendix C: Broken Trust 691
Appendix D: Renewed Trust 707

COMMENTS

Recreational Activity Liability in Hawai'i: Are Waivers Worth the Paper onWhich They Are Written? 715

CASENOTES

Re-Evaluating the Limits of the Full Faith and Credit Clause After *Baker v. General Motor Corporation* 747

RECENT DEVELOPMENTS

From *Mago* to *Duffield*: Recent Developments in the Enforceability of Mandatory Arbitration Agreements of Title VII Claims in the Ninth Circuit 779

Mitchell v. State and HRS § 386-3: Workers' Compensation Reform in the State of Hawai'i 807

Foreword

Edward C. Halbach, Jr.*

Princess Bernice Pauahi Bishop died testate in 1884, leaving her residuary estate to establish a charitable trust generally known as the Bishop Estate or KSBE (Kamehameha Schools Bishop Estate). Key provisions of her will instructed the trustees "to erect and maintain in the Hawaiian Islands two schools . . . to be . . . called the Kamehameha Schools."[1] No more than half of the fund was to be used to erect and furnish facilities for the (now unified) schools, with the trustees to invest the rest "as they may think best, and *to expend the annual income*" for school "maintenance," mentioning building repairs, "salaries of teachers," and "other incidental expenses," plus "the support and education of orphans, and others in indigent circumstances."[2] The trustees were granted "full power to lease or sell any portion of my real estate, and to reinvest the proceeds" as to them "may seem best," and "full power" to make and amend "*all such rules and regulations as they may deem necessary for the government of said schools and to regulate the admission of pupils* . . . ."[3] The trustees were further instructed to make and publish annually in "some" Honolulu newspaper "a full and complete report of all receipts and expenditures, and of the condition of said schools," with an "inventory" of estate holdings.[4] Next the will appointed five trustees, directed that this number continue, and provided for "vacancies [to] be filled by the choice of a majority of the Justices of the Supreme Court."[5] A later, somewhat repetitive, grant of "most ample" power to sell lands was followed by a qualified instruction not to sell "but to continue and manage" certain land

---

* Professor Emeritus, School of Law, University of California at Berkeley. The author is the Reporter for the RESTATEMENT (THIRD) OF TRUSTS (1992), and was Co-Reporter for the UNIFORM PROBATE CODE; he also serves in advisory roles for other Restatement and Uniform Law projects of relevance to the subject of this symposium.

The author wishes to disclose his service as trust law advisor to the Master for the Probate Court in recent Bishop Estate accountings, a role that did not involve factual investigation or determinations. Thus, observations here reflect no special knowledge of factual information that is not available to readers or the public generally.

[1] *Will of Bernice Pauahi Bishop* art. 13 [hereinafter *Will*], reprinted in Appendix B to this issue of the *University of Hawai'i Law Review*.

[2] *Id.* (emphasis added).

[3] *Id.* (emphasis added).

[4] *Id.*

[5] *Id.* art. 14.

holdings unless in the trustees' opinion "sale may be necessary . . . or for the best interest of my estate."[6]

Several preliminary observations seem appropriate at this point. First, a couple of troubling provisions of the will call for certain ethnic preferences in admissions and sought to impose a religious limitation on the hiring of teachers and appointment of trustees;[7] those provisions have not been involved in the recent controversies and are not further considered in this Foreword. Second, boards of directors, regents, or trustees of hospitals, universities, libraries, and the like regularly are responsible not only for the management and expenditure of endowment funds but also for the active operation of public or quasi-public institutions. Activities conducted in the traditional form of express charitable and private trusts, however, and to which the trust law is primarily directed, are usually confined (as the KSBE trustees' duties are not) to investment and distribution functions. (Might a court's equitable deviation power or *cy pres* wisely be used to split the trust into two trusts, or into a trust and a non-profit corporation?) Third, the trust investment law in Hawai'i has long been ahead of its time, well before the traditional "prudent man rule" was effectively displaced by the modernized "prudent investor rule."[8] Thus, Hawaiian decisions have allowed non-traditional investments, even entrepreneurial activities, without special authorization in the trust terms, at least by trustees in appropriate circumstances. The authority to operate within broad, flexible principles of prudence has been both applicable and attributable to several large, apparently well-managed, dynastic private trusts in Hawai'i as well as to charitable trusts.

Nothing in the special circumstances, mission, and authority of the trustees of the Bishop Estate and other huge Hawaiian trusts, of course, exempts them from the usual high standards of fiduciary conduct. If anything, their positions, broad authority, and economic power call for a thorough understanding of the law of trusts and scrupulous adherence to its mandates. Particularly rigorous attention should be paid to the trustees' strict duty of undivided loyalty and to principles of prudence in the strategic planning as well as the performance of their administrative responsibilities.

The Bishop Estate experience and especially the controversies of recent years suggest an array of broadly significant and challenging questions about

---

[6] *Will of Bernice Pauahi Bishop, Codicil No. 1* art. 17, reprinted in Appendix B.

[7] *See Will* art. 13 (directing "that the teachers of said schools shall forever be persons of the Protestant religion") & art. 14 (directing "the selection [of trustees] to be made from persons of the Protestant religion").

[8] This modernization has resulted from the American Law Institute's 1990 approval of the Restatement (Third) of Trusts: Prudent Investor Rule (published 1992) and the subsequent promulgation (1994) and the already widespread enactment of the Uniform Prudent Investor Act.

the general principles and application of the law of trusts, and also about the planning and drafting of the terms of both private and charitable trusts. Yet, as we shall see, these questions arise from the unique combination of provisions and circumstances of an immense charitable trust with a demanding, specialized mission and serious temptations for abuse. In this Foreword, I try to identify some problems of special interest to trust practitioners and scholars and that seem in particular need of attention from the perspective of trust law's continued evolution. Some of these matters are treated at length and depth in the articles that follow. Perhaps the few brief observations I can offer here about these and other issues will provide an overall setting for the articles and suggest a further agenda for trust law development and scholarly inquiry. (I shall simply "pass" on the serious charitable trust oversight and enforcement issues so interestingly covered, along with a history of the trust and the settlor and her family, by Professors Seto and Kohm and also addressed, along with other matters, in Professor Gary's article.[9])

I. ACCOUNTING AND INVESTMENT BY TRUSTEES

The absence of any authorization for the trustees either to accumulate income or to distribute principal (as in KSBE under the emphasized wording in the will excerpt in the opening paragraph above) inevitably places considerable emphasis on proper principal-and-income accounting practices. Controversy over the performance of trust investment programs places further emphasis on the accuracy and usefulness of accounting for asset and liability values. The combination of these factors in the Bishop Estate experience illustrates the pressure, generated by trust law and by frequently encountered provisions of both charitable and private trusts, to have meaningful and appropriate standards for trust accounting, regardless of when and to whom those accountings are to be made. Overly simplistic case and treatise references to generally accepted accounting principles must be understood and qualified to mean principles appropriately adapted to the needs and circumstances of express trusts. Trust terms often require distribution or application of whatever is determined to be trust accounting "income" under common law or, usually today, statutory principal and income rules, whereas net income determinations for corporations are softened by flexible dividend policies that allow directors to decide the extent to which earnings will be retained to maintain or expand the company's operations.

---

[9] *See* Susan N. Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 U. HAW. L. REV. 593 (1999).

Common law, trust codes, and competent drafters increasingly recognize the need for flexibility, whether in the distributive rights of income beneficiaries or in endowment expenditure policies. For the latter, where the Uniform Management of Institutional Funds Act (allowing expenditure of appreciation) has not been enacted or does not apply, there will be growing need for more imaginative use of equitable deviation or even *cy pres* principles to compensate for low yields resulting from a combination of declining dividend rates of corporations and total-return investment policies of trustees. (*Cf.* suggestions, and what are at least perceived as different immediate concerns, in Vice Provost Johnson's article later in this symposium.[10]) We are already seeing valuable writing on the private trust counterpart of this problem,[11] accompanied by more general legislative recommendations[12] that should ultimately affect charitable as well as private trusts. Quite astonishingly, a feature of the Bishop Estate controversy has involved a possible inverse of the income underproductivity problems being encountered elsewhere in the current world of trust administration, with allegations that the trustees have concealed and withheld income that (under both trust provision and court order) was to have been spent on school operations.

Similarly compelling is the need for recognition and enforcement of accounting requirements that would provide clear information on current asset and portfolio values. This is a realistic requirement even if, in the case of hard-to-value holdings, reasonable estimates are generally relied on with only occasional appraisals.[13] Coherent market value information is simply essential for the fiduciary's own planning, self-evaluation, and decision making, not to mention its critical role in providing fair and adequate disclosure for purposes of beneficiary monitoring or Attorney General/judicial supervision. Wouldn't it be nice, for example, if someone could tell us, reasonably reliably, how many billions of dollars the corpus of the Bishop Estate is currently worth, as well as what its market value has been from time to time in case anyone cares about the performance record of the trust and its various investment programs?

---

[10] *See* Alex M. Johnson, Jr., *Limiting Dead Hand Control of Charitable Trusts: Expanding the Use of the* Cy Pres *Doctrine*, 21 U. HAW. L. REV. 353 (1999).

[11] Beginning with Wolf, *Defeating the Duty to Disappoint Equally—the Total Return Trust*, 23 ACTEC NOTES 46 (1997), and Hoisington, *Modern Trust Design: New Paradigms for the 21st Century*, 31 U. MIAMI HECKERLING INST. ON EST. PLAN. ¶¶ 600-610 (1997), and extending to the instructively contrarian Garland, *The Problems with Unitrusts*, 1 J. PRIVATE PORTFOLIO MGMT. NO. 4 (Spring 1999).

[12] E.g., the allocation power in section 104 of the REV. UNIF. PRINCIPAL & INCOME ACT of 1997 and the unitrust approach to "income" rights as proposed in the N.Y. EPTL-SCPA Legislative Advisory Committee's Fifth Report on Principal and Income Act Revisions, May 1999.

[13] *See, e.g.*, CAL. PROB. CODE § 1063(a) (West 1999).

One can well imagine, under modernized principles of equitable deviation,[14] a court allowing trustees of a large charitable trust, like KSBE, under compelling circumstances either to accumulate trust accounting income or to expend trust accounting principal, as trust needs and objectives might indicate. That is, income that trust terms direct to be paid out might be retained if and as necessary to assure preservation of purchasing power, and even to provide for expanded operations in the future; or, despite the absence of a trust provision authorizing invasion of principal, some of the appreciation in trust principal might be expended directly (*cf.* Uniform Management of Institutional Funds Act) or by allocating it to trust accounting income (*see* § 104 of the 1997 Revised Uniform Principal & Income Act) to meet current school needs. The latter would compensate for an otherwise prudent and advantageous growth-oriented (i.e., deliberately "underproductive") investment strategy.

Certainly, any such judicial authorization would initially require presenting the court with a well thought out, comprehensive strategic plan. Such a plan would necessarily involve closely coordinated planning: (i) for the future development of the school and other programs falling within the present (or possibly *cy pres* expanded) purposes of the trust; and (ii) for the financial objectives and investment management of the trust estate. If, for example, the latter (ii) could be expected to provide inadequate support for the former (i) but is more beneficial overall than a "normally [income] productive" investment policy, the trust investment plan should proceed with the "elements" of the improved total return (income *plus* capital appreciation) being adjusted as appropriate to the present and future needs of the trust under its strategic plan (see (d) in next paragraph).

A trust's investment (and expenditure) policy should take account of certain fundamental principles of asset management as set out or implicit in the Third Restatement and the Uniform Prudent Investor Act. This is especially so in a modern trust law context in which, for good reason, no investments (e.g., venture capital) or courses of action (e.g., use of derivatives) are abstractly ruled out, each investment decision being judged instead by its role in the trust's overall portfolio and strategy. These principles of trust investment begin with fiduciary responsibility for risk management, involving (a) the normal duty to diversify (minimizing "uncompensated" risk) and (b) the duty

---

[14] *See, e.g.*, CAL. PROB. CODE § 15409(a) (West 1999) and proposed UNIFORM TRUST CODE § 411(a), allowing modification of *distributive* as well as *administrative* provisions, thereby avoiding occasionally difficult or arbitrary line drawing and providing the flexibility sometimes appropriate to accomplish a settlor's purposes. The RESTATEMENT (THIRD) OF TRUSTS (1992) can be expected to state the preferred common law view so as to provide similar flexibility. Also compare the article by Vice Provost Johnson in this symposium. *See* Johnson, *supra* note 10.

to establish risk-and-return objectives (involving "compensated" or market-rewarded risk) suitable to the particular trust's purposes, distribution requirements and other circumstances. In addition, investment policies must not underestimate the significance of (c) a trustee's duty to be cost-conscious in the design and implementation of trust investment programs. (This has increased importance in immense trusts like Bishop Estate not only to control extravagance but also to lessen the temptations of patronage or subtle intrusion of a trustee's personal interests.) Furthermore, the trust law imposes (d) a duty of impartiality, a particularly relevant element of which is the duty ordinarily to make the trust estate suitably productive of "income" for current beneficiaries of private trusts. The charitable endowment counterpart of this duty of productivity should be a duty to consider and balance, in light of trust terms and purposes, the needs of the *present* and the needs of the *future*. The former, in the Bishop Estate context, means both the amount and *stability* of income flow to meet the needs of ongoing school operations and any related programs that depend on trust income; the needs of the future essentially involve preservation of purchasing power (i.e., the *real* value of principal) to maintain a given level of future activity in the event of inflation, plus probably also reflecting potential need and opportunity for actual expansion of operations falling within the trust's charitable purposes.

In short, in light of this intertemporal duty of impartiality, with the Princess' probable purposes in mind, an asset management strategy should be developed to establish an optimal income-productivity and total-return policy suitable to the trust and its program objectives over the foreseeable future—i.e., essentially, a policy of seeking the maximum *total* return consistent with the trust's risk tolerance. If, however, an optimal total-return investment policy results or can be expected to result in an undesirably low level of income productivity, adequate concepts of equitable deviation (or the use of an adjustment power[15] or unitrust[16] concept) can provide the adaptation necessary to properly serve the trust's perpetual charitable purposes.

Incidentally, the Internal Revenue Code's requirement of an arbitrary (though, on policy grounds, probably justifiable) five-percent payout rate for private foundations is neither applicable to KSBE nor appropriate by analogy as a measure of expenditure in support of its current educational activities. Studies of historical performance data and projections of appropriate expenditure levels for settled funds with comparable objectives would suggest a rate a percent or two lower,[17] even assuming only an objective of maintaining purchasing power over time.

---

[15] *See* UNIF. PRINCIPAL & INCOME ACT (amended 1997) § 104, 7B U.L.A. (Supp. 1999).

[16] *See supra* notes 11 and 12.

[17] Relevant studies are discussed, *e.g.*, in the writings cited in note 11, *supra*.

II. DELEGATION BY TRUSTEES

The clear trend of modern trust law is to recognize the potential benefits of delegation by trustees, both skilled and unskilled. In most states today, trustees may delegate to agents "such functions and in such manner as a prudent investor would delegate under the circumstances," with due care to be exercised "in deciding whether and how to delegate authority and in the selection and supervision of agents."[18] Under these principles, and earlier Hawai'i law as well, trustees of large, complex, long-term private trusts or perpetual charitable trusts may establish efficient and effective management regimes, with operations officers and other employees having suitable financial, managerial, and clerical skills. For the Bishop Estate, these "operating officers" and others would certainly include a school principal (or president, as now) and staff. This seems especially appropriate when the terms of the governing instrument primarily suggest (see emphasized wording in will excerpt in opening paragraph above) a trustees' role of making and amending "rules and regulations" for the school's governance and admissions.

Hiring and relying upon employees and other agents, whom trustees can readily direct, supervise and terminate, however, is far different from what might be loosely called "delegation" among co-trustees. The latter invites inevitable risks of improperly "dividing up" the trusteeship and its responsibilities. It would also give rise to the practical difficulties and realities of instructing and monitoring peers in the co-trusteeship—not to mention the inability to fire them—with the attendant risks (to put it gently) of a "reciprocal-leniency" mentality. This serious array of issues can be little more than noted here and, unfortunately, is not significantly addressed in any of the articles in the symposium, although newspaper reports and other allegations have mentioned possible problems of a "lead trustee" practice in administering the financial and school affairs of the Bishop Estate.

III. COMPENSATION AND SUCCESSION OF TRUSTEES

The size, level of expenditures, and complexity of huge trusts and the associated problems of appropriate compensation for trustees and of procedures for filling (and creating!) vacancies in the trusteeship are aptly illustrated by problems that have arisen in the Bishop Estate. Although both

[18] Contrast this language of RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE §§ 227(c)(2) & 227 cmt. h (1992), with the restrictive rules of the RESTATEMENT (SECOND) OF TRUSTS § 171 cmt. h (1959); *see also* UNIF. PRUDENT INVESTOR ACT § 9(a) (1994), 7B U.L.A. (Supp. 1999) on the authority and requirements for trustee delegation of investment and management functions to agents.

compensation and succession issues are addressed elsewhere in this symposium, a few comments here might not be redundant or out of place.

The experience in Bishop and other large trusts in Hawai'i readily illustrates why the modern, nationwide trend is away from statutory fee schedules, or even relatively rigid reliance on rules of thumb, in favor of the flexibility of rules of reasonable compensation. Certain lessons are obvious even without suggesting widespread abuse, for trustees of large Hawaiian trusts have regularly agreed to serve for less than the amounts to which they apparently or presumptively would be entitled. Based on the qualifications and other opportunities of individuals who have been and should be attracted to some of these positions, not to mention the exceptional skills and dedication of operating or financial officers of some of the trusts, it would be most unfortunate and counterproductive to suggest that competitive, high levels of compensation should be ruled out or arbitrarily limited. On the other hand, the level of compensation should be commensurate not only with the risks and responsibilities undertaken but also with the trustees' time commitment to the trust, both contemplated and actual, and the real value of his, her, or its services, ordinarily based on qualifications and employment/compensation history. The notion that some fixed or presumed level of compensation is to be equally divided between co-trustees, such as a bank and a family member, is both unworkable and increasingly being rejected in the private trust context wherever the law allows flexibility and judgment to be brought to bear on the matter.

The common sense of such an approach to compensation, however, should not ignore the obvious and even subtle difficulties of application. This is especially so for large trusts with a panel of trustees, all of whom provide full-time service, *if* that is the *reality* of the situation. (The thoughtful and interesting Frumkin and Andre-Clark article deals charitable *trusts* only a glancing blow;[19] to their reference to the "Bishop Estate case" as "a common and important instance of a philanthropic market failure," it might be added that trustees' tenure under charitable and other trust law normally and strongly tends to insulate them from market forces. The IRS role in the matter of compensation control is specifically analyzed in Professor Brody's carefully crafted, imaginary Tax Court opinion.[20]) Here, perhaps the pressure realistically shifts to questions of tenure and removal by court, and especially to the trustee selection process.

---

[19] *See* Peter Frumkin & Alice Andre-Clark, *Nonprofit Compensation and the Market*, 21 U. HAW. L. REV. 425 (1999).

[20] *See* Evelyn Brody, *A Taxing Time for the Bishop Estate: What is the I.R.S. Role in Charity Governance?*, 21 U. HAW. L. REV. 537 (1999).

So far as the filling of vacant trusteeship positions is concerned, it is easier to identify fatally deficient or dangerous methods than it is to prescribe a general procedure that will work in all or even most cases. The larger the trust the greater the danger of conflicting-interest or patronage abuses in the selection process. And such abuses are very likely in turn to lead to divided-loyalty and patronage abuses in the administration of the trust. The method of filling vacancies in the Bishop Estate trusteeship (see will excerpt, above) is discussed later by Professor Beh[21] (and also by Professors Seto and Kohm[22]) and is so patently ill-advised as to require no further comment here—although the problems may have turned out to be even more serious than a reasonable lawyer and client should have anticipated. (Does this suggest probate court modification of the trust terms under equitable deviation?) In other parts of the country we are also beginning to see serious problems presented occasionally, usually in sensitive situations involving control or influential holdings or board positions in major corporations, as a result of common drafter reliance on simple provisions that call for vacancies in panels of trustees to be filled by the continuing trustees.

Apart from issues about selection and removal procedures, and general concerns over circumstances that increase risks of trustees abusing their positions, the trust law needs to develop clearer and better rules and alternatives, without necessarily punitive undertones, for the temporary or limited substitution of temporary or special trustees, or trustees *ad litem*. Such substitution for regular trustees should be used judiciously, and often mercifully, when and to the extent this appears conducive to the sound administration or representation of the trust. (Professor McCall's article on related matters is mentioned immediately below.[23])

IV. DUTIES AND FEES OF ATTORNEYS FOR TRUSTEES

The Bishop Estate controversies suggest a number of questions concerning the professional and financial relationships among trusts, trustees, and their lawyers. One perspective on some of these critical and increasingly troublesome issues is presented in Professor McCall's article, which amounts to an advocate's brief in support of a difficult position—not inappropriate

[21] *See* Hazel Beh, *Why the Justices Should Stop Appointing Bishop Estate Trustees*, 21 U. HAW. L. REV. 659 (1999).

[22] *See* Judge Robert Mahealani M. Seto & Lynne Marie Kohm, *Of Princesses, Charities, Trustees, and Fairytales: A Lesson of the Simple Wishes of Princess Bernice Pauahi Bishop*, 21 U. HAW. L. REV. 393 (1999).

[23] *See* James R. McCall, *Endangering Individual Autonomy in Choice of Lawyers and Trustees—Misconceived Conflict of Interest Claims in the Kamehameha Schools Bishop Estate Litigation*, 21 U. HAW. L. REV. 487 (1999).

given the author's disclosure of his experience and role as expert witness in the KSBE litigation (on behalf of the majority trustees) and his invitation to others to join in a dialogue.[24] Professor Roth's response to this invitation is illuminating, although one might question the emphasis in both articles upon the conceptual issue of whether a trust is a legal entity.[25]

Regardless of whether and where (and for what purposes) a trust is viewed as an entity (for which there is a beginning trend and much to be said[26]), a more relevant distinction needs to be drawn. The distinction—though not always easy to draw—is between legal services rendered to trustees in their representative capacities and services to trustees as individuals, in defense (or directly in anticipation) of a suit either for surcharge or for removal for alleged serious or repeated breach of trust. This distinction may well determine or influence: the answers to questions of privilege; whether (after providing advice "to the trust") a lawyer may later represent a trustee in a controversy between that trustee and a co-trustee or beneficiaries; and whether and when the attorney's fees are properly payable from trust funds rather than by the client-trustee personally, with the possibility of indemnification when and as appropriate.

Multiple trustee situations also raise the question of counsel fees for a trustee who takes action in performance of the duty to prevent or remedy breaches of trust by the other co-trustee(s).[27] Because of a dissenting or petitioning trustee's legal duty in such matters, it would seem that the attorney fees are expenses ordinarily payable directly from the trust estate, subject to recovery from a trustee who has acted in bad faith or without reasonable cause.

Also to be noted here are the right and duty of a co-trustee to be fully informed and advised about and to participate conscientiously in fiduciary deliberations, including legal consultations, even if it appears likely that he or she will eventually assume a minority or dissenting position on a matter.

These various matters concerning the role and responsibilities of trustees' counsel not only affect questions of ultimate liability for legal fees but may

---

[24] *See* McCall, *supra* note 23, at 487-88.

[25] *See* Randall Roth, *Understanding the Attorney-Client and Trustee-Beneficiary Relationships in the Kamehameha Schools Bishop Estate Litigation: A Reply to Professor McCall*, 21 U. HAW. L. REV. 511 (1999).

[26] See my *Joseph Trachtman Lecture: Restatements, Uniform Acts and Other Trends in American Trust Law at Century's End, reprinted in Introduction*, 25 ACTEC NOTES 101, 102-03 (1999).

[27] The Bishop Estate controversies aptly illustrate the need to recognize flexibility in the conduct deemed appropriate to discharge this duty, specifically, whether and at what stage remedial action might reasonably involve initiating litigation, alerting the Attorney General (or beneficiaries), or seeking publicity to begin a process that will not prove futile or unduly expensive.

also involve subtle or not-so-subtle issues of unfairness. These fairness issues inevitably arise from the risk of unwarranted fiduciary advantage over potential adversaries who often have limited ability to finance their side of trust litigation and who are, after all, other fiduciaries or the intended beneficiaries of the trust.

A Note on the Sources

Most of the events in the Bishop Estate controversy unfolded in Hawai'i state court and were reported in Honolulu newspapers. The *Honolulu Star-Bulletin* web-site reprints most of the articles and pleadings relevant to the controversy, making them accessible on the Internet. The law review encouraged authors contributing to this symposium issue to cite to documents posted on the *Star-Bulletin* web-site.

In September 1999, however, the owners of the *Star-Bulletin* announced their plan to shut down the 117-year old newspaper at the end of October 1999. This turn of events presented the law review with a dilemma—should authors cite to documents on a web-site that could become non-existent, or should they cite to original documents that may be difficult to access for persons living outside of Hawai'i? Before the law review editors made a decision, another twist in the newspaper shutdown developed: Honolulu citizens and the state attorney general filed a suit in federal court to enjoin the closing of the *Star-Bulletin*. The district court granted a preliminary injunction precluding the shutdown. The Ninth Circuit affirmed. The *Star-Bulletin* currently remains in operation, as does its web-site.

In light of these events, the editors of the law review made a compromise. For pleadings, citations in this issue are to the electronic version on the *Star-Bulletin* web-site, and if unavailable there, to the original hard copy. Citations of newspaper articles are to the original print version as much as possible (although the *Star-Bulletin* still reprints most of its articles on its web-site) since newspapers generally are more accessible than court documents. In either case, the citations to newspaper articles contain sufficient information to allow retrieval of the original source.

Readers may access the *Star-Bulletin* web-site by pointing their web browsers to <http://starbulletin.com/ksbe>. Other web-sites containing information relevant to the Bishop Estate are: the Kamehameha Schools Bishop Estate web-site, <http://www.ksbe.edu>; the *Honolulu Advertiser* web-site, <http://www.honoluluadvertiser.com>; and the Na Pua a Ke Ali'i Pauahi web-site <http://www.napua.com>.

Editors,
University of Hawai'i Law Review

Limiting Dead Hand Control of Charitable Trusts: Expanding the Use of the *Cy Pres* Doctrine

Alex M. Johnson, Jr.*

By now, most readers are familiar with, and knowledgeable of, the facts surrounding the establishment and recent (mis)management of the Kamehameha Schools Bishop Estate Trust ("KSBET") which provided impetus to the publication of this symposium issue focusing on the KSBET. Rather than providing a lengthy exegesis of the facts regarding the establishment of the trust and the current controversy and issues raised by the alleged mismanagement and misfeasance by recent trustees, I provide a relatively brief summary of KSBET's history, focusing only on the facts that are salient to the issues addressed in this Article.[1] However, before doing so, I provide a very brief, almost cursory, summary of these issues to arm the reader with enough information to place the arguments made herein in the appropriate context.

I. INTRODUCTION

A. *Precis of the Article*

The KSBET presents a classic example of a trust in need of modification via the *cy pres* doctrine to conform to conditions that have changed since it was established by the will of Princess Bernice Pauahi Bishop over 114 years ago. The exemption of charitable trusts from the Rule Against Perpetuities,[2]

---

* Vice Provost for Faculty Recruitment and Retention, University of Virginia, Mary and Daniel Loughran Professor of Law, University of Virginia School of Law; B.A., Claremont Men's College, 1975; J.D., University of California at Los Angeles School of Law, 1978. I thank Kathleen Lauinger for excellent research assistance. This Article is dedicated to Professor Jesse Dukeminier who instilled in me an appreciation, understanding, and love for the Rule Against Perpetuities. Sometimes, one person can make a difference.

[1] For a more detailed and thorough recitation of the history of the KSBET, see Judge Robert Mahealani M. Seto & Lynne Marie Kohm, *Of Princesses, Charities, Trustees, and Fairytales: A Lesson of the Simple Wishes of Princess Bernice Pauahi Bishop*, 21 U. HAW. L. REV. 393 (1999). Similarly, for a detailed review and examination of the alleged mismanagement and misfeasance of the trust by the recently removed trustees, see Evelyn Brody, *A Taxing Time for the Bishop Estate: What is the I.R.S. Role in Charity Governance?*, 21 U. HAW. L. REV. 537 (1999).

[2] For further discussion of the Rule Against Perpetuities and its inapplicability to charitable trusts, *see infra* Parts III and IV. I capitalize the "Rule Against Perpetuities" simply to designate

coupled with the settlor's limited knowledge of societal changes that will or may occur in the future, present a myriad of situations requiring analysis of charitable trusts to ascertain if courts should deploy the *cy pres* doctrine to change the express terms or conditions of the charitable trust to reflect societal changes that have transpired. The KSBET provides a very clear example of a trust in need of modification pursuant to the *cy pres* doctrine.

This focus of this Article, however, is not simply on the traditional deployment of *cy pres* as it is currently used by the courts. Indeed, a majority of courts continue to subscribe to a traditionally narrow view of *cy pres* that requires successful supplicants to make three showings before *cy pres* will be deployed: 1) that the settlor has created a valid charitable trust; 2) that the purpose of the trust has become illegal, impossible, or impracticable to complete; and 3) that the settlor possessed a general, as opposed to a particular or specific, charitable intent that would not be defeated or thwarted by changing the terms or conditions of the trust if *cy pres* is granted and the express terms of the trust are modified. This narrow interpretation, I contend, has resulted in indeterminate outcomes, and has resulted in the suboptimal use of *cy pres* (when viewed from a societal perspective), relegating the use of charitable assets to archaic and unproductive purposes.[3]

The focus of this Article is on the use and misuse of the *cy pres* doctrine by the courts and, comparatively, the relatively liberal use of the related doctrine of deviation by courts reforming administrative provisions of charitable trusts.[4] The thesis presented herein is that the distinction between administrative and substantive provisions of a trust are highly chimerical and illusory, and that courts can rather arbitrarily determine ex ante the outcome of a particular dispute or litigation by simply characterizing a proposed change in a trust's operation or management as administrative (calling for the liberal doctrine of deviation) or as substantive (calling for the much narrower doctrine of *cy pres*).

Instead, I contend that the deviation and *cy pres* doctrines should be combined and treated, for all intents and purposes, as the same. In other words, courts should employ the same test to determine whether to change terms and conditions of so-called administrative or substantive provisions of a charitable trust that is immune to the time restrictions established by the Rule Against Perpetuities. Moreover, instead of simply opting for the expanded use of the liberal deviation doctrine or the conservative *cy pres* doctrine, an analysis of the basis for both doctrines reveals the need for

---

the fact that although three words are used, in reality the "Rule Against Perpetuities" is one doctrine signified by those three words, any of which standing alone is meaningless.

[3] *See infra* Part III.

[4] For a definition of the deviation doctrine, *see infra* notes 86-92 and accompanying text.

separate and distinct doctrines in light of the charitable trust's exemption from the Rule Against Perpetuities and its resultant unlimited useful life. As a result of the perpetual nature of charitable trusts and the changed societal conditions that the settlor never considered when establishing the trust, but which inevitably occur, courts should deploy both equitable deviation and *cy pres* to allow efficient operation of such trusts.

The KSBET presents a classic example of a trust in need of modification (*cy pres*) to conform to conditions that have changed since it was established some 114 years ago. This Article uses the fact situation provided by the KSBET to examine anew the appropriate use of the *cy pres* doctrine in charitable trusts such as the KSBET. Building upon an earlier Article,[5] I argue for the expansive use of *cy pres* to modify the terms and conditions in perpetual charitable trusts to better utilize the assets of the trusts for the charitable purposes intended by the settlor. In doing so, I counter the argument that a liberal use of *cy pres* will have a chilling effect on charitable gifts and trusts.

To make my argument, I examine the issue of "dead hand" control and its limitation in non-charitable trusts through the operation of the Rule Against Perpetuities. I contend, and intend to prove, that a settlor faced with the choice of establishing a non-charitable trust that will be terminated within lives in being plus twenty-one years, versus a charitable trust that could exist in perpetuity, will continue to opt for charitable trusts, given the advantages of its perpetual nature and notwithstanding the liberal operation of the *cy pres* doctrine. Indeed, I make the argument that during the period covered by the Rule Against Perpetuities (that is, lives in being plus twenty-one years from the settlor's death with respect to a testamentary charitable trust of the type employed in the KSBET), the courts should, as a matter of law, refrain from employing *cy pres* except in exigent circumstances that implicate public policy. Such restraint in deploying the *cy pres* doctrine treats the settlor's intent as paramount during the same time period we would legally allow or defer to the settlor's intent to control the asset's disposition (i.e., the dead hand) in a non-charitable trust. In other words, during the period covered by the Rule Against Perpetuities, the courts should employ the traditional narrow view of *cy pres* and require the party seeking to employ *cy pres* to prove that the settlor had a general purpose and that the purpose is or will be impossible, impracticable, or illegal to perform unless the terms and conditions of the trust are modified as requested.

---

[5] *See* Alex M. Johnson, Jr., *Revolutionizing Judicial Interpretation of Charitable Trusts: Applying Relational Contracts and Dynamic Interpretation to Cy Pres and America's Cup Litigation*, 74 IOWA L. REV. 545 (1989).

However, after the period set by the Rule Against Perpetuities has expired, it is both efficient and beneficial for courts to employ a liberal or expansive view of *cy pres* similar to the current use of the deviation doctrine, which is used solely for "administrative" provisions. It is prudent and efficient to make the distinction between the conservative and liberal use of the *cy pres* doctrine for the same reasons that we employ the Rule Against Perpetuities to limit the duration of non-charitable trusts. That is, we recognize that for the non-charitable trust, the settlor cannot foresee and adequately internalize facts that will occur many years after her demise, and thus, the settlor cannot be given perpetual control over an asset when it is impossible to "recontract" with her to internalize changes postdating her death. Hence, non-charitable trusts are limited in duration to lives in being plus twenty-one years[6] because it is assumed that the settlor can only internalize those facts that she can reasonably foresee and that she can only rely on those heirs and descendants (children and typically grandchildren) of which she has knowledge, and over which she has some control. That same rationale should apply to charitable trusts and lead to the conclusion that a court, acting in good faith and placing itself in the settlor's position, should adhere strictly to the settlor's intent for the period covered by the Rule Against Perpetuities, but be allowed to deviate from strict adherence to the terms of the trust after the period has expired and when it determines that doing so results in a more optimal use of trust assets for the settlor's intended purposes.

The facts of the KSBET controversy also compel the conclusion that the use of *cy pres* should be expanded beyond its traditional scope, which focuses on changed conditions that could frustrate the donor's intention. What is oft-overlooked in cases involving charitable trusts are the problems created by terms establishing the administration of a trust that also have the potential to operate in perpetuity. The facts of KSBET demonstrate that the terms of trust administration, as well as trust purposes, should likewise be governed by the dichotomous *cy pres* doctrine that is proposed herein (i.e., strict interpretation before the expiration of the Rule Against Perpetuities and liberal interpretation of the same after expiration of that period) in order to avoid the problems created by the enormous value of the KSBET corpus, a fact the settlor could not have foreseen at the time she established the trust. Hence, it is similarly appropriate to apply *cy pres* to modify the terms of a trust that govern its administration. This represents a significant and novel expansion in the *cy pres* doctrine, but it is compelled by the reality that the administrative terms of a trust may have more impact on the efficient and appropriate use of trust assets than a determination of the settlor's intent.

---

[6] For further explanation of the Rule Against Perpetuities, *see infra* notes 41-50 and accompanying text.

Building upon the expansive or liberal use of *cy pres* after the expiration of Rule Against Perpetuities period, I conclude with a normative theory of charitable trusts. Under this normative theory, the settlor who establishes a charitable trust is viewed as entering into a contract with the public (represented by the attorney general of the requisite political body), pursuant to which the trust is given perpetual life in exchange for the public's right to modify the trust terms, both substantive and administrative, after the expiration of the period set by the Rule Against Perpetuities, to avoid the trust's obsolescence. Instead of chilling the creation of charitable trusts, the expansive use of *cy pres* can result in the increased creation of charitable trusts once settlors realize that the trust assets will be put to optimal use to benefit society beyond the period that the settlor can foresee, consistent with the settlor's intent.

B. Relevant Facts

Princess Bernice Pauahi Bishop died in 1884 with an estate consisting of the "ancestral lands of the Royal Kamehameha family."[7] Today, the Bishop Estate, as it is popularly known, plays an integral role in Hawai'i's economy because it owns or controls over 300,000 acres of land (almost ten percent of the land in Hawai'i), controls in excess of $1.2 billion in assets and funds, and manages the important Kamehameha Schools.[8] A recent article claimed that the KSBET assets are worth more than ten billion dollars, and that it is the nation's largest charitable trust.[9]

The pertinent provision of the charitable trust directed that the corpus of the trust be used to found, maintain, and operate the Kamehameha Schools.[10] Princess Bishop's will stated:

---

[7] KAMEHAMEHA SCHOOLS/BERNICE PAUAHI BISHOP ESTATE, THE LAND OF KAMEHAMEHA SCHOOLS/BERNICE PAUAHI BISHOP ESTATE 1 (1989).

[8] *See* Jon Van Dyke, *The Kamehameha Schools/Bishop Estate and the Constitution*, 17 U. HAW. L. REV. 413, 413 (1995).

[9] KSBET's assets were described as follows:

> For Hawaiians, it may be the biggest story since statehood, or even Pearl Harbor. After all, it has sex, suicide—and money. Lots and lots of money. It's the scandal over the $10 billion Bishop Estate, the nation's largest charitable trust. The legacy of Princess Bernice Pauahi Bishop, who died in 1884 as the last heir to King Kamehameha, the estate was created to educate native Hawaiian children. It owns 8 percent of the state's land and 10 percent of Goldman, Sachs.

Andrew Murr, *Trouble in Paradise (Mismanagement of Bishop Estate)*, NEWSWEEK (May 20, 1999), at 62.

[10] *See* Mary Leigh Caroline Case, Note, *Hawaiian Eth(n)ics: Race and Religion in Kamehameha Schools*, 1 WM. & MARY BILL RTS. J. 131, 131 (1992).

> I give, devise, and bequeath all of the rest, residue and remainder of my estate real and personal, wherever situated unto the trustees below named, their heirs and assigns forever, to hold upon the following trusts, namely: to erect and maintain in the Hawaiian Islands two schools, each for boarding and day scholars, one for boys and one for girls, to be known as and called the Kamehameha Schools.
>
> I direct my trustees to expend such amount as they may deem best, not to exceed however one-half of the fund which may come into their hands, in the purchase of suitable premises, the erection of school buildings, and in furnishing the same with necessary and appropriate fixtures furniture and apparatus.
>
> I direct my trustees to invest the remainder of my estate in such manner as they may think best, and to expend the annual income in the maintenance of said schools; meaning thereby the salaries of teachers, the repairing of buildings and other incidental expenses; and to devote a portion of each years income to the support and education of orphans, and others in indigent circumstances, giving preference to Hawaiians of pure or part aboriginal blood . . . .[11]

This provision of the will has been interpreted by the trustees of the KSBET to require that only children with Hawaiian ancestry be allowed to enroll and attend the Kamehameha Schools.[12] This provision serves as the focal point of this Article because its interpretation under either the related doctrines of *cy pres* or equitable deviation, which is demonstrated below,[13] can result in courts either modifying the trust on the ground that a provision is administrative (employing equitable deviation) or rejecting a request to modify the trust on the grounds that the affected provision is substantive, calling for the use of the relatively narrow doctrine of *cy pres*.

Hence, it is important and relevant to recognize that the will also contains other provisions that may be subject to legal and other challenges. For example, the will contains a provision that requires that the trustees be selected from "persons of the "Protestant religion" and that "teachers of said school shall forever be persons of the Protestant religion . . . [not] restricted

---

[11] *Will of Bernice Pauahi Bishop*, art. 13 [hereinafter *Will*]. The Will is reprinted in Appendix B to this issue of the *University of Hawai'i Law Review*.

[12] Charles Reed Bishop, one of the first trustees of the estate, wrote in a letter dated February 11, 1897:

> There is nothing in the will of Ms. Bishop excluding white boys and girls from the Schools, but it is understood by the Trustees that only those having native blood are to be admitted at present, that they are to have preference so long as they avail themselves of the privileges open to them to a reasonable extent.

Case, *supra* note 10, at 132 (citing GEORGE KANAHELE, PAUAHI: THE KAMEHAMEHA LEGACY 177 (1986)).

[13] *See infra* section II.E.

to persons of any particular sect of the Protestants."[14] These racial and religious restrictions imposed by the will have caused some, including a jurist, to question the legality of the trust provisions as applied to the Kamehameha Schools, given the public function provided by the schools and their connections to the state of Hawai'i.

In particular, Justice Kazuhisa Abe, in a concurring opinion in *In re Estate of Bishop*,[15] argued that these racial and religious restrictions violated the Equal Protection Clause of the United States Constitution because of the public nature of the schools.[16] In the only litigation to date challenging the validity of these racially and religiously restrictive clauses, the United States Court of Appeals for the Ninth Circuit affirmed the Equal Employment Opportunity Commission's (EEOC) decision that Kamehameha Schools' policy of hiring only Protestant teachers violated Title VII of the Civil Rights Act, and reversed the district court's decision holding that the school was exempt.[17]

In addition to requiring that the trustees be Protestant, the will also requires that any new trustee vacancies be filled by a majority of the justices of the Hawai'i Supreme Court. Princess Bishop's will provides that "the number of my said trustees shall be kept at five; and that vacancies shall be filled by the choice of a majority of the Justices of the Supreme Court, the selection to be made from persons of the Protestant religion."[18] Although this method of trustee selection has been challenged twice unsuccessfully,[19] many critics

---

[14] *Will*, *supra* note 11, art. 13.

[15] *In re* Estate of Bishop, 53 Haw. 604, 608, 499 P.2d 670, 673 (1972).

[16] Specifically, the concurrence is described as follows:

> Justice Abes's concurrence questions whether Kamehameha Schools may continue the policy of race-determined exclusion of all persons who lack Hawaiian ancestry, given that Kamehameha Schools are privately owned by the Bishop Estate and, therefore, exempt from equal protection requirements. Justice Abe concludes that Bishop did not intend to create a school system that would exclude all persons lacking Hawaiian ancestry. Further, Justice Abe reasons that the equal protection clause, applicable under the public function doctrine, is violated by the discriminatory policy.

Van Dyke, *supra* note 8, at 413; *see also* Case, *supra* note 10, at 132 (quoting and discussing *In re* Estate of Bishop, 53 Haw. at 608-16, 499 P.2d at 673-77).

[17] *See* EEOC v. Kamehameha Schools/Bishop Estate 990 F.2d 458 (9th Cir. 1993); *see also* discussion in Van Dyke, *supra* note 8, at 413.

[18] *Will*, *supra* note 11, art. 14.

[19] *See* Van Dyke, *supra* note 8, at 420. Specifically,

> Courts have twice upheld the role of Hawaii's Supreme Court Justices. In 1918, the U.S. Court of Appeals for the Ninth Circuit held in *In re Bishop's Estate* that the Supreme Court Justices were acting in their individual capacities when appointing Bishop Estate trustees, because the Justice's normal duties do not include trust administration. In the second case, *Kekoa v. Supreme Court of Hawaii* [55 Haw. 104, 516 P.2d 1239 (1973), *cert. denied*, 417 U.S. 930 (1974)], the Hawaii Supreme Court (with all five justices

contend that both the method of selecting trustees and the requirement that the trustee be Protestant are illegal and should be stricken, as should the requirement that all students be of Hawaiian ancestry.[20] The recent controversy, detailed below, over the actions of the recent trustees, coupled with the recent negative publicity created as a result, has apparently led four of the five justices of the Hawai'i Supreme Court to announce that they will no longer act in their individual capacity to participate in the selection of trustees.[21]

Not only is the trustee selection process controversial, but the remuneration paid to trustees (in excess of $900,000 per annum) and their autonomy have caused many to question whether anything can be done to reduce trustee compensation so that it is commensurate with effort, and whether action consistent with the trust terms can be taken to hinder or somehow limit the trustees' collective autonomy. A brief review of the allegations of misfeasance directed at the recently removed trustees places this issue in context.

Two of KSBET's recently removed trustees have been indicted on theft charges for allegedly accepting kickbacks for handling KSBET real estate deals.[22] The trustees, both former state legislators, were alleged to have sold their condominiums at inflated prices in exchange for allowing a real estate developer to engage in lucrative development deals with KSBET property and assets.[23] Another trustee, the lead trustee for the school, is alleged to have breached her fiduciary duties to the KSBET and engaged in mismanagement of the Kamehameha Schools. Two trustees petitioned for her removal as a result.[24] In addition, the State Attorney General who was recently ousted from her appointment by the State Senate,[25] petitioned a judge to remove all the

---

> replaced by circuit court judges for this decision) held that the selection process did not violate the due process clause of the Fourteenth Amendment, noting that it was well-established that the Justices were acting in their individual capacities when appointing Bishop Estate trustees.

Id. at 420-21.

[20] *See* Case, *supra* note 10, at 141-143.

[21] *See* Hazel Beh, *Why the Supreme Court Justices Should Stop Appointing Bishop Estate Trustees*, 2 HAW. B.J. 6 (Feb. 1998)(revised in this issue of the *University of Hawai'i Law Review* as Hazel Beh, *Why the Supreme Court Justices Should Stop Appointing Bishop Estate Trustees*, 21 U. HAW. L. REV. 659 (1999)).

[22] *See* Rick Daysog, *Wong Says He'll Win in Courtroom*, HONOLULU STAR-BULLETIN, Apr. 13, 1999, at A-1; Rick Daysog, *Grand Jury Indicts Peters in Theft*, HONOLULU STAR-BULLETIN, Nov. 26, 1998, at A-1.

[23] *See* Tom Lowry, *Trust Scandal Haunts Goldman Sullied Bishop Estate Owns 10% of Bank*, USA TODAY, May 3, 1999, at 1B.

[24] *See id.*

[25] *See* Rick Daysog, *Trustees Deny Influence on Senate*, HONOLULU STAR-BULLETIN, Apr. 29, 1999, at A-1.

trustees, charging them with gross mismanagement of KSBET, including allegations that the trustees made illegal campaign contributions to political allies and used $350 million in income for new, risky investments instead of for educational purposes.[26] These allegations culminated in the temporary removal of four trustees and the resignation of the fifth and last trustee of the KSBET in May of 1999.[27]

Lost amidst the allegations of trustee mismanagement and the resulting investigations and subsequent removal of the trustees is one fundamental fact that is often overlooked when the KSBET is discussed: This is a fabulously wealthy trust, and the Kamehameha Schools, which were the primary object of the settlor's intent, consist of only three percent of the trust's assets.[28] In other words, the corpus of this trust, which has an estimated value somewhere between $6 and $10 billion depending on who and how the assets are counted, was established by the settlor to benefit two schools (later merged into one school) to benefit native Hawaiians. Today, the private Kamehameha School is open to Hawaiian and part Hawaiian students in kindergarten through twelfth grade and has a total enrollment of approximately 3,000. And, although the trustees of the KSBET have invested the trust's assets in everything from Goldman Sachs to a Bermuda insurance company, and a methane gas company in Texas,[29] among other things, the trust instrument itself directs the trustees

> to invest the remainder of my estate in such manner as they may think best, and to expend the annual income in the maintenance of said school; meaning thereby the salaries of teachers, the repairing of buildings and other incidental expenses; and to devote a portion of each years income to the support and education of

---

[26] *See id.* There are other less serious allegations of impropriety involving the trustees. Those allegations are catalogued in a series of articles that appeared in the *Honolulu Star-Bulletin* investigating the actions of the KSBET trustees. *See* Samuel King, Msgr. Charles Kekumano, Walter Heen, Gladys Brandt & Randall Roth, *Broken Trust*, HONOLULU STAR-BULLETIN, Aug. 9, 1997, at B-1 [hereinafter *Broken Trust*], reprinted in Appendix C.

[27] See Todd Purdum, *Hawaii Breaks Cronies' Grip on Powerful School*, CHICAGO TRIB., May 16, 1999, at C18, which stated:

> The judge ordered the removals and accepted the resignation of the fifth trustee after the Internal Revenue Service threatened to revoke the tax exempt status of the trust, the cherished legacy of a childless 19th Century Hawaiian princess, amid an investigation into financial mismanagement and self-dealing by trustees, each of whom was paid about $1 million a year.

See also Peter Waldman, *Suspension of 4 Bishop Estate Trustees Clears Way for Negotiation with IRS*, WALL ST. J., May 10, 1999, at B2.

[28] *See* Isabella Aiona Abbott, Winona K.D. Beamer, Gladys A. Brandt, Roderick F. McPhee & Winona Ellis Rubin, *Schools Gross Mismanagement Must Stop Now*, HONOLULU STAR-BULLETIN, Nov. 27, 1997, at A-23 [hereinafter *Broken Trust II*].

[29] *See Broken Trust, supra* note 26; John H. Taylor, *Hawaii's Royal Legacy*, FORBES, Dec. 21, 1992, at 177.

> orphans, and others in indigent circumstances, giving preference to Hawaiians of pure or aboriginal blood. . . .[30]

Assuming a conservative payout rate of five percent on the lowest estimated value of the corpus of the trust, i.e., $6 billion, the trust, if well-managed, should produce $300 million annually, which is supposed to be spent primarily on the school and secondarily on the support and education of orphans and others in indigent circumstances, according to the terms of the trust. Since there is no evidence that the trustees have ever spent any of the income to support and educate orphans and others in indigent circumstances, it is assumed for the sake of argument that the $300 million dollars should be spent solely for the benefit of the school. If so, that would provide each of the 3000 students with a pro-rata share of $100,000 per annum for his or her educational benefit. If all the money generated by the KSBET was spent to support the Kamehameha Schools, in other words, the trustees would have to come up with creative ways to spend hundreds of millions of dollars annually to benefit a high school when such expenditures may be unnecessary, wasteful, and downright stupid.

This does not mean, of course, that that sort of money has been used solely for school purposes in the past. Indeed, it is contended that it is the amount of wealth generated by the corpus of the trust that has led to the mismanagement of the trust because not all, or not even a large portion, of the income generated by the trust is or was required to satisfy the settlor's main intent: the funding and operation of the Kamehameha Schools for Hawaiians of native ancestry.

This leads one to ask: when should the settlor's intent be modified to take into account societal changes that occur subsequent to the trust unforeseen by the settlor at the time she established the trust?

Should the trustees who are appointed to replace the recently removed trustees require that the entire income generated by the trust's investments be used solely to support the Kamehameha Schools, or do these trustees have a duty to disregard what the will says and apply only so much income as they believe is prudent to the operation and management of the schools? If the latter, what should be done with the remaining income? Should it be reinvested, or should it be used to help educate orphans and support other indigents? Who determines which indigents are preferred and entitled to receive the benefit of the trust's income?

It is clear that the current practice is not to follow the literal terms of the trust, and both judges and trustees, without express judicial or other authority, have deviated from the express terms of the trust when it has been deemed expedient or good practice:

---

[30] *Will, supra* note 11, art. 13.

> More than one hundred years have passed since Mrs. Bishop's death, and if she were here today, she unquestionably would decide some things differently. For example, the princess named five men, who happened to be haole, as the initial trustees of her trust. Does that mean she wanted all future trustees to be of that same make up? Of course not.
>
> In fact, the justices and trustees have themselves occasionally ignored the language of the will—perhaps with good cause. For example, the will says schools should be primarily vocational, and only secondarily college preparatory. That's changed. The will also specifically expresses a desire that the schools benefit orphans and others in indigent circumstances, and makes no mention of admissions based on academic ability. Again, the will's instructions have been modified to deal with the demands of time.[31]

More to the point, the will expressly calls for the trustees to found and operate two schools, one for boys and one for girls, but many years ago, the two schools were combined, and the focus shifted from vocational to college preparatory.

Conversely, the Bishop Estate trustees have terminated popular outreach programs such as prenatal and early education ostensibly because of concern that such efforts are not part of a traditional school curriculum and are not being performed or conducted on the Kamehameha Schools campus, and therefore, not covered by the terms of the settlor's will.[32] This raises questions regarding when a governing instrument should be read expansively. The will establishing the trust calls for "instruction in morals and in such useful knowledge as may tend to make good and industrious men and women; and I desire instruction in the higher branches to be subsidiary to the foregoing objects."[33]

Ignoring for the sake of argument any issues of mismanagement leveled at the recently removed trustees, the real issue the court should address regarding the operation of the KSBET is to what extent the governing instrument should be read creatively or expansively in light of current societal conditions that were not foreseen by Princess Bishop at the time she established the trust. In other words, as circumstances change, especially after the passage of over one hundred years, what sort of changes should courts require on the one hand, and permit on the other, and based on what principles? To what extent should the doctrine of *cy pres* be employed to modify the terms of the trust, and based on what principles? If this question is not answered, this trust, although perhaps not mismanaged, will continue to be used in a suboptimal fashion and

---

[31] *Broken Trust*, *supra* note 26.

[32] *See Broken Trust II*, *supra* note 28.

[33] *Will*, *supra* note 11, art. 13.

contrary to the wishes of the settlor whose predominant intent was to fund educational opportunities for students of Hawaiian ancestry.

The rest of this Article is devoted to a resolution of that issue. However, before turning to a theory of *cy pres* that balances the intent of the settlor with the demands of the intended beneficiaries of the trust many years later, a brief detour must be taken to define and explore the legal principles involved in the interpretation of charitable trusts when *cy pres* or equitable deviation is sought to modify their terms.

II. THE LEGAL ISSUES

A. *Charitable Trusts*

It is beyond cavil that the KSBET is a charitable trust immune from both income taxation and the operation of the Rule Against Perpetuities (of which more anon[34]). However, a brief analysis of charitable trusts and how they differ from non-charitable trusts or private trusts is warranted to highlight the salient attributes of the trust and delineate those attributes that support the expansive use of *cy pres* following the expiration of time required by the Rule Against Perpetuities.

Charitable trusts are trusts established to promote the public good in some capacity. Justice Gray summarized the definition of a valid charitable trust:

> A charity, in the legal sense, may be more fully defined as a gift, to be applied consistently with existing laws, for the benefit of an indefinite number of persons, either by bringing their minds or hearts under the influence of education or religion, by relieving their bodies from disease, suffering or constraint, by assisting them to establish themselves in life, or by erecting or maintaining public buildings or works or otherwise lessening the burdens of government.[35]

What differentiates a private trust from a charitable trust is the size or number of beneficiaries and the nature of the class of beneficiaries:

> Funds devoted to the use of specific persons designated as beneficiaries constitute private trusts, while those funds beneficial to the community as a whole, some part thereof, or an indefinite class, constitute charitable dispositions. The class of beneficiaries must represent a sufficient benefit to the community in order for a court to uphold a trust as charitable. Even if a trust accomplishes charitable purposes, if the class of potential beneficiaries is not sufficiently large and indefinite to make the gift of common and public benefit,

---

[34] *See infra* section II.B.

[35] Dominic Aiello & Tracy Craig, *Cy Pres Reformation of the Charitable Trust*, 81 MASS L. REV. 110, 111 (1996)(quoting Justice Gray in Jackson v. Phillips, 96 Mass. (14 Allen) 539, 556 (1867)).

the trust is not charitable. What matters is not the number of beneficiaries, but rather the breadth of the class, which is made up of recipients and non-recipients alike. Even if very few persons will benefit from the trust because of the size of the fund or the discretion given to the trustee, or because there is a limitation on the number of persons to be benefited, a court will consider a trust charitable if the class of potential recipients is sufficiently large and indefinite in extent. Likewise, so long as the donor designated a sufficiently indefinite class, provisions which identify members of the class to be assisted or given a preference will not deprive the bequest of charitable status.[36]

The Restatement of the Law of Trusts provides a comprehensive definition of charitable trusts:

Charitable purposes include:
(a) the relief of poverty;
(b) the advancement of education;
(c) the advancement of religion;
(d) the promotion of health;
(e) governmental or municipal purposes; and
(f) other purposes the accomplishment of which is beneficial to the community.[37]

Another important attribute of a charitable trust is its exemption from application of the Rule Against Perpetuities.[38] Thus, charitable trusts, as compared to private trusts, can last in perpetuity. Moreover, given the estate and income tax savings generated by charitable trusts, the creation and use of these trusts in estate planning has increased exponentially in the last fifty years.[39] The KSBET is over 100 years old and it will continue in operation as long as assets funding the trust are not depleted or exhausted and are properly deployed to benefit the intended beneficiaries.[40]

---

[36] *Id.* at 111-12 (citations omitted).

[37] RESTATEMENT (SECOND) OF TRUSTS § 368 (1957); *see also* Shenandoah Valley Nat'l Bank v. Taylor, 63 S.E.2d 786 (1951).

[38] *See* JESSE DUKEMINIER & STANLEY M. JOHANSON, WILLS, TRUSTS, AND ESTATES 672 (1995).

[39] *See id.* at 675.

[40] As commentators have suggested:

The seamier aspects of the saga notwithstanding, at the heart of the dispute are charges that the trustees haven't operated the Bishop Estate in the interest of the 15,000 native children who are its beneficiaries. [Attorney General Margery] Bronster charges that they failed to spend $350 million over the past decade—the equivalent of four years of budgets for the Kamehameha Schools—despite rules requiring all income go to them. "That's money that should have been spent on the children," Bronster asserts. The trustees say the funds were properly added to the estate's principal.

Andrew Murr, *supra* note 9, at 62.

B. The Rule Against Perpetuities

No interest is good unless it must vest, if at all, not later than twenty-one years after some life in being at the creation of the interest.[41]

Critical to the thesis of this Article is the contention that the Rule Against Perpetuities should be "applied" to charitable trusts to allow for the liberal use of *cy pres* when the period governed by the Rule has expired. Hence, some limited familiarity with the rule is a prerequisite to understanding the thesis. First, the purpose of the Rule:

> The Rule has three basic purposes: (1) to limit "dead hand" control over the property, which prevents the present generation from using the property as it sees fit; (2) to keep property marketable and available for productive development in accordance with market demands; and (3) to curb trusts, which can protect wealthy beneficiaries from bankruptcies and creditors, decrease the amount of risk capital available for economic development, and, after a period of time and change in circumstances, tie up the family in disadvantageous and undesirable arrangements.[42]

A scholar recently analyzed the Rule Against Perpetuities solely from an economic perspective and concluded that the operation of the Rule created three beneficial effects which, to my eyes, track the three traditional reasons cited above for having the rule, but in reverse order.

> So the Rule has three closely related, beneficial effects, some or all of which may obtain in any given case. First, as recognized by most authorities, the Rule makes more likely the efficient use of resources by collecting rights into bundles more easily exchanged, which facilitates market reallocation to the best use and best user. Second, the Rule increases wealth by sorting rights into packages that generate more enjoyment for the holders, irrespective of whether those packages of rights, those interests, are subsequently reallocated in the market. Third, the Rule accelerates enjoyment by redistributing rights from persons that are not yet

---

[41] J. GRAY, THE RULE AGAINST PERPETUITIES § 201 (4th ed. 1942). Although it took Gray almost 200 pages to distill the Rule Against Perpetuities into the one sentence cited, the history of the rule and its development is rather complex. A complete articulation of the historical development of the rule is beyond the scope of the Article. However, because of the deference paid to Gray's work by the courts, the Rule has sometimes been treated as if it were laid down at one time by this one man. In fact, the Rule had a long and involved evolution. The Rule against Perpetuities is judicial legislation par excellence, and the case-by-case development of the Rule by the courts took several centuries. The origins of the Rule Against Perpetuities are somewhat obscure because of the ambiguous nature of the concept *perpetuity*. The political and social evils attending on perpetual entails, permitted by the Statute de Donis (1285), led judges to become jealous of allowing any limitation tying up land in perpetuity.

[42] DUKEMINIER & JOHANSON, *supra* note 38, at 833.

alive and cannot possibly appreciate their interest to persons that are alive and able to enjoy their rights.[43]

However its purpose is stated, the Rule Against Perpetuities operates by voiding certain interests (typically future contingent interests and executory interests but also interests created by option agreements) in land and personality that vest in interest too remotely. For those unfamiliar with the Rule, what that means is that interests created in trusts which are not given to ascertainable persons (persons in existence at the time of the creation of the trust—in this case, at the death of Princess Bishop, which is when her testamentary charitable trust was legally established) at the time of creation of the trust are subject to the Rule Against Perpetuities.[44]

> The Rule against Perpetuities is a rule that strikes down contingent interests that *might* vest too remotely. The essential thing to grasp about the Rule is that *it is a rule of logical proof.* You must prove that a contingent interest will *necessarily vest or fail* within 21 years of some life in being at the creation of the interest. If you cannot prove that, the contingent interest is void from the outset. What you are looking for is a person who will enable you to prove that the contingent interest will vest within the life of, or at the death of, the person, or within 21 years after the death of the person. This person, if found, is called *the validating life.*[45]

---

[43] Jeffrey Stake, *Darwin, Donations, and the Illusion of Dead Hand Control*, 64 TUL. L. REV. 70, 740 (1990).

[44] For the sake of completeness, it should be noted that interests given to ascertainable persons at the time of the creation of the trust may also be subject to the Rule Against Perpetuities if there is a condition attached to that interest, i.e., Blackacre to Mary if and when the Dodgers when the World Series. Since Mary's interest is contingent upon an event that may or may not happen, that is, the Dodgers winning the World Series, it is a contingent interest and subject to the Rule Against Perpetuities. Moreover, since Mary has a contingent interest that is transmissible inter vivos or by will (that is, she can leave her interest in the property to her heirs in her will), she has a contingent interest in the subject property that can tie up the property—make it less alienable because of her contingent interest (would you buy it knowing that in any given year the Dodgers might win the World Series and cause Mary's interest to vest in Mary or her heirs if she is dead even if that event occurs 100 years from today?)—for a period beyond lives in being plus 21 years. In this hypothetical, Mary is the only relevant life in being but cannot be used as a measuring life because one cannot prove that her contingent interest will vest or fail to vest within 21 years of some event occurring during her life or at the time of her death. It is possible that Mary may die tomorrow and that the Dodgers might not win the pennant—especially the way they are currently playing—for say 30 years causing the interest to vest too remotely. As a result, the contingent interest created in Mary by this hypothetical is void. In order to create a valid interest, the settlor should make Mary a valid measuring life by using the following language: "To Mary if she is living if and when the Dodgers win the World Series." If the Dodgers win the World Series while Mary is alive, she gets the money. If not, Mary's contingent executory interest disappears when Mary disappears, i.e., dies.

[45] JESSE DUKEMINIER & JAMES KRIER, PROPERTY 300 (3d ed. 1993)(emphasis in original)(citation omitted).

The period, lives in being plus twenty-one years, was developed judicially and, in effect, allows the settlor or donor to control the disposition of owned assets for a maximum of two generations, typically children and grandchildren if any grandchildren are in being and are minors at the time the trust becomes legally effective.[46] Thus, the Rule allows settlors of non-charitable trusts to control the disposition of assets for roughly sixty years, at which point absolute ownership of the assets must be vested in one or more existing individuals to do with what those individuals please.[47]

Hawai'i, along with several other states, has enacted the Uniform Statutory Rule Against Perpetuities ("USRAP") as an attempt to reform the common law Rule Against Perpetuities. Under USRAP, an alternative perpetuities period is used to govern the duration of trusts. The statute provides two periods or rules against perpetuities: the common law perpetuities period and a statutory period of ninety years that permits the trust to endure for ninety years, which is considerably longer than the common law Rule Against Perpetuities.[48] The common law Rule Against Perpetuities typically causes trusts to terminate in sixty or so years because of the employment of the lives in being concept and the fact that those lives in being are typically exhausted within that period.[49] In Hawai'i, then, if USRAP is used to determine the relevant perpetuities period, and relatedly, the period during which *cy pres* will be strictly applied and judicial deference is given to the testator's or settlor's wishes, ninety years will be the controlling period rather than the common law lives in being plus twenty-one years. However, given the almost universal condemnation of USRAP by scholars,[50] and that this Article

---

[46] The history of the Rule Against Perpetuities is discussed as follows:

> At the time of the formulation of the Rule against Perpetuities, heads of families—the fathers—were much concerned about securing family land . . . from incompetent sons. . . [Judges] recognized this concern as legitimate and . . . developed an appropriate period of during which the father's judgment could prevail. The father could realistically and perhaps wisely assess the capabilities of *living* members of his family, and so, with respect to them, the father's informed judgment, solemnly inscribed in an instrument, was given effect. But the head of family could know nothing of unborn persons. Hence, the father was permitted control only so long as his judgment was informed with an understanding of the capabilities and needs of persons alive when the judgment was made. Subsequently, the judges permitted the testator to extend his control beyond lives in being if any of the persons in the next generation was actually a minor. Finally, after about 150 years, the judges fixed the period as lives in being plus 21 years thereafter.

Id. at 299 (emphasis in original).

[47] *See infra* note 48 and accompanying text.

[48] For an in-depth discussion of USRAP and a criticism of its statutory 90-year wait-and-see period, see DUKEMINIER & JOHANSON, *supra* note 38, at 886-91.

[49] *See id.* at 887.

[50] *See id.* at 888.

advocates the liberal use of *cy pres* in all jurisdictions, subsequent discussion will focus on the application of the common law Rule Against Perpetuities. If this Article's thesis is adopted in a state like Hawai'i that has adopted USRAP the analysis herein may be modified simply by substituting ninety years instead of the period provided by the common law Rule Against Perpetuities.

A charitable trust creates contingent equitable interests that are subject to the Rule Against Perpetuities. Thus, the KSBET creates equitable interests in future intended beneficiaries of the trust: namely children who will attend the Kamehameha Schools and other intended beneficiaries, i.e., "orphans, and others in indigent circumstances, giving the preference to Hawaiians of pure or aboriginal blood . . . ." The interests created by the charitable trust are contingent in that the interests are created in unascertained persons, persons who are not lives in being at the creation of the interest. Those interests would be subject to the Rule Against Perpetuities if not created in a charitable trust. Moreover, since these equitable contingent interests would vest in interest and possession too remotely, i.e., not within the perpetuities period, they would violate the Rule Against Perpetuities and be rendered invalid if created in a non-charitable trust.

C. *Traditional Cy Pres Doctrine*

The doctrine of *cy pres* is recognized and employed in almost all jurisdictions, including Hawai'i.[51] The doctrine was developed to modify charitable trusts whose purpose had become obsolete as a result of changed conditions not taken into account (internalized) or foreseen by the original settlor or donor.[52] *Cy pres* developed as a necessary corollary to charitable trusts, which are exempt from the Rule Against Perpetuities and are potentially infinite in duration.[53] The KSBET is an illustration of a superannuated charitable trust established by a long-dead settlor—Princess

---

[51] *See* 4A AUSTIN W. SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS § 399.2 (4th ed. 1987); *see also* Roger G. Sisson, Comment, *Relaxing the Dead Hand's Grip: Charitable Efficiency and the Doctrine of Cy Pres*, 74 VA. L. REV. 635, 635 n.6 (1988)(citations omitted)(noting that South Carolina is one state that recognizes no version of *cy pres*). For a Hawai'i case applying *cy pres*, see *In re Estate of Chun Quan Yee Hap*, 52 Haw. 40, 469 P.2d 183 (1970)(applying *cy pres* so that the trust would not violate the Rule Against Perpetuities).

[52] *See* Joseph A. DiClerico, Jr., Cy Pres: *A Proposal for Change*, 47 B.U. L. REV. 153, 154 (1967). When the settlor's intent becomes "impossible, impracticable, or illegal to perform, the court . . . will change the terms of a trust in a way which will both approximate the general intent of the testator or donor and make it possible for the trust to continue to benefit the community." *Id.*

[53] *See supra* note 2 and accompanying text.

Bernice Pauahi Bishop—whose intent, in light of changed circumstances, can only be guessed.[54]

The doctrine of *cy pres* allows courts to exercise their equitable powers to modify a trust's substantive provisions to avoid the obsolescence of the trust, while conforming as strictly as possible to the settlor's original intent.

> Where the continued enforcement of conditions in a charitable gift is no longer economically feasible, because of illegality . . . or opportunity costs . . . the court, rather than declaring the gift void and transferring the property to the residuary legatees (if any can be identified), will authorize the administrators of the charitable trust to apply the assets to a related (*cy pres*) purpose within the general scope of the donor's intent.[55]

Approximately two-thirds of the states recognize and apply *cy pres* when accomplishment of the particular purpose of the trust becomes impossible, impracticable or illegal.[56] Most courts employ a three-part test to determine if *cy pres* modification is appropriate.[57] To be successful, an applicant must show: first, there is a valid charitable trust; second, the settlor's specific charitable objective is frustrated, necessitating *cy pres* modification to carry out the settlor's wishes; and third, the settlor's "general charitable intent" is not restricted to the precise purpose identified in the trust instrument.[58]

---

[54] The changed circumstances alluded to here include, but are not limited to, the fact that the trust's wealth has grown exponentially to a sum that could support several hundred schools of the type envisaged by Princess Bishop. Similarly, the fact that Hawai'i is now a state might affect the Princess' wishes to prefer recipients with Hawaiian blood as well as the fact that the intermixture of races in Hawai'i has all but eliminated racial distinctions in the Islands.

> The sixth [racial] category, utilized largely in Hawai'i, employs a highly variable classification scheme that is independent of racial traits. In Hawai'i, class status serves as an important variable, and the achievement of one's status in no way turns upon racial or ethnic identification. Although Hawai'i is part of the United States and should employ the country's "one drop of blood" rule, the state has rejected this dichotomous classification system as a result of its population mix and its cultural norms. If racial identification rather than ethnic identification is retained as a viable method of categorizing people in the United States, then the classification scheme in Hawai'i would epitomize that goal.

Alex Johnson, *Destabilizing Racial Classifications Based on Insights Gleaned from Trademark Law*, 84 CAL. L. REV. 887, 900 (1996)(citations omitted).

[55] RICHARD POSNER, ECONOMIC ANALYSIS OF THE LAW § 18.4 (4th ed. 1992).

[56] In those states in which the *cy pres* doctrine has been rejected, courts instead apply a liberal doctrine of interpreting testator's charitable purpose, usually described as "approximation." *See* Stanley Johanson, *Charitable Trusts and Dispositions*, C523 A.L.I.-A.B.A. 571, 637 (1990).

[57] *See* Aiello & Craig, *supra* note 35, at 110.

[58] *See* RESTATEMENT (SECOND) OF TRUSTS § 399 (1957). For a novel criticism of the search for a general charitable intent, see DUKEMINIER & JOHANSON, *supra* note 38, at 977-78

Although a few courts have shown increased willingness to apply *cy pres* by construing these requirements liberally,[59] the majority continue to construe the doctrine narrowly.[60] Although I have been unable to discern any empirical data supporting this assumption, it is reasonable to assume that the courts worry that expanding the doctrine—i.e., using it liberally to change the terms and conditions of a settlor's trust—would thwart the testator's intent in many cases and ultimately lead to less charitable giving if future grantors/settlors are aware that courts may later change relevant terms and conditions of the trust.[61]

Courts, of course, apply *cy pres* only to charitable trusts—i.e., "property given in trust to be applied to a particular charitable purpose."[62] Because courts favor charitable dispositions of property, they typically construe the "charitable purpose" requirement liberally and have, as a result, usually found this prerequisite satisfied. Stating it differently, this requirement rarely has prevented the application of the *cy pres* doctrine.

The second element—whether changed circumstances sufficiently impede the execution of the settlor's specific charitable objective—is the requirement that creates most problems for petitioners seeking *cy pres* modification. Most courts have been unwilling to abandon the rigidly textual approach employed when analyzing the second prong of the three-pronged test for applying *cy pres*—i.e., the requirement that changed circumstances have rendered the fulfillment of the purposes of the trust illegal, impossible, or impracticable.

(arguing that the search for a general charitable intent is indeterminate because it relies on "the counterfactual").

[59] *See, e.g.*, Gallaudet Univ. v. National Soc'y of Daughters of the Am. Revolution, 699 A.2d 531 (Md. App. 1997)(employing a flexible approach based on an examination of the four corners of the donor's will to conclude that *cy pres* should be applied to allow funds designated to support a nursing home for members of the DAR to be used to support DAR members generally when the nursing home was closed).

[60] *See, e.g., In re* Estate of du Pont, 663 A.2d 470 (Del. Ch. 1994)(refusing to apply *cy pres* to allow funds donated to operate a convalescent hospital on a specific piece of property to be used to operate a similar facility in a different location when the original facility was closed due to lack of need).

[61] *See, e.g.*, Board of Trustees of Am. Indian, Heye Found. v. Board of Trustees of Huntington Free Library & Reading Room, 610 N.Y.S.2d 488, 501 (N.Y. App. Div. 1994)(refusing to apply *cy pres* when the trustees of the Museum of American Heye Foundation petitioned the court for a return of books it had donated to the Huntington Free Library after the Library, which was located in New York City, donated the books to the Smithsonian Institution in Washington, D.C., resulting in a lack of access to said books by intended beneficiaries of the Museum's trust). I contend, of course, that this reasoning is wrong and counterintuitive. Indeed, I argue later that applying *cy pres* liberally after the period governed by the Rule Against Perpetuities has expired will lead to the optimal use of trust assets. Further, such optimal use of trust assets several years after the settlor's death will be attractive to most settlors and increase the incentive for charitable giving. *See infra* section III.B. and Part IV.

[62] Fireman's Annuity & Benefit Fund v. Municipal Employee's, Officer's, & Official's Annuity & Benefit Fund, 579 N.E.2d 1003, 1006 (Ill. App. Ct. 1991).

This prong requires a fact-specific inquiry,[63] and the courts' refusal to construe this requirement liberally has caused it to become the major impediment to the application of the *cy pres* doctrine in cases in which it is asserted that trust assets can be put to more efficient or better uses consistent with the settlor's general charitable intent.[64]

In re Estate of du Pont[65] aptly illustrates this point. The case involved a dispute concerning the expenditure of funds from an endowment fund created by Eugene du Pont's will. The testator directed that the trust funds be used to create, construct, and operate a convalescent hospital on land—Pelleport—that had been occupied as a home by his mother.[66] He provided that "patients [should] have the benefits of such hospital at a cost less than they otherwise could."[67] The convalescent hospital was built at Pelleport and was operational for almost forty years. Then, in 1992, the trustees of the fund—the Medical Center of Delaware—moved its convalescent care center facility to the nearby Wilmington Hospital and in effect closed the Pelleport hospital. The Medical Center petitioned the court for a declaration that it be allowed to use the trust funds to support the operation of rehabilitative services it was the providing at the Wilmington Hospital facility instead of the recently closed Pelleport facility. The trustees invoked *cy pres* as support for its proposed alternative use of funds, which it claimed would, in the changed circumstances it was reacting to, achieve the settlor's overarching intent.[68]

Because the Medical Center failed to satisfy the court that the trust established by the settlor's will had become impracticable of fulfillment, the court refused to apply *cy pres*.[69] The Medical Center presented evidence that the introduction of Medicare into the health care system since the founding of Pelleport had changed the role of convalescent hospitals. As a result of the changes caused by the introduction of Medicare, Pelleport had begun to receive more seriously ill patients in need of more intensive care.[70] Pelleport apparently had encountered difficulties in servicing this new patient population, and the Medical Center had decided that it could either renovate Pelleport to make it an adequate treatment facility at an estimated cost of eight

---

[63] *See In re* Abrams, N.Y.S.2d 651, 655 (1991)(determining that whether a trust's purpose was impossible or impracticable to perform is a question of fact that requires a fact specific inquiry).

[64] The settlor's general charitable intent, as opposed to a specific charitable intent, must be proven as the third prong in the *cy pres* doctrine. That is discussed *infra* at notes 81-85 and accompanying text.

[65] 663 A.2d 470 (Del. Ch. 1994).

[66] *See id.* at 471.

[67] *Id.* at 473.

[68] *See id.* at 477.

[69] *See id.* at 478.

[70] *See id.* at 474.

to ten million dollars, or relocate the provision of rehabilitation services to the Wilmington Hospital where space was available for that specific purpose. The Medical Center chose the latter option and claimed that spending eight to ten million dollars to renovate Pelleport was impractical.[71]

The Delaware Attorney General and du Pont's son argued that renovating Pelleport was not impractical and that applying trust funds to the Wilmington Hospital would not fulfill "as nearly as possible" the settlor's intent since "his primary intent was that his mother's home be the locus of a convalescent care facility, not that convalescent care be supported in general."[72] Moreover, the Attorney General and du Pont argued that the trustees' "true motive for moving to Wilmington Hospital was simply increased profitability," and the court agreed, stating, "I cannot say from the evidence that it was impracticable for it [the Medical Center] to continue to operate Pelleport as a convalescent hospital, given the resources that Eugene du Pont's will made available and the estimated costs of improvements that would be necessary."[73] The court thus refused to approve a reformation of the trust that would enable the trustees to use its funds to underwrite and support the operation of rehabilitative services at Wilmington Hospital, although it acknowledged that such a reformation would produce a socially optimal result.[74]

A relatively small number of courts have found these considerations less worrisome and thus have abandoned the rigidly textual approach represented by *du Pont*. In *In re Estate of Vallery*,[75] members of a fraternal organization—the Knights Templar of Denver—argued that a provision in Mrs. Vallery's will—which devised the residue of her estate to a community hospital with income from the fund to be used for hospitalization of members of the organization—created a gift in trust (and designated the hospital as trustee) for the benefit of its members rather than an outright but restricted gift to the hospital.[76] They alleged that the hospital had breached its duties as trustee and asked the court to enter an order requiring the hospital to transfer the fund to the organization.[77] The trial court rejected the organization's argument that the will provision had created a trust, but also determined *sua sponte* that changed circumstances warranted reformation of the will to permit income from the fund to be used to defray costs of health care services besides hospitalization for needy members of the Knights Templar.[78] The trial court

---

[71] *See id.* at 477.
[72] *Id.*
[73] *Id.* at 477-78.
[74] *See id.* at 479.
[75] 883 P.2d 24 (Colo. Ct. App. 1993).
[76] *See id.* at 26.
[77] *See id.*
[78] *See id.* at 28.

took judicial notice of the changes that had occurred in the methods and financing of health care since the time of testator's death, and concluded that these changes had rendered the restriction of the fund to use for "hospitalization costs" an impracticable limitation.[79] The appellate court upheld this ruling stating that the "difficulty [which renders a trust term impracticable] need only be a reasonable one and not such as to make the donor's plan a physical impossibility."[80]

The third prerequisite to the application of *cy pres* is a finding that the donor displayed general charitable intent, as distinguished from an intent limited to a specific charitable purpose. Courts have always construed this requirement fairly broadly due to their desire to uphold charitable trusts.[81] Nevertheless, this requirement has constituted, and continues to constitute, a barrier to the application of *cy pres* in some instances.

Questions regarding the donor's intent arise in contexts in which a testator has made some reference to a particular charity. In determining whether the testator had general charitable intent, courts focus on "whether the donor would have preferred that his bequest be applied to a similar charitable purpose should his original scheme not work, or that the unused funds be diverted to private use."[82]

Most courts employ a "four corners approach" in making this determination. That is, they "confine [their] search for whether the testator has manifested a general charitable intent to the four corners of the will, and only consider extrinsic evidence if the language of the will is inconclusive."[83] Thus, many courts that claim to consider "all available, admissible evidence, both intrinsic and extrinsic"—rather than focusing solely on the individual clause that mentions the specific charity—actually refuse to admit extrinsic evidence regarding intent if the face of the will enables them to make a definitive conclusion.[84] Hence, a gift over provision, or even a provision that simply details how a named charity should use trust assets, will preclude further argument on the intent issue; the court will conclude that the testator evinced a specific intent.[85]

---

[79] *See id.*

[80] *Id.*

[81] *See* Aiello & Craig, *supra* note 35, at 113.

[82] *Id.*

[83] Gallaudet Univ. v. National Soc'y of Daughters of the Am. Revolution, 699 A.2d 531, 547 (Md. App. 1997). The court stated that only Maryland, Oklahoma and Vermont have adopted an approach "which permits a court to consider the language of the instrument along with extrinsic evidence when divining whether a testator has manifested a general charitable intent." *Id.*

[84] *In re* Estate of Crenshaw, 819 P.2d 613, 620 (Kan. 1991).

[85] *See In re* Estate of Champlin, 684 A.2d 798, 801 (Me. 1996)(rejecting argument for the application of *cy pres* because "the Champlin will provides a specific alternative gift in the event

D. Equitable Deviation

The doctrine of deviation may be utilized when "it appears to the court that compliance is impossible or illegal, *or that owing to circumstances not known to the settlor and not anticipated by him compliance would defeat or substantially impair the accomplishment of the purposes of the trust.*"[86] What is important, of course, is that deviation applies only to administrative provisions of the trust, in contrast to *cy pres* modification, which affects substantive provisions of the trust.[87] However, distinguishing between administrative and substantive provisions is extremely difficult, if not impossible. As one commentator has noted: "The terms 'substantive' and 'administrative' are obviously conclusionary and give rise to confused and vague court decisions, particularly when an administrative provision is of such central importance in the trust instrument as to take on a substantive nature."[88]

Courts appear to apply the deviation doctrine in situations short of impossibility, particularly when "effective philanthropy" or the public interest is paramount. Courts are less solicitous toward the *cy pres* doctrine because its application "reaches the central purpose of the trust, and is therefore subject to greater restraint" than deviation, which modifies the manner in which the trust is administered.[89] Thus, when the settlor's intent appears to be specific rather than general, or where changed circumstances have rendered the administration of the trust according to its express terms difficult but not "impossible" or "impracticable," courts sometimes invoke the doctrine of deviation to "save" the trust. In doing so, courts articulate the following distinction between these two related doctrines: In applying the deviation doctrine, a court "is merely exercising its general power over the administration of trusts," whereas the application of *cy pres* "requires the exercise of a more extensive power than the ordinary power of a court of equity in ordering deviation."[90] In other words, when applying the doctrine of deviation, the court "does not touch the question of the purpose or the object of the trust, nor vary the class of beneficiaries, nor divert the fund from

---

the gift to the city failed."); Vollman v. Rosenburg, 972 S.W.2d 490, 491-92 (Mo. Ct. App. 1998)(ruling that the language, "I give . . . [certain property] to the Salvation Army to be used, in perpetuity as a Rest Home, or Children's Camp, and aforesaid property never to be sold," demonstrates that testator evinced a specific intent in creating the trust).

[86] RESTATEMENT (SECOND) OF TRUSTS § 381 (1957)(emphasis added).

[87] *See id.* § 381 cmt. a.

[88] DiClerico, *supra* note 53, at 154-55.

[89] Sisson, *supra* note 52, at 648.

[90] Daloi v. Franciscan Health Sys., 679 N.E.2d 1084, 1092 (Ohio 1997)(quoting Craft v. Shroyer, 74 N.E.2d 589, 598 (Ohio Ct. App. 1947)).

the charitable purpose designated."[91] It simply allows "the trustees to deviate from the mechanical means of administration of the trust" in order to facilitate accomplishment of the trust's substantive ends.[92]

E. Traditional Doctrine Applied to the KSBET

Although the recent controversy concerning the operation of the KSBET by the recently removed trustees raises numerous issues, several legal issues transcend that tawdry state of affairs and are worth examining for their resolution under current (traditional) trust doctrine and law. For the sake of brevity, I have chosen to focus on what I perceive to be the two most salient issues arising from the existence and operation of the KSBET: 1) the selection and compensation of trustees; and 2) defining the class of beneficiaries, i.e., who can attend the Kamehameha Schools funded by the trust. These two issues will be analyzed employing the traditionally narrow view of the *cy pres* doctrine and the rather liberal or expansive deviation doctrine.

1. Selection and compensation of trustees

I have chosen this aspect of the KSBET as the first to be addressed regarding the state of current law because I believe it demonstrates the speciousness of the distinction between administrative and substantive provisions of a trust, and it illustrates how the manipulation of the doctrines of deviation and *cy pres* can create differing outcomes regarding trust administration. It is quite clear that the selection and compensation of the trustees can be regarded as either substantive, requiring *cy pres*, or administrative, calling for equitable deviation. If it can be shown that it was the settlor's primary purpose and intent that the trustees selected to operate the KSBET be Protestants, an argument can be made that this requirement is substantive, implicating testator's intent, and therefore modifiable only through *cy pres*.[93] However, the better and prevailing view is that the selection of the trustees is an administrative matter governed by the more liberal rules pertaining to equitable deviation.

> Settlors also frequently include in the trust instrument administrative provisions, which describe how the dispositive provisions will be executed. These may include, for example, provisions regarding investments, sale or retention of property, and the identity of the trustee. A court has the power to direct or permit the trustee of a private or charitable trust to deviate from trust provisions

---

[91] *In re* Estate of Craig, 848 P.2d 313, 321 (Ariz. Ct. App. 1992).

[92] Anderson v. Wolford, 604 N.E.2d 659, 664 n.12 (Ind. Ct. App. 1992).

[93] *See* RESTATEMENT (SECOND) OF TRUSTS § 381 (1957).

> relating to methods of administration "if it appears to the court that compliance is impossible or illegal, or that owing to circumstances not known to the settlor and not anticipated by [her] compliance would defeat or substantially impair the accomplishment of the purposes of the trust." This is true whether the trust is charitable or private, since administrative provisions should give way to the dispositive ones when they are in conflict.[94]

Hence, I contend that the real issue regarding the selection and compensation of the trustees, as well as their qualifications to serve, is not whether the court has the power to select non-Protestant trustees or to require some level of business or financial acumen as a prerequisite to appointment as trustee of this exceedingly wealthy trust. The real problem is that until recently, no one other than the attorney general had legal authority to object to the manner in which trustees were selected and compensated.[95] In the past, since the attorney general's office was part and parcel of the political process that selected the trustees, the attorney general had no reason to examine closely or object to the method of selecting and compensating trustees.[96] It is only when the KSBET attracted prominent and national negative press that sufficient legal attention was focused on the administration and operation of the trust.[97]

It is important to note at this point that the KSBET, like other charitable trusts, created a "negative societal externality" because of its characterization as a charitable trust and the method in which charitable trusts are treated by law. I characterize this phenomenon as a negative societal externality because the operation of charitable trusts generates enforcement costs that are not borne by the individuals most affected by the operation of the charitable trust, i.e., the beneficiaries.[98]

Instead, the attorney general in most states is given the power to enforce charitable trusts,[99] and that entity often has little or no incentive in monitoring, at a very simplistic level, the operation of a charitable trust to determine if a doctrine like equitable deviation should be deployed to create a more efficient use of assets.[100] In effect, there is no effective monitoring mechanism to ascertain when charitable trusts should be modified through the doctrine of

---

[94] GEORGE G. BOGERT ET AL., THE LAW OF TRUSTS AND TRUSTEES 546 (6th ed. 1991)(citing RESTATEMENT (SECOND) OF TRUSTS §§ 381 & 165-167 (1959)).

[95] *See Broken Trust, supra* note 26.

[96] *See id.*

[97] *See* Chronology of Events in the Kamehameha Schools Bishop Estate Controversy (1997-2000) in Appendix A.

[98] For an in-depth and exhaustive analysis of this issue, *see infra* Part IV.

[99] *See* Mary G. Blasko et al., *Standing to Sue in the Charitable Sector*, 28 U.S.F. L. REV. 37, 40-41 (1993).

[100] *See* Kenneth L. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433, 478-79 (1960).

equitable deviation or *cy pres*. This is especially true for charitable trusts which have unlimited useful lives, meaning that these long-term trusts will need to be interpreted when the settlor and his immediate heirs are dead. Due to the charitable character of the trusts, no one beneficiary has standing to sue unless he or she has a special interest.[101]

2. Defining the class of beneficiaries—native Hawaiians

Although it may be possible to modify the selection procedures used to choose the trustees of the KSBET, as well as the appropriate amount of compensation paid to such trustees, questions regarding the intended beneficiaries of the KSBET present substantive issues that should be resolved using the doctrine of *cy pres*. Hence, issues pertaining to the matriculants at the school or schools to be established by the KSBET present substantive questions that should not be conflated with procedural requirements that are resolvable by using equitable deviation. An argument can easily be made and defended that Princess Bishop's primary purpose in establishing the KSBET, her substantive intent, was to use the trust assets to benefit native Hawaiians.

The problem, however, is with the indeterminacy between substantive and administrative provisions when coupled with the provisions of the KSBET. Nowhere in the trust provisions does the settlor state that her principle or primary purpose is the education of native Hawaiians. The exact language of the trust is as follows:

> give, devise and bequeath all of the rest, residue and remainder of my estate real and personal, wherever situated unto the trustees below named, their heirs and assigns forever, to hold upon the following trusts, namely: to erect and maintain in the Hawaiian Islands two schools, each for boarding and day scholars, one for boys and one for girls; to be known as and called the Kamehameha schools.[102]

Nowhere does the trust state that the school is established for native Hawaiians. Indeed, the only reference to Hawaiians occurs later:

> I direct my trustees to invest the remainder of my estate in such manner as they may think best, and expend the annual income in the maintenance of said schools; meaning thereby the salaries of the teachers, the repairing of buildings and other incidental expenses; and to devote a portion of each years income to

[101] *See* DUKEMINIER & JOHANSON, *supra* note 38, at 675-76. As a result, I have prepared a proposal that would eliminate part of the costs generated by this negative societal externality by giving the relevant office of the attorney general sufficient funding to adequately monitor charitable trusts. *See infra* section IV.A.

[102] *Will*, *supra* note 11, art. 13.

the support and education of orphans, and others in indigent circumstances, given preferences to Hawaiians of pure or aboriginal blood . . . .[103]

Hence, given the rather ambiguous meaning of and differentiation between substantive and administrative provisions, and the rather vague provisions of the KSBET pertaining to the students who are intended to benefit from the trust, there is a credible argument that the provisions determining qualification for admission to the Kamehameha Schools are administrative provisions that can be modified by the more liberal doctrine of equitable deviation rather than *cy pres*.[104]

III. A THEORETICAL JUSTIFICATION FOR THE EXPANDED USE OF *CY PRES*

This Part is designed to accomplish three discrete, but related tasks. First, to establish that the distinction between *cy pres* and equitable deviation is specious, without merit, and unsupportable when applied to the facts of the KSBET. This leads me to conclude that the courts should no longer treat the doctrines as distinct. Courts should apply the same test, be it liberal and expansive (which I support) or conservative and restrained (the current treatment of *cy pres* by the majority of courts), irrespective of whether the administrative or substantive provisions of a charitable trusts are subject to interpretation by the court. To do otherwise, I argue, results in the supremacy of form over substance and the manipulation of definitional provisions (what is administrative, what is substantive) to determine outcomes.

The second section in Part III is devoted to explaining my thesis for what I characterize as the narrow, restrained view of *cy pres* (which includes the interpretation of administrative provisions since I have combined *cy pres* and equitable deviation) during the period covered by the Rule Against Perpetuities. This calls for a more liberal and expansive use of *cy pres*, as applied to charitable trusts, following the period covered by the Rule Against Perpetuities. I contend that, to date, the battle over whether courts should employ the narrow or expansive view of *cy pres* has resulted in indeterminate outcomes because an examination of the temporal nature of these trusts has been lacking and, as a result, has not been internalized in the rationale supporting one view or the other. Neither view is persuasive or determinative when time is factored into the decision. It would be ludicrous to apply an expansive view of *cy pres* to a charitable trust one year after it is established,

---

[103] *Id.*

[104] *See* DiClerico, *supra* note 53, at 154-55. "The terms 'substantive' and 'administrative' are obviously conclusionary and give rise to confused and vague court decisions, particularly when an administrative provision is of such central importance in the trust instrument as to take on a substantive nature." *Id.*

just as it is similarly ill-advised to hew strictly to the settlor's intent 200 years after the settlor's death. Time inexorably causes the interests to be benefited or represented in the trust to change.

The last section of Part III is devoted to justifying my temporal treatment of the *cy pres* doctrine. By examining the rationale for the Rule Against Perpetuities, I provide a similar rationale for my temporal analysis of the *cy pres* doctrine. I conclude that unlimited dead hand control of charitable assets through the traditional narrow view of *cy pres* employed by most courts is suboptimal from a societal perspective, and will result in the inappropriate use of charitable assets. However, to answer criticism that such an expanded view of *cy pres* will discourage settlors from funding charitable trusts, I demonstrate that the temporal approach to *cy pres* I advocate actually encourages the creation of charitable trusts by providing fidelity to the grantor's wishes for the period governed by the Rule Against Perpetuities, while allowing modification after the perpetuities period has passed.

A. *Collapsing the Distinction between Cy Pres and Equitable Deviation*

The distinction between *cy pres* and equitable deviation is specious and without merit. Applying the disparate doctrines to the two issues presented by the KSBET and the discussion below[105] clearly demonstrates that the doctrine of equitable deviation may be manipulated to create or result in substantive outcomes that are not allowed or warranted by narrow application of the *cy pres* doctrine. Thus, although the distinction between the two doctrines makes it seem clear and straightforward, current trends in the application of the doctrine reveal that the distinction is difficult to perceive. Furthermore, courts consider the results generated by the application of each doctrine before determining which doctrine to apply (courts tend to peek at the outcome before deciding whether to apply *cy pres* or equitable deviation). Thus, preserving the distinction between the two doctrines leads to indeterminate results.

Since courts have no principled basis for the application of the *cy pres* doctrine, courts feel compelled to make changes that maintain fidelity to the grantor's or settlor's original intent remain open to the charge that the use of *cy pres* is unwarranted and potentially deterrent to future settlors of charitable trusts. The only way to avoid this problem is to establish firm rules for the operation of *cy pres* that inform grantors of the courts' power in this area, and to assuage any concern that the courts' intent will be substituted for that of the grantor/settlor. I propose a temporal treatment of *cy pres* that does just that.

---

[105] *See supra* notes 93-104 and accompanying text.

B. A Temporal Treatment of the Cy Pres Doctrine

I start with the assumption that when the settlor of a charitable trust establishes a trust that will become effective immediately or, more likely, upon the settlor's death, the settlor is cognizant of the current state of affairs that will affect the operation and purpose of the charitable trust. Put another way, I assume that most settlors establishing charitable trusts do so based on their honest belief that there is a need for such a trust, that the assets designated for the trust are best allocated for that purpose, and that the trust's operation will have a beneficial or salutary effect on society.

Take, for example, the trust established by Princess Bishop. At the time of her death, Princess Bishop, based on her knowledge of Hawai'i's affairs, the educational state or well-being of native Hawaiians, and the needs of Hawaiians generally, must have believed that establishing a trust to erect and maintain two schools to educate native Hawaiians or Hawaiians of pure or aboriginal blood[106] resulted in the optimal allocation of her assets for charitable purposes. This is not to say that at the time she established the KSBET in her will, all would agree that the optimal use of those assets was to establish the Kamehameha Schools per the terms of the trust. No claim, empirical or otherwise, is made that even at the time the trust was established, the use to which the assets are put were optimal from a societal perspective. To the contrary, I contend that the charitable trust established by the settlor is optimal from the settlor's perspective based on facts and events known to the settlor at the time the trust is established and becomes operational.

Based on facts, events, feelings, etc., known only to Princess Bishop, it was her belief that assets devoted to the charitable trust could best be used to fund two schools to educate "orphans, and others in indigent circumstances, given preference to Hawaiians of pure or aboriginal blood."[107] That belief may have been true and based on fact, or false and based on fiction. That, however, is irrelevant. What is relevant and indisputable is that the settlor believed that, from her perspective, the assets were put to optimal use per the terms of her will.[108] That assumption is also premised on a belief that the testator was of

---

[106] *See Will, supra* note 11, art. 13.

[107] *See id.*

[108] It is important to keep in mind that these are subjective determinations made by the settlor that may be viewed by others as suboptimal or irrational. Thus, for example, when a settlor leaves thousands or millions of dollars to care for a pet, many may honestly believe that the money is or would be better spent for other purposes. However, it is the settlor's wish, bounded by some constraints, that must be ascertained and followed and those wishes will no doubt be influenced by events occurring during the settlor's life that are unique to that settlor's existence. Hence, our hypothetical settlor who establishes a charitable trust to benefit abandoned pets may not have disposed of her charitable trusts in a manner that most would view as optimal, has

sound mind at the time her will (which established the KSBET) was made, and that she was not suffering from undue influence or any other incapacity that would call into question the validity of her wishes.[109] To be quite clear, I argue that it is only rational to believe that if the testator, in this case Princess Bishop, thought the assets used to fund the trust (hereinafter the "charitable assets") could be better used to fund a hospital to provide indigent care to native Hawaiians given the existing state of Hawaiian hospitals, she would have decided to use the charitable assets to support that endeavor.

My point, and it is an obvious one, is that when a settlor establishes a charitable trust with charitable assets, the purpose of the trust and the use to which the trust assets are dedicated are optimal from the settlor's perspective. What is just as apparent and obvious in the case of charitable trusts established by wills is the temporal horizon that the testator/settlor must internalize in establishing the charitable trust. The settlor must not only believe that the charitable assets are being put to their optimal use at the time of her death, but she must also believe that the charitable assets are being put to optimal use for the foreseeable future as well.

The key of course is the recognition that the settlor, can only foresee so much. It is reasonable to conclude that the settlor can foresee and predict societal changes and evolution for a period of time based on facts within the settlor's knowledge when the trust is established. No one would assert that a settlor can predict future events and societal changes with a degree of certainty allowing the settlor to establish a trust that could successfully adapt to changed conditions occurring centuries after the trust was established. Furthermore, I have not found a settlor who asserts that, given the choice between creating a charitable trust that could last forever and a non-charitable private trust that will terminate under the Rule Against Perpetuities in approximately sixty or seventy years, he or she will fund a charitable trust because the settlor has a better potential to see the future and to draft the terms and conditions of the trust accordingly to respond to future changes. No, one must assume that the settlors of both non-charitable and charitable trusts have

---

disposed of her charitable assets in a fashion that she views and optimal and that provides her with the most satisfaction.

[109] *See* JESSE DUKEMINIER & STANLEY M. JOHANSON, WILLS, TRUSTS, AND ESTATES 176-77 (6th ed. 1999):

> Undue influence may occur where there is a confidential relationship between the parties or where there is no such relationship. Proof may be wholly inferential and circumstantial. The influence may be that of a beneficiary or that of a third person imputed to the beneficiary.
>
> In more recent times judges have tried to cabin this unruly concept by saying that, to establish undue influence, it must be proved that the testator was susceptible to undue influence, that the influencer had the disposition and the opportunity to exercise undue influence, and that the disposition is the result of the influence.

the same ability to foresee future events and to draft the terms and conditions of their respective trusts. The difference, of course, is that the non-charitable trust will, in all situations, terminate in approximately one hundred years,[110] thereby limiting the effects of changed conditions on the terms and conditions of the trust, whereas the charitable trust will endure for perpetuity.

Moreover, and just as importantly, no one today can say with any degree of certainty that he or she can discern what Princess Bishop would do with the assets in the KSBET if she were alive and apprised of the current state of affairs. Given the context within which Princess Bishop lived and the current societal conditions in which an interpreter of her trust finds himself or herself, today's interpreter of Princess Bishop's wishes is, at best, making educated guesses about just how Princess Bishop would have wanted to deploy the tremendous assets in her trust. Hence, asking an interpreter who is extant in today's society whether Princess Bishop had a general or specific intent and whether that intent is thwarted by changed conditions (all of which are predicate to the deployment of *cy pres*) is largely indeterminate because no one in today's society, looking back over a century ago, can answer these questions with certainty.

Further, assuming the interpreter, typically the judge in an equity setting, presumes that changed conditions have impeded the settlor's general charitable intent and call for the use of *cy pres*, it is sheer folly to allege that the resultant changes to the terms and conditions of the trust are the same changes the settlor would have made had she been presented with the same state of affairs. No reasonably intelligent person knows what Princess Bishop would think of the current controversy surrounding the operation of her trust and the problems engendered by the very mechanisms by which she intended her trust to be established and operated.[111]

Illuminating is the fact that the law of trusts inherently recognizes that no settlor can foresee an unlimited future with specificity, and it does so by insuring that non-charitable trusts terminate within a reasonable period of time (roughly consistent with the period of time that the settlor can foresee) through the operation of the Rule Against Perpetuities.[112] The operation of the Rule Against Perpetuities insures that, at least with respect to non-charitable trusts, the settlor's wishes will be adhered to, and to the letter, for a limited period of time. However, after that limited period of time, the assets will be delivered to an entity for disposition, and that entity will have power to dispose of the assets without any compliance or adherence to the settlor's

---

[110] *See supra* section II.B.

[111] Here I am referring specifically to the selection of the trustees by the Justices of the Hawai'i Supreme Court, which has allegedly caused some of the problems in the management of the trust. *See generally* Beh, *supra* note 21.

[112] *See supra* section II.B.

wishes. Moreover, the entity to whom the trust assets are devolved is a creature of the present, not the past. The "new" owner of the assets, which were formerly locked into a form or type of use mandated by the settlor, can use the assets as they are best suited to the owner in light of changes that have occurred since the original trust was settled.

The problem with charitable trusts is not that they will last forever. That perpetualism can be, and indeed is, I contend, a good, positive outcome for society, since that quantum of assets is dedicated to use for charitable purposes, and charitable purposes are viewed as synonymous with social good. The problem, of course, is that the assets are never delivered into a new owner's hands so that the new owner can determine the best use for the assets. What is missing is a new owner who can periodically reassess the best use to which the assets can be put consistent with the settlor's original intent, as set forth in the trust, and as subsequently interpreted by the individual situated in contemporary society.

Here's the puzzle: Given the infinite duration of charitable trusts, there is recognition and acknowledgment that changed conditions will occur that affect their operation. However, even I concede there is no way for someone in today's society to step into the settlor's shoes and accurately determine the settlor's wishes in light of changed conditions that the settlor did not foresee (I also assume the changed conditions are unforeseen because if the settlor foresaw them, she would have internalized mechanisms within the trust to deal with the anticipated changed conditions if and when they occur).

The response to that conundrum is to do nothing, to refuse to alter the terms and conditions of the trust based on what, at first glance, are two perfectly acceptable reasons. First, refusing to alter the terms and conditions of the trust, there is zero risk that the court will misinterpret the settlor's intent and misapply the assets to a purpose not intended by the settlor—this I call the "backwards looking" rationale to the narrow view and use of *cy pres*. By looking backwards to the settlor's original intent and purpose as set forth in the trust, and by refusing to make any changes in the terms and conditions of the trust, the court can rest assured that it is adhering to the settlor's intent. This is the low-risk approach to interpreting the settlor's intent.

The other reason the courts slavishly adhere to the settlor's original intent and refuse to employ *cy pres* is more forward looking, and thus, is designated the "forward looking" rationale for the narrow interpretation of *cy pres*. I suggest that the courts refuse to apply the liberal use of *cy pres* because of the alleged deterrent effect that the doctrine has on future charitable settlors. Courts believe that putative or future settlors of charitable trusts will be deterred from establishing the same if they are made knowledgeable of the fact that courts have broad inherent powers to alter the terms of charitable trusts. Thus, this "forward looking" rationale is premised on the idea that to

do otherwise would deter future settlors from establishing charitable trusts for fear of court interference and alteration with the terms of such trusts.

The problem with both the backwards and future looking rationale is twofold. First, it results in the suboptimal use of charitable assets, and second, it ignores a more plausible alternative: that the settlor would prefer to have her wishes followed when those wishes have some basis in fact—that is, when those wishes are based on facts and events within the settlor's temporal horizon. However, for that period of time beyond the foreseeable future, perhaps the settlor would prefer that the assets be put to their best use, as measured by the current state of affairs.

I support this with two theories. First, people acquire assets, set up trusts, and leave money notwithstanding the fact that they can control it for only so long. Why not have the same outcome with respect to charitable trusts? Second, the settlor of a charitable trust, when establishing the charitable trust, enters into contract with society. I discuss the first theory in the next section and the second theory in Part IV.

C. A Rationale for the Temporal Treatment of Cy Pres

One thing that has always puzzled me is the relatively narrow use by courts of *cy pres* premised on an allegiance to fidelity to the intent of a settlor that is long dead. I find this puzzling because of the widespread existence and acceptance of the Rule Against Perpetuities and the alleged salutary purposes that the Rule promotes. In other words, I find it odd and counterintuitive that with respect to non-charitable trusts, trusts established by the settlor to benefit his or her family and loved ones, we limit the settlor's control to the period governed by the Rule Against Perpetuities. Yet, with respect to charitable trusts, trusts that are established to benefit others and supported by some general charitable intent, it is presumed that the settlor's intent should continue to control the disposition of assets for several hundred years (perhaps forever) after the settlor's death unless one can establish (and the burden of proof is placed on the party seeking modification), with some degree of certainty, that a court should apply *cy pres*.

Why is it that the wishes of the settlor—the settlor's dead hand control—are limited with respect to non-charitable trusts, but not so limited with respect to charitable trusts? Why should society allow the settlor dead hand control in charitable trusts? If one looks at the traditional justification for the operation of the Rule Against Perpetuities—limitation of dead hand control, to make property marketable, and to curb trusts[113]—it is readily apparent that the last two reasons for operation of the Rule Against Perpetuities have no

[113] *See supra* note 39 and accompanying text.

applicability to charitable trusts. Charitable trusts are settled with assets that, by definition, will not be made marketable, at least not to the extent of the assets held in non-charitable trusts that are ultimately transferred at the termination of the trust to an owner who may then transfer the asset to the highest valued user.[114] Similarly, charitable trusts by definition are designed to endure forever, and therefore, the intent to curb the existence of trusts cannot be said to be a purpose of the Rule Against Perpetuities if applied to charitable trusts.

About the only purpose that can be satisfied by applying the purposes of the Rule Against Perpetuities, through an expanded use of *cy pres*, is the limitation on dead hand control. In other words, by not applying something akin to the Rule Against Perpetuities to charitable trusts, the dead hand is allowed to control the disposition of charitable assets in perpetuity. However, there is no persuasive reason that explains why the dead hand should control charitable assets in perpetuity but be limited to lives in being plus twenty-one years with respect to non-charitable assets governed by the Rule Against Perpetuities.

IV. A NORMATIVE JUSTIFICATION FOR THE EXPANSIVE USE OF THE *CY PRES* DOCTRINE

As Geoffrey Manne recently articulated in his article, *Agency Costs and the Oversight of Charitable Organizations*,[115] one major problem with charitable trusts is that, for largely historical reasons, the attorney general is assigned to monitor the operation of such trusts, and is also charged with seeking or opposing the use of *cy pres*, as appropriate.[116] Because of the inefficient monitoring that allegedly occurs, Manne argues that private entities should be created to engage in the monitoring that private investors and others accomplish with respect to for-profit corporate entities.

In this Part, I take a slightly different approach that focuses on the issues presented by the KSBET fact situation and the legal issues arising from it. Although Manne's article focuses on increasing the efficient operation of

[114] I'll ignore for the sake of argument that non-specific assets held in a charitable trust (i.e., land or a building that is not integral or specific to the operation of the charitable trust), may be, if allowed by the trust, transferred or sold by the trustee to third parties if the asset is more valuable in the hands of the third party and the resultant proceeds become part of the trust corpus and are used for the charitable purpose established by the trust. I ignore this possibility because it assumes a point that is in contention in this Article: that charitable trust assets should be treated similar to non-charitable assets with respect to transferability, etc. unless a justification is provided for some other treatment.

[115] Geoffrey Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 WIS. L. REV. 227.

[116] *See id.* at 238-39.

charitable trusts by employing capable monitors, the problem with charitable trusts and *cy pres* is that there is no one entity or person charged with determining when *cy pres* should be employed because it is optimal to do so from the perspective of the settlor, society, or both. This has caused courts to deploy the narrow view of *cy pres* because of the view that doing otherwise would deter settlors from establishing these trusts. As the temporal view of *cy pres* described above demonstrates, that possibility is minimized, if not eliminated, because *cy pres* is deployed expansively only several decades after the charitable trust is established, a time when the settlor's connection to the trust, and the benefits that flow from the establishment of the trust, are rather attenuated. I buttress my argument with the contention that by establishing a charitable trust, the settlor has entered into a contract with the state for its regulation and operation. This contract, which provides tangible and intangible benefits to the settlor and tangible benefits to society is not, however, a contingent contract. It is best viewed and characterized as a relational contract given the exemption of the charitable trust from the operation of the Rule Against Perpetuities.[117] Viewing the contract between the state and the settlor as a relational contract provides a normative basis for the expansive regulation of charitable trusts to internalize the changed conditions that result following the establishment of the charitable trust.

I conclude this Part, and this Article, with a modest proposal that supports the use of the expanded *cy pres* doctrine after the expiration of the Rule Against Perpetuities period. My proposal, unlike Professor Manne's, does not require the creation of separate contractual entities to monitor the efficacy of charitable trusts. Instead, my proposal results in a funding mechanism that will provide the respective offices of the attorneys general with sufficient resources to monitor charitable trusts adequately, including but not limited to, bringing suits, when necessary, to use *cy pres* to change the administrative or substantive terms of a charitable trust as a result of changed or unanticipated conditions that cause the suboptimal deployment—from a societal perspective—of charitable assets.

---

[117] A relational contract is defined as follows:

> A contract is relational to the extent that the parties are incapable of reducing important terms of the arrangement to well-defined obligations. Such definitive obligations may be impractical because of inability to identify uncertain future conditions or because of inability to characterize complex adaptations adequately even when the contingencies themselves can be identified in advance.... [L]ong-term contracts are more likely than short-term agreements to fit this conceptualization, but temporal extension per se is not the defining characteristic.

Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1091 (1981).

A. *Reconstructing the Ex Ante Bargain*

Professor Manne's thesis, which is quite elegant and illuminating, is informative in that it correctly adduces that one principal problem with the operation of charitable trusts is the failure to provide adequate monitors to ensure compliance with the settlor's wishes or the terms of the trust.[118] His solution, the ex post contracting with private firms to introduce capable monitors, represents an attempt to provide those monitors. Whether the insertion of third-party monitors who expressly contract to perform as such will result in the more efficient administration of charitable trusts (assuming one can define efficiency by congruence with the donor or settlor's original purpose or intent or some other standard) is beyond the scope of this Article.[119] The one salient critique I am willing to proffer regarding Professor Manne's thesis is that Professor Manne too easily overlooks and minimizes the one monitor who is charged with overseeing the performance of the trust: the attorney general of the governing jurisdiction where the charitable trust is located. Of course, it is hornbook law that the attorney general is charged with monitoring and enforcing the terms of charitable trusts and is frequently the only party who has standing to bring litigation to enforce relevant provisions of charitable trusts.[120] As Professor Manne correctly asserts, to date, this monitoring mechanism has been deficient because of the attorneys general's lack of interest and funds to monitor and pursue vigorously cases involving possible misfeasance of trusts. On that point I am in total agreement: To date, attorneys general collectively have failed in their obligation to effectively monitor and pursue breaches of duty owed to society arising from the creation and operation of charitable trusts.

---

[118] *See* Manne, *supra* 115, at 227-29.

[119] I find Professor Manne's solution intriguing but problematic for a number of reasons. Primary among my concerns would be aligning the parties' interests in a fashion that provides appropriate and correct incentives for the monitors to act in an efficacious fashion while engaging in monitoring. By that I mean that these third-party monitors have no substantive or underlying interest in the purpose to which the trust is dedicated. They are not intended beneficiaries of the trust, and they are neither benefited nor harmed by the performance or nonperformance of the trust. The monitor's primary interest is the collection of the fee for which it contracted. Thus, the monitors' interest, given the requisite facts, may diverge from that of the intended beneficiaries and, relatedly, that of the settlor. The monitor may be tempted to "look the other way" as long as its fee is paid. Professor Manne acknowledges the problem and argues that the monitor will have an incentive to do its job and internalize the wishes of the settlor and the beneficiaries because if it fails to do so, the reputational effects will be detrimental and preclude future charitable trusts from entering into contracts with the monitor. That argument makes sense in a world in which all have immediate access to perfect information concerning the performance of the monitors. In the imperfect world in which we live, however, Professor Manne's resolution of this issues seems far-fetched and naive.

[120] *See* Manne, *supra* note 115, at 250.

However, I attribute the failure of the attorneys general not to lack of interest or improper motive, but to the lack of funds devoted specifically to this purpose. The attorneys general, although charged with this specific and very important duty, are not given adequate resources to ensure performance of this task.[121] Given that most offices of attorneys general are funded with public dollars that are raised through the general fund and other taxation sources, it stands to reason that an attorney general faced with enforcing criminal statutes, interpreting laws, assisting in drafting legislation, and providing legal opinions, would place a very low priority on monitoring and bringing suits against charitable trusts which benefit only a small segment of the public.

To some extent, when the attorney general uses the scarce resources of its office to pursue and monitor misfeasance regarding the existence and operation of a charitable trust, one can argue that a type of inappropriate or suboptimal (from a societal perspective) wealth transfer has occurred. In essence, the attorney general has devoted resources that have been provided by the general public or public fisc to benefit a select intended group of beneficiaries of the subject charitable trust. This is not necessarily a bad or illegitimate act since the beneficiaries benefit through a charitable trust, the purpose of which is often to provide services that would, in the charitable trust's absence, have to be borne and provided for by the government.

In effect, when one establishes a valid charitable trust, one is entering into an implicit contract with the attorney general, and hence the state, allowing the state, through its attorney general, to fill the void left by the absence of beneficiaries who can sue, and to monitor and enforce the provisions of the subject trust. Technically speaking, by setting up a charitable trust, the settlor is imposing duties on the state and directing that assets be spent in performance of that duty. What is lacking in this implicit contractual arrangement, of course, is the funding mechanism which insures that the duty can and will be performed adequately. The charitable trust imposes a duty with no corresponding obligation to pay for that duty when it is informed. Hence, Professor Manne's proposal.[122]

My proposal is radically different and empirically untested. As I see it, there are two ways charitable trusts can pay for the services provided or performed by the attorney general. One method, perhaps the most direct, would be for the attorney general to bill charitable trusts for the monitoring and enforcement efforts in which it engages. This, however, is problematic in a couple of respects. First, it may be very difficult to determine what amount of effort is attributable to monitoring when no violations of the trust

---

[121] *See* Blasko et al., *supra* note 99, at 39.

[122] *See supra* notes 119-21 and accompanying text.

are alleged. In other words, the ex post mechanism of charging a trust for the enforcement costs it generates works best when there is litigation or some dispute that leads to settlement or judicial resolution. As to that action, costs can be accounted for and maintained. However, how do you charge a trust for standard monitoring to determine compliance? It may be done on an hourly or some other basis, but I predict an ex post determination would present insurmountable accounting problems and result in charitable trusts being charged only when some action is taken by the attorney general in response to some perceived or real problem with the operation or administration of the trust.

This reality leads to other problems concerning the incentive structure that would result if the attorney general received recompense only when violations or other problems are identified and subsequently rectified. I think they are rather obvious—e.g., excessive enforcement, chilling trustees from referring issues to the attorney general for resolution when they are reasonable interpretive questions that can be resolved by the attorney general—and they cause me to question the efficacy of what I am characterizing as an "ex post" cost model of monitoring and enforcement. Perhaps, just as importantly, given the issues that arise with respect to these trusts and their differing size, it may be inappropriate to charge trusts the same amount for the same services that are provided.[123] This creates similar incentives to focus on big rather than small charitable trusts in order to maximize the amount of revenue generated.

My solution to this problem is to favor a second type of funding for the attorney general's monitoring and enforcement duties that is both fair and administrable. I propose that trusts be charged an annual fee equal to some percentage of their corpus—which percentage I will leave to the accountants and other actuarially sophisticated parties, but there is a certain symmetry to have it equal the standard or statutory fee paid to the trustee for managing the trust. The fee will be remitted to the state's office of the attorney general to fund a division within the office whose sole purpose would be the monitoring and enforcement of charitable trusts. This fund would provide a stable basis for maintaining an office whose sole purpose is to act as the settlor's designate in ensuring that the charitable trust is performed according to the settlor's intent, and that there is no misfeasance on the part of the trustee or anyone connected to the trust. More importantly, the costs of this enforcement is paid for by the very people who benefit from the services provided: the settlor and the beneficiaries.

[123] Given the assets controlled by the KSBET, it is easy to see that an attorney general would be interested in monitoring this trust, and that to do so would be more costly than monitoring a million-dollar trust to provide funds to indigent hospital patients.

V. CONCLUSION

The inconsistent (and some would argue unprincipled) use of the *cy pres* doctrine by the courts has caused many scholars to criticize either the doctrine, or the courts, or both. The issue is almost incapable of resolution because it requires a balance between the needs of the present generation by internalizing and respecting changed conditions, and respect for the settlor's original intent in light of changed conditions that the settlor neither foresaw nor could have foreseen given her limited abilities to predict events occurring *in futuro*. The modest proposal advanced herein represents an attempt to harmonize the law of charitable and non-charitable trusts by acknowledging that in the non-charitable trust context, the law recognizes and limits temporally the amount of dead hand control the settlor can exercise over trust assets. By employing the same temporal limitations on dead hand control over charitable trusts, I propose bifurcating judicial review and modification of charitable trusts.

Thus, for the same reasons settlors are allowed to control assets after their deaths for the period governed by the Rule Against Perpetuities (i.e., striking a balance between respecting the wishes and needs of the living and those of the recently departed, deceased owner of the assets), the courts should refrain from employing *cy pres* and the related doctrine, equitable deviation, to change the substantive or administrative terms of a charitable trust during the applicable perpetuities period. Conversely, after the applicable perpetuities period has expired, courts should feel free to employ an expansive or liberal use of *cy pres* when requested to do so by the appropriate individual, i.e., the attorney general. Furthermore, the appropriate attorney general should be given adequate resources to monitor these charitable trusts through a funding mechanism that produces funds from the trusts that would benefit from the monitoring. Given the normative theory that undergirds the existence and operation of these unique charitable trusts, it is fair and reasonable to require that these trusts not only pay an annual fee to ensure their continued vitality given changing societal conditions, but also to ensure that the trust assets are put to their optimal use consonant with the settlor's wishes even though the settlor is long dead. Instead of deterring settlors from establishing charitable trusts, settlors will be encouraged to establish charitable trusts with confidence that the assets they devote to the trust will be put to their best and highest use in perpetuity.

Of Princesses, Charities, Trustees, and Fairytales: A Lesson of the Simple Wishes of Princess Bernice Pauahi Bishop

Judge Robert Mahealani M. Seto*
Lynne Marie Kohm**

"The law has long been the special guardian of philanthropy."[1]

INTRODUCTION

A judge of the probate court of Hawai'i recently reorganized one of the nation's richest charitable trusts. Judge Kevin S. C. Chang[2] ordered four of the five trustees of the Kamehameha Schools Bishop Estate ("KSBE" or "Estate") removed, and accepted the resignation of the fifth, Oswald Stender, citing "extraordinary and unprecedented circumstances not anticipated."[3] The multibillion-dollar charitable trust, the largest in America,[4] was established some 114 years ago in 1884 through the will of Princess Bernice Pauahi Bishop ("Princess Bishop").[5] Princess Bishop, who was the wealthiest woman in the Kingdom of Hawai'i in 1884,[6] left over 400,000 acres of prime Hawaiian fee simple land in a charitable trust for the education of Hawaiian children.[7] As of 1998, her charitable trust, had an aggregate value of approximately six billion[8] and produced over a quarter of a billion dollars

---

* Professor, Regent University School of Law, B.S., St. Louis University, 1962; J.D., St. Louis University, 1968 (Retired Judge, United States Court of Federal Claims).

** Associate Professor, John Brown McCarty Professor of Family Law, Regent University School of Law; B.A., Albany University, 1980; J.D., Syracuse University, 1989.

This Article is dedicated to the memory of Mrs. Beatrice Nipoaloha L. Seto, class of 1927, Kamehameha High School, mother of Judge Seto. "Who can find a virtuous woman? For her price is far above rubies. She stretcheth out her hand to the poor; yea, she reacheth forth her hands to the needy. Strength & honor are her clothing; and she shall rejoice in time to come. Her children arise up, and call her blessed." *Proverbs* 31:10, 20, 25, 28.

[1] F. Emerson Andrews, *Foundations and the Law–A Foreword*, 13 UCLA L. REV. 933, 933 (1966).

[2] Judge Chang is a graduate of Lewis & Clark College of Law and has been a member of the Hawai'i bar since 1978. *See* HAW. STATE BAR. ASS'N, 1998-1999 ANNUAL DIRECTORY 31.

[3] Gail Diane Cox, *Bishop Estate Gets Reorganized*, NAT'L L.J., May 24, 1999, at A5.

[4] *See* Lou Cannon, *Corruption Charges Catch Beloved Hawaii Charity in Furious Undertow*, WASH. POST, Dec. 23, 1997, at A3.

[5] *See* Cox, *supra* note 3.

[6] *See* GEORGE HUE'EU SANFORD KANAHELE, PAUAHI: THE KAMEHAMEHA LEGACY 166-67 (1986).

[7] *See* JULIE STEWART WILLIAMS, PRINCESS BERNICE PAUAHI BISHOP 79 (1992).

[8] *See* Master's Consolidated Report on the One Hundred Ninth, One Hundred Tenth, and

income per year.[9] The trustees of KSBE are charged with portfolio management of these assets, and with the responsibility of the maintenance and management of the Kamehameha Schools.[10]

Every trust is a triangle of three players: a trust settlor (or grantor), a trustee, and a trust beneficiary.[11] Beneficiaries generally enforce the trustee's duties.[12] The charitable trust, however, is one of the great exceptions to the beneficiary enforcement requirement. "As the result of a stormy history on both sides of the Atlantic, trusts for charitable purposes are enforced by the government; the typical official in an American state is the attorney general, although some states now have administrative agencies that are charged with that duty."[13] As the representative of the public at large, the state attorney general usually enforces the charitable trust, holding the trustee accountable to the beneficiaries.[14] If the trust funds benefit a particular individual, that person can also enforce the trust.[15] The recent events in Hawai'i illustrate these concepts in play. Princess Bishop was the settlor of KSBE, the trustees are court appointed by order of her will and the laws of charitable trusts, and the beneficiaries are the students of the Kamehameha Schools, their families and their future employers. A grave concern in this estate has been trustee misconduct.

---

the One Hundred Eleventh Annual Accounts of the Trustees, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Aug. 7, 1998), *available at* <http://starbulletin.com/98/08/07/news/masters2/masters2.html> [hereinafter Master's Report].

[9] *See id.* at 26.

[10] *See* Gail Diane Cox, *In Hawaii: A Princess, A Legacy, A Scandal*, NAT'L L.J. Jan. 11, 1999, at A1. "Her will set up a trust to educate children of Hawaiian blood in perpetuity at the Kamehameha Schools." *Id.* The language of Princess Bishop's will states:

> I give, devise and bequeath all of the rest, residue and remainder of my estate real and personal, wherever situated unto the trustees below named, their heirs and assigns forever, to hold upon the following trusts, namely: to erect and maintain in the Hawaiian Islands two schools, each for boarding and day scholars, one for boys and one for girls, to be known as, and called the Kamehameha Schools. . . . I direct my trustees to invest the remainder of my estate in such manner as they may think best, and to expend the annual income in the maintenance of said schools . . . .

Will of Bernice Pauahi Bishop art. 13 [hereinafter *Will*]. The Will is reprinted in Appendix B to this issue of the *University of Hawai'i Law Review*.

[11] *See* GEORGE T. BOGERT, TRUSTS 1 (6th ed. 1987).

[12] *See* THOMAS L. SHAFFER & CAROL ANN MOONEY, THE PLANNING AND DRAFTING OF WILLS AND TRUSTS 102 (3d ed. 1991). The basic notion is that the trustee must owe some duty to the beneficiaries. *See* ROGER W. ANDERSEN, UNDERSTANDING TRUSTS AND ESTATES 9 (2d ed. 1999).

[13] SHAFFER & MOONEY, *supra* note 12, at 102.

[14] *See* ANDERSEN, *supra* note 12, at 124.

[15] *See id.* at 124 n.2 (citing Hooker v. Edes Homes, 579 A.2d 608 (D.C. 1990)).

A trustee, by any standard, ought to act in the state of mind which the settlor contemplated when she set up the trust.[16] This general principle, however, "points to a human fact about trustees and to a source of tension in the development of trust-administration law. The human fact is that a trustee is usually seen as a surrogate for the dead settlor. . . ."[17] Human error is one thing, but depraved human behavior paid for by KSBE was seen all too frequently in its management.[18] The wealth of the Estate and the compensa-

---

[16] *See* SHAFFER & MOONEY, *supra* note 12, at 126 (attributing this principle to Professor Scott).

[17] *Id.*

[18] Examples of incidents of clear trustee indiscretion abound:

> The estate's "special project's director," former State Senator Milton Holt, had been partying at sex clubs from Honolulu to New Orleans with a VISA card that let him run up a $21,000 tab against the princess's legacy. . . . Professor Randall Roth, who teaches wills and trusts at the University of Hawaii William S. Richardson School of Law, says that Mr. Holt's bar bills illustrate the overall "lack of accountability" . . . . Toni Lee, the head of a group made up of Kamehameha School alumni, faculty and students, finds Mr. Holt's follies indicative of the "arrogance" of those she casts as betrayers of the trust. "How does one even think about using the princess's money in that fashion?" Ms. Lee marvels.

Cox, *supra* note 10. The *National Law Journal* also reported that "[t]he Western Association of Schools and Colleges, a national accreditation group, delivered a midsummer report slamming the trustees for an 'oppressive, intimidating and fearful professional climate' at the schools." *Id.*

Hearings for the removal of Trustee Jervis were postponed due to his illness, a result of a failed suicide attempt. *See* Rick Daysog, *Jervis Wins Delay in Hearing for Removal*, HONOLULU STAR-BULLETIN, Mar. 19, 1999, at A-3. Jervis tried to commit suicide after being caught in a hotel restroom having sex with a lawyer for the estate. *See* Rick Daysog & Christine Donnelly, *Jervis Improves After Overdose*, HONOLULU STAR-BULLETIN, Mar. 12, 1999, at A-1. Concerns over trustee Jervis existed at the outset of his appointment. *See* Jon Van Dyke, *The Kamehameha Schools/Bishop Estate and the Constitution*, 17 U. HAW. L. REV. 413, 425 (1995).

Trustee Richard "Dickie" Wong was indicted for first degree theft, perjury and criminal conspiracy. Rick Daysog, *Wong Says He'll Win in Courtroom*, HONOLULU STAR-BULLETIN, Apr. 13, 1999, at A-1. Fellow trustee Henry Peters was also indicted on a theft charge. *See* Rick Daysog, *Grand Jury Indicts Peters in Theft*, HONOLULU STAR-BULLETIN, Nov. 26, 1998, at A-1. Both indictments were dismissed. *See* Walter Wright, *Judge Throws out Wong Indictments*, HONOLULU ADVERTISER, June 17, 1999, at A1; Rick Daysog, *State Lets Bishop Trustee Wong and Wife off the Hook for Now*, HONOLULU STAR-BULLETIN, June 30, 1999, at A-3; Rick Daysog, *Judge: Peters Didn't Get a Fair Hearing*, HONOLULU STAR-BULLETIN, July 2, 1999, at A-1. Peters was indicted again on August 4, 1999. *See* Rick Daysog, *Peters, Stone Indicted Again by Grand Jury*, HONOLULU STAR-BULLETIN, Aug. 5, 1999, at A-8. This indictment also was dismissed. *See* Ken Kobayashi, *Peters' Case Dismissed*, HONOLULU ADVERTISER, Dec. 18, 1999, at A1. Wong was indicted for perjury a second time on December 9, 1999. *See* Rick Daysog, *Grand Jury Indicts Wong for Perjury*, HONOLULU STAR-BULLETIN, Dec. 10, 1999, at A-1.

The KSBE trustees were even at each other's throats. Attorneys for Trustees Jervis and Stender implored the court to remove Lindsey because she micro-managed the Kamehameha

tion given to its trustees[19] may have been the source from which various iniquities, breaches of duty, and indiscretions flowed. It is quite unlikely Princess Bishop herself would have committed such acts, much less exonerated the trustees for engaging in them, whether they acted in their official capacity as trustees or not. Moreover, the trustees did not want to be held accountable. This is made evident in the Master's Report[20] and in the circumstances surrounding the management of the Kamehameha Schools.[21]

This Article examines two key questions: (1) whom do the trustees represent? and (2) to whom are the trustees of a charitable trust accountable?

Schools, exercised poor judgment, and intimidated students. *See* Petition for Removal of Trustee Marion Mae Lokelani Lindsey, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Dec. 29, 1997).

Judge Kevin Chang eventually ordered the temporary removal of these "Incumbent Trustees," as he called them. *See* Order Regarding Order to Show Cause Regarding Special Purpose Trustees' Report and Order to Show Cause Regarding New CEO Based Management System, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. May 7, 1999), *available at* <http://starbulletin.com/1999/05/07/news/removal.html> [hereinafter Removal Order]. Among other interesting elements of his ruling, Chang ordered the Incumbent Trustees to surrender their offices immediately, and prohibited any communication between them and estate "employees, attorneys, agents and representatives." *Id.*

> The Court further finds and concludes, with the exception of Trustee Stender, under the strict fiduciary standard applicable to the Incumbent Trustees, that the inaction and indifference of the other Incumbent Trustees to . . . the potential loss [of tax-exempt status] constitutes a breach of duty. Simply put, with the exception of Trustee Stender, the other Incumbent Trustees are not acting in the interests of the welfare, protection and preservation of the Trust Estate.

Id. Earlier, the court had appointed five Interim Trustees to represent KSBE in negotiations with the Internal Revenue Service. *See* Minute Order Regarding Trustees Oswald Stender and Gerard Jervis' Petition for Approval of Voluntary Recusal with Respect to Pending Tax Audit and for Appointment of a Panel of Special Administrators with Respect to Pending Tax Audit and Trustees' Petition for Instructions and Approval of Appointment of IRS Dispute Advisory Panel, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Feb. 4, 1999). After the temporary removal of the five Incumbent Trustees, the court appointed the Interim Trustees to take their place. *See* Removal Order, *supra*.

Lokelani Lindsey was removed as a trustee the previous day. *See* Order Granting Petition for Removal of Trustee Marion Mae Lokelani Lindsey Filed on December 29, 1997, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. May 6, 1999). Her removal was immediate and permanent, and came in the form of an order from the judge who had presided over a five-month trial. *See id.*

[19] Each trustee's salary averaged $844,600 per year. *See* Cox, *supra* note 10, at A20.

[20] *See generally* Master's Report, *supra* note 8.

[21] The ousted trustees did not want beneficiary accountability nor student involvement. For instance, the "Lead Trustee for Education," Lokelani Lindsey, was reportedly using intimidation to oppress student voices, having "usurped," "undermined," and "subverted" the powers of Kamehameha Schools' president and his staff, and leaving the school in "turmoil" and "disarray." *See* Master's Report, *supra* note 8.

These questions are answered in part with a discussion of the testator's intent in a charitable purpose.

Using KSBE as an example, we begin in Part I by reviewing the wishes of Princess Bishop in her establishment of KSBE. In Part II we discuss the role, if any, of the beneficiaries in enforcing the terms of a charitable trust. Do these persons have any opportunity to hold the trustees accountable in the discharge of their duties in administration of the trust assets? If so, how might that be accomplished? We suggest they do, and propose some innovative methodology for establishing a critical additional layer of trustee accountability. Finally in Part III, we propose some guidelines for bringing the trust settlor and the beneficiaries back into the charitable trust triangle for invaluable accountability among the trustees. In our proposal for trustee succession in charitable or dynasty trusts, we suggest a way to preserve both the charitable purpose of the trust and the role of trust beneficiaries by linking trustee accountability and successor trustee selection to the involvement of present and future beneficiaries.

Our goal is to reestablish the solid principles designed to make trusts the wonderful vehicles of charitable benefits that they are intended to be. Charitable trusts like KSBE will then truly honor the wishes of the testator, here Princess Bishop, and the benefits she wished to confer on the children of Hawai'i in perpetuity.

I. TESTATOR'S INTENT: WHOM DO THE TRUSTEES REPRESENT?

A. *Charitable Purpose—The History Behind KSBE and Princess Bishop's Charitable Intent*

A historical review of the background behind KSBE is illuminating because it paints the context within which Princess Bishop's intent should be interpreted. This chronicle of events and the resulting attitudes help to analyze the current state of affairs of KSBE and the Kamehameha Schools. This school is the outgrowth of the testamentary trust set out by Princess Bishop, the last of the Kamehameha line of the Hawaiian dynasty. The Princess had a charitable purpose in establishing the trust.

It is important to understand why Princess Bishop, the richest woman in the Kingdom of Hawai'i, would turn down an offer from Kamehameha V to be the first ever sovereign Queen of the Kingdom of Hawai'i,[22] and leave almost her entire estate to all Hawaiian children rather than to her relatives. This makes a closer examination of her life necessary.

---

[22] After Kamehameha V died in 1872, Princess Bishop would have been crowned as Queen in 1872. *See* WILLIAMS, *supra* note 7, at 64.

Of particular importance are her formative years, her formal education, and her exposure to other more advanced kingdoms throughout the world. Most influential were her trips to the United States, England, and European nations.[23] Equally influential was her husband, Charles Bishop, who was the President of the Board of Education of the Kingdom of Hawai'i.[24]

Princess Bishop, who was the last of the royal descendants of King Kamehameha I, was born at 'Aikupika, the home of her parents, *ali'i* Abner Pākī and High Chiefess Laura Konia, in Honolulu, Hawai'i, on December 19, 1831.[25] She was indeed the *ke ali'i* Bernice Pauahi, the great-granddaughter of Kamehameha I, whose identical immense statue graces both downtown Honolulu's I'olani Palace[26] and the United States Capitol rotunda in Washington, D.C.[27]

At the time of her birth, it was common in Hawai'i to name the first born or *hiapo* a name of a favorite ancestor.[28] In this case, her name "Pauahi" came from her mother's half-sister and Princess Bishop's aunt, Princess Pauahi Kekūanaō'a.[29] Princess Pauahi Kekūanaō'a was also the mother of Princess Ruth Ke'elikolani, who would later bequeath to Princess Bishop the bulk of the royal lands which ultimately provided the foundation of Princess Bishop's future charitable trust for Hawaiian children.[30]

Princess Bishop's deep respect for education, which ultimately culminated in the genesis of the Kamehameha Schools,[31] was developed at an early age. Princess Bishop grew up under the reign of King Kamehameha III.[32] This King wanted his people to be educated because he firmly believed that the young *ali'i* needed the knowledge and special skills required when they inherited the onerous responsibility of protecting the Kingdom of Hawai'i against the onslaught of foreigners.[33] To accomplish this objective, King Kamehameha III established "The Royal School" in Honolulu to educate and

---

[23] *See* KANAHELE, *supra* note 6, at 127.

[24] *See id.*

[25] *See* JULIE STEWART WILLIAMS, KE KAMĀLI'i Waihine, Bernice Pauahi Bishop 2 (Haw. Language ed. 1995); KANAHELE, *supra* note 6, at 2, 3. *"Ali'i"* means the chief or chiefess. *See id.* at 2.

[26] The unveiling of the statue of Kamehameha I in front of Ali'iolani Hale took place on February 14, 1883. *See The 1800's*, HE AHA KA MEAHOU MA, Winter 1988, at 2 [hereinafter *The 1800's*].

[27] *See* KANAHELE, *supra* note 6, at x.

[28] *See id.* at 11.

[29] *See id.* at xi.

[30] *See id.* at 11.

[31] Originally two schools were established—one for boys and one for girls, and they were recently integrated into one school. *See* WILLIAMS, *supra* note 7, at 80.

[32] Kauikeaouli, Kamehameha III (1814-1854). *See id.* at 19.

[33] *See id.* at 18.

train the royal *ali'i* children.[34] Here, sixteen royal *ali'i* children who mainly spoke the Hawaiian language were taught to read and write English, as well as arithmetic, algebra, geometry, geography, astronomy, chemistry, literature, spelling, and history.[35] Among these 16 royal *ali'i* children, four later became kings of Hawai'i;[36] two later became queens of Hawai'i;[37] and one, Princess Bishop, later bequeathed almost her entire estate to form one of the largest charitable trusts in the world.[38]

Princess Bishop began her first day at the Royal School, also called the Chief's Children's School, on June 13, 1839.[39] Because the Royal School was a boarding school, the *ali'i* children received academic, spiritual, and discipline training both day and night.[40] During her ten years of intense education she received while boarding at the Royal School, Princess Bishop proved to be a star student, excelling in all aspects of her education.[41]

Her quest for knowledge was derived from the Hawaiian philosophy that knowledge was essentially sacred.[42] Ancient Hawaiians believed that knowledge was sacred because it made life possible; and life, according to the ancient Hawaiians, was the manifestation of *mana*, the intrinsic power of life itself that came from the gods.[43] Accordingly, "if knowledge is sacred, then the process of learning is also sacred."[44] Therefore, Princess Bishop was motivated to learn because she was the product of centuries of Hawaiian tradition and values that elevated knowledge, its acquisition and use, to the zenith of life-giving importance.[45]

Perhaps just as important to her academic education was Princess Bishop's exposure to other great empires of her day, such as the United States, England, and other European nations. In 1875, accompanied by her husband Charles Bishop, Princess Bishop sailed from Honolulu to San Francisco, then on to

---

[34] *See id.* at 26.

[35] *See id.* at 30.

[36] The four kings were Alexander Liholiho (Kamehameha IV); Lot Kapuāiwa (Kamehameha V); William Lunalilo and David Kalākaua. *See id.* at 27.

[37] The two queens were Emma, as the wife of Kamehameha IV, and Lili'u, who reigned as Queen Lili'uokalani. *See id.*

[38] *See id.* at 80; *see also* Cox, *supra* note 10.

[39] *See* KANAHELE, *supra* note 6, at 22, 23.

[40] *See id.* at 28, 29.

[41] *See id.* at 21, 46, 169. She mastered a foreign language, English, as well as the theorems of Euclid and Newton, the great civilizations of Egypt, Greece, Rome and China, the geography of the earth, and the mysteries of astronomy. *See id.* at 21, 46.

[42] *See id.* at 36.

[43] *Mana* is the Hawaiian word for the power of life that comes from the gods. *See id.* "*Mana*" means "[s]upernatural or divine power, mana, miraculous power. . . ." MARY KAWENA PUKUI & SAMUEL H. ELBERT, NEW POCKET HAWAIIAN DICTIONARY 102 (1972).

[44] KANAHELE, *supra* note 6, at 36.

[45] *See id.* at 37.

New York on the first leg of a European whirlwind odyssey.[46] Additionally, they attended numerous dinners, teas and parties with barons, dukes, princes, and princesses and other members of royalty.[47] The adventure, beauty, and enlightenment of these worldly experiences no doubt convinced her of the value of an education, and, on the other hand, the relative lack of education among the majority of her Hawaiian people. Thus, her desire to establish the Kamehameha School was derived from her deep commitment to the education of her people.

1. The debilitating plight of the ordinary Hawaiian

Relevant and important to the thesis of this Article is the fact that ordinary Hawaiians in the nineteenth century were not a formidable empire, but rather, a people in need of educational leadership to move them into the twentieth century. In 1883, one year before Princess Bishop's death, the Hawaiian people were in an appalling condition, being physically, morally and economically depressed.[48]

In the year Princess Bishop was born, the indigenous population of Hawai'i had already declined from 300,000, estimated at the time of Captain Cook's arrival in 1778, to 124,449.[49] By the time Princess Bishop was forty-one years old in 1872, the total population of the Hawaiian Kingdom had dwindled to 56,897, of which 51,531 were native Hawaiians.[50] In 1878, only 44,088 native Hawaiians remained in the Kingdom of Hawai'i.[51] Six years later, in 1884, the year Princess Bishop died, the population of the Hawaiian Kingdom had increased dramatically to 80,578 as a result of immigration caused by the sugar industry; however, the native Hawaiian population had further declined to 40,014.[52]

Indeed native Hawaiians were fast becoming a minority in their own kingdom.[53] Princess Bishop perhaps did not foresee the day in her lifetime

---

[46] Their itinerary covered more than thirty cities, including London, Geneva, Munich, Venice and Paris. They visited dozens of museums and galleries from Versailles to the Uffizi in Florence, cathedrals and castles from the Dom in Cologne to Windsor, and monuments and ruins from the Arch of Triumph to the Coliseum in Rome. *See id.* at 127.

[47] *See id.*

[48] *See id.* at 170.

[49] *See* Master's Report, *supra* note 8.

[50] *See id.*

[51] *See* OFFICE OF HAWAIIAN AFFAIRS, NATIVE HAWAIIAN DATA BOOK 1996 (1996), *available at* <http://oha.org/databook/go-chap1.htm> (derived from ROBERT C. SCHMITT, DEMOGRAPHIC STATISTICS OF HAWAII: 1778-1965 (1968); ROBERT C. SCHMITT, HISTORICAL STATISTICS OF HAWAII (1977)).

[52] *See id.*; *see also* KANAHELE, *supra* note 6, at 170.

[53] *See* LILI'UOKALANI, HAWAII'S STORY BY HAWAII'S QUEEN x (1998).

when *haoles* (foreigners) would outnumber the native Hawaiians. Exacerbating the substantial loss in numbers was the fact that too many of the remaining Hawaiians were dying off rapidly, largely because they had never had the opportunity to develop an immunity to the new diseases carried by the immigrating foreigners.[54]

In addition to facing the imminent danger of these new life-threatening diseases, many native Hawaiians were also psychologically traumatized by their own educational and economic inadequacies to face the new powerful class of American sugar planters.[55] Likewise, the new Chinese and Japanese immigrant laborers, after serving their terms in the sugar plantations, were driven to become educated in order to succeed economically, and to elevate themselves in the community.[56] Thus, many native Hawaiians were psychologically paralyzed, having lost their sense of dignity, self-esteem, and identity.[57]

2. The exacerbation of the plight of the native Hawaiians under the Great Māhele

Further historical examination reveals a great transformation of Hawaiian society. It was not enough that the decimated native Hawaiians had to fight off the myriad foreign diseases to which they had never developed immunity —they also faced the loss of their land.[58] Native Hawaiians lost their economic and social bases by being evicted from their own feudal lands in the Great Māhele, or the adoption of a Western-style system of ownership and property rights.[59] Historian Chinen called the Great Māhele of 1848 the most

[54] Diseases such as leprosy, tuberculosis, diabetes, gonorrhea, syphilis, mumps, measles, whooping cough and smallpox threatened the lives of native Hawaiians, and public health in general. *See* KANAHELE, *supra* note 6, at 170; WARWICK ARMSTRONG, ATLAS OF HAWAI'I 107 (2d ed. 1983).

[55] *See* KANAHELE, *supra* note 6, at 170-71.

[56] *See id.* at 17. The Chinese laborers arrived in 1852, while the Japanese laborers arrived in 1868. *See* ARMSTRONG, *supra* note 54, at 107. Subsequently, Portuguese, Puerto Rican, Korean, and Filipino laborers arrived in Hawai'i. *See id.*

[57] Native Hawaiians were stereotyped as lazy, having no self-initiative, thus instilling in them an overwhelming sense of inferiority. *See* KANAHELE, *supra* note 6, at 170-71.

The psychological, social, and economic devastation of the native Hawaiians was manifested by a litany of broken homes, absent fathers, crime, delinquency, and truancy throughout Hawai'i. The breakdown of the traditional family unit had its repercussions in the decline of education levels among the Hawaiians. *See id.*

[58] *See id.* at 171.

[59] Of the Great Māhele, historian Chinen explains:

The *Mahele* itself did not convey any title to land. The high chiefs and the lesser *konohikis* who participated in *The Mahele* and who were named in the Mahele Book were required to present their claims before the Land Commission and to receive awards for

important event in the reformation of the land system in Hawai'i because it led to the end of the feudal system of lands that existed in the Kingdom of Hawai'i to that point in time.[60]

Prior to the Great Māhele, common Hawaiians had always lived and worked on the land of their particular chief, paying a commutation to him for the right to do so.[61] Accordingly, the chiefs owned great areas of land, generally called *ahupua'as*,[62] and families of common Hawaiians lived and worked areas of this land for their subsistence and for tribute to their chiefs.[63]

When the Great Māhele came to pass, new mandates were promulgated. The revolutionary idea of one person owning a small piece of land outright in fee simple arrived and was made law almost overnight.[64] Under the Great Māhele, the lands of the Kingdom of Hawai'i were basically divided into four parts: (1) The king retained all of his private lands as his own individual property; (2) one-third of the remaining lands was to go to the Hawaiian Government; (3) one-third of the remaining lands for the chiefs and *konohikis*;[65] and (4) the final one-third of the remaining lands to the commoners or tenants who had actually worked and cultivated small plots of land.[66] The result was that the Great Māhele evicted many of the common Hawaiians from their feudal lands, created innumerable legal procedures to secure fee simple land, and made it all the more difficult for native Hawaiians to become land owners.[67]

> the lands quitclaimed to them by Kamehameha III. Until an award for these lands was issued by the Land Commission, title to such lands remained with the government.

JON J. CHINEN, THE GREAT MĀHELE, HAWAII'S LAND DIVISION OF 1848 20-21 (1996). However, many native tenants did not receive title to their land either because they failed to file claims with the Land Commission, or they failed to support their claims. *See id.* at 31. Moreover, the division of land under the Great Māhele was disproportionately against the native tenants' favor. Over 1,500,000 acres of land were set aside for the chiefs, approximately 1,000,000 acres were reserved by King Kamehameha III as "Crown Lands," and 1,500,000 acres were given by the king to the "government and people." *See id.* By contrast, native tenants received less than 30,000 acres of land. *See id.*

[60] *See id.*

[61] *See* RICHARD A. WISNIEWSKI, THE RISE AND FALL OF THE HAWAIIAN KINGDOM 47 (1979).

[62] *Ahupua'as* were generally large land divisions that extended from the top of the mountains, in a pie shape, down to the bottom of the shoreline. *See* PUKUI & ELBERT, *supra* note 43, at 6.

[63] *See* CHINEN, *supra* note 59, at 6.

[64] Chinen observes: "The first *mahele*, or division of lands was signed on January 27, 1848, by Kamehameha III and Princess Victoria Kamamalu by her guardians Mataio Kekuanaoa and Ioane Ii; the last *mahele* was signed by the King and E. Enoka on March 7, 1848." *Id.* at 16.

[65] *Konohikis* worked for the chiefs, and were the headmen of an *ahupua'a*, parceling out the land and fishing rights within the *ahupua'as*. *See* PUKUI & ELBERT, *supra* note 43, at 65.

[66] *See* CHINEN, *supra* note 59, at 16.

[67] *See id.* at 20-22, 30-31.

During this decade in Hawaiian history, the 1840s, most Hawaiians lacked "the knowledge and experience to deal with the growing complexity of governmental affairs."[68] Since even Princess Bishop had to be taught to read and write English at the Royal School, it is not surprising to learn that the general common class of Hawaiians may have spoken English as a second language were unable to read or write English.[69] As a result, some native Hawaiian tenants did not file claims with the Land Commission and others, after filing claims, failed to support their claims before the Land Commission.[70]

These facts lend insight into how the Princess Bishop's intent should be read today. Furthermore, this critical historical analysis explicitly reveals her objectives in establishing the Kamehameha Schools, and highlights the need for trustee accountability in the Estate. Trustees of an estate act, in essence, as agents of the deceased settlor.[71] The KSBE trustees essentially act for, and on behalf of, Princess Bishop. Their actions must therefore stay true to Princess Bishop's charitable intent.

An agency relationship established with a deceased principal, however, appears to create little accountability. Pragmatically speaking, a trustee is accountable not so much to the settlor as to the settlor's intended beneficiaries. Under agency principles, the trustee is an agent, accountable to the beneficiaries in a third-party beneficiary relationship.[72] Thus, the benefits of a charitable trust inure to the beneficiaries of that trust.[73]

To ensure that her trustees would confer the charitable benefits she designated in her will to the beneficiaries of her trust, Princess Bishop left

---

[68] WISNIEWSKI, *supra* note 61, at 45. Even the native chiefs were generally excluded from important positions in the Kingdom of Hawai'i that were being created to become equal with western civilization. *See id.*

[69] For members of an oral culture, there is a great divide between spoken and written language. *See* KANAHELE, *supra* note 6, at 38. Lack of proficiency in the English language made it almost impossible for Native Hawaiians to protect their legal property rights, particularly in view of the fact that after 1844, because of the foreign influence in Hawai'i's government, all newly enacted laws were written in English and then translated into Hawaiian. *See* WISNIEWSKI, *supra* note 61, at 45.

[70] *See* CHINEN, *supra* note 59, at 31.

[71] *See* SHAFFER & MOONEY, *supra* note 12, at 126.

[72] *See* GEORGE G. BOGERT & GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 17 (2d rev. ed. 1984).

[73] *See id.* Charitable purposes include the relief of poverty, the advancement of education or religion, the promotion of health, municipal or governmental purposes and other purposes, the accomplishment of which provide a benefit to the community. *See* RESTATEMENT (SECOND) OF TRUSTS § 368 (1959). In general, a charitable trust is exempt from the Rule Against Perpetuities, and may endure forever. *See* JESSE DUKEMINIER & STANLEY M. JOHANSON, WILLS, TRUSTS, AND ESTATES 672 (5th ed. 1995). KSBE is clearly a charitable trust—its purpose is to educate children of Hawaiian blood. *See Will*, *supra* note 10, art. 13.

specific instructions in her will regarding the disposition and management of her estate. We now take a closer look at her intent in establishing KSBE and the mechanisms by which she intended her will to be carried out.

B. Testator's Intent–The Princess's Will

During her life, Princess Bishop saw how the Great Māhele dramatically caused her native people to become alienated and disenfranchised from their *ahupua'as*.[74] She was acutely aware of the overwhelming physical and social decline of her people.[75] After anguished deliberation she reached the conclusion that, of the gifts she could give them, education was the only gift that could reverse the hopelessness of her people.[76] She believed that the power of education could "awaken the mind and spirit of the people to the world of possibilities and to their own potential."[77] She hoped education could strengthen their self-image, restore their dignity, and enable them to be gainfully employed.[78] She concluded that education would allow them to raise and support their families, increase their living standards, educate their own children, and that ultimately this would entitle all her people to stake out their rightful place in the Kingdom of Hawai'i.[79]

Accordingly, on the last day of October 1883, one year before her death, she affixed her seal to her properly witnessed and executed will.[80] It contained seventeen articles, the thirteenth of which created the Kamehameha Schools, the educational institution that now positively affects the future of thousands of native Hawaiians on a daily basis.[81] The will stated her wish

> to erect and maintain in the Hawaiian Islands two schools, each for boarding and day scholars, one for boys and one for girls, to be known as, and called The Kamehameha Schools. I direct my trustees to expend such amount as they may deem best, not to exceed however one-half of the funds which may come into their hands, in the purchase of suitable premises, the erection of school buildings, and in furnishing the same with necessary and appropriate fixtures, furniture and apparatus .... I direct my trustees to invest the remainder of my

---

[74] *See* KANAHELE, *supra* note 6, at 170-72. "There was an economic antecedent to most if not all of these problems. Hawaiians had long lost control of their economy, partly through the loss or sale of their lands and through being driven out of certain traditional occupational fields like farming ...." *Id.* at 171.

[75] *See id.* at 171.

[76] *See id.* at 170-72.

[77] *Id.* at 172.

[78] *See id.*

[79] *See id.*

[80] *See id.* at 174.

[81] *See Will, supra* note 10, art. 13.

> estate in such manner as they may think best, and to expend the annual income in the maintenance of said schools; meaning thereby the salaries of teachers . . .[82]

In paragraph fourteen of her will she named five trustees to oversee her trust. They were (1) Charles R. Bishop, her husband, who was a respected banker; (2) Samuel M. Damon, executor of Princess Bishop's estate; (3) Charles M. Hyde, a minister and renown educator; (4) Charles M. Cooke, a prominent businessman, and (5) William O. Smith, a reputable lawyer.[83] She further instructed "that the number of my said trustees shall be kept at five; and that vacancies shall be filled by the choice of a majority of the Justices of the Supreme Court, [and] the selection to be made from persons of the Protestant religion."[84]

In October 1884, the month of her death, the Princess executed two codicils to her will.[85] The first codicil was important because it specified additional actions that the trustees could undertake to increase the assets of the trust:

> I give unto the trustees named in my will the most ample power to sell and dispose of any lands or other portions of my estate, and to exchange lands and otherwise dispose of the same; and to purchase land, and to take leases of land whenever they think it expedient, and generally to make such investments as they consider best . . . .[86]

Four years later in 1887, the first of the Kamehameha Schools, the school for boys, was opened with thirty-seven students and four teachers.[87] In 1995-96, the campus enrollment at the Kapalama campus of Kamehameha Schools, from kindergarten through grade twelve, reached a peak of just over 3,000 students.[88] Additionally, the Kamehameha Schools provide preschool education throughout the state of Hawai'i to approximately 780 four-year-old Hawaiian children.[89] Moreover, KSBE now grants college scholarships to dollars over 1,800 students of Hawaiian ancestry, totaling over twelve million annually.[90]

Over the past 100 years, however, the nature of the business operations of KSBE has also evolved. KSBE's assets are no longer limited to the collection

---

[82] *Id.* art. 14.

[83] *See id.*; *see also* KANAHELE, *supra* note 6, at 173.

[84] *Will*, *supra* note 10, art. 14.

[85] *See The 1800's*, *supra* note 26, at 2. Codicil 1 may be found at <http://www.ksbe.edu/estate/will/codicil1.html> [hereinafter *Codicil 1*]. Codicil 2 may be found at <http://www.ksbe.edu/estate/will/codicil2.html>. Both Codicils are reprinted in Appendix B to this Symposium issue.

[86] *Codicil 1*, *supra* note 85, art. 14.

[87] *See The 1800's*, *supra* note 26, at 2.

[88] *See* Master's Report, *supra* note 8.

[89] *See id.*

[90] *See id.*

of rents from tenants on the Estate's leased properties. Rather, the infusion of substantial amounts of cash from the liquidation of residential land holdings under the threat of public condemnation has transformed KSBE into a complex business organization with wide-ranging and sophisticated domestic and international financial investments.[91] In view of the historical economic changes causing a dynamic rise of income, the challenges facing today's trustees in fulfilling the intent of Princess Bishop are extraordinarily daunting.[92]

Charles Bishop, the Princess' husband, predicted these challenges in letters he wrote to two principals of the Kamehameha Schools.[93] His apprehension regarding trustee responsibility was evident. For example, Charles Bishop wrote in 1889 to Uldrick Thompson, then principal of the Kamehameha Schools: "I have more fear of financial embarrassment [by acts of the trustees] or of undesirable reduction of the property of the estate than of being troubled with a surplus [in the trust fund]."[94] And in 1902, Mr. Bishop wrote to another principal, Charles Bartlett Dyke: "An impression has prevailed in the community that the income of the Estate was so large that there was no necessity for economy, or caution in expenditures or privileges, and that carefulness on the part of the Trustees might properly be called meanness!"[95]

Perhaps, Charles Bishop's letter of May 3, 1904, to Joseph O. Carter, a KSBE trustee from 1886 to 1909, summarized best Bishop's concern for the need of constant economic vigilance by future trustees: "The time will never come when the Trustees can safely or properly relax their grip on the finances or expenditures of the Trusts in their keeping."[96] Charles Bishop contemplated the trustee's duties with much anxiety.

Indeed, Princess Bishop's will did create a duty of accountability for her trustees by directing in her will that:

> [M]y said trustees shall annually make a full and complete report of all receipts and expenditures, and of the condition of said schools to the Chief Justice of the Supreme Court, or other highest judicial officer in this country; and shall also file before him annually an inventory of the property in their hands and how invested, and to publish the same in some Newspaper published in said Honolulu. . . .[97]

---

[91] *See id.*

[92] *See id.*

[93] *See* HAROLD W. KENT, CHARLES REED BISHOP, LETTER FILE 33 (1972)[hereinafter KENT, LETTER FILE]; *see also* HAROLD W. KENT, CHARLES REED BISHOP, MAN OF HAWAI'I 179 (1965)[hereinafter KENT, MAN OF HAWAI'I].

[94] KENT, LETTER FILE, *supra* note 93, at 33.

[95] KENT, MAN OF HAWAI'I, *supra* note 93, at 159.

[96] KENT, LETTER FILE, *supra* note 93, at 47.

[97] See *Will*, *supra* note 10, art. 13.

Whether the five recently removed trustees did indeed breach their fiduciary duty under the will and trust of Princess Bishop is up to the appropriate courts in the State of Hawai'i to determine. The Master's Report found profound breaches of the trust, the law, and numerous court orders.[98] When the Master sets forth a *prima facie* case of breach, the trustees have the burden of proving that there is no breach.[99]

The settlor's intent is the controlling factor and guiding principle in nearly all facets of trust and estate administration.[100] Trust matters are litigated in a court of chancery, where equity and court discretion determine outcome.[101] Princess Bishop selected a particular vehicle for promoting the education of Hawaiians. Despite their discretionary authority, in general, chancery courts must approve the educational plan of the settlor:

> Equity is lenient in approving as charitable trusts those encouraging the knowledge which the settlor believes would be for the best interests of mankind. It does not act as a censor and pass as charitable only those trusts which accord with the beliefs and social view of the chancellor. By and large it permits a man [or a woman] to use a charitable trust to secure converts for his notions, even though the majority of mankind would regard his views as freakish.[102]

As a general rule, the only time the settlor's wishes are disregarded is when clearly no social advantage is furthered, thus nullifying the charitable nature of the trust.[103] So long as some substantial benefit will result,[104] and persons are not deprived of their constitutional rights to the equal protection of the laws,[105] a settlor may limit the class of trust beneficiaries as he or she desires.

---

[98] *See* Attorney General's Response to Master's Consolidated Report on the 109th, 110th and 111th Annual Accounts, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Sept. 9, 1998), *available at* <http://starbulletin.com/98/09/10/news/bronster.html> [hereinafter Attorney General's Response]; *see also* Master's Report, *supra* note 8.

[99] *See* Attorney General's Response, *supra* note 98.

[100] *See, e.g.*, Heisserer v. Friedrich (*In re* Heisserer), 797 S.W.2d 864, 871 (Mo. Ct. App. 1990); Annan v. Wilmington Trust Co., 559 A.2d 1289, 1292 (Del. 1989); Estate of Taylor, 522 A.2d 641, 642 (Pa. Super. Ct. 1987).

[101] *See* BOGERT & BOGERT, *supra* note 72, § 870.

[102] BOGERT, *supra* note 11, at 231.

[103] An example is a trust created by George Bernard Shaw to propagandize in favor of an expanded alphabet. The charitable nature of the trust was held invalid in *In Re Shaw* 1 All E.R. 745 (Ch. 1957). The court reached a compromise by permitting the use of a portion of the funds for experimentation in the subject. *See id.* Another example would be where funds had been left to publish the diary of the settlor for non-educational/charitable purposes. *See* State *ex rel.* Emmert v. Union Trust Co., 86 N.E.2d 450 (Ind. 1949).

[104] *See* BOGERT, *supra* note 11, §60, at 230 n.35, where he lists three cases that demonstrate unlikely circumstances that qualified for this "substantial benefit."

[105] *See id.* at 231. Bogert again lists examples at n.36. The best illustration is *In re Girard College Trusteeship*, 138 A.2d 844 (Pa. 1958). A gift was made in trust to Philadelphia for poor

Princess Bishop desired to establish a system of education for Hawaiian children.[106] The trustees have not honored her will. An example of their breach of trust can be found in the admissions practices of the Kamehameha Schools. Selection of students is influenced by political factors, when the appropriate criteria should be need and native Hawaiian heritage.[107] In this regard, the trustees have effectively denied Princess Bishop's wishes. They have not acted as her agent at all. The Kamehameha Schools have become an institution of aristocracy rather than the wonderful charity it ought to be—one that provides the impetus for positive advancement of native Hawaiian children, and Hawaiian children in general. Identifying and preserving the

---

white orphan boys. The court held that public trustees should be enjoined from discriminatory practices. These trustees were enjoined from denying admission to Negro male orphans solely on the ground they were not white. When private trustees took over, the discriminatory trust was upheld. *See id.*

[106] A brief discussion of the constitutionality of the terms of Princess Bishop's will is needed. Limiting admission into the Kamehameha Schools to children of Hawaiian descent is constitutional. Although strong national policy against racial discrimination clearly exists, preferences for native peoples are treated differently under the laws of the United States, considered as "political" rather than "racial" in nature. *See generally* Van Dyke, *supra* note 18, at 414-16. The leading case in this area is *Morton v. Mancari*, 417 U.S. 535 (1974), which upheld a hiring preference for Native Americans for positions in the Bureau of Indian Affairs. *See id.* at 415 n.11. Under this analysis, charitable trusts limited to beneficiaries of Hawaiian descent do not violate the Equal Protection Clause. Indeed, the preference for native Hawaiian children is logical because KSBE lands were originally held in trust for the Hawaiian people by the *ali'i*. *See* Van Dyke, *supra* note 18, at 423.

The issue of racial preferences for native Hawaiians surfaced recently in *Rice v. Cayetano*, 146 F.3d 1075 (9th Cir. 1998). There, the Court of Appeals for the Ninth Circuit determined that voting restrictions on non-Hawaiians for a special election of trustees of the Office of Hawaiian Affairs ("OHA") did not violate equal protection requirements even under strict constitutional scrutiny. *See id.* at 1082. The court noted that since only native Hawaiians can be OHA trust beneficiaries, "the Equal Protection Clause does not preclude Hawaii from restricting the voting for trustees to Hawaiians and excluding all others." *Id.* at 1082. In rendering its decision, the court consulted Hawaiian history to frame the proper context of the issues, as we do in examining Princess Bishop's intent. See id. at 1076-78.

The United States Supreme Court reversed on February 23, 2000. *See* Rice v. Cayetano, 120 S. Ct. 1044 (2000). The Court also examined Hawaiian history at length, but it reached the conclusion opposite of the Ninth Circuit's decision—the Court determined that the race-based voting restriction violated the Fifteenth Amendment. *See id.* at 1047-48. Absent from the Court's holding was the determination that racial preferences for native Hawaiians violate the Equal Protection Clause of the Fourteenth Amendment.

For additional analysis of the competing issues in this case, see Stuart Miner Benjamin, *Equal Protection and the Special Relationship: The Case of Native Hawaiians*, 106 YALE L.J. 537 (1996); and Jon M. Van Dyke, *The Political Status of the Native Hawaiian People*, 17 YALE L. & POL'Y REV. 95 (1998).

[107] "By February 1998, the state had notified the courts that it was broadening its investigation into include possible 'manipulation of the student admission process.'" Cox, *supra* note 10.

role of the intended beneficiaries of this charitable trust can be of great significance in assuring that events like those involving KSBE are not repeated elsewhere.

II. THE ROLE OF THE BENEFICIARIES IN A CHARITABLE TRUST

Do trust beneficiaries have any opportunity to hold trustees accountable in the discharge of their duties as administrators of trust assets? In this case, the direct beneficiaries of KSBE, the students of Kamehameha Schools, are also members of the public. They have been selected to be educated at the Kamehameha Schools. Do the rules of charitable trusts allow these beneficiaries to maintain trustee accountability, and if so, how might this be accomplished?

Trustees of a charitable trust are fiduciaries performing trust duties.[108] Trustees have a duty to communicate with trust beneficiaries.[109] Due to the vast income and estate tax savings that can be achieved through charitable trusts, the government has two basic interests in the administration of charitable foundations.[110] The first interest is in preventing the abuse of tax privileges granted by the state, with the federal government primarily responsible for protecting this interest.[111] The Internal Revenue Code imposes substantial tax penalties on private charitable foundations[112] that do not annually distribute income in an amount equal to five percent of the value of the endowment.[113]

The second interest the government has in the administration of charitable trusts is as a representative of the public, which is the ultimate trust

---

[108] *See* UNIF. PROBATE CODE § 7-302 (amended 1983), 8 U.L.A. 507 (1998)(stating that the "trustee shall observe the standards . . . that would be observed by a prudent man dealing with the property of another . . . .").

[109] *See id.* § 7-303(b) (requiring trustees to answer beneficiaries' reasonable requests for information). "Sometimes the duty may go beyond telling what has happened." ANDERSEN, *supra* note 12, at 365. Andersen cites the related obligation for a fiduciary to keep itself informed about the status of the beneficiaries, as illustrated in *National Academy of Sciences v. Cambridge Trust Co.*, 346 N.E.2d 879 (Mass. 1976), where a trustee was surcharged when it continued to make payments to the testator's widow after she had remarried and her rights to income had ended. *See* ANDERSEN, *supra* note 12, at 365 n.57.

[110] *See* DUKEMINIER & JOHANSON, *supra* note 73, at 675.

[111] *See id.*

[112] *See* I.R.C. § 4942 (1986). These penalties are not imposed on publicly supported charities.

[113] *See id.*; *see also* DUKEMINIER & JOHANSON, *supra* note 73, at 675. Some argue that charitable trust law has been greatly complicated by the enactment of the Tax Reform Act of 1969, and subsequent federal legislation. *See generally* BOGERT, *supra* note 11, at 472-91. A trust as vast as KSBE demands expertise and attention in the area of taxation.

beneficiary, in assuring proper distribution of trust funds.[114] The state governments, through their respective attorneys general, have authority to supervise charitable foundations.[115] The common law confers power on the state attorney general to enforce charitable trusts, which is largely a formal supervision.[116] Unless an audit reveals serious irregularities, however, attorneys general rarely investigate the internal workings of charitable foundations.[117]

As the ultimate beneficiaries of charitable trusts, members of the public, nonetheless, are an important aspect of the fiduciary triangle. In particular, members of the public who are actual beneficiaries, here the students of Kamehameha Schools, have significant third-party beneficiary interests. "The only person other than the attorney general who can enforce a charitable trust is a person with a special interest as a beneficiary."[118] To have such standing, "[t]he person must show that he or she is entitled to receive a benefit under the trust that is not available to the public at large or to an average beneficiary."[119] For example, might a child of Hawaiian descent seeking education or a student at the Kamehameha School be permitted to sue to enforce the terms of the KSBE trust? In recent years, courts have broadened the definition of what constitutes a special interest.

In *Gray v. Saint Matthews Cathedral Endowment Fund, Inc.*,[120] a parishioner was able to sue to enforce a trust for the benefit of his church.[121] In *Gordon v. City of Baltimore*,[122] a taxpayer was allowed to sue to prevent the transfer of a Baltimore library held in trust from the Peabody Institute in Baltimore to the Pratt Library.[123] In *Parsons v. Walker*,[124] a citizen was allowed to sue to enjoin a deviation from the terms of administration, where a gift of land for a park was made to the University of Illinois.[125]

The question of whether students have special standing to sue trustees of a school, however, is not firmly settled. A student petitioner was denied

---

[114] *See* DUKEMINIER & JOHANSON, *supra* note 73, at 675.

[115] *See* SHAFFER & MOONEY, *supra* note 12, at 102.

[116] *See id.*

[117] *See* Kenneth L. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433, 478-79 (1960). *See also* Symposium, *Foundations, Charities and the Law: The Interaction of External Controls and Internal Policies*, 13 UCLA L. REV. 933 (1966) [hereinafter *Foundation, Charities and the Law*].

[118] DUKEMINIER & JOHANSON, *supra* note 73, at 675-76.

[119] *Id.* at 676.

[120] 544 S.W.2d 488 (Tex. Civ. App. 1976).

[121] *See id.*

[122] 267 A.2d 98 (Md. 1970).

[123] *See id.*

[124] 328 N.E.2d 920 (Ill. App. Ct. 1975).

[125] *See id.*

standing to sue in *Miller v. Aderhold*,[126] a case in Georgia where a student wished to sue the college's trustees.[127] The standing of students to sue can be a problem.[128] However, "[r]ecent charitable trusts cases have seemingly recognized the beneficiary status of students and by implication their standing to sue."[129] Several cases involving students as direct beneficiaries of charitable trusts indicate that courts may indeed be inclined to uphold the standing of plaintiff students receiving trust benefits.[130] Of particular interest is *Montclair National Bank & Trust Co. v. Seton Hall College of Medicine & Dentistry*,[131] where a court recognized, in dicta, that students were the true beneficiaries of a gift to a medical school.[132]

A strong argument can be made that students of Kamehameha Schools are third-party beneficiaries, bringing enforcement and accountability to the KSBE trustees. Taking together the scheme of direct beneficiaries, third-party beneficiaries "and the tort concept of the student as a trust beneficiary, the conclusion seems inescapable that responsible student groups should be entitled to seek redress of trustee misconduct in equity."[133] This principle appears ripe for application to the Kamehameha Schools and KSBE.

> Moreover, the theoretical basis for the exclusive standing rule—that the attorney general is in fact more capable of watching over trustees than interested alumni, donors, or students—is repudiated by a manifest inability on the part of the attorneys general's offices to secure enough manpower, money, and statutory authority to support a vigilant supervisory program.[134]

---

[126] 184 S.E.2d 172 (Ga. 1971).

[127] *See id.*

[128] *See* Charles R. Berry & Gerald J. Buchwald, *Enforcement of College Trustees' Fiduciary Duties: Students and the Problems of Standing*, 9 U.S.F. L. REV. 1 (1974)(examining the development of the law regarding trustees and its historical underpinnings, assessing its present effectiveness, and suggesting some directions for future development, especially student involvement).

[129] *Id.* at 37.

[130] *See id.* (citing Eckles v. Lounsberry, 111 N.W.2d 638 (Iowa 1961); Coffee v. Rice Univ., 387 S.W.2d 132 (Tex. Civ. App. 1965)). Compare, however, *Kolin v. Leitch*, 99 N.E. 2d 685, 688 (Ill. App. Ct. 1951), and *Miller v. Alderhold*, 184 S.E.2d 172, 177 (Ga. 1971), where students were denied standing because the courts feared "strike suits" against trustees, with the added rationale that the attorney general was the established representative for the whole class of charitable beneficiaries.

[131] 217 A.2d 897 (N.J. Super. Ct. Ch. Div. 1966) *rev'd on other grounds*, 233 A.2d 195 (N.J. Super. Ct. App. Div. 1967).

[132] *See id.* The students of a school funded by a charitable trust, as authentic beneficiaries, ought to be the focus.

[133] *Id.* at 39.

[134] *Id.* at 39-40.

The beneficiaries of a charitable trust are the keepers of the public trust, imposing on trustees the duty of accountability, and the obligation to enforce the duties they owe to the beneficiaries. "Trustees must be attuned to the changing personal needs of the beneficiaries and the changing markets which affect the management of the trust assets. Trust administration has a pro-active feel."[135] If trustees are held accountable by direct beneficiaries, the administration of that trust certainly becomes more authentic.

III. PROPOSAL FOR TRUSTEE SUCCESSION WITH CHARITABLE (OR DYNASTY) TRUSTS

There is a tendency, as seen in the management of KSBE, for trustees of charitable trusts to not only lose sight of the interests of the beneficiaries, but also to become removed and insulated from accountability to beneficiaries. The larger the estate, the greater the level of insulation. This is particularly true of dynasty trusts because of their perceived degree of imperviousness or invulnerability. Within this framework, we strive to provide a solution to these concerns.

Our proposal has foundational, yet innovative characteristics. First, we see it critical that every effort be made to reserve a role for the direct beneficiaries of a trust, here the students of the Kamehameha Schools. Second, the unidentified beneficiaries must be represented as well, and we suggest two avenues for that representation—the guardian *ad litem* device and the virtual representation doctrine. Finally, we submit that these measures will further the third purpose of our proposal, which is to preserve the charitable intent underlying a charitable trust. When these ideals are continually focused upon, the question of how to maintain trustee accountability becomes crystal clear.

So we ask these questions: *may* trust beneficiaries participate in the selection or removal of successor trustees? Might it be prudent to preserve the trustees' duty to communicate by allowing beneficiaries to participate in the selection of successor trustees? Or, possibly more appropriate: *should* trust beneficiaries participate in the selection or removal of successor trustees? Might it be prudent to preserve the trustees' duty of loyalty by *requiring* beneficiary participation in trustee succession?

A. Preserving the Role of Trust Beneficiaries

Should trust beneficiaries participate in the selection or removal of trustees? We submit that they should, and indeed, the key to holding trustees accountable, and ensuring that they make making wise choices in selecting

---

[135] ANDERSEN, *supra* note 12, at 353.

successor trustees, is to preserve the role of the trust beneficiaries. As Professor Andersen observes:

> Much of the law surrounding fiduciary-beneficiary relationships can be captured in one word: respect. Fiduciaries who think of their beneficiaries first will tend to avoid self-dealing and other conflicts of interest. . . . Building relationships with those you serve not only avoids liability, it greatly lowers the chance that someone will complain if things do go wrong.[136]

Having beneficiaries select the trustees makes sense because they are the ones who ultimately stand to benefit if the trust is managed well, or to lose if it is not.[137] Beneficiaries of the Bishop Estate are indeed the students of the Kamehameha Schools, persons of Hawaiian ancestry benefiting from an education at the Kamehameha Schools. Two avenues for their representation include appointment of a guardian *ad litem* or a virtual representative, devices which we discuss later. Furthermore, the state legislature is empowered to intervene and introduce a new method of selecting trustees.[138] "It would be fairer both to the trustees and to the justices if a different process [than court appointment] were used, and ultimately the Hawaiian beneficiaries should play a central role in this process."[139]

Preserving the beneficiaries' ability to participate in successor selection is of great significance. The possibility of such participation in the face of unidentified beneficiaries, however, remains a vital concern.

B. Representing Unidentified Beneficiaries

Two possibilities of ensuring representation of the interests of unidentified beneficiaries are apparent to us. The first is the use and appointment of a guardian *ad litem*. The second is the use of the "virtual representative" doctrine. A closer examination of these two concepts is helpful.

1. Guardian ad litem

The general rule is that the beneficiaries of a private trust are the only parties that have standing to enforce the duties created by a trust.[140] They enforce the trustees' duties by enjoining any breach of trust by a trustee,

---

[136] *Id.* at 366.

[137] *See* Van Dyke, *supra* note 18, at 424. Professor Van Dyke states, "[I]n a democracy, this approach seems like the only truly defensible solution." *Id.* at 425. We tend to agree.

[138] *See id.* at 424.

[139] *Id.* at 425 (discussing the suspicion and skepticism surrounding the appointment of Gerard Jervis in 1994 after he had previously served on the Judicial Selection Commission, having helped to nominate some of the judges who selected him).

[140] *See* PAUL G. HASKELL, PREFACE TO THE LAW OF TRUSTS 82 (1975).

recovering loss from any resulting breach, or replacing the trustee.[141] With regard to a charitable trust, the general rule is that the only party having standing to enforce the charitable trust is the state attorney general, or in some cases, the local district attorney.[142] "This is consistent with the theory that the community in general benefits from the charitable trust; it follows that the legal officer who represents the people's interest is the appropriate party to enforce the charitable trust."[143] There are, however, exceptions to this general rule.

Clearly, a trustee can always bring suit against a breaching trustee to correct a breach of trust,[144] and in some cases, a trustee has a duty to do so.[145] When the benefit of a charitable trust is distributed directly to specific beneficiaries, the trustees are accountable to more than each other.[146] In such cases, the beneficiary has standing to enforce the trust.[147]

These principles are applicable to KSBE. The benefits of the trust Princess Bishop created flow directly to students at the Kamehameha Schools, funding their education, and thus, making the trustees responsible to the students. The practicalities of student representation then becomes the issue. In such a case, the attorney general alone is inadequate to protect the interests of the trust. The attorney general represents the interests of the general public, but KSBE contemplates a more specific segment of the public as the direct beneficiaries.

The use and appointment of a guardian *ad litem* is significant in giving effect to Princess Bishop's intent. In one case, *Hatch v. Riggs National Bank*,[148] a guardian *ad litem* was appointed to represent the interests of unborn or unascertained beneficiaries.[149] The guardian was appointed for purposes of consent to modification or revocation of a trust.[150] The issue in *Hatch* was whether a settlor could modify a spendthrift trust when interests of yet unborn

---

[141] *See id.*

[142] *See, e.g.*, N.Y. EST. POWERS & TRUSTS LAW § 8-1.1 (McKinney 1999); GA. CODE ANN. § 108-212 (1999); 5 ME. REV. STAT. ANN. tit. 5, § 194 (West 1999); *see also, e.g.*, State v. Taylor, 362 P.2d 247 (Wash. 1961); People *ex rel.* Courtney v. Wilson, 63 N.E.2d 794 (Ill. App. Ct. 1945); *In re* Quinlan's Estate, 45 N.W.2d 807 (Minn. 1951).

[143] HASKELL, *supra* note 140, at 82.

[144] *See, e.g.*, Holt v. College of Osteopathic Physicians & Surgeons, 394 P.2d 932 (Cal. 1964)(in bank); Richards v. Midkiff, 48 Haw. 32, 396 P.2d 49 (1964).

[145] *See* HASKELL, *supra* note 140, at 82 (noting that "[t]his is . . . as true with respect to the private trust as it is with respect to the charitable trust.").

[146] *See id.*

[147] *See id.*

[148] 361 F.2d 559 (D.C. Cir. 1966).

[149] *See id.*

[150] *See id.* at 565.

heirs were involved.[151] The question of the use of a guardian *ad litem* was one of first impression for the equity court:

> Although the question has not been previously discussed by this court we think basic principles of trust law are in accord with appointment of a guardian ad litem to represent interests of unborn or unascertained beneficiaries, for purposes of consent to modification or revocation of a trust. This use of a guardian ad litem is not uncommon in other jurisdictions. In a number of states authority for such appointments is provided by statute. These statutes reflect a broad sentiment of the approaches that are consistent with the Anglo-American system of law and adopted to promote the objective of justice.[152]

The court also noted the flexibility afforded by appointment of such a representative.[153] "Given such protection, the equitable doctrine of representation embraces the flexibility, born of convenience and necessity, to act upon the interests of unborn contingent remaindermen to the same effect as if they had been *sui juris* and parties."[154]

This analysis is easily applied to charitable trusts such as KSBE. Nearly all future students of the Kamehameha Schools are unascertained, but they deserve representation of their future interest. Clearly, all current students under the age of majority ought to have been represented in the proceedings involving the KSBE trustees stemming from the attorney general's investigation. Theirs is the future that may be wasted by the actions of imprudent trustees. Furthermore, the guardian *ad litem* represents a specific beneficiary, as we have stated, whereas the attorney general represents general beneficiaries of the public at large—taxpayers in general, and employers and

---

[151] *See id.* at 560.

[152] *Id.* at 565 (footnote omitted). The leading case upholding such appointments is *Gunnell v. Palmer*, 18 N.E.2d 202 (Ill. 1938), where the court held that a statute authorizing the appointment of a trustee to represent persons not in being was constitutional. *See also* Wogman v. Wells Fargo Bank & Union Trust Co., 267 P.2d 423, 429 (Cal. Dist. Ct. App. 1954); Reynolds v. Remick, 99 N.E.2d 279 (Mass. 1951). *Compare* Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306, 317-18, (1950)(requiring actual notice for due process standards and applying this standard to both *in personam* and *in rem* actions). For a comprehensive and historical approach to guardians *ad litem*, see Martin D. Begleiter, *The Guardian Ad Litem in Estate Proceedings*, 20 WILLAMETTE L. REV. 643 (1984).

[153] *See Hatch*, 361 F.2d at 565-66 (citing Peoples Nat'l Bank v. Barlow, 112 S.E.2d 396, 398-99 (S.C. 1960)).

[154] *Id.* at 566. The court explained:

> The use of guardians *ad litem* to represent interests of unborn and/or otherwise unascertainable beneficiaries of a trust seems to us wholly appropriate. Though the persons whose interests the guardian *ad litem* represents would be unascertainable as individuals, they are identifiable as a class and their interest, as such, recognizable.

Id.

local industries in particular—that might benefit from Kamehameha School graduates in the future.

Professor Mark Begleiter of Duke University has published a comprehensive review of the guardian *ad litem* approach.[155] Concluding that a guardian *ad litem* may indeed solve many problems arising in probate proceedings, Professor Begleiter also agrees that this mechanism applies to trusts. "[I]n almost every state today the court has the power to appoint a guardian *ad litem* to represent infants, incompetents, unborns, and unknown parties in estate and trust proceedings."[156]

Of course, a court will not appoint a guardian *ad litem* if the beneficiary under disability already has a representative, such as a conservator or a guardian.[157] Professor Begleiter points out, however, that a court has equitable powers of discretion even in such instances. "[I]f the court deems the representation by the guardian or conservator inadequate, it will appoint a guardian *ad litem*."[158]

The added protection and accountability afforded by a guardian *ad litem* can be priceless assistance and representation in holding trustees to their duties,[159] particularly when several unascertained beneficiaries may exist with differing interests. The guardian *ad litem* becomes an officer of the court and may not compromise litigation.[160] The role of the attorney general as *parens patriae* does provide protection for the interests of the public. The guardian *ad litem*, however, keeps the direct beneficiary's interest first and foremost. Neither representative is in conflict, but together, they afford the most complete and competent representation to those benefited by the charitable trust.

2. *Virtual representative*

Another option is use of the virtual representative doctrine, which is considered a "major alternative to the guardian ad litem."[161] Virtual

---

[155] *See* Begleiter, *supra* note 152, at 643.

[156] *Id.* at 652-53.

[157] *See id.* at 653.

[158] *Id.* at 653-54 (citing Florida Nat'l Bank & Trust Co. v. Blake, 155 So. 2d 798 (Fla. Dist. Ct. App. 1963)); *In re* Estate of Trout, 131 P.2d 640 (Kan. 1942); *In re* Armour's Trust, 153 N.Y.S.2d 90 (N.Y. App. Div. 1956); *In re* Kenna Estate, 34 A.2d 617 (Pa. 1943); Smith v. Mann, 296 S.W. 613 (Tex. Civ. App. 1927)).

[159] Professor Begleiter details the qualifications for one serving as a guardian *ad litem*. *See* Begleiter, *supra* note 152, at 655-59.

[160] *See id.* at 714 and accompanying citations. Begleiter explains that a guardian *ad litem* may act as an attorney for the incompetent in a particular litigation, or as an officer of the court, and offers extensive analysis of this difference. *See id.* at 715-21.

[161] *Id.* at 721; *see also* ROGER ANDERSEN ET AL., FUNDAMENTALS OF TRUSTS AND ESTATES 327 (1996)).

representation permits one party to a proceeding to represent other persons or a class of persons having a future interest in the trust without making the persons represented parties or serving them with process.[162] The doctrine is premised on the logic that one person can speak for an unknown person who, if identified, would be in the same situation as the speaker.[163]

> The theory behind the doctrine is that, if the representative has the same economic interest as the persons represented, all arguments that could have been made by the person represented will be made by the representative. Therefore, to save time and money (by avoiding the appointment of a guardian *ad litem* for living persons under disability) and because of necessity (the impossibility of obtaining jurisdiction over unborns), one party to the proceeding is allowed to represent others with the same interest.[164]

The virtual representative represents all parties of a particular interest, named or unnamed, identified or unidentified, thereby allowing currently living persons to make decisions even though other beneficiaries may come into existence later.[165] Under the doctrine, all beneficiaries of estates and trusts are treated as necessary parties in litigation involving their interests.[166]

A Hawai'i case provides a current example of how the virtual representative doctrine serves as a means of representation. In *In re Herbert M. Dowsett Trust*,[167] the court stated that virtual representation is traditionally applied in the area of probate proceedings to bind persons who are "unknown, unascertained, or unborn through 'representation by someone with clearly aligned interests.'"[168] In *Dowsett*, the doctrine of virtual representation was used unsuccessfully as an argument to preclude relitigation of an issue by a

---

[162] *See* Begleiter, *supra* note 152, at 723.

[163] *See* ANDERSON ET AL., *supra* note 161, at 327.

[164] Begleiter, *supra* note 152, at 723-24. Another court expressed the utility of the virtual representation doctrine as such:

> The concept of virtual representation has been regarded generally as an advance in procedural methods and as a means of expediting relief and of reducing the expense of litigation while at the same time providing both a sufficient basis for jurisdiction and adequate protection to all interests requiring representation in a proceeding.

In re Estate of O'Connor, 339 N.Y.S.2d 726, 729 (N.Y. Sur. Ct. 1973). For an explanation of the various categories of virtual representatives and their limits, see Begleiter, *supra* note 152, at 724-36.

[165] *See* ANDERSON ET AL., *supra* note 161, at 327.

[166] *See* Begleiter, *supra* note 152, at 721. Professor Begleiter notes that a "[f]ailure to join a necessary party results in, at best, a judgment that will not bind the absent party or, at worst, a finding that the court lacks jurisdiction to decide the case." *Id.*

[167] 7 Haw. App. 640, 791 P.2d 398.

[168] *Id.* at 648, 791 P.2d at 403 (citing 18 CHARLES ALAN WRIGHT ET AL., FEDERAL PRACTICE AND PROCEDURE § 4457 (1981)).

party sharing a substantial identity with another party.[169] The court ruled that a "close family relationship," without more, was not enough to bind a non-party under the doctrine of virtual representation.[170]

State courts are not alone in recognizing the virtual representative doctrine. Federal courts have also held that individuals may be bound by a prior judgment if a party to the suit was so closely aligned with that individual's interests so as to be his virtual representative.[171] The doctrine of virtual representation is generally used in this defensive posture unless the party is a member of a class action, is involved in a will contest or a trust matter, or in a suit in which the parties come under the doctrine of virtual representation.[172] It would appear that the beneficiaries of the KSBE trust fall under two of these three exceptions: Kamehameha School students are members of a class of beneficiaries who are in a position to bring a class action, and a trust matter is involved here. Thus, virtual representation converts the traditional doctrine of res judicata from a clear rule into a vague principle that relies on the balancing of the equities, requiring a close analysis and inspection of the relationship between the parties in each individual case.[173] Any court attempting to apply this doctrine must closely examine the relationships between the parties to find and balance several elements, such as participation, apparent acquiescence, or an express or implied legal relationship where the first parties are accountable to the second parties.[174] Areas of law traditionally grounded in equity seem to demand this kind of approach.

There are risks involved in applying the virtual representation doctrine. As one court noted:

> [The doctrine of virtual representation], resting as it does on principles of convenience and necessity in the administration of justice and being in derogation of the general rule that a judicial decree does not bind a person not

---

[169] *See id.* at 642, 647-48, 791 P.2d at 403-04.

[170] *See id.* at 647, 791 P.2d at 403. *Dowsett* also discusses res judicata, citing an early case involving KSBE, *In re Bishop Estate*, 36 Haw. 403, 416 (1943). *See Dowsett*, 7 Haw. App. at 644, 791 P.2d at 401.

[171] *See* Chase Manhattan Bank v. Celotex Corp., 56 F.3d 343 (2d Cir. 1995)(holding that res judicata did not apply under the virtual representative doctrine as the requisite privity between the parties was lacking); Aerojet-General Corp. v. Askew, 511 F.2d 710 (holding that a person can be bound to a prior judgment if that party's interests are so closely aligned with the interests are original party); Doctor's Assocs., Inc. v. Reinert & Duree, P.C., No. 98-9156, 1999 WL 606843 (2d Cir. May 5, 1999)(holding that an agent of a principal was not a virtual representative).

[172] *See* California & Hawaiian Sugar Co. v. Bunge Corp., 593 S.W.2d 739 (Tex. Civ. App. 1979).

[173] *See* 1 HERBERT B. NEWBERG & ALBA CONTE, NEWBERG ON CLASS ACTIONS § 4.46 (3d ed. 1992).

[174] *See id.*

> before the court, is applied with great caution. And ordinarily, the principle of virtual representation may be invoked only when it is made to appear, and the pleadings should so show, that the persons not before the court have an interest in common—an interest similar—to that of the parties who sue or defend on behalf of others. In short, to bind unborn persons, it must be made to appear that the rights or interests asserted by the parties before the court are identical with those that might reasonably be expected to be asserted by unborn persons if they were *in esse* and before the court.[175]

One of the risks of virtual representation is neatly handled by the nature of the state's duties in regard to charitable trusts. When a virtual representative does not forcefully present the position of the party he or she represents, the attorney general provides the needed teeth for sanctions against breach of duties. In the case of the Kamehameha Schools, all students—past, present, and future—ought to be represented in any proceedings against the KSBE trustees. A virtual representative elected by the students themselves, such as their student body president, could quite adequately represent current students. Alumni and future students may have interests that conflict with those of current students in terms of present expenditures of funds, aggressive or conservative styles of investment, and other matters related to portfolio growth and diversity. A duly elected alumni representative could represent the interests of future students and alumni. The doctrine of virtual representation brings a much-needed and important added measure of accountability, not to mention a different perspective, to proceedings such as those initiated against the KSBE trustees.

So should trust beneficiaries participate in the selection or removal of successor trustees? We argue that they should. Such representation might more adequately advance the interests of the beneficiaries than would guardian *ad litem* representation because the individual acting as the virtual representative is appointed by the direct beneficiaries of KSBE, the students of the Kamehameha Schools. Princess Bishop's testamentary direction for court appointment of successor trustees, however, fits well with the court appointment of a guardian *ad litem*. Either method adds a dimension of representation conspicuously absent in the KSBE litigation. Provision for such representation can only add to the preservation of the charity's purpose.

C. Preserve the Charitable Purpose

Clearly, charitable trusts operate under different or special rules. Often, such trusts need—even deserve—special treatment. We have already observed this in KSBE, in that the state is the enforcer of the trust in the

---

[175] McPherson v. First & Citizens Nat'l Bank, 81 S.E.2d 386, 398 (N.C. 1954).

absence of definite beneficiaries.[176] Although we make the point in this Article that a charitable trust ought not to be limited by such enforcement, this tends to be one of the unique features of a charitable trust. Likewise, a charitable trust is not subject to the Rule Against Perpetuities, as a charitable trust generally is designed to benefit many future generations.[177] Would it be prudent to preserve the trustee's duty of loyalty by requiring beneficiary participation in trustee succession? We submit it would be not only prudent, but also beneficial and wise.

Furthermore, the charitable purpose is a function of the original time and place of establishment of that purpose.[178] Princess Bishop had Hawaiian history in mind in forming her ideals for education of Hawaiian children. She desired to end the oppression of the Hawaiians. It is important to maintain those benefits tied to the charitable purpose.[179]

Of course, it should be noted that the trust's administration and enforcement cannot involve "state action."[180] That concern does not appear to be an issue in the affairs of KSBE or the Kamehameha Schools because the school is privately funded by the private assets of the estate, the land being owned and developed by KSBE. Neither is equal protection a concern for this reason, and for reasons that we have discussed previously.[181] Furthermore, deviation is allowed for trust administration purposes only.[182] Our goal here has been to proffer some innovative concepts in preserving the role of the beneficiaries of a charitable trust, without compromising the nature of the charitable trust

---

[176] *See supra* notes 110-17 and accompanying text.

[177] *See* ANDERSEN ET AL., *supra* note 161, at 328, 331-35. "The Rule Against Perpetuities is among those rules of law which limit the power of one generation to restrict the uses future generations put to property." *Id.* at 387; *see also* WILLIAM M. MCGOVERN, JR. ET AL., WILLS, TRUSTS & ESTATES § 13.8 (1988); HASKELL, *supra* note 140, at 59, 88-90. Haskell explains: "It should be noted that the rule against perpetuities and the rule against the suspension of the power of alienation do not apply to charitable trusts, and that the law does not limit the duration of charitable trusts." *Id.* at 59. He further explains:

> When it is said that there is no limit upon the duration of a charitable trust, this does not constitute an exception to the rule against perpetuities because the rule does not deal with the duration of trusts. However, if there is a future interest under a trust in which all interests are charitable, it is not subject to the rule against perpetuities, and that does constitute an exception to the rule.

Id. at 89.

[178] *See* RESTATEMENT (SECOND) OF TRUSTS § 368 (1957).

[179] *See generally* ANDERSEN ET AL., *supra* note 161, at 328-31.

[180] *See In re* Estate of Wilson, 452 N.E.2d 1228 (N.Y. 1983).

[181] *See* discussion *supra* note 106.

[182] Although beyond the scope and purposes of this Article, a thorough review of deviation may be found at *Cy Pres and Deviation: Current Trends in Application*, 8 REAL PROP. PROB. & TR. J. 391 (1973)(Report of Committee on Charitable Trusts and Foundations).

to secure trustee accountability, and to propose additional guidelines and safeguards for trustee succession.

CONCLUSION: APPLICATION TO KSBE AND SIMILAR CHARITABLE TRUSTS

A recent symposium reviewed some of the concepts that we have presented in this Article, concluding, as we have, that remedies need not be exclusive of one another.[183] We have suggested that the appointment of a guardian *ad litem* to represent the beneficiaries of the trust is appropriate. Current Kamehameha Schools students would do well to protect the interests of the beneficiaries of the KSBE trust. Alternatively, we have suggested the possibly better method of virtual representation, allowing for example, the Kamehameha Schools student body president or some equivalent student-elected representative to represent current and future students of the schools in any trust litigation. A virtual representative or a guardian *ad litem* would serve not only to represent the beneficiaries, but to act on behalf of the beneficiaries to hold the KSBE trustees' attorneys accountable. These attorneys must be trustworthy and active in their positive representation of the trust.[184] The appointment of a

---

[183] *See generally Foundation, Charities and the Law, supra* note 117.

[184] Professor Randall W. Roth of the University of Hawai'i School of Law pointed out in a letter to the Interim Trustees the importance of the role of the attorneys for the Estate. In June 1989, the Interim Trustees promoted the Estate's long-time general counsel, Nathan Aipa, to the position of Chief Operating Officer. They also have continued to use the estate's long-time outside trust counsel, Bruce Graham. The following is from a memo Professor Randall W. Roth sent in response to these actions:

> As a citizen of this state, I want to thank the five of you for your willingness to accept the responsibilities that now confront you. Like many others, I view Kamehameha Schools Bishop Estate as a great institution whose resources are exceeded only by the importance of its mission.
>
> As the only tax and trust law professor in this state, I've felt both uniquely qualified and morally obligated to do what I could to help make things right at KSBE. For better or worse, this didn't end with the temporary removal of your predecessors.
>
> I'm writing now to express serious concerns. In case it isn't obvious, I'll begin by stating that I have nothing personal to gain by bringing these matters to your attention. I am not interested in being appointed to any position in government or at KSBE. I also bear no ill will toward any of the persons mentioned below.
>
> NATHAN AIPA AS COO AND BRUCE GRAHAM AS OUTSIDE COUNSEL. I find it hard to understand the degree of trust that seemingly has been placed in Nathan Aipa. Many specific actions attributed to him suggest either ignorance of basic trust law, or that he regularly buckled under the weight of pressure from trustees. Examples include his alleged role in insurance-procurement and related improprieties; an opinion letter that co-investment in the McKenzie Methane Gas deal was not improper; advice that fiduciary accounting income properly could be diverted to corpus, that this diversion could be done without proper disclosure, and that it could be hidden by asserting attorney-client privilege. These are just examples, a complete list of questionable actions would be much longer.

virtual representative is a compelling concept. It would bring to clearer light the settlor's intent, serving simultaneously to revive and preserve the original charitable purpose.[185]

What has become a grave concern with the Kamehameha Schools and the KSBE trust has been the total unfettered flexibility and freedom afforded to

Even more troubling is his long history of inaction in the face of obvious trustee improprieties. Examples include ignored court orders; use of trust funds to lobby against enactment of intermediate sanctions law; improper calculation of maximum trustee fees; ignorance (or worse) of the over-riding common law prohibition against unreasonable compensation; failure to educate trustees regarding their fiduciary duties; and failure to provide critical information to *all* trustees. Again, these are just examples. A complete list of questionable "inactions" would be even longer than one for "actions."

I suspect that Nathan saw his as an impossible predicament, and that had he stood up to your predecessors he would have been fired . . . or worse. I will accept that as a given. Exhibit A is Bobby Harmon. When he said no, Henry Peters set out to crush him, and did a reasonably thorough job of it. It's understandable that Nathan would not want to be on the receiving end of such unflinching brutality. . . .

But the bottom line for me is that he regularly chose not to take a principled stance when he had not just opportunity, but *duty* to do so. I have similar concerns about Bruce Graham.

Some people might see Nathan and Bruce as mere pawns, or even as victims. For example, I can imagine a lay person saying, "sure, these guys were in the command center when the ship ran aground, but they were just following orders." The problem with this analogy is that Nathan and Bruce are lawyers, not sailors. They both had a duty *not* to blindly follow orders.

Probate Court Rule 42(c), for example, explicitly requires lawyers "to bring to the attention of the court the nonfeasance of the fiduciary." Has either of them discussed with you the possibility that you have a duty to sue one or both of them? Do you think either of them will do so? Would you rely on their explanations if they did?

My point is that Nathan and Bruce both have personal exposure and each has a self-interest not to disclose vital information to you and the attorney general. Your continued reliance on them baffles me and, quite frankly, subjects you to unnecessary personal liability.

. . . .

TRUSTEE-SELECTION PROCESS. I was delighted to read recently that you are planning to propose a trustee-selection plan to the probate court. However, I'm troubled by what's been reported by the media as a plan to ban all past and present politicians, not just as potential trustees, but as participants in the selection process as well. While certainly a crowd pleaser under current circumstances, such a ban is irrational and eventually would prove to be ill-considered. To paraphrase Kipling, it's important that the five of you keep your heads even as others are losing theirs.

Letter from Randall W. Roth, Professor of Law, University of Hawai'i School of Law, to Robert Kihune, David Coon, Francis Keala, Connie Lau, and Ron Libkuman, Interim KSBE Trustees 1-3 (May 24, 1999)(on file with authors).

[185] Furthermore, the use of the guardian *ad litem* or the virtual representative may be appropriate and protective if the court requires the representative to apply for court approval, establishment, and order of their selection of successor trustee(s).

the court-appointed trustees.[186] The trustees were afforded flexibility in accomplishing Princess Bishop's wishes, but flexibility without proper accountability has led to a selfish and decaying freedom. Freedom without boundaries or accountability can lead to destruction.

Affording students of the Kamehameha Schools with a mechanism for holding the KSBE trustees accountable would have impeded trustee misconduct. A trustees' responsibilities[187] must be set, established and patterned at the outset, and watched closely by those most profoundly affected. Allowing a virtual representative or guardian *ad litem* to give a voice to the interests of the students certainly puts a different face on those responsibilities.

Finally, there is not only room for judicial discretion in the equitable nature of a trust proceeding, but an absolute need for such discretion. Human nature dictates, and the expelled KSBE trustees have demonstrated, that fiduciaries may not self impose checks on their conduct. Limits can, however, be imposed by the courts and enforced by representatives of beneficiaries acting as officers of the court. Judgment in favor of greater accountability can only serve to further prevent the waste of trust assets intended to benefit trust beneficiaries, rather than to aid trustees in their own escapades. Restoring accountability can also help to guard against the selection of successor trustees based on politics.

KSBE and the Kamehameha Schools are charities that not only warrant, but deserve, this kind of attention. A trustee, by any standard, ought to act in the state of mind which the settlor contemplated when she set up the trust. Princess Bishop wanted to bring freedom to her people through education. Our proposals in this Article would indeed add protections to hold the trustees accountable to the ideals which Princess Bishop intended when she established KSBE.

---

[186] *See* Samuel King, Msgr. Charles Kekumano, Walter Heen, Gladys Brandt & Randall Roth, *Broken Trust*, HONOLULU STAR-BULLETIN, Aug. 9, 1997, at B-1, reprinted in Appendix C to this issue.

[187] The KSBE trustees have always had knowledge of the general duties ascribed to trustees, including the duty to furnish information to their beneficiaries and the duty to render court accounting, with court approval. *See id.; see also* RESTATEMENT (SECOND) OF TRUSTS, §§ 172, 173, 220 (1957).

Nonprofit Compensation and the Market

Peter Frumkin*
Alice Andre-Clark**

INTRODUCTION

One of the most recent and vivid illustrations of the continuing need for scrutiny of nonprofit compensation is the Kamehameha Schools Bishop Estate ("KSBE" or the "Estate") scandal, which culminated in the removal of all of the trustees of a multi-billion dollar charity charged with the operation of Hawai'i's renowned Kamehameha Schools and other educational programs targeted at native Hawaiian children.[1] The Estate's highly generous compensation practices—forty million dollars in trustee fees over ten years, and an average of $900,000 in annual compensation per trustee between 1994 and 1997—proved a lightning rod for critics.[2] Concern over the Estate's management led the Internal Revenue Service ("IRS") to threaten to revoke KSBE's tax exemption unless the trustees were removed.[3] The trustees, in turn, lobbied unsuccessfully against the 1996 passage of "intermediate sanctions" reforms that permit the IRS to impose excise taxes on individuals who collect excessive salaries or other benefits from public charities.[4] The KSBE case both highlights the limited power of donors and customers to shape charities' compensation practices, and suggests some of the difficulties regulators will face, even after the passage of intermediate sanctions, in defining what level of compensation is legally reasonable.

Critics of KSBE's governance argued for the necessity of government intervention in part because the trustees were largely insulated from the institutional pressures that dissatisfied donors or other skeptical stakeholders might have created.[5] With a trust amounting to five to ten billion dollars, KSBE trustees did not need to court potential donors by demonstrating wise

---

* Assistant Professor of Public Policy, John F. Kennedy School of Government, Harvard University.

** Doctoral Candidate in Public Policy, John F. Kennedy School of Government, Harvard University.

[1] *See* Rick Daysog, *Then There Were None*, HONOLULU STAR-BULLETIN, May 8, 1999, at A-1.

[2] *See, e.g.*, Samuel King, Msgr. Charles Kekumano, Walter Heen, Gladys Brandt & Randall Roth, *Broken Trust*, HONOLULU STAR BULLETIN, Aug. 9, 1997, at B-1 [hereinafter *Broken Trust*], reprinted in Appendix C to this issue of the *University of Hawai'i Law Review*.

[3] *See* Rick Daysog, *IRS Wants Bishop Trustees Out*, HONOLULU STAR-BULLETIN, Apr. 28, 1999, at A-1.

[4] *See Broken Trust*, *supra* note 2; 26 U.S.C. § 4958 (Supp. III 1997).

[5] *See, e.g.*, *Broken Trust*, *supra* note 2.

management.[6] While trustees were required to submit to a court-appointed master's annual review, observers charged that the master's power to enforce recommendations was limited, and that many of the large Estate's transactions were too complex for an outside reviewer to grasp readily.[7] In addition, many warned that the trustee selection process—trustees were chosen by the justices of the Hawai'i Supreme Court—significantly weakened accountability.[8] Because justices were potentially personally liable for negligent trustee selection, they faced a disincentive to review trustees' actions rigorously during court proceedings.[9] Moreover, critics argued that the justices, themselves appointed through a politicized process, were motivated to select trustees with good political connections but little or no estate management experience.[10] While some of these difficulties are unique to KSBE, management incentive problems, including permanent endowment, poorly informed donors, and inattentive directors, appear by no means uncommon in public charities.[11]

If the governance and compensation practices of KSBE suggest a lingering need for careful government regulation of compensation, the case also hints at the complexity of the task of developing a standard of reasonableness. At first glance, the extent to which the KSBE trustees earned their pay appears relatively easy to evaluate. The five community leaders who initially called for investigation of the trustees in the 1997 "Broken Trust" article declared that, while "the people made responsible" for protecting billions of dollars of wealth and carrying out a unique educational mission "arguably ought to be highly paid," KSBE clearly was not getting its money's worth from its current group of trustees.[12] They drew this conclusion not only from the trustees' generally weak estate management credentials, but from a variety of bizarre management decisions.[13] These included a series of high-risk investments that generated $264 million in losses in one year, a continuing refusal to hire a professional CEO to manage the Estate, the abandonment of an acclaimed set of early education and outreach programs, and a set of abrupt firings and other incidents that had led to a rapidly deteriorating relationship with the faculty of Kamehameha Schools.[14] By the time a judge temporarily removed the remaining trustees in May 1999, as two trustees faced criminal charges, one

---

[6] *See id.*
[7] *See id.*
[8] *See id.*
[9] *See id.*
[10] *See id.*
[11] *See infra* notes 187-203 and accompanying text.
[12] *See, e.g., Broken Trust, supra* note 2.
[13] *See id.*
[14] *See id.*

for a kickback scheme involving Estate land,[15] few disagreed with the community leaders' early assessment. A poll taken shortly after the removal revealed that nine out of ten registered Hawai'i voters favored the move.[16]

Though the community was largely united in its perception of most of the trustees, the treatment of trustee Oswald Stender suggests that whether a job performance merits high pay may often be in the eye of the beholder. Although Stender accepted the same compensation the other trustees did, he had substantial estate management experience, and he broke publicly with other trustees, opposing the offer of a CEO position to a candidate who had not been selected through a formal hiring process, and ultimately suing to remove a trustee whom he alleged had mismanaged the Kamehameha Schools.[17] The "Broken Trust" writers, while not arguing that the amount of his salary was justified, singled him out as the only trustee who measured up to his job.[18] When Stender resigned as the others were removed, one of the writers observed, "[t]he only thing that I'm not happy about is that Oz Stender ended up being dragged down with the rest of them."[19] However, the Attorney General sought removal of all of the trustees, including Stender, for excess compensation, and also for such omissions as the failure to meet financial reporting requirements or to review investments with due diligence, and she characterized Stender's efforts to remove the other trustee as a late response to overwhelming public criticism.[20] These disparate views of Stender's actions suggest that it would not be easy for a regulator to determine how much compensation his skills and services should reasonably have earned him.

The KSBE case also illustrates the increasing centrality of salary comparisons in the determination of what compensation is reasonable. In her removal petition, the Attorney General observed that virtually all school and college trustees receive no compensation, that the average annual compensation of trustees of foundations with assets in excess of one billion is $14,730, and that even the CEOs of this group of foundations received an

---

[15] *See* Rick Daysog, *9 of 10 Residents Back Bishop Board's Removal*, HONOLULU STAR-BULLETIN, May 24, 1999, at A-1.

[16] *See id.*

[17] *See* Rick Daysog, *Oswald Stender: Ousted Trustee Says He Was Willing to Step Down to Help Preserve the Bishop Estate's Tax-Exempt Status*, HONOLULU STAR-BULLETIN, May 8, 1999, at A-2.

[18] *See Broken Trust*, *supra* note 2.

[19] *See* Daysog, *supra* note 17.

[20] *See* Petition of the Attorney General on Behalf of the Trust Beneficiaries to Remove and Surcharge Trustees, for Accounting, and for Other Equitable Relief, In re *Estate of Bishop*, Equity No. 2048, (Haw. Prob. Ct. Sept. 14, 1998), *available at* <http://starbulletin.com/98/09/11/news/removal.html> [hereinafter Petition for Removal and Surcharge].

average salary of just $323,600.[21] The Attorney General's comparisons raise several normative questions: How should compensation comparisons be made? Should for-profit, as well as nonprofit, organizations be considered appropriate sources of comparison? If organizations hire officers with especially strong or weak credentials, how far outside the comparison range should we expect them to deviate? If customers, clients or contributors are able to impose substantial market pressures on an organization, should their approval of a high salary satisfy a government regulator that the salary is appropriate?

This Article explores the development of compensation regulation in public charities and examines the philanthropic "market" forces that constrain or fail to constrain compensation to reasonable levels. Compensation regulation has traditionally taken, and is likely to take in the future, a process-based approach. Though the intermediate sanctions legislation imposes new specific salary comparison requirements, we argue that this approach is at best a stopgap measure to address extreme cases such as that of KSBE, and that it will do little to discourage nonprofit executives from allowing salaries to creep steadily upward. Rather, we suggest that government and the nonprofit sector should turn their attention to measures that increase the supply of low-cost information to donors, and that educate donors and board members to demand reliable and detailed information to guide their decision making with respect to the nonprofit sector.

Part I of this Article reviews the pre-intermediate sanctions law regarding compensation regulation, and describes why process requirements have had little effect in the past on firms' or charities' discretion to set high salaries. Part II shows how the new intermediate sanctions legislation attempts to bring more rigor to process analysis in compensation regulation, and draws from its legislative history a set of criteria for effective compensation regulation. Finally, in Part III, we argue that the intermediate sanctions' new focus on comparisons will not greatly improve the rationality of compensation decisions because cross-sector comparisons are often not meaningful, and because an emphasis on comparisons may simply create pressure to raise salaries to an ever-increasing mean. As an alternative, we explain how steps to increase the availability of information, and donors' and boards' interest in acquiring it, can make the nonprofit sector a more effectively functioning market economy.

---

[21] *See id.*

I. GOVERNMENT REGULATION OF COMPENSATION: A CROSS-SECTOR COMPARISON OF PRE-INTERMEDIATE SANCTIONS LAW

Before the 1996 passage of intermediate sanctions,[22] compensation within public charities was regulated primarily by the federal tax law doctrines of private inurement and private benefit, and, indirectly, by fiduciary duties found in state corporation law. Most government efforts to regulate compensation in both the private and nonprofit sectors have centered on preventing organization insiders from leveraging their positions of power to secure excessive compensation for themselves. For nonprofits, the courts and the IRS have on occasion recognized a second purpose for regulating compensation: that of ensuring that tax-exempt dollars serve one of the Internal Revenue Code's enumerated exempt purposes.

Efforts to address compensation to insiders have been characterized by a strongly procedural, rather than an outcome-based, approach. Enforcement has generally been lax, and has been limited largely to efforts to prevent outright fraud or embezzlement rather than the more difficult question of the reasonableness of compensation. Before the advent of the new intermediate sanctions, the IRS's sole remedy was the severe revocation of tax exemption penalty, which IRS officials were likely reluctant to use. Litigation efforts have been infrequent, and have concentrated not on highly compensated officials of major institutions such as universities and hospitals, but on tiny charities with very weak governance structures. Churches, which are required neither to demonstrate substantial public support nor to file annual disclosure documents, appear to have been a particular focal point for compensation regulation. In this context, enforcement has focused not on whether compensation is excessive, but on whether it amounts to bilking. In the case of large, sophisticated institutions, the differential standards under private inurement case law are weak enough so that clever overcompensators can probably meet them without modifying the substance of their compensation decisions.

In addition to the IRS's enforcement efforts, corporations, whether business or charitable, are subject to state fiduciary duty standards that may affect compensation. Self-dealing transactions—when directors or officers vote on their own pay—must meet a strict fairness standard under the fiduciary duty of loyalty.[23] However, corporations can largely avoid duty-of-loyalty scrutiny simply by setting up processes that are formally independent of the interested director or officer. The work of independent compensation committees might be subject to closer court scrutiny if they displayed a lack of due care, but the courts' process-oriented view of due care (combined with a traditional

[22] *See* 26 U.S.C. § 4958 (Supp. III 1997).

[23] *See infra* notes 100-31 and accompanying text.

reluctance to intervene in compensation matters) indicates that due care scrutiny is unlikely to restrain compensation committees substantially. Empirical and anecdotal evidence about these committees suggest that compensated executives are able to maintain significant control, and to exert strong pressure to raise wages, even in theoretically independent processes. For charitable corporations, the impact of fiduciary duty law is particularly weak because of resource and other constraints faced by state attorneys general, who generally have exclusive standing to enforce this law against charities.[24]

A. *Private Inurement in Public Charities*

In order to qualify for tax-exempt status, organizations must ensure that "no part of [their] net earnings . . . inures to the benefit of any private shareholder or individual."[25] Because the absence of private inurement is a condition for exemption, the only penalty for inurement prior to intermediate sanctions was revocation of the organization's tax exemption status.[26] In practice, the IRS often sidesteps more severe penalties by negotiating "closing agreements," which provide that further action will not be taken if an individual or organization corrects wrongdoing in specified ways.[27] However, when inurement is litigated, courts have generally held that even a minimal amount is enough to justify revocation.[28] There are two basic elements to the inurement cause of action: (1) that the compensated person is a "private shareholder or individual";[29] and (2) that the level of compensation is "unreasonable" for the services provided.[30]

---

[24] *See infra* notes 128-29 and accompanying text.

[25] 26 U.S.C. § 501(c)(3) (1994).

[26] *See Full Text: IRS Commissioner's Testimony at W&M Hearing on Tax Laws Applicable to Tax-Exempt Organizations* (June 15, 1993), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 93 TNT 127-40 (June 16, 1993)(statement of IRS Commissioner Margaret Milner Richardson before the Ways and Means Subcommittee on Oversight on June 15, 1993) [hereinafter *Commissioner's Testimony*].

[27] *See id.*

[28] *See* Rink v. Commissioner, 47 F.3d 168, 169-71 (6th Cir. 1995)(describing negotiations over a closing agreement resolving the extent of taxpayers' liability); Church of Scientology v. Commissioner, 823 F.2d 1310, 1316 (9th Cir. 1987)("The term 'no part' is absolute. The organization loses tax exemption if even a small percentage of income inures to a private individual."). *But see* Carter v. United States, 973 F.2d 1479, 1487 n.5 (9th Cir. 1992)("We have grave doubts that the de minimis doctrine, which is so generally applicable, would not apply in this situation.").

[29] *See, e.g.*, Variety Club Tent No. 6 Charities v. Commissioner, 74 T.C.M. (CCH) 1485 (1997).

[30] *See, e.g.*, World Family Corp. v. Commissioner, 81 T.C. 958, 968 (1983).

1. The insider

Federal regulations define the "private shareholder or individual"—or "insider"—as anyone "having a personal and private interest in the organization."[31] Until recently, the IRS took the position that anyone employed by a charity could be an insider. Through the 1980's, a series of IRS documents indicated the agency's broad conception of the insider. An outside investment advisor to a real estate company, physicians subsidized by a hospital to perform emergency room and training duties, and university athletic coaches all were termed insiders,[32] and a 1987 General Counsel Memorandum even declared that "all persons performing services for an organization" were insiders.[33] However, the Tax Court had made "substantial and formal practical control" of the organization's finances or governance processes the test of an insider.[34] Thus, a former president and current board member of a charitable bingo game was an insider given his control over the games' procedures and disposition of the proceeds, but a former bingo operator and current twenty percent stockholder in the corporation that rented the game its bingo hall was not, because he "did not have any formal voice" in, or practical control over, the entity's activities.[35]

The Seventh Circuit in its 1999 *United Cancer Council v. Commissioner*[36] ("*UCC*") decision definitively limited the definition of insider. Judge Posner's opinion stated that the purpose of private inurement is to stay the hands of those who are in a position to siphon off charitable funds for their own benefit, and not to stop arm's length transactions by disinterested but unwise managers and directors.[37] In 1984, UCC, a cancer charity verging on bankruptcy, entered into a five-year contract with direct-mail fundraiser Watson & Hughey ("W&H").[38] W&H fronted the expenses for a fundraising campaign in return for exclusive access to UCC's "housefile," or donor list, and the right to be UCC's exclusive fundraiser.[39] W&H sent out eighty million letters and raised $28.8 million for UCC, but collected $26.5 million to defray costs.[40] The Tax Court upheld the IRS' revocation of UCC's exemption, finding that, while the contract was negotiated at arm's length,

---

[31] 26 C.F.R. § 1.501(a)-(1)(c) (1998).

[32] *See* Gen. Couns. Mem. 38,905 (June 11, 1982); Gen. Couns. Mem. 39,498 (Apr. 24, 1986); Gen. Couns. Mem. 39,670 (Oct. 19, 1987).

[33] Gen. Couns. Mem. 39,670 (Oct. 19, 1987).

[34] *See Variety Club*, 74 T.C.M. (CCH) 1485.

[35] *See id.*

[36] 165 F.3d 1173 (7th Cir. 1999).

[37] *See id.* at 1176.

[38] *See id.* at 1175.

[39] *See id.*

[40] *See id.*

W&H became an insider with respect to later contract-related transactions.[41] It likened W&H's fronting the fundraising costs to the act of a founder, and, pointing to the contract's exclusivity, argued that W&H had substantial control because UCC would have been powerless to engage another fundraiser if it stopped its efforts.[42]

In reversing the Tax Court's finding, the Seventh Circuit described the private inurement test as follows:

> A charity is not to siphon its earnings to its founder, or the members of its board, or their families, or anyone else fairly to be described as an insider, that is, as the equivalent of an owner or manager. The test is functional. It looks to the reality of control rather than to the insider's place in a formal organizational table.[43]

While admitting that the terms of the contract were quite favorable to W&H, the court recognized it was an arm's length transaction with a disinterested though imprudent board.[44] The court maintained that the IRS had simply misunderstood the market incentives for allocation of risk that had likely shaped the contract,[45] interpreting the exclusivity as an inducement for W&H to front expenses for a risky endeavor.[46] Furthermore, because contract law implies a best effort clause, UCC would not have been powerless if W&H had stopped soliciting.[47] Ultimately, the court rested its decision on the bargaining process. The court determined that all of the contract's advantageous provisions had been agreed upon during the arm's length negotiations that took place before W&H became an insider.[48] The market analysis served to demonstrate that UCC could plausibly enter into such a contract even without the illegitimate influence of an insider.[49]

Three critical points emerge from the *UCC* decision. First, the *UCC* court makes clear that the IRS may not use the private inurement test to attack every bad compensation decision that results simply from a passive board's inattention.[50] Rather, the compensated person must have had some direct voice in the wage-setting process. Second, the compensated person probably

---

[41] *See id.* at 1176.

[42] *See id.*

[43] *Id.*

[44] *See id.*

[45] *See id.* at 1176-77.

[46] *See id.*

[47] *See id.* at 1177.

[48] *See id.* at 1178-79.

[49] *See id.*

[50] However, the court found that the private benefit test may have some application to excess compensation when the effect is to take substantial sums of money away from the organization's charitable purpose. *See id.* at 1179-80. *See also infra* notes 75-98 and accompanying text.

cannot escape insider status by formally distancing herself from the wage-setting process. The *UCC* court makes clear that the test of insider status is functional, suggesting that setting up an independent compensation committee will not protect an influential insider from an inurement finding. Third, though the *UCC* decision offered a functional definition of "control," there are few cases applying the definition to specific factual examples. Founders, directors, officers, and their family members almost certainly are insiders,[51] and independent contractors almost certainly are not,[52] but much territory lies between these extremes.

2. Unreasonable compensation

A central idea in private inurement cases pertaining to compensation is that the "law places no duty on individuals operating charitable organizations to donate their services; they are entitled to reasonable compensation for their efforts."[53] The Tax Court asserts that it applies to charities essentially the same test—I.R.C. § 162, which requires that the salary be reasonable, or an "ordinary and necessary" business expense—as the IRS uses to determine the deductibility of private firm salaries.[54] Although courts vary slightly in the factors they consider, one widely cited test comes from the Ninth Circuit's decision in *Elliotts, Inc. v. Commissioner*.[55] The *Elliotts* court considered five categories of factors: (1) the employee's role in the organization—position, hours worked, duties performed, and general importance to the organization's success; (2) comparisons of the employee's salary to salaries of those who perform similar services for similar organizations; (3) the "character and condition" of the organization—its size, complexity, and economic condition; (4) the extent of the employee's ownership interest (we might read "insider status" in the charity context); and (5) whether owner-employees (again, we might read insider-employees) are paid similarly to non-owner-employees.[56] Rather than state all the factors, the Tax Court tends to describe a rule-of-thumb version, asking simply whether the employee's services "would cost as much if obtained from an outside source in an arm's length transaction."[57]

While the Tax Court theoretically applies the same multi-factor test used to determine reasonableness for private firm salaries, courts seldom explicitly

---

[51] *See United Cancer Council*, 165 F.3d at 1176.

[52] *See id.*; *see also* National Found., Inc. v. United States, 13 Cl. Ct. 486 (1987).

[53] World Family Corp. v. Commissioner, 81 T.C. 958, 969 (1983).

[54] *See* Truth Tabernacle v. Commissioner, 57 T.C.M. (CCH) 1386 (1989).

[55] 716 F.2d 1241 (9th Cir. 1982).

[56] *See id.* at 1245-48.

[57] *World Family Corp.*, 81 T.C. at 969 (1983)(quoting B.H.W. Anesthesia Found. Inc. v. Commissioner, 72 T.C. 681, 686 (1979)).

state their test, make salary comparisons, or draw conclusions about the individual's special skills or the job's level of difficulty beyond the number of hours the individual worked.[58] Rather, the reasonableness determination has focused on process—on the degree of the compensated person's insider status, on the justifications offered for salary fluctuations, and on the appropriateness of these justifications to the compensated person's job description. Several patterns emerge from the inurement cases.

First, following the fourth factor in the *Elliotts* test, courts have given especially close scrutiny in instances in which the compensated person is what we might call a "super insider." In both *Church of Modern Enlightenment v. Commissioner*[59] and *Church of Eternal Life & Liberty, Inc. v. Commissioner*,[60] a close-knit three-member board of trustees led the Tax Court to observe that, when one individual or a "small self-perpetuating group" controls all of an organization's funds and activities, a strong inference of inurement is created.[61]

A second factor at work in the compensation cases is that, if compensation fluctuates, the organization should be able to attribute the fluctuation's relationship to the employee's performance. For example, contracts contingent on an organization's revenues might be reasonable for some types of employees, but courts have rejected contingent compensation for a gemology instructor[62] and a minister, with one court observing that "[w]hatever [the minister's] services are worth, they are not directly related to petitioner's gross receipts. The value of solace and spiritual leadership cannot be measured by the collection box."[63] In another case, when a minister's parsonage allowances varied from $13,600 to $33,650 and back to $12,000 without any evidence of a change in duties to justify the modification, the fluctuation was construed to support a finding of excess compensation.[64]

Third, the contingent contract mechanism generally has troubled the IRS. As seen above, one reason for this skepticism is the belief that, in many jobs, receipts are a poor measure of one's skill and effort. However, organizations have overcome this perception where skill and effort clearly are reflected in receipts, such as in the case of the president of an organization that raised

---

[58] See cases cited *infra* note 71.

[59] 55 T.C.M. (CCH) 1304 (1988).

[60] 86 T.C. 916 (1986).

[61] *See id.*

[62] *See* Gemological Inst. of Am. v. Commissioner, 17 T.C. 1604 (1952), *aff'd* 212 F.2d 205 (9th Cir. 1954).

[63] People of God Community v. Commissioner, 75 T.C. 127 (1980).

[64] *See* Unitary Mission Church v. Commissioner, 74 T.C. 507, 514, 516 (1980), *aff'd* 647 F.2d 163 (2d Cir. 1981).

funds for missionary work.[65] Another reason for courts' concern over contingent contracts is the fact that the private inurement clause specifically forbids organizations from allowing *net earnings* to inure to insiders.[66] When compensation is based directly on earnings, it might create an inference that inurement of earnings is precisely what is occurring.[67] While the concept of reasonable compensation would seem to suggest that the amount of compensation is what matters, courts have in practice often noted the percentage of earnings received. Even though the Tax Court rejected a minister's compensation scheme (which provided him more than two-thirds of the church's receipts) in part because it had no upper limit,[68] the same court later permitted contingent fees of up to twenty percent, with no upper limit, for fundraisers.[69] Courts appear unlikely to approve contingent compensation when it constitutes half or more of receipts, and the compensated person has a very high level of control over the wage setting process.

What is striking about the pattern of reasonableness assessment is that it has concerned the process more than the outcome of wage setting, and that it has required a very low level of process rigor. Organizations likely to face revocation for private inurement were those that allowed the compensated person to dominate all of its governance processes, that raised and lowered salaries without explanation, and that turned vast percentages of receipts over to employees without thought as to whether percentage of receipts appropriately measures performance. As we will see in Part II, part of the intent of intermediate sanctions is to make the IRS less reluctant to pursue excess compensation in sophisticated organizations such as universities and hospitals. While such major institutions do occasionally fail to follow minimal formal wage setting processes,[70] requiring no more than these

---

[65] *See* World Family Corp. v. Commissioner, 81 T.C. 958 (1983).

[66] *See* 26 U.S.C. § 501(c)(3) (1994).

[67] *See, e.g., Gemological Inst.*, 17 T.C. 1604. The Tax Court rejected as inurement a salary of 50% of net earnings:

> However, when petitioner further says that Shipley's compensation was not part of its earnings but only measured by the amount of its net earnings, we can not accept this argument. . . . Regardless of what these amounts are called, salary or compensation based on earnings, it is obvious that half of net earnings of petitioner inured to the benefit of an individual. . . . Such a distribution of net earnings is unequivocally prohibited by the statute.").

Id. at 1609-10.

[68] *See People of God Community*, 75 T.C. at 132.

[69] *See generally World Family Corp.*, 81 T.C. 958. This was a rare case in which a court made comparisons of a sort, noting that the percentage of receipts retained by the fundraiser fell well within the limits prescribed by state charitable solicitation statutes. *See id.* at 969 (citing FLA. STAT. ANN. § 496.11 (West 1976)).

[70] One notable example of a major institution's failure to meet even these minimal standards is Adelphi University trustees' grant of repeated raises to President Peter Diamandopoulos

processes may not be a significant check on these institutions' compensation levels. For example, given the many subjective factors that enter into a performance evaluation, it is probably not difficult for a board to record a few ex-post positive factors to justify a raise, and certainly few hospitals and universities are likely to be dominated by super insiders to the degree the churches described above were. Thus, the case law of private inurement suggests that any regulatory regime that focused on outcomes and salary comparisons would be operating on largely new territory. However, if the regime continues the private inurement's process focus, a higher process bar would certainly be necessary to change major institutions' decision making processes about compensation.

In the end, the IRS' reluctance to litigate the drastic penalty of revocation is apparent both in the scarcity of private inurement compensation cases—we found 33 reported Tax Court decisions over the past 20 years[71]—and in the

---

without a vote and without any formal evaluation of Diamandopoulos' performance, in violation of their own by-laws. *See* Bruce Lambert, *New York Regents Oust 18 Trustees from Adelphi U.*, N.Y. TIMES, Feb. 11, 1997, at A1.

[71] We considered Tax Court, Court of Claims, District Court, and Courts of Appeals cases in which a private inurement issue involving compensation was a significant issue. These are not, of course, necessarily a representative sample of the cases in which the IRS alleged inurement, and it does not take into account actions that were not appealed or disputes that were resolved in a negotiated settlement. The cases we found include: United Cancer Council v. Commissioner, 165 F.3d 1173 (7th Cir. 1999); Airlie Found. v. United States, No. 93-5254, 1995 WL 310025 (D.C. Cir. Apr. 24, 1995); Church of Scientology v. Commissioner, 823 F.2d 1310 (9th Cir. 1987); Presbyterian & Reformed Publ'g Co. v. Commissioner, 743 F.2d 148 (3d Cir. 1984); Bubbling Well Church of Universal Love v. Commissioner, 670 F.2d 104 (9th Cir. 1981); Brian Ruud Int'l v. Commissioner, 733 F. Supp. 396 (D.D.C. 1989); Freedom Church of Revelation v. United States, 588 F. Supp. 693 (D.D.C. 1984); Church of Gospel Ministry v. Commissioner, 640 F. Supp. 96 (D.D.C. 1986), *aff'd*, 830 F.2d 1188 (D.C. Cir. 1987); Incorporated Trustees of the Gospel Worker Soc'y v. United States, 510 F. Supp. 374 (D.D.C.), *aff'd mem.*, 672 F.2d 894 (D.C. Cir. 1981); Basic Unit Ministry of Alma Karl Schurig v. United States, 511 F. Supp. 166 (D.D.C. 1981); Bob Jones Univ. Museum & Gallery v. Commissioner, 71 T.C.M. (CCH) 3120 (1996); Church of the Living Tree v. Commissioner, 71 T.C.M. (CCH) 3210 (1996); Tony & Susan Alamo Found. v. Commissioner, 63 T.C.M. (CCH) 2422 (1992); Bill Wildt's Motorsport Advancement Crusade v. Commissioner, 56 T.C.M. (CCH) 1401 (1989); Truth Tabernacle Church v. Commissioner, 57 T.C.M. (CCH) 1386 (1989); Good Friendship Temple v. Commissioner, 55 T.C.M. (CCH) 1310 (1988); Church of Modern Enlightenment v. Commissioner, 55 T.C.M. (CCH) 1304 (1988); Universal Church of Jesus Christ v. Commissioner, 55 T.C.M. (CCH) 144 (1988); National Found., Inc. v. United States, 13 Cl. Ct. 486 (1987); Easter House v. United States, 12 Cl. Ct. 476 (1987), *aff'd*, No. 87-1519, 1988 WL 25416 (Fed. Cir. Mar. 28, 1988); Church of Eternal Life v. Commissioner, 86 T.C. 916 (1986); Triune of Life Church v. Commissioner, 85 T.C. 45 (1985), *aff'd mem.*, 791 F.2d 922 (3d Cir. 1986); New Concordia Bible Church v. Commissioner, 49 T.C.M. (CCH) 176 (1984); Church by Mail v. Commissioner, 48 T.C.M. (CCH) 471 (1984); Self-Realization Bhd. v. Commissioner, 48 T.C.M. (CCH) 344 (1984); Alive Fellowship of Harmonious Living, 47 T.C.M. (CCH) 1134 (1984); Truth Tabernacle, 41 T.C.M. (CCH) 1405 (1981); New Life

choice of organizations against which revocation was pursued. Over three quarters of the focal organizations were churches. The religious exemption category is particularly vulnerable to abuse, and indeed, many of the churches in question had spent no money on religious articles and had few members or infrequent services.[72] This vulnerability exists because of the low capital costs of starting a church, because churches (along with certain schools and medical organizations) can qualify as public charities without meeting a test of public support,[73] and because churches (unlike these other organizations) need not file the IRS's disclosure Form 990.[74] Thus, the IRS's choice of revocation targets likely reflects both suspicion that many did not serve a charitable purpose at all, and concern that low accountability and visibility to donors might lead to lax wage setting processes.

B. *Private Benefit in Public Charities' Compensation Processes*

Recent developments in case law suggest that the private benefit doctrine may support compensation regulation even when the compensated person is not an insider. The private benefit doctrine stems from the requirement that an exempt organization be "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary or educational

---

Tabernacle v. Commissioner, 44 T.C.M. (CCH) 309 (1982); John Marshall Law Sch. v. United States, Nos. 27-78 & 28-78, 1981 WL 11168 (Cl. Ct. June 24, 1981); World Family Corp. v. Commissioner, 81 T.C. 958 (1983); People of God Community v. Commissioner, 75 T.C. 127 (1980); Southern Church of Universal Bhd. Assembled, Inc. v. Commissioner, 74 T.C. 1223 (1980); Unitary Mission Church v. Commissioner, 74 T.C. 507 (1980), *aff'd*, 647 F.2d 163 (2d Cir. 1981).

[72] *See, e.g.*, *Bubbling Well Church*, 670 F.2d 104 (affirming denial of tax-exempt status to church that had no members other than the founding family, and that held services only at Christmas and Easter); *Southern Church of Bhd.*, 74 T.C. 1223 (denying tax-exempt status to church that had only five members, all of whom served as trustees); *Church of Modern Enlightenment*, 55 T.C.M. (CCH) 1304 (denying tax-exempt status to church where no church funds were spent on religious services, articles, or supplies).

[73] Certain schools and medical organizations can also avoid the requirement of public support and still qualify as public charities. Other public charities must demonstrate that they receive more than one-third of their support from gifts, grants, membership, and related business. Generally, no more than two percent of total receipts from a single person is countable, and contributions from donors providing over $5,000 are also excluded, so the organization must demonstrate that it receives support from multiple sources. *See* 26 U.S.C. §§ 170(b) & 509(a)(1)-(2) (1994).

[74] *See* 26 U.S.C. § 6033(a)(2) (1994). Form 990 requires disclosure of information about the organization's revenues, expenses, purposes accomplishments, and compensation levels for its officers, directors, trustees, and five highest paid other employees. *See IRS Form 990.*

purposes."[75] From this, courts have determined that expenditures that benefit a private interest more than incidentally justify exemption revocation.[76]

The private benefit test was stated most clearly in *American Campaign Academy v. Commissioner*,[77] in which the IRS revoked the exemption for a school for political campaigners.[78] It alleged no inurement to insiders, but noted that the Academy was funded by Republican interests, and that it could not report ever having graduated anyone who worked for candidates from any party other than the GOP.[79] The Tax Court agreed with the IRS's determination that the Academy provided substantial private benefit to the Republican Party.[80] The court acknowledged that the primary beneficiaries, the students, received educational benefits, and so they constituted a charitable class.[81] It added that all effective educational programs incidentally benefit some employer or other third party.[82] However, the secondary benefits in this case were targeted at "a select group of members earmarked to receive benefits."[83] Because the Republican Party is not a charitable entity—helping it does not fit any of the purposes listed in § 501(c)(3)—the substantial private benefit it received was enough to justify revoking the exemption.[84]

The IRS has most frequently applied the private benefit test to compensation in the context of hospitals' recruitment incentives for physicians.[85] Because hospitals receive their exemption under the nebulous "community benefit" standard, the IRS appears to scrutinize hospitals—and the recruitment incentives that hospitals offer to induce physicians to affiliate with them—more heavily than other types of organizations.[86] Even though the

---

[75] 26 U.S.C. § 501(c)(3) (1994).

[76] *See, e.g.*, American Campaign Academy v. Commissioner, 92 T.C. 1053, 1069-79 (1989). A private interest is one that is not listed in the statute.

[77] 92 T.C. 1053 (1989).

[78] *See id.* at 1079.

[79] *See id.* at 1071-79.

[80] *See id.* at 1069-79.

[81] *See id.* at 1073.

[82] *See id.* at 1074.

[83] *Id.* at 1076.

[84] *See id.* at 1069-79.

[85] *See, e.g.*, Harding Hosp. v. United States, 505 F.2d 1068 (6th Cir. 1974); Rev. Rul. 97-21, 1997-18 I.R.B. 8; Gen. Couns. Mem. 39,862 (Nov. 22, 1991); Gen. Couns. Mem. 39,498 (Apr. 24, 1986); Announcement 95-25, 1995-14 I.R.B. 11; Todd Greenwalt, *Full Text: Hermann Hospital Closing Agreement Released* (Oct. 13, 1994), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 94 TNT 203-59 (Oct. 17, 1994).

[86] Until 1969, the IRS took the position that hospitals were required, to the extent of their financial ability, to provide services to indigents. *See* Rev. Rul. 56-185, 1956-1 C.B. 202; *cf.* Rev. Rul. 69-545, 1969-2 C.B. 117. However, as health benefits and insurance became more widely available, the IRS determined that a hospital could qualify for exemption if it met the community benefit standard—i.e., if it promoted the health of a class sufficiently broad to

IRS now acknowledges that many staff physicians are not insiders, recruitment incentives have been controversial in part because they can be a way for hospitals to win physician loyalty and limit competition from outpatient facilities.[87] In the most recent of several rulings and memoranda on the subject, the IRS strongly indicated that, whether or not a physician is an insider, hospitals providing recruitment incentives must demonstrate through a community needs assessment that the recruited physician will ease a shortage of physicians who specialize in a certain area of medicine, or who are willing to accept indigent patients.[88] While many different types of incentives (e.g., below-market rent on office space, liability reinsurance reimbursement, even a mortgage guarantee on a personal residence) are acceptable, the compensation provided should fall within the range reflected in national or regional surveys for the doctor's specialty.[89] Ignoring requests for clarification, the IRS declined to say whether it would permit hospitals to offer retention incentives.[90] This standard's attention to community needs strongly

---

benefit its community. See Rev. Rul. 69-545, 1969-2 C.B. 117, which states:

> The promotion of health, like the relief of poverty and the advancement of education and religion, is one of the purposes in the general law of charity that is deemed beneficial to the community as a whole even though the class of beneficiaries eligible to receive a direct benefit from its activities does not include all members of the community, such as indigent members of the community, provided that the class is not so small that its relief is not of benefit to the community.

However, as for-profit hospitals have proved to be stronger and stronger players in health care, many commentators have suggested that we should demand more charity care and community commitment from nonprofits if we are to justify exempting them. *See, e.g.*, Nina J. Crimm, *Evolutionary Forces: Changes in For-Profit and Not-For-Profit Health Care Delivery Structures, a Regeneration of Tax Exemption Standards*, 37 B.C. L. REV. 1, 103-10 (1995); David A. Hyman, *The Conundrum of Charitability: Reassessing Tax Exemption for Hospitals*, 16 AM. J.L. & MED. 327, 375-80 (1990). To see if a broad enough class benefits, the IRS considers whether the hospital operates a free emergency room, whether it makes staff privileges and office space available to all qualified physicians, whether it draws its board from the community, and whether it treats patients insured through Medicaid and Medicare. *See* Rev. Rul. 83-157, 1983-2 C.B. 94; *see also* Sonora Community Hosp. v. Commissioner, 397 F.2d 814 (9th Cir. 1968)(denying exemption to a hospital that limits staff privileges to a few doctors and instructs ambulance drivers to take emergency patients elsewhere); Rev. Rul. 69-545, 1969-2 C.B. 117 (identifying free emergency care as a strong indicator of community benefit).

[87] *See* Consuelo Lauda Kertz, *Executive Compensation Dilemmas in Tax Exempt Organizations: Reasonableness, Comparability and Disclosure*, 71 TUL. L. REV 819, 838-42, 846 (1997)(reviewing recent developments in intermediate sanctions law).

[88] *See* Rev. Rul. 97-21, 1997-18 I.R.B. 8.

[89] *See id.*

[90] *See id.*; *see also* Marlis L. Carson, *Health Care Practitioners Suggest Improvements to Proposed Physician Recruitment Revenue Ruling* (July 21, 1995), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 95 TNT 142-3 (July 21, 1995)(requesting that IRS guidance also encompass retention incentives). The IRS's widely publicized closing agreement with Hermann Hospital prohibited all retention incentives. *See* Greenwalt, *supra* note 85.

suggests that the IRS views physician compensation practices as an indicator of whether the hospital adheres to the difficult-to-measure standard of community benefit.

While most of the IRS's examination of compensation to non-insiders has taken place around hospitals, the *UCC* decision suggests that private benefit may apply to compensation in other kinds of organizations. Judge Posner's opinion argues both that incentives for donors and directors to monitor charities can be very weak, and that private benefit revocation may be in order when less-than-diligent management allows exempt dollars to drift too far from their public purpose.[91] While the court ruled that no inurement occurred, it pointed to state court decisions finding that charities' directors owe a duty of care,[92] and lamented:

> Charitable organizations are plagued by incentive problems. Nobody owns the right to the profits and therefore no one has the spur to efficient performance that the lure of profits creates. Donors are like corporate shareholders in the sense of being the principal source of the charity's funds, but they do not have a profit incentive to monitor the care with which the charity's funds are used. Maybe the lack of profit made UCC's board too lax. Maybe the board did not negotiate as favorable a contract with W&H as the board of a profitmaking firm would have done.[93]

The court remanded the case for a determination as to whether the UCC board's lack of due care resulted in substantial private benefit to W&H.[94] It argued that perhaps by means of the disastrous contract, UCC did operate for W&H's benefit, "though not because it was the latter's creature."[95]

The private benefit cases suggest a purpose for compensation regulation that is present in charities but not in the private sector: keeping charitable dollars within the confines of authorized exempt purposes. This function may be especially important where authorized purpose is ambiguously defined, as is the community benefit standard. The *UCC* decision adds broader significance to the private benefit doctrine. It argues that protecting donors and taxpayers from insiders' greed is only part of the incentive problem that charities face—that regulating only inurement fails to address the carelessness that may result from the absence of profit incentives. While the implications of aggressively pursuing private benefit in compensation cases would be

---

[91] *See* United Cancer Council, Inc. v. Commissioner, 165 F.3d 1173, 1179-80 (7th Cir. 1999).

[92] *See id.* at 1180 (citing Riss v. Angel, 934 P.2d 669, 680-81 & n.5 (Wash. 1997); Fairhope Single Tax Corp. v. Rezner, 527 So.2d 1232, 1236 (Ala. 1987); Frances T. v. Village Green Owners Ass'n, 723 P.2d 573, 582 n.13 (Cal. 1986)).

[93] *Id.* at 1179.

[94] *See id.* at 1179-80.

[95] *See id.* at 1179.

significant, the cases' likely impact on charities' behavior should not be overstated. One IRS official estimated recently that the agency had actually revoked a hospital's exemption only twice since the current auditing program began in the early 1990s.[96] Moreover, because the less severe remedy of intermediate sanctions is available only in cases involving insiders, private benefit revocations are not likely to become more common in the near future.[97] Finally, the scope of private benefit regulation in cases not involving hospitals remains undefined. The *UCC* court stated only that private benefit had possible application in a case in which tens of millions of dollars and over ninety percent of a charity's funds moved directly into its fundraiser's pocket.[98] If an outsider must receive compensation as substantial as W&H's in order for private benefit revocation to be invoked, the private benefit test is likely to be a very infrequent source of compensation regulation.

C. Duty of Loyalty and Duty of Care for Private and Nonprofit Corporation Directors

The Internal Revenue Code is not the only source of compensation regulation for nonprofits. Common law or statute in every state imposes at least some fiduciary obligations on the directors of both charitable and for-profit corporations, most notably the duty of loyalty and the duty of care. Like courts enforcing § 501(c)(3), those interpreting fiduciary duties have focused most of their attention on conflict-of-interest transactions, but have inferred conflict in a narrower range of situations than under private inurement. Absent such a conflict, courts give very broad discretion. To the extent courts have intervened when no conflict was present, they have focused largely on procedural shortcomings rather than outcomes. The threat of duty-of-care sanctions likely has a very small impact on compensation, both because corporations have proved adept at displaying procedural formalities without modifying the substance of decision making, and because courts have shown a particular reluctance to overturn compensation decisions. Fiduciary duties are perhaps an even weaker check on charities because the state attorneys general who are tasked with enforcement are often constrained from acting by resource shortages or by reluctance to deter charitable efforts.[99]

---

[96] *See* Carolyn D. Wright & Fred Stokeld, *Revocation Threat Against Hospital System Chastens Exempts* (Dec. 19, 1997), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 97 TNT 244-3 (Dec. 19, 1997).

[97] *See* 26 U.S.C. § 4958 (Supp. III 1997).

[98] *See United Cancer Council*, 165 F.3d at 1176.

[99] *See* Robert Franklin, *Critics Say Charity Watchdogs are Nearly Toothless; Many State Agencies Have Inadequate Staff, Resources*, MINNEAPOLIS STAR TRIB., Sept. 28, 1992, at A1; Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1410-13 (1998).

The duty of loyalty is a duty to refrain from self-dealing at the corporation's expense.[100] A director or officer who violates this duty can be required to compensate the corporation and rescind the transaction or pay rescissory damages.[101] While conflict-of-interest transactions were voidable at common law regardless of fairness, most states now permit the transaction to stand if it was fair to the corporation, and it was approved by disinterested directors or shareholders who were aware of the relevant conflicts of interest.[102] Fiduciary duty case law also strongly suggests that the duty is implicated only when a director or officer who stands to benefit from a decision actually votes in the decision making process.[103] Thus, a corporation can usually secure a safe harbor for its compensation decisions simply by setting up an independent compensation committee of outside directors.

Apart from their obligation not to self-deal, directors have a duty to oversee the organization's operations with due care. Specifically, they have an obligation to evaluate whether the business is being properly managed, review its major plans and actions, and, most relevantly to compensation regulation, select principal executives, evaluate them regularly, and set their compensation.[104] One commonly invoked standard of due care is that the director should act as the "ordinarily prudent person" would behave in the conduct of her own affairs.[105] However, a key limitation on directors' due care liability is the business judgment rule. The business judgment rule provides a safe harbor for directors who make their decisions under certain conditions, generally that: (1) the decision is made without a conflict of interest; (2) directors were informed—i.e., they availed themselves of relevant information reasonably available at the time of the transaction; and (3) they acted with a rational belief that their judgment was in the corporation's best interests.[106] If these requirements are met, courts generally reexamine the

---

[100] *See* Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 IOWA J. CORP. L. 631, 646; *see also* AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS 199-382 (1994) [hereinafter PRINCIPLES OF CORPORATE GOVERNANCE].

[101] *See* Cinerama, Inc. v. Technicolor, Civ. Action No. 8358, 1991 Del. Ch. LEXIS 105, at *30 (Del. Ch. June 21, 1991).

[102] *See* Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1, 6 (1993).

[103] *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). In *Van Gorkom*, a cash-out merger was heavily promoted by the CEO, who owned 75,000 shares of stock, which would be purchased in the merger. If private inurement law applied, a CEO who had a large financial interest in a transaction would clearly be an insider, but because a disinterested board of directors approved the transaction, breach of the duty of loyalty was not an issue. *See id.* at 865-70.

[104] *See* PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 100, at 86.

[105] *See id.* at 144-61.

[106] *See id.* at 172-88.

merits of the decision only if gross negligence is present.[107] If they are not met, directors have the burden of showing that the terms of the transaction to the corporation are "entirely fair" to the corporation.[108] Among the rationales offered for this deference to business judgment are the desire to encourage directors' rational risk taking and innovation, the effort to avoid deterring quality directors from service, and the courts' reluctance to second-guess directors who are better positioned to understand their corporation's needs.[109]

In the context of challenges to compensation, courts generally have characterized their deference as "particularly broad."[110] If a compensation decision has received shareholder ratification, courts normally require a showing of waste of corporate assets in order to find breach of a duty of care, meaning that "'no person of ordinary sound business judgment would say that the consideration received... was a fair exchange for the options granted.'"[111] Explaining this position, one court acknowledged that "compensation payments may grow so large that they are unconscionable," but observed that a "court is confronted with inherent difficulties in determining whether payments for services are 'reasonable' or 'excessive'. The value of services is obviously a matter of judgment on the part of the person who must pay for them."[112] In a recent case, a court also passed up the opportunity to toughen the "informed" prong of the business judgment rule in the compensation context.[113] It did so by refusing to allow a shareholder derivative suit to go forward over the $140 million severance package that Michael Ovitz had received from Disney.[114] In this case, compensation expert Graef Crystal, who had advised the board on the Ovitz employment agreement, acknowledged in hindsight that "nobody quantified [the total cost of the severance package] and

---

[107] *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 364 n.31 (Del. 1994).

[108] *See* Cinerama v. Technicolor, 1991 Del. Ch. LEXIS 105 at *30 (1991).

[109] *See* PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 100, at 135.

[110] *See, e.g., In re* Walt Disney Co. Derivative Litig., 731 A.2d 342 (Del. Ch. 1998). Delaware courts are clearly not alone in reducing scrutiny for executive compensation decisions. *See* PAT K. CHEW, DIRECTORS' AND OFFICERS' LIABILITY (1998)(citing Cohen v. Ayers, 596 F.2d 733, 739-40 (7th Cir. 1979)("[A] plaintiff attacking a corporate payment has the heavy burden of demonstrating that no reasonable businessman could find that adequate consideration had been supplied for the payment.")); PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 100, § 5.03 cmt. c (arguing that a lower level of scrutiny is appropriate for compensation decisions than for other self-interested transactions, because of the deterrent value of the publicity they receive, and the institutionalization of disinterested compensation decision-making processes).

[111] Michelson v. Duncan, 407 A.2d 211, 224 (Del. 1979); *see also* Zupnick v. Goizueta, 698 A.2d 384, 387 (Del. Ch. 1997).

[112] Saxe v. Brady, 184 A.2d 602, 610 (Del. Ch. 1962).

[113] *See Walt Disney*, 731 A.2d 342.

[114] *See id.*

I wish we had."[115] The court maintained that it was sufficient that the board knew how the payment was calculated, and relying on an expert who did not actually make the calculation lacked the "egregiousness" necessary to take the case outside of the business judgment rule.[116]

Finally, the procedural requirements contained in fiduciary duty cases are easily met. The strictures of fiduciary duty cases are not difficult for firms to follow without changing the substance of their decision making practices.[117] While corporations have not had to fear regulation of fiduciary duty, some manipulation of process is apparent in their use of independent compensation committees to avoid scrutiny. Since the 1980s, corporations have increasingly turned to independent compensation committees and compensation consultants to set executives' wages.[118] Graef Crystal describes a process with little real independence from the compensated person. He observes that often the outside directors on the committee are personal friends of the compensated CEO, and that the CEO may in turn set their fees.[119] Moreover, Crystal argues that the independent compensation consultants, recognizing that they must please the CEO in order to get future consulting opportunities, serve as strong advocates for pay increases.[120] If surveys performed by consultants show the CEO's salary to be below average, a compensation committee already positively inclined towards that CEO will likely have difficulty justifying that it remain that way.[121] Even for executives of poorly performing firms, consultants are often able to justify pay increases in the form of stock options and restricted stock as a motivator for improved performance.[122] As a reviewer of Crystal's work observes, if every CEO believes he should be paid at the 75th percentile, and there are few voices to raise countervailing concerns, upward pressure on salaries is probably inevitable.[123] These observations suggest that it may be difficult for a government regulator to craft process guidelines that move wage setting closer to a genuine arm's-length bargain.

Most of the case law defining the duty of care has come from the for-profit rather than the nonprofit sector. Do courts and legislatures treat the two types

---

[115] *Id.* at 361 (internal quotation marks omitted).

[116] *See id.* at 362.

[117] *See* Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649, 681-88 (1995).

[118] *See* Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1878 (1992)(book review).

[119] *See id.* at 1877 & n.27. Yablon refers to GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES 42-50 (1991).

[120] *See id.* at 1878-81 (citing CRYSTAL, *supra* note 119, at 23-65).

[121] *See id.*

[122] *See id.*

[123] *See id.* at 1878.

of corporations differently? Some commentators have suggested that the for-profit treatment of self-dealing is inappropriate to nonprofits, pointing out that allowing disinterested directors to ratify interested transactions is problematic in the nonprofit form because directors do not represent any owner group that can consent to self-dealing of their property.[124] However, Delaware case law explicitly rejects a common law tradition of treating directors of charitable corporations as trustees (who are forbidden to self-deal under virtually any circumstances).[125] Though case law on the subject is limited, courts in several states have indicated that the business judgment rule is appropriate for nonprofit corporations.[126] Dicta in the Delaware case *Oberly v. Kirby* suggested that something like the private benefit test may limit business judgment protection. The court noted that a board's approval of an "action that poses a palpable and identifiable threat" to the organization's charitable purposes would not be binding, but it declined to specify how it would review such actions, and the private benefit analogue does not seem to have developed further since then.[127]

A significant reason for the absence of case law developing charity directors' fiduciary duties is the limitation of standing to sue to the state's attorney general.[128] Attorneys general often report that they are hampered by the lack of resources. Illinois' chief charity prosecutor once lamented, "We should tell our citizens that nobody in Illinois is looking at this stuff," while others express the belief that they are failing to call to account a large number of tiny charities that appear to self-deal extensively.[129] Some suggest that in cases involving negligence but no self-dealing, it is politically almost impossible to win cases against respected community leaders for misjudgments in their charitable efforts.[130] Moreover, the actions of both attorneys general and courts hint at apprehension that potential directors will be deterred from serving if they face significant risk of liability.[131] In addition

[124] *See, e.g.*, Deborah A. DeMott, *Self-Dealing Transactions in Nonprofit Corporations*, 59 BROOK. L. REV. 131, 140-44 (1993)(describing the common law tradition and its rejection).

[125] *See* Oberly v. Kirby, 592 A.2d 445, 466-67 (Del. 1991).

[126] See Goldschmid, *supra* note 100, at 644 & n.76 for citations of cases applying the business judgment rule to charities.

[127] *See Oberly*, 592 A.2d at 462, 469.

[128] Directors, voting members, and the corporation itself may sue a director for breach of fiduciary duty, but service recipients and donors generally may not. *See* CHEW, *supra* note 110, at 208-10.

[129] *See* Franklin, *supra* note 99.

[130] *See* Michael C. Hone, *Aristotle and Lyndon Baines Johnson: Thirteen Ways of Looking at Blackbirds and Nonprofit Corporations — The American Bar Association's Revised Model Nonprofit Corporation Act*, 39 CASE W. RES. L. REV. 751, 771-72 (1988).

[131] See Brody, *supra* note 99, at 1410-13 (citing George Pepperdine Found. v. Pepperdine, 271 P.2d 600, 604 (Cal. Dist. Ct. App. 1954), in which a foundation founder was held not liable

to the negative incentives attorneys general face, they of course lack the shareholder's positive incentive to recover or prevent lost profits due to breach of fiduciary duty.

As the foregoing discussion makes clear, state efforts at enforcement of the fiduciary duties of directors do not appear to have had a substantial impact on compensation practices in general, and on charities' compensation practices in particular. While courts have occasionally deviated from the business judgment rule, they have expressed particular reluctance to attempt to acquire the knowledge of executive talents and organizational needs necessary to scrutinize compensation decisions carefully. To the extent that the fiduciary duty has modified the behavior of corporations, it appears to have done so by causing careful documentation of procedures. While such documentation might lead to more thoughtful decisions, it is unclear that this documentation translates into rigorous and tough compensation negotiation.

D. Pre-Reform Compensation Regulation as an Approximation of Comparative Advantage

One way to conceptualize compensation regulation is as an assessment of comparative advantage—the idea that two parties in a trade maximize their gain when each specializes in providing the good it is best at producing.[132] Government, directors and officers, and donors all have significant potential to influence how executives are compensated, and have different abilities and opportunities to gather information about what constitutes reasonable compensation for a particular executive. In developing its systems for regulating compensation, government has implicitly defined two concepts as particularly important in determining comparative advantage, namely self-interest and the distinction between substance and process. In doing so, it has left largely unresolved the question of who should evaluate whether compensation furthers a charitable purpose, and it has only in the broadest terms explored oversight abilities and opportunities.

Directors and officers start with some obvious advantages over government in their opportunities to gather information about how much an executive should be compensated. They have more chances for personal interactions that allow them to observe subtleties of an executive's abilities, and a window into the day-to-day operations of the organization that might help them to

---

for losing $300 million in bad investments because, in the court's opinion, it would be "crazy and cruel as to assert a claim against him for his carelessness in not holding intact the fortune which he intended to bestow on others.").

[132] *See* Randall Stokes & David Jaffee, *Another Look at the Export of Raw Materials and Economic Growth*, 47 AM. SOC. REV. 402, 402 (June 1982).

determine the special skills required to manage it. To the extent that for-profit board members are also executives, they may bring a wealth of general business expertise to guide them in predicting the company's future problems and in estimating the value of someone who can solve them. Similarly, a nonprofit board member with strong community contacts may have a similar grasp of community problems and how urgently they require a particular executive who commands a high salary. The core of the business judgment rule is the recognition that those with firsthand knowledge and special expertise should be free to operate without fear that they will incur substantial liability for taking a risk.[133] Counterbalancing this deference to business judgment is a widespread perception that boards do not always work very hard at exercising their best business judgment.[134]

When does business judgment fail to give directors the advantage in determining appropriate compensation? In both the private sector and nonprofits, government has recognized that its disinterested perspective may give it the advantage when someone who will receive the compensation has enough influence over the compensation decision. Courts have often carved out a sphere of protection for board judgment by making their decisions about process, rather than about substantive outcomes.[135] Private inurement decisions have focused almost entirely on such factors as the extent of the compensated person's influence and the organization's ability to explain the reasoning behind its wage structure, and not on the compensated person's skills or the particular demands of the job. Courts interpreting due care have

---

[133] *See* Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 64 (Del. 1989)(noting that the business judgment rule is an extension of the fundamental principle the board manages and directs the affairs of a corporation); Zapata Corp. v. Maldonado, 430 A.2d 779, 782 (Del. 1981)(observing that the business judgment rule gives recognition and deference to directors' business expertise when exercising their managerial power).

[134] Literature criticizing the passive and management-captured board includes, e.g., James J. Fishman, *Standards of Conduct for Directors of Nonprofit Corporations*, 7 PACE L. REV. 389, 397 (1987)("Because nonprofits tend to have many directors who are on the board for 'window dressing' only, a common phenomenon of nonprofit boards is directors who do not direct."); Goldschmid, *supra* note 100, at 633-34 (detailing the inaction and other negligence of the United Way board in the face of CEO William Aramony's criminal conduct); Alison Leigh Cowan, *Board Room Back-Scratching?*, N.Y. TIMES, June 2, 1992, at D1 (suggesting the reciprocity inherent in board relationships—a computer analysis by consulting firm Directorship revealed that 39 of the 788 largest public companies had cross-directorships with another company).

[135] *See* Unitary Mission Church v. Commissioner, 74 T.C. 507, 514, 516 (1980), *aff'd* 647 F.2d 163 (2d Cir. 1981)(decrying unexplained fluctuations in compensated person's salary); Church of Modern Enlightenment v. Commissioner, 55 T.C.M. (CCH) 1304 (1988)(focusing on the salaried person's near-total control of the wage-setting process).

expressed reluctance to evaluate compensation decisions at all given the subjectivity of valuing services.[136]

There are likely two reasons for the process focus. First, evaluating the best process for making a compensation decision might require some general knowledge of best practices, but it requires far less organization-specific knowledge and community or business expertise than determining the actual salary. Second, a weak process provides evidence that directors were not actually exercising their business judgment. A court could reasonably decide that its careful weighing of factors justifying compensation is a better decision making process than an expert's intuitive judgment that is unsupported by performance analysis or salary comparisons.

While courts are probably right to recognize that boards have a greater advantage in choosing outcomes than in analyzing processes, it is not clear that one can develop a process analysis of any rigor without challenging directors' substantive expertise. The IRS has expressed the hope that intermediate sanctions will allow it to address overcompensation in major institutions that are otherwise sound.[137] These institutions, however, will be significantly more sophisticated at reshaping processes to justify their pre-existing compensation decisions than the tiny churches that private inurement typically targeted. The change in targets suggests that courts and the IRS might have to step outside the confines of process regulation if they are to be the agents of meaningful reform.

Part II of this Article examines the legislative history of intermediate sanctions in order to develop criteria for effective government monitoring of nonprofits, and explains how intermediate sanctions law has been structured to further these criteria and to build on existing regulation. Part III draws on the criteria developed in Part II to suggest that government may be ineffective if it relies only on process rules in compensation regulation. We conclude by exploring some of the mechanisms that government and the nonprofit sector itself might develop to permit donors and clients to take a more active and effective role in fostering efficient compensation decisions.

II. INTERMEDIATE SANCTIONS: THE MOST RECENT EFFORT TO REGULATE COMPENSATION IN PUBLIC CHARITIES

The passage of intermediate sanctions legislation in 1996 was preceded by a significant amount of discussion on why government is needed in regulating nonprofit salaries, and why the private inurement and private benefit doctrines

---

[136] *See* Michelson v. Duncan, 407 A.2d 211 (Del. 1979); Zupnick v. Goizueta, 698 A.2d 384 (Del. Ch. 1997).

[137] *See Commissioner's Testimony*, *supra* note 26.

are inadequate remedies. We begin this Part with a brief description of the legislative history of intermediate sanctions. Drawing on this history and commentary related to it, we develop two categories of criteria for government's regulatory role. The negative criteria are constraints that government should place on its power to regulate. The positive criteria are the "value added" by regulation, the flaws in the philanthropic market that government can address, and the public purposes it can achieve. Finally, we outline key provisions of the 1996 intermediate sanctions legislation and its regulations, identifying how they support the criteria outlined in the legislative history, and how they supplement existing law.

Legislative history suggests five constraints that should shape a regulatory remedy for compensation. First, a regulatory remedy should minimize harm to stakeholders who did not participate in the excess compensation. Second, equality demands that government as regulator treat like cases equally. Third, organizations are entitled to fair notice of their obligations under the law. Fourth, the costs of disclosure and documentation should be minimized, and should be to some degree proportional to the amount of exempt money at stake. Fifth, compensation regulation should show some deference to charities' business judgment. Legislative history and commentary also suggest four answers to the question of why government adds value as a regulator: (1) because existing disclosure mechanisms remain flawed; (2) because the nondistribution constraint and the structure of nonprofits weaken both donors' and boards' incentives to monitor; (3) because several categories of nonprofits are substantially insulated from a market of donors or customers; and (4) because, even if stakeholders monitor diligently, compensation regulation may be necessary to ensure that charitable dollars stay within the confines of exempt purposes.

The intermediate sanctions law and its proposed regulations build on the law's existing emphasis on regulating process and insiders, and they also furthers the criteria described above in several important ways. The IRS has attempted to provide better notice to organizations by clarifying both the definition of the insider (now called "disqualified person") and by describing in some detail a process of compensation comparison and evaluation to which it will grant some deference to business judgment. In specifying the compensation decision making process, it relaxed its rules to some degree for small organizations. New disclosure requirements have addressed concerns about informing donors. Most significantly, the intermediate sanctions penalty, a targeted excise tax modeled on the self-dealing rules for private foundations, is designed not only to focus more narrowly on wrongdoers, but to improve notice and equal treatment by giving the IRS a moderate penalty that will reduce its reliance on the draconian remedy of exemption revocation or closing agreements.

A. A (Very) Brief History of Intermediate Sanctions Legislation

Significant efforts to pass intermediate sanctions began in 1991, when the House Ways and Means Committee and its subcommittees held hearings on several issues related to the tax-exempt status of medical organizations. Witnesses at one set of hearings lamented the fact that many hospitals were providing charity care in dollar amounts far lower than the value of their exemption.[138] At another, Representative Fortney "Pete" Stark called attention to the conversion of HMOs to for-profit status, expressing the fear that HMO insiders would receive private inurement from the conversion.[139] In response to questions by committee members, one IRS official observed that the capacity of agents to address the problem was limited because agents were "reluctant to propose revocation" in many inurement cases.[140] Following this testimony, Stark introduced legislation to impose excise taxes on certain medical organizations.[141]

While the legislation did not pass, the issue surfaced again during 1993 and 1994 hearings of the Committee's Oversight Subcommittee.[142] Opening the hearings, Representative J.J. Pickle voiced his concern over media reports of public charity executives' using tax-exempt dollars to pay for cars, servants, and country-club memberships.[143] He observed that the Subcommittee had found that fifteen percent of the top 2000 executives of the 250 largest charities were earning more than $200,000 per year, and thirty-eight individuals were receiving more than $400,000.[144] As the hearings unfolded, several witnesses expressed frustration at the difficulty that donors faced in

---

[138] *See, e.g.*, Michele Melden, *Health Care Advocate Testifies on Tax-exempt Status of Hospitals* (July 10, 1991), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 91 TNT 146-43 (July 11, 1991)(testifying in support of H.R. 1374 and 790, proposed legislation to require more indigent care from tax-exempt hospitals).

[139] *See* Bernadette M. Broccolo et al., *Rules to Live By: IRS Releases Intermediate Sanctions Regulations* (Sept. 8, 1998), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 98 TNT 173-77 (Sept. 8, 1998)(citing *Tax-Exempt Status of Hospitals, and Establishment of Charity Care Standards: Hearing Before the House Ways and Means Comm.*, 102d Cong. 112 (1991)(statement of John E. Burke, IRS Assistant Commissioner)); H.R. 4042, 102d Cong. (1991).

[140] *See* Broccolo et al., *supra* note 139.

[141] *See id.* (citing H.R. 4042, 102d Cong. (1991)).

[142] Rep. J.J. Pickle, *Full Text: Rep. Pickle's Statement at W&M Oversight Hearing on Public Charities* (Aug. 2, 1993), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 93 TNT 161-43 (Aug. 3, 1993).

[143] *See id.*

[144] *See* Subcommittee on Oversight of the House Committee on Ways and Means, *Full Text: Unofficial Transcript of Oversight Hearing on Nonprofit Abuses* (June 15, 1993), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 93 TNT 131-19 (June 21, 1993).

getting enough information to make informed decisions, while IRS Commissioner Margaret Milner Richardson reiterated the agency's dissatisfaction with having no penalty options other than revocation.[145] Following this round of hearings, the Treasury Department sent an excise tax proposal to Congress.[146] Intermediate sanctions were finally enacted, as part of the Taxpayer Bill of Rights in July 1996.[147] In August 1998, the IRS released proposed intermediate sanctions regulations and it is currently revising those regulations based on public comments.[148]

B. The Intermediate Sanctions Law and Proposed Regulations

The 1996 intermediate sanctions law[149] and the IRS's 1998 proposed regulations implementing it continue compensation regulation's traditional focus on the self-interested insider. However, the proposed regulations significantly clarify who constitutes an insider (or "disqualified person," in the legislation's terminology), and what decision making processes are likely to demonstrate that any given decision was made with due care. A particularly important component of the legislation is the excise tax scheme it provides, which reduces harm to non-culpable beneficiaries of the charity, and targets incentives for due care towards those who are in a position to influence compensation decisions directly. Below we outline some of the most significant features of the legislation and proposed regulations.

1. "Disqualified person" defined

Consistent with the idea that the ability to set one's own salary puts one at special risk of placing self-interest ahead of the organization's interest, the intermediate sanctions law limits its penalties to "disqualified persons," who include "any person who was, at any time during the 5-year period [prior to the transaction], in a position to exercise substantial influence over the affairs of the organization," a family member of someone with substantial influence, or an entity of which a disqualified person has more than thirty-five percent

---

[145] *See id.*

[146] *See* Leslie B. Samuels, *Samuels Submits White House Intermediate Sanctions Proposal* (Aug. 8, 1995), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 95 TNT 155-23 (Aug. 9, 1995).

[147] *See* 26 U.S.C. § 4958 (Supp. III 1997).

[148] *See* Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Transactions, 63 Fed. Reg. 41,486, 41,495-505 (1998)(to be codified at 26 C.F.R. § 53.4958-53.4958-6)(proposed Aug. 4, 1998); Jon Almeras, *IRS, Treasury Mulling Comments on Intermediate Sanctions Regs* (May 7, 1999), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 89-5 (May 10, 1999).

[149] *See generally*, Kertz, *supra* note 87.

control.[150] The intermediate sanctions statute states that presidents, CEOs, CFOs, and those with a material interest in a provider-sponsored organization are by definition disqualified persons.[151] Beyond these categories, "substantial influence" is a matter of facts and circumstances,[152] but the IRS lists several categories of persons who would be likely to have substantial influence:

- founders;
- substantial contributors (those who donate more than $5,000 or two percent of total contributions);
- those whose compensation is contingent on revenues from activities of the organization that they control;
- those with authority to control or determine a significant portion of the organization's capital expenditures, operating budget, or employee compensation;
- those who have managerial authority, or who serve as key advisors to someone with managerial authority;
- those with controlling interests in a disqualified entity.[153]

Facts and circumstances tending to show the absence of substantial influence include the focal person's bona fide vow of poverty or her status as an independent contractor who does not benefit (other than receiving professional fees) from the transaction on which she advises.[154] The regulations indicate that managerial control over a discrete segment of the organization can in some circumstances constitute substantial influence. For example, the dean of a law school which contributes substantially to a university's reputation and revenues and the head of a hospital cardiology department which is a major source of patients may both be disqualified persons if they have sufficient authority over their units.[155] The IRS is currently revising the disqualified person standard, based on comments and on the *UCC* decision.[156] Commentators have noted that the standard does not make clear whether a CEO, for example, is a disqualified person for purposes of the contract that

---

[150] 26 U.S.C. § 4958(f) (Supp. III 1997).

[151] *See* Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Transactions, 63 Fed. Reg. 41,486, 41,490 (1998)(to be codified at 26 C.F.R. § 53.4958-3(c))(proposed Aug. 4, 1998).

[152] *See id.* at 41,490 (to be codified at 26 C.F.R. § 53.4958-3(e)(1)).

[153] *See id.* (to be codified at 26 C.F.R. § 53.4958-3(e)(2)).

[154] *See id.* at 41,490-91 (to be codified at 26 C.F.R. § 53.4958-3(e)(3)).

[155] *See id.* at 41,499 (to be codified at 26 C.F.R. § 53.4958-3(f)).

[156] *See* Almeras, *supra* note 148.

made her a CEO, or whether someone with shared or secondary managerial authority is disqualified.[157]

2. Unreasonable compensation

The intermediate sanctions statute defines excess benefit transactions as those in which an economic benefit provided by a tax-exempt organization to a disqualified person "exceeds the value of the consideration (including the performance of services) received for providing such benefit."[158] Proposed regulations state that compensation is an excess benefit if it "exceed[s] what is reasonable under all the circumstances," and that compensation is reasonable "if it is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances."[159]

3. The rebuttable presumption

Given the dearth of case law defining what is reasonable, the reasonable compensation definition by itself would leave organizations with little notice as to what was required of them, and offer little protection of their expert judgment. In order to allow charities to exercise this judgment with greater certainty, Congress placed a rebuttable presumption in the legislative history, and the IRS adopted it in the proposed regulations.[160] Charities may rely on a rebuttable presumption that their compensation decision was reasonable if it was approved by a board that: (1) is made up entirely of individuals unrelated to, and not subject to, the control of the disqualified person; (2) obtains and relies on appropriate comparability of compensation data; and (3) adequately documents the basis for its salary decision.[161]

Relevant data for demonstrating reasonableness include:

---

[157] *See, e.g.*, Carolyn D. Wright, *Intermediate Sanctions Witnesses Wrap Up Testimony* (Mar. 17, 1999), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 52-2 (Mar. 18, 1999)(describing testimony in which Phil Royalty of Ernst & Young urges that an individual should not become a disqualified person by virtue of a first transaction with the organization—the "first-bite rule").

[158] Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Transactions, 63 Fed. Reg. 41,486, 41,501 (1998)(to be codified at 26 C.F.R. § 53.4958-4(b)(3))(proposed Aug. 4, 1998).

[159] *Id.*

[160] *See* H.R. REP. NO. 104-506, pt. 2, at 56-57 (1996); Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Transactions, 63 Fed. Reg. 41,486, 41,495 (1998)(to be codified at 26 C.F.R. § 53.4958-6(a))(proposed Aug. 4, 1998).

[161] *See* Taxes on Excess Benefit Transactions, 63 Fed. Reg. 41,486, 41,495 (1998)(to be codified at 26 C.F.R. § 53.4958-6(a))(proposed Aug. 4, 1998).

1. compensation levels paid by similarly situated tax-exempt and taxable organizations for positions that are functionally comparable;
2. the price of similar services in the organization's geographic area;
3. independent compensation surveys conducted by independent firms;
4. actual written offers from similar organizations competing for the compensated person's services.[162]

The proposed regulations offer a rather daunting illustration of appropriate comparability data, describing as appropriate a customized compensation survey commissioned by a hospital, covering executives with similar responsibilities, sorting survey data by hospital size, nature of services, level of experience and specific responsibilities of executives, and the composition of the compensation packages.[163] In the example, board members also received a detailed written analysis of the survey data, and had opportunities to question a member of the survey firm. While the proposed regulations do not provide examples of a less exacting comparability data standard that would suffice, they do recognize that documentation costs for small organizations are large relative to program budgets. Charities with annual gross receipts of less than one million dollars may rely on the compensation paid by five comparable organizations in the same community, or similar communities, for similar services.[164]

The third requirement, under which a board must follow several documentation procedures, seems designed to address the weak incentives for diligence among charity board members. The IRS specifies that in all cases, adequate documentation must include:

1. the terms of the compensation transaction, the date of its approval and who participated in debate or voted on the transaction;
2. a description of the comparability data and how it was obtained;

[162] *See* Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Transactions, 63 Fed. Reg. 41486, 41,504 (1998)(to be codified at 26 C.F.R. § 53.4958-6(d)(2))(proposed Aug. 4, 1998).

[163] *See id.* In another example, a university's use of a national compensation survey for university presidents, which is not divided by size of university or any other criteria, and which is used by a board with general business experience but without significant experience in higher education compensation, is deemed not appropriate data. *See id.*

[164] The proposed regulations offer an example in which a small repertory theater had appropriate data for setting its artistic director's salary when it conducted a telephone survey of six theaters of similar size, summarized findings in a written report, and had the board evaluate the director's prior salary and performance. *See id.* at 41,505.

3. actions taken on the compensation decision by anyone who was a board member but who had a conflict of interest.[165]

In addition, where compensation is higher or lower than the range of comparable data, the board must document by the time of its next meeting after approving the transaction (with reasonable time to review and approve the documentation) its basis for determining that compensation outside the comparability range was appropriate.[166] On rebutting the presumption, the proposed regulations say simply that the IRS can rebut it with "additional information showing that the compensation was not reasonable . . . ."[167]

4. The intermediate sanctions penalty

A critical tool for strengthening incentives for manager diligence and minimizing the effect of penalties on innocent parties—and therefore making the IRS less reliant on the case-by-case closing agreement procedure—is the structure of the intermediate sanctions penalty. Based on a similar excise tax scheme the IRS applies to self-dealing in private foundations,[168] the intermediate sanctions penalty is a two-tiered tax. Once the IRS determines that a charity has paid excess compensation, it imposes an initial twenty-five percent tax on the excess on the disqualified person who received the excess amount.[169] This individual must not only pay the tax, but repay the amount of the excess compensation to the organization.[170] If she does not repay the excess by the time the IRS mails a notice of deficiency or assesses the twenty-five percent tax, she is then liable for a 200% tax on the excess.[171]

Intermediate sanctions penalties also target managers who willfully fail to prevent the excess compensation. Any manager who participates willfully and without reasonable cause in the compensation transaction is liable for a ten percent tax on the excess amount.[172] Participation is willful if the manager actually knows of facts indicating that the compensation is excessive, or

---

[165] *See id.* at 41,505 (to be codified at 26 C.F.R. § 53.4958-6(d)(3)).

[166] *See id.*

[167] *Id.* at 41,504 (to be codified at 26 C.F.R. § 53.4958-6(c)).

[168] *See* 26 U.S.C. §§ 4940-4948 (1994).

[169] *See* 26 U.S.C. § 4958(a)(1) (Supp. III 1997).

[170] *See* 26 U.S.C. § 4958(f)(6).

[171] *See* 26 U.S.C.§ 4958 (a)(1) & (b).

[172] *See* 26 U.S.C. § 4958(a)(2); Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Transactions, 63 Fed. Reg. 41,486, 41,496-97 (to be codified at 26 C.F.R. § 53.4958-1(d)(3))(proposed Aug. 4, 1998). Participation includes silence where the manager had a duty to speak, but does not include unsuccessful attempts to prevent the transaction.

negligently fails to ascertain whether it is excessive.[173] The manager has reasonable cause for participation (and so is not liable for the tax) if she has acted "with ordinary business care and prudence."[174] One who acts under the guidance of a reasoned, written legal opinion will normally be found to have reasonable cause.[175]

Thus, the intermediate sanctions legislation enables the IRS to pursue excess compensation more aggressively by permitting it to target penalties narrowly at those who received or could have prevented excess compensation. The application of more formal penalties will likely reduce reliance on inconsistent and unequal closing agreements. The legislation recognizes the special danger that self-interested insiders pose when incentives for rigorous oversight are weak, as well as the need to discourage charity managers from negligent decision making. At the same time, it provides some insulation for business judgment by specifying processes that invoke the rebuttable presumption and shielding ordinarily prudent managers. Donors and government can also look to significant reforms in Form 990's requirements to make information gathering about compensation decisions easier.

C. *Criteria for Evaluating Compensation Regulation in Public Charities*

As representatives of government, watchdog organizations, charities, and charities' legal organizations commented on intermediate sanctions legislation and the proposed regulations, they implicitly or explicitly advanced two sets of policy criteria against which government should evaluate its efforts. The first concern was what government should not do, namely the instances in which fairness or efficiency mandated that government refrain from regulating compensation. The second concern was to figure out when government had comparative advantage in regulating compensation.

1. *Policy constraints on government as charitable compensation regulator*

Perhaps the core concern over the inadequacy of the revocation penalty for intermediate sanctions was expressed by IRS Commissioner Margaret Milner Richardson at the 1993 intermediate sanctions hearings:

> Revocation of an exemption is a severe sanction that may be greatly disproportional to the violation in issue. For example, assume that an

---

[173] *See* Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Transactions, 63 Fed. Reg. 41,486, 41,497 (1998)(to be codified at 26 C.F.R. § 53.4958-1(d)(4))(proposed Aug. 4, 1998).

[174] *See id.* at 41,497 (to be codified at 26 C.F.R. § 53.4958-1(d)(6)).

[175] *Id.* at 41,488 (to be codified at 26 C.F.R. §53.4958-1(d)(7)).

> examination of a large university reveals that the university is providing its president with inappropriate benefits. The university may be paying the president a salary that appears excessive in comparison to that paid to presidents of comparable universities [or provided a large interest-free loan or luxuries for the official residence]. Each of these facts would raise serious inurement questions. Revoking the university's exemption, however, may be an inappropriate penalty. Revocation could adversely affect the entire university community—employees, students, and area residents.[176]

Tiny, weak-governance churches have likely been popular targets for inurement revocation because revoking their exemption often harms no one other than the few board members who made up most or all of the congregation, and who also allowed the excess compensation. However, even a school, hospital, or museum that grossly overcompensates is likely to create some significant value for employees and customers who have little or no power to stop the overcompensation. Thus, a *first* principle of compensation regulation is that the penalty should minimize harm to those who did no wrong, and, instead, it should target narrowly those who were in a position to reduce the excess compensation.

Two more principles are reflected in the IRS practice of using closing agreements to address overcompensation in organizations for which revocation would have been inappropriate. Richardson observed that closing agreements have been useful in curbing some excess benefit transactions, but that the agreements were "not an ideal tool."[177] "In particular, because each agreement results from separate negotiations with a particular organization, it is difficult to ensure that similar organizations are treated consistently."[178] When government relies heavily on a negotiated remedy, the result is to make arbitrary distinctions in its treatment of citizens, with the sharper negotiators regulated less strictly. Moreover, closing agreements are problematic both because they do not create incentives for other organizations to emulate a clear standard of behavior, and because other organizations risk facing an inurement penalty without having received fair notice of what conduct was expected. When the IRS concluded a protracted battle with Hermann Hospital with strict negotiated limits on the physician recruitment incentives the hospital could use, representatives of other hospitals expressed confusion as to whether the limits constituted precedent even after IRS officials issued public statements saying that they did not.[179] Thus, the closing agreement experience suggests

---

[176] *Commissioner's Testimony*, *supra* note 26.

[177] *See id.*

[178] *Id.*

[179] *See* Paul Streckfus, *Significance of Hermann Hospital Closing Agreement Downplayed by IRS at Tax Conference* (Oct. 28, 1994), *available in* LEXIS, Fedtax Library, State Tax Notes File, *as* 95 STN 3-62 (Jan. 5, 1995); R. Todd Greenwalt & Timothy J. Deveski, *IRS Rules on*

second and *third* criteria: government should provide reasonable notice of required conduct before imposing a regulatory penalty; and regulators should offer equal treatment to like organizations.

A fourth issue that emerged briefly during the 1993 hearings and repeatedly in comments and hearings on the proposed regulation was the cost of disclosure. In his 1993 testimony, Thomas E. McCabe, chairman of the accrediting organization Evangelical Council for Financial Accountability ("ECFA"), recognized the importance of disclosure and documentation for accountability, but revealed that his organization did not accredit very small organizations lest its disclosure requirements "unduly burden" them.[180] He warned that charities were bearing "greater responsibilities in addressing social, spiritual, physical and economic needs of society (with ever dwindling government funding)" and urged that the IRS do more to offer overburdened nonprofits adequate resources and instruction to allow them to meet disclosure requirements.[181]

Hearings and comments on the proposed regulations again brought out the general cost concern and in particular the solicitude of small organizations. One former IRS attorney said of the process of making salary comparisons: "YOU [the IRS] may get the information when YOU call, but that is not what happens to non-IRS people. We will have to go in person to each office to inspect their annual reports, which may take perhaps 30 to 50 hours over several months."[182] Others warned that small organizations would have difficulty finding salary comparability data, and that the costs of disclosure could consume a significant portion of their budgets relative to those of larger organizations.[183] These statements suggest a *fourth* criterion, that the costs of documentation and disclosure should not be disproportionate to the amount of exempt money at stake, and should not detract substantially from program budgets.

Finally, a critical consideration that we covered extensively in Part I is the business judgment concept, that diligent charity officers and directors have

---

Cross-Town Recruiting of Physicians (July 15, 1999), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 140-83 (July 22, 1999).

[180] *See* Thomas E. McCabe, *Full Text: Evangelical Group's Testimony at W&M Hearing on Tax Laws Applicable to Tax-Exempt Organizations* (June 15, 1993), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 93 TNT 93-6776 (June 16, 1993).

[181] *Id.*

[182] Walter A. Ludewig, *Recordkeeping Requirements Must be Reasonable, Says Former IRS Attorney* (Mar. 8, 1999), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 58-27 (Mar. 26, 1999).

[183] *See* Internal Revenue Service, *Unofficial Transcript of IRS Hearing on Intermediate Sanctions* (Mar. 16, 1999), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 63-23 (Apr. 2, 1999)(testimony of law professor Ellen Aprill and Bar Association of the City of New York representative Pamela Mann).

expert, firsthand knowledge of the needs of their communities, and of the subtle personal qualities and special skills that the compensated person brings to the job.[184] An IRS agent or a court reviewing credentials and salary statistics simply cannot replicate this level of knowledge. Several statements in the legislative history of intermediate sanctions address the business judgment concern. In his letter accompanying the Treasury Department's intermediate sanctions proposal, Assistant Secretary Leslie B. Samuels emphasized the importance of "prevent[ing] intermediate sanctions from unduly interfering with the operation of organizations that are complying with the law."[185] Several comments on the IRS's proposed intermediate sanctions regulations touched on the desirability of this deference. Los Angeles attorney J. Patrick Whaley urged the IRS to clarify its intention not to "manage the affairs of an exempt organization by second-guessing those who are responsible for administering the organization's affairs[,]" and he warned against a "cookie-cutter approach to compensation."[186] While observers of nonprofits might differ on how much deference is owed to directors' and officers' business judgment, a *fifth* criterion is that regulators should take into account charities' generally superior opportunities for fact finding about their employees and their community before restricting compensation flexibility.

B. Policy Objectives of Government as Compensation Regulator

The legislative history of intermediate sanctions and other commentary on nonprofits have offered reasons to believe that government may have comparative advantage in regulating compensation, and that it can fulfill several important policy objectives by reviewing compensation decisions carefully, at least under some circumstances. The first three policy objectives we describe—correcting poor disclosure, bolstering weak board and donor monitoring incentives, and addressing organizations whose funding sources limit their need to be responsive—center on failures in a philanthropic "market" in which the donor's intent fails to get effectuated and government intervention becomes necessary. The fourth objective—protecting charitable purpose—holds that government may need to protect the public interest in charitable function even if donors are satisfied with compensation decisions.

---

[184] *See supra* notes 133-36 and accompanying text.

[185] Leslie B. Samuels, *Samuels Submits White House Intermediate Sanctions Proposal* (Aug. 8, 1995), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 95 TNT 155-23 (Aug. 9, 1995).

[186] Patrick J. Whaley, *Attorney Suggests Changes to Proposed Intermediate Sanctions Regs* (Mar. 16, 1999), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 67-33 (Apr. 8, 1999).

1. Correcting poor disclosure

First, explicitly featured in the history of intermediate sanctions is the idea that donors, even if they strive to be well informed and thoughtful in their donations, cannot access enough information to make optimal decisions. Given that firsthand observation of charitable programs and conducting detailed studies on outcomes cost dearly in terms of time and money, donors must generally rely on existing documentation describing the charity's purposes, programs, expenditures, and outcomes in order to determine whether it is a worthy donee. Neutral accrediting or monitoring agencies might provide this information, but the organizations themselves are expected to make it available via IRS Form 990.

Form 990 is an annual reporting form filed by all public charities except for churches and certain other religious organizations, religious schools below the college level, government entities, and organizations whose annual receipts are $25,000 or less.[187] Form 990 requires organizations to report the amounts of their revenues, expenses and assets and liabilities, with the expense category broken down by program, management, and fundraising.[188] They must report their major purpose and describe program service accomplishments.[189] Most relevant to reasonable compensation, they must disclose compensation for officers, trustees, and directors, as well as for their five highest paid employees other than officers, trustees, and directors, and for their five highest paid independent contractors.[190] They must also disclose certain taxes and fines paid during the previous year, now including intermediate sanctions penalties.[191]

Although the law has long required charities to make their Form 990s available upon request, participants in the intermediate sanctions hearings reported difficulties in gaining access to them. In addition, participants complained that some organizations neglected to report fringe benefits, spread compensation reporting among several affiliated organizations so that it appeared smaller, or simply reported incorrect numbers.[192] Responding to these concerns, Congress passed legislation toughening the Form 990

---

[187] *See* IRS Form 990.

[188] *See id.*

[189] *See id.*

[190] *See id.*

[191] *See id.*

[192] *See* Consuelo Lauda Kertz, *New Sanctions Aimed at Noncompliant Tax-Exempt Groups*, 25 TAX'N FOR LAWYERS 219, 225-226 (1997); *Commissioner's Testimony*, *supra* note 26.

disclosure requirements, and the IRS finalized regulations in April 1999.[193] Congress and the IRS aimed at improving access by requiring not merely that organizations make Form 990s available, but that they photocopy and mail them upon request.[194] Alternatively or in addition to this requirement, the organization may make its Form 990 available over the Internet.[195] To increase incentives for disclosure, the statute provides for a twenty dollars per day penalty (up to a maximum of $10,000) for failing to make the Form 990 available—up from the ten dollars per day and $10,000 maximum penalty previously in force.[196] A finding of willful failure to make the return available leads to a penalty of $5,000 per return (up from $1,000).[197] In addition, the intermediate sanctions legislation contains some provisions to try to resolve some of the difficulties in reporting compensation. Organizations must now count all direct or indirect payments received by employees as compensation, so that fringe benefits must not be concealed, and reported compensation must not be split among several affiliated organizations.[198]

2. Bolstering monitoring incentives

A likely second set of concerns motivating intermediate sanctions is the absence of strong monitoring incentives for either board members or donors. To the extent they have input into the makeup of their board of directors, charity managers have little incentive to encourage selection of board members who will observe carefully and ask tough questions. When an insider has a strong self-interest in securing a large salary, a half-attentive board is likely to be a particularly weak check. Donors do not have a good mechanism for assessing whether a board member is diligent as a board member, and they have no direct control over board selection because they do not have the voting power of shareholders.

Furthermore, funders of charitable organizations differ from shareholders in their incentives to monitor. As Judge Posner pointed out in *UCC*, donors do not have the profit incentive to monitor.[199] They also may face a more

---

[193] *See* T.J. Sullivan, *Regs Make Nonprofits' Information Widely Available*, 1999 TAX NOTES TODAY 104-82, June 1, 1999, *available in* LEXIS, Fedtax Library, TNT File (citing 26 U.S.C. § 6104).

[194] *See* 26 U.S.C.A. § 6104(d)(1)(B) (West Supp. 1999).

[195] *See* 26 C.F.R. § 301.6104(d)-2(b)(2) (1999).

[196] *See* 26 U.S.C.A. § 6652(c)(1)(A)(ii) (West Supp. 1999).

[197] *See* 26 U.S.C.A. § 6685 (West Supp. 1999).

[198] *See* 26 U.S.C. § 4958(c)(1)(A) (Supp. III 1997); Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Requirements, 63 Fed. Reg. 41,486, 41,501 (1998)(to be codified at 26 C.F.R. § 53.4958-4(b)(3))(proposed Aug. 4, 1998).

[199] *See United Cancer Council v. Commissioner*, 165 F.3d 1173, 1179 (7th Cir. 1999).

complex information gathering challenge than shareholders because nonprofit goals may be more complex and long-term than those of an owner. For example, a private firm owner can rely on a financial statement for fairly clear objective measures of the firm's profitability in the recent past. In contrast, if a donor is interested in whether an after-school program reduces dropout rates, she must hope that the charity has commissioned a scientifically sound study, or attempt to guess at children's future behavior from anecdotal evidence of their program experiences. Donors' incentives may also be weaker than those of a charity or a private firm's customers. Customers have some advantages over donors as effective monitors in that: (1) the customer learns information about the charity by firsthand experience of its services; and (2) in deciding whether to give repeat business, the customer need only make a judgment about the program's impact on her own utility, and not on someone else's. Thus, we might expect monitoring to be more problematic for charities in which most funds come from donors who do not use services, as opposed to customers. Generally, the second set of concerns motivating government role in compensation regulation are that funders and board often have weak incentives to pay careful attention to the compensation decisions of charities.

3. Addressing organizations that do not respond to a market

A third category of concerns driving intermediate sanctions is the desire to find a solution to the problem of creating oversight of organizations for which funders are unable to offer strong incentives for establishing reasonable compensation. Most public charities must meet a support test—i.e., they must demonstrate that they receive at least one-third of their annual support from contributions, grants, or fees (with no more than two percent of the total counted from any one source under one test and no contributions counted at all for donors of over $5,000 under another).[200] The support test provides some indicator that multiple funders have found the outcomes of compensation and other program decisions sound. Because churches, schools, hospitals, and medical research organizations need not meet the support test,[201] they may choose to rely primarily on endowments or (particularly in the case of small churches) a single donor or a handful of donors. Endowments would seem to weaken the incentives to compensate reasonably because they liberate organizations from having to satisfy donors or customers once the initial funding decision is made. As the church cases

[200] *See* 26 U.S.C. §§ 170(b)(1)(A)(vi) & 509(a)(1)-(2) (1994); 26 C.F.R. § 1.170A-9(e)(ii) (1999).

[201] *See* 26 U.S.C. §§ 170(b)(1)(A)(vi) & 509(a)(1)-(2); 26 C.F.R. § 1.170A-9(e)(ii).

on private inurement illustrate,[202] reliance on a small number of donors may provide especially weak incentives when the handful of donors all do business or receive compensation from the charity, or are related to those who do. Furthermore, because churches are not required to meet Form 990 disclosure requirements,[203] funders may be unable to find enough information to take into account compensation decisions when deciding whether to donate. From the IRS's concentration on churches in private inurement cases and its attention on the compensation practices of hospitals, we might infer that compensation regulation is particularly needed in categories of organizations which are not required to disclose to, or draw support from, a broad range of donors.

4. Preventing private benefit

Suppose that funders and the board have diligently reviewed and approved a particular compensation decision. Absent disclosure and incentive problems, is there any role for compensation regulation in protecting charitable purpose? If hospital exemptions are to be permitted only under the community benefit standard,[204] the standard clearly suggests an additional role. It is easy to see that a hospital board and its major donors and patients might agree on a strategy of paying top dollar to lure the nation's foremost specialists, rather than looking for doctors who would be willing to care for the poor at more modest salaries. Further, the *UCC* decision[205] indicates that, even within other types of organizations, overcompensation by a careless board may violate a duty to taxpayers by taking the organization's dollars outside of its exempt purpose. However, the *UCC* court's emphasis on due care suggests that, outside the context of the ambiguous community benefit standard, the government's duty to protect charitable purpose is principally a matter of getting the board's incentives right. It remains unclear whether there are instances in which a diligent and well-informed board could pay a university president or a museum curator so much that the excess compensation would constitute an illegitimate private benefit. However, *UCC* and the physician recruitment cases suggest a fourth purpose for compensation regulation: to prevent excessive salaries from diverting charitable dollars from furthering a charitable purpose. As we saw in section II.B., intermediate sanctions legislation would appear to satisfy many of the constraints identified by witnesses, and address several of the compensation regulation purposes that commentators have identified. However, at least some aspects of the new

---

[202] *See supra* notes 59-69 and accompanying text.

[203] *See* 26 U.S.C. § 6033(a)(2) (1994).

[204] *See supra* notes 59-69 and accompanying text.

[205] *See supra* notes 37-47 and accompanying text.

regulations raise questions about how successful any attempt by government to regulate nonprofit compensation is ultimately likely to be. The potential problems left unaddressed by the new legislation are explored in Part III.

III. NONPROFIT ACCOUNTABILITY: CREATING A SUPPLY OF AND A DEMAND FOR INFORMATION

The compensation given to the trustees of KSBE bring to mind two questions related to trusteeship.[206] The first is related to fairness: were the trustees entitled to be compensated at the rate of nearly $900,000 a year for their stewardship of the massive endowment and the educational mission it funded?[207] This question amounted to a challenge to the qualifications of the Estate trustees and the nature and quality of the work they performed on behalf of the charity. This was a question that could be answered, in principle, by looking at the tasks performed by the trustees, the work that other trustees performed on behalf of other organizations, and the performance of the organization under this particular group of leaders.

The second question is a more philosophical one. Should trustees ever be compensated at the rate of those of KSBE? To answer this second question, no study is needed to compare work responsibilities and no outside consultants are required to conduct a survey of practices at other like organizations. The question simply raises an ethical question about whether any trustee who works for any charity should ever accept large amounts of compensation for their work, no matter its nature and no matter the success with which their duties are fulfilled.

The new system for regulating nonprofit compensation allows one to sketch an answer to the first question, but not the second question. As we have seen, the standards rest in large measure on the idea of "reasonableness" that can be met through a rebuttable presumption. This approach emphasizes a good faith effort to find information on what other similar organizations pay their executives. By looking at and documenting the decisions reached by others, nonprofit boards can justify their compensation decisions and inoculate themselves from intermediate sanctions. There are at least two criticisms that can be leveled against this standard and each are discussed in this section. The first is that the universe of organizations to which nonprofits can compare their salaries *includes taxable organizations*, especially if the candidate has offers to work for a business corporation. Given the fact that many for-profit

---

[206] For a broad analysis of the duties of trustees, see DAVID H. SMITH, ENTRUSTED: THE MORAL RESPONSIBILITIES OF TRUSTEESHIP (1995).

[207] *See* Mike Yuen, *Allegations of Conflict of Interest Prompt Cayetano to Order an Inquiry*, HONOLULU STAR-BULLETIN, Aug. 13, 1997, at A-12 (noting that the annual compensation for KSBE trustees is approximately $843,000).

salary packages include stock options and incentives keyed to profits, it is not clear how nonprofits can engage in this kind of cross-sector inquiry into comparative worth while continuing to breathe life into the non-distribution constraint that many believe defines the nonprofit sector. Second, the idea of regulating nonprofit compensation in public charities through the enforcement of penalties is an inferior approach to the creation of a broader more active market for information that turns clients and donors into regulators, not just of an organization's compensation, but of the more critical question of the organization's performance. We argue that the idea of creating a rebuttable presumption and new sanctions is not optimal for those nonprofits that depend on donors and clients for their funds, and that there is ultimately no substitute for both a reliable *supply* of information about nonprofits, along with stakeholders that *demand* this information and act on it. We conclude by explaining that the cultural consequences of setting up a system that both creates a supply and demand for information are likely to be significant and could even change part of the identity of the nonprofit sector.

A. *Nondistribution and Cross-Sector Comparisons*

At the core of the new regulatory regime is the idea that nonprofit compensation can be alternatively judged excessive or allowable through a process of comparing what one nonprofit worker earns to the salary of a group of persons performing similar tasks in similar circumstances. A key part of this comparative process involves looking not just to other nonprofit salaries, but to those paid in the business sector. Given the nondistribution constraint under which nonprofits operate, this cross sector comparison may turn out to be unworkable because many corporate compensation packages include stock options that translate into huge bonuses based on the company's performance as measured by the company's stock. In short, for-profit compensation is inextricably bound with the distribution of profits and therefore may never be the basis of a workable starting point for judging nonprofit compensation.

Why do nonprofits operate under a non-distribution constraint that prohibits those who control nonprofits from benefiting from or distributing earnings? Bound by their promise to use their resources to advance their missions rather than benefit private parties, nonprofit organizations emerge as a solution to what Hansmann called "contract failure."[208] People seek out nonprofits in areas where they cannot penetrate and police services using ordinary contractual devices, in situations where trust and information are scarce, and assessing the value of the services they receive for their money is difficult.

[208] *See generally*, Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835 (1980)(arguing that the idea of contract failure is central to the theory of nonprofit provision).

The legally binding non-distribution constraint of nonprofit organizations provides a powerful contractual assurance that the consumer will not be taken advantage of or betrayed by producers for personal gains. The fact that profits are not allowed to be distributed to shareholders or owners gives the consumer of services a certain confidence that the transaction will result in a fair exchange.

The nonprofit sector's ability to respond to contract failure is not without its complications. Hansmann pointed to the loss of efficiency due to the elimination of financial incentives created by the non-distribution constraint and the possibility that the spirit of the non-distribution constraint will be violated through high levels of staff compensation.[209] Still, in cases where the consumer has little information and where the need to trust producers is important, the attraction of nonprofit sector provision can be powerful.

Contract failure occurs in a wide variety of contexts and takes on a broad array of forms. The purchaser and the recipient of the service may be distanced from one another. With some charities, donors are unable to see the actual recipients of their money because the recipients may be far away or because it would be inappropriate to reveal the names of service recipients. With overseas famine relief programs like CARE and Oxfam, for example, the donors that respond to appeals for contributions do so in part because they trust the charities to use their funds responsibly. It is unlikely that small donors living in the United States will be able to monitor closely the activities of a relief agency operating in Bangladesh and make judgments about of how well or efficiently their funds were used. To be sure, some relief organizations have attempted to provide detailed information to donors about the people or children that are served, but, for the most part, many emergency assistance efforts are done with minimal client tracking. For donors, the fact that recipient organizations may be separated by great distances is not an insurmountable problem because the charity operates under the nondistribution constraint. Unlike in a for-profit business, the staff of relief organizations have no obvious incentive to maximizing anything except the assistance they deliver to needy people.

According to Hansmann, contract failure may also be a factor with certain public goods, which are defined by their equal cost of provision to one person or to many, and by the impossibility of preventing others from consuming the good once it has been consumed by one person.[210] Examples of such nonexcludable public goods include air pollution control and public radio. Unlike relief organizations that serve clients, the contributor to public radio is also the consumer of the good. Thus, the problem of generating

---

[209] *See id.* at 873-76.

[210] *See id.* at 848-51.

contributions does not stem from an inability to see if the services are ultimately delivered, but instead, from the indivisible nature of the broadcast service involved, which makes it a public good and creates a free rider problem.

For organizations that depend significantly on fees for the services they render, the problem of contract failure is somewhat different. Consumers will actively seek out nonprofit organizations because they want to be able to trust producers and grant them a great deal of discretion. It is therefore hardly surprising that nonprofit day care centers enjoy broad popularity. By offering parents critical services that they will consume while removing the profit motive, a complex service can be delivered in a way that inspires confidence in the consumer.

Hansmann's central argument is consistent. We can understand the emergence of the nonprofit sector by looking at the unsatisfied demand for certain kinds of goods. Contract failure opens a door through which the nonprofit sector can move and capitalize on some of the shortcomings of for-profit firms. For Hansmann, the appearance and continued survival of nonprofit activity in a broad array of fields ultimately comes down to the ability of these organizations to satisfy an unmet demand by inspiring trust.[211] Rising nonprofit salaries clearly have the potential to undermine the trust that lies at the heart of at least one powerful rationale for the existence of nonprofit organizations. If staff salaries and directors' fees become too high, they can siphon off organizational resources for private advantage, which, for all intents and purposes, is equivalent to a "distribution" of "excess revenue."

This kind of distribution through salaries and fees rather than through the payment of dividends is problematic for three reasons, each of which corresponds to a critical constituency for nonprofits. First, it weakens a *community*'s confidence in the motives of nonprofit workers and weakens support for the tax exemption that charitable nonprofits enjoy. Second, it shakes the confidence of *clients* in the services that are being rendered because the motives of the providers are different when the constraint of profiteering is lifted. Third, it undermines the ability of *donors* to assume a link between the size of their gift and the amount of charitable services delivered. Clients of nonprofits, their donors, and the community in which they operate are thus all affected by a violation of the nondistribution constraint. For all these reasons, some limits on the ability of nonprofits to pass increased revenues on in the form of increased salaries are needed if the ability of nonprofit to respond to contract failure is to continue.

Our concern is that the new process requirements embodied in intermediate sanctions are unlikely to prevent violations of the non-distribution constraint,

[211] *See id.* at 844.

particularly in large nonprofit organizations. The nonprofit sector has grown over the years to the point where many very large nonprofits, including the Salvation Army, the YMCA, the American Red Cross, and many hospitals and universities have billion dollar budgets and employ tens of thousands of people.[212] Since the pool of very large nonprofits is still relatively small, the question becomes what the salaries of these most visible nonprofit leaders should be.

Under the new regulations, an organization like the American Red Cross could argue that in making compensation decisions it is appropriate for it to compare its executive salaries with those of a diversified service corporation with annual revenues of two billion dollars, rather than look only to the small pool of other large nonprofit organizations. If the executive of the Red Cross were recruited directly from business, as many of the senior managers in the blood services division have been, this would appear to be not only a permissible action, but a responsible one. In building a rebuttable presumption, the Red Cross might begin its search process by assembling a list of what business managers in large bio-tech and health corporations earn, which might then be a first step toward justifying extraordinarily generous compensation packages.

Part of the difficulty involved in basing a system of regulation on cross sector equivalencies lies in the subjectivity with which many comparisons are made and the consequences of such comparisons. In the case of the Red Cross, the "comparable list" would have to take into account both the salary paid to senior business managers and the stock options that are part of many compensation packages. In many corporations the stock options given to a senior executive can often amount to millions of dollars of deferred compensation.[213] In many small and mid-sized companies, stock options, though smaller in dollar terms, remain a critical tool for motivating and retaining senior managers. The question that naturally arises is the following: how can nonprofit make the kind of comparisons envisaged in the new regulations, particularly if cross-sector comparisons involve non-distributing nonprofit organizations and corporations that distribute profits generously?

Cross-sector comparisons are also problematic in that it is common for a business executive to be paid well for performance that was perceived as poor. For example, many objected to Disney's Michael Ovitz's earning a multimillion-dollar golden parachute after a fourteen-month tenure that was

---

[212] *See* Thomas J. Billitteri & Debra E. Blum, *Salaries Rise Moderately at Charities*, CHRON. PHILANTHROPY, Sept. 24, 1988, at 1.

[213] When the chief of one of Lucent's biggest divisions recently left to become the CEO of Hewlett Packard, she left behind stock options worth over $50 million only to be granted new ones worth potentially $90 million. *See* Steve Lohr, *Setting Her Own Precedents*, N.Y. TIMES, July 23, 1999, at C1.

widely viewed as quite unsuccessful.[214] Observers have also criticized boards that remain passive in the face of poor performance, as when IBM directors allowed the firm to lose market share over several years before choosing a new CEO.[215] Analysts of the broader trends in executive compensation point out both that for-profit executive salaries are growing, and that they are very weakly related to firm performance.[216] The ambiguity of performance standards in nonprofits make establishing a strong performance-pay link even more problematic. Moreover, analysts of nonprofits and for-profits have raised remarkably similar concerns about the quality of governance. As the

---

[214] *See* Charles Pretzlik, *Where Getting Fired Can Make You a Fortune: Hooray For Hollywood and Its Multi-Million Payoffs*, DAILY TELEGRAPH, Jan. 7, 1997, at 8; Claudia Eller & James Bates, *Company Town; Rank and File Are Smarting Over Ovitz's Severance Deal*, L.A. TIMES, Dec. 20, 1996, at D1.

[215] *Cf.* Elson, *supra* note 117, at 657 n.15.

[216] One study indicated that the median annual pay package for major industrial company CEOs rose by more than 70% in real terms between 1983 and 1993. *See* Susan J. Stabile, *Is There a Role for Tax Law in Policing Executive Compensation?*, 72 ST. JOHN'S L. REV. 81, 81 n.2 (citing MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 9 (1995)). Evidence of an often-weak link between performance and pay includes a 1991 study by compensation expert Graef Crystal, which revealed that a 20% decline in company profits was associated with a 7.6% increase in pay, and a 30% decline in profits with a 6.1% pay increase. *See* Lori B. Marino, Comment, *Executive Compensation and the Misplaced Emphasis on Increasing Shareholder Access to the Proxy*, 147 U. PA. L. REV. 1205, 1214 (1999)(citing Graef S. Crystal, *How Much CEOs Really Make*, FORTUNE, June 17, 1991, at 72, 76). Other analyses have generally indicated that the relationship between firm performance and CEO pay is positive, but very weakly significant. *See, e.g.*, Maura A. Belliveau et al., *Social Capital at the Top: Effects of Social Similarity and Status on CEO Compensation*, 39 ACAD. MGMT J. 1568, 1569 (1996)(citing GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES (1991)); G. Baker et al., *Compensation and Incentives: Practice vs. Theory*, 18 J. FIN. 593, 611, 615 (1988)). Another study revealed that "'each $1,000 change in shareholder wealth corresponds to an increase in this year's and next year's salary of only two cents.'" Baker et al., *supra*, at 611. The increasing popularity of stock options and pay for performance suggests that this relationship might improve, however. A 1998 study of CEO panel data set suggests that the relationship between performance and pay has increased dramatically over the past fifteen years—the elasticity of CEO compensation to firm market value more than tripled between 1980 and 1994—and that previous researchers have neglected the impact of stock holdings and stock options. *See* Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?* CXIII Q.J. ECON. 653, 653-56, 686 (1998). Still, if performance incentives are poorly structured they can reward weak performance. Charles Yablon (in reviewing a Graef Crystal book on compensation) cites several examples of circumstances in which stock options can result in large gains for mediocre performance, including when a rise in stock price merely matches the market, or when the grant consists of so many shares that even a tiny gain in value leads to a multi-million dollar payoff. *See* Yablon, *supra* note 118, at 1879-80 & nn.32-34. Of course, performance incentives are less readily available to improve compensation decisions in nonprofits, simply because performance, outside of fund raising, generally cannot be easily summarized in a bottom line.

public learns of individual cases involving months or even years of self-dealing or incompetence, the question almost invariably asked is simply: where was the board?[217]

The problem of making cross sector comparisons is not limited to compensation decisions in large public charities like the American Red Cross or the YMCA. While many small nonprofits do not appear to have corporate equivalents, some nonprofit executive directors could well argue that their organizations are roughly analogous to small businesses. In both sectors, the work is entrepreneurial, involves the mobilization of resources, and often demands supervising a small group of workers. The rise of a new cadre of more bottom-line oriented managers in start-up nonprofits only makes this connection more realistic. Again, however, the question will arise as to how to translate the profits paid to small business owners into terms that are meaningful in the nonprofit sector.

New cross-sector comparisons may also open up excuses where none previously existed. In the case of KSBE, the ability to compare compensation across sectors would appear to be the only possible defense for what many viewed as excessively high levels of pay. Within the nonprofit sector, payments or fees to trustees are not uncommon. Most often they tend to range from a hundred to a few thousand dollars. Although the national trade association representing the sector generally frowns on such payments, it allows that they can be justified in some cases. In the case of KSBE, where one of many criticisms centered on the trustees' compensation of $900,000 a year,[218] it would be very hard to find many other nonprofit organizations that pay fees anywhere near this amount.[219] However, under a system where payments could be justified with reference to compensation in the business sector, a whole new set of justifications and arguments appears to be open to the trustees of the Estate.

Instead of being limited by the fact that nonprofit directors do not generally receive generous compensation, the KSBE trustees, who manage assets worth by some estimates up to ten billion dollars,[220] might conceivably argue the appropriate comparison is actually with private sector investment fund

---

[217] Charles Elson, reflecting on IBM retaining its CEO despite several years of poor performance, and SEC General Counsel Harvey J. Goldschmid, noting the United Way board's inaction in the face of William Aramony's excesses, both ask precisely this question. *See* Elson, *supra* note 117, at 660; Goldschmid, *supra* note 100, at 633-34.

[218] *See* Yuen, *supra* note 207.

[219] For a review of compensation practices within the more specialized field of private foundations, see COUNCIL ON FOUNDATIONS, FOUNDATION MANAGEMENT REPORT (1998) [hereinafter FOUNDATION MANAGEMENT REPORT].

[220] *See* Pete Pichaske, *IRS Audit Can Be 'Ruinous' to Tax-Exempt Organizations*, HONOLULU STAR-BULLETIN, Nov. 4, 1997, at A-1.

managers. Large mutual fund companies often pay their fund managers huge salaries, sometimes reaching tens of millions of dollars—based both on performance and on the amount of assets under management. For-profit firms that manage large university and foundation endowments also receive generous compensation. For example, the private firm that manages Harvard University's fourteen billion endowment recently reported that one of its key portfolio managers earned over seven million dollars in 1997.[221] This level of compensation was explained by the fact that Harvard's endowment registered returns in recent years that outpaced the performance of other elite university endowments.[222]

Whether the KSBE trustees managed the Estate astutely or not is a subject of some controversy. There is some evidence that mistakes were made.[223] However, whatever one's judgment of their performance might be, it remains likely some will be tempted to create a rebuttable presumption by pointing to what financial managers in the business world routinely earn. Although few if any of the KSBE trustees had the formal training that large fund managers typically possess, the management of the Estate does in fact involve the oversight of a huge and complex portfolio of assets. Thus, the problem with opening the door to cross-sector comparisons of compensation is that it makes possible—and to some extent legitimizes—a whole new set of arguments about what is reasonable compensation in the nonprofit sector.

While the IRS has reserved for itself the right to challenge and reject any wrongheaded comparisons, the problem of creating a sense of entitlement to cross-sector pay equity may cause confusion and problems for years to come. In the end, a system of regulating nonprofit compensation that explicitly allows for cross-sector comparisons is problematic because it threatens to undermine the fragile identity of public charities as service and mission-driven organizations where motives and rewards cannot be measured in terms of dollars and cents. If every major hiring decision takes place in a regulatory environment that encourages scrutiny of comparable hires in other nonprofits and businesses, it is unlikely that the Salvation Army and the American Red Cross would be able to recruit and retain their presidents while paying only

---

[221] *See* Steve Bailey & Steven Syre, *Top Gun Quits Harvard Management to Start Hedge Fund: University to Invest $500M in Jacobson's Firm*, BOSTON GLOBE, Apr. 7, 1998, at C-1.

[222] *See id.*

[223] *See* Stephen G. Greene, *Bishop Estate to Pay IRS $9-Million but Retain Its Tax-Exempt Status*, CHRON. PHILANTHROPY, Dec. 12, 1999, at 32 (reporting that KSBE has entered into a settlement that permanently removes five trustees and requires major changes in management and governance). Daniel Kurtz, an expert on trustee liability, is quoted in the article: "There was so much venal behavior and so much abuse of power, where people running [the charity] thought they could laugh at the law." *Id.*

$78,646 and $90,000 respectively in 1997.[224] While the Salvation Army has long had a reputation for frugality, the levels of compensation it pays most senior managers can only be described as meager.[225] For some nonprofits, however, low wages are part of the identity of the organization and a critical reason why clients trust and believe in it. Clients and donors are attracted to organizations that spend money on programs that advance a charitable mission rather than on compensation and perks for those who are doing the work.[226]

Yet, the newly enacted regulations, although far from eliminating or discouraging financial abuses, may create new pressure to pay "comparable worth" in the nonprofit sector, leading to the unintended outcome of rising salaries in some charities. As boards begin to consult studies of what other organizations pay and what businesses offer to their executives, a slow but steady "regression to the mean" is possible. Concerned with not paying too much, nonprofits may collect data on what others are doing and gravitate toward what they believe is the mean salary for the kind of position they are seeking to fill. This regression to the mean has already occurred in some fields where professionals and experts play a prominent role. In the field of private foundation philanthropy, for example, annual "management reports" document in detail the educational backgrounds and salaries of foundation staff.[227] These reports are the starting points for many compensation decisions within foundations.[228] While there is nothing inherently wrong with paying the mean salary, it may well be that a charity could well find someone who would work for less money. Of course, it would be an ironic turn of events if the creation of a system designed to limit nonprofit compensation based on comparisons actually ended driving up some salaries. The history of public policy implementation is absolutely full of stories of surprising and unintended consequences.[229]

---

[224] *See* Billitteri & Blum, *supra* note 212, at 1.

[225] *See* Julie Connelly, *Marching Smartly to Their Own Drummer*, N.Y. TIMES, Nov. 17, 1999, at H1.

[226] *See* DWIGHT F. BURLINGAME, CRITICAL ISSUES IN FUNDRAISING (1997).

[227] *See* FOUNDATION MANAGEMENT REPORT, *supra* note 219.

[228] For a discussion of professionalization in philanthropy, see generally Peter Frumkin, *The Long Recoil from Regulation: Private Philanthropic Foundations and the Tax Reform Act of 1969*, 28 AM. REV. PUB. ADMIN. 266 (1999); and Peter Frumkin, *Private Foundations as Public Institutions*, *in* PHILANTHROPIC FOUNDATIONS: NEW SCHOLARSHIP, NEW POSSIBILITIES 69-98 (Ellen Condliffe Lagemann ed. 1999).

[229] *See* JEFFREY L. PRESSMAN & AARON WILDAVSKY, IMPLEMENTATION 35-69 (3d ed. 1980)(describing how complex details of implementing an economic development project ultimately led to its slow completion and very modest results).

B. Accountability in the Nonprofit Sector

If the process regulations detailed in the new regulations are problematic, how then should abuses in charities be detected and how should punishment be delivered? In this final section, we examine the idea of "information as regulation" and suggest that creating both a supply of reliable information and a strong demand for usable information would be one possible alternative. However, to move fully away from a regime built on rebuttable presumptions and government imposed fines, the nonprofit sector would have to change dramatically both its management and its culture. To understand the complexity of alternatives to intermediate sanctions, it is important to start with the fact that nonprofits have no owners and how this fact shapes both the supply of, and demand for, information about these organizations.

1. No owners equals little accountability

Beyond the fact that they operate under a non-distribution constraint, a second defining feature of nonprofit organizations is that they have no clear owners. This trait separates these entities from both business and government. Businesses must meet the expectations of shareholders or they risk financial ruin. The ownership question in the business sector is clear and unambiguous, with shareholders owning larger or smaller pieces of the company depending on the number of shares of stock they own. Similarly, government is tethered to a well-identified group of individuals, namely voters. Executive and legislative bodies—and the public agencies they supervise—must heed the will of the electorate if they are to be able to pursue public purposes and retain the support and legitimacy needed to govern. There is also a long tradition in the United States of conceiving government as "belonging" to citizens, though the ways in which this ownership claim can be exercised are severely limited. In the nonprofit sector, lack of clear lines of ownership complicates the accountability question substantially.

Nonprofit organizations have many masters that they must serve, including donors, clients and local communities, none of which is ultimately able to exert complete control over these organizations nor make an ownership claim. The relative strength of any claim made by these groups ultimately depends on how an organization is funded. Nonprofit organizations that depend heavily on charitable contributions are often held closely accountable by their donors, some of whom believe that as social investors, they have a strong stake in their donees. Nonprofits that are largely driven by the service fees charged to clients are in a completely different position. While these more commercial organizations do not have donors asserting claims over them, they must respond to the needs and demands of clients or risk financial trouble.

Often, however, the lines of ownership and accountability are rendered more complex by the fact that many nonprofit organizations combine grants from multiple sources—foundations, corporations, government, and individuals—with earned income, making it hard to point to any particular party as the key stakeholder to whom these special institutions must answer. One might be tempted to point to the fact that nonprofit organizations are almost always governed by boards as a solution to the ownership and accountability issue. Unfortunately, board members are not owners but rather stewards that are held responsible for the actions of the organization. In the end, nonprofit organizations are authorized to act in the public interest by the communities in which they operate, though the lines of accountability are weaker than those in the public sector and the lines of ownership are far more obscure than in the business sector.

One of the most obvious problems raised by unclear lines of accountability and the ownerless character of nonprofit organizations is that the potential for fraud and abuse is significant. Financial scandals are cause for concern and draw attention to the fact that determined thieves will find a way of siphoning off charitable funds for private benefit. In organizations that do not have owners watching vigilantly over the register, it is not only possible, but likely, that some will attempt to take advantage and steal.

Even if charities follow the new process regulations and make difficult comparative judgments about compensation, it is not clear how this kind of action will solve some of the deep-seated legal and ethical problems in these distinctive ownerless organizations that operate with weak accountability systems. Instituting a set of detailed process regulations that spell out steps that nonprofits must take to create a rebuttable presumption for their compensation decisions will not eliminate graft outside the formal decision making processes. In fact, the very nature of the embezzlement and fraud are that they are done secretly and without the knowledge of others. Thus, while process rules may tighten up the way honest nonprofits go about making their compensation decisions, these rules will be of little concern to those committed to crime. Only greater enforcement of existing criminal laws will deter someone bent on stealing from a charity. Unfortunately, the IRS is ill-equipped at present to mount a major law enforcement effort in the nonprofit arena. In fact, some reports suggest that the IRS has reached an all time low in terms of its ability to audit and investigate suspect tax-exempt organizations.[230]

[230] *See* Elizabeth Greene & Grant Williams, *Asleep on the Watch?*, CHRON. PHILANTHROPY, July 27, 1995, at 1; Jennifer Moore & Grant Williams, *Taxing Times for the Tax Agency*, CHRON. PHILANTHROPY, Oct. 17, 1996, at 1.

The fact that nonprofits do not have owners and clear lines of accountability raises the question of how to eradicate both inappropriate compensation decisions and other financial abuses, while at the same protecting the independence of charities and allowing them to operate freely. For some charities, one answer may lie in the creation of a supply of reliable information about the financial management of charities and in a vibrant demand for this information within the many stakeholders that surround charities, including the donors, the clients, and the general tax paying public. The idea of "information as regulation" is appealing because it offers a way of bringing behavior in the nonprofit sector under control without resorting to process regulations that are difficult to apply. We believe that by opening up nonprofits to the "marketplace" of competition and empowering the multiple stakeholders in these organizations with information that can inform and guide their contributions and use of services, it may be possible to begin to overcome the problems that grow out of the lack of clear ownership and accountability. A first step in moving in the direction of a market alternative to more regulation involves creating a better and more reliable *supply* of data and information on nonprofit organizations.

2. The supply of information

As part of the IRS' move to implement intermediate sanctions, new disclosure requirements were put in place. Charities must now send their Form 990, which available to any interested party, or post it on the Internet.[231] This marked a major change from the previous disclosure law, which only required that the forms be shown upon request in a charity's office.[232] Few contributors ever made pilgrimages to see the forms. The supply of information on the management of public charities was therefore largely determined by what organizations chose to disclose in their annual reports.

Despite the recent reform, there is reason to believe that improvement in the quantity and quality of information supplied to donors will not be instantaneous. A study of Form 990 returns from exempt organizations in twelve states, begun after the new disclosure regulations took effect in June 1999, revealed that just thirty-seven percent immediately fulfilled Form 990 requests, and thirty-one percent responded in ways coded as obfuscation—they referred survey takers to another office, or required them to leave

[231] *See* 26 U.S.C.A. § 6104(d)(1)(B) (West Supp. 1999); 26 C.F.R. § 301.6104(d)-2(b)(2) (1999).

[232] *See* 26 U.S.C. § 6104(d) & (e) (1994)(repealed 1999).

voicemail messages that were not returned.[233] The study organizer suggested that many organizations appeared either to be following a long-established process, or to have no process at all, for responding to information requests.[234] Whether Form 990s will become substantially more accessible in the future depends on several unknowns, including how quickly organizations communicate rules changes through their networks, and how aggressively the IRS is perceived to be monitoring compliance. Still, we believe that government could do more to both inform nonprofits of the rule change and enforce disclosure requirements. This would require that the government take an active role in simplifying Form 990, communicating more directly with nonprofit organizations, and building a credible enforcement staff capable of letting nonprofits know that disclosure is a critical responsibility.

Making Form 990s easier to access is a first step in improving the supply of information, but it is not the only alternative. Some critics of nonprofits have long argued that the weak supply of information will only be solved by creating independent accrediting and watchdog organizations that will not only collect data, but analyze it and explain it to the public. Independent accrediting and oversight agencies have in fact been established in many fields, though the results have been mixed. The Better Business Bureau, for example, reviews charities' compliance with standards regarding, among other things, using a high percentage of funds for program activities, having active governance, and providing complete and accurate solicitations and informational materials to donors.[235] It also catalogues government action against national charities.[236] The National Charities Information Bureau ("NCIB") acts as a kind of accreditor for charities by collecting information on nonprofits and reporting which organizations have complied with requests for information and which have not.[237] These broad voluntary systems rely on the good will of charities to both send in information and to report data accurately. The main problem with these approaches is that they are unable to monitor the organizations that ignore requests for information, which are of course the organizations in which problems are most likely to occur. While NCIB has in the past attempted to attach a stigma to not complying with requests for information by publishing and disseminating lists of those who

---

[233] *See* Fred Stokeld, *Study of EO Compliance with Disclosure Rules Has Mixed Results* (July 9, 1999), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 132-5, (July 12, 1999).

[234] *See id.*

[235] *See* Bennett M. Weiner, *Full Text: Better Business Bureau's Testimony at W&M Hearing on Tax Laws Applicable to Tax-Exempt Organizations* (June 15, 1993), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 93 TNT 127-42 (June 16, 1993).

[236] *See id.*

[237] NCIB's statement of purpose can be found at <http://www.give.org>.

ignore their requests, it is not clear that such publicity is likely to pose much of a threat to nonprofits. The audience for these reports is still relatively limited.

Within narrower sub-fields of the nonprofit sector, focused accrediting systems have been set up, aimed at ensuring that member organizations act responsibly. However, there are at least two major limitations to these kind of accrediting agencies. First, like IRS enforcement, they tend to be audit lotteries, processes that select few enough cases for review so that quiet noncompliance becomes an attractive gamble. The Evangelical Council for Financial Accountability, for example, reviews documents for all accredited agencies, but only performs field tests of accuracy on about six percent of its members each year.[238] Second, while accreditors can record objective salary data and organizations' descriptions of their activities and successes, they are not as well-positioned to aid donors in determining whether an organization's accomplishments or an individual's talents are enough to justify a particular salary. The subjectivity of the salary determination and the high costs of gathering enough data to reevaluate organizations' decisions are problematic for any neutral agency that must monitor a large case load.

There is at least one major development on the horizon that may help answer the supply side of the information equation. A new nonprofit organization has been formed to disseminate financial information on nonprofits over the Internet. The project, known as Guidestar, is still in its early stages, but it promises to overcome at least part of the information problem. The Guidestar web-site will allow any person to access the essential financial data for a large number of nonprofit organizations.[239] Information about operating expenses, administrative overhead, and fund-raising costs will all be available to potential contributors and volunteers.[240] The goal of the project is to make research on nonprofits easier for the average donor by putting this data where it is easiest to access.

There are at least two challenges facing this effort and a range of other state-level efforts to put information about charities on line, problems that have plagued other efforts to improve reporting undertaken by accreditors. The first is that all the information that is made available is supplied voluntarily by the charities.[241] This means that organizations with either embarrassing data to report (such as very high administrative-to-program-expense ratios) will likely avoid the system entirely. The second is that there are major gaps in the generally accepted accounting principles for nonprofits

---

[238] *See* McCabe, *supra* note 180.

[239] See Guidestar's web-site at <http://www.guidestar.org>.

[240] *See id.*

[241] *See id.* Nonprofit organizations are requested by GuideStar to provide data that is not on the Form 990. There is no penalty for non-compliance.

that make it hard to ensure the accuracy of reported information.[242] This is especially problematic given that Guidestar is also set up as an on-line giving program that allows contributors to look up information and then make a pledge on line. Since no hard and fast rules exist for separating out program and administrative costs, the temptation for many charities will be to put their best foot forward and to engage in a kind of strategic "gaming" aimed at making themselves look as efficient as possible. With contributors' dollars hanging in the balance, Guidestar may well end up fueling a race to the bottom as creative accounting techniques allow charities to control their image. None of these technical problems is insurmountable with a few modest reforms, including separating more clearly the reporting and fund-raising functions of the service and developing a workable auditing system. To date, however, it remains unclear how aggressively Guidestar will confront these pressures, while at the same time working to ensure the broadest possible participation among nonprofits.

The problems inherent in voluntary reporting, both through accrediting organizations and via on-line databases, are significant enough to lead Herzlinger to argue that the only real solution to the accountability problem in the nonprofit sector, and the narrower compensation question that has emerged most recently, may lie in the establishment of an SEC-type organization that could ensure openness and disclosure as way of regulating through information.[243] The principal role of a "nonprofit SEC" would be to be to bring uniform accounting techniques to public charities, disseminate information on the financial condition of organizations, and create channels through which donors, volunteers, clients, and community members could access and use this information. Of course, this would be a far more complex proposition in the nonprofit sector, where lines of ownership are overlapping and ill-defined, than in the business sector, where one group of owners, namely shareholders, have clear interests in solid information. For information to have a chance to work as regulation and for Herzlinger's provocative idea of a "nonprofit SEC" to have an opportunity to succeed, a major transformation is needed not just in the kind of information that is made available, but in the outlook of the many stakeholders of nonprofit organizations, including donors, clients and the general public.

---

[242] *See* Regina Herzlinger, *Can Trust in Government and Nonprofits Be Restored?*, HARV. BUS. REV., Mar.-Apr. 1996, at 103.

[243] *See id.*

3. The demand for information

Information is ultimately only as good as the purpose to which it is applied. Information that is accurate, broadly available, and reliable performs little ultimate service unless it is used. Three questions thus impose themselves. Is there currently a demand for information? How can and should information be used by nonprofit stakeholders? What would the nonprofit sector look like if data and information on the finances—and perhaps even the performance—of nonprofits were in fact suddenly used to make critical decisions about which organization will receive contributions and which organizations will be patronized by clients?

Although public charities are ownerless organizations, they do have a number of important stakeholders, parties that are interested in and committed to the missions and organizations that make up the nonprofit sector. Each group has a different interest in the compensation issue and each is affected differently by charities that compensate excessively. Clients may be hurt by excess compensation because excess salaries drive up the cost of services and make the use of nonprofit organizations less attractive. Donors may be hurt by excess compensation, in that charitable resources are siphoned off for non-charitable purposes, which thwarts the donor's charitable intent and the organization's stated mission. Taxpayers and community members are also hurt because the tax expenditure that they make to support nonprofit organizations is not being used to produce outcomes that are most valuable to the community. Although each of these three stakeholders in public charities is potentially affected by excessive compensation within nonprofit organizations, each faces substantial obstacles to taking an active interest in the performance and management of the charities to which they are committed.

Clients. Over the past two decades, earned income—revenues derived from client fees or commercial ventures—has quietly become a critical engine driving many parts of the nonprofit sector. While there are still some parts of the sector that are entirely dependent on charitable gifts, the vast majority of nonprofit organizations depends in part or in great measure on revenue that is derived from fees and other commercial activities. The more a charity is dependent on fees and ventures, the more it is exposed to market pressures and the more it is dependent on the judgment of clients. At present, however, few clients of nonprofits act like aggressive consumers. Because many nonprofits engender trust and are often viewed as community resources, it is a rare occasion indeed that clients ask tough questions before using charitable services. The primary concern is with the quality and affordability of the services to be delivered. Rarely, however, do concerns over quality and price

translate into inquisitiveness about the underlying factors that make a charity either able or unable to meet expectations.

Donors. Many charities are dependent to a greater or lesser extent on contributed income. These "donative" nonprofits gather funds from foundations, corporations, federated funders, and individuals in order to carry out their charitable missions. Institutional funders have long studied the financial statements of nonprofits during the grant review process. This oversight is limited in impact and scope, however, by the fact that the vast majority of giving is done by individuals, not by the more visible institutional givers.[244] Research indicates that individual contributors typically support organizations with which they have contact in the past or which are working in their local communities.[245] Contributions are thus often a way for individuals to enact their values and commitments, to help causes that are important to the donors. As a consequence, individual contributions rarely reflect the careful consideration of a charity's financial statements, including its compensation decisions.

Community. Within neighborhoods and communities, public charities are often viewed as critical resources, especially in areas where business investment is low and where public programs are lacking. Even in the most organized and politically-engaged communities, however, few residents watch over the local nonprofits with a sense of ownership. Some community members may become involved in an organization, sometimes by serving on an advisory board or volunteering. Nevertheless, it is rare for members of the general public to actively oversee the operations of nonprofit organizations operating in the community. Far more important to many residents are the programs that the charity offers. At times, local governments have taken action against nonprofits to protect community interests, in one case zoning social service agencies out of a city's downtown business district, in another case seeking to impose property taxes on affluent charities, and in a few cases attempting to block nonprofit to for-profit hospital conversions.[246] These episodes are rare, however, and do not usually reflect a consistent ongoing scrutiny of nonprofit administration and finance. Communities may want charities to act as good citizens, but rarely do they ask questions about compensation decisions or attempt to shape them by applying political or moral pressure.

---

[244] *See* Elizabeth T. Boris, *The Nonprofit Sector in the 1990s*, *in* PHILANTHROPY AND THE NONPROFIT SECTOR IN A CHANGING AMERICA 1, 19 (Charles T. Clotfelter & Thomas Ehrlich eds., 1999).

[245] *See* FRANCIE OSTROWER, WHY THE WEALTHY GIVE 86-99 (1995). Giving to colleges and cultural organizations is a clear example of this tendency.

[246] For an overview of the full range of public nonprofit interactions, see BURTON WEISBROD, TO PROFIT OR NOT TO PROFIT? (1998).

Patterns of client, donor and community involvement with nonprofit organizations raise two questions. First, how might a SEC-type organization for the nonprofit sector operate? Second, could such an organization operate as the hub of a new system for the dissemination and use of accurate financial information about charities? In the business world, the SEC regulates the securities exchanges through disclosure requirements, civil and criminal law enforcement, and auditing and oversight of corporate accounting.[247] By ensuring that the information about publicly-held corporations reaching investors is accurate and consistent, the SEC is able to create confidence in the markets. Demand for information on companies is intense because investors use this information to predict how well a company is likely to do in the future, which in turn informs their investment decisions. In recent years, both SEC disclosure[248] and proxy law regulating their interactions with shareholders has undergone review and reform designed to address a perceived overcompensation problem.[249] The results of reforms in SEC proxy rules are especially relevant for nonprofits, because they suggest that there

---

[247] *See* 15 U.S.C. §§ 78a-78mm (1994 & Supp. IV 1999).

[248] In 1992, following complaints that corporations present compensation packages in an overly complex and even sometimes a deliberately misleading manner, the SEC adopted several new disclosure requirements designed to make compensation practices more comprehensible. *See* Executive Compensation Disclosure, 57 Fed. Reg. 48,126 (1992)(to be codified at 17 C.F.R. pts. 228, 229, 240, 249). Corporations must now present the following information for their highest paid executives: a summary compensation table, putting in one place the major forms of compensation (i.e., not only salaries, but bonuses, payouts from long-term performance plans, and restricted stock value); a table describing stock option incentives in detail; a chart comparing the company's stock price over the past five years to that of a peer group of other companies; and a report from the firm's compensation committee explaining how it arrived at its compensation figures. *See id.*; *see also* Kevin J. Murphy, *Politics, Economics, and Executive Compensation*, 63 U. CIN. L. REV. 713, 731-38 (1995); Michael E. Ragsdale, Comment, *Executive Compensation: Will the New SEC Disclosure Rules Control "Excessive" Pay at the Top?*, 61 UMKC L. REV. 537, 549-61 (1993).

[249] One critical way in which shareholders can dissent from governance they see as faulty is by introducing a shareholder proposal, which, provided certain threshold conditions are met, the corporation must include in its proxy materials. *See* 17 C.F.R. § 240.14a-8 (1999). The SEC has generally required that these proposals be phrased in advisory, non-binding language. *See* Carol Goforth, *Proxy Reform as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little, But Not Too Late*, 43 AM. U. L. REV. 379, 418 n.232 (1994). The corporation is permitted to exclude the proposal if (among other reasons) the proposal relates to its "ordinary business operations." *See* 17 C.F.R. § 240.14a-8(i)(7). In 1992, the SEC reconsidered its longstanding policy of permitting corporations to exclude compensation-related proposals under this exception and began to require that these proposals be included, provided that they relate to senior executives' compensation. *See* Goforth, *supra*, at 418. With this reform, and with a recent increase in the holdings of sophisticated and knowledgeable institutional investors (i.e., banks managing trust funds, mutual funds, endowments, insurance companies, etc.), it appeared possible that shareholders would have a significant new influence on compensation matters. *See id.*

may be significant additional barriers to any activist's ability to deter overcompensation.

Many of the disincentives to activism for individual and institutional investors—such as the dispersion of voting power, the high costs of activism relative to its potential to increase profits, and the desire to maintain ongoing business relationships—appear to have analogues for nonprofit stakeholders who may wish to constrain compensation. Although it would be tempting to simply argue that the market will reward and encourage the development of programs that donors, clients, and communities value, the "Wall Street Rule"—a cornerstone in the business world that holds that dissatisfied investors can express themselves by moving funds from one investment to another—is not fully operative in the charitable world. After all, those who want to give to disaster relief in a particular region, support and go to the opera, or attend a local university may have few or no substitute organizations from which to choose. Some unique nonprofit services raise the possibility that nonprofit stakeholders will be left deeply dissatisfied with an organization's governance but unprepared to stop donating and patronizing a particular organization. The number of unique nonprofit services is, however, likely to diminish as competition between nonprofits for financial support intensifies in fields ranging from social services to education to the arts.

Reform of nonprofit compensation also seems potentially vulnerable to the collective action problems and institutional pressures that exist in the business world. Recent reforms in SEC law have made it easier for those who offer proposals to communicate with other shareholders,[250] but nonprofit stakeholders dissatisfied with a charity's compensation policy have no easy way to contact other concerned parties to let them know about the problem. Compared to shareholders, it will likely be more costly and time-consuming for nonprofit stakeholders to educate themselves about the issue of reasonable compensation and reach collective conclusions about appropriate levels in particular cases. Because a donor, a client, or a community member does not personally profit from the charity's efficient operations, the returns to improving efficiency through reduced compensation levels may simply outweigh the costs of action.

Still, some stakeholders have in fact taken an active role in improving charities. In some cases, action by stakeholders has turned out to be a far more potent tool for regulating nonprofit behavior than the modest penalties provided by intermediate sanctions.[251] The recent history of the United Way provides perhaps the best example of donors reshaping an organization

---

[250] *See supra* note 249 and accompanying text.

[251] *See* Liz Spayd, *United Way Chapters Battling to Regain Public Confidence*, WASH. POST, Sept. 15, 1994, at A12.

through pressure and through the withholding of funds. Following the scandal that led to the jailing of its president, the United Way experienced a significant fall-off in the amount of funds it collected within many of its critical chapters.[252] Many faithful donors to the organization demanded change and greater accountability for the use of their charitable dollars.[253] Over the past few years, the United Way has responded to this pressure by giving contributors more options, including more say in the selection of beneficiaries, and by instituting a rigorous evaluation program for the grants that are made.[254] Today, the United Way actively solicits contributions on the basis of the efficiency and cost effectiveness of its recipient organizations.[255] Of course, these reforms occurred only after a national scandal brought enormous publicity to the organization.[256] However, it is clear that nonprofits can and do respond to pressures brought to bear on them by their stakeholders. What is needed is a system by which information can be circulated and used to inform decisions—before scandals or problems occur. Vesting primary responsibility for the oversight of nonprofit compensation in the IRS's new process regulations is a much weaker solution to the long-run problem of bringing greater accountability to donative and commercial nonprofits than the creation of a system of checks and balances anchored in a reliable and usable supply of information and active and engaged demand for this information.

Among public charities that are exposed to market pressures and that depend on earned income from client fees or contributions from donors, there is an opportunity to create a self-regulating system anchored in both a greater supply and demand for information. However, for information to work as a way of regulating nonprofit compensation, major changes would be needed in the way clients, donors, and communities view their relationship with the charities. Clients will need to realize that the way nonprofits are managed directly impacts the quality and cost of services that are rendered. They would also have to begin to view the nonprofits on whose services they rely less as vendors and more as community assets. Donors will have to stop thinking of their contributions as symbols of their good will and begin instead to view their gifts more strategically as financial investments, which need to be monitored in order to produce maximum outcomes. While many large donors are moving in this direction, smaller donors will have to at least ask tough questions before writing a check to an organization whose mission simply sounds appealing. At the same time, communities will need to take an active

[252] *See id.*

[253] *See id.*

[254] *See* Tracy Thompson, *United Way Funding Shifts from Districts to Suburbs: Donors' Desire to Target Charities Limits Agency*, WASH. POST, Oct. 2, 1995, at A1.

[255] *See id.*

[256] *See id.*

interest in the governance and management of local charities. This may mean that the governance systems of nonprofits will need to be opened up not just to wealthy and influential citizens, but to a broader cross section of people interested and committed to an organization's cause and willing to devote significant time to it.

In the end, all stakeholders in public charities will need to become more involved in the oversight of these ownerless organizations if an alternative to more cumbersome and unworkable process rules is to be found. This will call for an adjustment to the dominant culture of the nonprofit sector, where performance and outcomes sometimes play second fiddle to commitment and mission. One of the best ways to help build a demand for usable and reliable information on nonprofit finances is to improve substantially the supply of information by lowering the barriers to quick access and by increasing the quality of the metrics that are used. Though still in need of improvement on several fronts, the independent web-based purveyors of data, including NCIB and Guidestar, will need to play an active role not just in the collection of data, but in the cultivation of higher levels of demand for their services. Such work may well find itself bolstered by new fund-raising practices that emphasize not just mission, but efficiency and effective use of contributions. At a time when competition for donations has become fierce, many nonprofits no longer position their organizations solely on the basis of mission; they now stress the organization's management, as well as the nature of its programs. To differentiate themselves from competitors, nonprofits are becoming more and more willing to share and explain data about their operations. Changes in fund-raising thus portend well for stimulating demand in the coming years for data on the financial performance of nonprofit organizations, as donors may well come to expect heightened levels of disclosure.

The problem of mobilizing nonprofit stakeholders to take interest in assuming a role in the oversight of charity compensation decisions does raise the important problem that changing the way donors, clients, and community approach their engagement with charities will ultimately require new norms in a sector that has long depended on good will and, in many cases, faith. This means making the argument that having a vital and effective nonprofit sector requires input from those who support and those who patronize nonprofits. Until the movement for greater accountability spreads more widely, perhaps due to competition for donations, it may be necessary to view the new IRS process regulation as an imperfect stopgap measure, not the final word on the question of controlling nonprofit compensation.

CONCLUSION

The problem of excess compensation is serious. It threatens to undermine the trust that is a critical part of charitable work, while also exposing the weaknesses that are inherent in the ownerless character of nonprofits. The new intermediate sanctions are clearly needed for those charities like KSBE that are shielded from market pressures by large endowments. In such organizations, clients, donors, and community members are in no position to act as overseers. However, for the vast majority of charities that are buffeted by the financial environment around them, an alternative to process regulation exists—one that has not been fully explored. Creating a system of regulation that has information at its core would change many of the dynamics of the nonprofit sector. Until more reliable, more consistent, and more meaningful financial data is made available and used, charities and their stakeholders will have little choice but to rely on the problematic new rules that encourage nonprofits to engage in cross-sector salary comparisons in an attempt to create rebuttable presumptions. At the same time, there can be little doubt that the nonprofit sector deserves, and must work to build, a far better system for managing accountability than this.

Endangering Individual Autonomy in Choice of Lawyers and Trustees—Misconceived Conflict of Interest Claims in the Kamehameha Schools Bishop Estate Litigation

James R. McCall*

INTRODUCTION 487
I. THE CONTEXT AND CONTENT OF THE CONFLICT CLAIMS 490
   A. *The KSBE Actions* 490
   B. *The Conflict Claims* 492
      1. *The privilege elimination claim* 492
      2. *The limited Board removal claim* 494
   C. *Basic Considerations* 495
II. EVALUATION OF THE PRIVILEGE ELIMINATION CLAIM 497
   A. *The Entity Theory and the Identity of the Client* 497
   B. *The Entity Theory and the Privilege Elimination Claim* 502
III. EVALUATION OF THE LIMITED BOARD REMOVAL CLAIM 504
   A. *The Conceptual Basis of the Claim* 504
   B. *Trust Law and the Potential Trustee Liability Concept of Conflicting Interests* 506
CONCLUSION 509

INTRODUCTION

This Article discusses two claims of conflict of interest made in legal actions involving the Kamehameha Schools Bishop Estate Trust ("KSBE" or the "Trust") during the period of November 1998 to March 1999. The first

* Professor of Law, University of California-Hastings College of Law, San Francisco, California; A.B., Pomona College, 1958; J.D., Harvard Law School, 1962.

The author was retained as a consultant and expert witness in several of the legal proceedings involving Kamehameha Schools Bishop Estate during the period of November 1998 to March 1999. The author's expertise relevant to these legal actions was in the law governing the professional responsibility of attorneys and the law of conflicts of interest. All of the opinions expressed in this Article are the author's own and do not represent the opinions of Kamehameha Schools Bishop Estate or any members past or present of its Board of Trustees. All of the observations and opinions expressed in this Article are based solely on information from documents on file and available to the public in the Kamehameha Schools Bishop Estate actions, public newspaper accounts of those proceedings, and published case reports and statutes available in any law library.

claim of conflict of interest attacked the attorney-client relationship between KSBE and its attorney. The second conflict claim sought to sever the relationship between KSBE and its Board of Trustees (the "Board"). Both conflict claims were sustained by rulings of the probate court of Hawai'i. If given even informal value as a precedent by other trial courts, these rulings will be a significant step toward the elimination of a valuable freedom enjoyed by individuals under Anglo-American law. The endangered freedom is the right of any person to choose a fiduciary to accomplish a sophisticated or complicated task beyond the ability of the individual to undertake successfully.

The probate court rulings discussed in this Article have the perverse capacity to disrupt the effective operation of countless fiduciary roles, including that of an executor of an estate as well as that of an attorney retained by a client.[1] The large potential for ill effect stems from the conflict of interest concepts embraced in the rulings.[2] One method for correcting the errors in these rulings is by debating the validity of the rulings in scholarly journals, and this Article was written to initiate such a debate.

---

[1] Although the academic literature does not stress the point, an attorney has a fiduciary relationship with the attorney's client in the same way an agent has a fiduciary relationship with the principal or a trustee has a fiduciary relationship with the beneficiaries. *See* CHARLES W. WOLFRAM, MODERN LEGAL ETHICS § 4.1 (1986). Because the attorney-client relationship is heavily regulated by codes of legal ethics, attorney conflicts problems are usually regarded as outside the application of the law of fiduciary obligations or trusts. Nonetheless, both fiduciary relationships are governed by the same general conflict of interest principles. These principles lead to the same results in similar conflict of interest issues regardless of whether the fiduciary is an attorney in the attorney-client relationship or the fiduciary is a trustee in the trustee-beneficiary relationship.

The trustee-beneficiary relationship is more complicated than the attorney-client relationship. The client initiates the relationship in the latter, and it is the client's intentions and wishes that direct the duties of the attorney. In the trustee-beneficiary relationship, the settlor initiates the fiduciary relationship, and it is the settlor's original intentions, on rare occasions modified by the trustee's good faith determination of the best interests of the beneficiary, that direct the trustee. Nonetheless, the beneficiary of the trustee's performance of fiduciary duties is considered to be the beneficiary of the trust. *See* 1 AUSTIN W. SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS, § 2.5 (4th ed. 1987); RESTATEMENT (SECOND) OF TRUSTS § 2 cmt. b (1959).

[2] The guiding concept in fiduciary conflicts questions is the same, whether the relationship is between an attorney and a client or a trustee and a beneficiary. That concept is whether the individual financial or personal concerns of the fiduciary will impair his or her ability to carry out the intentions of the person establishing the fiduciary relationship. Thus, the most important consideration in determining conflict issues is accomplishing the intentions of the client in an attorney-client relationship, or the intentions of the settlor in a trustee-beneficiary relationship. The trial court rulings on the conflict claims in the KSBE actions disregarded this lodestar concept in the law of fiduciary relationships. *See* discussion *infra* Parts II and III.

It is important to debate the wisdom of the conflicts of interest principles embraced in the rulings because voluntarily established fiduciary relationships are extremely valuable to individuals and society at large. Fiduciary relationships enable individuals to act more effectively than they could without the benefit of the sophistication and continuity of action provided by a fiduciary. In a society founded on principles of limited government, economic free enterprise, and individual liberty, increasing the effectiveness of individuals to accomplish lawful objectives is an objective of the highest priority.

Court action preventing an attorney or a trustee from fulfilling a fiduciary obligation frequently has serious consequences for individuals benefiting from the performance of the fiduciary obligation. Cumulatively, court actions of this type erode the principle that individual freedom of action is of the greatest value to our society. For these reasons, development of erroneous conflict of interest concepts that prevent fiduciaries from fulfilling their obligations, and court orders accepting such concepts, is a matter of great concern.

Anticipating the discussion to follow, the author believes that the rulings eliminating the attorney-client privilege and the limited removal of the KSBE trustees from participating in the investigation of the Trust by the Internal Revenue Service ("IRS") stemmed from a failure to give proper importance to the expressed intentions of the person establishing the fiduciary relationships, Princess Bernice Pauahi Bishop ("Princess Bishop"). In conflict of interest controversies, the Anglo-American legal tradition considers the desires of the person establishing the fiduciary relationship to be the most important consideration.[3] Unless rectified on appeal, the much publicized trial court rulings in the KSBE actions[4] may foster conflict of interest rulings that will defeat the intentions of individuals seeking to establish fiduciary relationships and play havoc with attorney-client and trustee-beneficiary relationships for years to come.

Part I of this Article sets out the factual and litigation contexts in which the conflict claims were made. Part II evaluates the first conflict claim, which related to attorney-client privilege. The second conflict claim, which challenged the propriety of trustee supervision of KSBE's response to ostensibly serious allegations of tax law violations, is evaluated in Part III. On policy and legal grounds, Parts II and III conclude that the probate court rulings accepting the conflict claims under examination were in error.

---

[3] *See* GEORGE G. BOGERT & GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 481 (2d rev. ed. 1978).

[4] *See, e.g.*, Rick Daysog, *Bishop Estate Master Seeks Panel to Take over Trustees' Tax Work*, HONOLULU STAR-BULLETIN, Jan. 22, 1999, at A-3 [hereinafter Daysog, *Tax Work*]; Rick Daysog, *Judge Removes All 5 Trustees from IRS Case, Will Pick Panel*, HONOLULU STAR-BULLETIN, Feb. 4, 1999, at A-1; Rick Daysog, *State Hails a 'Wake-up Call'; Estate Says Ruling is 'Bizarre'*, HONOLULU STAR-BULLETIN, Feb. 5, 1999, at A-1.

I. THE CONTEXT AND CONTENT OF THE CONFLICT CLAIMS

A. The KSBE Actions

In broad terms, the KSBE actions included a number of law suits, investigations, and legal proceedings challenging the decisions and the conduct of members of the Board over a period of years.[5] KSBE is a testamentary trust established by the will of Princess Bishop executed shortly before her death in 1884. The initial assets of KSBE were the extensive Hawaiian lands owned by Princess Pauahi Bishop. She had inherited these lands as the last living descendent of King Kamehameha. The will devised her property to five named trustees to be held subject to a trust to erect and maintain a school for Hawaiian boys and girls, to be "called the Kamehameha Schools."[6]

The will provided that future vacancies on the KSBE Board should be filled by "the choice of a majority of the Justices of the [Hawai'i] Supreme Court . . . ."[7] Anticipating future divisions of opinion among the five-member Board, the will stated: "I direct that a majority of my said trustees may act in all cases and may convey real estate and perform all of the duties and powers hereby conferred; but three of them at must join in all acts."[8] At the present, the value of the trust's assets is estimated to be about six billion dollars.[9]

Various legal actions and court and administrative proceedings involving KSBE and members of the Board have been filed in recent years. The conflict claims discussed in this Article were raised in two of the KSBE legal actions. Among the other actions and proceedings involving KSBE, the most heavily reported was an investigation by the acting Attorney General of the State of Hawai'i into the management and supervision by the Board of KSBE's extensive property and business interests.[10] That investigation officially

---

[5] Only those events and proceedings in the KSBE actions which bear directly upon the two conflict claims will be mentioned in this summary. The events and proceedings in the KSBE actions were so numerous and multifaceted that a summary of all of the events and proceedings in this Article would be impractical.

[6] *Will of Bernice Pauahi Bishop* art. 13 [hereinafter *Will*]. The Will is reprinted in Appendix B of this issue of the *University of Hawai'i Law Review*.

[7] *Id.* art. 14.

[8] *Id.*

[9] *See* Rick Daysog, *9 of 10 Residents Back Bishop Ouster*, HONOLULU STAR-BULLETIN, May 24, 1999, at A-1.

[10] *See* Mike Yuen, *Trustees Face State Inquiry*, HONOLULU STAR-BULLETIN, Aug. 13, 1997, at A-1; Jim Witty, *Bronster Says That If Serious Misconduct Is Revealed, Trustees Could Be Removed*, HONOLULU STAR-BULLETIN, Sept. 11, 1997, at A-1. In April 1999, the Hawai'i Senate did not re-appoint Margery Bronster to a second term as the Hawai'i State Attorney General.

commenced in 1997[11] and produced indictments of two Board members.[12] Both indictments were quashed by the probate court shortly after the indictments were handed down.[13]

The first of the two proceedings in which significant conflict claims were made was a lawsuit filed by two members of the Board, Gerard Jervis and Oswald Stender, to remove from office a third member of the Board, Lokelani Lindsey.[14] This "trustee removal action" was filed in December 1997. After trial, the probate court judge issued an order in May 1999 removing trustee Lindsey.[15] That order is presently under appeal.[16]

The second proceeding, the "limited Board removal action," was filed after the IRS began an audit of KSBE[17] that focused on possible violations of federal tax laws.[18] This second proceeding was initiated by the same two

---

See Craig Gima, *'A Deal Was Cut'*, HONOLULU STAR-BULLETIN, Apr. 29, 1999, at A-1. However, the attorney general's investigation has continued under her successor, Earl Anzai. *See Anzai Cleared to Handle Bishop Estate Matters*, HONOLULU ADVERTISER, July 20, 1999, at A-1.

[11] *See* Yuen, *supra* note 10; Witty, *supra* note 10.

[12] *See* Rick Daysog, *Grand Jury Indicts Peters in Theft*, HONOLULU STAR-BULLETIN, Nov. 26, 1998, at A-1; Rick Daysog, *Wong Says He'll Win in Courtroom*, HONOLULU STAR-BULLETIN, Apr. 13, 1999, at A-1.

[13] *See* Walter Wright, *Judge Throws out Wong Indictments*, HONOLULU ADVERTISER, June 17, 1999, at A-1; Rick Daysog, *State Lets Bishop Trustee Wong and Wife off the Hook for Now*, HONOLULU STAR-BULLETIN, June 30, 1999, at A-3; Rick Daysog, *Judge: Peters Didn't Get a Fair Hearing*, HONOLULU STAR-BULLETIN, July 2, 1999, at A-1. Peters was indicted again on August 4, 1999. *See* Rick Daysog, *Peters, Stone Indicted Again by Grand Jury*, HONOLULU STAR-BULLETIN, Aug. 5, 1999, at A-8. That indictment was also dismissed. *See* Ken Kobayashi, *Peters' Case Dismissed*, HONOLULU ADVERTISER, Dec. 18, 1999, at A1.

[14] *See* Petition for Removal of Trustee Marion Mae Lokelani Lindsey, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Dec. 29, 1997).

[15] *See* Order Granting Petition for Removal of Trustee Marion Mae Lokelani Lindsey Filed on December 29, 1997, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. May 6, 1999) [hereinafter Lindsey Removal Order].

[16] *See* Rick Daysog, *Ex-Trustee Lindsey Faces More Problems with IRS*, HONOLULU STAR-BULLETIN, Oct. 12, 1999, at A-8. Although Lindsey has since resigned as trustee, she is continuing to appeal the removal order. *See Attorney General Asks Court to Toss out Appeal of May Removal Order*, HONOLULU STAR-BULLETIN, Dec. 22, 1999, at A-2.

[17] *See* Pete Pichaske, *IRS Audit Can Be 'Ruinous' to Tax-Exempt Organizations: Bishop Estate and the IRS Have Confirmed an Audit of the Trust*, HONOLULU STAR-BULLETIN, Nov. 4, 1997, at A-1.

[18] *See* Rick Daysog, *IRS Audit Puts Added Pressure on Estate*, HONOLULU STAR-BULLETIN, Sept. 17, 1998, at A-1. KSBE and the IRS have entered into a settlement agreement, which has been approved by the court, that provides for payment to the IRS of nine million dollars by KSBE to secure its tax-exempt status. *See* Order Approving Petition for Approval of Settlement of IRS Audit Issues, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Dec. 1, 1999) [hereinafter Order Approving IRS Settlement]; Ken Kobayashi, *Settlement OK'd for Estate, IRS*, HONOLULU ADVERTISER, Dec. 2, 1999, at A1.

Board members who had brought the trustee removal action.[19] The two trustees, who disagreed on a number of public issues with the majority of the Board, petitioned the probate court for an order removing the entire Board from participating in the negotiation of the deficiency claims with the IRS.[20] This limited Board removal action was initiated by a petition filed in January 1999.[21]

The probate court granted the petition shortly after it was filed, ordering all members of the Board to abstain from any participation in the negotiations and appointing a new Board for the limited purpose of supervising KSBE's response to the IRS claims.[22] In May 1999, the probate court removed the old Board from their offices until the claims of the IRS were resolved.[23] The removal order was originally appealed by members of the old Board, but that appeal was subsequently abandoned.[24]

B. The Conflict Claims

1. The privilege elimination claim

The conflict claims in the KSBE actions were imaginative if ill-founded. The first conflict claim was raised in the trustee removal action. The conflict claim stated that the filing of a removal action between trustees created a

---

[19] *See* Trustees Oswald Kofoad Stender and Gerard Aulama Jervis' Petition for Approval of Voluntary Recusal with Respect to Pending Tax Audit and for Appointment of a Panel of Special Administrators with Respect to Pending Tax Audit, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Jan. 29, 1999) [hereinafter Petition for Recusal].

[20] Before the proceeding was filed, the Special Master appointed to review the yearly accounting of KSBE had formally recommended that the Board be removed from participation in negotiations and supervision of KSBE's response to the IRS tax deficiency claims. *See* Daysog, *Tax Work, supra* note 4.

[21] *See* Petition for Recusal, *supra* note 19.

[22] *See* Minute Order Regarding Trustees Oswald Stender and Gerard Jervis' Petition for Approval of Voluntary Recusal with Respect to Pending Tax Audit and for Appointment of a Panel of Special Administrators with Respect to Pending Tax Audit and Trustees' Petition for Instructions and Approval of Appointment of IRS Dispute Advisory Panel, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Feb. 4, 1999) [hereinafter Minute Order].

[23] *See* Order Regarding Order to Show Cause Regarding Special Purpose Trustees' Report and Order to Show Cause Regarding New CEO Based Management System, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. May 7, 1999), *available at* <http://starbulletin.com/1999/05/07/news/removal.html> [hereinafter Removal Order].

[24] *See Then There Were None: Kamehameha Supporters Embrace the Chance for Reform and Healing*, HONOLULU STAR-BULLETIN, May 8, 1999, at A-1. A proposed settlement of the tax liability of KSBE and its tax-exempt status of KSBE was reported in August 1999. *See* Rick Daysog, *Proposed Estate Deal: Pay IRS $9 Million-Plus*, HONOLULU STAR-BULLETIN, Aug. 23, 1999, at A-1. The probate court approved the settlement in December 1999. *See* Order Approving IRS Settlement, *supra* note 18.

dispute between former clients of the "Board attorney,"[25] who advised and otherwise represented the Board.[26] The effect of this alleged conflict was to eliminate the attorney-client privilege between the Board attorney and his former clients.

The existence of a dispute between an attorney's former clients eliminates the attorney-client privilege covering communications between the clients and their former attorney that are relevant to the clients' present dispute.[27] Thus, this "privilege elimination" claim had a superficial appearance of validity. In the specific terms of the trustee removal action, the plaintiff minority trustees claimed the right to discover and introduce into evidence confidential communications regarding KSBE matters between the Board attorney and Board members that were relevant to the trustee removal action.[28]

One of the most important duties of all fiduciaries, including attorneys, is to keep confidential all private communications engaged in with the entity to whom fiduciary duties are owed regarding matters within the relationship.[29] Confidentiality is considered so important to the attorney-client fiduciary relationship that the law of evidence deems such communications privileged and beyond court-compelled disclosure regardless of the relevance and probative value of the communications.[30] The Board attorney, as a fiduciary

---

[25] For the sake of simplicity, the singular term "Board attorney" will be used to refer collectively to the many attorneys in the office of the general counsel of KSBE and in the independent law firms who acted under the direction of the KSBE general counsel to represent the Trust in the various transactions and lawsuits to which the Trust was a party.

[26] *See, e.g.*, Petitioner-Defendant Oswald Kofoad Stender's Motion to Compel Respondent-Plaintiff Marion Mae Lokelani Lindsey to Produce Documents and to Appear for Her Disposition, In re *Estate of Bishop*, Equity No. 2048, at 8 (Haw. Prob. Ct. May 12, 1998) [hereinafter Stender's Motion to Compel]; Petitioner-Defendant Oswald Kofoad Stender's Reply Memorandum to Respondent-Petitioner Marion Mae Lokelani Lindsey's Memorandum in Opposition to Petitioner-Defendant Oswald Kofoad Stender's Motion to Compel Respondent-Plaintiff Marion Mae Lokelani Lindsey to Produce Documents and to Appear for Her Deposition, In re *Estate of Bishop*, Equity No. 2048, at 5-6 (Haw. Prob. Ct. May 26, 1998) [hereinafter Stender's Reply].

[27] Proposed Federal Rule of Evidence ("FRE") 503(d)(5) states the universally accepted "dispute between former clients" exception to the attorney-client privilege. The Hawai'i Rules of Evidence incorporate the exception: "[There is no privilege under Rule 503 of the Hawai'i Rules of Evidence as] to a communication relevant to a matter of common interest between two or more clients if the communication was made by any of them to a lawyer retained or consulted in common, when offered in an action between any of the clients . . . ." HAW. R. EVID. § 503(d)(6).

[28] *See, e.g.*, Stender's Motion to Compel, *supra* note 26, at 8; Stender's Reply, *supra* note 26, at 5-6.

[29] *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6 (1995).

[30] *See* HAW. R. EVID. § 503(b) (stating attorney-client privilege).

of KSBE, owed the duty of confidentiality to the Board, which consisted of the fiduciaries of the Trust.[31]

The privilege elimination claim was premised upon the assertion that the Board attorney had a conflict of interest because he had an individual attorney-client relationship with each Board member.[32] Thus, according to the claim, the Board attorney was representing both the individual plaintiff trustees (i.e., trustees Jervis and Stender) and the individual defendant trustee (i.e., trustee Lindsey) when those trustees were functioning as Board members and there was no dispute between them.[33] Arguing from the concept of Board attorney representation of each individual trustee, the privilege elimination claim pointed out that the trustees, who formerly were in agreement, were now in dispute, thus triggering the exception to the attorney-client privilege regarding disputes between former clients.[34]

The probate court accepted the conceptual premise of the claim and held that the exception eliminated the attorney-client privilege because the dispute between the plaintiff and defendant trustees in effect created a conflict of interest for the Board attorney.[35] As noted, the trustee removal action has ended with the court removing the defendant trustee.[36] The propriety of the court's order to the Board attorney to disclose confidential communications may be tested through an appeal from the judgment removing the defendant trustee.

2. The limited Board removal claim

The second conflict claim was raised in the limited Board removal action. There, two minority members of the Board asserted that the IRS's claims against KSBE for tax deficiencies, which necessarily challenged the Board's past judgment on federal income tax law, created a conflict of interest between the entire Board and KSBE.[37] The theory of the minority trustees was that the Board would not be able to protect the best interests of KSBE because the

[31] See discussion *infra* section II.B. for a discussion of the importance of the "entity theory" as it relates to the privilege elimination claim.

[32] *See, e.g.*, Stender's Reply, *supra* note 26, at 6.

[33] *See id.*

[34] *See id.*

[35] *See* Discovery Master's Order Granting Motion to Compel Deposition of Nathan Aipa, In re *Estate of Bishop*, Equity No. 2048, at 2 (Haw. Prob. Ct. Oct. 15, 1998) [hereinafter Discovery Master's Order].

[36] *See* Lindsey Removal Order, *supra* note 15; Rick Daysog, *Trustee Lindsey Removed*, HONOLULU STAR-BULLETIN, May 6, 1999, *available at* <http://starbulletin.com/1999/05/06/news/story1.html>.

[37] *See* Petition for Recusal, *supra* note 19, at 8-9.

IRS's charges involved a direct challenge to the past judgment of the Board.[38] The minority trustees argued for the limited removal of the trustees to preclude them from discharging their fiduciary duty to defend the Trust against the IRS's tax claims.[39] The probate court found merit in the limited removal claim and ordered the Board to cease directing KSBE's response to the tax deficiency claims.[40]

C. Basic Considerations

Conflict of interest issues arise when a fiduciary, such as an attorney or a trustee, does not give undivided loyalty to the beneficiary of the fiduciary duty, such as a client or a trust, pursuant to goals set by the person establishing the fiduciary relationship, such as a client or trust settlor. When the fiduciary has an interest claiming his or her attention that conflicts with the beneficiary's interest, the law declares that the fiduciary must be removed.[41] That conflicting interest can be the advancement of the fiduciary's own financial interests or the advancement of the interests of a third person.[42]

Conflict claims against lawyer fiduciaries who cannot fulfill fiduciary duties owed to different clients whom they represent or have represented are said to be the most pervasively felt of all professional responsibility problems that affect lawyers.[43] Similarly, the obligation of a trustee to administer the trust solely for the benefit of the trust beneficiaries in accordance with the terms of the trust is a basic tenet of the law of trust administration,[44] and the fiduciary cannot personally profit at the expense of the beneficiary when administering the trust.[45] There is a well-drafted body of rules governing questions of conflicts of interest regarding lawyer fiduciaries,[46] and the case law prohibiting actual or apparent trustee self-dealing with trust property is well-developed.[47]

---

[38] *See id.* at 8.

[39] *See id.*

[40] *See* Minute Order, *supra* note 22, at 6-7.

[41] *See* BOGERT & BOGERT, *supra* note 3, § 543.

[42] *See id.*

[43] *See* WOLFRAM, *supra* note 1, § 7.1.1.

[44] Section 170(1) of the Restatement (Second) of Trusts provides: "The trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary." RESTATEMENT (SECOND) OF TRUSTS § 170(1) (1959).

[45] *See id.* § 170 cmt. a.

[46] *See* MODEL RULES OF PROFESSIONAL CONDUCT Rules 1.7-1.11, 1.13 (1995). These Rules and the previous rules on conflict of interest promulgated by the American Bar Association are discussed in WOLFRAM, *supra* note 1, §§ 7.1.2-7.4.3, 7.6.2-8.2.2, 8.3.1-8.10.3.

[47] The provision of the Restatement (Second) of Trusts prohibiting trustee self-dealing is quoted in *supra* note 44. That provision, section 170(1), has been applied in reported opinions

The duties of an attorney or trustee toward the beneficiary include advancing the interests of the beneficiary in all legal ways to best accomplish the objective of the fiduciary relationship.[48] The goal of an attorney-client relationship is dictated by the client to the attorney.[49] The duties of a trustee to administer the trust are governed by the "terms of the trust," a phrase adopted by the Restatement (Second) of Trusts, and therein defined as the legally provable intentions of the settlor of the trust.[50] The duty to advance the interest of the beneficiary is total and requires the best efforts of the fiduciary.[51] Fiduciaries have a subsidiary duty to keep all confidential information learned from the beneficiary as well as any confidential communications between them.[52] The conflict claims in the trustee removal action and the limited Board removal action impeded the trustees from fulfilling their duty to advance the interests of the beneficiaries, and the Board attorney's duty to keep confidential conversations with Board members regarding Board matters.

Consideration of the conflict claims is superficially complicated by the fact that KSBE is far from the usual trust. Everything from the great wealth it holds to the central place the trust holds in the economic and political life of Hawai'i means that KSBE has the potential to be the focus of great media attention. In the KSBE actions, that potential was fully realized. Application of rather cut-and-dried legal rules seemingly intended for private and much smaller fiduciary organizations may seem anomalous when an entity of the size and prominence of KSBE is involved. Nonetheless, the governing principles are clear, and are based upon sound policy judgments.

The applicable principles are readily available in Hawai'i law. Hawai'i has adopted a number of statutes and administrative regulations that address the issues presented by the privilege elimination claim. These include the American Bar Association Model Rules of Professional Conduct ("Model

---

more than 180 times since the provision was promulgated in 1959. *See* RESTATEMENT (SECOND) OF TRUSTS app. §§ 170 (1987 & Supp. 1999).

[48] *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.2 (1995).

[49] *See id.* cmt. 1.

[50] *See* RESTATEMENT (SECOND) OF TRUSTS, §§ 4, 164 (1959)(stating that trustee's duties are established by the "terms of the trust" and defining that phrase). General rules of trust administration apply to a trustee only if there are no trust terms establishing the trustees duties and powers. *See id.* § 164(b).

[51] *See id.* § 170.

[52] *See* Austin W. Scott, *The Fiduciary Principle*, 3 CAL. L. REV. 539, 553 (1949)("A fiduciary in the course of his employment may acquire confidential information. It is a breach of his duty as fiduciary to use this information for his own purposes, or to communicate it to a third person who may so use it.").

Rules"),[53] the Hawai'i Rules of Evidence ("HRE"),[54] and the Hawai'i Probate Rules ("HPR").[55] The Hawai'i Supreme Court also has announced clear principles in several opinions to guide courts in conflict issues relating to KSBE.[56] Finally, accessible principles of general fiduciary law provide a firm answer to the limited Board removal action.

II. EVALUATION OF THE PRIVILEGE ELIMINATION CLAIM

A. *The Entity Theory and the Identity of the Client*

Identification of the client-beneficiary was the most important question in addressing the privilege elimination claim.[57] Specifically, the question was, who is the Board attorney's client? If the client is the majority of the Board, the Board attorney has no attorney-client relationship with any individual Board member. If the Board attorney has an attorney-client relationship with individual Board members, then the Board attorney has no attorney-client relationship with the Board as a collective body.

The intent of the person establishing the fiduciary relationship is the most important consideration in fiduciary law.[58] Observing that principle in the

---

[53] *See* HAW. RULES OF PROFESSIONAL CONDUCT Rules 1.7-1.13 (addressing relevant conflict of interest issues). The Hawai'i Rules of Professional Conduct are patterned after the Model Rules.

[54] HRE 503(b) provides:

> (b) General rule of privilege. A client has a privilege to refuse to disclose and to prevent any other person from disclosing confidential communications made for the purpose of facilitating the rendition of professional legal services to the client (1) between the client or the client's representative and the lawyer or the lawyer's representative, or (2) between the lawyer and the lawyer's representative, or (3) by the client or the client's representative or the lawyer or a representative of the lawyer to a lawyer or a representative of a lawyer representing another party in a pending action and concerning a matter of common interest, or (4) between representatives of the client or between the client and a representative of the client, or (5) among lawyers and their representatives representing the same client.

HAW. R. EVID. 503(b).

[55] *See* HAW. PROB. R. § 42(a)-(d).

[56] *See* Richards v. Midkiff, 48 Haw. 32, 40, 396 P.2d 49, 55 (1964); *see also* Takabuki v. Ching, 67 Haw. 515, 695 P.2d 319 (1985).

[57] A consideration of any issue in fiduciary law requires identification of the fiduciary and the beneficiary of the fiduciary relationship. Both questions provide no difficulty in the majority of fiduciary relationships. When there is an identity question it almost always concerns the identification of the beneficiary.

[58] The Restatement (Second) of Trusts states that a trustee's duties are established by the "terms of the trust." RESTATEMENT (SECOND) OF TRUSTS § 164 (1959). That phrase is defined in section 4 of the Restatement as "the manifestation of intention of the settlor with respect to the trust expressed in a manner which admits of its proof in judicial proceedings." *Id.* § 4.

context of the privilege elimination claim, it is clear that Princess Bishop intended for KSBE to carry out her specific intention to create and maintain the Kamehameha Schools.[59] For the trust to function in pursuit of that objective, the trustees must hire employees and agents, including attorneys, and direct their activities.[60]

Princess Bishop was very clear on her intent in the event that the five member Board could not unanimously agree on a matter—she provided that a majority of the Board would make the decision on the matter.[61] She obviously believed that the majority control concept was the most effective way the multiple trustee Board could manage KSBE to carry out her specific intention. Therefore, a majority, and only a majority, of the KSBE Board can hire an attorney and direct the attorney to protect the interests of KSBE.

The law of legal ethics, which is the same in Hawai'i on all relevant points as it is in general American jurisprudence, serves to implement the intentions of the settlor of a multiple trustee trust such as Princess Bishop. This is accomplished by the legal ethics concept of the "entity" theory. The theory, which has been uniformly adopted by commentators and modern appellate opinions,[62] establishes that an attorney for an organization represents the governing body of the trust as an entity.[63] Since the governing body of KSBE has five members and must be directed by the majority of the Board, which consists of three or more trustees, the attorney for KSBE must take directions from a majority of the Board. Unless there are unusual circumstances,[64] the Board attorney functions for all practical purposes as the lawyer for the majority of the Board.

The entity theory is expressed in these terms in Rule 1.13 of the Hawai'i Rules of Professional Conduct ("HRPC"): "A lawyer employed or retained by an organization represents the organization acting through its duly authorized

---

[59] *See supra* note 6, and the portion of the Will quoted in the accompanying text.

[60] *See* BOGERT & BOGERT, *supra* note 3, § 555; *see also In re* Bishop Estate, 36 Haw. 403 (1943)(holding that trustees are entitled to incur reasonable expenses, chargeable to the trust estate, to hire administrative assistants to perform delegable duties which are reasonably necessary to the efficient administration of the estate).

[61] *See Will*, *supra* note 6, art. 14.

[62] *See* WOLFRAM, *supra* note 1, § 8.3.2, and cases cited therein; MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.13(a) & cmts. 1-5 (1995); RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 26 & cmt. f (Proposed Final Draft No. 1 1996), and cases cited therein; Charles W. Wolfram, *Corporate-Family Conflicts*, 2 J. INST. STUD. LEGAL ETHICS 295, 307-21 (1999); Jeffrey N. Pennell, *Representations Involving Fiduciary Entities: Who Is the Client?*, 62 FORDHAM L. REV. 1319, 1334-41 (1994).

[63] *See* HAW. RULES OF PROFESSIONAL CONDUCT Rule 1.13.

[64] Unusual circumstances exist when the Board wishes to direct the organization in illegal conduct that is likely to result in substantial injury to the organization. In such a case, the organization's attorney may resign from representation of the organization. *See id.* Rule 1.13(c).

constituents."[65] Comment 3 to HRPC 1.13, entitled "The Entity as the Client," drives the point home by stating that when an organization's lawyer interviews employees or "constituents" of the organization, "[t]his does not mean... that constituents of an organizational client are the clients of the lawyer."[66] Comment 4 states: "When constituents of the organization make decisions for it, the decisions ordinarily must be accepted by the lawyer . . . ."[67]

Turning to the law of evidence, HRE Rule 503(a)(1) states the entity theory in this fashion: "A 'client' is a person . . . or . . . organization or entity, either public or private, who is rendered professional legal services by a lawyer . . . ."[68] HPR Rule 42(a) states, "An attorney employed by a fiduciary for [a] . . . trust represents the fiduciary as client as defined in Rule 503(a) of the Hawaii Rules of Evidence and shall have all the rights, privileges, and obligations of the attorney-client relationship with the fiduciary . . . ."[69] In paragraph three of the commentary to HPR Rule 42, the drafters of the Rule expressly adopt the "lawyer client privilege" under HRE Rule 503, which explicitly adopts the entity theory.[70]

The entity theory has also been adopted by the Hawai'i Supreme Court, and has been applied by that court to KSBE under the synonym of the "collective trustee" concept.[71] Collective trustee theory logically requires that the majority of the KSBE Board have sole and exclusive rights both to hire and direct attorneys and to either claim or waive the attorney-client privilege. Collective trustee theory also means that an individual trustee never has an individual attorney-client relationship with a KSBE attorney concerning KSBE matters. This basic principle of legal ethics is established by the general legal ethics concepts reviewed above and by two specific points of Hawai'i law.

---

[65] *Id.* Rule 1.13(a)

[66] HAW. RULES OF PROFESSIONAL CONDUCT Rule 1.13 cmt. 3.

[67] *Id.* Rule 1.13 cmt. 4.

[68] HAW. R. EVID. 503(a)(1).

[69] HAW. PROB. R. 42(a). An assertion was made by one of the minority trustees in a discovery hearing that the use of the singular noun "fiduciary" in HPR 42(a) meant that each of the individual trustees had an individual attorney-client relationship with the Board attorney. *See* Letter from attorneys for trustee Oswald Kofoad Stender to Clyde Matsui, Discovery Master 2 (Oct. 2, 1998)(on file with author). The discovery master in the proceeding accepted this argument and ruled that, during the relevant period, there was a "joint attorney-client privilege among the trustees and Nathan Aipa as general counsel for KSBE . . . ." Discovery Master's Order, *supra* note 35, at 2.

[70] *See* HAW. R. EVID. 503(a)(1).

[71] *See* Richards v. Midkiff, 48 Haw. 32, 40-41, 396 P.2d 49, 55-56 (1964)(citing with approval Mossman v. Damon, 15 Haw. 401, 404 (1904)); *see also* Takabuki v. Ching, 67 Haw. 515, 526-28, 695 P.2d 319, 326-27 (1985). *Richards* is discussed *infra* in notes 81-83 and accompanying text.

The first of these points is stated in HRPC 1.13(a).[72] That subsection states that a lawyer retained by an organization represents the organization.[73] While MRPC Rule 1.13(e) authorizes an organization's attorney to represent individuals owning, directing, or employed by the organization, such "dual representation" is only permissible if the interests of the individual client are not adverse to the interests of the organization under the usual test governing an attorney's ability to represent any new client.[74] Any representation of the trustee in connection with a position of the trustee contrary to a position taken by a majority of the Board would be professional misconduct under HRPC Rule 1.7, a rule referenced in HRPC Rule 1.13(e).[75]

The second point has been stated on several occasions by the Hawai'i Supreme Court. A KSBE trustee who disagrees with the position taken by a majority of the Board cannot assert his or her position in a legal proceeding as the position of the KSBE.[76] A minority trustee is free to assert his or her position in a legal proceeding challenging Board action, but, when doing so, the minority trustee is not acting on behalf of the Board.[77] In the words of the Hawai'i Supreme Court, the minority trustee is "suing his fellow trustees to redress a breach of trust [and] is in effect bringing a derivative action on behalf of the beneficiaries of the trust."[78] In this situation, "one trustee has no standing to maintain an action on behalf of the trust estate as he alone cannot act in such representative capacity."[79]

Furthermore, the Board attorney can never represent any person or group in an action against a majority of the Board under HRPC 1.7. For this reason, a minority trustee can never direct a Board attorney to take a legal position against a majority of the Board, and an individual trustee can never have an attorney-client relationship with a Board attorney concerning KSBE matters. No Board attorney could ethically represent an individual trustee in such a

---

[72] *See* HAW. RULES OF PROFESSIONAL CONDUCT Rule 1.13(a).

[73] *See id.*

[74] Model Rule 1.13(e) makes any dual representation by an organization's attorney "subject to the provisions of Rule 1.7." MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.13(e) (1995). That Rule prohibits an attorney from representing any new client with interests that are adverse to the interests of another client. *See id.* Rule 1.7(a). Rule 1.7 also prohibits an attorney from representing a new client if that representation "may be materially limited by the lawyer's responsibilities to the organization." *Id.* Rule 1.7(b). A lawyer may engage in dual representation if the organization gives informed consent to the representation, and the lawyer "reasonably believes" that the representation will not adversely affect the lawyer's representation of the organization.

[75] *See* HAW. RULES OF PROFESSIONAL CONDUCT Rule 1.13(e).

[76] *See Richards*, 48 Haw. at 40-41, 396 P.2d at 55; *see also Takabuki*, 67 Haw. at 526-28, 695 P.2d at 325-27.

[77] *See Richards*, 48 Haw. at 41-42, 396 P.2d at 55-56.

[78] *Id.* at 42, 396 P.2d at 56 (citing RESTATEMENT (SECOND) OF TRUSTS § 200 (1959)).

[79] *Id.*

situation under HRPC Rule 1.16(a), because to do so would "result in violation of the Rules of Professional Conduct [such as HRPC 1.7] . . . ."[80]

Over thirty years ago, the Hawai'i Supreme Court, having specifically reasserted the collective trustee concept, wrote about the collective trustee as if the majority of the KSBE Board were a single person. In *Richards v. Midkiff*, decided in 1964, the court noted the application of the collective trustee rule to KSBE, and, immediately afterward, stated: "The application of this rule is limited to situations where *the trustee* is attempting to exercise the powers conferred upon him."[81] Pursuant to collective trustee theory, the Hawai'i Supreme Court thereby authorized the use of the singular noun "trustee" to describe the majority of the trustees of a trust.[82]

The Hawai'i Supreme Court's use of the collective noun "trustee" to designate a majority of the Board provides an explanation for the reference in HPR Rule 42(a) to "the fiduciary" as the client of an attorney for a trust or estate. The Hawai'i Attorney General and others arguing for the privilege elimination claim asserted that the use of the singular noun "fiduciary" in HPR Rule 42(a) meant that individual fiduciaries on a board of multiple fiduciaries of a trust, such as KSBE, have an individual attorney-client relationship with the attorney for the trust.[83] However, the use of the singular noun "fiduciary" in Rule 42 can carry no such meaning. It must be assumed that the drafters of Rule 42(a), who were trust specialists, were aware of the Hawai'i Supreme Court's use of the singular noun "trustee" in *Richards* to refer to a multiple person "collective trustee." Common sense also dictates that the drafters sought to simplify the language of the rule, choosing to use the singular noun because most estates or trusts commonly have only one fiduciary.

With the use of the singular "fiduciary" in Rule 42(a) explained as consistent with the Hawai'i Supreme Court's adoption of the entity theory, as evidenced by its use of the term "collective trustee," there is no other basis for contesting the application of the entity theory-collective trustee concept to the identification of the client of the Board attorney. When an attorney is retained by a trust, whose board of fiduciaries is split on a matter of policy, the client's identity is clear. The rules of professional ethics, the law of evidence, and precedents of the Hawai'i Supreme Court are in accord with the common sense requirement that a trust with a split board must be able to use and direct legal services. The client in that situation is the majority of the board of fiduciaries.

---

[80] HAW. RULES OF PROFESSIONAL CONDUCT Rule 1.16(a)(1).

[81] *Richards*, 48 Haw. at 41, 396 P.2d at 55 (emphasis added).

[82] *See id.*

[83] *See supra* note 69.

B. The Entity Theory and the Privilege Elimination Claim

The KSBE Board attorney never represented an individual trustee. That attorney's duties of representation and confidentiality were owed only to the Board as a "collective trustee" under the entity theory. Therefore, the fact that the minority trustees brought suit to remove a third trustee raised no issue concerning the application of the exception to the attorney-client privilege pertaining to disputes between former clients. No single trustee could have been a client of the Board attorney at any given time.

In Hawai'i and elsewhere, there is an exception from the attorney-client privilege for communications between an attorney and client when the client is seeking the assistance of the attorney for the purpose of perpetrating a crime or a fraud.[84] Thus, if any individual member of the Board had sought assistance from the Board attorney to commit a crime or tort on behalf of KSBE, the attorney-client privilege would not apply to communications engaged in furtherance of the crime. Under well-accepted procedures, the party who claims the privilege does not apply has the burden of producing evidence to the trial court.[85] However, the parties attacking the privilege in the trustee removal action never tendered or produced evidence that any member of the Board communicated with the Board attorney to seek assistance in accomplishing wrongdoing.

Finally, due to the fiduciary status of the trustees, HPR Rule 42(c) provides that the attorney for a trust, such as the Board attorney, has an independent duty to inform the probate court if the attorney "knows" of the commission or possible commission of a crime that could injure the trust.[86] This rule imposes on the trust attorney a duty to inform that goes beyond the usual obligation of an attorney to report false statements made in a proceeding.[87] Public records,

---

[84] *See* HAW. R. EVID. 503(d)(1).

[85] *See* United States v. Zolin, 491 U.S. 554, 572 (1989).

[86] *See* HAW. PROB. R. § 42(c). HPR Rule 42(c) provides:

> An attorney for an estate, guardianship, or trust is an officer of the court and shall assist the court in securing the efficient and effective management of the estate. The attorney has an obligation to monitor the status of the estate and to ensure that required actions such as accountings and the closing a probate estate are performed timely. The attorney, after prior notice to the fiduciary, shall have an obligation to bring to the attention of the court the nonfeasance of the fiduciary.

Id.

[87] The Model Rules require attorneys to inform a court of certain information if the attorney is appearing before the tribunal. This information includes "a material fact . . . when disclosure is necessary to avoid assisting a criminal or fraudulent act by the client" and facts that are necessary as a reasonable "remedial measure[]" when the lawyer discovers he or she has offered evidence in court "that the lawyer knows to be false." MODEL RULES OF PROFESSIONAL CONDUCT Rules 3.3(a)(2), (a)(4) (1995). A lawyer is also required to disclose "all material facts known to the lawyer which will enable the tribunal to make an informed decision" in an ex parte

court transcripts, and media reports of the privilege elimination proceedings contain no indication that a Board attorney made any report of a possible commission of a crime of any type.

The attorney-client privilege represents a basic policy of Anglo-American law to promote full and frank communication between clients and attorneys in order to make available the best legal advice possible. Few organizations need such legal advice more than large fiduciary organizations, with myriad activities in many fields of endeavor.

Based upon the trial court's ruling on the privilege elimination claim, all that is necessary for a retroactive removal of the privilege is the assertion by one trustee in a trust having multiple trustees that another trustee should be removed. The trial court failed to pursue the most traditional route for ousting the privilege and did not require a showing to establish the exception to the attorney client privilege for crime-fraud communications.[88] Therefore, it is

---

proceeding. *Id.* Rule 3.3(d). HPR Rule 42(c) does not require that a lawyer be involved in a proceeding in any court before the duty to disclose arises. *See* HAW. PROB. R. 42(c).

[88] The trial court also failed to require any consideration of the type a few courts have authorized under the controversial opinion in *Garner v. Wolfinbarger*, 430 F.2d 1093 (5th Cir. 1970). In *Garner*, the shareholders of a corporation sued the corporation and its officers alleging fraud in the corporation's sale of its stock to the shareholder plaintiffs. The corporation claimed the attorney-client privilege shielded any communications between the officer defendants and the corporation's attorney. The court held that the privilege could be asserted by the corporation, but the plaintiffs could gain access to the communications if they made a showing of good cause. The court noted that the previously "absolute" attorney-client privilege was qualified in certain corporate shareholder dispute situations. *See id.* at 1100-03.

Garner considered both the joint client dispute and crime/fraud exceptions to the attorney-client privilege and held that neither applied. The court was mindful of the obligation the corporation management owed to shareholders and considered it against public policy to allow management to stand "behind an ironclad veil of secrecy which under all circumstances preserves it from being questioned by those for whom it is, at least in part, exercised." *Id.* at 1101.

The indicia to be considered to determine if the plaintiff shareholders had shown good cause included: the percentage of the corporation's stock the plaintiffs held; whether the claim of fraud is "obviously colorable" (meaning likely to prevail unless controverted); the necessity of obtaining the information from the privileged communications; the criminality of the alleged actions of the corporate officers; and the risk of revealing sensitive information such as trade secrets. *See id.* at 1104.

The *Garner* approach to the attorney-client privilege in suits by shareholders against corporate directors has been adopted by the Fourth Circuit in *Sandberg v. Virginia Bankshares, Inc*, 979 F.2d 332, 348 (4th Cir. 1992), the Fifth Circuit in *Ward v. Succession of Freeman*, 854 F.2d 780, 784 (5th Cir. 1988), and the Sixth Circuit in *Fausek v. White*, 965 F.2d 126, 129-30 (6th Cir. 1992). On the other hand, the *Garner* approach has been heavily criticized. The most thorough academic study of the Garner concept concluded that "*Garner's* exception to the privilege should be reexamined and rejected." Stephen A. Saltzburg, *Corporate Attorney-Client Privilege in Shareholder Litigation and Similar Cases:* Garner *Revisited*, 12 HOFSTRA L. REV. 817, 848 (1984).

not an exaggeration to say that the mere allegation that a fiduciary in a multiple fiduciary organization should be removed would eliminate the attorney-client privilege for communications between the organization and its attorney. Unless rejected, the trial court ruling will force fiduciaries to avoid any type of confidential communication with the attorney for the organization in which the fiduciary serves. Such would truly be a perverse result.

III. EVALUATION OF THE LIMITED BOARD REMOVAL CLAIM

A. *The Conceptual Basis of the Claim*

The limited Board removal action was instituted in the probate court by the minority trustees in January 1999.[89] The minority trustees never made clear the exact nature of the conflict of interest between members of the Board and the Trust. Their petition to the court merely stated:

> Trustees Stender and Jervis have been informed and believe that there is a potential and/or actual conflict of interest now existing or hereafter arising as to all of the Trustees with respect to the [IRS] Audit. As a result, Trustees Stender and Jervis believe it is in the best interest of the Trust Estate for *all* Trustees to recuse themselves with respect to exercising any trust powers related to the Audit.[90]

In their moving papers, the minority trustees presented no evidence relevant to their claim of conflict and did not elaborate on the alleged "potential and/or actual conflict of interest."[91]

Regardless of the wisdom of the *Garner* approach, the factors considered in that opinion were not mentioned in the privilege elimination claim. However, *Garner* shows how a small number of federal jurisdictions have altered the traditional approach to the attorney-client privilege in a corporation context. Under that view, in situations in which the privilege could be used to defeat justice and a strong case has been made by the opponent of the privilege, the privilege will no longer be considered absolute.

[89] *See* Petition for Recusal, *supra* note 19; *see also* Rick Daysog, *Judge to Rule on Trustees' Conflict of Interest*, HONOLULU STAR-BULLETIN, Jan. 30, 1999, at A-3. The conflict claim was apparently based upon an earlier recommendation made by the Special Master appointed to review the consolidated accounting of KSBE. *See* Petition for Recusal, *supra* note 19, at 5.

[90] Petition for Recusal, *supra* note 19, at 8 (emphasis in original).

[91] *See* Trustee Oswald Kofoad Stender's Reply Memorandum to Trustees Richard Sung Hong Wong's, Henry Haalilio Peters', and Marion Mae Lokelani Lindsey's Objection and Response to Trustees Oswald Kofoad Stender and Gerald Aulama Jervis' Petition for Approval of Voluntary Recusal with Respect to Pending Tax Audit and for Appointment of a Panel of Special Administrators with Respect to Pending Tax Audit, In re *Estate of Bishop*, Equity No. 2048, at 9 (Haw. Prob. Ct. Feb. 2, 1999). Without elaboration, Trustee Jervis basically cited case law supporting the ability of the court to appoint special administrators, known as "trustees ad litem," where the trustees' personal interest in a particular matter conflicts with that of the trust or beneficiaries. *See* Trustee Gerard Aulama Jervis' Supplemental Memorandum Re: (1)

The Minute Order of the court granting the minority trustees' petition provided the most complete allegation of the conflict claim:

> Based on the IRS Forms 5701[92] received by the Trust Estate and its subsidiaries, the Court finds and concludes that actual, apparent, adverse and material conflicts of interest exist between the individual interests of Trustees of the Trust Estate . . . and the interests of the Trust Estate with respect to the claims and issues raised in the IRS Forms 5701 and the IRS Audit.[93]

As an example of "an actual, apparent, adverse and material conflict of interest" between the trustees and the Trust, the court pointed to the fact that the IRS proposed an "adjustment to the Trust Estate which is based on the payment of excessive or unreasonable compensation to the Trustees of the Trust Estate."[94]

The above suggests that the conflict claim in the limited Board removal action amounted to no more than the proposition that a third party can create a conflict of interest between a trustee and a trust when it asserts that the trustee, acting on a behalf the trust, committed a mistake or wrongful act for which the trust or the trustee could be held liable. The result of such an alleged conflict is that the trustee must be removed from settling or supervising the response by the trust to the third-party allegation. Essentially, the principle on which the conflict claim was based would mandate that if a trustee is potentially liable to the trust for conduct that exposes the trust to liability, he or she cannot supervise the trust's response to third-party claims against the trust arising from such conduct. For good reasons, well-settled trust law completely rejects the idea that potential trustee liability establishes a conflict of interest.[95]

The basic misconception in this argument, which the court accepted in the limited Board removal action, is that the trustees' potential malfeasance in responding to a third-party claim for which they may be personally liable will always warrant their removal, even if that meant disregarding the settlor's

---

Trustees Oswald Kofoad Stender and Gerard Aulama Jervis' Petition for Approval of Voluntary Recusal with Respect to Pending Tax Audit and for Appointment of a Panel of Special Administrators with Respect to Pending Tax Audit (filed 1/21/99) and (2) Trustees' Petition for Instructions and Approval of Appointment of IRS Dispute Advisory Panel (Filed 1/22/99), In re *Estate of Bishop*, Equity No. 2048, at 2-4 (Haw. Prob. Ct. Feb. 1, 1999).

[92] The IRS Form 5701 documented the claims of tax deficiencies made by the IRS.

[93] Minute Order, *supra* note 22, at 6.

[94] *Id.* The court also noted that trustee Stender had alleged that all of the trustees had been advised that the IRS at that time expected to issue Notices of Proposed Adjustments (IRS Form 5701) to one or more individual trustees in the near future. *See id.*

[95] *See* discussion *infra* section III.B.

intentions and choice of trustees.[96] This would mean that any assertion of a claim against a trust by a third party would result in the limited removal of the trustees, as long as it is possible to imagine a theory on which the trustees might have ultimate liability to the trust for the claim. Because a trustee is liable to a trust for any negligent act of the trustee that results in harm to the trust,[97] it will usually be possible to conceive of allegations of trustee negligence in connection with even the most mundane claims by third parties against the trust.[98]

B. Trust Law and the Potential Trustee Liability Concept of Conflicting Interests

A trustee always has the right to defend his or her stewardship of the trust, and the fact that a trustee may have some personal interest in that defense does not create a conflict of interest.[99] Trustees commonly defend or supervise the defense of a trust against claims attacking the trustees' management of the trust. This right to defend is recognized in the Uniform Trustee Powers Act,[100] which is the law of Hawai'i[101] and fifteen other states.[102] The right is also

---

[96] Where a trustee specifically chosen by the settlor has died or otherwise has become unable to function as trustee, the successor trustee will also be considered specifically chosen by the settlor if the appointment was made pursuant to the settlor's prescribed method for selecting successor trustees. *See* 2 SCOTT & FRATCHER, *supra* note 1, § 108.3. This principle applies directly to the Will of Princess Bishop. *See Will*, *supra* note 6, art. 14 (directing "that vacancies shall be filled by the choice of a majority of the Justices of the Supreme Court, the selection to be made from persons of the Protestant religion.").

[97] *See* RESTATEMENT (SECOND) OF TRUSTS §§ 201, 205 (1959). Comment b to section 201 of the Restatement (Second) of Trusts specifies that a trustee commits a breach of trust if the trustee acts negligently. *See id.* § 201 cmt. b. Section 205 establishes the liability of a trustee to a trust for any breach of trust by the trustee that causes loss to the trust. *See id.* § 205.

[98] E.g., assume a trust employee allegedly operates an automobile in a negligent manner while on trust business, thereby causing an accident that injures a third party. If it is possible to allege that the trustee of the trust negligently hired the employee by not first investigating the driving history of the employee, the trustee faces potential personal liability to the trust for the amount of the claim the trust has to pay to the injured third party.

[99] *See* Bank of Am. Nat'l Trust & Sav. Ass'n v. Long Beach Fed. Sav. & Loan Ass'n, 297 P.2d 443, 448 (Cal. Dist. Ct. App. 1956).

[100] The wording of the Uniform Trustees' Powers Act is: "a trustee has the power . . . to prosecute or defend actions, claims, or proceedings for the protection of trust assets and of the trustee in the performance of his duties . . . ." UNIF. TRUSTEES' POWERS ACT § 3(c)(25), 7B U.L.A. § 748 (1985).

[101] See the identical language in HAW. REV. STAT. § 554A-3(c)(24) (Supp. 1999).

[102] For a list of the states, see UNIF. TRUSTEES' POWERS ACT Table of Jurisdictions Wherein Act Has Been Adopted, 7B U.L.A. 741 (Supp. 1999).

recognized as the settled rule by the leading commentators on fiduciary law[103] and the Restatement (Second) of Trusts.[104] Not only is there no "conflict of interest" between the trustee's defense of his or her stewardship and the interests of the trust, but trustees are authorized to collect their reasonable expenses in successfully making such a defense.[105]

The principle that the intent of the settlor must be followed dictates that a trustee must have the right to direct the trust's response to third party claims even though the trustee is potentially liable.[106] If the settlor intended that a particular trustee or a trustee chosen by a specific procedure should manage the affairs of the trust, that intention should be followed. That basic principle applies absent actual proof that the trustee is incapable of carrying out the settlor's intentions.[107]

A trustee must have a personal interest actually adverse to the interest of the trust before being required to petition the court for permission to exercise his or her right to defend. This is the requirement under Hawai'i Revised Statutes ("HRS") section 554A-5(b).[108] Actions requiring court approval under that subsection must meet a difficult standard—only situations in which a trustee may gain a cognizable financial advantage at the expense of the trust meet the standard.[109] If the trustee does not actually have an interest adverse to the

---

[103] *See* 2A SCOTT & FRATCHER, *supra* note 1, § 178 ("[A trustee] should defend actions brought against him that if successful would cause a loss to the trust estate."); *see also* BOGERT & BOGERT, *supra* note 3, § 581.

[104] *See* RESTATEMENT (SECOND) OF TRUSTS § 178 (1959).

[105] *See* Grey v. First Nat'l Bank in Dallas, 393 F.2d 371, 387 (5th Cir. 1958); Weidlich v. Comley, 267 F.2d 133, 134 (2d Cir. 1959); Jessup v. Smith, 119 N.E. 403, 404 (N.Y. 1918); *see also* 3 SCOTT & FRATCHER, *supra* note 1, § 188.4.

[106] *See* 2A SCOTT & FRATCHER, *supra* note 1, § 164.1; RESTATEMENT (SECOND) OF TRUSTS § 164(a) (1959).

[107] *See* 2 SCOTT & FRATCHER, *supra* note 1, §§ 107, 107.1; RESTATEMENT (SECOND) OF TRUSTS § 107(a), § 107 cmt. b (1959).

[108] HRS § 554A-5(b) provides:

> (b) If the duty of the trustee and the trustee's individual interest or the trustee's interest as trustee of another trust, conflict in the exercise of a trust power, the power may be exercised only by court authorization (except as provided in section 554A-3(c)(1), (5), (17), and (23)) upon petition of the trustee. Under this section, personal profit or advantage to an affiliated or subsidiary company or association is personal profit to any corporate trustee.

HAW. REV. STAT. § 554A-5(b) (1993).

[109] *See, e.g.*, Keye v. Gautier, 684 So. 2d 210 (Fla. Dist. Ct. App. 1996)(per curiam)(upholding summary judgment against trustee alleged to be in violation of Florida's equivalent of HRS § 554A-5(b)). Citing GEORGE G. BOGERT & GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 453(J) (2d ed. 1993), the opinion held that court approval was necessary for a trustee's decision to lend funds to himself from the trust corpus without giving the trust a security interest to secure repayment. *See Keye*, 684 So. 2d at 211.

trust, he or she is free to act without court approval and the settlor's intent in designating this person as the fiduciary prevails.

As long as the interest of the trustee and the trust coincide or reinforce each other, there is no conflict of interest. Such was the case of KSBE with respect to the IRS claims. Both the trustees, whose judgment in tax law matters was implicated, and the trust stand to benefit from the defeat of the tax claims. The interests of KSBE and the Board are actually identical, rather than conflicting. The legal reasoning stated by Judge Learned Hand in *Weidlich v. Comley*[110] is definitive on this point. Judge Hand had before him a claim that a trustee invariably had a conflict of interest in using trust funds to defend himself from charges of malfeasance.[111] Judge Hand wrote:

> That completely misses the true situation: a trustee was appointed to administer the assets; the settlor selected him to do so, and whatever interferes with his discharge of his duty pro tanto defeats the settlor's purpose. When the trustee's administration of the assets is unjustifiably assailed it is a part of his duty to defend himself, for in so doing he is realizing the settlor's purpose.[112]

The law of trusts adequately protects the interests of trust beneficiaries in the situation in which a trustee defends the trust from a claim for which he or she may be personally liable. If any of the IRS claims are eventually validated, and if any valid claim indicates malfeasance on the part of a member of the KSBE Board, there are adequate remedies available to protect the interests of the Trust at that time. A surcharge action can be brought[113] and a removal action will lie against the trustee or trustees who were guilty of malfeasance.[114] Furthermore, if there was any proof of trustee wrongdoing that gave the court reasonable doubt about the ability and probity of the trustees to supervise KSBE's response to the IRS claims, interim removal was also an option.[115] The presence of any evidence of wrongdoing or the trustees' lack

---

[110] 267 F.2d 133 (2d Cir. 1959).

[111] *See id.* at 134.

[112] *Id.*

[113] *See* HAW. REV. STAT. § 560:7-306 (1993); BOGERT & BOGERT, *supra* note 3, § 862; 3 SCOTT & FRATCHER, *supra* note 1, § 205; RESTATEMENT (SECOND) OF TRUSTS § 205 (1959).

[114] *See* HAW. REV. STAT. § 560:7-305 (1993); BOGERT & BOGERT, *supra* note 3, § 861; 2 SCOTT & FRATCHER, *supra* note 1, § 107; RESTATEMENT (SECOND) OF TRUSTS § 107(a), § 107 cmts. a & b (1959).

[115] According to the Restatement (Second) of Trusts section 107, comments a and b, a court with jurisdiction over a trust may remove the trustee "if his continuing to act as trustee would be detrimental to the interests of the beneficiary[,]" including those situations in which the court finds the trustee unfit due to "old age, habitual drunkenness, [and] want of ability or other cause . . . ." RESTATEMENT (SECOND) OF TRUSTS § 107 cmts. a & b (1959). "The matter is one for the exercise of a reasonable discretion by the court." *Id.* § 107 cmt. a.

of ability or probity would justify the invocation of such a remedy by the minority trustees or the court on its own motion.[116]

The important point here is that any accusation of trustee malfeasance must be proven to the court through the introduction of evidence.[117] Allowing trustee removal on the basis of allegations of speculative and potential conflicts of interest severely derogates the intentions of the settlor as to who is authorized to manage the assets of the trust.

CONCLUSION

This Article discussed two conflict claims made in two proceedings in the KSBE litigation. While both claims were sustained by the probate court, neither had merit and both undermine important fiduciary relationships. The controversy and notoriety of the legal actions involving KSBE should in no way obscure the fact that the conflict claims discussed in this Article strike at the heart of the law of fiduciary relationships. That law has proven to be effective for the myriad fiduciary relationships that are taken for granted in the American legal system. To protect the ability of individuals to choose lawyers and trustees effectively, both claims should be unequivocally rejected through appellate procedures and by academic commentary.

---

[116] As a leading authority on trusts notes:

> It might also prove useful if the court could suspend or remove [a trustee] for a brief time. ... [T]he court's power to suspend seems to exist, at least where an investigation of the grounds of removal takes considerable time and there is evidence indicating a danger of waste or misappropriation pending the proceedings.

BOGERT & BOGERT, *supra* note 3, § 528.

[117] "Evidence which merely shows a decrease in the value of the trust property, without showing that the trustee wrongfully caused the decrease, does not make a case [for removal of a trustee]." BOGERT & BOGERT, *supra* note 3, § 871.

Understanding the Attorney-Client and Trustee-Beneficiary Relationships in the Kamehameha Schools Bishop Estate Litigation: A Reply to Professor McCall

Randall Roth*

Professor McCall contends that two particular trial court decisions in the Kamehameha Schools Bishop Estate ("KSBE") controversy "play havoc with attorney-client and trustee-beneficiary relationships. . . ."[1] The two decisions that concern Professor McCall so greatly were rendered by different judges in separate actions. One has to do with the attorney-client privilege,[2] the other with conflicts of interest.[3] Each of these two decisions reflects basic trust law principles and was properly made.

This Reply begins with a brief overview of relevant trust law principles in Part I. Part II then describes the decisions that trouble Professor McCall and the context of each. Part III critiques Professor McCall's analysis and conclusions. The Reply then suggests, in Part IV, a framework for resolving the underlying issues.

---

* Professor of Law, University of Hawai'i School of Law; B.S., Regis College, 1970; J.D., University of Denver College of Law, 1974; LL.M. University of Miami School of Law, 1975. Professor Roth co-authored the Broken Trust essay that is widely believed to have played a role in the removal and resignation of trustees of the Kamehameha Schools Bishop Estate. The author appreciates the assistance of Hawai'i State Deputy Attorney General Hugh R. Jones in the preparation of this Article.

[1] James R. McCall, *Endangering Individual Autonomy in Choice of Lawyers and Trustees —Misconceived Conflict of Interest Claims in the Kamehameha Schools Bishop Estate Litigation*, 21 U. HAW. L. REV. 487, 489 (1999).

[2] *See id.* at 492-94; *see also* Findings of Fact, Conclusions of Law, and Trial Court Order (Stayed) Following Hearing by Order of Hawaii Supreme Court, In re *Estate of Bishop*, Equity No. 2048, at 10-12 (Haw. Prob. Ct. Jan. 11, 1999)(stating in Conclusion of Law No. 7 that the "attorney employed by a fiduciary for an estate . . . represents the fiduciary as client as defined in Rule 503(a) of the Hawaii Rules of Evidence." (quoting HAW. PROB. R. 42(a))(internal quotation marks omitted)).

[3] *See* McCall, *supra* note 1, at 494-95; *see also* Minute Order Regarding Trustees Oswald Stender and Gerard Jervis' Petition for Approval of Voluntary Recusal with Respect to Pending Tax Audit and for Appointment of a Panel of Special Administrators with Respect to Pending Tax Audit and Trustees' Petition for Instructions and Approval of Appointment of IRS Dispute Advisory Panel, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Feb. 4, 1999) [hereinafter Minute Order].

I. SELECTED TRUST LAW PRINCIPLES

A trust is a relationship between trustees and beneficiaries, not a separate entity.[4] Unlike a corporation, for example, a trust cannot own assets, conduct business or hire lawyers.

To illustrate: $6 billion of trust corpus, including stock in Goldman Sachs and approximately 370,000 acres of land in Hawai'i, is not owned by KSBE . . . it is KSBE. What sometimes is called trust corpus, or the trust estate, is owned by trustees.

Trustees have the power (though not the right) to do just about anything they want to do with the trust estate.[5] The potential for abuse is obvious and is the reason why trust law imposes strict fiduciary duties on trustees, including a duty of undivided loyalty to the interests of the beneficiaries.[6] Trustees' use of trust funds to serve their own personal interests is strictly forbidden.[7]

Trustees, acting in their fiduciary capacity, often hire lawyers to assist in the administration of the trust estate. It is both logical and appropriate for these lawyers to be paid with funds from the trust estate and that they be called "Trust Counsel," meaning simply that they do legal work that is directly related to the administration of the trust and that is intended to serve the best interests of the trust beneficiaries. The clients are the trustees, but the trustees' duty of undivided loyalty prevents them from using such lawyers in any way that would put their personal interests ahead of those of the beneficiaries. Trust Counsel, so defined, are said to represent trustees in the trustees' "representative" or "fiduciary" capacity.

It also is possible for trustees to retain counsel primarily to further the trustees' personal interests ("Personal Counsel"). This sometimes happens in reaction to, or anticipation of, an action against trustees by, or on behalf of,

---

[4] *See* RESTATEMENT (SECOND) OF TRUSTS § 2 (1959)(stating that "a trust is a fiduciary relationship with respect to property, subjecting the person by whom the title to property is held to equitable duties to deal with the property for the benefit of [others]."); *see also* 1 AUSTIN W. SCOTT & FRATCHER, THE LAW OF TRUSTS § 2.3 (4th ed. 1987); Ronald C. Link, *Developments Regarding the Professional Responsibility of the Estate Administration Lawyer: The Effect of the Model Rules of Professional Conduct*, 26 REAL PROP. PROB. & TR. J. 1, 60 (1991)("[A] trust . . . is not generally regarded in law as a separate juristic entity."); Ziegler v. Nickel, 75 Cal. Rptr. 2d 312 (Ct. App. 1998)(holding that a trust is not an entity separate from its trustees).

[5] *See* UNIF. TRUSTEES' POWERS ACT § 3(c) (1964), 7B U.L.A. 764 (1985); HAW. REV. STAT. § 554A-3(c) (1993).

[6] *See* GEORGE G. BOGERT & GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 543 (2d rev. ed. 1991); *see also* Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928)("[T]he punctilio of an honor the most sensitive . . . is . . . the standard of behavior [of the trustee]."); Ahuna v. Department of Hawaiian Homelands, 64 Haw. 327, 340, 640 P.2d 1161, 1169 (1982).

[7] *See* BOGERT & BOGERT, *supra* note 6, § 95.

trust beneficiaries. Such lawyers may or may not be paid out of trust funds initially. The cost of a trustee's Personal Counsel in the context of a dispute involving the trust ultimately should be borne by the losing party (i.e., a trustee who initially uses personal funds to pay such a lawyer is entitled to full reimbursement upon prevailing; a trustee who initially uses trust funds to pay such a lawyer must fully reimburse the trust estate upon failing to prevail). A trustee's Personal Counsel is said to represent trustees in their "personal," "individual," or "nonrepresentative" capacity.[8]

Attorney-client privilege generally applies to communications between attorneys and their clients, including when the clients are trustees or other fiduciaries.[9] But because the privilege frustrates the search for truth, its use "must be strictly limited to the purpose for which it exists."[10] That purpose is to encourage candid communications. Trustees seeking advice from their Personal Counsel need the assurance of confidentiality provided by the privilege. In the case of trustees seeking legal advice from Trust Counsel, however, there is no need to encourage candid communications. Trustees have a duty to be fully forthcoming when discussing trust administration with such lawyers, and also when responding to beneficiaries who want information reasonably needed to hold trustees accountable.[11] In short, trustees

[8] Whether a lawyer is representing a trustee in that trustee's representative or individual capacity should be made clear by the lawyer. In the absence of an explicit agreement to the contrary, a lawyer initially paid with trust funds generally is presumed to be representing the trustee in the trustee's representative capacity. Lawyers initially paid from the trustee's own funds generally are presumed to be representing that trustee in that trustee's individual capacity. *See generally* ACTEC COMMENTARIES ON THE MODEL RULES OF PROFESSIONAL CONDUCT (3d ed. 1999) [hereinafter ACTEC COMMENTARIES].

[9] *See* HAW. R. EVID. 503

[10] DiCenzo v. Izawa, 68 Haw. 528, 535, 723 P.2d 171, 175 (1986)(quoting Dike v. Dike, 448 P.2d 490, 496 (Wash. 1968)).

[11] *See, e.g.*, United States v. Mett, 178 F.3d 1058, 1064 (9th Cir. 1999)(holding that a trustee may invoke the federal common-law attorney-client privilege against beneficiaries when the trustee "retains counsel in order to defend herself against the . . . beneficiaries," but not when the "trustee seeks an attorney's advice on a matter of [trust] administration and where the advice clearly does not implicate the trustee in any personal capacity . . . ."); Comegys v. Glassell, 839 F. Supp. 447, 449 (E.D. Tex. 1993)("[T]he Court holds that no independent attorney-client privilege exists between a trustee and its attorney to the exclusion of the beneficiaries when the alleged privileged documents relate to the administration of the trust or the trusts' res."); Martin v. Valley Nat'l Bank, 140 F.R.D. 291, 322 (S.D.N.Y. 1991)("Insofar as the trustee is consulting an attorney to assist him in providing adequate service to the trust, and hence to its beneficiaries, the trustee cannot shield those communications from the beneficiaries."); Wells Fargo Bank, N.A. v. Superior Court, 990 P.2d 591, 595 (Cal. 2000)("In most of the other jurisdictions in which this question has arisen, courts have given the trustee's reporting duties precedence over the attorney-client privilege."); Lasky, Haas, Cohler & Munter v. Superior Court, 218 Cal. Rptr. 205, 214 (Ct. App. 1985)("[D]ecisions in California and in other states, as well as commentators, have adopted the rule that the trustee's fiduciary duty of

"cannot subordinate the fiduciary obligations owed to the beneficiaries to their own private interests under the guise of attorney-client privilege."[12]

Trustees are required to avoid conflicts of interest.[13] When conflicts develop, trustees must act in the best interests of the beneficiaries.[14] If the conflict is great, trustees may be required to step aside temporarily or even permanently.[15] Should they not do so voluntarily, a court of competent jurisdiction can order them to step aside.[16] Any such decision should be based on the best interests of the beneficiaries, not the personal interests of the trustees.[17]

---

full disclosure to the trust beneficiaries extends to all contents of the trustee's file concerning trust administration matters affecting the trust interests of the beneficiaries."); *In re* Estate of Baker, 528 N.Y.S.2d 470, 473 (N.Y. Sur. Ct. 1988)("This court is of the opinion that a fiduciary has an obligation to disclose [to beneficiaries] the advice of counsel with respect to matters affecting the administration of the estate . . . ."); RESTATEMENT (SECOND) TRUSTS § 173 & cmt. b (stating that a trustee generally must furnish "complete and accurate information[,]" but the trustee is "privileged to refrain from communicating to the beneficiary opinions of counsel obtained by him at his own expense and for his own protection."); RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 134A cmt. b (Proposed Final Draft No. 1 1996)("In litigation between a trustee of an express trust and beneficiaries of the trust charging breach of the trustee's fiduciary duties, the trustee cannot invoke the attorney-client privilege to prevent beneficiaries from introducing evidence of the trustee's communications with a lawyer retained to advise the trustee in carrying out the trustee's fiduciary duties."); BOGERT & BOGERT, *supra* note 6, § 961 ("The beneficiary . . . has a right to obtain and review legal opinions given the trustee to enable the trustee to carry out the trust, except for such opinions as the trustee has obtained on his own account to protect himself against charges of misconduct."); 2A SCOTT & FRATCHER, *supra* note 4, § 173 ("A beneficiary is entitled to inspect opinions of counsel procured by the trustee to guide him in the administration of the trust"); Rust E. Reid et al., *Privilege and Confidentiality Issues When a Lawyer Represents a Fiduciary*, 30 REAL PROP. PROB. & TR. J. 541, 560 (1996)("[T]he general trend is for courts to permit, at a minimum, discovery [by beneficiaries] of attorney-client communications generated in the ordinary course of administering the trust."); Robert W. Tuttle, *The Fiduciary's Fiduciary: Legal Ethics in Fiduciary Representation*, 1994 ILL. L. REV. 889, 940 (1994)("As a number of courts have found, when counsel is employed at the trust's expense, communications between a trustee and counsel are not privileged against discovery by the trust beneficiaries.").

[12] Riggs Nat'l Bank v. Zimmer, 355 A.2d 709, 714 (Del. Ch. 1976).

[13] *See* BOGERT & BOGERT, *supra* note 6, §§ 394, 541, 543.

[14] *See id.* § 543.

[15] *See id.*

[16] *See id.* § 527

[17] *See In re* Estate of Holt, 33 Haw. 352, 355-57 (1935). The Hawai'i Supreme Court in *Holt* stated:

> A court of equity may and will remove a trustee who has been guilty of some breach of trust or violation of duty. The exercise of this function by a court of equity belongs to what is called its sound judicial discretion and is not controlled by positive rules except that the discretion must not be abused.

Id. at 357 (quoting *Gaston v. Hayden*, 73 S.W. 938, 941 (Mo. Ct. App. 1903)). In *Holt*, the court permanently removed a trustee on the basis of the master's report, for lack of stewardship

II. THE KSBE DECISIONS CRITICIZED BY PROFESSOR MCCALL

A. *The Attorney-Client Privilege Decision*

Following the publication of the "Broken Trust" essay, the five KSBE trustees individually retained separate Personal Counsel to represent their respective individual interests. Together, the five trustees unanimously agreed to retain various Trust Counsel to assist them in their capacity as trustees in dealing with the Attorney General's investigation, master's inquiry, Internal Revenue Service ("IRS" or "Service") audit, and related matters. Whereas Trust Counsel conferred with all five trustees from time to time and were paid with trust funds,[18] Personal Counsel conferred only with each one's respective

and lack of mutual confidence between trustees.

> It is evident that the relations between the trustees were not amicable and that there was a lack of mutual confidence. This should not be overlooked in determining whether the court below abused its discretion in removing [the trustee]. There is nothing in the record which reflects on his honesty or impugns his integrity. There is much, however, from which the court could reasonably have inferred that [the trustee] was not sufficiently careful and diligent in the performance of his duties to meet the requirements of good stewardship.

Id. at 362.

[18] Trust Counsel sometimes described their client(s) by naming the individual trustees or by referring collectively to "the trustees," but at other times they said they represented "KSBE," "the trust" or "the trust estate." For example, Trust Counsel William McCorriston in various pleadings claimed to be attorney for the "Estate of Bernice Pauahi Bishop, Richard S.H. Wong, Marion Mae Lokelani Lindsey, Henry Peters, Gerard Jervis and Oswald Stender," "the trustees in their capacity as trustees of KSBE," and "the Board of Trustees of the Kamehameha Schools Bernice Pauahi Bishop Estate." Memorandum in Opposition to Motion of Attorney General to Compel Obedience to Subpoena 97-83 (the Lindsey Subpoena), *Bronster v. Wong*, S.P. 97-0520, at 4, 5 (Haw. Cir. Ct., 1st Cir. Oct. 20, 1997); Defendants' Reply Memorandum in Support of Motion to Dismiss First Amended Complaint Filed January 29, 1998, Filed March 12, 1998, *Burgert v. Estate of Bishop*, Civ. No. 97-01637 HG, at cover page (D. Haw. Apr. 30, 1998); Stipulation to Stay All Trial and Discovery Proceedings, *Medeiros v. Estate of Bishop*, Civ. No. 98-00082 HG, at 1 (D. Haw. Oct. 9, 1998). In a single 1999 petition, this same attorney characterized his representation three different ways: "Attorney[] for Trustees under the Will and of the Estate of Bernice Pauahi Bishop"; and attorney for Trustees Wong, Peters, and Lindsey "acting as a majority of the Board of Trustees"; and "counsel for the Board of Trustees." Trustees' Emergency Ex Parte Petition for Stay of Order Re: IRS Audit Pending Disposition of Appeal and/or Petition for Writ of Mandamus, In re *Estate of Bishop*, Equity No. 2048, at 1 (Haw. Prob. Ct. Feb. 18, 1999); Declaration of William C. McCorriston of 2/17/99, In re *Estate of Bishop*, Equity No. 2048, at 1 (Haw. Prob. Ct. Feb. 18, 1999).

A different Trust Counsel, Robert Bruce Graham, repeatedly indicated that his clients were the five trustees and that there is no such thing as a trust entity. The following is a typical example: "[Outside Counsel] MR. GRAHAM: There is no entity as KSBE. It's a trust estate, Your Honor. I represent the trustees." Partial Transcript of Proceedings before the Honorable

individual client. Personal Counsel were paid by either their respective client or KSBE's errors and omissions insurance carrier. Two of the trustees (the minority trustees) instructed Trust Counsel to cooperate fully with the various investigations, but the other three (the majority trustees) directed Trust Counsel not to cooperate fully. From that point forward, Trust Counsel followed instructions from the majority trustees.[19] In-house attorneys for KSBE (General Counsel) also took orders from the majority trustees during this period of time.

In the context of an action by the minority trustees to remove one of the majority trustees, the minority trustees asked the trial court to disqualify Trust Counsel, arguing that these lawyers had clients (i.e., various trustees) on opposite sides of the controversy.[20] The minority trustees also asked that the majority trustees not be allowed to use attorney-client privilege to prevent Trust Counsel and General Counsel from testifying about matters relating to trust administration.[21] Professor McCall at that time argued as an expert witness against the minority trustees' attempt to disqualify Trust Counsel, and against the minority trustees' efforts to elicit testimony from Trust Counsel and General Counsel.[22] Professor McCall consistently has stressed that Trust Counsel and General Counsel had but one client, an entity known as "the

---

Bambi Weil, Judge, Presiding, on December 21, 1998, In re *Estate of Bishop*, Equity No. 2048, at 2 (Haw. Prob. Ct. Dec. 21, 1998).

[19] According to Trustee Oswald Stender, Trust Counsel sometimes ignored his requests and failed to communicate with him even though Stender considered himself a client of Trust Counsel. *See* Declaration of Oswald Kofoad Stender of 2/22/99, In re *Estate of Bishop*, Equity No. 2048, at 1-2 (Haw. Prob. Ct. Feb. 23, 1999). The existence of an attorney-client relationship generally is based on the reasonable beliefs of the client, not on the basis of what the attorney thinks. *See* Otaka, Inc. v. Klein, 71 Haw. 376, 383, 791 P.2d 713, 717 (1990); Butler v. State Bar, 721 P.2d 585, 589 (Cal. 1986); *In re* McGlothlen, 663 P.2d 1330, 1334 (Wash. 1983). The Hawai'i Supreme Court stated in *Otaka*: "Legal consultation occurs when the client believes that he is approaching an attorney in a professional capacity with a manifest intent to seek professional legal advice. Thus, the deciding factor is what the prospective client thought when he made the disclosure, not what the lawyer thought." *Otaka*, 71 Haw. at 383, 791 P.2d at 717 (internal quotation marks omitted)(quoting *Developments in the Law—Conflicts of Interest in the Legal Profession*, 94 HARV. L. REV. 1244, 1322 (1981)).

[20] *See, e.g.*, Petitioner-Defendant Oswald Kofoad Stender's Motion to Compel Respondent-Plaintiff Marion Mae Lokelani Lindsey to Produce Documents and to Appear for Her Disposition, In re *Estate of Bishop*, Equity No. 2048, at 8 (Haw. Prob. Ct. May 12, 1998).

[21] *See* Discovery Master's Order Granting Motion to Compel Deposition of Nathan Aipa, In re *Estate of Bishop*, Equity No. 2048, at 2 (Haw. Prob. Ct. Oct. 15, 1998).

[22] *See* Declaration of James R. McCall in Support of Trustees' Supplemental Memorandum in Opposition to Petition of Trustees Oswald Kofoad Stender and Gerard Aulama Jervis' Petition to Disqualify William C. McCorriston, Darolyn Lendio and the Law Firm of McCorriston Miho Miller Mukai Filed on March 4, 1999, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. March 8, 1999).

trust."[23] Two trial courts disagreed. Citing basic principles of trust law, both courts ruled that the trustees as fiduciaries were the clients.[24] Since trustees effectively were suing each other, a joint-client exception to the attorney-client privilege rule applied.[25]

B. *The Conflict of Interest Decision*

The minority trustees argued in a separate action that all five trustees had a conflict of interest in dealing with the IRS.[26] The IRS had been auditing KSBE for some years, and it generally was believed that KSBE's tax-exempt status was in jeopardy, especially if the trustees continued in office.[27] Also, the five trustees faced exposure to intermediate sanctions imposed by the Service.[28] Such action by the IRS would result in the trustees not only having

---

[23] Professor McCall's arguments are detailed in his article herein. *See* McCall, *supra* note 1, at 497-501. Attorneys of record for the Majority Trustees principally relied on two cases to support their use of the entity theory: *Greate Bay Hotel & Casino Inc. v. City of Atlantic City*, 624 A.2d 102 (N.J. 1993), and *United States v. De Lillo*, 448 F. Supp. 840 (E.D.N.Y. 1978). *See, e.g.*, Objection to Trustees Oswald Kofoad Stender and Gerald Aulama Jervis' Petition to Disqualify William C. McCorriston, Darolyn Lendio and the Law Firm of McCorriston Miho Miller Mukai, In re *Estate of Bishop*, Equity No. 2048, at 11, 12-15 (Haw. Prob. Ct. Feb. 23, 1999). The attorneys cited *Greate Bay* for the proposition that a trust may be considered an "entity" under MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.13, and *De Lillo* as "the only case truly on point." *See id.* But the trust at issue in *Greate Bay* was a "business trust," which is "not a trust in the ordinary sense of holding and conserving property but rather is a device for the conduct of a business." *Greate Bay*, 624 A.2d at 104. Indeed, that Court noted that business trusts are expressly excluded from the scope of the Restatement of the Law of Trusts. *See id.* at 105.

De Lillo concerns the criminal prosecution of the former chairman of a union pension fund. *See De Lillo*, 448 F. Supp. at 841. *DeLillo* cites absolutely no authority for its blanket statement that "there is no logical or policy reason for treating a Board of Trustees any differently than a corporation[,]" *see id.* at 842, even though such a statement flies in the face of the Restatement of the Law of Trusts. *See, e.g.*, RESTATEMENT (SECOND) OF TRUSTS, §§ 2-16 (1959)(defining trusts, and see particularly section 16A, distinguishing charitable corporations from trusts). *De Lillo* then transposes, word for word, the holding of a corporation case into the trust law context. *See De Lillo*, 448 F. Supp. at 842-43 (quoting *In Re* Grand Jury Proceedings, Detroit, Mich., Aug. 1977, 434 F. Supp. 648, 650 (E.D. Mich. 1977)).

[24] *See supra* notes 2 and 3 and accompanying text.

[25] *See* HAW. R. EVID. 503(d)(6).

[26] *See* Minute Order, *supra* note 3, at 5.

[27] *See* Order Regarding Order to Show Cause Regarding Special Purpose Trustees' Report and Order to Show Cause Regarding New CEO Based Management System, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. May 7, 1999), *available at* <http://starbulletin.com/1999/05/07/news/removal.html>.

[28] *See* Stephen G. Greene, *Trustees of Hawaii's Wealthiest Charity Make Changes to Quell Criticism*, CHRON. PHILANTHROPY, Jan. 15, 1998, at 39; Stephen G. Greene, *Bishop Estate to Pay IRS $9-Million but Retain Its Tax-Exempt Status*, CHRON. PHILANTHROPY, Dec. 16, 1999, at 32.

to pay a substantial penalty to the IRS, but also being forced to reimburse the trust estate for any "excess benefits," such as trustee compensation that might be determined by the IRS to have been unreasonably high.[29]

After reviewing 2,500 pages of relevant materials and considering the recommendation of a three-person panel, the trial judge found that the five incumbent trustees had a conflict of interest that was "actual, apparent, adverse and material."[30] He then appointed five special-purpose trustees to represent KSBE interests in the IRS audit.[31]

III. PROFESSOR MCCALL'S FLAWED ANALYSIS AND CONCLUSIONS

A. *The Attorney-Client Privilege Decision*

Professor McCall cites Rule 1.13 of the Hawai'i Rules of Professional Conduct for the proposition that attorneys retained by trustees to represent them in their fiduciary capacity really have but one client, the trust entity.[32]

---

[29] See I.R.C. § 4958 (Supp. II 1996), effective with respect to excess benefit transactions occurring on or after September 14, 1995. Prior to the enactment of section 4958 ("intermediate sanction" law), upon discovering trustee abuse at a public charitable trust, the IRS could revoke the charity's tax exempt status, or do nothing. *See* D. Alexander Ritchie, *Intermediate Sanctions: Controlling the Tax-Exempt Organization Manager*, 18 VA. TAX REV. 875, 881 (1999). The only available sanction—revocation—harmed blameless beneficiaries of the charity and not the trustees who had abused their position of trust. *See id.* at 876. The intermediate sanction law, which was passed unanimously in both the House and in the Senate, empowers the IRS to sanction insiders who have abused the trust. With this option available to it, the IRS is highly unlikely to revoke the tax-exempt status of any viable public charity, at least not so long as it has reason to believe that the abuse will not continue. *See* H.R. REP. No. 104-506, at 59 n.15 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1143, 1182 n.15.

The intermediate sanctions law empowers the IRS to assess a 25% penalty on trustees who receive an "excess benefit," such as excessive compensation. *See* I.R.C. § 4958 (Supp. II 1996). The charitable trust benefits by not losing its tax-exempt status and because any such "excess benefit" must be repaid to the trust. For example, if a trustee received compensation of $900,000 for a year when reasonable compensation to that trustee would have been only $100,000, that trustee will have to pay an intermediate sanction of $200,000 to the IRS (25% of the $800,000 excess benefit) and pay back the entire $800,000 excess benefit to the trust estate.

The KSBE trustees reportedly spent nearly $1 million of trust funds unsuccessfully fighting the enactment of intermediate sanctions law and attempting to lessen its potential impact on them. *See* Petition of the Attorney General on Behalf of Trust Beneficiaries to Remove and Surcharge Trustees, for Accounting, and for Other Equitable Relief, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Sept. 10, 1998), *available at* <http://starbulletin.com/98/09/11/news/removal.html>.

[30] Minute Order, *supra* note 3, at 6.

[31] *See id.* at 8.

[32] *See* McCall, *supra* note 1, at 498-99.

His position is that only the trust (and not individual trustees) can waive the privilege, and that such decisions are properly made by majority vote of the trustees. The rule he cites basically says that attorneys hired by agents of an organization to represent interests of the organization have but one client, the organization.[33] But neither Rule 1.13 nor its companion comments mention trusts, much less suggest that they are "organizations." As big a departure from the common law as it would be to start treating trusts as organizations rather than relationships, one would expect the question to be addressed. That it is not suggests that Professor McCall's interpretation was not intended or even anticipated when the rule was adopted.

Professor McCall then states that Rule 503 of the Hawai'i Rules of Evidence "explictly adopts the entity theory."[34] But this rule simply defines a client as "a person . . . or . . . organization or entity . . . who is rendered professional legal services by a lawyer . . . ."[35] Nowhere in the rule or companion comments is it even suggested that a trust is a person, organization or entity.

Professor McCall then quotes Hawai'i Probate Rule 42(a): "An attorney employed by a fiduciary for [a] . . . trust represents the fiduciary as client as defined in Rule 503(a) of the Hawaii Rules of Evidence and shall have all the rights, privileges, and obligations of the attorney-client relationship with the fiduciary[,]" and suggests that the word fiduciary in this context refers to a trust entity, rather than trustees.[36] A close look at the comments to Rule 42, however, demonstrates that the drafting committee used the word fiduciary to describe a natural or juridical person responsible for the administration of a trust estate, not the trust estate itself.[37]

Professor McCall also incorrectly states that commentators and modern appellate opinions "uniformly adopt" the entity theory.[38] The theory has other proponents, and at least one court has adopted it, but Professor McCall is simply wrong when he suggests it currently is the favored approach,[39] and that

---

[33] *See* HAW. RULES OF PROFESSIONAL CONDUCT Rule 1.13.

[34] McCall, *supra* note 1, at 499.

[35] HAW. R. EVID. 503(a)(1).

[36] McCall, *supra* note 1, at 499.

[37] HAW. PROB. R. 42 commentary ("The fiduciary must be conscious of the difference between personal actions and fiduciary actions. For example, an attorney could not represent a fiduciary with respect to the administration of a trust and also represent that same individual . . . [if it] would present a conflict of interest.").

[38] *See* McCall, *supra* note 1, at 498.

[39] An overwhelming majority of authorities conclude that the fiduciary is the attorney's client. *See, e.g.*, Coverdell v. Mid-South Farm Equip. Ass'n, 335 F.2d 9, 12-15 (6th Cir. 1964)(holding that a trust cannot sue or be sued, but rather, legal proceedings are properly directed at the trustee); Wells Fargo Bank, N.A. v. Superior Court, 990 P.2d 591, 595 (Cal. 2000)(noting that the "suggestion that the trustee 'is not the real client' of the attorney retained

his interpretation and application of the theory have been embraced by many others.[40] Professor McCall also is mistaken in thinking that a Hawai'i Supreme Court opinion has adopted and applied the entity theory.[41]

---

by the trustee directly contradicts California law . . . ." (citation and internal quotation marks omitted)(quoting United States v. Mett, 178 F.3d 1058, 1063 (9th Cir. 1999)); Ziegler v. Nickel, 75 Cal. Rptr. 2d 312, 314 (Ct. App. 1998)(stating that a trust "is not an entity separate from its trustees." (internal quotation marks omitted)); *In re* Estate of Gory, 570 So. 2d 1381, 1383 (Fla. Dist. Ct. App. 1990)(noting that "in Florida, the personal representative is the client rather than the estate or beneficiaries." (internal quotation marks omitted)); Wagner v. Lamme, 386 N.W.2d 448, 450 (Neb. 1986)("Attorneys represent people. There is no such position known as 'attorney of an estate.'"); Roberts v. Fearey, 986 P.2d 690, 694 & n.3 (Or. Ct. App. 1999)("[W]e hold that, when an attorney undertakes to represent a fiduciary, he or she represents only the fiduciary . . . We have found only one case holding that an attorney hired by the trustee represents the estate and not the trustee."); Thompson v. Vinson & Elkins, 859 S.W.2d 617, 623 (Tex. Ct. App. 1993)(finding "considerable authority" that an estate or trust cannot be represented, as it is "not a legal entity that can sue or be sued."); RESTATEMENT (SECOND) OF TRUSTS § 2 (1959) (stating that a trust is a "relationship"); ACTEC COMMENTARIES, *supra* note 8, at 211 ("[A] minority of cases and ethics opinions have adopted the so-called entity approach under which the fiduciary estate is characterized as the lawyer's client. However, most cases and ethics opinions treat the fiduciary as the lawyer's client . . . ."); John R. Price, *Duties of Estate Planners to Non-Clients: Identifying, Anticipating and Avoiding the Problems*, 37 S. TEX. L. REV. 1063, 1081 (1996)(noting that "a majority of the cases and ethics opinions all consider the fiduciary to be the lawyer's client—not the fiduciary estate or its beneficiaries."); Tuttle, *The Fiduciary's Fiduciary*, *supra* note 11, at 927 (observing that "[t]he entity theory represents a novel departure from the law in nearly all jurisdictions . . . ."); *but see* Steinway v. Bolden, 460 N.W.2d 306, 307 (Mich. Ct. App. 1990)(concluding that, under the Revised Probate Code of Michigan, "although the personal representative retains the attorney, the attorney's client is the estate, rather than the personal representative.").

[40] Professor Jeffrey N. Pennell, an advocate of the entity approach, has acknowledged that it has "little direct precedential support[,]" and that it was specifically rejected by an ABA Study Committee "as lacking sufficient support in the law." Jeffrey N. Pennell, *Representation Involving Fiduciary Entities: Who Is the Client*, 62 FORDHAM L. REV. 1319, 1334, 1355 (1994). Unlike Professor McCall, Professor Pennell's conception of an entity approach generally expands rather than limits the level of protection afforded trust beneficiaries.

> Under the entity approach, each trust entity acts through an "agent" . . . but the attorney ultimately is responsible to the entity and its constituents . . . rather than to the agent who hired the attorney. Moreover, the attorney is authorized to disclose otherwise confidential information to constituents of the entity [i.e., beneficiaries] on an "as needed" basis. This alternative has not been considered by many courts--probably because of the historical notion that . . . a trust has no legal existence . . . . This approach . . . is somewhat novel . . . .

Id. at 1334. "As perceived in this manner, the fiduciary who hired the attorney . . . is merely another agent of the true client (the entity) and could not, for example, dismiss the attorney in an effort to cover up any wrongdoing." *Id.* at 1336.

[41] *See* McCall, *supra* note 1, at 499-501. In *Richards v. Midkiff*, 48 Haw. 32, 40-41, 396 P.2d 49, 55 (1964), the Hawai'i Supreme Court merely adopted the universal rule "that multiple trustees can only act as a unit . . . ." Specifically, the court stated that "the determination of whether the trust estate should maintain a legal action requires the requisite concurrence of the

Though it does not go to his central point, Professor McCall's mischaracterization of another Hawai'i authority should not go unchallenged. Specifically, he asserts that "HPR Rule 42(c) provides that the attorney for a trust . . . has an independent duty to inform the probate court if the attorney *'knows'* of the commission or possible commission of a crime that could injure the trust."[42] That is his characterization of the rule. Here is the language of the rule itself:

> An attorney for an estate, guardianship, or trust is an officer of the court and shall assist the court in securing the efficient and effective management of the estate. The attorney . . . shall have an obligation to bring to the attention of the court the nonfeasance of the fiduciary.[43]

There is a world of difference between the "nonfeasance of the fiduciary," as stated in the rule, and the "commission of a crime," as the rule is described by Professor McCall. And one can only wonder why he would emphasize that the attorney must actually *know* about wrongdoing. The rule itself does not use that word. In fact, attorneys are required by Rule 42(c) "to monitor . . . and to ensure that required actions [are taken]."[44]

Professor McCall expresses concern that the trial court's decision effectively eliminates the attorney-client privilege whenever trustees sue one another, and that this will prevent effective representation of trustees: "Unless rejected, the trial court ruling will force fiduciaries to avoid any type of confidential communications with [Trust Counsel]."[45] But this ignores that individual trustees always are free to retain Personal Counsel with their own funds (and sometimes with funds from the trust estate) to watch out for their personal interests. Each of the five KSBE trustees did exactly that.[46]

Unsurprisingly, Personal Counsel were never called upon to testify about communications with their respective clients. Presumably, each individual

---

trustees, just as the exercise of any other power." *Id.* at 41, 396 P.2d at 55 (citations omitted). On March 8, 1999, the Hawai'i Supreme Court denied a writ of mandamus filed on behalf of the majority trustees following Judge Weil's ruling that Trust Counsel represented five trustees rather than one entity. *See* Order Denying Petition, In re *Estate of Bishop*, Equity No. 2048 (Haw. S. Ct. Mar. 8, 1999).

[42] McCall, *supra* note 1, at 502 (emphasis added).

[43] HAW. PROB. R. 42(c).

[44] *Id.* Perhaps Professor McCall confused Rule 42(c) with Rule 42(b), which imposes a duty on trust counsel "to notify . . . *beneficiaries* . . . of activities of the fiduciary actually known by the attorney to be illegal . . . ." *Id.* 42(b) (emphasis added).

[45] McCall, *supra* note 1, at 504.

[46] Personal Counsel were not paid directly from the trust estate. However, much of their fees were paid by KSBE's insurance carrier pursuant to a "cannibalizing" policy (amounts paid to lawyers reduced coverage protection to KSBE).

trustee was candid when conferring with his or her respective Personal Counsel.

Trust Counsel are supposed to be working for the ultimate benefit of beneficiaries, not the personal interests of trustees. The attorney-client privilege has no place in a lawsuit by beneficiaries, or by a co-trustee on behalf of beneficiaries, where the attorney in question was retained as Trust Counsel.

B. The Conflict of Interest Decision

Professor McCall claims that a judge found conflicts of interest requiring the appointment of special-purpose trustees despite "no evidence relevant" to the conflict claim.[47] The judge's order in that matter indicates otherwise.[48] Furthermore, Professor McCall neglects to mention the implications of a Hawai'i statute and rule that enables the court to appoint special-purpose trustees once a conflict has been found. Hawai'i Revised Statutes section 554A-5(b) states, "If the duty of the trustee and the trustee's individual interest . . . conflict in the exercise of a trust power, the power may be exercised only by court authorization . . . ."[49] This means that the court must get involved once a conflict of interest has been established. A panel composed of a master, General Counsel, and KSBE's long-time tax counsel, after reviewing 2,500 pages of relevant materials and conferring with senior IRS personnel, unanimously found an "actual, apparent, adverse and material" conflict, and recommended the appointment of special-purpose trustees to represent KSBE interests in the IRS audit.[50] Hawai'i Probate Rule 56(e) provides for appointment of special administrators, such as the special-purpose trustees, where a conflict of interest arises or a fiduciary cannot or should not act for any other reason.[51]

---

[47] McCall, *supra* note 1, at 504.

[48] *See* Minute Order, *supra* note 3. The Minute Order stated: "*Based on the IRS Forms 5701* . . . the Court finds . . . that actual, adverse and material conflicts of interest exist between the individual interests of Trustees of the Trust Estate . . . and the interests of the Trust Estate with respect to the claims and issues raised in the IRS Forms 5701" *Id.* at 6 (emphasis added). The court also relied on the findings and recommendations of the master.

[49] HAW. REV. STAT. § 554A-5(b) (1993).

[50] Report of the Master Pursuant to the Order Adopting Recommendation No. 18 of the Master's Consolidated Report on the 109th, 110th, and 111th Annual Accounts of the Trustees Filed on October 21, 1998, and the Order Adopting Amended Recommendation No. 22 of the Master's Second Supplemental Report on the One Hundred Ninth, One Hundred Tenth, and One Hundred Eleventh Annual Accounts of the Trustees, In re *Estate of Bishop*, Equity No. 2048, at 6 (Haw. Prob. Ct. Jan. 21, 1999).

[51] *See* HAW. PROB. R. 56(e).

There also is case-law support in Hawai'i for appointing additional trustees. In the case of *In re Estate of Ikuta*,[52] the Hawai'i Supreme Court appointed an additional trustee over the objection of the sole incumbent trustee. The Supreme Court noted that there was a conflict between the sole trustee and the beneficiaries, and held: "[W]e find that the lower court was empowered to 'appoint additional trustees, and not merely fill vacancies by appointment, when the circumstances are such that the appointment of such additional trustees would be conducive to the better administration of the trust.'"[53] It should be remembered that the special-purpose trustees were appointed to represent KSBE interests in the IRS audit at a time when the Attorney General, acting as *parens patriae*, was calling for the permanent removal of incumbent trustees who appeared to have lost the trust of many key parties, including the IRS.[54]

Professor McCall has overreacted to a fact-driven decision. According to him, this particular conflict of interest ruling means that any trustee now can be forced to the sidelines by any third party who "asserts that the trustee, acting on behalf of the trust, committed a mistake or wrongful act for which the trust or the trustee could be held liable."[55] As if this possibility is not shocking enough, he then extends it to *every* claim against a trust, whether or not a trustee is personally implicated: "[A]ny assertion of a claim against a trust by a third party would result in the limited removal of the trustees, as long as it is possible to imagine a theory on which the trustees might have

[52] 64 Haw. 236, 639 P.2d 400 (1981).

[53] *Id.* at 248, 639 P.2d at 408 (quoting RESTATEMENT (SECOND) OF TRUSTS § 108 cmt. e (1959)).

[54] *See, e.g.*, Letter from Terry Franklin, Chief, EP/EO Division Western Key District and Marcus Owens, Director, Exempt Organizations Division of the IRS, to Interim Trustee Robert K.U. Kihune, Aug. 19, 1999 (copy on file with author). This letter states:

> Due to fundamental concerns about whether the Incumbent Trustees would effectively implement any agreement that would be entered into between the Service and Kamehameha Schools Bishop Estate (KSBE), the Service required, as a precondition to entering into Closing Agreement negotiations with KSBE and as an alternative to continuing with administrative revocation procedures, that steps be taken to permanently remove the Incumbent Trustees from their positions as Trustees of KSBE. In coming to this decision, we have relied upon evidence in our administrative files that indicates that the Incumbent Trustees have a history of ignoring Probate Court Orders, Master Report recommendations, Probate Court Stipulations, and the advice of independent experts whose opinions were sought out by KSBE at great expense to KSBE, relating to activities which impact KSBE's exempt status. In addition, we have relied upon evidence that indicates the Incumbent Trustees have a history of pursuing activities which are inconsistent with furthering KSBE's exempt purpose.

Id.

[55] McCall, *supra* note 1, at 505.

ultimate liability to the trust for the claim."[56] According to Professor McCall, a trustee would be prevented from defending a lawsuit where "a trust employee allegedly operates an automobile in a negligent manner while on trust business, thereby causing an accident that injures a third party."[57]

This radical departure from current law, according to Professor McCall, is the logical consequence of the court in this KSBE case finding a conflict of interest and appointing special-purpose trustees. But, the court did not act simply because a claim of wrongdoing had been asserted. The court's decision reflected its evaluation of specific claims, including the potential impact on the interests of the trust beneficiaries. It should be remembered that the IRS was at that time contemplating the revocation of KSBE's tax-exempt status, a move that would have reduced the trust estate by $750 million, or more. It also is relevant that a master had already found dozens of serious breaches of trust,[58] and that in Hawai'i, a master's report has the weight of a jury's verdict.[59]

It is difficult to take seriously Professor McCall's statement that the interests of the trustees and the trust beneficiaries were "actually identical, rather than conflicting."[60] Perhaps he has not considered the implications of the federal intermediate sanctions law. That 1996 legislation was not mentioned in his declaration that was submitted to the court by the majority trustees, nor was it cited in his article. For example, by arguing that they had not paid themselves unreasonably high compensation, the trustees would be arguing against reimbursement to KSBE of an "excess benefit."

---

[56] *Id.* at 506.

[57] *Id.* at 506 n.98.

[58] *See* Master's Consolidated Report on the One Hundred Ninth, One Hundred Tenth, and the One Hundred Eleventh Annual Accounts of the Trustees, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Aug. 7, 1998), *available at* <http://starbulletin.com/98/08/07/news/masters2/masters2.html>.

[59] In *Monting v. Leong Kau*, 7 Haw. 486 (1888), the Hawai'i Supreme Court stated:

> The settled practice of courts of equity is to regard the report of a Master upon questions of fact referred to him as having substantially the weight of the verdict of a jury, and his conclusions are not to be set aside or modified without clear proof of error or mistake on his part.

Id. at 487; *see also In re* Estate of Baker, 34 Haw. 263, 267-68 (1937)(holding that a master's report on questions of fact will not be set aside or modified absent clear proof of error).

[60] McCall, *supra* note 1, at 508.

IV. A BETTER WAY TO FRAME THE ISSUES

A. The Conflict Decision

Trustees should not automatically be removed simply because someone has accused them of wrongdoing. When, however, the stakes are high and trustees have a serious conflict of interest, a court of competent jurisdiction should do whatever it determines to be in the best interests of the trust and trust beneficiaries. In short, a judgment call must be made.

Trustees with a conflict of interest are not legally entitled to continue to act on behalf of the trust without regard to the nature of the claim or the seriousness of the conflict. Common sense alone suggests that some conflicts are simply too great. For example, if a trust is owed money by a trustee who recently put his assets in his spouse's name, should that trustee be the one to decide on behalf of the trust whether to accuse himself of a fraudulent transfer? This extreme example of a conflict simply points out that a line has to be drawn somewhere, by someone. The judge is the best person in such cases to draw the line, and the judge in the KSBE situation made what appears to be a reasonable decision, especially in light of the three-person panel's findings and recommendation. Even if Hawai'i did not have a statute explicitly calling for court involvement once a conflict of interest has been determined, and a rule authorizing the appointment of special purpose trustees, the court would have been justified in responding as it did to the minority trustees' petition. In fact, this particular court had the power and responsibility to remove the trustees permanently on the basis of the master's report or conflict among the trustees, and to take such action *sua sponte*.[61]

B. The Privilege Decision

Trust Counsel in the KSBE controversy were determined by two separate trial court judges to have multiple clients (the five trustees), rather than a single client (the trust entity).[62] As a result, the joint-client exception to the applicable attorney-client privilege rule prevented three of the joint clients from using the privilege to withhold attorney-client communications from the other two joint clients of those attorneys. If the judges instead had adopted Professor McCall's entity approach, the three-trustee majority would have been able to assert the privilege. In Professor McCall's words, this is because the trust entity "must be directed by the majority of the Board [of trustees]."[63]

---

[61] *See In re* Estate of Holt, 33 Haw. 352, 355-57 (1935).

[62] *See supra* notes 2 and 3 and accompanying text.

[63] McCall, *supra* note 1, at 498.

Under this thinking, the trust entity remains constant as individual trustees come and go and the makeup of the controlling majority changes. This suggests that no trustee, not even one who currently is part of the controlling majority of a multi-trusteed trust, can safely rely on the privilege being available when it is "needed."

If a trustee wants to know that the privilege will be his or hers individually to assert, that trustee must retain Personal Counsel, not Trust Counsel. If a trustee uses personal funds and clearly documents that the representation is to be of the trustee in the trustee's individual capacity, and if the attorney is not involved in the administration of the trust, then the privilege clearly will be available. If one or more of these factors is missing, there will be some degree of doubt. In such cases, trustees should give serious thought to petitioning the court for instructions.

What this suggests is that any debate about the trust as a relationship or an entity misses the main point. When a lawyer is hired by a trustee, the important question is "what role is this lawyer playing?"[64] If the lawyer is to be paid out of trust funds, that suggests (but does not finally determine) that

---

[64] ACTEC COMMENTARIES, *supra* note 8, at 55-56. The Commentaries provide:

> *Representation of Fiduciary in Representative Not Individual Capacity.* If a lawyer is retained to represent a fiduciary generally with respect to the fiduciary estate, the lawyer represents the fiduciary in a representative and not an individual capacity—the ultimate objective of which is to administer the fiduciary estate for the benefit of the beneficiaries. Giving recognition to the representative capacity in which the lawyer represents the fiduciary is appropriate because in such cases the lawyer is retained to perform services that benefit the fiduciary estate and, derivatively, the beneficiaries—not to perform services that benefit the fiduciary individually. The nature of the relationship is also suggested by the fact that the fiduciary and the lawyer for the fiduciary are both compensated from the fiduciary estate. . . .
>
> *General and Individual Representation Distinguished.* A lawyer represents the fiduciary generally (i.e., in a representative capacity) when the lawyer is retained to advise the fiduciary regarding the administration of the fiduciary estate or matters affecting the estate. On the other hand, a lawyer represents a fiduciary individually when the lawyer is retained for the limited purpose of advancing the interests of the fiduciary and not necessarily the interests of the fiduciary estate or the persons beneficially interested in the estate. For example, a lawyer represents a fiduciary individually when the lawyer, who may or may not have previously represented the fiduciary generally with respect to the fiduciary estate, is retained to negotiate with the beneficiaries regarding the compensation of the fiduciary or to defend the fiduciary against charges or threatened charges of maladministration of the fiduciary estate.

Id.; *see also* Hoopes v. Carota, 531 N.Y.S.2d 407, 410 (N.Y. App. Div. 1988), *aff'd*, 543 N.E. 2d 73 (N.Y. 1989). The court distinguished representation in the trustee's representative capacity from representation in his individual capacity and stated that disclosure might not have been required had the trustee established "that he solicited advice from counsel solely in an individual capacity and at his own expense, as a defensive measure regarding potential litigation over his disputes with the trust beneficiaries." *Id.* at 410 (citations omitted).

the lawyer will be involved in the administration of the trust and therefore is representing the trustee in the trustee's representative capacity. If the lawyer is paid out of the trustee's personal funds, that suggests (but does not finally determine) that the lawyer will be watching out for the personal interests of the trustee, not involved in the administration of the trust, and is therefore representing the trustee in the trustee's individual capacity. Lawyers should not accept an assignment from a trustee without first making sure that all key parties understand the nature of the relationship and the implications. In some cases, this will include notification to the beneficiaries. Such relationships do not need to be of the "one-size-fits-all" variety. So, for example, if the lawyer and the trustees want to create a relationship more or less patterned after a corporate or entity model, that clearly can be done.

The traditional treatment of a trust as a relationship rather than an entity can lead to some hair-pulling situations in the case of a multi-trusteed, wheeling and dealing trust like KSBE. For example, any one trustee effectively can disqualify or waive the attorney-client privilege with respect to Trust Counsel, even when the majority disagrees. That can be chaotic. But rather than contend that the law of corporations applies to trusts, or even to argue that it should apply (i.e., that the entity approach should be embraced), lawyers and commentators should recognize that traditional trust law and typical codes of ethics make possible the crafting of customized relationships that fit perfectly the parties' needs and expectations. This fact and its implications is stated beautifully by Professor John Price in the Reporter's Note to the ACTEC Commentaries:

> *Anticipating and Avoiding Conflicts.* This edition . . . continues to emphasize the advantages to clients and lawyers of anticipating and attempting to avoid potential problems . . . . Estate planners not infrequently encounter difficult problems of professional responsibility, particularly ones involving confidentiality and conflicts of interest. Serious problems can often be reduced or eliminated by advance discussion and planning. In particular, in many instances uncertainties regarding the lawyer's duty of confidentiality can be eliminated with sufficient advance planning and consent. Disclosure and agreement may also allow the same lawyer to represent the interests of multiple parties who have somewhat conflicting interests, but not clients whose interests are seriously adverse, such as adverse parties in litigation.[65]

V. CONCLUSION

In the following "Comment on Professor Roth's Reply," Professor McCall states that positions expressed in this Reply are based on two premises: (1)

---

[65] ACTEC COMMENTARIES, *supra* note 8, at 7-8.

"that trustees do not need and should not enjoy the benefits of the attorney-client privilege," and (2) "that a court may properly announce and rely upon any ground" to remove an allegedly unfit trustee.[66] This is misleading. As stated herein, trustees do sometimes need the protection of, and may properly rely upon, the attorney-client privilege. The point made and emphasized herein, is that trustees in such situations should retain Personal Counsel, not Trust Counsel.[67] This Reply is equally clear that no trustee ever should be removed simply on the basis of an allegation of wrongdoing.[68]

In addition to distinguishing positions actually taken from ones alleged to have been taken, readers might consider the roles played by many lawyers and jurists in the KSBE controversy. For example, the now-former KSBE trustees were selected by state supreme court justices, seemingly on the basis of politics rather than merit. That is troubling. The selection of justices themselves seems to have been inextricably intertwined with the selection of trustees,[69] and justices who picked trustees regularly decided cases in which those same trustees were parties.[70] That it took so many years even to *begin* to hold wayward trustees accountable suggests something less-than-complimentary about Hawai'i's probate judges and attorneys general, especially when one realizes that many of the most egregious breaches of trust had been public knowledge for years. That justices of the Hawai'i Supreme Court could seemingly ignore judicial ethics and their own fiduciary duties for so long, and then avoid completely any measure of accountability, also makes

---

[66] James R. McCall, *Comment on Professor Roth's Reply*, 21 U. HAW. L. REV. 531 (1999).

[67] *See supra* note 46 and accompanying text.

[68] *See supra* p. 525.

[69] Members of Hawai'i's Judicial Selection Commission are appointed by the President of the Senate, Speaker of the House, Chief Justice of the Hawai'i Supreme Court, and the Governor. Recent appointments to the KSBE Board of Trustees include a President of the Senate, Speaker of the House, Chief Justice of the Hawai'i Supreme Court, and a Governor's closest advisor (who also happened to be a chairman of the Judicial Selection Commission just prior to his KSBE appointment). *See* Samuel King, Msgr. Charles Kekumano, Walter Heen, Gladys Brandt & Randall Roth, *Broken Trust*, HONOLULU STAR-BULLETIN, Aug. 9, 1997, at B-1, reprinted in Appendix C to this issue of the *University of Hawai'i Law Review*. Another former chairman of the Commission admitted to having asked candidates for the supreme court how they might go about appointing a KSBE trustee if a vacancy were to occur while they were a sitting justice. *See id.* The law firm of that former chairman, incidentally, received more than $15 million in legal fees from KSBE over the years following his service on the Commission. The law firm of the former Governor who appointed all five of the current justices also received millions in legal fees. *See id.*

[70] *See* Hazel Beh, *Why the Justices Should Stop Appointing Bishop Estate Trustees*, 21 U. HAW. L. REV. 659, 661 (1999). KSBE trustees have been parties in litigation in front of the supreme court on the average of nearly once per year. Eventually, the justices agreed to stop deciding cases involving the trustees they selected. *See* Ian Lind & Harold Morse, *5 Justices Step Aside in Estate Inquiry*, HONOLULU STAR-BULLETIN, Mar. 12, 1998, at A-1.

one wonder about Hawai'i's political milieu and its impact on the state system of justice.

In short, readers might appropriately wonder how the situation could get so bad, and go on for so long, despite a theoretically sound system of accountability.

Comment on Professor Roth's Reply

James R. McCall*

In his Reply[1] to the criticisms of the probate court rulings I sought to make in my Article,[2] Professor Roth argues from two premises. Neither premise is mentioned in the probate court rulings, nor does either premise have any logical connection with those rulings. In my opinion, both premises are invalid, and, with due respect to Professor Roth and appreciation for his efforts, I believe the points in my Article stand unrefuted.

Professor Roth's first premise is that trustees do not need and should not enjoy the benefits of the attorney-client privilege.[3] The second premise of the Roth Reply is that removal of allegedly unfit trustees from supervising extremely important activities of a trust is so crucial that a court may properly announce and rely upon any ground for such removal.[4]

Premise #1: *"Trustees should not be allowed to invoke the attorney-client privilege."*

Professor Roth states:

> Trustees seeking advice from their Personal Counsel need the assurance of confidentiality provided by the [attorney-client] privilege. In the case of trustees seeking legal advice from Trust Counsel, however, there is no need to encourage candid communications.[5]

Of course, the law of Hawai'i, and every other American jurisdiction, recognizes that a trustee is generally entitled to the protection of the attorney-

---

* Professor of Law, University of California-Hastings College of Law, San Francisco, California; A.B., Pomona College, 1958; J.D., Harvard Law School, 1962.

1 Randall W. Roth, *Understanding the Attorney-Client and Trustee-Beneficiary Relationships in the Kamehameha Schools Bishop Estate Litigation: A Reply to Professor McCall*, 21 U. HAW. L. REV. 511 (1999).

2 James R. McCall, *Endangering Individual Autonomy in Choice of Lawyers and Trustees —Misconceived Conflict of Interest Claims in the Kamehameha Schools Bishop Estate Litigation*, 21 U. HAW. L. REV. 487 (1999).

3 Thus, Professor Roth concludes I am in error in arguing that the probate court erred in holding that KSBE could not invoke the attorney-client privilege. It should be recalled that the probate court ruled as it did on the privilege elimination claim solely because it determined that each individual member of the KSBE Board of Trustees ("Board") was a separate client of the Board attorney, and that a dispute between several individual Board members now existed.

4 This premise, according to Professor Roth, invalidates my argument that the probate court erred in holding that the old Board had a conflict of interest in supervising the KSBE response to IRS claims that past tax law judgments of the Board were incorrect and could eventually subject Board members to personal liability.

5 *See* Roth, *supra* note 1, at 513.

client privilege when communicating with the attorney for the trust about the trust's legal concerns.[6] Without the privilege, it would be impossible for a trustee to direct litigation or receive legal counsel on trust matters under the trustee's supervision. Although Professor Roth vehemently denies it in his Reply, the universally accepted theoretical basis for applying the attorney-client privilege to these communications is the "entity theory."[7]

Claiming that the trial court correctly eliminated the trust attorney-trustee attorney-client privilege, Professor Roth alternatively argues for less than a total negation of the privilege:

> The attorney-client privilege has no place in a lawsuit by beneficiaries, or by a co-trustee on behalf of beneficiaries, where the attorney in question was retained as Trust Counsel.[8]

The concept that the attorney-client privilege should not be available to a trustee in a breach of trust action brought by a beneficiary is a tenable proposition.[9] However, the concept is immaterial to consideration of the probate court's ruling on the privilege elimination claim for three reasons. First, the privilege elimination claim was made in an action brought to remove a trustee for alleged unfitness, not to establish a breach of trust. Second, the action was brought by two trustees who disagreed with decisions made by a

---

[6] RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 134A cmt. a (Proposed Final Draft No. 1, 1996).

[7] *Id.* and § 123 cmt. c. Directly on point is Formal Opinion 380, issued by the American Bar Association's Committee on Ethics and Professional Responsibility. *See* ABA Comm. on Ethics and Professional Responsibility, Formal Op. 380 (1994). As pointed out in my Article, the Hawai'i Supreme Court explicitly adopted the entity theory in opinions dealing with KSBE. *See* McCall, *supra* note 2, at 499, 501.

The point is truly beyond controversy. However, Professor Roth devotes a lengthy footnote to refute his mischaracterization of my point that the entity theory is the guiding concept for attorneys representing organizations. *See* Roth, *supra* note 1, at 519 n.39. His authorities are either misleadingly selective or flatly miscited.

These are not the only miscited or flatly incorrect statements in the Reply. Professor Roth states that I "argued . . . against the minority trustees' attempt to disqualify Trust Counsel" in the trustee removal action. Roth, *supra* note 1, at 516. I made no argument of any type in that proceeding, and Professor Roth is flatly in error on the point. Rather than tediously refute a number of such errors on the Professor's part, I will rest with the general observation that in legal argumentation, mistakes can occur.

[8] Roth, *supra* note 1, at 522.

[9] Section 134A of the Restatement (Third) of the Law Governing Lawyers sets out the proposition that the attorney-client privilege should not shield communications between the trustee and the trust attorney concerning the trust's legal affairs when a beneficiary alleges a breach of trust in a suit against the trustee. *See* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 134A (Proposed Final Draft No. 1 1996). Professor Roth expands the concept, as he must, to apply to suits brought by co-trustees. The Restatement section is clear in limiting the concept to suits brought only by beneficiaries.

majority of the Board, not by a beneficiary of the trust. Third, the probate court did not mention the concept in its ruling and was prohibited from considering it by Hawai'i Rule of Evidence ("HRE") 501.[10] That rule prohibits the courts of Hawai'i from altering the privileges contained in the HRE.[11]

The well-known prohibition of HRE 501 means that policy arguments for either eliminating the trustee-trust attorney privilege or creating a new exception to the privilege in breach of trust actions brought by a beneficiary are immaterial to any discussion of the probate court ruling. Unfortunately, Professor Roth never informs the reader that it was, and is, legally impossible for any court in Hawai'i to adopt his views. He does inform the reader in a form of magical incantation that: "A trust is a relationship between trustees and beneficiaries, not a separate entity."[12] The proposition is incontestable, but it is completely beside the point that an organization, which happens to be a trustee, must enjoy the benefits of the attorney-client privilege to function in a complex economy.[13]

Premise #2: *"Disqualification of allegedly unfit trustees from supervising extremely important trust matters is a crucial goal that justifies judicial reliance on any ground for removal."*

The only ground on which the probate court disqualified the old Board from supervising KSBE's response to the IRS claims was that it had a conflict of interest with the beneficiaries of the trust. The conflict claim grew out of the IRS's allegation that the old Board had authorized excessive compensation to itself and other KSBE officials and employees.[14] In his Reply, Professor Roth

[10] *See* HAW. R. EVID. 501

[11] The drafters of HRE 501 expressly intended that the Rule to have the same effect as California Evidence Code section 911, which prohibits California courts from adding to, or altering the scope of, the privileges established in the California Evidence Code. *See* HAW. R. EVID. 501 commentary. In *Wells Fargo Bank, N.A. v. Superior Court*, 990 P.2d 591 (Cal. 2000), the California Supreme Court held that California Evidence Code section 911 precluded California courts from altering the attorney-client privilege contained in California Evidence Code section 954 by adopting the exception applicable to beneficiaries suing a trustee for breach of trust, which Professor Roth proposes.

[12] Roth, *supra* note 1, at 512.

[13] At page 512, Professor Roth illustrates his "a trust is a relationship" concept and, apparently, its relevance to the argument, as follows:

> To illustrate: $6 billion of trust corpus, including stock in Goldman Sachs and approximately 370,000 acres of land in Hawai'i, is not owned by KSBE . . . it is KSBE.

Roth, *supra* note, at 512. The statement is beyond my powers of comprehension and, in my view, is a classic example of obscure formalistic argumentation.

[14] See my discussion of the probate court's Minute Order in the text accompanying notes

never identifies the conflict of interest the members of the old Board allegedly had. He simply states that a "serious conflict" existed,[15] but it is axiomatic that if it is impossible to explain the nature of an alleged conflict of interest, there is no conflict.

The only proposition Professor Roth could have had in mind is that public allegations of the trustees' unfitness somehow produced a conflict of interest between the trustees and the trust beneficiaries.[16] He certainly mentions no other possibility, and the proposition is clearly implicit in numerous passages in his Reply:

> It is also relevant that a master had already had found dozens of serious breaches of trust[17] . . . . In fact, this particular court had the power and responsibility to remove the trustees permanently on the basis of the master's report . . . .[18] Trustees should not automatically be removed simply because someone has accused them of wrongdoing. When, however, the stakes are high and trustees have a serious conflict of interest, a court of competent jurisdiction should do whatever it determines to be in the best interests of the trust and trust beneficiaries.[19]

Elementary notions of fairness in the administration of laws require that courts truthfully set out the reasons for their rulings, and I have no doubt that the probate court did just that. In my opinion, the court was seriously mistaken, but I have no doubt it was not simply acting upon what appears to be Professor Roth's "just get rid of allegedly unfit trustees" concept. If there was a case to be made that the old Board was unfit, *that* case should have been presented to the court. Instead of requiring proof of such a case, however, the court was unfortunately persuaded to adopt an incorrect, extremely vague, and highly mischievous concept of "conflict of interest."

---

93 and 94 of my Article. In my Article, I argued that no conflict of interest exists between a trustee and a beneficiary simply because a third party alleges that the trust acted unlawfully and it is possible to conceive of facts under which the trustee is personally liable to the trust for the consequences of the unlawful act. *See* McCall, *supra* note 2, at 505-06. I pointed out that such a conflict of interest theory would eliminate the ability of a trustee to supervise the defense of the trustee to most, if not all, liability claims. *See id.* It is possible to conceive of a trustee's ultimate personal liability for virtually any unlawful conduct since a trustee is liable to the trust for any unlawful or negligent conduct on the trustee's part that injures the trust.

[15] The phrase, never defined, specified, or explained in any way, appears at Roth, *supra* note 1, at 525.

[16] Professor Roth also states that a special panel had reviewed various documents and concluded that the old Board had "an 'apparent, adverse and material' conflict [of interest.]" Roth, *supra* note 1, at 522. However, neither Professor Roth nor his quotations from the special panel's report identify what the conflict of interest actually was.

[17] *Id.* at 524.

[18] *Id.* at 525.

[19] *Id.*

CONCLUSION

My aim in writing my Article was to stimulate debate over the probate court rulings and, eventually, rejection of the concepts they embrace. I wish to thank the editors of the *University of Hawai'i Law Review* for giving me the chance to voice my thoughts, and to thank Professor Roth for expressing his views in the type of debate I had in mind.

A Taxing Time for the Bishop Estate: What Is the I.R.S. Role in Charity Governance?

Evelyn Brody*

"IRS Is Threatening to Revoke Status of Hawaii Estate if Trustees Don't Quit," blared the headline in the *Wall Street Journal*.[1] I could not believe this brinkmanship by the Internal Revenue Service against the 115-year-old, $6 billion Kamehameha Schools Bishop Estate ("KSBE"). I felt like a witness to the collision between the Irresistible Force and the Immovable Object.

A week later it was essentially over, a higher authority having intervened to prevent catastrophe. On May 7, 1999, probate court judge Kevin Chang accepted the interim resignation of trustee Oswald Stender and ordered the temporary removal of the four other trustees.[2] Judge Chang found credible the IRS's "non-negotiable" threat that unless all five trustees resigned or were removed, the Service[3] would move to revoke the exemption of the Estate. In place of these "Incumbent Trustees," Judge Chang installed the existing five

---

* Associate Professor of Law, Chicago-Kent College of Law; B.A., Yale College, 1976; J.D., Georgetown University Law Center, 1981. This work was supported by the Marshall D. Ewell Research Fund at the Chicago-Kent College of Law. Randall Roth, while he disagrees with some of my conclusions, was unstinting in his willingness to discuss this case with me, and to keep me apprised of the developing facts. I appreciate comments on earlier drafts from Professor Roth, John Colombo, Marion Fremont-Smith, Jack Siegel, Al Slivinski, and participants at the 28th Annual Conference of the Association for Research on Nonprofit Organizations and Voluntary Associations (Washington, D.C., Nov. 6, 1999), and the careful eye of editor Elijah Yip. Although I served as an attorney/advisor in the Office of Tax Policy at the U.S. Treasury Department from 1988-1992, my tenure preceded the development of the intermediate sanctions legislation discussed in this Article, and I have no personal knowledge of Bishop Estate matters; all opinions expressed are mine alone. I regret that as one century-old Hawaiian institution emerges from crisis strengthened and renewed, the equally venerable newspaper *Honolulu Star-Bulletin* announced its shutdown, and remains functioning only as the result of litigation; the *Star-Bulletin*'s coverage of the Bishop Estate kept pressure on the investigation, and I could not have written this piece without the documents and news stories maintained in the paper's online database.

1 Lee Gomes, *IRS Is Threatening to Revoke Status of Hawaii Estate if Trustees Don't Quit*, WALL ST. J., Apr. 30, 1999, at A16.

2 *See* Order Regarding Order to Show Cause Regarding Special Purpose Trustees' Report and Order to Show Cause Regarding New CEO Based Management System, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. May 7, 1999), *available at* <http://starbulletin.com/1999/05/07/news/removal.html> [hereinafter Removal Order].

3 Throughout this Article, I use the abbreviations "IRS" and "Service" interchangeably.

"Special Purpose Trustees" to act as "Interim Trustees."[4] Judge Chang had previously appointed these individuals to deal with the IRS on KSBE's tax issues, having found that the highly-compensated regular trustees faced insurmountable conflicts of interest due to their own potential tax exposure.[5]

Judge Chang's decisive act is all the more startling in the context of complex and expensive legal wrangling that seemed to be going in circles. Just the day before, another probate court judge *permanently* removed trustee Lokelani Lindsey, upon suit filed December 29, 1997, by co-trustees Oswald Stender and Gerard Jervis.[6] On September 9, 1998, the Hawai'i Attorney General sued for the temporary removal of all five trustees (although she later excluded trustee Stender from her suit[7]), charging that they jeopardized the tax-exempt status of the trust; on September 10, 1998, the Hawai'i Attorney General sued for the permanent removal of trustees Richard Wong, Henry Peters, and Lindsey, charging that they took part in a pattern of self-dealing and mismanagement; on November 25, 1998, Peters was indicted for theft in

---

[4] The five Interim Trustees are Robert Kihune, David Paul Coon, Francis Keala, Constance Lau, and Robert Libkuman. *See* Rick Daysog, *Interim Trustees Make Big Changes*, HONOLULU STAR-BULLETIN, July 9, 1999, at A-1.

[5] Order Granting Trustees Stender and Jervis' Petition for Approval of Voluntary Recusal With Respect to Pending Tax Audit and For Appointment of a Panel of Special Administrators With Respect to Pending Tax Audit Filed January 21, 1999 (filed Feb. 26, 1999), described in Removal Order, *supra* note 2.

Not only was it unprecedented (to my knowledge) for a judge to appoint special-purpose trustees to handle the tax issues while leaving the regular trustees in place, but also one can only speculate about how this arrangement might have played out. What does it mean to have one set of trustees for the "real" issues and another set for the tax issues? Are we to assume not only that the special-purpose trustees kept the regular trustees in the dark about the IRS proceeding, but also that the regular trustees kept the special-purpose trustees in the dark about ongoing KSBE matters? What if these KSBE matters—like investment decisions and compensation issues—could give rise to fresh violations of tax requirements? *See generally* Special Purpose Trustees' Report, Apr. 27, 1999 (describing the Special Purpose Trustees' belief that they lack the authority to meet IRS demands to: (1) remove the incumbent trustees; (2) control or determine the method for selecting new trustees; (3) limit the compensation paid to the trustees in the 1999 fiscal year; and (4) prevent the removal of assets from KSBE and subsidiaries beyond the supervision of the court and the IRS). *Cf.* Rick Daysog, *Judge Orders Bishop Estate: Don't Pay Trustees Until I Say*, HONOLULU STAR-BULLETIN, Apr. 30, 1999, at A-1 (reporting that Judge Chang, after learning that each trustee received more than $1 million in the year ending June 1998 and another $862,000 for the first 10 months of the Estate's 1999 fiscal year, ordered the trustees not to take compensation from the Estate or its for-profit subsidiaries until a hearing has been held).

[6] *See* Rick Daysog, *Trustee Lindsey Removed*, HONOLULU STAR-BULLETIN, May 6, 1999, *available at* <http://starbulletin.com/1999/05/06/news/story1.html>.

[7] *See* Rick Daysog, *Bronster Wants Trustees Out, Except Stender*, HONOLULU STAR-BULLETIN, Nov. 14, 1998, at A-1.

a charged kickback deal involving the Estate; and on April 12, 1999, Wong was indicted for theft, perjury and conspiracy.[8] Finally, just 10 days before Judge Chang's temporary removal of the Incumbent Trustees, the Hawai'i Senate refused to reconfirm Margery Bronster to a second term as attorney general, a vote viewed as motivated at least in part by her role in the Bishop Estate investigation.[9]

Events unfolded relatively briskly following the May 1999 temporary removal of the Incumbent Trustees. One by one, all five unconditionally resigned—the final three in December, on the eve of their trial for permanent removal.[10] On December 1, 1999, Judge Chang approved a Closing Agreement, dated August 24, 1999, entered into by the IRS and the Interim Trustees on behalf of KSBE.[11] This Closing Agreement, which again called for the permanent removal of the Incumbent Trustees, also required, among other items: the reorganization of KSBE around a chief executive officer to carry out the policy decisions of the Board of Trustees; the adoption of an investment policy and a spending policy focused on education; adoption of a conflicts-of-interest policy and adherence to the Probate Court's directive for setting Trustee compensation; a ban on hiring any governmental employee or official until three years after termination of governmental service (or earlier Probate Court approval); the Internet posting of the final Closing Agreement and of KSBE financial statements for the next five years; and a $9 million

---

[8] For a timeline through May 6, 1999, see Appendix A to this issue of the *University of Hawai'i Law Review*. Both Wong's and Peter's indictment were quashed, without prejudice to the prosecution, because of tainted testimony. *See* Rick Daysog, *Judge Throws out Wong Grand Jury Indictments*, HONOLULU STAR-BULLETIN, June 16, 1999, at A-1; Rick Daysog, *State Lets Bishop Trustee Wong and Wife off the Hook for Now*, HONOLULU STAR-BULLETIN, June 30, 1999, at A-3; Rick Daysog, *Judge: Peters Didn't Get a Fair Hearing*, HONOLULU STAR-BULLETIN, July 2, 1999, at A-1. Peters was re-indicted on Aug. 4, 1999. *See* Rick Daysog, *Peters, Stone Indicted Again by Grand Jury*, HONOLULU STAR-BULLETIN, Aug. 5, 1999, at A-8. A judge dismissed this indictment without prejudice in December 1999, and a ruling is expected by February 7, 2000, on Peters' motion to bar the attorney general from seeking reindictment. *See Decision Nears on Motion to Drop Case Against Peters*, HONOLULU STAR-BULLETIN, Jan. 19, 2000, at A-2. On December 10, 1999, Wong was indicted for perjury. Rick Daysog, *Grand Jury Indicts Wong for Perjury*, HONOLULU STAR-BULLETIN, Dec. 10, 1999, at A-1.

[9] *See* Rick Daysog, *Trustees Deny Influence on Senate*, HONOLULU STAR-BULLETIN, Apr. 29, 1999, at A-1.

[10] *See* Leila Fujimori, *Critics See Hope Ahead as Last Trustee Falls*, HONOLULU STAR-BULLETIN, Dec. 17, 1999, at A-4.

[11] The text of Judge Chang's December 1, 1999 "Order Approving Petition for Approval of Settlement of IRS Audit Issues" [hereinafter Order Approving Settlement] is available in LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 238-60, *Hawaiian Court Approves IRS Settlement with Educational Trust* (Dec. 13, 1999).

payment (plus interest).[12] However, the deal does not extend to KSBE's taxable subsidiaries, from which the IRS is reportedly seeking $46 million.[13] Moreover, the Closing Agreement does not cover any personal tax liability of the trustees.[14] As a separate matter, the Attorney General also seeks fines and surcharges from the former trustees for imprudent management and self-dealing; a trial on these issues is scheduled to begin in September 2000.[15]

The Bishop Estate saga arose under a unique set of facts and law practically designed to create fiduciary conflicts of interest.[16] As detailed below, in 1884 Bernice Pauahi Bishop, a descendent of King Kamehameha, devised her vast landed estate to establish a school for Hawaiian children. Her Will directed that successor trustees be named by the individual justices of the Hawai'i Supreme Court. The governor of Hawai'i appoints the justices.[17] Inevitably, the appointment of trustees to Kamehameha Schools Bishop Estate became a political payoff. What made service so desirable? As Hawai'i law developed

---

[12] See Rick Daysog, *Proposed Estate Deal: Pay IRS $9 Million-Plus*, HONOLULU STAR-BULLETIN, Aug. 23, 1999, at A-1. The IRS initially sought $65 million. *See* Stephen G. Greene, *Bishop Estate to Pay IRS $9-Million but Retain Its Tax-Exempt Status*, CHRON. PHILANTHROPY, Dec. 16, 1999, at 32. The Proposed Closing Agreement, dated August 18, 1999, was filed as Appendix II to the Petition for Removal of Trustees Marion Mae Lokelani Lindsey, Henry Haalilio Peters and Richard Sung Hong Wong, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Aug. 24, 1999), and is posted on KSBE's website at <http://www.ksbe.edu/news&info/filings/final.pdf> [hereinafter Closing Agreement].

[13] This $46 million expected settlement amount is less than a third of the $165 million tax bill originally feared—and negotiations could bring the amount down even further. *See* Rick Daysog, *Estate's Tax Bill Shrinks to $46 Million*, HONOLULU STAR-BULLETIN, Feb. 8, 2000, at A-1. *Cf.* Stephen G. Greene, *Kamehameha Schools Faces $165-Million Tax Bill*, CHRON. PHILANTHROPY, Jan. 13, 2000, at 50; Rick Daysog, *Bishop Board Focusing on Education Programs, Investments*, HONOLULU STAR-BULLETIN, Dec. 21, 1999, at A-2.

[14] *See* Closing Agreement, *supra* note 12, at 9 (regarding trustees), 29 (regarding non-exempt affiliates).

[15] See Rick Daysog, *'End of the line'*, HONOLULU STAR-BULLETIN, Dec. 17, 1999, at A-1 ("[Deputy Attorney General] Morris said the state will continue to press its surcharge claims against [the] trustees for causing tens of millions of dollars of damage to the estate. Trial is scheduled for next September.")

[16] *See* Edward Halbach, *Foreword*, 21 U. HAW. L. REV. i (1999); James R. McCall, *Endangering Individual Autonomy in Choice of Lawyers and Trustees—Misconceived Conflict of Interest Claims in the Kamehameha Schools Bishop Estate Litigation*, 21 U. HAW. L. REV. 487 (1999); Randall W. Roth, *Understanding the Attorney-Client and Trustee-Beneficiary Relationships in the Kamehameha Schools Bishop Estate Litigation: A Reply to Professor McCall*, 21 U. HAW. L. REV. 511 (1999); James R. McCall, *Comment on Professor Roth's Reply*, 21 U. HAW. L. REV. 531 (1999). *See generally* Samuel King, Msgr. Charles Kekumano, Walter Heen, Gladys Brandt & Randall Roth, *Broken Trust*, HONOLULU STAR-BULLETIN, Aug. 9, 1997, at B-1 [hereinafter *Broken Trust*], reprinted in Appendix C to this issue.

[17] *See Broken Trust*, *supra* note 16.

in the twentieth century, charity trustees became entitled to fees based on charity income. Moreover, huge jumps in renewal rates on long-term land leases prompted legislative reform; forced to sell residential leasehold lands,[18] KSBE wound up with an estimated $2 billion to reinvest.[19] In the last few years, annual fees for the five Trustees approached and then exceeded $1 million—each.[20] Finally, the Trustees never adopted a corporate-style governance structure to provide management checks and balances; the Trustees retained all administrative authority (not to mention the compensation) rather than create separate officers and limiting their own role to policy matters. By all accounts, the Incumbent Trustees (or at least the majority) were an absolute disaster for KSBE. By contrast, the reforms already instituted by the Interim Trustees,[21] and new court procedures for selecting replacement trustees,[22] promise a happy ending to this long, sad story.

The permanent resignation of the Incumbent Trustees removed the IRS's precondition to entering into the Closing Agreement. Thus, we will never reach an adjudication of the IRS's authority to condition KSBE's tax exemption on replacing the board of trustees. The issue of the extent of federal power, though, is critical to the administration of the charitable sector. Accordingly, I am inspired by this century-old charity—established by a Hawaiian princess and comprising "a feudal empire so vast that it could never be assembled in the modern world"[23]—to invent the court opinions that *might have* been written. What if events had taken an unlikely turn? What if the Incumbent Trustees had refused to resign and the Hawai'i courts delayed in

---

[18] *See infra* note 52.

[19] *See infra* note 55 and accompanying text.

[20] *See* Daysog, *supra* note 5.

[21] *See, e.g.*, Daysog, *Bishop Board to Focus on Education, Investments*, *supra* note 13 (describing new board's plan to restore outreach programs and open a new 300-acre, K-12 campus on the Big Island; adopt a more diversified and stable investment policy; and name a new chief executive officer); *see also* Kamehameha Schools, *Spending and Investment Policy* (Jan. 20, 2000), *available at* <www.ksbe.edu/news&info/spend_invest/index.htm>.

[22] Ken Kobayashi, *Seven-Member Committee Named to Select Trustees*, HONOLULU ADVERTISER, Jan. 7, 2000, at A-1 (describing order of Judge Chang naming an 8-member committee to nominate future trustees for selection by a probate judge, but recognizing that the Hawai'i Supreme Court could resume its practice of naming trustees if it wishes to). The court is considering a recommendation that pay for trustees be capped at $97,000 each ($120,000 for the chair). *See* Rick Daysog, *'There's Still a Lot of Work to Do' in Overhaul of Bishop Estate*, HONOLULU STAR-BULLETIN, Dec. 17, 1999, at A-4.

[23] Todd S. Purdum, *Hawaiians Angrily Turn on a Fabled Empire*, N.Y. TIMES, Oct. 14, 1997, at A1.

ruling on the removal motion, thus prompting the unappeased IRS to made good on its threat to revoke the Estate's federal tax exemption?

According to the Closing Agreement between the IRS and KSBE, KSBE faced possible loss of exemption on two grounds:[24] "private inurement" of charitable assets to the benefit of charity insiders, and operation of KSBE for a private, as opposed to public, purpose.[25] The fictitious opinions set out below consider the high pay enjoyed by the Incumbent Trustees, and whether this results in enough private inurement to threaten the Estate's exemption. I include here the allegation that the Trustees managed KSBE's assets and income in a way that minimized education expenditures and increased the base that determines the Trustees' fees.[26] Separately, my opinions also consider whether for federal tax purposes KSBE fails to conduct a charitable program "commensurate in scope" with its financial resources, so that revocation of exemption is appropriate.[27]

---

[24] The document also describes "a pattern of campaign intervention throughout the years examined by the IRS involving both Federal and state candidates for public office, including incumbents. . . ." Closing Agreement, *supra* note 12, at 3. As described in the first concurring opinion below, Internal Revenue Code section 501(c)(3) conditions charity exemption on abstinence from electioneering, but the IRS appears to administer this absolute requirement by applying a de minimis standard. The $9 million payment called for by the Closing Agreement "includes an excise tax under IRC Section 4955 for political intervention during the taxable years 1992 through 1996." *Id.* at 27.

[25] *See* Letter from Miller & Chevalier to KSBE Interim Trustees, "Assessment of Risks of Litigating Revocation Issues," attached as an Exhibit to Petition for Approval of Settlement of IRS Audit Issues (Aug. 24, 1999) [hereinafter Miller & Chevalier Letter], at 4 (describing the draft IRS Notice of Proposed Adjustment labeled "Primary Purpose" as charging that "the educational purpose of the Estate was 'relegated to a position of relative unimportance in the overall operation of the Estate and to a position of relative unimportance to the Trustees.'"). Specifically, the IRS charges that the Incumbent Trustees' "'time, efforts, energy, and financial resources' were 'disproportionately devoted to' investments and commercial activities," and "that the Incumbent Trustees failed to spend enough on education programs: although asset values and revenues increased substantially over the audit period, expenses for 'school operating costs' did not grow 'proportionately,' and the school operated on a 'zero growth budget.'" *Id.*

[26] Perhaps unfairly to the IRS's case, I largely ignore additional private inurement arising from the self-dealing and other financial benefits from the complex web of KSBE intercompany transactions. While the draft IRS Forms 5701, Notices of Proposed Adjustment, are not public documents, Appendix B to the Miller & Chevalier Letter, *supra* note 25, summarizes some of the specific allegations of private inurement, such as KSBE payment of personal expenses and contracts between KSBE and associates and family members of trustees. Sad to say, but the dollar amounts of these transactions, while significant, pale beside the size of the commissions the trustees took. However, these other transactions do lend color to the IRS's assertion of pervasive self-dealing.

[27] In addition, several of the Incumbent Trustees charged that the Service was seriously considering challenging KSBE's admission policy favoring native Hawaiians. *See, e.g.*, Rick Daysog, *Peters: IRS Looks at School Policy*, HONOLULU STAR-BULLETIN, Jan. 29, 1999, at A-1;

While the resolution is close, my fictitious majority opinion rejects both charges, and upholds the Estate's federal tax exemption—at least at this stage in the process. Let me make clear that I would not have disagreed with a Probate Court decision to oust any Incumbent Trustees that refused to resign—assuming the judge's decision is made on the individual merits—and to adopt other reforms in KSBE's governance and management structure. Indeed, I believe that Congress generally intended that investigations of charity fiduciary behavior be a state, not a federal, case. I am skeptical of the Service's statutory authority to demand, during the pendency of vigorous state proceedings, that the Incumbent Trustees resign as a quid-pro-quo for not revoking exemption. Moreover, I question the wisdom of doing so.

As a statutory matter, the Service lacks plenary equity powers over charity fiduciaries. As a practical matter, however, revocation of exemption was never the IRS's only weapon. This very case illustrates how the agency has used the *threat* of the ultimate sanction of revocation to exact specific management changes in the course of negotiating "closing agreements" that ensure future compliance—changes including reduced compensation, repayment of amounts improperly obtained or expended, and the adoption of a compensation committee structure or other governance changes. But when the IRS demands that charity trustees or directors resign before negotiating a closing agreement, and the fiduciaries refuse, fiduciary recalcitrance can be ascribed to either of two opposite motives. On the one hand, the fiduciaries might not care about the tax fate of the organization—and if they have been looting the assets in the first place, why should threatened revocation cause

---

see generally Bob Jones Univ. v. United States, 461 U.S. 574 (1983)(upholding the IRS's interpretation of the term "charitable" in Internal Revenue Code section 501(c)(3) as prohibiting tax-exempt private schools from discriminating on the basis of race, a practice which violates fundamental public policy). In the spring of 1999, however, the IRS reaffirmed its 1975 ruling that the Kamehameha Schools' admissions policy is not impermissible race-based. Tech. Adv. Memo. (unnumbered and undated, but referencing a conference date of Feb. 4, 1999), filed as Exhibit B to Kamehameha Schools Bishop Estate, Supplemental Appendix to Form 1023, Reaffirmation Submission (Aug. 18, 1999)(finding that, while all students have some quantum of Hawaiian ancestry, many races are represented; moreover, there appear to be federal and state public policies favoring a preference for native Hawaiians); *cf.* Gen. Couns. Mem. 36,363 (1975)(stating, evidently concerning KSBE, that: "technically these facts illustrate discrimination on the basis of national origin" rather than on the basis of race, and suggesting as a possible alternative basis for its ruling the argument that affirmative actions plans might be consistent with anti-discrimination policy). *See generally* Jon M. Van Dyke, *The Kamehameha Schools/Bishop Estate and the Constitution*, 17 U. HAW. L. REV. 413 (1995). However, the 1999 TAM, *supra*, concludes with a suggestion that KSBE consider filing a new private letter ruling request after the Supreme Court issues its opinion in *Rice v. Cayetano*, argued on October 6, 1999.

a change of heart? Alternatively, the fiduciaries might care very much about the organization, and genuinely believe that their continued service is in the best interests of the charity and its beneficiaries. The IRS evidently believed that the first description applied to KSBE, and Judge Chang, aware of the other state court proceedings, evidently agreed with this interpretation. But then if the state court process worked here, why should the IRS not be content to let these proceedings take their course?[28] After all, a state process will still be required to appoint new fiduciaries, if the charity is to be saved. Moreover, by staying its hand, the IRS avoids imposing requirements inconsistent with later state-ordered reforms.[29]

Most important, since 1996 revocation has not even been the IRS's only statutory weapon. That year Congress finally granted the Service "intermediate sanctions" authority to sue charity insiders in cases of private inurement. By requiring that wrongdoers repay "excess benefits" to the charity, new Internal Revenue Code ("Code") section 4958 allows the Service to punish the responsible individuals without necessarily jeopardizing the exemption of the charity. Thus, the federal regime converges with the state law aim of making the charity whole in cases of insider financial benefit.

---

[28] The Interim Trustees' Petition for Removal of Trustees Marion Mae Lokelani Lindsey, Henry Haalilio Peters and Richard Sung Hong Wong, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Aug. 24, 1999) [hereinafter Petition for Removal of Trustees], suggests the potential for IRS bootstrapping by citing trustees' obligations under state law not to deprive the trust of an available tax exemption: "By their refusal to resign, the Remaining Incumbent Trustees have created a significant risk to the Trust Estate's tax exempt status, have breached their duties to their beneficiaries, have violated H.R.S. § 554A-3, and should be permanently removed." *Id.* at 23, *available at* <http://www.ksbe.edu/news&info/filings/removal.pdf>. The Foreword to the Interim Trustees' newly-adopted detailed Governance Policy declares that "if for any reason a Trustee cannot fulfill or has violated his/her fiduciary duties and obligations, he or she, without hesitation, must voluntarily and loyally resign as a Trustee." Kamehameha Schools Bernice Pauahi Bishop Estate, *Governance Policy* (Aug. 18, 1999), *available at* <http://www.ksbe.edu/news&info/filings/govern_doc.pdf>. KSBE's exemption-application supplemental filing, dated August 18, 1999, enumerates 28 grounds for removal of a trustee for cause under state law. *See* Kamehameha Schools Bishop Estate, Supplemental Appendix to Form 1023, Reaffirmation Submission (Aug. 18, 1999), *available at* <http://www.ksbe.edu/news&info/filings/FinalReaffirmDoc.pdf> [hereinafter Exemption-Application Supplemental Filing].

[29] Notably, in describing the benefits of an exempt organization's waiving confidentially protections and thereby permitting the IRS to cooperate with a State investigation, IRS Exempt Organizations Director Marcus Owens stated: "That enables the IRS and state attorneys general to make sure that both regulatory agencies, which have virtually congruent interests, are satisfied that the changes made are appropriate and that you're not going to have 15 changes coming down from the IRS conflicting with directives from the state attorney general." Fred Stokeld, at al., *With Changes Afoot, EO Reps Get the Latest from IRS, Treasury*, 85 TAX NOTES 1136, 1137 (Nov. 29, 1999).

Indeed, the Service long petitioned Congress for such an intermediate remedy precisely to avoid compounding the harm to the innocent beneficiaries of charity. Significantly, the legislative history to this new Code section 4958 declares Congress's intent that intermediate sanctions should be the *only* remedy where the continued operations of the charity are not inconsistent with tax exemption.[30] Assuming further and imminent significant reform of KSBE's management and operations, I have trouble seeing a court upholding the revocation of KSBE's exemption, given that it is operating a genuine charitable program.

No intermediate sanctions laws, unfortunately, apply to fiduciaries of "public charities" who breach duties other than of financial loyalty. Thus, for such inadequacies of governance as running an indifferent charitable program, accumulating excess income, or paying undue attention to investment returns, the IRS is as helpless (or powerful) now as it was before new Code section 4958. By contrast, for those charities designated as "private foundations," Congress in 1969 adopted a panoply of intermediate sanctions. As an educational institution, KSBE automatically qualifies as a public charity, although its enormous endowment would otherwise cause it to be classified as a private foundation. Paradoxically, then, the only statutory remedy available to the IRS for KSBE mismanagement not involving private inurement remains revocation of exemption. Hawai'i's recent statutory limit of "reasonableness" on charity trustee fees has removed any personal incentive for trustees to accumulate KSBE income for investment, and courts generally refrain from micro-managing charities. Accordingly, I do not see revocation as an appropriate sanction for perceived deficiencies in KSBE's investment and spending activities.

In the sound administration of nonprofit governance, the Internal Revenue Service is an important and helpful player. My institutional concern being for the Service, I cannot believe that an IRS that usurps state law is good for either the IRS, the states, or the charitable sector. Worse, few charities, small or large, can afford such a high-stakes gamble by challenging the IRS over their very claims to exemption: Until the case is resolved in court, donations could dry up, tax-exempt bond covenants could be breached, and local governments might challenge property-tax exemption. Yet should the issue addressed in this Article never reach the courts, the IRS might increasingly

---

[30] *See* H.R. REP. No. 104-506, at 59 n.15 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1143, 1182 n.15.

threaten to pull charities' exemptions, a heavy-handed approach besmirching the Service's bona fides in the administration of exempt-organization cases.

Better would be for Congress to permit the IRS to share investigative information with the State attorneys general for their own investigations, as recommended by a January 2000 study by the staff of the Joint Committee on Taxation.[31] Under current law, the states may share information with the IRS, but the IRS may inform nontax state regulators only of the denial or revocation of tax-exempt status.[32] Worse, it does not appear that the IRS could inform state authorities when it imposes intermediate sanctions on charity insiders (because this would not be a final determination with respect to the organization);[33] this might put pressure on the IRS also to revoke

---

[31] JOINT COMM. ON TAX'N, STUDY OF PRESENT-LAW TAXPAYER CONFIDENTIALITY AND DISCLOSURE PROVISIONS AS REQUIRED BY SECTION 3802 OF THE INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998, VOLUME II: STUDY OF DISCLOSURE PROVISIONS RELATING TO TAX-EXEMPT ORGANIZATIONS 101-05 (JCS-1-00, Jan. 28, 2000), *available at* <http://www.house.gov/jct/s-1-00vol2.pdf>. Specifically—

> The Joint Committee staff recommends that the IRS should be permitted to disclose to Attorneys General and other nontax State officials or agencies audit and examination information concerning tax-exempt organizations with respect to whom the State officials have jurisdiction and have made a specific referral of such organization to the IRS prior to a final determination with respect to the denial or revocation of tax exemption. In addition, the Joint Committee staff recommends that the IRS should be permitted to share audit and examination information concerning tax-exempt organizations with nontax State officials and agencies with jurisdiction over the activities of such organizations and who regularly share information with the IRS when the IRS determines that such disclosure may facilitate the resolution of cases.

Id. at 101. The report concludes: "In order to ensure that the information provided to State officials is used for appropriate purposes, the Joint Committee staff recommends that additional information provided to such officials should be subject to the confidentiality and nondisclosure restrictions applicable to State officials under section 6103." *Id.* at 105. The initial public reaction to this proposal has been favorable, although other aspects of the Joint Committee's report are proving controversial (notably its recommendation regarding closing agreements, discussed in note 119, below). *See, e.g.*, Carolyn Wright & Fred Stokeld, *EO Practitioners, Former Officials React to JCT Disclosure Study*, 86 TAX NOTES 744 (Feb. 7, 2000).

[32] *See* Treas. Reg. § 301.6104(c)-1.

[33] The Treasury Regulations, which predate the enactment of section 4958, contemplate either the revocation of the organization's exemption or a penalty tax imposed on the organization itself. *See* Treas. Reg. § 301.6104(c)-1(c).

exemption just so that the state may become informed.[34] Accordingly, the study observes:

> because a final determination by the IRS concerning the denial or revocation of tax-exempt status may not be made for a number of years, a tax-exempt organization may have exhausted its assets through illicit transactions or disposed of its assets or changed its operations in a way which can no longer be corrected by the time the IRS is permitted to provide notice to the appropriate State officials.[35]

Appearing on a recent panel discussing the relationship between state charity regulators and the IRS, former Hawai'i attorney general Bronster eloquently described her frustration at not knowing whether she was duplicating the efforts of the IRS in her Bishop Estate investigation; her belief that the Incumbent Trustees were providing conflicting information to her office and to the IRS; and her desire to obtain documents being denied her by the Incumbent Trustees (who initially claimed confidentiality under the tax laws!).[36]

The development of nonprofit law will be as much affected by what happens to the Incumbent Trustees as by what happens to the Bishop Estate. Regrettably, because of lack of publicly available facts, my opinions below do not include the individual trustees and their likely significant tax problems. I do believe, though, that the most likely outcome of the IRS investigation will be intermediate sanctions imposed on the Incumbent Trustees. If the IRS cannot prove that the Incumbent Trustees' compensation was "unreasonable," it is hard to conceive of a situation in which this new regime would apply. However, because of the relatively recent effective date of this statute, its uncertain scope, and the potentially enormous sums involved, a settlement will

---

[34] The Joint Committee on Taxation's disclosure study quotes a 1975 comment by then-IRS Assistant Commissioner (EP/EO) Alvin D. Lurie:

> Either we can determine not to revoke the exemption, thereby presumably being unable to inform the state attorney general about a situation calling for his action; or, in some cases no less unacceptably, we can compound an already difficult situation by revoking the exemption and imposing ordinary income taxes against the charitable assets, and giving notice of this action to the state attorney general.

JOINT COMM. ON TAX'N, *supra* note 31, at 103.

[35] *Id.* at 103 (citing James B. Lyon, *The Supervision of Charities in the United States by the State Attorneys General (and Other State Agencies) and the Internal Revenue Service*, N.Y.U. 24TH CONF. ON TAX PLANNING FOR 501(C)(3) ORGANIZATIONS, § 5.04 (1996)).

[36] *See Author's Notes of the January 21, 2000 ABA Exempt Organizations Committee Meeting* (forthcoming April 2000) [hereinafter *EO Committee Meeting*] (panel on "When the Left Hand is Required to Leave the Right Hand in the Dark: The Monodirectional Interface Between IRS Auditors and State Attorneys General," with panelists Margery S. Bronster, former Hawai'i attorney general; Richard Allen, former Massachusetts attorney general; and Marcus Owens, director of IRS Exempt Organizations Division).

be probably be reached. (I confess to some surprise at the willingness of the Incumbent Trustees to resign without a simultaneous determination of their potential state and well as federal personal exposure: Evidently they calculated that they were demonstrating sufficient good faith to forestall maximum financial sanctions.)

Let me now introduce the fictitious court opinions that follow. Readers will immediately notice unusual stylistic features. First, while the "facts" are based to the extent possible on court-filed documents that have been made public, I also rely on news stories. (I apologize to those privy to the actual facts for any unintentional inaccuracies.) Second, because I write for a general audience, I explain and footnote somewhat more than would an actual judge (but, for convenience, I number the notes sequentially). On the other hand, I adopt three major, and unrealistic, simplifications: A real adjudication of this case would cover the KSBE affiliates included in the audit; revocation would likely be retroactive to the beginning of the audit (1992); and decision would be entered only after a (lengthy) trial.[37] Finally, because the legal issue is so close, I chose to bring this declaratory judgment action in the United States Tax Court, where the trial judge's opinion could be reviewed by the full court, and I supply two concurrences and one dissent. However, not daring to predict anyone's views, I invent my own Tax Court judges.[38]

---

[37] First, the Closing Agreement, *supra* note 12, includes the tax-exempt Kamehameha Activities Association, both on its own and as successor to Pauahi Holdings Corporation, Inc. *See id.* at 1. Second, the Closing Agreement describes the draft IRS Forms 5701, Notice of Proposed Adjustments, issued on January 4, 1999 to KSBE as proposing to revoke exemption retroactive to July 1, 1989. *See id.* at 3. The Miller & Chevalier Letter, *supra* note 25, quantifies the substantial cost of retroactive loss of exemption: "We understand that the anticipated size of the tax payment could be in excess of $500 million (excluding interest) for the Estate's 1992 to 1998 tax years. . . ." *Id.* at 17. Third, this letter concludes: "It is our view that the Service's proposed revocation would raise material issues of fact that would be disputed by the parties[, and so] a lengthy trial would be required" in which "[t]he burden of proof would be on KSBE to introduce credible factual evidence establishing that it is entitled to retain its section 501(c)(3) status." *Id.* at 18.

[38] Among other stylistic deviations, I commonly refer to the parties as Kamehameha Schools/Bishop Estate ("KSBE") and the Internal Revenue Service ("IRS" or "Service") rather than exclusively as "petitioner" and "respondent." Incidentally, in a move to shed some of the bad associations the public makes with the name "Bishop Estate," the Interim Trustees adopted a resolution, effective January 1, 2000, to shorten the name of the institution to "Kamehameha Schools." Communications will include the following acknowledgement: "Founded and Endowed by the Legacy of Princess Bernice Pauahi Bishop." *See* <www.ksbe.edu/news&info/announcements/name_change.pdf>.

BERNICE PAUAHI BISHOP ESTATE AND TRUST,
Petitioner

v.

INTERNAL REVENUE SERVICE,
Respondent

Tax Court Docket No. 1234-2000 X
Filed Dec. 1, 2000

GIRARD, J.

OPINION

This case is before us on petitioner's motion for summary judgment pursuant to Rule 121.[39] Petitioner initiated this action following a decision of respondent to revoke its tax-exempt status. Petitioner seeks a declaratory judgment under section 7428[40] that it continues to qualify as an organization described in section 501(c)(3) which is exempt from tax under section 501(a) and that it continues to qualify as an organization described in section 170(c)(2). The parties have stipulated to all relevant facts. In this case of first impression, we must decide how, if at all, new section 4958, enacted in 1996, affects the prohibition under section 501(c)(3) against private inurement. We are also asked to determine whether the petitioner should lose its exemption on the ground that it fails to carry on a charitable program commensurate in scope with its financial resources. Upon consideration of the motion, the Court concludes that the petitioner has established that there are no material facts in dispute and that it is entitled to judgment as a matter of law.

I. Factual Background

A. *History of KSBE Operations*

Petitioner, the Bernice Pauahi Bishop Estate and Trust, is a charitable trust whose legal address is 567 South King Street, Suite 310, Honolulu, Hawaii, 96813.

[39] Unless otherwise indicated, all Rule references are to the Tax Court Rules of Practice and Procedure.

[40] Unless otherwise indicated, all section references are to sections of the Internal Revenue Code of 1954, as amended, or the Internal Revenue Code of 1986, as amended, depending on the time period referred to.

Princess Bernice Pauahi Bishop ("Princess Pauahi") was a great-granddaughter and last direct descendant of King Kamehameha I, who unified the Hawaiian islands. Having married New York banker and businessman Charles Bishop against her family's wishes, and having turned down the chance to be queen, the childless Princess Pauahi died testate in 1884.[41] Her landed estate comprised over 375,000 acres (worth approximately $300,000 and producing income of about $30,000 annually) and $18,000 cash.[42] Princess Pauahi left the bulk of her estate for the construction and maintenance of two schools, one for boys and one for girls. (The schools were subsequently combined, and the Estate and schools are often referred to in combination as "Kamehameha Schools Bishop Estate," or simply "KSBE," a term we will use when appropriate.) Over the years, having graduated leaders in all fields of endeavor, KSBE became a "major player on the economic stage of Hawai'i," with "so dominating a presence that critics ascribe to it whatever economic ills may be afflicting the State at any given point in time."[43]

Paragraph 13 of Princess Pauahi's Will directs, in relevant part:[44]

> I give, devise and bequeath all of the rest, residue and remainder of my estate... to hold upon the following trusts, namely: to erect and maintain in the Hawaiian Islands . . . the Kamehameha Schools. . . . I direct my trustees to invest the remainder of my estate in such manner as they may think best, and to expend the annual income in the maintenance of said schools; . . . and to devote a portion of each year's income to the support and education of orphans, and others in indigent circumstances, giving the preference to Hawaiians of pure or part aboriginal blood; the proportion in which said annual income is to be divided among the various objects above mentioned to be determined solely by my said trustees they to have full discretion. . . . For the purposes aforesaid I grant unto my said trustees full power to lease or sell any portion of my real estate, and to reinvest the proceeds and the balance of my estate in real estate, or in such other manner as to my said trustees may seem best. . . .

The Will further directs that the individual justices of the Hawaii high court are to name KSBE's successor trustees. This arrangement continued until December 1997, when four of the five justices of the Hawaii Supreme Court announced in a joint statement that "continuing to exercise the powers of appointments granted by the Princess will further promote a climate of distrust and cynicism and, more particularly, will undermine the trust that people must have in the judiciary"; in January 2000, the probate court assumed the power to name new trustees, subject to the authority of the Supreme Court to reclaim

---

[41] *See* Purdum, *supra* note 23.

[42] *See* "The Will of Pauahi and the Will of Her People," Part One: Historical Perspective (1997, 1998), *available at* <http://www.napua. com/html/bonding_part_one.htm>.

[43] *Id.* at <http://www.napua.com/html/bonding_part_one.htm> ("The Legacy").

[44] The Will and Codicil 1 are reprinted in Appendix B of this issue.

it.[45] Furthermore, in recent years the Trustees employed a "lead trustee" system of governance, under which each of the five retained primary responsibility for a specified area of KSBE operations; the Trustees did not even begin to adopt a corporate-style separate executive structure until ordered to do so by the probate court in 1999.[46]

KSBE was a fairly simple organization for its first eight decades. Then the recent land reform described below forced KSBE to sell some of its residential leasehold lands. Because of how the Trustees decided to reinvest the enormous amount of cash generated by these sales, KSBE became much more complicated, in terms of both investment strategy and operations.[47]

KSBE's property—both charitable and investment—is estimated to be worth about $6 billion.[48] The Kamehameha Schools facility is located on a 600-acre campus, and elementary schools at four other locations are either operating or planned.[49] In recent years, KSBE has reported total revenue in

---

[45] Stephen G. Greene, *Trustees of Hawaii's Wealthiest Charity Make Changes to Quell Criticism*, CHRON. PHILANTHROPY, Jan. 15, 1998, at 39. Unfortunately, this leaves the fifth justice apparently in control of appointments. Subject to the justices reclaiming their authority to name Bishop Estate trustees, under a procedure announced by Judge Chang, new trustees will be selected by the probate court from a slate chosen by a committee he appointed in January 2000. *See* Kobayashi, *supra* note 22.

[46] *See* Removal Order, *supra* note 2 (citing, in his temporary removal order, the Incumbent Trustees' failure to obey Judge Chang's earlier order to appoint a chief executive); Daysog, *supra* note 4 (reporting that the Interim Trustees have appointed general counsel Nathan Aipa as KSBE's acting chief operating officer as "part of a larger shift toward a single-voice management system headed by a chief executive officer").

[47] *See* Arthur Andersen LLP, Management Audit Findings, Executive Summary (1998), prepared under the authorization and direction of the Special Master (and agreed to by KSBE) [hereinafter Andersen Report], Executive Summary, *available at* <http://www.napua.com/html/arthurexec.htm>.

[48] *See* Rick Daysog, *Kamehameha's Revenues Surge*, HONOLULU STAR-BULLETIN, Feb. 9, 2000, at A-1 (summarizing audited financial statements recently filed in probate court). *Cf.* Petition of the Attorney General on Behalf of Trust Beneficiaries to Remove and Surcharge Trustees, for Accounting, and for Other Equitable Relief, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Sept. 10, 1998) [hereinafter Petition for Removal and Surcharge], *available at* <http://starbulletin.com/98/09/11/news/removal.html> (Count 5, "The Trustees Have Mismanaged the Trust Assets," second paragraph)(estimating a value as high as $10 billion).

[49] These data come from KSBE's website at <http://www.ksbe.edu/campus/schools.html>. Kamehameha Schools educate 3,200 elementary and high school students. *See* Greene, *supra* note 45, at 39. In 1998, KSBE received a grant of over $1 million from the U.S. Department of Education under the Native Hawaiian Higher Education Program "to continue its eight year administration of various programs and build on its established record of success and innovation program design." Senator Dan Inouye, "Inouye Announces $2,695,229 in United States Department of Education Grants for Native Hawaiian Higher Education Programs," Cong. Press Release, Apr. 29, 1998, available in LEXIS, News Library. *See also* Daysog, *supra* note 4 ("Last month, the new board agreed to install a parent-infant education program, establish new

excess of expenses of almost $187 million (out of revenue of $304 million) in fiscal year 1994, $120 million (out of revenue of $258 million) in fiscal year 1995, and $66 million (out of revenue of $203 million) in fiscal year 1996.[50]

Since Princess Pauahi's Will admonishes the trustees to sell the land only as a last resort, significant portions of KSBE's land were held for long-term lease.[51] In 1967, after years of debate, the Hawaii legislature was finally spurred by the prospect of surging renewal rates to enact reform that eventually forced KSBE to offer its residential land for sale to homeowner/ lessees.[52] For the next 17 years, the Estate challenged the constitutionality of this legislation, up through the U.S. Supreme Court, and continues to contest the prices at which it must sell, believing that "forcing a private landowner to sell property only to deliver it into the hands of another private homeowner amounts to theft, as does using government law as a tool to force lower prices."[53] KSBE obtained numerous rulings from the Internal Revenue

---

partnerships with the state Department of Education and add preschool programs for 3-year-old children to the current programs for 4-year-olds.").

[50] Andersen Report, *supra* note 47, at 273.

[51] Will of Princess Pauahi, *supra* note 44, at Codicil 1, para. 17 ("I further direct that my said trustees shall not sell any real estate, cattle ranches, or other property, but to continue and manage the same, unless in their opinion a sale may be necessary for the establishment or maintenance of said schools, or for the best interest of my estate."). Hawaiian land took on a particular significance in the context of its dispossession. *See* GEORGE COOPER & GAVAN DAWS, LAND AND POWER IN HAWAII 413 (1985). "Particularly in Bishop's case, where the trust was perpetual and the beneficiaries were native Hawaiians who over the years had lost so much land, trustees could reasonably believe the estate ought to preserve its lands intact." *Id.* *Cf.* MATSUO TAKABUKI, AN UNLIKELY REVOLUTIONARY 213 (1998)(Appendix D, "Bishop Estate Today—The Rest of You Tomorrow," July 17, 1984, Rotary Club of Honolulu):

> Had Lunalilo [Estate] directed its trustees, as Princess Pauahi Bishop did, to retain the land and sell it only as necessary to run the home for the aged, the Lunalilo Trust today would rival the Bishop Estate in its net asset value, and it would be able to assist many more than the approximately fifty elderly Hawaiians who now live in Lunalilo Home.

[52] *See* Hawaii Housing Auth. v. Midkiff, 467 U.S. 229 (1984)(upholding Hawaii's Land Reform Act of 1967 as constitutional on public use grounds); *see also* Richardson v. City and County of Honolulu, 124 F.3d 1150 (9th Cir. 1997), *cert. denied sub nom.* City and County of Honolulu v. Small Landowners, 119 S. Ct. 168 (1998); Hawaiian Leaseholders Equity Coalition v. Small Landowners, 119 S. Ct. 544 (1998)(upholding the Honolulu City Council's "lease-to-fee" ordinance challenged by the Bishop Estate and other landowners, but striking a rent control ordinance); COOPER & DAWS, *supra* note 51, at 422 ("It was mostly the lessees' reaction to Bishop's renegotiated rents in the early to mid-1970s that led to the additional legislation in 1975 that finally brought about sales."). Meanwhile, no statutory reform of commercial property occurred.

[53] The Estate's Lands, <http://www.ksbe.edu/estate/lands/lands.html> (updated Aug. 9, 1999)("Government Condemnation"). KSBE asserts that it lost $2 billion in these mandatory conversions. *Id.* Given the contrast between the identities of the KSBE beneficiaries and its lessees, one authoritative treatment of Hawaiian land politics scorns the notion of this so-called Maryland legislation as "land reform":

Service that these sales activities would neither jeopardize its tax exemption nor result in unrelated business income tax ("UBIT").[54]

The Estate then faced the dilemma of what to do with the estimated $2 billion generated by these sales.[55] KSBE invested in 300,000 acres of Michigan timberland; a bank in China; a majority interest in the Southern California Federal Savings and Loan Association; several golf courses; and

---

> What could in, say, 1960, have reasonably been called "land reform" through application of a Maryland-type law, redistributing land away from the more fortunate to the less, had by the 1980s come in a way to look like the opposite—a fairly prosperous group securing for itself by leasehold conversion a useful economic benefit, and over the objections of the representatives of a socially deprived and oppressed group.

COOPER & DAWS, *supra* note 51, at 412-13.

[54] *See* Anderson Report, *supra* note 47, at 273. From 1939 through March 1997, the Estate has received over 50 rulings from the IRS, most involving proposed real estate transactions. *Id.* *See, e.g.*, Priv. Ltr. Rul. 93-40-061 (July 16, 1993). While the identity of a taxpayer requesting a private letter ruling and other specific facts are redacted, the ensuing description of the applicant and of the litigation over state and local land laws suggests that the requesting taxpayer is KSBE. IRS General Counsel Memorandum 36,130 involves the land development activities of an unidentified Estate, "a perpetual trust created in *** [which] operates the *** Schools in ***[.] The Estate also owns and actively manages over 300 million acres of land, from which substantial rental income is derived." Gen. Couns. Mem. 36,130 (Jan. 6, 1975)("Facts"). (Assuming that the word "million" should be "thousand," the ruling appears to relate to the Bishop Estate; *see In re* Bishop Estate, 36 Haw. 403, 427 (1943)("The assets of Bernice P. Bishop Estate consist largely of real estate comprising an area of more than 378,000 acres.").) For a description of KSBE's residential property development, leasing, and sales from a federal income tax perspective, see TAKABUKI, *supra* note 51, at 102-05.

More intriguingly, former trustee Matsuo Takabuki claims credit (in alliance with Duke University) for a change to the Internal Revenue Code permitting educational institutions for the right (already granted to pension plans) to invest in leveraged real estate without triggering the tax on debt-financed investments. *Id.* at 105-10; *see* I.R.C. § 514(c)(9) (as amended in 1984). Takabuki declares:

> With the use of debt, the Estate could develop and redevelop its land for commercial, industrial, and residential use and it could leverage real property investment purchases. Understandably, then, the Bishop Estate led the effort among educational institutions to pass this amendment to the tax code in Congress. . . . This debt-financing amendment became an economic prop for the future development and expansion of the Estate's real estate holdings.

TAKABUKI, *supra* note 51, at 105-06. Takabuki explains how this law change enables KSBE to earn tax-free arbitrage profits because of its ability to borrow at low rates due to its excellent credit rating. *See id.* at 108.

[55] *See* Martin Kasindorf, *In Hawaii, a Loss of Trust in Once-Sacred Estate*, USA TODAY, Nov. 12, 1997, at 5A. *See also* John H. Taylor, *Hawaii's Royal Legacy*, FORBES, Dec. 21, 1992, at 177: "The trustees lost [the litigation against the state's land reform law]—but the timing was terrific. By the time the estate was forced to sell, property values in Hawaii had multiplied severalfold."

methane gas ventures.[56] As former trustee Matsuo Takabuki, responsible for much of this redeployment of assets, recalls:

> We diversified our investments in reinsurance, hospitals, managed health care, retailing, banking, regional convenience stores, oil and natural gas, and research companies in science and technology to spread the risk exposure over a wide and diversified field. The Bishop Estate was now being recognized as one of the 'big' players among tax-exempt institutions in the capital markets on Wall Street with a reputation for being knowledgeable and having the ability to move relatively quickly if necessary.[57]

The Bishop Estate is still the largest private landowner in Hawaii. *Souza v. Estate of Bishop*, 821 F.2d 1332, 1334 (9th Cir. 1987).[58] However, because 47% of KSBE's land is held for conservation and another 51% for agricultural use, most of KSBE's land revenue comes from the small percentage in commercial or residential use.[59]

Perhaps KSBE's most spectacular investment is its interest in the Goldman Sachs investment banking firm.[60] (While he was Treasury Secretary, Robert Rubin, a former Goldman Sachs partner, recused himself from all matters involving KSBE.)[61] Because Goldman was a partnership engaged in debt-

---

[56] *See* Susan Essoyan, *Shaken Trust: Wealthy Bishop Estate—Hawaii's Educational Benefactor—Comes Under Scrutiny and Criticism over Its Managerial and Ethical Practices*, L.A. TIMES, Nov. 9, 1997, at D1.

[57] TAKABUKI, *supra* note 51, at 113.

[58] As of 1985, "Trust lands comprise about 8% of the land area in the State and 15.1% of the lands on Oahu; about 2% of its total holdings are devoted to residential leaseholds. The estate owns 19.6% of Oahu residential land and 24.43% of that island's unimproved residential land." Hawaii Housing Auth. v. Lyman, 68 Haw. 55, 66 n.7, 704 P.2d 888, 894 n.7 (1985). *See also* Richardson v. City & County of Honolulu, 124 F.3d 1150, 1154 n.3 (9th Cir. 1995)("The City contends that the Bishop Estate owns approximately 20% of the condominiums on Oahu. The Bishop Estate does not refute this number.").

[59] *See KSBE Hawai'i Lands, available at* <http://www.ksbe.edu/estate/lands/landsmap.html>. As of June 30, 1996, KSBE's Website shows that it earns 92% of its income from its commercial property, 6% of its income from residential property, 2% of its income from agricultural property, and no income from the conservation property. *Id.*

[60] Former trustee Takabuki describes this investment without, however, disclosing the amounts invested or the percentage interest obtained. *See* TAKABUKI, *supra* note 51, at 113-19. Other reports put KSBE's total investment (part in 1991 and part in 1994) at $500 million; Goldman had approached its client KSBE for cash to finance the retirement of 40 profit-holding partners at a time of one of the worst downturns in bond history. *See, e.g.*, Tom Lowry, *Need for Capital Drove Original Deal*, U.S.A. TODAY, May 3, 1999, at B3.

[61] *See* Essoyan, *supra* note 56. In addition, Rubin paid the Bishop Estate large sums to insure him against the risk that his Goldman Sachs share would fall in value during his tenure at the Treasury Department. *See, e.g.*, *Estate Guaranteed Rubin's Holdings*, HONOLULU STAR-BULLETIN, May 12, 1999, at B-1; Alix M. Freedman & Laurie P. Cohen, *Goldman's Big Hawaiian Investor Plays Clever Tax Game*, WALL ST. J., Apr. 25, 1995, at A1.

financed commercial activities, a direct equity interest would produce "unrelated business taxable income" to KSBE. Sec. 512(c). Accordingly, KSBE made the $500 million investment through a taxable subsidiary, which provided greater flexibility without additional tax cost.[62] However, returns to a corporate investment, in contrast to partnership income, would not result in unrelated business income tax to an exempt organization. Sec. 12(b)(1) (dividends), (5) (gain on sale of stock).[63] Accordingly, prior to Goldman's incorporation and initial public offering in May 1999, KSBE transferred its limited partner interest in Goldman Sachs from the taxable subsidiary to a tax-exempt affiliate called Kamehameha Activities Association.[64] The IRS and the Attorney General objected to this transfer of assets as offering the opportunity for KSBE assets to elude regulatory oversight, but a court-appointed special master approved the reorganization.[65] In Goldman's initial public offering, KSBE cashed out $477 million of its interest, leaving it with stock worth over $1.5 billion based on the value at the end of the first day of trading.[66]

Turning to expenditures for educational purposes, Kamehameha Schools admits only one out of eight applicants.[67] "Kamehameha still enrolls just under 7 percent of the children in the state of Hawaiian ancestry, the same percentage it did in the early 1960's with assets valued at a few hundred

---

[62] *See generally* TAKABUKI, *supra* note 51. Former Trustee Takabuki describes the income and deductions of this subsidiary. Reports of a potentially large tax bill for KSBE's taxable affiliates suggest that the IRS might be questioning the tax treatment of some of these transactions. *See, e.g.*, Rick Daysog, *Bishop Estate Faces $165 Million Tax Bill*, HONOLULU STAR-BULLETIN, Dec. 20, 1999, at A-1.

[63] Under the U.S. tax system, corporations as well as their shareholders pay tax, but partnership income flows through to the partners without tax at the partnership level; in the case of tax-exempt investors (either shareholders or partners) Congress wants to ensure one level of tax on income earned by the business entity.

[64] *See* Rick Daysog, *Estate Shifts Goldman Sachs Holdings to Nonprofit Corp*, HONOLULU STAR-BULLETIN, Oct. 21, 1998, at A-2; *see also* Form S-1, Goldman Sachs Group Inc. (filed with the Securities and Exchange Commission on Mar. 16, 1999), available on LEXIS at EDGARPlus. *See* I.R.C. § 512(b)(1) & (5). Presumably, KSBE's taxable subsidiary avoided gain on the transfer of this asset by closing the transaction before the effective date of the section 337(d) regulations. *See* T.D. 8802 (Dec. 29, 1998)(describing a January 28, 1999 effective date).

[65] *See* Rick Daysog, *Master Sides with Estate*, HONOLULU STAR-BULLETIN, Apr. 15, 1999, at A-2.

[66] *See* Rick Daysog, *Trust Makes a Bundle*, HONOLULU STAR-BULLETIN, May 4, 1999, at A-1.

[67] Kasindorf, *supra* note 55. "Rumors began that students had to have the right connections to be admitted—just like the ex-politicos who found their way onto the estate's payroll." Gail Diane Cox, *In Hawaii: A Princess, A Legacy, A Scandal*, NAT'L L.J., Jan. 11, 1999, at A1. "By February 1998, the state had notified the courts that it was broadening its investigation to include possible 'manipulation of the student admission process.'" *Id.*

million dollars."[68] In 1995, "citing a financial squeeze and consolidation of the estate's mission, the trustees eliminated community education programs that were reaching 10,000 people a year. Those shut out included public school children in largely Hawaiian areas, preschoolers and young parents."[69] In response, thousands of concerned alumni, parents, students and others formed a group to pressure for educational reform of KSBE, calling for reduced micro-management by Trustees in school operations.[70] Inspired by this group (called "Na Pua a Ke Ali'i Pauahi," or "Our Flowers of Princess Pauahi"), five prominent Hawaiians published an op-ed piece in the *Honolulu Star-Bulletin* called "Broken Trust"; its allegations of trustee mismanagement and conflict of interest prompted the governor to call for an attorney general investigation.[71]

However, KSBE asserts that it has been opening schools on the outer islands, and as of November 1997, 210 students were enrolled in temporary quarters.[72] KSBE justified its shift from outreach to new campuses by

---

[68] Purdum, *supra* note 23. *Cf.* TAKABUKI, *supra* note 51, at 125-26:

> One of the immediate major challenges remaining before the Bishop Estate is expanding the educational mission to include more Hawaiian children. The present campus provides an educational opportunity to only about 6 percent of eligible beneficiaries. Only one out of ten applicants of Hawaiian lineage is accepted to the schools. Kamehameha Schools does not, and cannot, meet all the educational needs of the Hawaiian community. . . . Kamehameha Schools' off-campus extension program was an attempt to meet this need to expand . . . . While assisting the public school system with troubled Hawaiian youth has been a costly program if analyzed on a cost-benefit ratio, this effort by the schools is important in meeting the educational needs of the Hawaiian community. . . .
>
> The trustees have considered building another campus to expand the educational outreach. During my tenure on the board, it was felt that the capital expenditure and eventual operating costs of such a campus would strain the funding capacity of the Estate. . . . The current board of trustees is moving forward with the construction of new schools . . . .

[69] Essoyan, *supra* note 56.

[70] *Id.*

[71] *See Broken Trust*, *supra* note 16. *See also* Lou Cannon, *Corruption Charges Catch Beloved Hawaii Charity in Furious Undertow*, WASH. POST, Dec. 23, 1997, at A3. "Proud that all board members claim at least some Hawaiian ancestry for the first time, native Hawaiians repeatedly squelched legislators' attempts to change the estate's business structure. What finally riled them was trustee handling of education." Kasindorf, *supra* note 55. According to *Broken Trust* co-author and University of Hawaii law professor Randall W. Roth, "'Anyone with any bit of Hawaiian blood has an emotional feeling toward the Bishop Estate[.]' . . . 'Anyone perceived as a threat runs the risk of losing a tremendous amount of political support from the native community.'" *Margery Bronster: Troublemaker*, GOVERNING, Dec. 1997, at 92. Lou Cannon commented: "Some observers link [the] new activism to a political and cultural awakening among Hawaiians that in the last decade has led to a call for restoration of Hawaii's national independence. The sovereignty movement has subsided, but the political consciousness it created in Hawaiians has lingered." Cannon, *supra*.

[72] *See* Essoyan, *supra* note 56.

explaining that it preferred to offer its own curriculum in its own facilities; moreover, "[i]n some of these [prior] programs, we were serving more non-Hawaiians than Hawaiians."[73]

KSBE annually prepares an account which is reviewed by a special master, who files a report with the probate court. In 1998 Arthur Andersen LLP ("Andersen"), a consultant retained by the special master and agreed to by KSBE, issued a report analyzing KSBE's investments and expenditures. Andersen found that KSBE rejected the 1987 advice of consultant Cambridge Associates, Inc., to establish a spending target based on 5% of endowment value. Andersen also criticized KSBE's investment practices—

> [T]he Trustees moved in a direction contrary to the adopted policy established in 1985 and its consultant's advice. With no apparent portfolio planning, the Trustees became more opportunistic and ad hoc and invested in high risk and illiquid non-Hawaii real estate ventures, private equity investments and oil and gas ventures. Much of this investing was done with little due diligence by the Estate and a heavy reliance on advice from their co-investors.[74]

In 1996, the Trustees failed to formally enact the strategic investment recommendations of Cambridge Associations. Moreover, Andersen found that the Trustees' investment due-diligence process "does not provide for any risk versus return assessment and appears to largely be a premium return seeking process de-emphasizing a balancing of the total risk exposure."[75] The Trustees failed to document their investment decisions, contributing "significantly" to poor investment results, and KSBE's practices lacked important aspects of best practices in the industry, including "evaluation of background investigations of sponsors and/or management, sufficient expertise to perform the due diligences, sharing of risks and rewards appropriately with sponsors, establishing reporting requirements and defining the exit strategies."[76]

---

[73] *Id.* (quoting KSBE spokesperson Elisa Yadao). In July 1999, the Interim Trustees (described below) announced an expansion of outreach programs, but an "attorney for one ousted board member . . . criticized the new board's decision . . ., saying that independent consultants have found the programs to be costly and ineffective in reaching their target native Hawaiian audience." Daysog, *supra* note 4.

[74] Andersen Report, *supra* note 47, sixth paragraph under "Management Audit—Summary of Significant Findings: Investment Planning," *available at* <http://www.napua.com/html/arthurexec.htm>.

[75] *Id.*, first paragraph under "Management Audit—Summary of Significant Findings: Investment Due Diligence".

[76] *Id.*, at third paragraph. In KSBE's exemption-application supplemental filing, *supra* note 28, the Interim Trustees describe reforms they intend to make to KSBE's spending and investment policies.

B. History of Trustee Compensation

Hawaii statutory law first provided for compensation to charity trustees in 1928. Commissions for the Trustees have been determined under Hawaii Revised Statutes §§ 607-18 and 607-20, which, until a recent amendment capping charity trustee fees at a "reasonable" level, set out specific formulas and limitations for allowable commissions. KSBE Trustee commissions have been calculated monthly based on cash received or paid by the Estate, with certain adjustments.[77] Specific questions under this formula have occasionally been litigated.[78] Commissions are examined annually during an independent audit and reviewed by a special master appointed by the probate court. The Trustees have waived commissions on: residential land sales as part of the fee sales program; educational revenue receipts; final disbursements of cash principal; and all capital receipts (effective July 1, 1995). In recent years, KSBE has commissioned outside studies of comparable compensation.[79]

Prior to the schedule adopted by the legislature in 1943, the Bishop Trustees had earned fees of about $10,000 a year. In 1943, the legislature grew concerned with the high administrative expenses of the Bishop Estate, including KSBE Trustee fees.[80] While the 1943 schedule initially cut fee levels in half,

---

[77] The following description comes from pages 317-21 of the Andersen Report, *supra* note 47. "Commissionable Revenue Receipts" include such items as rents; royalties, interest and dividends; partnership income; tax refunds; tuition and other educational income; and other fees. "Commissionable Capital Transactions" (net of realized capital losses) include capital gains on the sale or disposition of an investment; sale of original corpus lands; and disbursement of cash principal for construction, renovation and furniture, fixtures and equipment for school facilities.

[78] *See* Smith v. Lymer, 29 Haw. 169 (1926)(authorizing payment of commissions on amounts spent out of corpus to erect and equip new school buildings); *In re* Estate of Bishop, 37 Haw. 111 (1945)(allowing commissions to be paid on income from schools leased to the federal government for use as a hospital during wartime); *In re* Estate of Bishop, 53 Haw. 604, 499 P.2d 670 (1972)(holding that trustees are entitled to commissions on gross rents unreduced by real property taxes paid).

[79] The IRS included KSBE's payment for two studies in 1996 in the "Inurement" Notice of Proposed Adjustment, on the ground that the second study "served only to benefit the Incumbent Trustees by attempting 'to justify the amount of compensation they are currently being paid.'" Miller & Chevalier Letter, *supra* note 25, App. B, at 2-3.

[80] A Senate Judiciary Committee report compared expenditures on Kamehameha Schools unfavorably with expenditures on Punahou, then the elite school for *haoles* (whites). As Cooper and Daws related:

> The committee wrote that Punahou 1936-1941 had an income of $2 million, of which $1.7 million, or 85%, was spent on education, and that 5,730 students were taught. Kamehameha, on the other hand, through the Bishop Estate took in $4.3 million, of which $1.5 million, or only 35% was spent on education, and educated only 3,719 students. Although Kamehameha outspent Punahou on a per-student basis (about $400 to $300), still the drafters of the committee report seemed appalled at how little Bishop

by the late 1950s the fees had surpassed the earlier level. At this time, prominent politicians were becoming entangled with large landowners, including the Bishop Estate, in real estate development projects. In 1959 the legislature lowered the break points of the decreasing sliding scale, so that charitable trustees would be entitled 2% on income above $205,000. Meanwhile, the base on which the KSBE Trustees' fees were measured—trust income—grew along with property development activities. "Because of the new schedule and the development boom, each Bishop trustee got about $35,000 in 1960; in 1962 about $44,000; and by the early 1980s the five Bishop trustees between them were getting more than $1 million a year."[81]

Critics have charged that this connection between land development and the 1959 statutory increase in charitable trustee fees was more than coincidental: Might the Senate sponsor, who was in negotiations with the Bishop Estate to develop some of its land privately, have "felt in some way impelled to reciprocate for the opportunity that Bishop was offering him"?[82] Several prominent politicians later were named Bishop Estate trustees. (With the governor appointing the supreme court justices, until the recent change in trustee selection, the practice had continued.)[83]

Estate/Kamehameha was spending in comparison with what could be spent.
See COOPER & DAWS, *supra* note 51, at 49. The Committee Report concluded that "the exorbitant cost of administering the Bishop Estate, the limited benefits received by the beneficiaries for whom Bernice [Pauahi] Bishop created the trust, have rendered long overdue this amendment to the statute awarding commissions to the trustees of charitable trusts." *Id.* (quoting SEN. STAND. COMM. REP. No. 241, 22d Leg., Reg. Sess. (1943), *reprinted in* 1943 HAW. SEN. J. 638, 640).

[81] *Id.* at 49-50 (footnote omitted).

[82] *Id.* at 51; *see also id.* at 50-53. Cooper and Daws also assert: "One clear consequence of Sen. Kido obtaining the agreement with Bishop was that it played a role in his voting 'no' in 1963 on a Democratic Party lease-to-fee conversion bill. The bill was to allow homeowners whose houses stood on lease land to compel their landlords to sell them the fee interest in the land. . . . The bill was defeated in the Senate by one vote." *Id.* at 52.

[83] *See id.* at 52-53 (describing appointment as Bishop Estate trustees of Matsuo Takabuki, "a leading member of the Honolulu Board of Supervisors and one of Gov. Burns' closest advisors"; William S. Richardson, "a Democratic Party leader"; and Myron B. "Pinky" Thompson, "a former aide to Gov. Burns"). *See also id.* at 53-55, Table 2 ("Burns and Other Mainstream Democrats and Democratic Appointees Who by 1970 Had Ties to Major Landowners"). This table describes the following investors in "Heeia Dev. Co. which had development agreement with Bishop Estate on 520 acres windward Oahu": Tadao Beppu, House Speaker; S. George Fukuoka, State Circuit Court Judge; James M. Izumi, Maui County Personnel Director; Hiroshi Kato, House Judiciary Chairman; Mitsuyuki Kido, Former State Senator and Honolulu Supervisor; Sunao Kido, Chairman State Board of Land and Natural Resources; Yoshikazu Matsui, Chairman Maui County Planning Commission; Matsuo Takabuki; and Mamoru Yamasaki, State Senator. The table also describes other politicians with development ties to the Bishop Estate: Duke T. Kawasaki, State Senator ("Investor Wiliwili Nui Ridge Subdivision (a partnership), which had development agreement with Bishop Estate"), and

In a 1972 review of KSBE trustee fees, the Hawaii Supreme Court displayed unhappiness with the consequences of the fee formula. While rejecting the Attorney General's attempt to reduce commissionable income by property taxes paid, the court declared: "We share the Attorney General's concern over the fact that the trustees' yearly commissions are increasing dramatically."[84] The court pointedly illustrated in a footnote:

> Previous to 1967 the Estate received an annual rental on the Royal Hawaiian Hotel property of $25,000 per year. Beginning in 1976, the annual rental will be increased to $1,170,000 per year. This increase alone will give each trustee an increase in additional yearly compensation of almost $4,600, and is but one example of the need for reevaluation of the schedule used to compute trustees' commissions.[85]

In response to public criticism, the trustees waived the commissions to which they were legally entitled for these land sales.[86] Indeed, former KSBE Trustee Matsuo Takabuki, named to the board in 1972, claimed that he had been making more in the private practice of law, but yielded to the appointment as a sacrifice to public service.[87] Twenty years later, *each* trustee received about $860,000, and by 1998 was drawing in excess of $1 million.[88]

Herman T.F. Lum, State Circuit Court Judge, holder of two office-building Bishop Estate leases. *See also id.* at 56-59, Table 3 ("Legislative Leaders 1955-1984 Real Property Investment and Development Activity, Affiliations with Major Landowners and Developers")(describing Henry H. Peters, Bishop Estate trustee, as House Speaker 1981-84, and director of a Hong Kong-owned company formed to do real property business in Hawaii). In 1993 (subsequent to publication of Cooper and Daws' book), Richard S.H. ("Dickie") Wong, who was a former Senate president, was named a Trustee. *See, e.g.*, *Top Trustee Indicted at Big Charity*, CHRON. PHILANTHROPY, Apr. 22, 1999, at 58.

[84] In re *Estate of Bishop*, 53 Haw. 604, 606, 499 P.2d 670, 672 (1972).

[85] *Id.* at 606 n.3, 499 P.2d at 672 n.3.

[86] *See, e.g.*, Wallace Turner, *Hawaii Trust Wields Unusual Power*, N.Y. TIMES, July 17, 1983, Sec. 1, at 30 (stating that the trustees waived $885,000 since sales of residential leaseholds to homeowners began in 1979).

[87] In his autobiography, Takabuki relates his meeting with Supreme Court chief justice William S. Richardson and associate justice Bert Kobayashi:

> "How much does a trustee earn?" I then asked. The figure was quite a bit less than what I was earning in my practice. Bert then intervened, saying, "Don't tell me about the financial sacrifice you will be making. Remember the sermon you and the governor gave me about public service? You knew I was making a big financial sacrifice when I became attorney general."

TAKABUKI, *supra* note 51, at 95-96.

[88] *See* Petition for Removal of Trustees, *supra* note 28, at 19. Specifically, each trustee received $860,653 in FY 1992, $823,974 in FY 1993, $915,238 in FY 1994, $938,047 in FY 1995, $823,706 in FY 1996, $844,599 in FY 1997, $1,037,011 in FY 1998, and $735,420 through the first nine months of FY 1999. *Id.* at 19, ¶¶ 71 & 72.

In May 1998, the Hawaii legislature enacted a new limitation for charity trustees:[89] Henceforth, trustee compensation must be "reasonable under the circumstances." Haw. Rev. Stat. § 607-20 (as amended by L. 1998, ch. 310 § 2). In January 2000, probate judge Kevin Chang held a hearing on a recommended cap of $97,000 per trustee ($120,000 for the chair).[90]

C. Current Tax Dispute

In 1939, the IRS recognized KSBE as a charitable organization under what is now section 501(c)(3); in 1969, the IRS recognized KSBE as an educational organization.[91] The IRS subsequently recognized KSBE as a non-private foundation under section 170(b)(1)(A)(ii).[92]

The IRS's examination of KSBE and its taxable subsidiaries covers the fiscal tax years ended June 30, 1992, through June 30, 1996.[93] The IRS examined five issues: trustee compensation, benefits, and expense reimbursements; lobbying activities; the relationship of Estate expenses/activities to exempt purpose; the school's racially nondiscriminatory policy; and intercompany transactions involving the Estate and its taxable affiliates.[94]

In the early 1990's, the IRS District Office requested a technical advice memorandum from the National Office regarding the reasonableness of the Trustees' compensation. "Estate personnel and Price Waterhouse stated that the request was returned by the National Office of the IRS to the field agents since it was a question of fact rather than law."[95] The Service is reported to be separately considering application of section 4958 "excess-benefit" taxes against the individual Trustees.[96] Because of potential conflicts of interest,

---

[89] The new regime, effective January 1, 1999, falls far short of one version urged by reformers. In 1997, Governor Benjamin Cayetano announced his plan to introduce a bill to cap trustee compensation—and "called on the chairman of the Judiciary Committee of the Hawaii House of Representatives, who is on a $4,000-a-month legal retainer with Bishop Estate, to recuse himself on the issue." Essoyan, *supra* note 56. "During conference talks, the House rebuffed the Senate's compromise of setting trustee pay at $94,780 annually—what Hawaii's chief justice is paid. Instead, the House insisted a task force study compensation of trustees for various charitable trusts." Mike Yuen, *Case Pushes for House Vote to Limit Trustee Salaries*, HONOLULU STAR-BULLETIN, May 5, 1998, at A-8.

[90] *See* Daysog, *supra* note 22.

[91] *See* IRS Determination Letter to The Bernice P. Bishop Estate, Apr. 16, 1969, at 2, *available at* <http://www.ksbe.edu/news&info/tax_info/exempt_ltr.html>.

[92] *See* Andersen Report, *supra* note 47, at 272 (describing 1970 ruling on non-private foundation status).

[93] *See id.* at 272.

[94] *See id.* at 274.

[95] *Id.* at 287.

[96] *See, e.g.*, Stephen G. Greene, *Trustees Ousted in Hawaii*, CHRON. PHILANTHROPY, May

Probate Judge Kevin Chang approved a motion by Trustee Oswald Stender to appoint "Special Purpose Trustees" to act on behalf of KSBE in negotiating for a closing agreement with the Service.

On May 4, 1999, Terry Franklin, Chief of the Employee Plans/Exempt Organizations Division in the IRS Western Key District, and Marcus Owens, Director of the Exempt Organizations Division in the IRS National Office, wrote to the Special Purpose Trustees.[97] This letter confirmed that the resignation or removal of the five incumbent trustees is, as Judge Chang later characterized it, a "non-negotiable" condition precedent to entering into negotiations for a closing agreement and preventing revocation of exemption.[98]

20, 1999, at 30 ("[A]t least four of the five former trustees are widely expected to face hefty fines imposed by the I.R.S. under a 1996 law that allows the agency to penalize charity officials who receive overly generous financial benefits.").

[97] Letter to the Special Purpose Trustees, Kamehameha Schools/Bernice Pauahi Bishop Estate, from Marcus S. Owens, Director, Exempt Organizations Division, Internal Revenue Service, and Terry Franklin, Chief, EP/EO Division, Western Key District, Internal Revenue Service (May 4, 1999), identified by stamp as Exhibit B (no date) [hereinafter IRS Letter to Special Purpose Trustees].

[98] Removal Order, *supra* note 2. The IRS's letter reads, in relevant part:

> 1. With respect to the status of the trustees, it is our position that the Estate lacks internal controls and the requisite fiduciary oversight to ensure that only activities appropriate for a tax exempt charity occur. In our view, the inappropriate expenditures and other uses of funds are ongoing and include, but are not limited to, continuing payment of excessive compensation. Given the absences of effective internal controls and oversight, there is little to prevent the continuing misuse of assets and the possible movement of assets beyond the jurisdiction of the Service, perhaps in the guise of legitimate investment activities. *Consequently, it is of critical importance that you understand that as long as the five incumbent trustees are in a position to direct the Estate's operations, the Service believes that the assets are at risk. Should we receive indications that such movement is being contemplated, we will terminate any negotiations that are underway, revoke federal income tax exemption, and otherwise move to protect the interests of the federal government.* Interim removal of the incumbent trustees will ensure a stable environment for closing agreement discussions and clearly demonstrate the bona fide nature of negotiations on behalf of the Estate. Such interim removal is a clear signal of the sort required by the Service in order for negotiations to proceed. Please be advised that so long as such action is not taken, there is a very real risk that an intentional or inadvertent indication of a transfer of assets will trigger immediate and decisive action by the Service. Because of the ability to move funds rapidly and electronically, it is highly unlikely that the Service would be able to differentiate between intentional and inadvertent indications of a transfer before having to initiate action.
>
> 2. Furthermore, it is absolutely necessary as a precondition to negotiations that the scope of the Special Purpose Trustees' authority be clarified to encompass all subsidiaries and related or controlled organizations, whether tax exempt or taxable, including but not limited to, Kamehameha Activities Association. The Service will require that all parts of the Kamehameha Schools/Bishop Estate "family" be subject to the terms and conditions of any closing agreement to ensure that operations in the future are appropriate.

On May 7, 1999, Probate Judge Chang accepted the interim resignation of trustee Oswald Stender and ordered the temporary removal of the other trustees.[99] Judge Chang found credible the Internal Revenue Service's threat that unless all five trustees resigned or were removed, the Service would move to revoke KSBE's exemption. Judge Chang installed the five Special Purpose Trustees as "Interim Trustees."

In the context of Probate Court proceedings to reform KSBE's governance and management structure, and conditioned on the removal of the Incumbent Trustees, Judge Change approved a closing agreement between KSBE and the IRS on December 1, 1999.[100] Shortly thereafter, however, the probate court held a lengthy trial (only recently concluded, without yet a ruling) on the Interim Trustees' petition for permanent removal of the Incumbent Trustees. Even though the court left the Interim Trustees in place pending resolution of that case, the Internal Revenue Service revoked the closing agreement at the outset of that trial. Specifically, following a technical advice memorandum issued by the IRS National Office,[101] on December 31, 1999 the Western Key District director issued a final notice of revocation of KSBE's favorable

---

3. Any closing agreement must set forth the structure or outline of a systematic process for selecting qualified trustees. We understand that actual implementation of such a system and selection of new trustees may require some time to effectuate and that some form of interim governance may be necessary as a practical matter.

4. Any closing agreement will cover all tax years beginning with the first year under examination, 1990, and will extend forward in time for an appropriate period. The organizational and operational changes that will be incorporated into a closing agreement will also be reflected in a new application for exemption, Form 1023, to ensure that the protections as delineated will become conditions of exemption from federal income tax and, as such, have legal significance after the specific term of the closing agreement. We hope that the preceding clarification of our views is helpful but should be understood to identify broad categories of change that will be necessary. The Service will require significant and specific actions implementing the general requirements. Any negotiated resolution of federal tax concerns must also address such matters as investment policy, procedures for ensuring that appropriate resources are actually expended on charitable activities, and prohibitions on questionable expenditures.

IRS Letter to Special Purpose Trustees, *supra* note 97 (emphasis in original).

[99] Removal Order, *supra* note 2.

[100] Order Approving Settlement, *supra* note 11. [Reminder: The entire remainder of this paragraph in the text—written after the permanent resignation of all five trustees—is fiction!]

[101] *See* Lawrence M. Brauer & Marvin Friedlander, *Section 4958 Update*, IRS EXEMPT ORG. CPE TEXT FOR FY 2000, ch. B (Aug. 31, 1999), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 169-13 (Sept. 1, 1999)(explaining that key district offices and appeals offices must request technical advice from National Headquarters in "[a]ll cases in which an adverse action under an inurement proscription is being proposed" and "[a]ll private inurement cases that are being considered for resolution by closing agreement"). However, a technical advice memorandum revoking exemption is not a public document, unless it deals with issues other than revocation. *See* I.R.C. §§ 6110(k)(1), 6104; Treas. Reg. § 301.6104(a)-1(i) (1982).

determination letter, on a prospective basis. The notice of revocation reads, in relevant part, as follows:

> We have completed our review of your activities, and examination of your Forms 990, for the years ending June 30, 1990, and all later filed years. By this letter I am formally informing you that the Internal Revenue Service is revoking, effective immediately and on a prospective basis, the recognition of the Bernice Pauahi Bishop Estate and Trust (Estate), as an entity exempt from Federal Income taxes under section 501(a) of the Internal Revenue Code (Code), as an organization described in section 501(c)(3) of the Code. The National Office concurs in this decision pursuant to our request for technical advice. The reasons for this determination are as follows:
>
> (1) By failing to spend its income on current operations, the Estate is not operating a charitable program commensurate in scope with its financial resources.
>
> (2) The compensation paid to the trustees amounts to excess benefit transactions between the Estate and its disqualified persons; along with self-dealing by the trustees, these instances of private inurement are so significant that revocation of exemption is appropriate.
>
> Contributions to you are no longer deductible under section 170. . . .

Petitioner has exhausted its administrative remedies within the Internal Revenue Service. As required by section 7428(b)(3), the petitioner's complaint was filed before the 91st day after the date of mailing of the determination letter notifying petitioner of the revocation of its tax-exempt status under section 501(c)(3). This Court is empowered to issue declaratory relief.

II. DISCUSSION

A. Legal Framework

As charity operations grow more important in our economy, and as pressures on the Internal Revenue Service increase to fill gaps left by State regulators, the regulation of charities has raised questions of federalism.[102] That is, the question is not so much, "What is the right result?", but rather,

---

[102] *See generally* Evelyn Brody, *Institutional Dissonance in the Nonprofit Sector*, 41 VILL. L. REV. 433, 480-84 (1996)(describing proposals for a uniform law of charity, under a central regulatory authority); Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1434-40 (1998)(describing the regulation of charity fiduciaries through the federal tax system).

"Which level of government should obtain the right result?" Often by default, due to the inaction of State attorneys general, the public has come to expect the Internal Revenue Service to keep charities on the straight and narrow path. However, even after recent legislation dealing with "excess benefits" paid to charity insiders, Congress has never given the Service broad equity powers over nonprofit organizations.

Accordingly, we introduce the legal issues by providing an overview of the powers Congress grants the IRS in the regulation of section 501(c)(3) organizations (collectively referred to as "charities"). Notably, we distinguish between the detailed rules that apply to fiduciaries of "private foundations" (which KSBE is not) and the more general rules that apply to fiduciaries of "public charities" (which include KSBE).

Section 501(c)(3) describes entities that are organized and operated "exclusively" for a religious, charitable, or educational purpose. *See also* sec. 1.501(c)(3)-1, Income Tax Regs. The regulations soften the absolute standard in the statute by requiring the entity to be engaged "*primarily* in activities which accomplish one or more of such exempt purposes." Sec. 1.501(c)(3)-1(c)(1), Income Tax Regs. (emphasis added). The respondent does not contend that petitioner is organized for other than an exempt purpose. Rather, the respondent asserts that KSBE is not primarily operated for an exempt purpose.

The Code imposes the additional constraint that an organization is described in section 501(c)(3) only if "no part of the net earnings of [the organization] inures to the benefit of any private shareholder or individual." For purposes of this prohibition on private inurement, the regulations define "private shareholder or individual" rather unhelpfully as "persons having a personal and private interest in the activities of the organization." Secs. 1.501(c)(3)-1(c)(2) & 1.501(a)-1(c), Income Tax Regs. Judge Posner recently cut to the heart of the private inurement prohibition: "A charity is not to siphon its earnings to its founder, or the members of its board, or their families, or anyone else fairly to be described as an insider, that is, as the equivalent of an owner or manager." *United Cancer Council Inc. v. Commissioner*, 165 F.3d 1173, 1176 (7th Cir. 1999).

Respondent asserts two distinct bases for revoking KSBE's exemption: (1) that KSBE allows its assets to inure to the benefit of its Trustees, and (2) that KSBE fails to conduct a charitable program "commensurate in scope" with the organization's charitable resources. The first charge essentially says to the organization: "What you're spending, you're spending for a private rather than a public purpose." The second charge essentially says to the organization: "What you're earning, you're not spending enough for charity now."

These two charges overlap in this case. Following the lead of the Hawaii attorney general, the respondent asserts that the KSBE Trustees minimized operating expenses and focused on reinvesting surplus in order to produce investment income, presumably to generate a high base on which trustee fees are measured.[103] Similar misuse of some family foundations prompted the enactment of the Tax Reform Act of 1969. In the 1960's Congress grew concerned that wealthy individuals were establishing "private foundations" in order to hold unproductive real estate or stock in the family business. The foundation would make few demands for income, either in the form of rents or dividends, and would carry on minimal charitable activities. The assumed real purpose of the foundation was to control the assets for the benefit of the family.

In 1969, Congress adopted a set of excise-tax rules designed to induce private foundations to make productive, prudent investments, and to pay out a minimum percentage of investment assets for charitable purposes. Under the current version of the payout rule, a private foundation must annually dispense at least 5% of the value of its net investment assets for charitable purposes. Sec. 4945.[104] In addition, a private foundation may not make investments that jeopardize its charitable purpose. Sec. 4944. While private foundations remain subject to the general section 501(c)(3) prohibition on private inurement, section 4941 imposes a penalty tax on a foundation "self-dealer" and on the foundation manager who knowingly participated in specified acts of self-dealing. The statute carves out the "payment of

---

[103] *See* Petition for Removal and Surcharge, *supra* note 48 (Count 1, "The Trustees Have Violated the Directives of the Will and the Purpose of the Trust: Depriving Kamehameha Schools of Annual Income," fortieth to forty-third paragraphs):

40. The Trustees at all times during the terms of Stender, Wong, Lindsey, and Jervis and during the last 13 years of Peters' term have accumulated $350 million in income directed by the Will for the use of Kamehameha Schools and then depleted the accumulated income by reclassifying it as corpus.

41. The Trustees calculated their compensation on the Trust income while it was classified as income and before it was later reclassified as corpus.

42. The reclassification of Trust income as corpus was not disclosed to the Beneficiaries and was not disclosed to the court.

43. The effect of the reclassification has been to subvert the single purpose of the Trust, to necessitate reductions in educational programs and services, to deprive thousands of children of the opportunity to obtain educational benefits from the Trust, and to deprive the Kamehameha Schools of $350 million intended by Ke Ali'i Pauahi to educate Hawaiian children.

[104] Moreover, under the prohibition on "excess business holdings," a private foundation cannot own more than 20% of the stock of company (counting the shares of "disqualified persons"). *See* I.R.C. § 4943. *See generally* Evelyn Brody, *Charitable Endowments and the Democratization of Dynasty*, 39 ARIZ. L. REV. 873, 925-26 (1997) [hereinafter Brody, *Charitable Endowments*].

compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation . . . if . . . not excessive." Sec. 4941(d)(2)(E).

Under the 1969 regime, every section 501(c)(3) organization is presumed to be a private foundation unless it fits within a statutory exclusion. (Non-private foundations are often referred to as "public charities.") The distinction generally rests on the sources of support for the organization: Where an organization enjoys broad support from the general public, the marketplace for donations and other patronage can substitute for tight regulatory oversight and controls. However, Congress also created several types of *per se* public charities, regardless of their sources of support or any third-party oversight. Importantly, KSBE is not a private foundation because it is a school. Sec. 509(a)(1) and 170(b)(1)(A)(ii).[105] But for this statutory exclusion, KSBE would be classified as a private foundation, given that more than one-third of its income comes from investments. *See* sec. 509(a)(2). Accordingly, sections 4942 through 4945 do not apply here.

From time to time policy makers considered extending private-foundation-type rules to public charities.[106] In 1977, the Treasury Department proposed that public charities "would be required to spend or distribute annually for

---

[105] To be precise, section 170(b)(1)(A)(ii) describes "an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on . . . ."

[106] An influential study commission in 1977 recommended extending a minimum payout regime to public charities. *See* COMM'N ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS (JOHN H. FILER, CHAIRMAN), TREASURY DEP'T., COMMENTARY ON COMMISSION RECOMMENDATIONS, DONEE GROUP REPORT AND RECOMMENDATIONS, *in* 1 RESEARCH PAPERS 28-29 (1977). In the case of an operating charity, though, such a requirement could be fairly easy to satisfy, as indicated by the Filer Commission's commentary on its proposal:

> Public charities are not currently subject to any payout requirement, and at least one well publicized instance has come to light in which a charitable organization has amassed large financial holdings while doing little to expand its charitable activities. So the Commission believes that a payout rule is desirable for other endowed charities as well as for foundations. For organizations other than private foundations, however, the payout rate should be set at a smaller percentage and it should be satisfied by the use of funds for the direct conduct of the organization's activities, including the acquisition, construction or repair of buildings or other facilities, the acquisition of art objects by museums, and so forth. Accumulations, in fact, should be liberally allowed for purposes that clearly further the organization's tax-exempt functions and services.

REPORT OF THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS, GIVING IN AMERICA: TOWARD A STRONGER VOLUNTARY SECTOR 176 (1975). For a discussion of the administrative difficulties of imposing a minimum payout requirement on public charities, see Evelyn Brody, *Charities in Tax Reform: Threats to Subsidies Overt and Covert*, 66 TENN. L. REV. 687, 723-26 (1999).

charitable purposes at least 3-1/3 percent of their noncharitable assets."[107] Perhaps more radically, the Treasury also advocated investing the United States District Courts with a range of equity powers. The Treasury Department introduced this latter proposal with the following general description:

> United States District Courts would be invested with (1) equity powers (including, but not limited to, power to rescind transactions, surcharge trustees and order accountings) to remedy any detriment to a philanthropic organization resulting from any violation of the substantive rules, and (2) equity powers (including, but not limited to, power to substitute trustees, divest assets, enjoin activities and appoint receivers) to ensure that the organization's assets are preserved for philanthropic purposes and that violations of the substantive rules will not occur in the future.[108]

This proposal specified that the federal courts would defer to any State equitable proceedings:

> In the event that appropriate State authorities institute action against a philanthropic organization or individuals based upon acts which constitute a violation of substantive rules of law applicable to such organization, the United States District Court before whom the federal civil action is instituted or was pending would be required to defer action on any equitable relief for protection of the organization or preservation of its assets for its philanthropic purposes until conclusion of the State court action. At the conclusion of the State court action, the District Court could consider the State action adequate or provide further equitable relief, consistent with the State action, as the case warrants. However, no action by a State court would defer or abate the imposition of the initial Federal excise taxes for the violations.[109]

Congress did not enact these 1977 proposals.

But pressure continued to build for some "intermediate" sanction for fiduciary infractions. Most worrisome was the absolute bar on private

---

[107] *Treasury Proposals to Improve Private Philanthropy* (Treas. Dept. News Release Jan. 18, 1977), [1977] 9 STANDARD FED. TAX REP. (CCH) & 6156, at 70,850-57 (Jan. 26, 1977) [hereinafter 1977 Treasury Proposal]. The only public charities subject to a payout requirement—of 3.5%—are "medical research foundations." Treas. Reg. § 1.170A-9(c)(2). This rule was created as a compromise for the wealthy Howard Hughes Medical Institute, which wrangled for years with the Service over its qualification for public charity status. *See, e.g.*, Bill Richards, *Hughes Institute Wins Round at IRS*, WASH. POST, Jan. 20, 1979, at A4 ("In September 1970 the institute requested tax-exempt status under the 1969 act as a public medical research charity. . . . Like a number of the other specific exemptions it was carefully tailored for just one organization—in this case the Hughes Medical Institute.").

[108] 1997 Treasury Proposal, *supra* note 107, at Technical Explanation, part 1.C.1.b.(2)(a), at 70,855 (Improving the Philanthropic Process, Enforcement Procedures, Alternative Sanctions, Treasury Proposal, Detailed Description, Equity Powers).

[109] *Id.* at part 1.C.1.b.(2)(c), at 70,856.

inurement: In theory, a single dollar of private inurement threatens the ultimate sanction—loss of tax exemption. *See Founding Church of Scientology v. United States*, 412 F.2d 1197, 1202 (Ct. Cl. 1969), *cert. denied*, 397 U.S. 1009 (1970) ("Congress, when conditioning the exemption upon 'no part' of the earnings being of benefit to a private individual, specifically intended that the amount or extent of benefit should not be the determining factor."); *Airlie Foundation, Inc. v. United States*, 55 F.3d 684 (D.C. Cir. 1995)(unpublished opinion)(the inurement prohibition does not require a showing of harm to the organization).[110]

In cases of inurement, however, revocation of exemption compounds the harm to the bilked charity instead of punishing the wrongdoers. Hence, the Service hesitates to carry out this authority, acting only in such egregious cases as the PTL church, brought down by the greed of its minister Jim Bakker and his wife Tammy Faye Bakker.[111] Instead, the Service usually bent over backwards to avoid finding irremediable private inurement, preferring to work out changes in governance and compensation via "closing agreements" with the entities and their fiduciaries.[112] Closing agreements, however, occur only

[110] For an in-depth examination of the policy behind and mechanics of the private inurement prohibition, see Darryll K. Jones, *The Scintilla of Individual Profit: In Search of Private Inurement and Excess Benefit*, 19 VA. TAX REV. __ (forthcoming 2000).

[111] *See* Teague v. Bakker, 35 F.3d 978, 984 (4th Cir. 1994), *cert. denied*, 1995 U.S. LEXIS 1088 (Feb. 21, 1995). The court noted that "in late 1983, PTL fell prey to an IRS audit which culminated in PTL being stripped of its tax-exempt status. The IRS took this action in part due to private inurement allocated to Bakker and Tammy. The loss of tax exempt status threatened to create huge tax liabilities and to leave PTL unable to attract the deductible contributions which were its lifeblood." *Id.* at 984. For a description of PTL's rise and fall—including James Bakker's 5-year compensation of nearly $4.5 million, Tammy Faye Bakker's compensation of over $1.1 million over this period, and lavish living expenses, as well as the amounts claimed by the IRS as resulting in private inurement—see the decision in PTL's bankruptcy case, *In re* Heritage Village Church & Missionary Fellowship, Inc. a/k/a PTL, 92 B.R. 1000 (Bankr. D.S.C. 1988).

[112] Best known is the settlement between the Service and the Church of Scientology, including all of its constituent entities. *Compare* Founding Church of Scientology v. United States, 412 F.2d 1197, 1199, 1201 (Ct. Cl. 1969), *cert. denied*, 397 U.S. 1009 (1970)(payments to founder L. Ron Hubbard of 10% of gross income of affiliated Scientology organizations "were disguised and unjustified distributions of plaintiff's earnings"); *and* Church of Scientology v. Commissioner, 823 F.2d 1310, 1317 (9th Cir. 1987)("[T]he payments in this case cross the line between reasonable and excessive."), *id.* at 1317, *aff'g* 83 T.C. 381 (1984), *with* Closing Agreement on Final Determination Covering Specific Matters (Oct. 1, 1993), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 97 TNT 251-24 (Dec. 1, 1997)(note that this document was leaked, and never acknowledged by either party). The introduction to Part VI.A of this putative closing agreement states: "it is intended that the consensual sanctions set forth in this section are to provide the Service with intermediate sanctions for activities or conduct not in accordance with the provisions of Code section 501(c)(3) for which revocation of recognition of exemption may be too harsh or otherwise

in the enforcement process and are negotiated on a case-by-case basis; thus they fail to set forth a systematic set of rules binding on exempt organizations and the government, even when the IRS make public disclosure a condition of the closing.[113]

In recent years, congressional bodies held hearings on various pro-posals for intermediate sanctions, short of revocation of exemption, that would apply to public charities.[114] In 1994, Congressman J.J. Pickle, chair of the Oversight Subcommittee of the House Ways and Means Committee, issued a report on proposed reforms.[115] The Pickle Report found: "With regard to revocation of tax-exempt status, in 1991 and 1992, IRS revoked the tax-exempt status of 60 section 501(c)(3) organizations. Private inurement was the reason for revocation of the exemption of 20 organizations, [and] failure to operate as a section 501(c)(3) organization was the reason for 16 revocations. . . ." Obvious-ly, in a universe containing over 500,000 section 501(c)(3) organizations, the exemption of most organizations is safe. Discussing the difficulty of administering a regime in which revocation exists as the only sanction, the Pickle Report quoted from the testimony of the Commissioner of Internal Revenue:

> The Commissioner testified that "lack of a sanction short of revocation in cases in which an organization violated the inurement standard or one of the other standards for exemption causes the Service significant enforcement difficulties. Revocation of an exemption is a severe sanction that may be greatly disproportional to the violation in issue." * * *
>
> To illustrate the dilemma facing IRS, the Commissioner cited the case of a hypothetical university which revealed serious questions of private inurement regarding the university's president, including a salary that appeared excessive, a substantial interest-free loan, and costly amenities in the official residence. To

---

inappropriate as a sanction . . . .". *Id.* at VI.A.

[113] *See also* Peter Frumkin & Alice Andre-Clark, *Nonprofit Compensation and the Market*, 21 U. HAW. L. REV. 425, 457 n.178 and accompanying text (quoting the 1993 testimony of then-IRS Commissioner Margaret Richardson before the Subcommittee on Oversight that with closing agreements "it is difficult to ensure that similar organizations are treated consistently").

[114] *See generally* Marion R. Fremont-Smith, *Current Proposals for Public Charity Intermediate Sanctions*, 10 EXEMPT ORG. TAX REV. 115 (July 1995)(describing 1991 proposals for health care organizations, a 1992 proposal by the IRS Penalty Task Force, and a 1993 formal request to Congress by the Commissioner of Internal Revenue in testimony before the Oversight Subcommittee of the House Ways and Means Committee); Harry G. Gourevitch, *Congressional Research Service Report on the Tax Treatment of Exempt Organizations: Intermediate Sanctions* (CRS 94-901 S, Nov. 15, 1995), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 95 TNT 64-60 (Apr. 3, 1995).

[115] WAYS AND MEANS OVERSIGHT SUBCOMMITTEE, REFORMS TO IMPROVE THE TAX RULES GOVERNING PUBLIC CHARITIES (May 5, 1994), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 94 TNT 89-7 (May 9, 1994).

> address these problems by revocation would adversely affect the entire university community. Moreover, even if IRS were to revoke the university's tax-exempt status, the president's salary and fringe benefits would not be affected.[116]

Based on this and other testimony and evidence, the Oversight Subcommittee concluded:

> The Subcommittee believes that, due to the severity of the revocation sanction in cases of private inurement, IRS has been reluctant to impose it. As a result, IRS enforcement is adversely affected and charity officials are able to undertake certain questionable activities knowing it is unlikely that such activities will result in loss of the organization's tax exemption. Further, the Subcommittee is concerned that current IRS enforcement tools are not appropriate because revocation of an organization's tax-exempt status adversely affects the beneficiaries of the public charity, rather than the individuals who engaged in and benefited from the self-serving transactions.[117]

A week after the May 1994 Pickle Report came out, members of the Exempt Organizations Committee of the American Bar Association Section on Taxation released comments on the various proposals.[118] They observed:

> [I]n recent years, the Service increasingly has utilized closing agreements as a means of imposing what is in practical effect an intermediate penalty. Because the circumstances surrounding the use of closing agreements are subject to the confidentiality provisions of IRC section 6103, the public is rarely made aware of this process. Accordingly, it is difficult to evaluate the extent to which the closing agreement process alleviates the need for a formal intermediate sanction or the extent to which it could do so if closing agreements were made more public.[119]

---

[116] *Id.*

[117] *Id.*

[118] Members of the ABA Tax Section Exempt Organizations Committee, *Comments on Compliance with the Tax Laws by Public Charities* (May 11, 1994), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 94 TNT 105-25 (June 1, 1994).

[119] *Id. See* I.R.C. § 7121 (closing agreements); Tax Analysts v. Internal Revenue Serv., 53 F. Supp. 2d 449 (D.D.C. 1999)(holding that closing agreements relating to tax exemption are not subject to disclosure). *See also* Peter J. Meadows & William A. Dobrovir, *Who Killed Guidance?*, 73 TAX NOTES 221 (Oct. 14, 1996)("The secrecy of exempt organization closing agreements raises an important policy question" because "the danger exists that the Service may treat similarly situated charitable organizations differently[.]"). In a few notable cases, including this one, the Service insisted that the organization agree to publicize either the closing agreements themselves or a summary. *See id.* (describing the Hermann Hospital closing agreement that allowed a hospital which offered improper physician recruitment incentives to retain its exemption, but requiring it to pay $1 million, the amount of federal tax it would have paid if taxable; and the closing agreements with Jimmy Swaggart Ministries and with Christian Broadcasting Network regarding prohibited political activity). In January 2000, the Joint Committee on Taxation recommended that exempt-organization closing agreements be made

In addition, the ABA members cautioned that if intermediate sanctions are adopted for some, but not all, requirements of section 501(c)(3), "the Service would be relegated to its current status of asserting revocation, attempting to obtain a closing agreement, or not penalizing the violation, although an intermediate sanction may be the more appropriate option."[120]

Finally, in 1996, Congress enacted a set of intermediate sanctions for public charities. Sec. 4958.[121] While the new rules adopt a penalty excise tax approach similar to that already applicable to private foundations, important differences exist. Most significantly, the intermediate sanctions rules apply only to the portion of a transaction that results in private inurement under prior law. (Not all payments to insiders result in "inurement" of profits; since charities are permitted to pay the expenses of their operations, the issue usually arises in cases of excessive payments.) None of the other private foundation taxes, such as the minimum payout rules or taxes on jeopardizing investments, were extended to public charities.

An "excess benefit" transaction occurs when the charity directly or indirectly provides an economic benefit to or for the benefit of the insider and "the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit." Sec. 4958(c)(1)(A).[122] In such a case, the rules apply a two-tier tax scheme. The first-tier tax on the insider is 25% of the excess benefit portion. Sec. 4958(a)(1).[123] The real purpose of this first-tier tax, however, is to induce the benefited insider to disgorge the excess benefit to the charity: The second-tier tax—which applies if the transaction is not "corrected"—is a confiscatory 200% of the excess benefit, to be paid by the benefited insider. Sec. 4958(b).[124] The IRS has the authority to abate the first-tier penalty taxes

public, without redaction of taxpayer identifying information. *See* JOINT COMM. ON TAX'N, *supra* note 31. For an opposing view, see Letter from T.J. Sullivan to Tax Analysts (Jan. 15, 1998), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 98 TNT 13-34 (Jan. 21, 1998)("I fear that the Service will be less willing to compromise and taxpayers will be less willing to acknowledge error if closing agreements are made public.").

[120] Members of the A.B.A. Tax Section, *supra* note 118.

[121] The rules apply to excess benefit transactions after September 14, 1995, unless the transaction is pursuant to a binding contract in effect on September 13, 1995 and continuously until the transaction occurred.

[122] Certain "revenue-sharing" transactions can also trigger intermediate sanctions, even in the absence of an excess benefit. As discussed below, the Incumbent Trustees' fees might be considered a revenue-sharing transaction.

[123] The participating "organization manager" is separately subject to a tax of 10% of the excess benefit, but only if his or her participation is willful and not due to reasonable cause. I.R.C. § 4958(a)(2) (providing that a personally benefited organization manager could be subject to both taxes). Moreover, the managers' combined liability per excess benefit transaction cannot exceed $10,000. I.R.C. § 4958(d)(2).

[124] No second-tier tax applies to the organization manager.

if the violation was due to reasonable cause and not willful neglect, and the wrongdoer corrects the transaction promptly upon notice from the IRS. Sec. 4962. Correction means "undoing the excess benefit to the extent possible, and taking any additional measures necessary to place the organization in a financial position not worse than that in which it would be if the disqualified person had been dealing under the highest fiduciary standards." Sec. 4958(f)(6).

To date, guidance on these provisions is limited to the legislative history in the House report to H.R. 2337, the "Taxpayer Bill of Rights 2," and to regulations proposed by the Treasury Department and Internal Revenue Service in August 1998. *See* H.R. Rep. No. 104-506, at 51, 53-61 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1143, 1174, 1176-84; Notice of Proposed Rulemaking, "Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Transactions," 63 Fed. Reg. 41,486 (Aug. 4, 1998).[125]

We now turn to the two specific grounds for revocation in this case, and reject both.

B. Commensurate-in-Scope Test

Respondent demanded that "[a]ny negotiated resolution of federal tax concerns must also address such matters as investment policy, [and] procedures for ensuring that appropriate resources are actually expended on charitable activities . . . ."[126] The respondent essentially charges that KSBE operates a (poorly managed) large investment program with a small school on the side.

As described above, the subset of section 501(c)(3) organizations classified as private foundations operates under a specific statutory obligation to pay out at least 5% of the net value of its investment assets for charitable purposes

[125] The first petitions to contest asserted section 4958 tax were filed in the Tax Court in July, September, and November 1999 by six Mississippi home health-care organizations (three nonprofit agencies and their three for-profit successors) and the five family members who control them. The intermediate sanctions in these cases reportedly total $240 million, and the IRS retroactively revoked the exemption of the nonprofit organizations. Excess benefits allegedly arose from the conversion of the nonprofit organizations to for-profit status following a change in Mississippi law. The family's appraiser assigned a negative value to the businesses, which had been losing money for years, but the IRS contends that each was worth at least $5 million. *See* Jennifer Moore & Grant Williams, *Big Test for the IRS*, CHRON. PHILANTHROPY, Jan. 13, 2000, at 49; the full text of some of these petitions and bibliographic information on the others is available electronically under entity names starting with "Sta-Home Health" and the family name "Caracci" in LEXIS, Fedtax Library, PETEXT File.

[126] IRS Letter to Special Purpose Trustees, dated May 4, 1999, *supra* note 98 (concluding paragraph).

each year. No such statutory payout obligation applies to public charities, including schools. In theory, in the absence of a private-benefit purpose, under federal tax law an entity organized and to be operated as a school could accumulate all of its investment income for expenditure at a later date.

Moreover, an organization may still qualify for exemption under section 501(c)(3) "although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the *primary purpose* of carrying on an unrelated trade or business." Sec. 1.501(c)(3)-1(e)(1), Income Tax Regs. (emphasis added).[127] This requirement has become known as the "primary purpose" test.[128] The distinction between purposes and activities led the Service to pronounce the "commensurate in scope" requirement: Revenue Ruling 64-182, 1964-1 (Part 1) C.B. 186, held that a charitable corporation deriving its income principally from the rental of space in a large commercial office building, and making grants to other charities, is entitled to retain its exemption where it is shown to be carrying on through such contributions and grants a charitable program commensurate in scope with its financial resources.[129]

---

[127] Income from an unrelated trade or business would be taxable. *See* sec. 511 *et seq.* Of course, if the organization were a private foundation, it would be subject to the excess business holding limits of section 4943, as described in note 104, *supra.*

[128] Thus, an entity operated for the primary purpose of benefiting private interests is not entitled to exemption. *See, e.g.*, Redlands Surgical Servs., Inc. v. Commissioner, 113 T.C. No. 3 (1999); Housing Pioneers, Inc. v. Commissioner, 58 F.3d 401 (9th Cir. 1995); American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989); B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352 (1978); Church by Mail, Inc. v. Commissioner, 765 F.2d 1387 (9th Cir. 1985); Plumstead Theatre Soc'y, Inc. v. Commissioner, 675 F.2d 244 (9th Cir. 1982); est of Hawaii v. Commissioner, 71 T.C. 1067 (1979), *aff'd without published opinion*, 647 F.2d 170 (9th Cir. 1981); Goldsboro Art League, Inc. v. Commissioner, 75 T.C. 337 (1980); Aid to Artisans, Inc. v. Commissioner, 71 T.C. 202 (1978); Harding Hosp., Inc. v. United States, 505 F.2d 1068 (6th Cir. 1974).

[129] A 1971 IRS General Counsel Memorandum explained that the primary purpose test rejects objective tests such as "a comparison of the relative physical size and extent of organizational activities devoted to business endeavors and to charitable endeavors in which the ends to which the beneficial use of an organization's resources are applied . . . ." Gen. Couns. Mem. 34,682 (Nov. 17, 1971). Focusing on purpose, under Code section 502 an organization operated for the primary purpose of carrying on a trade or business cannot claim exemption even if all its profits are turned over to a charity; however, the definition of "trade or business" for this purpose does not include renting real estate, the activity covered in Rev. Rul. 64-182. Separate from the section 502 rules on "feeder organizations," an otherwise exempt charity must pay tax on its unrelated business taxable income. *See, e.g.*, Tech. Adv. Memo. 96-36-001 (Jan. 4, 1996)(ruling that a school conducting substantial publishing activities retains its section 501(c)(3) exemption because it conducts charitable activities commensurate in scope with its resources, but it must pay UBIT on the publishing profits).

Even as it adopted a commensurate-in-scope requirement, the Internal Revenue Service showed little stomach for applying it aggressively.[130] Indeed, Revenue Ruling 64-182, the ruling that first enunciated the test, was taxpayer-favorable. "The fact is," explained a 1971 memorandum written by the IRS Chief Counsel's Office, "the devotion of charity property to business use to produce income in the administration of charity properties can be perfectly compatible with and fully in furtherance of exclusively charitable purpose in the administration of such properties."[131] Indeed, the memorandum continued by discussing the *obligation* of charity managers to make investment assets productive.

Nor have recent years seen an aggressive application of the commensurate test.[132] Indeed, in 1999, the Service released an undated "Field Service

---

[130] *See* Gen. Couns. Mem. 34,682, *supra* note 129: "In the years past, the Service sought by ruling and by litigation to deny the right of charities to engage in business, insisting that somewhere, somehow in the enactment of the exemption provisions Congress must have intended to limit the classification of exempt charities to those charities not engaging to any substantial extent in commercial endeavors." Footnote 3 to this statement cites to Kenneth C. Eliasberg, *Charity and Commerce: Section 501(c)(3)—How Much Business Activity?*, 21 TAX L. REV. 53 (1965), which details the Service's unsuccessful litigation history on this issue.

[131] Gen. Couns. Mem. 34,682, *supra* note 129. Subsequent internal memos describe how the commensurate-in-scope test has been used primarily to support the recognition of exempt status under section 501(c)(3) for organizations that exist solely for the purpose of distributing income to other section 501(c)(3) organizations. *See, e.g.*, Field Service Advisory 1999-10-007 (dated Nov. 24, 1998; release date Mar. 12, 1999), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 49-89 (Mar. 15, 1999)(ruling that organization that earns and distributes the net proceeds from the operation of annual sports tournaments to other section 501(c)(3) charities is entitled to exemption).

[132] For a recent discussion of the commensurate-in-scope test, see Paul Streckfus, *Interview with Marc Owens*, 1 EO TAX J. 23, 25-26 (Apr. 1996), in which reporter Streckfus engaged in the following exchange with the director of the IRS's Exempt Organizations Division on February 29, 1996:

> *Streckfus*: . . . A reporter recently asked me about the commensurate test in regards to the Bishop Estate because the reporter pointed out that the estate has a relatively small school and tremendous assets.
>
> *Owens*: There are a number of universities that fall into that category.
>
> *Streckfus*: Well, let's go after them, too, if they're just sitting on the endowment. . . . Is there any life left in the commensurate test, derived from that 1964 revenue ruling, or have you all pretty much given up in applying a commensurate test in any of these instances?
>
> *Owens*: Well, Paul, I've just explained that you have to go through a very intensive factual analysis when you see an organization that has a mix of activities to try and glean from the facts about the nature of the entity. . . . [W]e have that analysis occurring in a lot of cases. We may not always use the word "commensurate" to describe the analysis, but it basically is there. It is what happens any time the IRS analyzes an organization frankly. You look to see what its goals and activities are, what its purposes are, and whether those are charitable or not, and that involves a weighing when you have some mixture.

Memorandum" that calls into question the Service's confidence in the commensurate test as an independent requirement for exemption.[133] While a field service memorandum provides no precedential guidance, the discussion it contains is instructive. In this memorandum, the office of the Assistant Chief Counsel (Employee Benefits and Exempt Organizations) answered several questions posed by an unidentified district counsel, who wanted to apply the commensurate test to a claimed educational organization engaged primarily in conducting bingo games. The district office proposed revoking the exemption on the "sole basis" that "the organization could not be said to be carrying on a charitable program commensurate in scope with its financial resources."[134] The district office conceded that neither private inurement nor private benefit existed. The Field Service Memorandum focused on this concession:

> This raises a concern because it is our opinion that indications of private benefit are the most effective means of denying section 501(c)(3) exemptions to troublesome fundraising organizations whose claim to exempt status is the raising of money for charity through the conduct of events such as bingo. The [Technical Advice Memorandum issued by the Exempt Organizations Technical Division] concludes that it does not appear that the bingo activity was initiated by the organization for any other purpose than to raise funds for a charitable program. This statement acknowledges that the organization's principal activity had an exclusively charitable purpose, and would appear that the organization is described in section 501(c)(3) unless it runs afoul of other section 501(c)(3) restrictions.[135]

As of June 30, 1996, the Estate's accumulated income exceeded $288 million.[136] Surpluses are not, however, only a recent phenomenon. A 1926

Streckfus: Have you all taken action against an organization recently based on the commensurate test analysis? Something we haven't seen because it would be an exemption issue.

Owens: We certainly have challenged exempt status based on the inherent nature of the activities. I don't know if the word commensurate was involved or not. As you know, we don't review all adverse actions here [in the National Office].

[133] *See* FSA 1999-530, *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 15-105 (Jan. 25, 1999).

[134] *Id.*

[135] In light of "significant litigating hazards" in relying solely on the commensurate test, the Assistant Chief Counsel's office suggested that "[i]t may be appropriate for the Service to compromise and restore exemption if the organization agrees to distribute the existing fund to established section 501(c)(3) organizations that are unaffiliated with officers of the organization within a reasonable period of time, and agrees to distribute net profits currently for charitable purposes." *Id.*

[136] Master's First Supplemental Report on the 109th, 110th, and 111th Annual Accounts of the Trustees, In re *Estate of Bishop*, Equity No. 2048, at VII.D (Haw. Prob. Ct. Sept. 29, 1998), *available in* <http://starbulletin.com/98/09/29/news/masters3.html>.

opinion of the Hawaii Supreme Court found that the "present gross annual income of the estate is approximately $450,000, and the annual expenditures amount to about $408,000, and upon the expiration of old leases and the obtaining of higher rentals under new leases the trustees expect that the income of the estate will gradually increase . . . ." *Smith v. Lymer*, 29 Haw. 169, 171 (1926). In that case, the trustees obtained approval to construct replacement school buildings out of corpus. In a 1943 case, the Estate filed a statement showing over $2 million of accumulated income, of which it wanted to treat nearly $1 million as spent on new school buildings, and the issue was whether the trustees properly used accumulated surplus income as well as corpus. *Collins v. Hodgson*, 36 Haw. 334, 335-36 (1943). Holding that the testatrix intended only corpus to be spent on construction, while "a portion of each year's income" would be used to support and educate orphans and others in indigent circumstances, the court observed that "[t]he testatrix apparently did not anticipate that there would be surplus income." *Id.* at 339. In dicta, the court commented: "The fact that more than one million dollars of income has accumulated makes it apparent that the expressed intention of the testatrix has not been complied with." *Id.* Noting that the record does not disclose "facts from which it could be determined whether or not a continual increase in the surplus income is or may become inevitable," the court suggested that its decision "is not to be understood as having any reference to the power of the chancellor, on a proper bill and showing, to apply the doctrine of *cy pres* and authorize an inevitable surplus, if any, to be applied to some other use within the purview of that doctrine." *Id.* at 340.

A charity can accumulate income for a variety of exempt purposes, including smoothing of expenditures and saving for future expenditures.[137] Regulators and courts have generally taken a laissez-faire approach to matters of the board's "business" judgment, refraining from second-guessing decisions by charity fiduciaries about how or when to make charitable expenditures.[138] To the extent the KSBE Trustees violated the direction of the settlor, we observe that while accumulation was criticized by the Hawaii Supreme Court in 1943, *Collins v. Hodgson*, *supra* at 339, the State courts exercise ongoing supervision of KSBE; moreover, accumulation is currently the subject of an attorney general complaint. We are not satisfied that Congress has empowered the Internal Revenue Service to act as a plenary regulator to fill any perceived supervisory vacuums left by the administration of State charity laws. There is no requirement in the Code that a public charity expend a certain percentage of its income or assets in the current conduct of its charitable program. We decline to support the Service's imposition of such

---

[137] *See generally*, Brody, *Charitable Endowments*, *supra* note 104.

[138] *See generally id.*

a requirement, mechanical or vague, on a charitable board. Accordingly, so long as the resources are dedicated to a charitable purpose, we leave it up to the discretion of KSBE's trustees, guided by State law, to determine when to make such expenditures.

Conclusion as to Commensurate Test:

We appreciate that the Internal Revenue Service is unhappy with the Bishop Estate's performance in managing its investments and program expenditure level. Indeed, this is an issue that also greatly concerns the Hawaii Attorney General. However, in our opinion, the Service's determination to revoke exemption cannot be sustained on the basis of the commensurate test. If Congress desires to give the Service equitable powers to surcharge fiduciaries of public charities for breaches of the duty of care, and to otherwise direct their activities, Congress may enact a set of excise taxes modeled on those that currently apply to private foundations and their fiduciaries.

On the other hand, to the extent the Trustees' failure to spend income was motivated by their desire to increase future income for the purpose of generating larger fees payable to themselves, the Service would be raising a private inurement issue. Hence, we now turn to that asserted ground for revocation.

C. *Private Inurement*

The respondent asserts that the compensation paid to the Trustees is so egregious that it amounts to private inurement requiring revocation of KSBE's exemption.

The new section 4958 excess-benefits tax can apply only to the benefited insider and to certain charity managers. No tax applies to the organization. None of the Incumbent Trustees is a party to this case. Nevertheless, we discuss section 4958 here because of the relationship between this new regime and the continuing prohibition in section 501(c)(3) on private inurement.[139] If no violation of section 4958 has taken place, then *a fortiori* no private inurement has taken place. Moreover, even if section 4958 sanctions apply, a footnote in the legislative history suggests that revocation would be inappropriate where, on the whole, the organization continues to merit tax-exemption:

[139] Section 53.4958-7 of the proposed regulations states: "(a) *Substantive requirements for exemption still apply.* The excise taxes imposed by section 4958 do not affect the substantive statutory standards for tax exemption under sections 501(c)(3) or (4). Organizations are described in those sections only if no part of their net earnings inure to the benefit of any private shareholder or individual."

> In general, the intermediate sanctions are the sole sanction imposed in those cases in which the excess benefit does not rise to a level where it calls into question whether, on the whole, the organization functions as a charitable or other tax-exempt organization. In practice, revocation of tax-exempt status, with or without the imposition of excise taxes, would occur only when the organization no longer operates as a charitable organization.

H.R. Rep. No. 104-506, *supra*, at 59 n.15, *reprinted in* 1996 U.S.C.C.A.N. 1182 n.15.

The preamble to the proposed regulations promises that the "IRS intends to exercise its administrative discretion in enforcing the requirements of sections 4958, 501(c)(3) and 501(c)(4) in accordance with the direction given in the legislative history." 63 Fed. Reg. at 41,505. The proposed regulations do not describe the circumstances under which an organization will be able to maintain its exemption in an excess-benefit situation. However, according to the preamble, "guidance issued in conjunction with the issuance of final regulations under section 4958" will include the following factors that the Internal Revenue Service will consider in exercising its administrative discretion to preserve an organization's exemption: "whether the organization has been involved in repeated excess benefit transactions; the size and scope of the excess benefit transaction; whether, after concluding that it has been party to an excess benefit transaction, the organization has implemented safeguards to prevent future recurrences; and whether there was compliance with other [federal and State] applicable laws." *Id.* at 41,488.

No formula applies for determining when compensation is reasonable. A footnote in the section 4958 legislative history declares: "the Committee intends that an individual need not necessarily accept reduced compensation merely because he or she renders services to a tax-exempt, as opposed to a taxable, organization." H.R. Rep. No. 104-506, *supra*, at 56 n.5, *reprinted in* 1996 U.S.C.C.A.N. at 1179 n.5.[140] However, proposed section 53.4958-4(b)(3), Income Tax Regs., echoes a footnote in the legislative history (reportedly added in rebuke of intense lobbying by KSBE): "The fact that a State or local legislative or agency body or court has authorized or approved a particular compensation package paid to a disqualified person is not determinative of the reasonableness of compensation paid for purposes of section 4958 excise taxes." 63 Fed. Reg. at 41,488-89; *see* H. R. Rep. No.

[140] Oversight Subcommittee Chairman Pickle once mentioned the possibility of a salary cap, perhaps set at $200,000 to match the salary of the President of the United States. *See* Robert A. Boisture & Milton Cerny, *Treasury Proposes Intermediate Sanctions on Public Charities and Section 501(c)(4) Organizations*, 63 TAX NOTES 353, n.7 (Apr. 18, 1994).

104-506, *supra* at 57 n.7, *reprinted in* 1996 U.S.C.C.A.N. at 1180 n.7 (interestingly, the proposed regulations added "or court" to the list).[141]

Until recently, KSBE had not employed officers; rather the Trustees acted as their own chief executives. This structure does not neatly fit a safe harbor in the legislative history and in the proposed regulations (see proposed section 53.4958-6(d), Income Tax Regs.); the typical nonprofit corporate structure separates the directors, who make the compensation decision, from the officers receiving the compensation.

As a separate matter, compensation measured by a percentage of investment returns paid to those who determine investments could trigger a little-understood provision of section 4958: Private inurement can result from a "revenue-sharing" transaction between the charity and the insider, even if the amount of compensation is fair to the charity. Because in such a situation there might be *no* unreasonable amount, the statute provides that where this definition applies, the penalty tax will apply to the entire amount of the revenue sharing. This rule is to apply only to the extent provided in regulations. *See* sec. 4958(c)(2). The proposed regulations carrying out this provision have been strongly criticized. After all, if a charity is permitted to pay reasonable compensation for services, what is wrong with paying incentive compensation where appropriate?[142] Indeed, the facts-and-circumstances test in proposed section 53.4958-5, Income Tax Regs., provides:

> A revenue-sharing transaction may constitute an excess benefit transaction regardless of whether the economic benefit provided to the disqualified person exceeds the fair market value of the consideration provided in return if, at any

---

[141] As a separate matter, the Hawaii attorney general accuses KSBE of expending "over $900,000 of Trust assets to lobby the United States Congress against passage of the Intermediate Sanctions provision and then, when it was clear that the measure would pass, to seek modifications in the legislative history beneficial to the Trustees." Petition for Removal and Surcharge, *supra* note 48 (Count 3, "The Trustees Have Enriched Themselves at the Expense of the Beneficiaries by Accepting Excessive Compensation from the Trust and by Expending Trust Assets to Preserve Their Excessive Compensation: Preserving Excessive Compensation—Self-interested Lobbying," second paragraph). The attorney general also charges that the Trustees "lobbied, advertised, and testified extensively" against any change to the Hawaiian fee schedule for charity trustees. *Id.* (Count 3, same subsection, third paragraph). The attorney general asserts that this amount "was spent entirely for the benefit of the Trustees and to protect their excessive compensation and not at all for the interests of the Beneficiaries or the Trust purpose of educating Hawaiian children." *Id.* (Count 3, same subsection, fourth paragraph). Other charitable organizations opposed the intermediate sanctions proposals as not being in the best interests of sound charity administration. In any event, the tax consequences of the KSBE lobbying expenditures can be left to the section 4958 case against the Incumbent Trustees; we are not prepared to uphold revocation on this ground alone.

[142] *See* Jones, *supra* note 110 (describing situations in which incentive compensation makes economic sense for nonprofit organizations).

> point, it permits a disqualified person to receive additional compensation without providing proportional benefits that contribute to the organization's accomplishment of its exempt purpose.

63 Fed. Reg. at 41,503. The first example in this proposed regulation approves of a compensation arrangement in which a charity investment manager is paid a percentage of any increase in the asset value, because the charity benefits in proportion to the manager. *See* proposed sec. 53.4958-5(D), Example 1, Income Tax Regs.

With the availability of intermediate sanctions to correct prior excess benefits, the refusal of the Incumbent Trustees to step down would not by itself be grounds for the IRS to revoke KSBE's exemption. However, refusal could indicate that something else is amiss—perhaps that wrongdoing insiders are remaining in power, and continuing to violate prohibitions against private inurement. Indeed, the IRS's May 1999 revocation threat appeared to be based on a concern akin to jeopardy assessments: that swift action is needed because otherwise assets might slip out from under their jurisdiction.[143] The Interim Trustees subsequently charged that the Incumbent Trustees had considered moving the Bishop Estate out of Hawaii and reforming it in the Cheyenne River Sioux Reservation in South Dakota.[144] However, this alleged activity took place in 1995, and there is no suggestion that such a move, as alarming as it might sound, could take place without probate court approval.

Moreover, the Service's insistence on the heads of all Incumbent Trustees suggests that the Service has failed to judge each Trustee's situation on its individual merits. We can understand that the Service is unhappy with a highly politicized trustee selection process, and that the Service is unhappy with the unheard-of levels of compensation paid. However, it appears that trustee Oswald Stender acted in the best interests of KSBE. Stender opposed the decision of the other trustees to terminate the community outreach

---

[143] As set out in note 98 above, the IRS's letter said: "Should we receive indications that such movement [of assets beyond the jurisdiction of the Service] is being contemplated, we will terminate any negotiations that are underway, revoke federal income tax exemption, and otherwise move to protect the interest of the federal government." IRS Letter to Special Purpose Trustees, *supra* note 97 (emphasis omitted).

[144] *See* Interim Trustees' Trial Memorandum, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Dec. 13, 1999) [hereinafter Interim Trustees' Trial Memorandum], at III.B.1 ("The Incumbent Trustee Investigated Moving KSBE's Domicile to Escape Oversight of their Activities By the Hawai'i State Courts, Legislature, and Executive Branch"), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 241-10 (Dec. 16, 1999); Interim Trustees' Proposed Findings of Fact, Conclusions of Law and Order, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Dec. 13, 1999) [hereinafter Interim Trustees' Proposed Findings of Fact], at ¶¶ 55-63 ("Possible Changes in Domicile and Tax Status"), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 241-11 (Dec. 16, 1999). *See also* Rick Daysog, *Bishop Eyed Move to Dakota*, HONOLULU STAR-BULLETIN, Oct. 12, 1999, at A-1.

programs "which reduced the number of Hawaiians served by KSBE from approximately 30,000 in 1992 to 3,200 in 1996 and caused a substantial layoff in the KSBE workforce, resulting in community anger and anxiety on the part of the remaining workforce . . . ."[145] Stender's urging that the management of the Kamehameha Schools be returned from trustee Lindsey to the president and staff was ignored by the board.[146] Stender, joined by trustee Gerard Jervis, filed suit to oust Lindsey before the attorney general showed interest in KSBE's governance matters.[147] Stender cooperated with the Hawaii attorney general's investigation.[148] Stender and Jervis petitioned the probate court to appoint Special Purpose Trustees to deal on the KSBE's behalf in the tax matters. Stender, like the true mother in the story of Solomon's judgment, volunteered to step aside temporarily to prevent loss of KSBE's tax exemption.[149] Even after his interim resignation, Stender proposed that KSBE establish a voucher system for Native Hawaiian students; praising the proposal, an editorial in the *Honolulu Star-Bulletin* commented: "Stender was a courageous dissident on the old board of trustees. His campaign against mismanagement and improprieties by the board led to the [temporary] ouster of the other four members."[150]

---

[145] Miller & Chevalier Letter, *supra* note 25, at 11, 13 (summarizing June 10, 1999 findings of probate Judge Weil in her removal of Trustee Lindsey).

[146] *See id.* at 6 (again referring to Judge Weil's findings).

[147] *See also* Debra Barayuga, *Trustees' Attorney Fees to Be Repaid*, HONOLULU STAR-BULLETIN, Aug. 14, 1999, at A-1 (reporting that the Probate Court has approved the bid by Oswald Stender and Gerard Jervis for reimbursement from the Estate for "reasonable" legal fees and other expenses incurred in suit to remove trustee Lokelani Lindsey; the deputy attorney general said the State was pleased with the ruling).

[148] *See* Daysog, *supra* note 7 (quoting Deputy Attorney General John Anderson as saying: "Stender could have done a lot more, but we don't feel like there will be a tremendous amount of harm if he is not removed.").

[149] Notably, Judge Chang's temporary removal order stated:

> The Court further finds and concludes, with the exception of Trustee Stender, under the strict fiduciary standard applicable to the Incumbent Trustees, that the inaction and indifference of the other Incumbent Trustees to the potential loss of the opportunity to engage in bona fide and meaningful settlement negotiations with the IRS in a special consolidated procedure which is advantageous to the Trust Estate and the potential loss of the Trust Estate's tax-exempt status might thereby result because of their refusal to offer their resignations as Trustees of the Trust Estate constitutes a breach of duty. Simply put, with the exception of Trustee Stender, the other Incumbent Trustees are not acting in the interests of the welfare, protection and preservation of the Trust Estate.

Removal Order, *supra* note 2 (near end of "Negotiations With The IRS"); *see also id.* ("CEO Management Based System")("The Court notes that trustees Stender and Jervis were in favor of a CEO based management system," but the majority trustees violated KSBE's stipulation with the Attorney General and the Special Master to establish this structure).

[150] *Stender's Proposals*, HONOLULU STAR-BULLETIN, Aug. 30, 1999 (editorial), at A-10.

Today, both Hawaii law and the Internal Revenue Code limit compensation to charitable trustees to a "reasonable" amount. To the extent Stender received excess benefits, he, along with the other Trustees, can be made to restore the amounts to KSBE. (We note that Stender offered to limit his 1999 compensation to $621,393 in order to address the IRS's concerns.)[151] Probate court proceedings as to a reasonable level of compensation for KSBE trustees are ongoing.

Conclusion as to Private Inurement:

Given that section 4958 addresses only fiduciary misbehavior involving self-dealing and excess financial benefit, it is our opinion that Congress did not intend to grant the Internal Revenue Service broad powers to require restitution and other remedies for breaches of the duty of care. That is, by enacting the intermediate sanctions that it did—and no more, despite calls to do so—Congress did not mean for the IRS to become a super-State attorney general, with removal powers, nor did Congress mean for the Tax Court, the District Court of the District of Columbia, and the Claims Court to become super-probate courts.[152] Moreover, concurrent federal and State jurisdiction runs the risk of inconsistent governance directives. Recall that the 1977 Treasury proposal to invest federal courts with equity powers over charity

[151] *See* Daysog, *supra* note 5.

[152] *See* I.R.C. § 7428 (declaratory judgment actions). *Cf.* United Cancer Council v. Commissioner, 165 F.3d 1173 (7th Cir. 1999)(reversing the Tax Court's finding of private inurement in a "one-sided" fund-raising contract). Judge Posner, writing for the court, complained:

> The Service and the Tax Court are using "control" in a special sense not used elsewhere, so far as we can determine, in the law, including federal tax law. It is a sense which . . . threatens to unsettle the charitable sector by empowering the IRS to yank a charity's tax exemption simply because the Service thinks the charity's contract with its major fundraiser too one-sided in favor of the fundraiser, even though the charity has not been found to have violated any duty of faithful and careful management that the law of nonprofit corporations may have laid upon it. . . .
>
> We were not reassured when the government's lawyer, in response to a question from the bench as to what standard he was advocating to guide decision in this area, said that it was the "facts and circumstances" of each case. That is no standard at all, and makes the tax status of charitable organizations and their donors a matter of the whim of the IRS.

Id. at 1178-79; *see also* Frances R. Hill, *Deregulating the Exempt Sector? CA-7 Reverses Tax Court in United Cancer Council*, J. TAX'N, May 1999, at 303. Professor Hill comments:

> The Seventh Circuit's opinion is a call for deregulation of aspects of exempt organizations' operations. At the same time, its remand on private benefit suggests that some aspects of exempt organizations' operations require continued regulatory scrutiny based on tax law. It is this sophisticated consideration of the role of competing market and regulatory frameworks that makes the Seventh Circuit opinion one of the more important opinions on exempt organizations in recent years.

fiduciaries would have stayed federal proceedings until the conclusion of State enforcement actions.

KSBE is a public charity, with significant charitable assets, operating a significant charitable program. Its trustee fee structure, investment practices, and operations have been under the supervision of the Hawaii probate courts and annual special master review for decades. The fact that the attorney general has initiated an enforcement action and that the special master has sought governance and operational reforms suggests that the State system is working. If the test for entitlement for exemption—despite section 4958 excess-benefit violations—is "would this entity be granted recognition under section 501(c)(3) on a going forward basis?", the answer clearly is yes.

Based on the foregoing discussion, we conclude that this is not a case where the continued operation of KSBE, as supervised by the Hawaii attorney general and the probate courts, would be inconsistent with its federal tax exemption. Contrary to the suggestion of the dissent, we are not holding that the Service can never revoke KSBE's exemption on grounds of inurement, but rather that such an action would, in light of current State proceedings, be premature. We of course draw no conclusions as to the application of Code section 4958 to the individual Incumbent Trustees.

Decision for petitioner.

Reviewed by the Court.

BROWN, SIERRA, MUELLER, DARTMOUTH, PEPPERDINE, AMORY, JACKSON, SCHAUMBERG, and WALZ, JJ., join in this Opinion for the Court.

WALZ, J., concurring.

I whole-heartedly endorse the decision of the Court. Let me also congratulate the courage of the petitioner's Incumbent Trustees for standing up to the respondent. The Interim Trustees assert that loss of tax-exempt status could cost KSBE in excess of $900 million.[153] In many cases, loss of exemption entails taxation on income, loss of deductibility for donations, loss of tax-exemption on the interest paid on the entity's section 501(c)(3) bonds, and possible collateral State tax consequences including loss of property-tax exemption. Given the high stakes, one might expect all but the most impoverished of charities to capitulate to any demands made under threat of revocation. The public knows of only a handful of closing agreements, yet the IRS finalized 78 closing agreements with section 501(c) organizations in fiscal year 1999, 72 in fiscal year 1998, and 65 in fiscal year 1997.[154] The

---

[153] Interim Trustees' Proposed Findings of Fact, *supra* note 144, at ¶ 91 (citing to October 6, 1999, expert report by Diane Cornwell of Arthur Andersen LLP, contained in Attachment C thereto).

[154] *See* JOINT COMM. ON TAX'N, *supra* note 31, at 38, n.97 (citing the IRS Exempt

respondent's approach to the administration of tax-exempt charities, no matter how commendable its motivation, should not be allowed to proceed without appropriate judicial scrutiny.[155] Someone has to stop the blackmail.

BROWN, J., concurring.

I write only to respond to the assertion raised by the dissent that we should ignore legislative history in this case. Whatever the merits of legislative history generally, the contrast between the section 4958 legislative history and that of another statute emphasizes the validity of the Court's approach. In 1987, Congress added section 4955, which imposes an excise taxes on public charities that engage in political activities.[156] This is so even though section 501(c)(3) contains an absolute prohibition on political campaign activity. Thus, the obvious question arises under section 4955: Is this an intermediate sanction scheme which, like section 4958, renders revocation necessary only

---

Organization Return Inventory and Classification System). In fiscal year 1999, the IRS revoked the exempt status of 97 organizations, of which 20 were exempt under section 501(c)(3); in fiscal year 1998, the IRS revoked the exemption of 97 organizations, 38 described in section 501(c)(3); and in fiscal year 1997, the IRS revoked the exemption of 89 organizations, 38 described in section 501(c)(3). *Id.* at 27 n.56 (citing the IRS Audit Information Management System, Tables 41 and 42).

[155] Even the threat of revocation disrupts charity operations. As KSBE's counsel Miller & Chevalier warned their client before litigation commenced:

> [S]uch litigation would impose a significant financial burden on the Estate, involving at least several million dollars in legal fees and other expenses. Moreover, the time period between the Service's revocation of KSBE's tax-exempt status and the rendering of a judicial opinion concerning KSBE's continuing qualification as a 501(c)(3) organization would be lengthy, potentially more than three years. The threat of revocation would create financial uncertainty in the Estate's operations during these years, thereby possibly precluding the Estate from engaging in meaningful strategic planning for educational programs, or implementing expansion plans, until litigation is resolved and the amount of the liability resulting therefrom (including a substantial tax bill if revocation is sustained) is resolved.

Miller & Chevalier Letter, *supra* note 25, at 21.

[156] The organization might also be subject to tax under section 527(b) on political organization taxable income. *See also* secs. 501(h) & 4911 (excise tax on excess lobbying expenditures by electing public charities). Unlike its absolute prohibition against political campaign activity, section 501(c)(3) allows public charities to lobby so long as this activity is not a "substantial part" of its activities. In 1976, to provide some certainty to charities, Congress created an election for certain public charities to lobby within dollar and percentage limitations, with excise taxes imposed on charities that exceed the limits and "with revocation of exempt status reserved as a sanction for those organizations that exceed the limits by a significant amount over a period of several years." *Testimony of Assistant Treasury Secretary for Tax Policy Roger J. Mentz before the House Ways and Means Subcommittee on Oversight* (Mar. 12, 1987), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 87 TNT 49-6 (Mar. 13, 1987) [hereinafter *Testimony of Assistant Treasury Secretary for Tax Policy*].

in egregious cases, or is the excise tax collectible on top of revocation of exemption?

The conference committee report to the Revenue Act of 1987 explains that section 4955 was prompted by the dual concerns that revocation could equally be disproportionate to inadvertent actions and be ineffectual in cases of significant violations:

> As the Congress concluded in adopting the two-tier foundation excise tax structure in 1969, the Internal Revenue Service may hesitate to revoke the exempt status of a charitable organization for engaging in political campaign activities in circumstances where that penalty may seem disproportionate— i.e., where the expenditure was unintentional and involved only a small amount and where the organization subsequently had adopted procedures to assure that similar expenditures would not be made in the future, particularly where the managers responsible for the prohibited expenditure are no longer associated with the organization. At the same time, where an organization claiming status as a charity engages in significant, uncorrected violations of the prohibition on political campaign activities, revocation of exempt status may be ineffective as a penalty or as a deterrent, particularly if the organization ceases operations after it has diverted all its assets to improper purposes.

H.R. Rep. No. 100-391, at 1623-24 (1987), *reprinted in* 1987 U.S.C.C.A.N. 2313-1, 2313-1204. However, the report emphasizes:

> The adoption of the excise tax sanction does not modify the present-law rule that an organization does not qualify for tax-exempt status as a charitable organization, and is not eligible to receive tax-deductible contributions, unless the organization does not participate in, or intervene in, any political campaign on behalf of or in opposition to any candidate for public office (secs. 501(c)(3), 170(c)(2)).

Id. at 1624; *see also id.* at 1626 (same).

This statement in effect rebuffs an earlier suggestion made by the Treasury Department that the excise taxes on public charities engaged in political activities should operate "in lieu of automatic revocation of exempt status." The Assistant Secretary for Tax Policy had proposed that "the organization should be subject to loss of its exempt status" only "[a]bsent correction of the expenditure, or in cases of repeated or flagrant violations."[157]

The IRS evidences some understandable contortions in the administration of this purported absolute ban on political activity. On the one hand, section 53.4955-1(a), Income Tax Regs., reiterates the legislative history that "[t]he excise taxes imposed by section 4955 do not affect the substantive standards for tax exemption under section 501(c)(3), under which an organization is described in section 501(c)(3) only if it does not participate or intervene in

[157] *Testimony of Assistant Treasury Secretary for Tax Policy, supra* note 156.

any political campaign on behalf of any candidate for public office." However, the IRS's Continuing Professional Education program for its exempt-organizations technical staff espouses an interest in a flexible approach to enforcement, with taxes in some cases operating as an intermediate sanction.[158]

As a policy matter, Congress could rationally have concluded that the political activity prohibition should be absolute while inurement violations should be subject only to taxes on the wrongdoers in appropriate cases. After all, "correction" in the case of inurement can remedy mere financial harm done to the charity, whereas prohibited campaign activity cannot be so easily undone. Accordingly, the closing agreements with Jerry Falwell's Old Time Gospel Hour, Jimmy Swaggart Ministries, and Pat Robertson's Christian Broadcasting Network not only required the payment of taxes, but also required the organizations to make changes in corporate governance and to publicize the general terms of the closing agreements.[159] However, I share the

---

[158] See also the comments of Marcus Owens, director of the Exempt Organizations Division:

> [W]e are not interested in creating a safe harbor at a particular level of campaign intervention for charities . . . If the charity does have an ongoing program of truly charitable activity and recognizes that an error was committed and takes appropriate steps to insure that it won't happen again, we would take those factors into consideration in fashioning a resolution of the case.

Transcript of A.B.A. Tax Section Mini-Program: Political Activities of Exempt Organizations, PACs, and IRC Section 527: An Overview of IRS and Federal Election Commission Rules, Held on May 8, 1993, in Washington, D.C., 8 EXEMPT ORG. TAX REV. 267, 277 (Aug. 1993).

[159] *See Public Statement, Jimmy Swaggart Ministries, Baton Rouge, Louisiana* (Dec. 17, 1991), 5 EXEMPT ORG. TAX REV. 205 (Feb. 1992). In this agreement, the organization agreed to desist from political activities—Jimmy Swaggart Ministries had endorsed Pat Robertson's presidential bid—and to pay about $170,000 in back taxes and interest. According to the public statement: "Under the terms of a closing agreement between itself and the IRS, JSM has made certain changes in its organizational structure, including the creation of an 'Audit and Compliance Committee' composed of members of an expanded board of trustees, to ensure that no further political campaign intervention activities will occur." *Id.* at 207; *see also Statement of Jerry Falwell Regarding Closing Agreement* (Feb. 17, 1993), 7 EXEMPT ORG. TAX REV. 876 (May 1993), describing the agreement by the Old Time Gospel Hour to a two-year revocation of exemption and the payment of $50,000 in tax for political activity. According to Reverend Falwell's statement: "The IRS agrees that the organizational changes made by OTGH are satisfactory to preclude future political activity and has reinstated tax-exempt status for years after 1987." *Id.*; *see also News Release, The Christian Broadcasting Network* (Mar. 16, 1998), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 98 TNT 55-78 (Mar. 23, 1998), describing the terms of the agreement, including:

> the loss of CBN's tax exemption for 1986 and 1987 due to the application of the rules prohibiting intervention in political campaign activities . . .; a significant payment by CBN to the IRS . . . ; an increase in the number of outside directors on CBN's board; and other organizational and operational modifications to ensure ongoing compliance with the tax laws.

Id. Practitioner Gregory L. Colvin complained about the lack of specificity in the CBN news

uneasiness of some of my fellow judges with the use of closing agreements: Not only did these organizations release statements rather than the closing agreements themselves, but the bases for the penalties and taxes were not spelled out, leaving the charitable sector with an abiding sense of lack of accountability in the Service.[160] (KSBE's Closing Agreement includes an unallocated amount of the total $9 million payment for section 4955 taxes, as well requires publication of the Closing Agreement.) While we might commend the agency for endeavoring to preserve exemptions, in enacting the section 4958 intermediate-sanction regime, Congress evidently decided not to leave such an important matter up to agency discretion.

BUCK, J., dissenting.

I would uphold respondent's determination. As a threshold matter, I am baffled by the majority's ruling that the disposition of this important issue turns on a single footnote of legislative history. As Justice Scalia has often observed, Congress enacts laws, not committee reports. *See, e.g., Conroy v. Aniskoff*, 507 U.S. 511, 518-529, 123 L. Ed. 2d 229, 113 S. Ct. 1562 (1993)(Scalia, J., concurring in judgment); *United States v. Thompson/Center Arms Co.*, 504 U.S. 505, 521 (1992)(Scalia, J., concurring in judgment); *Blanchard v. Bergeron*, 489 U.S. 87, 98-100, (1989)(Scalia, J., concurring in part and concurring in judgment). If Congress so clearly wanted revocation to be a sanction of last resort, it could have said so in section 4958, not just in a footnote to a committee report.

More substantively, I am alarmed by the majority's view that the administration of the federal tax-exemption scheme is, essentially, preempted by State law. To the contrary, the Internal Revenue Service has been and must be free to enforce the requirements of the Code independently of the

---

release:

> In the Jimmy Swaggart case we learned something about the IRS's view about how the statements of an individual can be attributed to the organization[.] . . . But here, . . . [t]here is nothing of concrete substance to let us know how the IRS is interpreting the law, except that it is interpreting it strongly and with definitive consequences for the organization.

Fred Stokeld, *Christian Broadcasting Network, IRS Reach Settlement*, 78 TAX NOTES 1596 (March 30, 1998)(internal quotation marks omitted).

[160] *See* Tax Analysts v. Internal Rev. Serv., 53 F. Supp. 2d 449, 452 (D.D.C. 1999)(holding that exempt organization closing agreements are not subject to the public disclosure requirements of section 6104, and that section 6103 bars their disclosure because closing agreements constitute "return information" by containing "determinations of the existence . . . of liability."); Tax Analysts v. Internal Rev. Serv., Civ. No. 98-2345 (TPJ) (D.D.C. Aug. 6, 1999), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 152-78 (Aug. 9, 1999)(denying release of closing agreement between IRS and Christian Broadcasting Network).

operations of State nonprofit laws. The respondent cannot be expected to defer to the pace, resources, and judgment of 50 State attorneys general. This case illustrates how the threat of exemption and nothing less can get the attention of the State courts. Moreover, there might never be a State proceeding that leads to governance reforms, particularly since the IRS is barred by law from disclosing its investigations to the State until final determination of revocation of exemption—and revocations are so rare. In sum, the American taxpayer should not be expected to support charities that lack basic fiduciary discipline.

If ever a case invokes the ultimate sanction of loss of exemption, the continuing tenure of these Incumbent Trustees does. The Court's narrow construction of the issues in this case fails to acknowledge that much more than excess compensation—highly excess compensation, I may add—appears in the record. The hubris of the Incumbent Trustees has so distorted their perception that they simply forgot why they were placed in such an important position of trust. What charity trustees spend hundreds of thousands of dollars paying lawyers to seek ways to evade regulatory oversight, to the point where they considered giving up tax-exempt status altogether, at a potential cost of $900 million?[161] Evidently, only the quirk that the Bishop Estate was a charitable trust rather than a nonprofit corporation averted such a flight from regulation, since probate court approval would not have been required for a corporate change in domicile.[162] Moreover, the Incumbent Trustees expended over $800,000 in legal fees during 1995 and 1996 to lobby against the intermediate sanctions legislation, including the failed effort to have the "state law" footnote removed from the legislative history.[163] Additionally, trust assets were expended for political activities, and at least one Incumbent Trustee reportedly lobbied to defeat the reconfirmation of the attorney general, the Incumbent Trustees' nemesis.[164] Finally, the record includes cases of co-investing and other improprieties by Incumbent Trustees and their affiliates, matters that in some cases have inspired criminal investigations.[165] This litany makes the neglect of prudent investing and educational purpose seem almost

---

[161] *See* Interim Trustees' Proposed Findings of Fact, *supra* note 144, at ¶ 63 (citing testimony that KSBE spent almost $300,000 in evaluating a possible change in domicile and tax status). As the expert report of Professor John Langbein stated: "Prudent trustees do not spend trust funds to explore ways of harming their beneficiaries." Interim Trustees' Trial Memorandum, *supra* note 144, at III.B.1 & n.8 (quoting Expert Report of John Langbein, Oct. 6, 1999, Attachment D to the Interim Trustees' Proposed Findings of Fact, *supra* note 144).

[162] Former attorney general Bronster commented recently that the interests of her office and of the IRS were not perfectly aligned. As an example, she observed that the federal tax agency showed no concern over the state of domicile. *EO Committee Meeting*, *supra* note 36.

[163] *See* Interim Trustees' Proposed Findings of Fact, *supra* note 144, at ¶¶ 64-72.

[164] *Id.* at ¶¶ 76-80.

[165] *See* note 26, *supra*.

a benign sideshow. Nevertheless, the Incumbent Trustees flaunted State court authority by ignoring probate court orders to terminate the lead-trustee governance system and to institute a CEO-based management system; to clarify Estate financial records; to adopt a plan for spending accumulated income; and to waive commissions on final distributions of capital.[166]

Given the strong federal interest in making sure that charitable organizations operate within the confines of law, I see no compelling reason why Congress's failure to enact a broad "equity" power in the IRS should be seen as a refutation of the IRS's ability to extract whatever concessions it deems appropriate in the closing agreement process. In the absence of Congressional direction to the contrary, I would not handcuff the agency to the extent the Court suggests.

Moreover, the IRS did not exercise impermissible equity powers; its warning was not a threat, but a courtesy. Effectively, the IRS said: "We cannot permit this charity to keep its tax-exempt status with these people at the helm—the pattern of abuse is simply too great. Nevertheless, to avoid punishing the beneficiaries, before revoking exemption and sending a tax bill, we'll announce our intentions to allow the appropriate court to remove the trustees (or let them resign)."[167] Should this not be how the Service negotiates a closing agreement?

In this case, the respondent determined that the Incumbent Trustees engaged in a pattern of activity so consistently adverse to the interests of KSBE that, on a going-forward basis, KSBE could not be considered to be operating as a charitable organization. Indeed, by concluding a (provisional) closing agreement before the permanent removal of the Incumbent Trustees, the respondent has exercised admirable deference to the State law proceedings.

Finally, this Court does not address the broader administrative concern: If we restrict the IRS's powers with respect to closing agreements in the section 501 area, what, if anything, does this do with respect to IRS powers in other closing agreement situations? In the business setting, closing agreements can often specify in detail acceptable transfer pricing methods which in essence would dictate a change in internal business practices.[168] It appears that the "new" IRS will focus even more on education and settlement under the general rubric of "voluntary compliance." Before propounding a restriction on IRS powers in closing agreements in the section 501 area, this Court should make certain that the exempt-organization regime is sufficiently distinguishable enough from other areas of tax enforcement that we avoid creating a bad precedent for tax administration generally. The complexity of

---

[166] Interim Trustees' Proposed Findings of Fact, *supra* note 144, at ¶¶ 92-96.

[167] I am grateful to Professor Randall Roth for this formulation.

[168] I thank Professor John Colombo for this observation.

the issues can be illustrated by a recent legislative provision to preserve the confidentiality of advance pricing agreements; perhaps we should also leave it to Congress to decide whether exempt-organization closing agreements should be kept confidential in all cases, which would facilitate settlements, but at the cost of public education.[169]

HERNANDEZ, OPPEWAL, BULLOCK, DAVIS, JONES, DE COSTA, GRANT, and SIBLEY, JJ., join in this dissenting opinion.

---

[169] See sections 6103(b)(C) and 6110(b), as amended by section 521 of The Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. No. 106-170, 113 Stat. 1860 (1999) (treating advance pricing agreements as confidential taxpayer information). Note that the Joint Committee has recently recommended that exempt-organization closing agreements be made public (and without redaction), but makes no disclosure recommendation with respect to closing agreements not involving tax-exempt organizations. *See* JOINT COMM. ON TAX'N, *supra* note 31, at 85 n.186.

Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law

Susan N. Gary*

I. INTRODUCTION

Recent and very public problems in the nonprofit world point to the need for greater scrutiny and some means to protect charities[1] from overreaching by directors, trustees, and managers. In 1991, investigative journalists exposed lavish personal expenditures by United Way's president, William Aramony.[2] Aramony himself was later convicted of theft,[3] but United Way's problems raise serious questions about corporate governance in the nonprofit context.[4] United Way's thirty-person board of directors provided little supervision and oversight during Aramony's tenure.[5] The board's passivity allowed a dominant executive officer to manage the charity in a way that benefited himself and his friends at the expense of the organization.[6]

---

* Assistant Professor of Law, University of Oregon. B.A., Yale University, 1977; J.D. Columbia University School of Law, 1981. Work on this Article was supported by a 1999 Summer Research Award from the Office of Research and Faculty Development, University of Oregon. The author thanks Evelyn Brody, Caroline A. Forell, Alexander B. Murphy, and Randall W. Roth for extremely helpful comments on this Article, Valerie H. Sasaki for research assistance, and Karyn Smith for administrative and secretarial support.

[1] Terminology with respect to charities and nonprofits is problematic. The term "nonprofit" refers to an organization subject to a nondistribution constraint, that is, "an organization that is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees." Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980) [hereinafter Hansmann, *Role*]. "Charities" is a subclass of nonprofits, and not all nonprofits are charities. For the most part, the focus of the Article is on charities, and that term will be used predominantly. Nonetheless, much of this Article also applies to entities organized as nonprofits but not necessarily as charities—for example, mutual benefit corporations.

[2] *See* Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631, 633-35 (1998).

[3] *See* Karen W. Arenson, *Former United Way Chief Guilty in Theft of More Than $600,000*, N.Y. TIMES, Apr. 4, 1995, at A1; *see also* United States v. Aramony, 88 F.3d 1369 (4th Cir. 1996), *cert. denied*, 520 U.S. 1239 (1999)(upholding all but one count of his conviction).

[4] *See* Evelyn Brody, *Institutional Dissonance in the Nonprofit Sector*, 41 VILL. L. REV. 433, 455-56 (1996) [hereinafter Brody, *Institutional Dissonance*]; Goldschmid, *supra* note 2, at 634-35.

[5] *See* Goldschmid, *supra* note 2, at 634; David Shenk, *Board Stiffs*, WASH. MONTHLY 9-13 (May 1992).

[6] *See* Goldschmid, *supra* note 2, at 633; Charles E. Shepard, *Perks, Privileges and Power in a Nonprofit World*, WASH. POST, Feb. 16, 1992, at A1.

Adelphi University also fell victim to conflicts of interest and neglect of duty by its president and its board of trustees.[7] After alumni, faculty and students formed the Committee to Save Adelphi, the New York Board of Regents investigated and found misappropriation of funds, conflicts of interest of board members, and excessive expenditures by President Diamandopoulos.[8] At a time when the University's academic reputation and student body was declining, Diamandopoulos was the second highest paid university president in the country.[9]

The most recent example of a major charity facing issues involving breaches of fiduciary duties is the Kamehameha Schools Bishop Estate ("Bishop Estate"). Investigations into the management of Bishop Estate assets have exposed favoritism, incompetence and numerous transactions involving conflicts of interests and private inurement of the trustees and others connected with the trust.[10] Public outcry, an Internal Revenue Service ("IRS") audit,[11] and an investigation by the Attorney General[12] eventually led to the resignation or removal of the five Bishop Estate Trustees.[13]

---

[7] *See* JAMES J. FISHMAN & STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS (1995)(Supp. 1998) at 9-10; Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1401-02 (1998) [hereinafter Brody, *Limits*].

[8] *See* FISHMAN & SCHWARZ, *supra* note 7, (Supp. 1998) at 9-18.

[9] *See id.* (Supp. 1998) at 10.

[10] *See* Petition of the Attorney General on Behalf of Trust Beneficiaries to Remove and Surcharge Trustees, for Accounting, and for Other Equitable Relief, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Sept. 10, 1998) [hereinafter Petition of the Attorney General], *available at* <http://starbulletin.com/98/09/11/news/removal.html>; Samuel King, Msgr. Charles Kekumano, Walter Heen, Gladys Brandt & Randall Roth, *Broken Trust*, HONOLULU-STAR-BULLETIN, Aug. 9, 1997, at B-1 [hereinafter *Broken Trust*], reprinted in Appendix C to this issue of the *University of Hawai'i Law Review*.

[11] *See* Rick Daysog, *IRS Wants Bishop Trustees Out*, HONOLULU STAR-BULLETIN, Apr. 28, 1999, at A-1.

[12] *See* Rick Daysog, *Trustee Lindsey Removed*, HONOLULU STAR-BULLETIN, May 6, 1999, *available at* <http://starbulletin.com/1999/05/06/news/story1.html> (describing the permanent removal of Trustee Lokelani Lindsey). *See* Petition of the Attorney General, *supra* note 10.

[13] *See* Rick Daysog, *Then There Were None*, HONOLULU STAR-BULLETIN, May 8, 1999, at A-1 (describing the resignation of trustee Oswald Stender and the probate court's temporary removal of trustees Richard Wong, Henry Peters, Lokelani Lindsey, and Gerard Jervis); Rick Daysog, *Gerard Quits Trustee Post*, HONOLULU STAR-BULLETIN, Aug. 20, 1999, at A-1 (describing the resignation of Trustee Jervis); Rick Daysog, *For Wong, 'it took courage to resign'*, HONOLULU STAR-BULLETIN, Dec. 4, 1999, at A-1 (describing the resignation of Trustee Richard "Dickie" Wong); Rick Daysog, *Last Trustee Standing, Henry Peters Resigns*, HONOLULU STAR-BULLETIN, Dec. 14, 1999, at A-1 (describing the resignation of Trustee Peters); Rick Daysog, *'End of the line'*, HONOLULU STAR-BULLETIN, Dec. 17, 1999, at A-1 (describing the resignation of Trustee Lindsey which will take effect 30 days after her appeal of her permanent removal is decided).

The United Way and Adelphi University scandals, and now the Bishop Estate problems, have reduced public confidence in charities, while highlighting inadequacies in the regulatory framework that governs the activities of those who manage charities.[14] To protect charities, the law imposes fiduciary duties on the directors and trustees of charitable organizations.[15] These duties require the directors or trustees to act in the best interests of the organization and not to benefit personally at the expense of the organization.[16] Since the restoration of public confidence in nonprofits requires adequate enforcement of these fiduciary duties, the rules governing nonprofit management have recently come under considerable scrutiny.[17]

Confronting the problem of fiduciary duty abuse is complicated because, in the words of Professor Deborah DeMott, the fiduciary obligation is "one of the most elusive concepts in Anglo-American law."[18] Fiduciary duties arise in a variety of settings, and the extent and nature of the obligations vary depending upon the context.[19] The fiduciary concept arose in private trust law[20] and is now an integral part of corporate law. The regulation of charities does not fit neatly within the rules governing private trusts or for-profit business.

The laws that have developed for charitable organizations do not always work well, in part because they depend on enforcement mechanisms that work in the private trust or for-profit business context, but that do not necessarily make sense for charities.[21] Oversight by persons other than the trustees or directors is a case in point. The trust beneficiaries of a private trust can sue the trustee for breach of any of the trustee's fiduciary duties. Since the beneficiaries may lose part of their beneficial interest if the trustee violates the trust, the beneficiaries have an incentive to monitor the actions (or inaction) of the trustee. In a corporation, the shareholders keep an eye on the directors since director malfeasance will harm their interests. In addition, the

---

[14] *See* Rayna Skolnik, *Rebuilding Trust*, PUB. REL. J. 29, 32 (Sept. 1993)(describing "[t]he public's shift from sympathy to skepticism" following the United Way scandal).

[15] *See* FISHMAN & SCHWARZ, *supra* note 7, at 158-59.

[16] *See id.*

[17] *See* Harriet Bograd, *The Role of State Attorneys General in Relation to Troubled Nonprofits* 24 (Program on Non-Profit Orgs., Yale Univ., Working Paper No. 206, Aug. 1994); Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. SCH. L. REV. 457 (1996) [hereinafter Brody, *Agents*]; Goldschmid, *supra* note 2; Shenk, *supra* note 5, at 9-13.

[18] *See* Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879 (1988).

[19] *See* FISHMAN & SCHWARZ, *supra* note 7, at 158-59.

[20] *See* DEBORAH A. DEMOTT, FIDUCIARY OBLIGATION, AGENCY AND PARTNERSHIP 12 (1991).

[21] *See infra* notes 238 and 245 and accompanying text.

marketplace and the need to make a profit provide other external incentives for directors to perform their jobs properly.

Unlike private trusts, charitable trusts have no specific individuals identified as beneficiaries who can sue to enforce the trust.[22] And unlike business corporations, nonprofit corporations have no shareholders.[23] If the nonprofit has voting members, the members may have a legal right to represent the nonprofit by taking directors who misbehave to court, but most nonprofits do not have voting members.[24] For both types of charitable entities, the persons who have direct knowledge of the organization and who can sue are often limited to the trustees and directors themselves. In many situations, only the attorney general can sue to protect the charity from overreaching managers.[25]

Some state and federal laws on charitable management exist. However, without the immediate oversight of shareholders and the marketplace or of private beneficiaries, many charities are controlled by one or a few persons. Those persons may be able to operate undetected if they seek private benefit at the expense of the nonprofit.[26]

This Article considers what can and should be done to improve enforcement of fiduciary duties in the charitable sector. The Article analyzes the fiduciary duties concept in both trust and corporate law and looks at the development of fiduciary duties law in the charitable context. It then reviews federal tax regulations of fiduciary behavior and considers recent changes that may improve the supervision of charities and the enforcement of the fiduciary duties of charitable directors and trustees. Regulation at the federal level, through the IRS, has become increasingly important. The Article concludes that problems associated with breaches of fiduciary duties lie not so much in the standards of conduct prescribed by the fiduciary duty requirements as in the enforcement of those standards. Greater access to information under new federal rules should help, but alternative means to enforce the standards are also necessary. Nonlegal strategies should complement legal enforcement.

---

[22] *See* RESTATEMENT (SECOND) OF TRUSTS § 112 cmt. h (1959)(explaining that charitable trusts can be created without named beneficiaries); *infra* notes 281-90 and accompanying text (discussing the special interests doctrine).

[23] *See* REV. MODEL NONPROFIT CORP. ACT xxiv-ix (1988)(Introduction)("One general rule is that members, unlike shareholders in business corporations, can have no ownership interest in their corporation.").

[24] *See infra* notes 267-71 and accompanying text.

[25] *See infra* notes 259-63 and accompanying text.

[26] James Fishman has been quoted as saying, "Non-profits are essentially unregulated and unmonitored unless the press gets wind of a story." Thomas J. Billitteri, *Rethinking Who Can Sue a Charity*, CHRON. PHILANTHROPY, Mar. 12, 1998, at 26, 35.

II. TRUST LAW

In England and in the colonies, charities organized themselves primarily as trusts.[27] After the American Revolution, some states refused to uphold the validity of charitable trusts, and charities began to form as corporations in substantial numbers.[28] Charities continue to be organized and operated as either charitable trusts or as nonprofit corporations.

Rules governing the fiduciary duties of trustees of private, noncharitable trusts also apply to the trustees of charitable trusts.[29] In addition, the fiduciary duties of directors of nonprofit corporations have developed as a hybrid of trust law and corporate law.[30] Thus, to understand the current state of the fiduciary laws that apply to charitable trustees and directors, it is instructive to review the laws of fiduciary duties that have developed for private, noncharitable trusts and for business corporations.

The law imposes a number of stringent duties upon trustees.[31] In a trust, ownership of the trust property is divided between the trustee, who holds legal title and controls the trust property, and the beneficiary, who holds equitable title and has the beneficial interest in the property.[32] The trust provides a useful vehicle for situations in which separating control from beneficial ownership makes sense.[33] Yet, separating control from beneficial ownership creates the risk that people controlling the property will use it for their own benefit or will mismanage it.[34] Fiduciary duties are intended to make the division of ownership function properly.[35]

Trustees must, first and foremost, administer the trust in conformance with the terms of the trust.[36] In general, a trustee cannot alter the terms of the trust,

---

[27] *See* FISHMAN & SCHWARZ, *supra* note 7, at 35.

[28] *See id.*

[29] *See* RESTATEMENT (SECOND) OF TRUSTS § 379 (1959).

[30] *See infra* notes 140-55 and accompanying text.

[31] *See* RESTATEMENT (SECOND) OF TRUSTS, § 2 cmt. h (1959); GEORGE G. BOGERT & GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES §§ 541-544 (2d rev. ed. 1991). The duty of loyalty and the duty of care are the most significant. *See infra* notes 39-54 and accompanying text.

[32] *See* GEORGE T. BOGERT, TRUSTS § 1 (6th ed. 1987).

[33] *See id.* § 2 ("It was said by an English lawyer many years ago that the parents of the trust were fraud and fear and that the court of conscience was its nurse.").

[34] *See id.* § 95.

[35] Justice Cardozo provided the classic statement of fiduciary standards:

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.

Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928)

[36] *See* UNIF. TRUST ACT § 801 (1999 Annual Meeting draft); RESTATEMENT (SECOND) OF

although under some circumstances a court may authorize modification or termination of a trust.[37] For this reason, the trust form is less flexible than the corporate form.[38]

A. *Duty of Loyalty*

Trustees must administer the trust solely in the interest of the beneficiaries.[39] The official comment to the Uniform Trust Act describes this "duty of loyalty" as "perhaps the most fundamental duty of the trustee."[40] The duty of loyalty is integral to the proper functioning of the trust because the trustee must manage the trust property with the interests of the beneficiaries, and not the trustee's own interests, in mind.[41] If a trustee breaches the duty of loyalty by entering into a transaction with the trust on the trustee's own behalf, then the trustee is held strictly liable for that self-dealing.[42] The beneficiary can require the trustee to undo the transaction, to pay to the trust any profit the trustee made on the transaction, or to repay the trust for any loss suffered by the trust.[43] A trustee who deals directly with the trust will have breached his or her duty of loyalty regardless of whether the trustee acted in good faith and regardless of the fairness of the transaction.[44] For example, if a trustee buys property from the trust, the beneficiary can void the transaction even if the trustee paid fair market value for the property.[45] A self-dealing transaction is voidable unless a court approved the transaction or the

---

TRUSTS § 169 (1959). An interesting issue, beyond the scope of this Article, is the extent to which the terms of the trust set forth in Princess Bernice Pauahi Bishop's will have been modified over the years. *See Broken Trust*, *supra* note 10.

[37] *See* discussion *infra* note 252.

[38] Charitable corporations may be deemed to hold property "in trust" or subject to a trust, so a charity organized as a nonprofit corporation may be bound by the *cy pres* doctrine if the charity seeks to change its charitable purpose. *See In re* Multiple Sclerosis Serv. Org. of N.Y., Inc., 496 N.E.2d 861 (N.Y. 1986)(applying New York's quasi-*cy pres* statute for charitable corporations).

[39] *See* UNIF. TRUST ACT § 802 (1999 Annual Meeting draft); RESTATEMENT (SECOND) OF TRUSTS § 170 (1959); BOGERT & BOGERT, *supra* note 31, § 543. Note that most charitable trusts have no specifically identified beneficiaries. Instead, the trust may specify a charitable purpose. *See* discussion *infra* section IV.B.1.

[40] *See* UNIF. TRUST ACT § 802 cmt. (1999 Annual Meeting draft); *see also* BOGERT & BOGERT, *supra* note 31, § 543.

[41] RESTATEMENT (SECOND) OF TRUSTS § 179 (1959); FISHMAN & SCHWARZ, *supra* note 7, at 200.

[42] *See* BOGERT, *supra* note 32, § 95.

[43] *See id.* The court acts in equity and the penalties and remedies available are subject to the discretion of the court. *See id.*

[44] *See id.*

[45] *See id.*

beneficiary approved the transaction after the trustee disclosed all material facts.[46]

A trustee will also breach the duty of loyalty if the trustee causes the trust to enter into a transaction with respect to which the trustee has a conflict of interest. In this situation, the trustee will not have breached the fiduciary fiduciary duty if the trustee can prove that he or she acted in good faith and that the transaction was reasonable and fair to the trust.[47]

B. Duty of Care

Trustees also must comply with a number of duties relating to the care of the trust property. The overall duty in this regard is the duty of prudent administration, sometimes referred to as the "prudent person" rule.[48] Trustees must administer the trust as a prudent person would, exercising reasonable care, skill and caution in doing so.[49] A trustee is expected to use the skills the trustee has, including special skills or ability.[50]

A trustee must control and protect the trust property,[51] earmark the property as property belonging to the trust[52] and keep the property separate from the trustee's own property.[53] Finally, the trustee must exercise all powers granted to the trustee reasonably and in good faith and with due regard for interests of the beneficiaries.[54]

---

[46] *See* UNIF. TRUST ACT § 802 (1999 Annual Meeting draft); BOGERT & BOGERT, *supra* note 31, § 543.

[47] *See* BOGERT & BOGERT, *supra* note 31, § 543; *see also* JESSE DUKEMINIER & STANLEY M. JOHANSON, WILLS, TRUSTS, AND ESTATES 905, 907 (5th ed. 1995). Related to the duty of loyalty is the duty of impartiality which is the duty to act impartially with respect to all beneficiaries of the trust, taking into consideration their respective rights and interests. *See* RESTATEMENT (SECOND) OF TRUSTS § 183 (1959); UNIF. TRUST ACT § 803 (1999 Annual Meeting draft).

[48] *See* FISHMAN & SCHWARZ, *supra* note 7, at 161; UNIF. TRUST ACT § 804 (1999 Annual Meeting draft)("Prudent Administration").

[49] *See* UNIF. TRUST ACT § 804 (1999 Annual Meeting draft).

[50] *See* RESTATEMENT (SECOND) OF TRUSTS § 174 (1959)("[I]f the trustee has or procures his appointment as trustee by representing that he has greater skill than that of a man of ordinary prudence, he is under a duty to exercise such skill.").

[51] *See id.*

[52] *See id.* § 179 cmt. d.

[53] *See id.* § 179.

[54] *See id.* §§ 172-182; UNIF. TRUST ACT §§ 809-813 (1999 Annual Meeting draft); BOGERT & BOGERT, *supra* note 31, § 544.

C. Delegation

The existence of these onerous duties of the trustee[55] raises the question of when a trustee can delegate some of these responsibilities. Historically, rules permitting delegation in the trust context were limited in scope.[56] The limits on delegation reflect the importance of the trustee's role and the need for the grantor of the trust to place his or her trust in the person designated as trustee.[57]

The traditional formulation of the rule on delegation states that a trustee cannot delegate to others acts that the trustee can reasonably be expected to perform personally.[58] However, the trustee can delegate those duties that an ordinarily prudent person would delegate to agents.[59] Over the years, a distinction was drawn between ministerial duties, which could be delegated, and discretionary duties, which could not be delegated due to the need for ongoing analysis and decision making.[60]

A trend to permit trustees to delegate more of their discretionary duties began as early as 1964, when the Commissioners on Uniform State Laws adopted the Uniform Trustees' Powers Act.[61] This act provides that a trustee may employ agents "to advise or assist the trustee in the performance of his administrative duties . . . ."[62] The trustee must act reasonably in selecting the agents and in relying on their advice, but the trustee may act on the recommendations of the agents without independent investigation.[63] The trustee may also employ agents to perform "any act of administration, whether discretionary or not."[64]

Important fiduciary duties are associated with investment decision making. Fiduciary behavior has, in the past, been guided by the prudent person

---

[55] *See* DUKEMINIER & JOHANSON, *supra* note 47, at 905.

[56] *See generally* Jerome J. Curtis, Jr., *The Transmorgrification of the American Trust*, 31 REAL PROP. PROB. & TRUST J. 251, 253-66 (1996)(describing the history of the duty not to delegate in English and American law).

[57] *See id.*

[58] *See* RESTATEMENT (SECOND) OF TRUSTS § 171 (1959).

[59] *See id.* § 378 cmt. a; *see also* Curtis, *supra* note 56, at 253-66 (describing the history in England and the United States of the duty not to delegate).

[60] *See* 2A AUSTIN W. SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS, § 171 (4th ed. 1987); *see also* Curtis, *supra* note 56, at 257-65.

[61] *See* UNIF. TRUSTEES' POWERS ACT (1964), 7B U.L.A. 741 (1985).

[62] *Id.* § 3(c)(24).

[63] *See id.*

[64] *Id.*; *see also* Curtis, *supra* note 56, at 254-55. Sixteen states—Arizona, Florida, Hawai'i, Idaho, Kansas, Kentucky, Maine, Michigan, Mississippi, Nebraska, New Hampshire, New Mexico, Oregon, South Carolina, Utah, and Wyoming—have adopted the approach taken by the Uniform Trustees' Powers Act. *See* UNIF. TRUSTEES' POWERS ACT Table of Jurisdictions Wherein Act Has Been Adopted (1964), 7B U.L.A. 741 (Supp. 1999).

standard. That standard, combined with the duty not to delegate investment decision making (an administrative duty), has been criticized as not keeping pace with changes in investment theory and the need for many trustees to work with investment advisors.[65] The prudent person standard for investment decision making focuses on individual assets and dictates conservative investments to protect principal.[66] New investment theories, in contrast, advocate managing risk across a portfolio, looking at the investments as they relate to each other rather than individually.[67]

In 1972, the National Conference of Commissioners on Uniform State Laws adopted the Uniform Management of Institutional Funds Act (hereinafter "UMIFA").[68] UMIFA applies specifically to charities, both to trustees of charitable trusts and to directors of nonprofit corporations.[69] It eases restrictions on investments that apply under trust law and adopts a business judgment approach in the duty of care it imposes on directors and trustees in connection with investment decision making.[70] Charitable advisors greeted this loosening of fiduciary standards with enthusiasm.[71]

Building on the UMIFA, the Uniform Law Commission promulgated the Uniform Prudent Investor Act in 1994, embracing modern portfolio theory by creating new rules with respect to delegating the power to select investments.[72] The Uniform Prudent Investor Act adopts a prudent investor standard to replace the prudent person standard regarding investment decisions, recognizing that for many individual trustees, delegating some investment

---

[65] *See* Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 N.Y.U. L. REV. 52 (1987); Kenneth L. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433 (1960); John H. Langbein, *Reversing the Nondelegation Rule of Trust-Investment Law*, 59 MO. L. REV. 105 (1994).

[66] *See* BEVIS LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE 152-57 (1986).

[67] *See id.* at 156; *see also* UNIF. PRUDENT INVESTOR ACT § 3 (1994), 7B U.L.A. (Supp. 1999).

[68] *See* UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT (1972), 7A pt. II U.L.A. 475 (1999).

[69] *See* Carolyn C. Clark & Glenn M. Troost, *Forming a Foundation: Trust vs. Corporation*, 3 PROB. & PROP. 32 (May/June 1989); Antonia M. Grumbach & W.B. McKeown, *Fiduciary Responsibilities of Private Foundation Boards*, 125 TR. & EST. 37, 38 (Sept. 1986).

[70] *See* UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT § 6 (1972), 7A pt. II U.L.A. 500 (1972)("[M]embers of a governing board shall exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision . . . .").

[71] *See, e.g.*, Grumbach & McKeown, *supra* note 69.

[72] *See* UNIF. PRUDENT INVESTOR ACT § 2(b) (1994), 7B U.L.A. (Supp. 1999)("A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.").

authority is actually the prudent approach.[73] The Act reflects changes in investment theory, particularly the development of portfolio theory.[74]

Most recently, the Restatement (Third) of Trusts and the Uniform Trust Act have both adopted the approach of the Uniform Prudent Investor Act, permitting delegation to the extent that a prudent trustee would delegate.[75] The trustee may delegate only those responsibilities that a prudent person acting on his or her own behalf might delegate, and must exercise care in selecting and supervising the agents who conduct the duties.[76] Whether delegation is permissible still depends on the terms of the trust, the particular facts surrounding the trust, and the skills and abilities of the trustee.[77] For example, delegation of certain aspects of trust administration may be more appropriate for an individual trustee than for a corporate trustee.[78]

The impetus behind the changes to the nondelegation rules in the Restatement (Third) and the Uniform Trust Act was concern about the

---

[73] *See* Langbein, *supra* note 65, at 117-18.

[74] *See id.* at 105; *see also* John H. Martin, *A Preface to the Prudent Investor Rule*, 132 TR. & EST. 42 (Nov. 1993); Ronald A. Sages, *The Prudent Investor Rule and the Duty Not to Delegate*, 134 TR. & EST. 22 (May 1995).

[75] *See* RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 171 (1992); UNIF. TRUST ACT. § 807 (1999 Annual Meeting draft).

The Restatement (Third) of Trusts provides as follows:

> § 171 Duty with Respect to Delegation
>
> A trustee has a duty personally to perform the responsibilities of the trusteeship except as a prudent person might delegate those responsibilities to others. In deciding whether, to whom and in what manner to delegate fiduciary authority in the administration of a trust, and thereafter in supervising agents, the trustee is under a duty to the beneficiaries to exercise fiduciary discretion and to act as a prudent person would act in similar circumstances.

RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 171 (1992).

The Uniform Trust Act provides as follows:

> Section 807. Delegation by Trustee.
>
> (a) A trustee may delegate duties and powers that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in:
>
> (1) selecting an agent;
>
> (2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and
>
> (3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

UNIF. TRUST ACT § 807 (1999 Annual Meeting draft).

[76] *See* RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227 cmt. j (1992).

[77] *See id.*

[78] *See* UNIF. TRUST ACT § 807 (1999 Annual Meeting draft)("For example, delegation of trust administration and reporting duties must be prudent for a family trustee but unnecessary for a corporate trustee.").

trustees' duties to make investment decisions.[79] Comments to the Restatement state that the new rules simply extend and clarify the prudent person rule, noting that in some circumstances a prudent person would employ agents.[80] Yet, the Restatement (Third) and the Uniform Trust Act do not limit their statements of when delegation is permissible to the investment context.[81] By creating rules that describe a trustee's ability to delegate discretionary duties in general terms, the Restatement and the Uniform Trust Act leave open questions about the delegation of discretionary duties other than investment decision making.[82] The trustee still must act prudently in deciding when to delegate authority,[83] but the Restatement and the Uniform Trust Act reflect an erosion of the duty not to delegate that may go beyond investment decisions.[84]

D. Standing to Enforce the Trust

The fiduciary duties of a trustee of a private trust protect the interests of the trust beneficiaries.[85] If a trustee breaches a duty, the beneficiaries have standing to sue the trustee.[86] So important is the beneficiary to the proper functioning of the trust that a valid private trust cannot exist without a reasonably identifiable beneficiary.[87] A trust must have beneficiaries both because the trust must be administered for the benefit of the beneficiaries and because the beneficiaries can monitor the trustee and enforce the trust if the trustee breaches a duty the trustee owes to the beneficiaries.[88] In general, the beneficiaries are the only persons who can enforce the trust, although third parties can sue the trustee to protect an interest in the trust property.[89]

In order to protect their interests, beneficiaries need information about the trust.[90] Therefore, trustees have an additional duty to keep the beneficiaries of the trust reasonably informed about the administration of the trust and to respond promptly to reasonable requests for information from the

---

79 *See* LONGSTRETH, *supra* note 66, at 158-59.

80 *See* RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227 cmt. a (1992).

81 *See* Curtis, *supra* note 56, at 269.

82 *See id.* at 269-76 (describing the need for restrictions on delegation and liability for improper delegations).

83 *See* RESTATEMENT (THIRD) OF TRUSTS § 227(c)(2)(1992)(requiring trustees to act with prudence in deciding when to delegate).

84 *See* Curtis, *supra* note 56, at 252-53, 269 (expressing concern about the erosion of the duty not to delegate).

85 *See supra* notes 31-35 and accompanying text.

86 *See* RESTATEMENT (SECOND) OF TRUSTS §§ 198, 199 (1959).

87 *See id.* § 112.

88 *See id.* § 199.

89 *See id.* § 200.

90 *See* BOGERT, *supra* note 32, § 141.

beneficiaries.[91] Adequate information combined with the fiduciary duties imposed on the trustee should give beneficiaries the tools necessary to enforce the trust. Of course, supervision by the beneficiaries is not always effective and mismanagement by trustees of private trusts does occur.[92] Nonetheless, the existence of beneficiaries greatly increases the supervision of private trusts as compared with charitable trusts.

III. CORPORATE LAW

In a corporation, the directors control the corporate assets while the shareholders own the corporation.[93] As in the trust setting, fiduciary duties imposed on corporate directors help to manage the division between control and beneficial ownership.[94] Although the fiduciary concepts in corporate law are similar to those in trust law, they have evolved somewhat differently. This Part reviews the laws that regulate directors of business corporations.

A. *Duty of Loyalty*

Directors of a corporation have a general duty to put the interests of the corporation above their personal interests.[95] The Corporate Director's Guidebook explains that the principle underlying the duty of loyalty is that "the director should not use his corporate position to make a personal profit or gain other personal advantage . . . ."[96] Like a trustee, a director must put the interests of the corporation first. Unlike trust law, however, corporate law provides that a transaction between a director and the corporation will not be voidable if the transaction is fair to the corporation at the time the director and

---

[91] *See* UNIF. TRUST ACT § 813 (1999 Annual Meeting draft); *see also* RESTATEMENT (SECOND) OF TRUSTS §§ 172 (duty to keep and render accounts), 173 (duty to furnish information) (1959).

[92] *See* Lewis Beale, *An Heir-Raising Enterprise*, L.A. TIMES, Nov. 18, 1992, at E1 (describing complaints by trust beneficiaries against bank trustees).

[93] *See* ADOLPH A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 4-5 (1932). The separation of ownership (by the shareholders) and control (by the directors) creates a "principal-agent problem." Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327, 342 (1983).

[94] *See* Brody, *Limits*, *supra* note 7, at 1424. The directors owe their duties to the corporation, rather than to the shareholders, but the existence of the duties serves to protect the interests of the shareholders. *See id.*

[95] *See generally*, WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 837.50 (rev. ed. 1994) [hereinafter FLETCHER CYC. CORP].

[96] 1 AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS 137 (1994) [hereinafter ALI PRINCIPLES] (citing THE CORPORATE DIRECTOR'S GUIDEBOOK 1599-1600).

the corporation entered into it.[97] The American Law Institute's Principles of Corporate Governance ("ALI Principles") uses the term "duty of fair dealing" for the duty of loyalty.[98]

The ALI Principles provide for a lower level of scrutiny if the interested director makes adequate disclosure and if disinterested directors or shareholders ratify the transaction.[99] The interested director must disclose to the decision maker (either the disinterested directors or the shareholders) all material facts[100] concerning the conflict of interest and the transaction.[101] Disinterested directors who could reasonably have concluded that the transaction was fair to the corporation must either authorize the transaction in advance or ratify the transaction.[102] In the alternative, shareholders may authorize or ratify the transaction if the transaction does not constitute a waste of corporate assets.[103] The ALI Principles additionally require that the approval by disinterested directors or shareholders be "in good faith."[104] If the director complies with these safe harbor rules requiring disclosure and disinterested approval, then law in most states will provide that the person attacking the transaction will have the burden of proof to show that the transaction lacked fairness.[105]

B. Duty of Care

A corporate director must oversee the conduct of the corporation's business and review and approve major corporate plans.[106] The actual management of the corporation is conducted by the senior executives, designated by the directors.[107] Thus, the corporate structure assumes a supervisory role for the directors.[108] In fulfilling his or her duties, a corporate director must act "in

---

[97] *See id.* at 206-07 (explaining that, in the past, courts held that interested transactions were voidable without regard to fairness, but that the modern view is to let a transaction stand if the transaction was fair).

[98] *See id.* at 199-200 (explaining that the duty of loyalty encompasses a director's pecuniary and nonpecuniary interests in a transaction, and that for purposes of the ALI Principles, the duty of fair dealing refers only to pecuniary conflict of interest situations).

[99] *See id.* § 5.02.

[100] *See id.* § 1.25 (stating that "[a] fact is 'material' if there is a substantial likelihood that a reasonable person would consider it important under the circumstances in determining the person's course of action.").

[101] *See id.* § 1.14.

[102] *See id.* § 5.02(a)(2)(B), & (C).

[103] *See id.* § 5.02(a)(2)(D).

[104] *See id.* at 212.

[105] *See id.* § 5.02(b).

[106] *See id.* § 3.02.

[107] *See id.* at § 3.01.

[108] *See id.* at 82-88.

good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances."[109] This characterization of the duty of care from the ALI Principles reflects the approach taken in most states.[110] In general, the duty of care requires a director to oversee the business of the corporation, to make further inquiries if information suggests trouble in the corporation, to obtain adequate information for decision making and to make decisions carefully.[111]

The business judgment rule, now widely adopted,[112] modifies the duty of care. The business judgment rules protects a director who makes a decision the director "rationally believes" to be in the best interests of the corporation, if the director does not have a personal interest in the transaction, and if the director is informed "to the extent the director or officer reasonably believes to be appropriate under the circumstances . . . ."[113] Comment d to section 4.01 of the ALI Principles explains that the term "'rationally believes' is intended to permit a significantly wider range of discretion than the term 'reasonable' . . . ."[114] Thus, if a director is not an interested party in the transaction and has obtained adequate information about the transaction, then only a rational belief is necessary to protect the director from liability if the decision made does not produce results hoped for by the corporation.[115]

In addition to the protection for directors provided by the business judgment rule, many states permit corporations to include a provision in the articles of incorporation limiting director liability under the duty of care.[116] Under the Delaware statute, for example, the corporation can reduce liability for a breach of the duty of care but cannot limit liability for a breach of the duty of loyalty for acts not in good faith, intentional misconduct, or acts that result in improper personal benefit to the director.[117] Melvin Eisenberg[118] has argued

---

[109] *Id.* § 4.01(a).

[110] *See id.* § 401 cmt. a.

[111] *See* Melvin Aaron Eisenberg, *The Duty of Care of Corporate Directors and Officers*, 51 U. PITT. L. REV. 945, 951-69 (1990)(describing the moral obligations that underlie the duty of care such as the duty to monitor, the duty of inquiry, and the duty to use reasonable care in performing the decision making function both procedurally and substantively).

[112] *See* 1 ALI Principles, *supra* note 96, at 144.

[113] *Id.* § 4.01(c).

[114] *Id.* § 4.01 cmt. d.

[115] *See* FLETCHER CYC. CORP, *supra* note 95, § 837.50 (describing the fiduciary duties of corporate directors).

[116] *See generally* Douglas M. Branson, *Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors*, 57 FORDHAM L. REV. 375, 380-82 (1988)(describing "The Parade to Opt Out of Duty of Care Liability"). At least 30 states now permit exclusions from duty of care liability. *See id.* at 381 n.30.

[117] *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1988).

[118] Chief Reporter of the American Law Institute's Principles of Corporate Governance, Part

that loss of the duty of care through statutes such as the Delaware statute could lead to increased government intervention in the future.[119] In his view, the duty of care has served as an important mechanism for director accountability and has reduced the need for government intervention.[120] Nonetheless, the trend toward greater private control of corporations by removing common law boundaries on shareholder rule may extend to reductions in the duty of loyalty as well.[121]

C. Delegation

Increasingly, directors can "delegate functions and powers to committees of the board, individual directors or officers, employees, and other persons."[122] The directors continue to have oversight responsibility, but for duty of care purposes the focus has become the care taken in selecting the person who will provide assistance and the reasonableness of reliance on information provided or recommendations made by that person.[123] The ALI Principles allow a director who acts reasonably and in good faith to rely on board committees and on individual directors, officers, employees, and professionals hired by the board[124] for decisions, judgments and performance, as well as for information.[125] A director must read or understand the information or decision in order to rely on it. The reasonableness of relying without making an independent review can depend on such factors as the importance of the issue

---

IV of which concerns the duty of care. *See* Eisenberg, *supra* note 111, at aa.

[119] *See id.* at 972; *see also, e.g.*, Mark J. Loewenstein, *The SEC and the Future of Corporate Governance*, 45 ALA. L. REV. 783 (1994)(proposing an amendment to the Securities Act of 1933 authorizing the SEC to condition the availability of certain simplified methods of issuing securities under the Act on the existence of an independent board, as determined by the SEC).

[120] *See* Eisenberg, *supra* note 111, at 972; *see also* Diane L. Saltoun, *Fortifying the Directorial Stronghold: Delaware Limits Director Liability*, 29 B.C. L. REV. 481, 484 (1988)(arguing that the Delaware statute "destroys the balance between shareholder protection and management autonomy by permitting a corporation to eliminate directorial accountability and thus effectively render shareholders defenseless.").

[121] *See generally*, Branson, *supra* note 116 (describing and decrying recent proposals to permit corporations to "opt out" of the duty of loyalty).

[122] 1 ALI PRINCIPLES, *supra* note 96, at 141.

[123] *See id.* § 4.02.

[124] The ALI Principles follow the lead of the Model Business Corporation Act in providing that directors can rely on a wide range of experts. This approach, while consistent with recent statutory provisions and court decisions, has not yet been widely adopted. *See id.* at 193.

[125] *See id.* §§ 4.02, 4.03; *see also* Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1487 (1984)("The law has also become more realistic in recognizing that much of a board's work is, and must be, done in committee, and in according to the board the privilege of reliance upon the work product of its committees.").

to the corporation, the complexity of the issue, and the background and experience of the person providing the information or making the decision.[126]

In addition to the fact that directors increasingly rely on persons within and without the corporation, the corporate structure itself operates to remove the board from management of the business. The ALI Principles reflect the fact that corporate directors no longer manage the corporation or make business policy.[127] Instead, the corporate structure set forth in the ALI Principles assumes that senior executives will manage the corporation, including making business policy, while the directors will supervise the senior executives and review and approve major corporate actions.[128] Thus, fiduciary duties in the business corporation context have weakened in recent years and cannot serve as a resource for strengthening laws regulating fiduciary duties in the charitable sector. To the contrary, reliance on corporate law developments as a model for change in the rules governing charities may further weaken charitable laws.

D. Standing

To protect their interests in the corporation, shareholders can bring derivative suits on behalf of the corporation.[129] The introductory note on derivative actions in the ALI Principles explains the need to balance "the availability of legal recourse" to enforce "management's obligations to its shareholders"[130] with the financial and other costs to the corporation and its managers of nonmeritorious suits.[131] The ALI Principles assign "only a limited role to the derivative action as a mechanism of corporate accountability,"[132] but recognize that "the derivative action may offer the only effective remedy in those circumstances in which a control group has the ability to engage in self-dealing transactions with the corporation."[133]

If directors breach their fiduciary duties to the corporation, a shareholder can sue on behalf of the corporation, thereby protecting the interests of all the shareholders.[134] Any recovery will be paid to the corporation, and not to the shareholder who brought the suit.[135] Although shareholders theoretically have

---

[126] *See* 1 ALI PRINCIPLES, *supra* note 96, at 190.

[127] *See* Eisenberg, *supra* note 111, at 949.

[128] *See* 1 ALI PRINCIPLES, *supra* note 96, §§ 3.01, 3.02; *see also* Eisenberg, *supra* note 111, at 949-50.

[129] *See* 2 ALI PRINCIPLES, *supra* note 96, §§ 7.01, 7.02.

[130] *Id.* Intro. Note, at 4-5.

[131] *See id.* at 6.

[132] *Id.*

[133] *Id.* at 5.

[134] *See id.* §§ 7.01, 7.02.

[135] *See id.* § 7.16.

the remedy of a derivative suit, in large corporations, shareholder oversight of management is minimal.[136] Shareholders can also address concerns about director mismanagement by voting the directors out of office, but in large, public companies, an individual shareholder's only recourse in the face of director mismanagement may be to sell the stock.[137]

IV. CHARITABLE ORGANIZATIONS

A. *State Law*

Against this background of private trusts and business corporations stand charitable organizations. Like their private counterparts, charities are subject to regulation under state law, either the law of charitable trusts or the law of nonprofit organizations.[138] A peculiarity of the law of charities is that that the organizational form of the entity—whether the charity is organized as a trust or as a nonprofit corporation—will determine the standards to which its fiduciaries will be held. This section reviews these state law rules governing the fiduciary behavior of those who manage charities. Since the fiduciary rules that apply to private trusts also apply directly to charitable trusts, this section focuses on the development of fiduciary rules for directors of nonprofit corporations.

The strict standards for fiduciaries of private trusts apply to fiduciaries of charitable trusts.[139] In addition, the fiduciary duties under trust law have, in the past, been applied to directors of charitable corporations.[140] Thus, directors of a charitable corporation have been held to the trust law standards, including the restrictive trust law duty of loyalty.[141] Indeed, directors of charitable corporations were often called "trustees," reflecting this intermingling of the trust form and the corporate form.[142] In a treatise on trust

---

[136] *See* Berle & Means, *supra* note 93, at 47-48 (discussing the dispersion of stock ownership and the resulting lack of control over director's elections).

[137] *See* Brody, *Agents*, *supra* note 17, at 474-75.

[138] In addition, federal tax law also regulates charities that seek to qualify as organizations exempt from income tax. *See infra* notes 298-302 and accompanying text.

[139] *See* RESTATEMENT (SECOND) OF TRUSTS § 379 (1959)("The duties of the trustees with respect to the administration of charitable trusts are the same as the duties of the trustees of private trusts. . . .").

[140] *See* RESTATEMENT (SECOND) OF TRUSTS § 379 cmt. b (1959).

[141] *See* FISHMAN & SCHWARZ, *supra* note 7, at 34-38.

[142] *See, e.g.*, Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries, 381 F. Supp. 1003 (D.D.C. 1974); Holt v. College of Osteopathic Physicians & Surgeons, 394 P.2d 932 (Cal. 1964). Courts looked to trust law with respect to other aspects of charitable corporations. Property held by the charitable corporation might be considered held "in trust" by the corporation for charitable purposes. Because the property was "impressed with a

law, George Gleason Bogert and George Taylor Bogert discuss fiduciary duties of trustees of charitable trusts and corporations almost interchangeably, and then explain, "It is in the related areas of the standard of care or conduct imposed and the duty of loyalty owed that some distinctions between charitable trustees and corporate directors have begun to be drawn."[143]

One of the first clear rulings that fiduciaries of a nonprofit corporation would be held to the corporate standard came in 1974.[144] The federal District Court for the District of Columbia held that the trustees of a hospital organized as a nonprofit corporation were subject to the corporate standard rather than the trust standard with respect to fiduciary duties.[145] The court explained:

> The applicable law is unsettled. The charitable corporation is a relatively new legal entity which does not fit neatly into the established common law categories of corporation and trust. As the discussion below indicates, however, the modern trend is to apply corporate rather than trust principles in determining the liability of the directors of charitable corporations, because their functions are virtually indistinguishable from those of their 'pure' corporate counterparts.[146]

The trend the court identified gained steam with this frequently cited opinion,[147] and the drafters of the Revised Model Nonprofit Corporation Act took this approach.

Shortly before the *Lucy Webb Hayes* decision, the National Conference of Commissioners on Uniform State Laws had adopted the UMIFA.[148] The UMIFA provides rules for investment decision making by both directors of nonprofit corporations and trustees of charitable trusts.[149] The Act adopts the business judgment approach for both directors and trustees[150] and is presumably a part of the trend to apply corporate principles that the *Lucy Webb Hayes* court identified.[151]

---

charitable trust," trust rules applied with respect to changes in the purposes of the corporation. *In re* Los Angeles County Pioneer Soc'y, 257 P.2d 1 (Cal. 1953) (in bank).

[143] BOGERT & BOGERT, *supra* note 31, § 394.

[144] *See Stern*, 381 F. Supp. at 1003.

[145] *See id.*

[146] *Id.* at 1013.

[147] *See, e.g.*, Raven's Cove Townhomes, Inc. v. Knuppe Dev. Co., 171 Cal. Rptr. 334, 344 (Ct. App. 1981); Louisiana World Exposition v. Federal Ins. Co., 864 F.2d 1147, 1151-52 (5th Cir. 1989); Oberly v. Kirby, 592 A.2d 445, 466 (Del. 1991).

[148] *See* UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT (1972), 7A pt. II U.L.A. 475 (1999); *see also supra* notes 68-71 and accompanying text.

[149] *See* Clark & Troost, *supra* note 69, at 32; Grumbach & McKeown, *supra* note 69, at 38.

[150] *See* UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT § 6 (1972), 7A pt. II U.L.A. 500 (1972)("[M]embers of a governing board shall exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision. . . .").

[151] *See* Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries, 381 F. Supp. 1003 (D.D.C. 1974).

The Revised Model Nonprofit Corporation Act ("RMNCA"), first promulgated in 1987, adopts corporate standards in the fiduciary duties it imposes on directors of nonprofit corporations.[152] The 1954 Model Nonprofit Corporation Act had been silent on directors' duties.[153] The RMNCA sets standards of care and loyalty for directors, both to resolve questions of which standard should apply but also to protect directors who act properly in carrying out their fiduciary duties.[154] The introduction explains: "The Subcommittee had little difficulty in rejecting trust standards and adopting the same general language the MBCA [Model Business Corporation Act] uses for directors of business corporations."[155]

1. Duty of care

The duty of care adopted by the RMNCA states that directors and officers must act:

(1) in good faith;
(2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
(3) in a manner the director reasonably believes to be in the best interest of the corporation.[156]

Although the standard is in essence the same as the standard used in the business context,[157] the official comments to section 8.30 of the RMNCA note that directors of a nonprofit organization have different goals and resources

---

[152] *See* REV. MODEL NONPROFIT CORP. ACT § 8.30 (1988). The official comment to section 8.30, General Standards of Conduct, explains that the section "settles the dispute as to whether directors of nonprofit corporations should meet the general business standards or the trustee standards." *See id.* § 8.30 cmt. 1 (1988).

[153] *See* Henry Hansmann, *The Evolving Law of Nonprofit Organizations: Do Current Trends Make Good Policy?*, 39 CASE W. RES. L. REV. 807, 814 (1988-89)(explaining that the drafters of the Model Nonprofit Corporation Act "simply took the Model Business Corporation Act and deleted from it all provisions that seemed inappropriate for nonprofits, such as those dealing with the issuance of stock. The result was a rather empty enactment."). Hansmann writes more favorably about the RMNCA: "In general, and in conspicuous contrast to the old Model Act, the Revised Model Act is marked by careful and detailed draftsmanship throughout." *See id.* at 819. Hansmann approves of the "rigorous but by no means unrealistic duties of care and loyalty" imposed on directors but argues that the same standards should be applied to all nonprofits or at least to all nonprofits that are not organized as clubs. *See id.*

[154] *See* REV. MODEL NONPROFIT CORP. ACT xxxv (1988).

[155] *Id.* This is not surprising given that a subcommittee of the American Bar Association's Committee on Corporate Laws drafted the RMNCA. The drafters of the nonprofit statute simply took the business corporation act and made modifications to it. The fiduciary duty sections were not modified, so the duties imposed on business directors became part of the model act.

[156] *Id.* § 8.30(a).

[157] *See supra* note 111 and accompanying text.

than the directors of a business corporation.[158] The official comments explain that the standards adopted, including "ordinarily prudent person," "in a like position," and "under similar circumstances" can be applied in a flexible manner.[159] The official comments note that directors of a nonprofit organization have different goals and resources than the directors of a business corporation.[160] The drafters intend that the fiduciary duties imposed on the directors will be applied in a manner that considers the differences between nonprofits and business corporations as well as the variations within the nonprofit sector.[161]

In the business corporation context, the business judgment rule has modified the duty of care to protect directors who act in good faith and without a conflict of interest with respect to a decision made on a reasonably informed basis and with a rational belief that the decision is in the best interests of the corporation.[162] This rule, sometimes called the "best judgment rule" in the nonprofit context,[163] has been applied to the decisions of nonprofit directors by a few courts.[164] The official comment to section 8.30 of the RMNCA explains that the use of the rule is consistent with application of the duty of care under the RMNCA.[165]

Use of the business judgment rule in the charitable context may be appropriate.[166] The rule requires a director to act in good faith, rationally and after having considered sufficient information to make a reasonably informed decision.[167] The business judgment rule does not apply to a decision in which a director had a conflict of interest,[168] and the duty of loyalty will apply in that situation.[169] Thus, the rule cannot be used to protect a director who attempts to benefit personally from the corporation.[170] The other requirements of the business judgment rule are consistent with the duty of care set forth by the RMNCA and can appropriately be used to protect a director who makes decisions that appear in hindsight to be detrimental to the organization.

---

[158] *See* REV. MODEL NONPROFIT CORP. ACT § 8.30(a).

[159] *See id.* § 8.30 cmt. 2.

[160] *See id.*

[161] *See id.*

[162] *See* Goldschmid, *supra* note 2, at 644; *see also supra* notes 112-15 and accompanying text.

[163] *See* FISHMAN & SCHWARZ, *supra* note 7, at 185.

[164] *See* Goldschmid, *supra* note 2, at 644.

[165] *See* REV. MODEL NONPROFIT CORP. ACT § 8.30 cmt. 3 (1988).

[166] *See* Goldschmid, *supra* note 2, at 644 ("The assumption is erroneous, however, that the business judgment rule provides directors with an overly protective free ride from liability.").

[167] *See* 1 ALI PRINCIPLES, *supra* note 96, § 4.01(a).

[168] *See id.* § 4.01 cmt. d.

[169] *See id.* § 5.02.

[170] *See id.* § 5.02(a)(2)(B).

Under the RMNCA, then, the duty of care and the business judgment rule create a flexible standard for nonprofit directors, but still require that directors act with reasonable care. The standard attempts to take into account the differences between nonprofits and businesses. For example, applying the duty of care in the nonprofit context requires consideration of the size and purpose of the nonprofit, the personal expertise of the director, and the circumstances of the particular decision being made.[171] Professors Fishman and Schwarz have written that the standard as applied to nonprofits is "quite low."[172] Even if the standard itself is adequate, the lack of enforcement mechanisms in the charitable context make adoption of the corporate standard without considering enforcement problematic.[173]

2. Duty of loyalty

The duty of care adopted by the RMNCA is similar to the trust law standard.[174] In contrast, the duty of loyalty differs significantly. While trust law provides that a trust can void any self-dealing transaction engaged in by a trustee,[175] the RMNCA permits a director to engage in self-dealing or conflict of interest transactions, if certain requirements are met.[176] The RMNCA creates two standards—one for public benefit corporations[177] and one for mutual benefit corporations[178]

The RMNCA applies the business standard to mutual benefit corporations.[179] A transaction may be approved by either the board or the members, as long as the material facts of the transaction and the director's

---

[171] *See id.*

[172] *See* FISHMAN & SCHWARZ, *supra* note 7, at 186.

[173] Harvey Goldschmid suggests that the standard is adequate, even potentially demanding, but lack of enforcement creates the "myth" of low duty of care standards. *See* Goldschmid, *supra* note 2, at 642-43.

[174] *See supra* notes 48-50 and accompanying text .

[175] The beneficiaries of a private trust can void any self-dealing transaction, regardless of the fairness of the transaction, unless they consented to the transaction after full disclosure. *See* BOGERT, *supra* note 32, § 95.

[176] *See* REV. MODEL NONPROFIT CORP. ACT § 8.31(b), (c) (1988).

[177] *See id.* § 1.40 (28); *see also id.* at xxiv-viii (1988)("Public benefit corporations hold themselves out as doing good works, benefiting society or improving the human condition."). Public benefit corporations are corporations that benefit the public and not merely their members. This Article focuses on charitable nonprofits organized as public benefit corporations.

[178] *See id.* § 140(23). Mutual benefit corporations are formed for the benefit of their members. Although mutual benefit corporations cannot make distributions to members, mutual benefit corporations can purchase a membership of a member who resigns, *see id.* §§ 6.22(b), 13.01, 13.02, and can distribute its assets to its members on dissolution. *See id.* § 14.06(a)(7).

[179] *See id.* § 8.31 cmt. 2.b.

interest in the transaction were disclosed to or known by the directors or the members.[180] This standard, although perhaps appropriate for mutual benefit corporations whose members will, presumably, monitor the actions of the directors, is insufficiently protective for charitable organizations.

For public benefit corporations, the statute provides that the transaction will not be voidable if it was (1) fair at the time, (2) approved by the board of directors based on disclosure of the material facts of the transaction and a good faith, reasonable belief that the transaction was fair, or (3) approved by the attorney general.[181] This standard creates a higher standard than the business judgment rule that many states apply to business corporations,[182] but leaves a significant gap in protecting charities from self-dealing.[183]

The RMNCA rule requires only a determination that the disinterested directors "reasonably believe" that the transaction is fair to the corporation.[184] The rule focuses on the directors' reasonable belief rather than on the actual fairness of the transaction. Given the structure of many charitable boards and the lack of attentiveness of the directors, disinterested directors may be unlikely to challenge the interested director's characterization that the transaction is fair.[185] A reasonable belief in fairness does not require a particular level of scrutiny and does not require that the transaction be the best approach for the charity.[186] Given the lack of external monitoring of charities, the RMNCA relies too heavily on business law.[187]

The status of state law with respect to nonprofit organizations, then, is that the form of the organization determines the fiduciary standards to be applied to those who manage the organization.[188] Trust law continues to govern charitable trusts, and the strict duty of loyalty standard continues to apply to trustees of charitable trusts. The law of nonprofit corporations, however, has shifted to something closer to the business standard. With sufficient protections built into the law, a standard other than the trust law standard can

---

[180] *See id.* § 8.31(c), 8.31 cmt. 2.b.

[181] *See id.* § 8.31(b).

[182] *See* Goldschmid, *supra* note 2, at 648-49 (explaining that although the ALI Principles use an intermediate standard of review for conflict of interest transactions, many states apply the more deferential business judgment rule).

[183] *See* Deborah A. DeMott, *Self-Dealing Transactions in Nonprofit Corporations*, 59 BROOK. L. REV. 131, 137-43 (1993)(explaining why the RMNCA rule is not appropriate for nonprofits and characterizing the rule as "a charade.") [hereinafter DeMott, *Self-Dealing*].

[184] *See* REV. MODEL NONPROFIT CORP. ACT § 8.31(b) (1988).

[185] *See* FISHMAN & SCHWARZ, *supra* note 7, at 187 (describing the common problems of inattentive and overcommitted directors); DeMott, *Self-Dealing*, *supra* note 183, at 139-41.

[186] *See* DeMott, *Self-Dealing*, *supra* note 183, at 141.

[187] *See infra* notes 344-50 and accompanying text.

[188] *See* FISHMAN & SCHWARZ, *supra* note 7, at 64-67.

work,[189] but the resulting legal anomaly is that the standard to which the law holds a person who manages charitable assets depends on the organizational form of the entity holding those assets.[190] The law protects public interests, but the public has no say in the standard that applies to the organization and its managers.[191] Increasingly, those who create nonprofits use the corporate form, but there remain many existing charitable trusts.[192]

B. Who Benefits from Fiduciary Duties?

Before thinking about who can or should enforce fiduciary standards, it is important to determine whom the standards protect. In a private trust, the fiduciary duties protect the interests of the trust beneficiaries from overreaching or mismanagement by the trustees. The beneficiaries can enforce a breach of trust, and the trustees are held to a strict standard with respect to self dealing.[193] This strict standard is appropriate in the private trust context because it is difficult for beneficiaries to learn about or prove trustee misconduct.

In the corporate context, the shareholders are owners of the corporation and are protected by the fiduciary standards imposed on the directors. If the directors breach their fiduciary duties, shareholders can protect their interests by bringing a derivative action.[194] A less strict fiduciary standard applies in the corporate context, in part because the shareholders have other types of recourse if the directors mismanage the corporation. If the shareholders do not approve of the way the directors run the corporation, the shareholders can sell their stock or, theoretically at least, vote the directors out of office.[195] In contrast, trust beneficiaries have less opportunity for recourse against the trustees.

---

[189] Deborah DeMott proposes a fairness standard that is not as strict as the trust law standard, but is more appropriate for charities than a business law standard. *See* DeMott, *Self Dealing*, *supra* note 183, at 143 (1993); *see also infra* notes 351-54 and accompanying text.

[190] *See* Brody, *Limits*, *supra* note 7, at 1417 (noting that choice of organizational form is not likely to be a well thought-out decision).

[191] The persons who establish the charity, or their lawyers, choose the organizational form and that form will determine which standards apply. The public plays no role at this stage.

[192] *See* FISHMAN & SCHWARZ, *supra* note 7, at 64. Princess Bernice Pauahi Bishop created the Kamehameha Schools as a trust under her will. *See* Petition of Attorney General, *supra* note 10.

[193] *See supra* notes 42-46 and accompanying text.

[194] *See supra* notes 129-33 and accompanying text.

[195] *See* Brody, *Agents*, *supra* note 17 at 476-77; Eisenberg, *supra* note 111, at 971.

1. Clients/Beneficiaries

In the charitable context, the question of whose interests should be protected is less clear. The charity may serve clients who can be considered "beneficiaries," but the beneficiaries are not specifically identified and usually change over time. For example, the Kamehameha Schools operated by the Bishop Estate serve their students, but the identity of the students receiving services changes from year to year. Further, in addition to serving the students who take classes, the Kamehameha Schools serve the public by contributing to an educated populace. A hospital serves its patients; again there is no defined group of beneficiaries. Similarly, soup kitchens serve changing groups of people. Any person served by the entity has an interest in seeing that it is run properly, but no one person is likely to have the incentive, the ability, or the information necessary to monitor the charity. Further, beneficiaries are unlikely to have standing to enforce their rights as beneficiaries.[196]

2. Donors

A charity also serves those who have contributed money or property to it. If an individual donor contributes a substantial amount of money to a charity, that individual will want some assurance that the money will be spent responsibly. In general, however, the law treats donors as having relinquished any legal interest in the organization after making the gift.[197] As a practical matter, to be able to attract future gifts from the same donors or from other donors, the charity must not stray far from its mission and must manage its assets effectively. Nonetheless, potential donors may be able to obtain only limited information concerning the management of the charity. Once a donor makes a gift, if the donor discovers breaches of fiduciary duty on the part of the directors, the donor can choose not to make future gifts. It is unlikely, however, that the donor will have standing to sue the directors for mismanagement.[198]

Despite the importance of donors for some charities, in the charitable sector as a whole, donor support is shrinking as a percentage of total support.[199]

---

[196] *See infra* notes 259-63 and accompanying text.

[197] *See, e.g.*, Carl J. Herzog Found., Inc. v. University of Bridgeport, 699 A.2d 995 (Conn. 1997)(denying a donor standing to sue the charity).

[198] *See infra* notes 259-63 and accompanying text.

[199] *See* FISHMAN & SCHWARZ, *supra* note 7, at 14 (reporting that in 1989 contributions constituted 27.2 % of the nonprofit sector's funds); Gabriel Rudney, *The Scope and Dimensions of Nonprofit Activity*, *in* THE NONPROFIT SECTOR 62 (Walter W. Powell ed., 1987)(reporting that in 1980, contributions constituted 34% of the sources of revenue for philanthropic organizations).

Increasingly, fees for services finance the charitable sector.[200] In addition, some large charities, like the Bishop Estate, receive funds from a single donor and do not rely on additional contributions. For many organizations maintaining good relationships with donors remains important. However, for the sector as a whole, donors may provide less oversight than in the past,[201] and except for donors who have made restricted gifts, donors will not have standing to take legal action against the fiduciaries.[202]

3. The public

The public has a role as both donor and beneficiary of the charitable sector.[203] Most charities receive tax benefits, so the public coffers are depleted to benefit the charity.[204] If public dollars, in the form of lost tax revenue, support a charity, the public has an interest in having those dollars used for a public, and not a private, purpose. If directors receive excessive salaries or benefit financially as the result of self-dealing transactions with the charity, the public's indirect support of the charity has been betrayed. The public, as a donor to the organization, has an interest in the charity's use of the money for public purposes.

The public also has an interest in the activities the charitable sector conducts. Although an individual member of the public is not a direct beneficiary of every charity, the existence of the charitable sector benefits the public as a whole.[205] Further, since the public benefits, in a general sense, from activities conducted by charitable organizations,[206] the public has an interest in maintaining a healthy charitable sector. Throughout the history of the United States, charities have played an important role in providing

---

[200] *See* Rudney, *supra* note 199, at 62.

[201] *See* FISHMAN & SCHWARZ, *supra* note 7, at 12 (noting that many nonprofits no longer rely on charitable contributions).

[202] *See infra* notes 259-63 and accompanying text.

[203] *See* Brody, *Limits*, *supra* note 7, at 1431 (citing George Gleason Bogert, *Proposed Legislation Regarding State Supervision of Charities*, 52 MICH. L. REV. 633, 633 (1954)(arguing that "the human beings who are favorably affected by the execution of the trust are merely the media through whom the social advantages flow to the public.")).

[204] A tax-exempt charity keeps money that would otherwise be paid to the government in the form of taxes. In addition to the exemption from income tax, the charity may also benefit from a property tax exemption. The tax exemptions cost the federal government more than $36.5 billion a year. *See* FISHMAN & SCHWARZ, *supra* note 7, at 10.

[205] *See id.* at 5-9 (describing benefits of the charitable sector).

[206] *See* Regina E. Herzlinger, *Can Public Trust in Nonprofits and Governments Be Restored?*, HARV. BUS. REV., (Mar.-Apr. 1996, at 97)(stating that "we entrust [nonprofits] with society's most important functions—educating our minds, uplifting our souls, and protecting our health and safety.").

services, and the sector continues to play a key role.[207] If the public loses trust in the charitable sector, the sector as a whole may suffer through reduced tax benefits, increased administrative costs related to increased supervision, and reduced financial support from donors.[208] This, in turn, will lead to loss of benefits to the members of the public who are direct beneficiaries.

V. ENFORCEMENT IN THE CHARITABLE SECTOR

In the charitable setting the enforcement mechanisms on which the fiduciary concepts depend are missing.[209] A charity organized as a trust does not have beneficiaries in the sense that a private trust has beneficiaries.[210] Although beneficiaries of private trusts can obtain information about the trust from the trustee,[211] those who benefit from a charitable trust may have difficulty obtaining information about the trust.[212] Even if the beneficiaries can obtain sufficient information to determine that the trustees have breached their fiduciary duties to the trust, beneficiaries of a charitable trust usually do not have standing to sue to enforce the trust.[213]

Similarly, a charity organized as a nonprofit corporation has no shareholders to monitor the directors.[214] In addition, the market mechanisms that may help to regulate corporations do not exist for nonprofits.[215] A nonprofit

---

[207] *See* FISHMAN & SCHWARZ, *supra* note 7, at 34-38 (describing the history of charities in the United States).

[208] *See* Skolnik, *supra* note 14 (describing increased public scrutiny and the importance to nonprofits of maintaining the public's trust).

[209] *See generally*, Brody, *Limits*, *supra* note 7 (explaining that in the charitable context there are no principals to enforce the fiduciary duties of agents).

[210] *See supra* section IV.B.1.

[211] *See, e.g.*, UNIF. TRUST ACT. § 813(b)(1) (1999 Annual Meeting draft)("Duty to Inform and Report").

[212] The disclosure rules enacted in 1996 should help. *See infra* notes 222-31 and accompanying text.

[213] *See infra* notes 259-63 and accompanying text.

[214] *See* REV. MODEL NONPROFIT CORP. ACT § 13.01 (1988)(stating that a public benefit nonprofit corporation can make no distributions); *see also* Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 568 (1981) [hereinafter Hansmann, *Reforming*] (comparing the ability of shareholders to obtain information as a result of corporate disclosure requirements and to exercise control through voting power and use of the derivative suit with the lack of oversight available for patrons of a nonprofit); Brody, *Agents*, *supra* note 17, at 465 (comparing the accountability of a corporate board (agents) to the corporation's shareholders (principals) with the lack of "principals" for a nonprofit and the resulting concerns about accountability in the nonprofit context); Brody, *Limits*, *supra* note 7, at 1429.

[215] *See* Brody, *Agents*, *supra* note 17, at 476-77 (describing mechanisms of accountability for managers of business corporations: (1) a shareholder's ability to sell the stock if the shareholder loses confidence in management, (2) the price of the shares on the stock market as a

cannot continue to operate in the red indefinitely, so economics do constrain directors of nonprofits.[216] Yet, the directors of a nonprofit, unlike their business counterparts, do not need to worry about falling stock prices or losing their jobs in a hostile takeover.[217]

Given that neither shareholders nor specifically identified beneficiaries can enforce the fiduciary duties imposed on directors and trustees of nonprofit organizations, two issues must be examined: who has access to information about the nonprofit and who has standing to sue for breach of fiduciary duty? Part V begins by describing tax law changes that have increased public access to information about charities. Increasing the availability of information about charities may improve the effectiveness of oversight by the public. As the following subsections of this Part V explain, however, standing to enforce breaches of fiduciary duties in the charitable context is still limited in most cases to the attorney general. Changes to this general rule include statutes conferring status to sue on private persons as relators and a court-created special interests doctrine that gives certain specifically identified beneficiaries standing. These modest expansions of standing signal attempts to create mechanisms for enforcement beyond the limited resources of the attorney general. Finally, Part V examines the legal structure that provides the IRS with authority to supervise charities, an increasingly important aspect of the regulation of charities.

A. Access to Information

Supervision and enforcement depend upon adequate information. In recent years, changes in the laws regulating charities have increased the reporting requirements that apply to charities and have increased the availability to the public of information about charities.

1. Federal reporting

Each charity exempt from federal income tax and with annual gross receipts in excess of $25,000 must file an information return, Form 990, annually with the IRS.[218] The information return provides the IRS with financial data,

---

reflection of the quality of management and (3) the possibility of a corporate takeover to replace poor managers).

[216] *See* FISHMAN & SCHWARZ, *supra* note 7, at 72 (explaining that "nonprofits are more likely to resist closure and simply hold on in the face of economic setbacks than for-profits" but that eventually a nonprofit that cannot satisfy its creditors must dissolve or merge with another organization).

[217] *See infra* notes 129-37 and accompanying text.

[218] *See* Treas. Reg. § 1.6033-2.

information concerning the organization's exempt activities and income-producing activities, and some additional information designed to reveal whether the organization has violated any of the tax rules.[219] Although the information return reveals some useful information about the charity, limited review by the IRS may mean that problems at the charity are overlooked.[220] Further, until recently, public access to the information was difficult. The Internal Revenue Code required a charity to have copies of its Application for Recognition of Exempt Status (Form 1023) and its most recent Form 990 available for public inspection at its office, but did not require the charity to make copies available.[221]

As part of the 1996 Taxpayer Bill of Rights,[222] Congress enacted requirements making it easier for members of the public to get information about charities.[223] The new law requires a charity to provide copies of its Application for Recognition of Exempt Status and its annual returns for the three most recent years to anyone who requests the information.[224] The nonprofit organization can charge reasonable fees for photocopying the form[225] and can make the forms available on the Internet as an alternative to making copies.[226]

A former IRS employee, James McGovern, has suggested that the new requirements "will lead to sharply increased oversight of tax-exempt organizations' activities by the public as well as by state and federal regulators . . . ."[227] A newspaper devoted to nonprofit issues echoed this sentiment: "Charities nationwide are gearing up for a new era of public scrutiny."[228] The

---

[219] *See* IRS Form 990.

[220] The number of IRS staff is declining at a time when the charitable sector is growing rapidly. *See* John F. Coverdale, *Preventing Insider Misappropriation of Not-For-Profit Health Care Provider Assets: A Federal Tax Law Prescription*, 73 WASH. L. REV. 1, 15 (1998).

[221] *See* I.R.C. § 6104(e) (1994).

[222] *See* Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1452 (1996)(Jul. 30, 1996)(codified in scattered sections of 26 U.S.C.).

[223] *See* I.R.C. § 6033(b) (1994 & Supp. II 1996); *see also* Grant Williams, *New Rules for Charity Disclosure*, CHRON. PHILANTHROPY, Oct. 16, 1997, at 37. The new rules took effect June 8, 1999, 60 days after the IRS issued final regulations. *See id.*

[224] *See* I.R.C. § 6104(d) (1994 & Supp. II 1996).

[225] The IRS has defined "reasonable" as the amounts charged by the IRS for copies: $1 for the first page and 15 cents for each additional page. Treas. Reg. § 301.6104(d)-3(d)(3).

[226] *See* Public Disclosure of Material Relating to Tax-Exempt Organizations, 64 Fed. Reg. 17279, 17282 (Apr. 9, 1999)(to be codified at 26 C.F.R. pts. 301 & 602); *see also* Jennifer Moore & Grant Williams, *Charities May Use Internet to Comply with New Rules*, CHRON. PHILANTHROPY, Oct. 16, 1997, at 41 (describing proposal of Cliff Landesman, founder of the Internet Nonprofit Center, for electronic filing).

[227] Grant Williams, *IRS Issues Final Rules for Charities on Making Tax forms Available to Public*, CHRON. PHILANTHROPY, Apr. 22, 1999, at 58 (quoting James J. McGovern).

[228] Jennifer Moore & Grant Williams, *Return of the Future*, CHRON. PHILANTHROPY, Dec. 17, 1998, at 1.

public's easy access to charitable information returns through the Internet[229] should influence managers to be more careful that the charity's forms report data accurately.[230] In addition, the knowledge of greater public scrutiny should influence behavior because concealing misdeeds or misappropriation of funds will become more difficult.[231] Thus, the increased federal reporting and access requirements should improve the level and quality of supervision by the public.

2. State reporting

Most states require charities to register with the attorney general and to file annual reports.[232] The reports, which in some states require attaching a copy of the federal Form 990,[233] provide a basic level of information and may be a helpful starting point for further investigation if the attorney general receives a complaint from the public.[234] Failure to file the required returns may also signal problems that warrant investigation.[235]

So important is the federal filing requirement to the work of the attorney general that a recent IRS proposal to raise the threshold for filing the Form

---

[229] Several organizations are helping charities make their Forms 990 available on the Internet. *See Help for Charities in Putting Their Tax Forms on the Web*, CHRON. PHILANTHROPY, Dec. 17, 1998, at 33.

[230] *See id.*

[231] *See infra* notes 374-78 and accompanying text. A private citizen may find that Form 990 does not convey enough information to provide a clear picture of what an organization has been doing. Requiring the submission of financial data prepared according to Generally Accepted Accounting Principles could help. Further, organizations that represent charities are encouraging charities to add descriptive information to the Form 990 so that potential donors reading the form can get a good understanding of the organization's mission and activities. *See* Moore & Williams, *supra* note 226, at 32.

[232] *See* Office of the Ohio Attorney General, *The Status of State Regulation of Charitable Trusts, Foundations, and Solicitations*, 5 COMM'N ON PRIVATE PHILANTHROPY & PUBLIC NEEDS, RESEARCH PAPERS at 2706 (U.S. Treas. Dep't 1977) [hereinafter *Status of State Regulation*]; *see, e.g.*, OR. REV. STAT. § 128.650 ("Register of charitable corporations and trustees; authority of Attorney General to maintain register") & § 128.670 ("Filing of reports; fees; authority of Attorney General relating to reports; civil penalty") (1997). States also require registration and reporting related to solicitation of donations. As Evelyn Brody has pointed out, "Perhaps because a donor's power is strongest before making a contribution, state oversight concentrates on the aspect of charities that deals with the public as donors." *See* Brody, *Institutional Dissonance*, *supra* note 4, at 485.

[233] *See, e.g.*, Or. Dep't of Justice, Form CT-12, pt. 1, sec. IV.

[234] *See* Bograd, *supra* note 17, at 23-24.

[235] *See id.* at 23.

990 drew criticism from those who supervise charities.[236] Under current law, exempt organizations with annual gross income of greater than $25,000 must file a Form 990.[237] The IRS proposed increasing that amount to $40,000 or perhaps even $100,000 to reduce the burdens on small nonprofits.[238] In a letter recommending against the idea, the National Association of State Charity Officials wrote, "It is often the smaller, less sophisticated charities that have the greatest need for checks and balances and public scrutiny . . . ."[239] The states that allow charities to meet their state law filing requirement by submitting a copy of the Form 990 would likely have to create their own form for filing, increasing paperwork for the nonprofits.[240] After considering the concerns raised by the state attorneys general, the IRS dropped the plan to increase the minimum amount required for filing.[241]

B. Attorney General

By statute or common law, all states give the state attorney general the authority to supervise nonprofits organized in the state.[242] The attorney general, as the representative of the public's interest in a charity, has standing to sue a charity regardless of whether the charity is organized as a trust or a corporation.[243] While the powers of the attorney general are substantial,[244] the extent of the supervision the attorney general provides is limited.[245]

---

[236] *See* Jennifer Moore & Grant Williams, *Idea to Change Filing Rules Draws Fire from Regulators*, CHRON. PHILANTHROPY, Apr. 23, 1998, at 45 [hereinafter Moore & Williams, *Idea to Change Filing Rules*].

[237] *See* Treas. Reg. § 1.6003-2(g)(1)(iii).

[238] *See* Announcement 97-115, 1997-47 I.R.B. 17.

[239] Moore & Williams, *Idea to Change Filing Rules*, *supra* note 236.

[240] *See id.* James J. McGovern, a former official in the exempt-organizations office at the IRS notes that many exempt organizations fail to file as required under existing rules, and raising the threshold would exacerbate that problem. *See* Jon Craig & Grant Williams, *IRS Plan Would Require Fewer Charities to File Forms*, CHRON. PHILANTHROPY, July 10, 1997, at 49.

[241] *See* Jennifer Moore & Grant Williams, *Tax Agency Shelves Idea of Changing Filing Rules*, CHRON. PHILANTHROPY, Nov. 19, 1998, at 39.

[242] *See Status of State Regulation*, *supra* note 232, at 2715 (Table 1, "Attorneys General Enforcement Authority: Statutory Basis for Regulation of Charitable Trusts and Foundations (as of August 1974)") & 2773-74 (Appendix A, "Selected Citations to Cases From Twenty-Three Jurisdictions Holding That the Attorney General Retains His Common Law Powers").

[243] *See id.* at 2705 (providing extensive data on charitable registration and reporting requirements, the authority of the attorney general under statutory law and common law, and the extent to which attorneys general are involved in regulating charities).

[244] *See* Hansmann, *Reforming*, *supra* note 214, at 601. "Unfortunately, in most states there has been little effort to exercise even the substantial powers that the attorney general already has." *Id.*

[245] *See* Bograd, *supra* note 17, at 32-33 (explaining that the attorneys general who participated in the study "play a valuable but limited role in dealing with nonprofits. [They]

States vary in the number of staff allocated to supervising nonprofits. In some states, several assistant attorneys general form a charitable division of the attorney general's office. For example, a 1994 study found that Connecticut had four attorneys working in the charities division of the attorney general's office, Massachusetts had seven and New York had seventeen.[246] Even Oregon, a much less populous state than any of these three, has three.[247] In other states, however, one assistant attorney general supervises the nonprofit sector as only one part of his or her assignment. Hawai'i has reported 0.5 attorneys working with charities, and many states do not list any attorneys specifically assigned to charitable matters.[248]

Those working in three state charities offices—New York, Connecticut and Massachusetts—report that the registration and reporting system, although useful, is not the source of most of the investigations those offices conduct.[249] The attorneys in these three states report that inquiries or complaints from dissenting board members, employees, beneficiaries or other members of the public, including the press, are much more likely to trigger investigations than reviews of annual reports conducted in the attorney general's office.[250] In determining which cases to pursue, the attorneys consider the amount involved, the size of the organization, the impact on the public, and the egregiousness of the conduct.[251] The worst abuses receive attention, but many problems probably go undetected or unaddressed. The attorneys general perform an important supervisory role in the charitable sector,[252] but other

---

come in as a 'last resort' when groups are paralyzed or abandoned . . . .").

[246] *See id.* at 9.

[247] Telephone conversation with Judith L. Woodruff, Assistant Attorney General, Oregon Charitable Activities Section (Oct. 15, 1999) [hereinafter Conversation with Judith L. Woodruff].

[248] *Number of Full-Time Equivalent (FTE) Attorney Positions by Selected Practice Areas: "Public Protection"* (Nat'l Ass'n of Attorneys General), 1997, at 18, 20; *see also Status of State Regulation*, *supra* note 232, at 2728 (listing number of personnel—attorneys, accountants and others assigned to charities work in the offices of the attorneys general as of August 1974, and indicating that 11 offices had no attorneys and 17 offices had only one part-time attorney assigned to charities work).

[249] *See* Bograd, *supra* note 17, at 12.

[250] *See id.* at 11-13. The attorneys noted that media involvement, while not determinative in a decision about whether to devote staff time to a case, does add pressure. *See id.* at 16.

[251] *See id.* at 15-16 (citing Pamela Mann, the attorney in charge of the New York charities office, as stating that the focus there is to "get the bad guys.").

[252] *See id.* at 14. A charity that can no longer carry out its original mission or comply with the restrictions placed on a gift must notify the attorney general before changing its charitable purpose. Under the trust law doctrine of *cy pres*, change will be permitted only if the original purpose is impossible or impracticable, and the change must be as close as possible to the original purpose. *See* BOGERT & BOGERT, *supra* note 31, § 431. Nonprofit corporations are deemed to hold property in trust for the public, so courts sometimes apply the *cy pres* doctrine to charities organized as nonprofit corporations. *See, e.g.*, Lynch v. Spilman, 431 P.2d 636

forms of supervision are both necessary and desirable.

C. Limited Standing for Others

1. Limited standing

If it is true that attorneys general regulate charities in a "valuable but limited" manner[253] due to limited resources and if "attorneys general rarely pursue their rights with the same zeal that private parties exhibit[,]"[254] then some additional means to regulate charities must be found. Persons involved in an organization have access to information about that organization and are more likely than the attorney general to be aware of conflicts of interest or mismanagement issues. Further, they have an interest, even if not an economic one, in ensuring that those managing the organization heed their fiduciary duties.[255]

The attorney general may be able to respond to complaints raised by trustees, directors or employees of a charity. As noted above, contacts from persons inside charitable organizations account for a substantial number of the investigations conducted by the attorney general.[256] Nonetheless, the attorney general will not be able to investigate all complaints.[257] Finding a way to harness the knowledge and interest of those connected to the charity without overwhelming the courts and the nonprofit sector with "vexatious" and "harassing" litigation[258] may be a key element in improving regulation of nonprofits.

For the most part, states continue to restrict standing to sue a nonprofit to the state attorney general.[259] Although some states have begun to supplement

(1967). But in some states statutes have loosened the *cy pres* rules somewhat with respect to charities formed as nonprofit corporations. *See, e.g.*, N-PCL § 1005(a)(3)(A)(McKinney 1997)(requiring a dissolving corporation to distribute assets held for a charitable purpose to one or more organizations "engaged in activities substantially similar to those of the dissolved corporation.").

[253] Bograd, *supra* note 17, at 34.

[254] Brody, *Limits*, *supra* note 7, at 1431.

[255] *See* Karst, *supra* note 65, at 444 ("The charity's own representative has at least as much interest in preserving charitable funds as does the attorney general.").

[256] *See* Bograd, *supra* note 17, at 12 (reporting that the Assistant Attorney General in Charge of the Public Charities Unit in Connecticut estimated that of 150 total inquiries, 130 came from dissenting board members and employees).

[257] *See id.* (describing criteria used to determine when to intervene).

[258] *See* Hansmann, *Reforming*, *supra* note 214, at 607.

[259] *See* Mary G. Blasko et al., *Standing to Sue in the Charitable Sector*, 28 U.S.F. L. REV. 37, 40-41 (1993)(describing the history of the principle that the state, through the attorney general, enforces charities).

the attorney general's authority,[260] recent cases in two states adhered closely to the rule that only the attorney general has standing to sue a charity.[261] The Supreme Judicial Court of Massachusetts denied standing to members of a religious congregation who sought to sue the governing board of their church,[262] and the Connecticut Supreme Court denied standing to a donor who attempted to sue a grantee who failed to comply with the conditions the donor had placed on the grant.[263] The Massachusetts and Connecticut cases suggest that sweeping changes in standing rules are unlikely, but limited exceptions to the rule that only the attorney general can sue a charity do exist for members of the charity, for persons who can qualify as relators, and for beneficiaries who can establish standing under a special interests doctrine.

2. Members

In some states, statutes provide that a director or trustee has standing to sue the other directors or co-trustees.[264] Case law may also provide standing for a director or trustee.[265] As a practical matter, however, directors and trustees may be reluctant to sue each other.[266]

Some state statutes give members of nonprofits organized as membership

---

[260] *See id.* at 48-49.

[261] *See* Weaver v. Wood, 680 N.E.2d 918 (Mass. 1997), *cert. denied*, 522 U.S. 1049 (1998); Carl J. Herzog Found., Inc. v. University of Bridgeport, 699 A.2d 995 (Conn. 1997).

[262] *See Weaver*, 680 N.E.2d at 918. Members of the first Church of Christ, Scientist, sued the governing board of the Church and a related publishing organization. The court held that only the attorney general had standing to "bring an action alleging the misuse of charitable assets." *See id.* at 922.

[263] *See Carl J. Herzog Found.*, 699 A.2d at 995. The Herzog Foundation had made a grant to the University of Bridgeport on the condition that the grant plus matching funds would be used for need-based scholarships for students studying medicine. When the university failed to carry out the conditions, the foundation sued to force the university to transfer the funds to another foundation that would carry out the terms of the grant. The court stated that only the attorney general had standing to enforce the restriction on the gift. Responding to this case, Connecticut's Attorney General "pledged to be diligent in supporting aggrieved donors while respecting the rights of charities to financial independence." *See* Vince Stehle, *Connecticut Supreme Court Blocks Donors from Suing to Enforce Limitations on Gifts*, CHRON. PHILANTHROPY, Sept. 4, 1997, at 12.

[264] *See, e.g.*, CAL. CORP. CODE § 5142(a) (West 1990)(granting standing to directors and officers); REV. MODEL NONPROFIT CORP. ACT § 6.30 (1988).

[265] *See, e.g.*, Holt v. College of Osteopathic Physicians & Surgeons, 394 P.2d 932, 937 (Cal. 1964)(extending the rule that one trustee can sue a co-trustee to directors of a nonprofit corporation: "There is no sound reason why minority directors or 'trustees' of a charitable corporation cannot maintain an action against majority trustees when minority trustees of a charitable trust are so empowered.").

[266] *See* Brody, *Institutional Dissonance*, *supra* note 4, at 484 (explaining that if directors lose a role of the board, they cannot try again in court).

corporations the right to bring derivative suits.[267] Similar to the rights of shareholders to bring derivative suits under corporate law, a member can sue the corporation to protect the rights of all the members.[268] For example, the RMNCA provides that voting members may bring a derivative suit, but only if the suit is brought by fifty or more members, or, if the nonprofit has fewer than fifty members, by five percent or more of the members.[269] The comparable New York statute permits derivative suits by members holding at least five percent of the voting power.[270] Although members can sue derivatively in many states, most charities do not have voting members, so these statutes have limited impact.[271] Thus, neither directors nor members provide a significant source of monitoring for charities.

3. Relators

The use of relators may provide a means to supplement the resources of the attorney general's office while providing an opportunity for private citizens to take a greater role in supervising nonprofits.[272] A relator is a private person who sues a charity on behalf of the attorney general.[273] A statute enacted in 1980 provides for relators in California.[274] The statute permits persons granted relator status by the attorney general to sue a charity on behalf of the attorney general.[275] Pursuant to the statute, a private person can notify the attorney general of abuse by the charity or its fiduciaries.[276] If the attorney general agrees, the relator can proceed with the suit on behalf of the attorney general.[277] The private relator pays the court costs, but the attorney general remains in control of the action.[278] By permitting relators to bring suit on behalf of the attorney general, the statute may enable the attorney general to

---

[267] *See* Blasko, *supra* note 259, at 53-57; *see also, e.g.*, REV. MODEL NONPROFIT CORP. ACT. § 6.30 (1988).

[268] *See* Blasko, *supra* note 259, at 53.

[269] *See* REV. MODEL NONPROFIT CORP. ACT. § 6.30 (1988).

[270] *See* N.Y. NOT-FOR-PROFIT CORP. LAW § 720(b) (McKinney 1970 & Supp. 1997).

[271] *See* Brody, *Institutional Dissonance*, *supra* note 4, at 484; Hansmann, *Reforming*, *supra* note 214, at 612 (criticizing the New York and California statutes that permit suits by members as taking a "narrow and misguided view" as a result of "uncritical imitation of the business corporation statutes."). Hansmann agrees that members should have standing but advocates standing for all "patrons"—members, donors and those who purchase services from the organization. *See id.*

[272] *See* Blasko et al., *supra* note 259, at 49.

[273] *See id.*

[274] *See* CAL. CORP. CODE § 5142(a) (West 1990).

[275] *See id.* § 5142(a)(5).

[276] *See* Blasko et al., *supra* note 259, at 49-50.

[277] *See* CAL. CORP. CODE § 5142(a)(5) (West 1990).

[278] *See* Blasko et al., *supra* note 259, at 49-50.

increase enforcement efforts.[279] The suit must be one which the attorney general within his or her discretion could have brought, and the attorney general must authorize the suit before the relator can proceed.[280]

4. Special interests doctrine

Courts have occasionally permitted private persons to sue a charity by finding that the persons have a "special interest" in the charity.[281] In general, the plaintiffs must be identifiable beneficiaries or potential beneficiaries in the organization.[282] The plaintiffs must have a specific interest that will be directly affected by the charity's failure to carry out its purpose or by a breach of fiduciary duties.[283] The plaintiff must be a member of an identifiable class of beneficiaries of the charity and not merely a member of the general public who is concerned that the charity be run properly.[284] Courts have been willing to let such beneficiaries sue the charity to protect the "special interest" in a manner analogous to a suit by a beneficiary of a private trust,[285] but the remedy sought must be a benefit to the charity itself and not money damages for the plaintiffs.[286]

A study published in 1993 identified factors most likely to induce a court to grant standing to private persons:

> (a) the extraordinary nature of the acts complained of and the remedy sought by the plaintiff; (b) the presence of fraud or misconduct on the part of the charity or its directors; (c) the state attorney general's availability or effectiveness; and (d) the nature of the benefitted class and its relationship to the charity.[287]

---

[279] *See id.*

[280] *See id.*

[281] *See, e.g.*, Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries, 367 F. Supp. 536, 540 (D.D.C. 1973)(granting standing to a group of patients to sue the directors of a hospital for breaches of fiduciary duties); Kapiolani Park Preservation Soc'y v. City & County of Honolulu, 751 P.2d 1022, 1025 (Haw. 1988)(granting standing to members of the public as beneficiaries of a charitable trust of which the city of Honolulu was trustee, with respect to a dispute in which the attorney general "has actively joined in the supporting of the alleged breach of trust . . . ."); Jones v. Grant, 344 So. 2d 1210 (Ala. 1977)(granting standing to students, staff and faculty of Daniel Payne College who sued the college, its president and its directors for misuse of funds given to the college to be used for grants or loans to students and to upgrade the faculty, staff, student body, equipment and facilities).

[282] *See* Blasko et al., *supra* note 259, at 70.

[283] *See id.*

[284] *See id.* at 70-72.

[285] *See id.* at 59-78.

[286] *See id.* at 61-62; *Stern*, 367 F. Supp. at 540 (refusing to allow the plaintiffs to sue under Rule 23(b)(3) for money damages resulting from trustee mismanagement).

[287] Blasko et al., *supra* note 259, at 61.

A court will review the seriousness of the allegations and will be more likely to grant standing if the alleged actions threaten the charitable purpose or the existence of the charity or if it appears that fraud or misconduct is involved.[288] Courts will defer to a determination previously made by the attorney general. That is, if the attorney general has reviewed the case and declined to pursue it, a court is unlikely to grant standing to a private party, especially in a state with a strong record of charitable enforcement by the attorney general.[289] In contrast, if the court perceives lax enforcement efforts or lack of resources or interest on the part of the attorney general, the court may be willing to supplement the "official" enforcement and grant standing to a private party with special interests.[290]

The Bishop Estate situation presents the sort of facts that would make granting standing to private persons appropriate. A class consisting of students and faculty of the Kamehameha Schools would have been appropriate plaintiffs had the attorney general not brought suit against the trustees. Those persons have a direct interest in the trust and their interests were directly affected by the misconduct of the trustees. A suit brought under the special interests doctrine would have been brought as the result of misconduct by the trustees. The acts complained of certainly were extraordinary: self-dealing transactions with financially costly consequences to the trust,[291] procedures for setting compensation that created conflicts for the trustees in managing the trust,[292] delegation of authority by the trustees to each other in a manner that adversely affected management of the trust,[293] and management decisions that had undermined the administration of Kamehameha Schools.[294] The appropriate remedy would be removal of the trustees and recovery from the trustees of losses suffered by the trust as a result of breaches of their duties. Due to the size and public importance of the Bishop Estate, the public would benefit from the suit.

---

[288] *See id.* at 62-65.

[289] *See id.* at 68 (pointing out that the charities division of the Massachusetts attorney general's office maintains an active enforcement system and, perhaps for that reason, Massachusetts courts have a history of refusing to grant standing to private plaintiffs). *See, e.g.* Weaver v. Wood, 680 N.E.2d 918 (Mass. 1997), *cert. denied*, 522 U.S. 1049 (1998)(refusing to grant standing in Massachusetts to church members).

[290] *See* Blasko et al., *supra* note 259, at 69 (citing Holt v. College of Osteopathic Physicians & Surgeons, 394 P.2d 932 (Cal. 1964)).

[291] *See* Master's Consolidated Report on the One Hundred Ninth, One Hundred Tenth, and the One Hundred Eleventh Annual Accounts of the Trustees, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Aug. 7, 1998), *available at* <http://starbulletin.com/98/08/07/news/masters2/masters2.html> [hereinafter Master's Report].

[292] *See id.*

[293] *See id.*

[294] *See id.*

Given the public importance of the trust and the egregious nature of the misconduct, the state attorney general did bring suit against the trustees.[295] At the time the Broken Trust article was published, however, the authors noted that "no attorney general had initiated a lawsuit to sanction or remove a trustee."[296] Given the lack of a charities section in the attorney general's office and the political nature of the position of the attorney general in Hawai'i,[297] granting private standing would have been appropriate had the attorney general not brought the suit. The Bishop Estate provides a good example of the need for the special interests doctrine when an attorney general chooses not to act.

D. Internal Revenue Service

In addition to enforcement by the state attorney general and others of the fiduciary duties of trustees and directors, the IRS enforces tax rules that regulate charities. Indeed, as the charitable sector has shifted increasingly to the use of the corporate form, and the rules governing directors of charitable corporations have moved away from the strict trust law standard,[298] concern about whether adequate monitoring of charities exists has led to *increasing* regulation through the IRS. Although IRS resources are limited and the IRS cannot identify every example of wrongdoing, the IRS provides an enforcement mechanism in addition to enforcement of fiduciary duties under state law.

Breach of fiduciary duties can result in federal tax penalties imposed on the organization and, in some cases, on the director or trustee. Although the focus of the tax code is whether organizations are exempt from income tax and whether contributions to organizations are deductible, the rules for tax-exempt status and for deductibility of contributions include restrictions on trustee and director behavior.[299] Section 501(c)(3) and section 170(c) of the Internal Revenue Code both include the requirement that "no part of the net earnings of [the organization] inures to the benefit of any private shareholder or individual . . . ."[300] Thus, if a director, trustee or other person takes advantage of the charitable organization by taking excessive salary or by engaging in a self-dealing transaction that benefits the individual and harms the organization, the organization will fail to meet the requirements of sections

---

[295] *See* Petition of the Attorney General, supra note 10.
[296] *See Broken Trust, supra* note 10.
[297] *See id.* (stating that Hawai'i has an appointed attorney general).
[298] *See supra* notes 140-55 and accompanying text.
[299] *See* I.R.C. §§ 170(c), 501(c) (1994).
[300] I.R.C. §§ 170(c); 501(c)(3) (1994).

501(c)(3) and 170(c).[301] If the situation is sufficiently egregious, the IRS can revoke the organization's tax-exempt status.[302] In the Bishop Estate situation, the IRS threatened to revoke the trust's tax-exempt status unless the five trustees resigned or were removed.[303] That threat resulted in the temporary removal of the trustees[304] and likely influenced the decision to remove the trustees permanently.

Revoking an organization's exempt status is such a drastic measure that the IRS uses it infrequently.[305] If an individual director has benefited at the expense of the nonprofit organization, revoking the organization's exempt status may be disproportionate to the offense committed.[306] Rather than penalizing the director who benefited privately, revocation of exempt status penalizes the organization and the public interests served by the organization.[307] For this reason, two sets of tax rules create penalties for those who breach their fiduciary duties in specified ways. Rules governing private foundations and intermediate sanctions imposed on excess benefit transactions both provide the IRS with enforcement mechanisms that do not depend on revocation of the organization's exempt status. The private foundation rules apply to a subset of charities, but the intermediate sanction rules, adopted in 1996, give the IRS greater regulatory power over all charities. This section will examine first the private foundation rules and then the intermediate sanctions, both of which reflect increasing regulation of charities by the IRS.

1. Private foundation rules

In the 1950s and 1960s, Congress became concerned about abuses in the charitable sector.[308] Testimony described scenarios in which wealthy individuals created charitable foundations, took tax deductions for contributions to the foundations, obtained tax-exempt status for the foundation, and then used the resources of the foundations for private purposes.[309] Since the individual donor and his or her family members served

---

[301] *See* Treas. Reg. § 1.501(c)(3)-1(b)(6).

[302] *See* Church of Scientology v. Commissioner, 823 F.2d 1310, 1312 (9th Cir. 1987).

[303] *See* Daysog, *supra* note 11; *see also* Evelyn Brody, *A Taxing Time for the Bishop Estate: What is the I.R.S. Role in Charity Governance?*, 21 U. HAW L. REV. 537 (1999)(discussing this use of IRS authority).

[304] *See supra* note 13.

[305] *See* Hansmann, *Reforming, supra* note 214, at 603.

[306] *See* FISHMAN & SCHWARZ, *supra* note 7, at 75.

[307] *See* Hansmann, *supra* note 214, at 603. "Withdrawal of exemption, which is the principal threat that the IRS can offer in such cases, will often hurt rather than help those innocent individuals whom the organization is designed to serve." *Id.*

[308] *See* FISHMAN & SCHWARZ, *supra* note 7, at 589-93.

[309] *See id.*

as directors and managers of the foundation, outside scrutiny was limited. These family-controlled nonprofits were particularly susceptible to private inurement problems, and at the same time, policing these nonprofits was difficult.[310]

To counter these concerns, Congress enacted new sections of the tax code—the "private foundation rules"–in 1969.[311] The changes in the tax law created two categories of exempt nonprofits—public charities and private foundations.[312] Public charities are those that have a broad donor base, significant government support, or some form of public control.[313] Private foundations are charities created and managed by an individual, a family or a corporation–a limited group of people operating without public involvement or oversight.[314]

The distinction between public charities and private foundations implicitly recognizes the role of the public in supervising charities. Public monitoring occurs through decisions about contributions, through serving as a watchdog for the attorney general, or through the public's involvement in the operation of the charity itself as employees, trustees, or directors.[315] The public has incentive and opportunity to monitor public charities but not private foundations. Thus, the changes enacted in 1969 create stricter standards for private foundations than for public charities.

The private foundation rules prohibit activities that Congress determined were the most susceptible to abuse.[316] Of particular interest with respect to fiduciary duties is an absolute prohibition on self-dealing by a person connected with the foundation–a major donor, a director, or a family member of either.[317] Congress viewed this extreme approach as necessary due to the

---

[310] *See id.*

[311] *See* Tax Reform Act of 1969, Pub. L. 91-172, 83 Stat. 487 (1969)(codified in scattered sections of 26 U.S.C.).

[312] *See* I.R.C. § 509 (1994)(defining private foundation as an exempt organization that fails to qualify as a public charity under one of the three tests of Section 509).

[313] *See id.*

[314] *See* Gail K. Neuharth, *A Primer on Private Foundations*, 12 PROB. & PROP. 33, 34 (Nov.-Dec. 1998). Although the Bishop Estate trust was created by the gift of one person, Princess Bishop, the trust is considered a public charity by virtue of its educational mission. *See* I.R.C. § 509(a)(1).

[315] Public monitoring is critical to adequate supervision of charities. Increased public access to information about charities may improve the regulation of charities. *See infra* notes 223-32 and accompanying text.

[316] Private foundations cannot hold majority interests in a business. *See* I.R.C. §§ 4943(c)(2)(A)(ii) & (B)(i)(ii) (1994). Private foundations cannot make investments that jeopardize the charitable purpose by being too risky. *See id.* § 4944(a)(1). Private foundations cannot make expenditures that are inconsistent with the foundation's exempt purposes. *See id.* § 4941.

[317] *See id.* § 4941.

difficulty of monitoring the activities of this type of charity.[318] The private foundation rules provide for sanctions in the form of taxes imposed on the organization or on the individual involved in the proscribed behavior.[319] The taxes imposed under the private foundation rules put some teeth into the statute. Since the IRS is in the business of collecting taxes, giving the IRS a tax reason to supervise private foundations should increase the scrutiny on those nonprofits.[320] Further, the taxes provide a way for the IRS to penalize private foundations for bad acts without taking the drastic step of revoking the foundation's tax-exempt status.[321] The taxes provide a penalty for the initial act, but perhaps more importantly, the substantial second tier tax provides a strong incentive for the foundation to undo the self-dealing once the IRS identifies the problem.[322] Nonetheless, the supervision is still limited by the availability of IRS staff and the difficulty of identifying acts of self-dealing in the private foundation context.

2. *Intermediate sanctions*

For nonprofits operating as public charities, the only enforcement mechanism available to the IRS until 1996 was the threat of revoking the nonprofit's tax-exempt status.[323] To address continuing concern about private inurement by directors and others connected with charities,[324] in 1996 Congress enacted Internal Revenue Code section 4958.[325] The new section

---

[318] *See* FISHMAN & SCHWARZ, *supra* note 7, at 648-49.

[319] *See, e.g.*, I.R.C. § 4941 (1994). If a private foundation enters into a self-dealing transaction with a director or other disqualified person, section 4941(a)(1) imposes a tax of five percent of the amount involved in the transaction on the self-dealer and section 4941(a)(2) imposes a tax of two-and-a-half percent of the amount involved on a foundation manager who knowingly participated in the act of self-dealing, unless the participation was not willful and was due to reasonable cause. If the foundation does not "correct" the transaction by undoing it to the extent possible, under section 4941(b)(1), the tax jumps to 200 percent on the self-dealer and 50 percent on the foundation manager.

[320] *See* Hansmann, *Reforming*, *supra* note 214, at 604.

[321] In this way, the private foundation rules provide a model for the intermediate sanctions enacted in 1996. *See infra* notes 325-34 and accompanying text.

[322] *See, e.g.*, I.R.C. § 4941(b)(i) (1994)(imposing a tax of 200% on the disqualified person who participated in an act of self-dealing if the self-dealing is not corrected).

[323] *See* FISHMAN & SCHWARZ, *supra* note 7, at 75.

[324] At congressional hearings conducted in 1993, IRS officials described examples of abuse, many of which involved excessive compensation of officers and directors. *See* FISHMAN & SCHWARZ, *supra* note 7, at 75 (citing *Report on Reforms to Improve the Tax Rules Governing Public Charities: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 103d Cong. 1415 (1994)).

[325] *See* Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1452 (1996)(July 30, 1996)(codified in scattered sections of 26 U.S.C.).

imposes excise taxes on insiders who engage in transactions that result in "excess benefits"[326] to the insiders.[327] The new section defines "insider" as someone who, within the five years preceding the transaction, was "in a position to exercise substantial influence over the affairs of the organization . . . ."[328] Thus, the intent is to impose penalties on the persons who benefit personally by reason of their position in the charity.[329] The new section imposes the tax on the insider and on managers who participated knowingly in the transaction, not on the organization.[330] Like the private foundation rules, section 4958 imposes a second tier tax if the transaction is not corrected.[331]

The rules have been referred to as "intermediate sanctions" because of the intent that these taxes be imposed in lieu of the ultimate sanction–revocation of tax-exempt status.[332] If the organization has provided so much private benefit to individuals that it is no longer charitable, the IRS can seek to revoke its exemption.[333] In a more typical case in which one or a few individuals have taken private benefits from the organization, section 4958 provides for an excise tax on the wrongdoers and not on the organization itself.[334] The intermediate sanctions seek to preserve the exempt organization's assets for public purposes.

3. *The Bishop Estate*

The IRS audit of the Bishop Estate led to a demand by the IRS that the trustees resign.[335] Within days after the IRS filed its report with the probate

---

[326] I.R.C. § 4958 (c)(1) (Supp. II 1996)(defining "excess benefit" as an economic benefit provided by the organization directly or indirectly to or for the use of a disqualified person to the extent that the benefit is in excess of the value of the consideration received by the organization. Consideration includes the performance of services).

[327] *See id.* §§ 4958(a) & (b).

[328] *Id.* § 4958(f)(1)(A).

[329] *See id.* § 4958(f) (defining disqualified person).

[330] *See id.* §§ 4958(a) & (b).

[331] *See id.* (imposing a first tier tax of 25 percent on the disqualified person and ten percent on the manager, and a second tier tax of 200 percent on the disqualified person).

[332] *See* Grant Williams, *Stopping Excessive Benefits*, CHRON. PHILANTHROPY, Aug. 13, 1998, at 29.

[333] *See id.* at 30.

[334] If the organization reimburses the insider for excise taxes paid by the insider, the payment to the insider will be considered compensation. The total amount of compensation must be reasonable or it will be considered an excess benefit. *See* Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Transactions, 63 Fed. Reg. 41,486, 41,501 (1998)(to be codified at 26 C.F.R. § 53.4958-4(a)(4))(proposed Aug. 4, 1998).

[335] *See* Daysog, *supra* note 11.

court, the probate judge permanently removed Trustee Lindsey, accepted the resignation of Trustee Stender, and temporarily removed the remaining three trustees,[336] saying that the exempt status of the trust was at risk. The IRS thus played a role in monitoring the fiduciary duties of the trustees of the Bishop Estate.[337] The IRS may impose penalties for excess benefit transactions that occurred before the removal of the trustees.

VI. WHAT SHOULD BE DONE?

While fiduciary duties exist under both trust and corporate law, corporate standards are less strict. Thus, the shift toward the use of corporate standards for charities has weakened the standards applied to charities organized as nonprofit corporations. Mechanisms for enforcement of those standards exist, but have always been weak. The growth in the charitable sector further depletes existing resources for enforcement. Some recent changes under the tax laws—the intermediate sanctions and the disclosure rules—should improve both monitoring and enforcement. Additional changes may be necessary to strengthen the charitable sector and to guard against further decline in the applicable standards. This section describes a number of proposals, some new and some recommended by others, that could improve the regulation of charities.

A. Strengthen and Protect the Standards

1. Self-dealing and a fairness standard

Self-dealing transactions and conflicts of interests generate much of the concern about proper management of nonprofits. In the Bishop Estate, the Hawai'i attorney general found breaches of both the duty of care and the duty of loyalty, as well as breaches of other duties owed by the trustees.[338] Directors have access to the assets of the nonprofit, assets that are dedicated to the public benefit.

---

[336] *See supra* note 13.

[337] *See generally* Brody, *supra* note 303 (arguing that the IRS's role in forcing the removal of the trustees was inappropriate).

[338] *See* Attorney General's Response to Master's Consolidated Report on the 109th, 110th and 111th Annual Accounts, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Sept. 9, 1998) [hereinafter Attorney General's Response], *available at* <http://starbulletin.com/98/09/10/news/bronster.html>; *see also infra* notes 446-56 and accompanying text.

In 1981, Henry Hansmann proposed a flat prohibition on self-dealing transactions between nonprofits and their directors.[339] The federal tax law takes this approach for private foundations,[340] but prohibiting all self-dealing transactions could unnecessarily deprive small nonprofits of beneficial opportunities.[341] A director of a nonprofit may be able to provide office space, goods or services to the nonprofit at a price that is below fair market value.[342] Obtaining help from directors may enable some nonprofits, in particular small, local nonprofits, to survive.[343] An absolute prohibition on such transactions seems too drastic.

If permitting some conflict of interest transactions between charities and the persons who control them is necessary, then the standards for when such transactions are permissible must protect charities from overreaching by directors. Trust law sets a high standard for review: any self-dealing transaction is voidable.[344] Although charities organized as nonprofit corporations may hold property "in trust" for the public,[345] rules governing charities organized as nonprofit corporations have shifted closer to corporate standards.[346] Treating charitable directors like their business counterparts is appropriate in some respects, but in connection with fiduciary duties, laws should draw a distinction because of the difference between organizations focused on public purposes and businesses dedicated to private gain, and because of the different mechanisms for monitoring behavior. Further, within the charitable sector the same, or at least similar, standards should govern charitable trustees and charitable directors. Imposing different standards on those who manage charities based on the organizational form of the charity does not make sense.[347]

---

[339] *See* Hansmann, *Reforming*, *supra* note 214, at 569.

[340] *See* I.R.C. § 4941 (1994).

[341] *See* FISHMAN & SCHWARZ, *supra* note 7, at 221; DeMott, *Self-Dealing*, *supra* note 183, at 144.

[342] *See* FISHMAN & SCHWARZ, *supra* note 7, at 221; DeMott, *Self-Dealing*, *supra* note 183, at 144.

[343] *See* FISHMAN & SCHWARZ, *supra* note 7, at 221 (stating that "[a]n absolute ban ignores the reality of much of the charitable sector"); *see also* Goldschmid, *supra* note 2, at 647.

[344] *See* BOGERT, *supra* note 32, § 95.

[345] *See In re* Los Angeles Pioneer Soc'y, 257 P.2d 1 (Cal. 1953) (in bank). Some older cases have applied trust law rules to nonprofits organized as nonprofit corporations because they deem the charities to hold property "in trust" even though the property is not held in trust. *See id.*

[346] *See supra* notes 144-55 and accompanying text.

[347] In the private sector, trust law imposes stricter standards on trustees than corporate law imposes on directors. This distinction may make sense in the private sector, where different types of monitoring occur. In the charitable sector, monitoring is the same whether the charity is structured as a trust or as a nonprofit corporation.

The RMNCA goes too far toward the corporate standard by permitting a conflict of interest transaction if disinterested directors reasonably believed that the transaction was fair to the corporation.[348] The "reasonably believed" test is more stringent than the rationally believed test of the business judgment rule,[349] but in the charitable context, a board's review of a self-dealing transaction may be much more cursory than in the business context.[350]

Deborah DeMott has proposed strengthening the fairness requirement of the duty of loyalty for directors of nonprofit corporations.[351] She proposes making a self-dealing transaction voidable unless the transaction's proponents can affirmatively establish its fairness to the corporation at the time of the transaction.[352] Professor DeMott's approach not only adopts a fairness test, but also puts the burden of proving that the transaction was fair on the proponents of the transaction. As she points out, even "reasonably believed" creates a low standard in the charitable context when board members may be reluctant to criticize each other.[353]

Professor DeMott's proposal creates a more appropriate level of restriction on director behavior than does the RMNCA approach.[354] The difficulties of supervising charities make a standard that is more strict than the business corporation standard appropriate. Combined with the federal tax rules on excess benefit transactions, the fairness standard should provide an acceptable level of restriction on conflict of interest transactions.

Whether or not a state adopts the DeMott proposal, further erosion of the duty of loyalty standard applied to nonprofit corporations presents risks to charities. In the business sector, corporations can reduce liability of directors for breaches of the duty of care and perhaps even for breaches of the duty of loyalty.[355] Protecting directors of charities from liability for some acts may be appropriate,[356] but reducing liability in connection with conflict of interest

---

[348] *See* REV. MODEL NONPROFIT CORP. ACT § 8.31(b)(1)(ii) (1988).

[349] *See* Goldschmid, *supra* note 2, at 648-49.

[350] *See* DeMott, *Self-Dealing*, *supra* note 183, at 137-41.

[351] *See generally id.* (arguing that importing rules on self-dealing from the business context is not wise, critiquing the RMNCA approach, and advocating stricter requirements).

[352] *See id.* at 143.

[353] *See id.* at 140-41. DeMott notes, "directors' motives and incentives for service on nonprofit boards differ dramatically from motives and incentives in the for-profit environment." *Id.* at 140.

[354] Harvey Goldschmid finds "considerable strength" in DeMott's proposal. *See* Goldschmid, *supra* note 2, at 648. He recommends either the DeMott approach or the intermediate standard of judicial review that the ALI Principles use for interested director transactions for business corporations. *See id.* at 648-49.

[355] *See supra* notes 116-21 and accompanying text.

[356] The Volunteer Protection Act protects uncompensated directors from liability for ordinary negligence, but not from actions brought against the volunteer by the nonprofit organization or a governmental entity. *See* Volunteer Protection Act of 1997 § 4, 42 U.S.C. §

transactions is not. The current duty of loyalty standards should be tightened and not reduced.[357] As corporate standards continue to change, the rules applicable to charities should not blindly follow corporate law. The risk of looking increasingly to corporate law to find standards for nonprofit corporations is that the standards borrowed will not meet the needs of the charitable sector.

2. *Large charities and a prohibition on self-dealing*

Small organizations may depend on financial help from directors. That assistance may include the provision of goods or services on a below-market cost basis and should be permitted.[358] In contrast, the directors of a large charity may be more likely to consider the advantages to themselves of doing business with the charity than to view self-dealing transactions as a way to help the charity.[359]

Creating a blanket prohibition on self-dealing is too extreme, but prohibiting self-dealing by directors and managers of large charities could reduce abuse without unduly restricting the activities of the charities. The Internal Revenue Code could be amended to create the additional restriction on self-dealing. The new provision would prohibit self-dealing by persons who control a charity[360] with assets exceeding a set amount, for example

---

14503 (1994 & Supp. III 1997). Thus, the attorney general can sue a director for breach of the duty of loyalty.

[357] The board's failure to exercise its duty of care can result in excessive executive compensation or self-dealing by an executive going undetected. In the United Way case, the board should have monitored Aramony's behavior and excessive spending. Board inattention is a serious problem. *See* Goldschmid, *supra* note 2, at 633-34 (describing the United Way scandal and stating that "the most significant question from both a corporate governance perspective and a public policy perspective, is: Where was the Board?"); Shenk, *supra* note 5, at 10 (describing reasons for board detachment).

[358] *See* DeMott, *Self-Dealing*, *supra* note 183, at 144 ("It is not unusual for directors of small nonprofits to sell goods and services to the nonprofit at below-market prices.").

[359] *See id.* at 140-41 ("Some [directors] . . . reportedly believe that directors who make financial contributions have a reciprocal entitlement to self-deal. Indeed the prospect of self-dealing may entice some directors to serve and to make financial contributions to the organizations." (footnotes omitted)). The larger the organization, the greater the potential for a lucrative self-dealing contract.

[360] The definition of persons to whom the restriction applies could be the same definition used for disqualified person under the excess benefit rules. *See* I.R.C. § 4958(f)(1); Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Requirements, 63 Fed. Reg. 41,486, 41,498 (1998)(to be codified at 26 C.F.R. § 53.4958-3)(proposed Aug. 4, 1998)(defining a "disqualified person" as "any person who was, at any time during the five-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization.").

$10,000,000.[361] Reasonable compensation would still be permitted, of course,[362] and would be subject to the excess benefit rules.

Since a category based on size of assets would include many hospitals and health maintenance organizations, such a proposal would have to consider whether to provide an exception for health care conversions. A phenomenon in the health care sector is the conversion of hospitals and other health care organizations from nonprofit status to for-profit status.[363] The nonprofit assets must remain dedicated to nonprofit endeavors, but examples of the undervaluation of nonprofit assets and the resulting benefits to successor for-profit entities have led to concern about greater scrutiny of these conversions.[364] Because the issue of hospital conversions is a troubling one,[365] a prohibition on insider involvement in the transaction could solve some of the concerns.[366] It is possible, however, that with respect to conversions, the

---

[361] The amount set can be larger or smaller but should be large enough to exclude small, grassroots charities.

[362] Hawai'i recently adopted a rule, effective January 1, 1999, under the circumstances limiting trustee compensation to what is "reasonable." *See* HAW. REV. STAT. § 607-20 (1993, Supp. 1998).

[363] The topic of health care conversions was the core topic of a Nonprofit Symposium issue of the Journal of Corporation Law. *See* Evelyn Brody, *Introduction to Nonprofit Symposium Issue*, 23 J. CORP. L. 581 (1998). Many of the symposium articles touched on conversion issues, reflecting the importance of the changes occurring in the health care sector as hospitals and other health care providers convert from the nonprofit to the for-profit form. *See id.* For additional discussions of fiduciary issues involved in health care conversions, see Brody, *Limits*, *supra* note 7, at 1465-75 (describing the legal questions involved in determining whether the board of directors of a hospital has the authority to sell the assets of the hospital and whether the board can determine what to do with the sale proceeds); Coverdale, *supra* note 220 (proposing that private citizens be permitted to sue as relators on behalf of the United States to enforce intermediate sanctions in connections with health care conversions); James J. Fishman, *Checkpoints on the Conversion Highway: Some Trouble Spots in the Conversion of Nonprofit Health Care Organizations to For-Profit Status*, 23 J. CORP. L. 701 (1998); Goldschmid, *supra* note 2, at 651-52 (citing Harvey J. Goldschmid, *Nonprofit Conversion Transactions: Existing Fiduciary Duties and Necessary Reforms*, in THE NATIONAL CENTER ON PHILANTHROPY AND THE LAW, CONVERSION TRANSACTIONS: CHANGING BETWEEN NONPROFIT AND FOR-PROFIT FORM 15-16).

[364] *See* FISHMAN & SCHWARTZ, *supra* note 7, at 102-07 (describing health care conversions and giving as an example the conversion of Family Health Program ("FHP"), a nonprofit founded in 1969). Preparing to sell its assets to a for-profit entity, FHP initially valued itself at approximately $13.5 million. The Department of Corporations rejected that amount and, following negotiations, agreed to a sales price of $38.5 million. Eight months later, the purchasing entity, owned in large part by insiders connected with the nonprofit FHP, made a public offering of its stock at a market value of $150 million dollars. *See id.* at 104.

[365] *See* FISHMAN & SCHWARZ, *supra* note 7, at 103 ("Because of the absence of case law, the lack of rigor of attorney general scrutiny of valuation issues, and the paucity of statutory direction on dissolution, the capacity for abuse in conversion transactions is readily present.").

[366] *See* FISHMAN & SCHWARZ, *supra* note 7, at 104-05 (describing a number of controversial

approach may be overbroad and not attuned to the reality of the health care sector.[367] Conversion transactions depend, of course, on finding a qualified buyer. Precluding insiders from involvement may diminish the potential for finding the best buyer or, indeed, any buyer. Professor Goldschmid's proposal for a "market test" approach,[368] combined with the intermediate sanctions for excess benefit transactions,[369] may be sufficient to deal with the problems in this area.

In the Bishop Estate, a prohibition on self-dealing would not only have prevented many of the questionable investments in which the trustees engaged, assuming that the trustees complied with the prohibition. A ban on self-dealing also would have enabled the trustees to focus on an investment strategy that was most appropriate for the trust without the distraction of considering benefits for themselves. The advantage of a prohibition on self-dealing for a charity of this size is that the prohibition avoids issues of appropriateness of the investment and removes the temptation of the trustees to self-deal.

B. Require Greater Disclosure to Regulating Bodies and to the Public

To supervise charities adequately and to determine whether the trustees and directors are fulfilling their fiduciary duties, those who monitor charities need adequate information. Easier public access to information, more effective disclosure, and for certain transactions, increased disclosure, will help.

1. Access

Changes in federal tax law adopted in 1996[370] increase access to information for the federal government, for state attorneys general, and for the public. Due to the rules on excess benefit transactions, the IRS will likely receive more information on Form 990. In order to provide evidence of intent to treat an economic benefit to a disqualified person as compensation to the person, the organization must report the economic benefit as compensation on

---

conversions involving self-dealing and financial benefits obtained by insiders).

[367] This issue is beyond the knowledge of the author and beyond the scope of this Article.

[368] *See infra* notes 392-95 and accompanying text.

[369] *See, e.g.*, Coverdale, supra note 220, at 11-14. John Coverdale suggests that the IRS may have difficulty using the excess benefit rules to prevent insider misappropriation of health care assets, and suggests strengthening the enforcement potential of the excess benefit rules by permitting relators to sue on behalf of the government. *See id.* at 15-17.

[370] The 1996 Taxpayer Bill of Rights added intermediate sanctions and increased disclosure requirements to the Internal Revenue Code. *See supra* notes 324-34 and accompanying text (describing the intermediate sanctions rules), and *supra* notes 222-26 and accompanying text (describing the disclosure requirements).

its Form 990 or on a Form W-2 or 1099.[371] The charity will have an incentive to provide more information to the IRS,[372] and therefore to the state attorney general.[373]

New federal rules make information regarding charities much easier for the public to obtain. Internal Revenue Code section 6104(e) requires a charity to provide a copy of its Form 990 to anyone who asks.[374] Thus, a private person with a concern about a particular charity will be able to see the information that has been filed with the IRS. Since the attorneys general respond to inquiries and complaints from the public in determining where to allocate scarce enforcement resources,[375] putting more information into the hands of the public will increase the role the public can take in oversight of the sector.

The IRS will make Forms 990 filed by charities available on CD-ROM or on the Internet.[376] Electronic filing by charities should facilitate this endeavor. In addition, a number of organizations are working to help charities make the informational returns accessible on the Internet.[377] A properly managed charity benefits by posting its Form 990 on its web page because by doing so, the charity avoids the cost of photocopying and mailing forms to those who request them.[378] In addition, charities can and should provide more information than that required on the Form 990, in particular, information describing how they conduct their exempt activities. Making information available in an accessible form will strengthen the charitable sector as a whole

---

[371] *See* Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Transactions, 63 Fed. Reg. 41,486, 41,502 (1998)(to be codified at 26 C.F.R. § 53.4958-4(c)(2))(proposed Aug. 4, 1998).

[372] If the charity fails to establish by clear and convincing evidence that the economic benefit was provided as compensation for services, then unless the person receiving the benefit provided some consideration other than services, the provision of the benefit will be an excess benefit transaction. *See* Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Transactions, 63 Fed. Reg. 41,486, 41,500, 41,502 (1998)(to be codified at 26 C.F.R. § 53.4958-4(a)(1), (c)(3)).

[373] In 35 states, a charity can comply with the state filing requirements by filing the federal Form 990. *See* Marcus S. Owens, remarks at the panel entitled *Intermediate Sanctions After the Proposed Regulations: How They Impact Charitable Giving and Directors and Trustees of Public Charities*, given at the Estate Planning Symposium, A.B.A. Sec. Real Prop., Prob. & Tr. L. (May 20, 1999) [hereinafter Marcus S. Owens, Remarks]. Thus, the incentive to report benefits aids the state attorneys general as well as the IRS. Further, Mr. Owens, Director of the Exempt Organizations Division of the IRS, indicated that the IRS expects to work with the state attorneys general in reviewing excess benefit issues. *See id.*

[374] *See* I.R.C. § 6104(e) (1994).

[375] *See* Bograd, *supra* note 17, at 14-16.

[376] The IRS plans to sell Forms 990 on CD-ROM. *See* Marcus S. Owens, Remarks, *supra* note 373. Making the filed forms available on the Internet without cost to the public will be even better. Many Forms 990 are already available at <http://www.guidestar.org>.

[377] *See supra* note 229.

[378] *See* Treas. Reg. § 301.6104(d)-4.

and may benefit an individual charity by making it more appealing to donors. In fact, well-run charities should tout the accessibility of their information, thereby, by negative implication, raising questions about those charities that do not make information accessible.

2. Accounting

Increased access to information will help, but a remaining problem in the charitable sector is the need for standardized accounting practices. Regina Herzlinger advocates greater accountability for nonprofits through increasing disclosure requirements.[379] She recommends requiring that nonprofits follow Generally Accepted Accounting Principles ("GAAP") as articulated by the Financial and Governmental Accounting Standards Boards in preparing annual financial statements.[380] Although Professor Herzlinger recognizes that some improvements could be made before applying these accounting principles to nonprofits,[381] the benefits of standardized accounting are significant. Requiring charities to prepare financial statements using a standardized format would help all those who monitor charities. In addition, standardized financial statements should make it easier for directors and trustees to exercise their duty of care. Since all charities with gross receipts in excess of $25,000 must meet federal reporting requirements,[382] the appropriate place to require a standardized format would be through the tax rules related to the Form 990 annual report. Since these reports will now be more accessible to the public,[383] requiring standardized reporting in connection with the Form 990 will make it easier for persons to compare charities' use of assets and income.

In addition, Professor Herzlinger recommends that nonprofits prepare annually a "management discussion and analysis" ("MD&A") report comparable to the MD&A report required by the Securities and Exchange Commission for business corporations.[384] Requiring audited financial statements and a MD&A Report for all charities would be unduly burdensome on small organizations. Making audited statements a requirement for nonprofits of a significant size, based on assets, gross revenues or a

---

[379] *See* Herzlinger, *supra* note 206, at 100-02.

[380] *See id.* at 102.

[381] *See id.* at 103.

[382] *See supra* notes 218-19 and accompanying text (explaining that charities with gross receipts in excess of $25,000 must file an annual report with the IRS).

[383] *See supra* notes 222-26 and accompanying text (describing the requirement that a charity mail copies of its Form 1023 and its three most recent forms 990 to anyone who requests the forms).

[384] *See* Herzlinger, *supra* note 206, at 103.

combination of the two, would provide an additional check on the sector and could reinforce the reviews conducted by the IRS and the state attorneys general. In a similar way, requiring a MD&A Report could assist those who monitor charities. A federal requirement, perhaps that a MD&A Report be submitted with the organization's annual Form 990, would be an effective approach. Creating a federal commission to supervise charities could also work, but would require a much greater commitment of resources than adding to the IRS's existing role in the supervision of charities.[385]

Financial reporting, conducted in a clear, intelligible and appropriate form, is essential to adequate monitoring of charities. In the Master's Report filed in the Bishop Estate, the Master noted that the duty of the trustees to provide meaningful financial information to the court requires appropriate financial accounting.[386] The Master stated that the accounts prepared by the trustees "made it difficult to obtain an overview of the financial status of the Trust Estate and its subsidiaries."[387] Following an independent audit of the trust's financial statements, Arthur Andersen LLP made a number of recommendations concerning the presentation of the financial data, including preparing the financial statements in accordance with GAAP.[388] The Master asked that the court order the trust to adopt the financial statement presentation format that Arthur Andersen LLP recommended.[389] Although the trustees argued that the information sought was available and that "format" was of secondary importance,[390] it seems clear that providing information in a format that is understandable is indeed necessary. For financial information in particular, reporting data in a manner that does not conform to generally understood accounting methods hampers the person reviewing the information. The Attorney General concluded that the trustees failed to fulfill their duty to account and that the accounts intentionally concealed the true condition of the Bishop Estate.[391] Requiring standardized accounting procedures for all charities, or at least for all charities of a significant size, will enhance monitoring of those charities.

---

[385] *See infra* notes 407-09 and accompanying text (considering the establishing of a state commission on charities to assist the attorney general's office with supervision at the state level).

[386] *See* Master's Report, *supra* note 291.

[387] *Id.*

[388] *See id.*

[389] *See id.*

[390] *See* Trustees' Response to Master's Consolidated Report on the One Hundred Ninth, One Hundred Tenth, and One Hundred Eleventh Annual Accounts of the Trustees, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Sept. 9, 1998) [hereinafter Trustees' Response], *available at* <http://starbulletin.com/98/09/10/news/trustees.html>.

[391] *See* Petition of Attorney General, *supra* note 10.

3. Conversion transactions

Harvey Goldschmid has recommended greater scrutiny and a new mandatory disclosure system for transactions in which a nonprofit converts to a for-profit.[392] Even if the transaction does not involve conflicts of interest, Professor Goldschmid advocates involving disinterested outside experts in the transaction and applying a "market test" that would provide:

> (i) public disclosure of the proposed transaction; (ii) the provision of relevant information (subject to appropriate confidentiality safeguards) to responsible persons interested in making a competing offer; and (iii) adequate time for competing offers to be made.[393]

Goldschmid would also require enhanced scrutiny "with respect to the placement of the proceeds of a conversion transaction into a new nonprofit foundation and with respect to any joint venture undertaken by the nonprofit entity (or its successor) and a for-profit purchaser."[394]

Professor Goldschmid first presented his proposal at a conference focusing on issues associated with health care conversions. He has expanded his original proposal to require that other "similar sensitive transactions" meet the market test and increased disclosure rules he proposes for conversion transactions.[395] Professor Goldschmid does not specify what these additional transactions should be or who should make the determination. Nonprofits vary widely in structure and activity, so flexibility in determining what constitutes a "sensitive transaction" for a particular charity will be important.

Conversion transactions present a good starting point for heightened scrutiny. Additional transactions that should be subject to enhanced scrutiny include transactions involving the sale of a significant portion of a charity's assets or the sale of an asset with significance to the charity. These transactions carry with them both the risk of self-dealing and the public's need for disclosure and enhanced review.

In the case of Bishop Estate, a transaction such as the sale or closure of the Kamehameha Schools would be the sort of transaction that should be subject to additional disclosure and heightened scrutiny. The recent problems did not involve an attempt to close the schools, but the trustees did adopt a new

---

[392] *See* Goldschmid, *supra* note 2, at 651-52.

[393] *Id.* at 651-52 (citing Harvey J. Goldschmid, *Nonprofit Conversion Transactions: Existing Fiduciary Duties and Necessary Reforms*, in THE NATIONAL CENTER ON PHILANTHROPY AND THE LAW, CONVERSION TRANSACTIONS: CHANGING BETWEEN NONPROFIT AND FOR-PROFIT FORM 15-16).

[394] Goldschmid, *supra* note 2, at 651-52 (citations omitted).

[395] *See id.*

strategic plan, the first plan of such magnitude since a 1961 strategic plan.[396] A once-in-a-generation strategic plan intended to shape the future of the trust and the Kamehameha Schools is the kind of sensitive matter deserving heightened public scrutiny. Subjecting routine transactions to heightened scrutiny is unnecessary and would undermine the board's authority. Nonetheless, a charity contemplating significant change such as the strategic planning initiative could benefit from the application of Professor Goldschmid's approach.

C. Increase Enforcement

The standards governing fiduciary behavior are, for the most part, adequate,[397] and disclosure requirements have increased. Given human nature, however, violations of fiduciary duties will likely continue to occur. The critical issue is whether the enforcement mechanisms in place are working and if not, whether they can be strengthened.

1. Federal enforcement through the IRS

The intermediate sanction rules create a distinction that applies stricter standards to self-dealing transactions than to other transactions.[398] The rules focus on conduct that poses a significant risk of harm to the charity without detection: benefits authorized by and received by those who control the charity. By imposing sanctions on "excess benefits," benefits for which the organization did not receive adequate consideration, these rules will penalize those who use a charity's assets for personal benefit.

The intermediate sanction rules do not prohibit self-dealing but rather, require that any self-dealing transaction, including the payment of compensation for services, be conducted for adequate consideration. The rules complement existing trust law and nonprofit corporation law, which imposes a duty of loyalty on trustees and directors. The intermediate sanction rules add an enforcement mechanism, giving the IRS a regulatory role. The

---

[396] *See* Master's Report, *supra* note 291.

[397] The fiduciary duties under trust law and nonprofit corporation law provide reasonable standards for fiduciary behavior in the charitable context. Changes needed, such as Deborah DeMott's proposal for a fairness standard for nonprofit corporations, and the proposal made in this Article to prohibit self-dealing in large charities, address the difficulty of monitoring the behavior and enforcing the standards.

[398] *See* I.R.C. § 4958 (Supp. II 1996). The intermediate sanction rules use the term "excess benefit" rather than "self-dealing," and the definition applies more broadly than the section 4941 definition of self-dealing. *See* I.R.C. § 4941 (1994).

prospect of substantial penalties for violations may provide incentive for the IRS to enforce these rules.[399]

The new rules raise questions as to how "excess benefit" will be determined and whether excessive salaries and self-dealing can be curtailed using the intermediate sanctions. The parties to a transaction must prove that the transaction was reasonable, but there is a range of reasonableness. Nonetheless, the intermediate sanctions provide an important new enforcement tool, and will likely encourage charities and their directors and trustees to look more carefully at self-dealing transactions.[400]

With respect to the Bishop Estate, the intermediate sanction rules will apply to transactions that occurred before the trustees resigned or were removed.

2. *Attorney general*

Increasing IRS enforcement may help, in particular for large, national charities. Many charities, however, operate locally or on a statewide level. Those charities may be better supervised by those closer to them, both the state attorney general and the public.

Given the limited time state attorneys general can devote to supervising charities, observers of the charitable sector have repeatedly voiced concerns that the attorneys general do not provide adequate enforcement.[401] Some increase in the staffing of the charities sections of the offices of state attorneys general has occurred over the past twenty-five years, but the number of

---

[399] *See* Williams, *supra* note 227, at 58 (quoting James J. McGovern, a former IRS employee, as saying that the penalties will provide an incentive for the IRS to begin "a relatively significant enforcement effort."); *see also* Hansmann, *Reforming*, *supra* note 214, at 604 (stating that "federal revenue agents have, at best, only an indirect interest in policing fiduciary behavior in nonprofits" since the goal of the income tax is "to produce revenues to finance the government."). Although the penalties provide incentive for enforcement, John Coverdale worries that an understaffed IRS may still be unable to monitor charities adequately. *See* Coverdale, *supra* note 220, at 15. Professor Coverdale proposes allowing private parties to sue for excess benefit transactions as relators on behalf of the United States. *See id.* at 16.

[400] The new rules have generated much interest concerning compliance among those who advise charities and their directors. *See, e.g.*, Carol G. Kroch & Marcus S. Owens, address at the panel entitled *Intermediate Sanctions After the Proposed Regulations: How They Impact Charitable Giving and Directors and Trustees of Public Charities*, given at the Estate Planning Symposium, A.B.A. Sec. Real Prop., Prob. & Tr. L. (May 20, 1999).

[401] *See* FISHMAN & SCHWARZ, *supra* note 7, at 247 ("Staffing problems and a relative lack of interest in monitoring nonprofits makes attorney general oversight more theoretical than real."); Blasko et al., *supra* note 259, at 39 ("Lack of money, coupled with the obligation to discharge the other important duties of the attorney general's office, contributes to inadequate staffing for the purpose of supervising charities."); Hansmann, *Reforming*, *supra* note 214, at 601 (describing the inadequate enforcement of the nonprofit sector by the attorney general as a "sad state of affairs"); Karst, *supra* note 66, at 433.

charities being supervised by those offices also has grown.[402] At the same time, the attorneys who work in three of the most active states suggest that they can investigate only a small fraction of inquiries concerning charities in their state;[403] that they respond primarily to inquiries from outside their office rather than from an independent review of documents filed by the charities;[404] and that, in their view, the attorney general should not be the watchdog for the nonprofit sector.[405]

To improve enforcement at the state level, states should strengthen the attorney general's office by providing funds for additional staff for charitable supervision.[406] In states that do not have staff assigned specifically to charitable work, creating a charities section will help. In all states, adding additional attorneys, paralegals, investigators and accountants will improve monitoring. Unfortunately, increasing the number of employees may not be economically feasible.

An additional possibility for enforcement by the state would be the creation of state commissions or even a federal commission in charge of charitable oversight.[407] Creating a separate government agency to monitor charities could work, but the additional bureaucracy involved might divert resources from actual monitoring.

States like Hawai'i, in which the attorney general is appointed and politics may affect the monitoring of charities, might benefit from the creation of a separate agency. Concerned that political pressure would prevent the attorney general of Hawai'i from investigating the Bishop Estate, the Broken Trust article called for the creation of an "independent watchdog" to monitor all

---

[402] A 1974 study found that Oregon allocated one attorney to charities work and New York allocated 10. *See Status of State Regulation*, *supra* note 232, at 2728. As of 1994, New York had 17 attorneys doing charitable work. *See* Bograd, *supra* note 17, at 9. Oregon now has three attorneys assigned to the charitable section, but the number of charities the office supervises has increased comparably, so there may not be a significant increase in the ability to supervise charities. *See* Conversation with Judith L. Woodruff, *supra* note 247.

[403] *See* Bograd, *supra* note 17, at 14-16 (discussing the criteria for intervening in charity in New York, Massachusetts, and Connecticut).

[404] *See id.* at 12.

[405] *See id.* at 5. The study focused on three states that have separate charities offices that are well-staffed and may be "among the most active in the country." *Id.* at 11. The statements reflect the circumstances of their attorney's own offices and may not be representative of the views of attorneys general across the country.

[406] *See Status of State Regulation*, *supra* note 232, at 2708-09 (recommending increases in staff attorneys and accountants assigned to charitable work).

[407] *See* Blasko et al., *supra* note 259, at 83 (suggesting the creation of a national committee or equivalent state committees to evaluate claims against charities and either make recommendations to the state attorney general or be given authority to pursue claims against the charities in federal court).

charitable trusts in Hawai'i.[408] Such an independent entity may still be an appropriate idea for Hawai'i, but the supervision should extend to all charities, whether organized as a trust or as a nonprofit corporation.[409] Regardless of whether a state increases the charities section of the attorney general's office or creates a separate agency to monitor charities, more resources should be devoted to supervision of charities at the state level.

3. Private citizens

If IRS and attorney general supervision is not enough, what other options exist? Those connected with a charity, as donors, employees, volunteers or beneficiaries, are often in the best position to monitor the charity's activities and the actions of the trustees or directors. Persons with information about problems in the management of the charity can notify the attorney general, but the attorney general cannot handle every case.[410] In finding a means to use private persons to supplement the supervisory and enforcement work of the attorney general's office, there must be a balance between the potential for improved enforcement and the need to minimize vexatious and unnecessary litigation.

The most promising way to increase the involvement of private citizens in enforcing fiduciary duties appears to be the use of relators.[411] Permitting members of the public to sue on behalf of the attorney general's office expands the reach of the attorney general's office without the use of additional state resources. Relators cannot provide a complete solution, since only the most dedicated observers of charity are likely to take the step of suing a charity as a relator. As an additional weapon against egregious behavior, however, permitting suits by relators makes sense.

Another means to increase the enforcement of fiduciary duties is for courts to adopt more flexible standing rules for persons with "special interests." Again, care must by taken to permit suits only in situations in which the potential abuse is serious and the persons suing are directly connected to the charity. The framework of analysis developed by Mary Grace Blasko, Curt S. Crossley and David Lloyd indicates when a court will likely find "special interests," based on existing decisions.[412] The framework provides a good

---

[408] *See Broken Trust*, *supra* note 10.

[409] The trustees of the Bishop Estate attempted to transfer estate assets into a nonprofit corporation, perhaps to avoid this sort of monitoring.

[410] *See* Bograd, *supra* note 17, at 14-16 (describing the criteria used by New York, Massachusetts and Connecticut's attorney generals' offices for intervening in troubled nonprofits).

[411] *See supra* notes 272-80 and accompanying text.

[412] *See* Blasko et al., *supra* note 259, at 61-78.

resource for courts to use as a guideline in determining when to allow such suits.

Expanding standing in any manner, whether by the use of relators or by finding standing for those with "special interests," must be carefully considered, keeping in mind the competing interests. The law should not attempt to second guess charitable managers with respect to every decision, but ways to enforce the fiduciary duties of those managers must be found so that the managers do not benefit at the expense of the charity. Professor Hansmann reported that for the period during which Wisconsin permitted suits by ten or more donors or beneficiaries, he could find no reported cases in which donors or beneficiaries actually brought suit against a charity under the statute.[413] This may indicate that the risk of a flood of lawsuits is small. In addition, the requirement that the attorney general must approve any suit under a relator statute will help to minimize abuse. Continued monitoring of the use of relator statutes and findings of "special interests" may help to determine whether permitting more law suits helps or hurts the charitable sector. Despite fears of proliferating litigation, the countervailing concern, that breaches of fiduciary duties will otherwise go unchecked, is quite real.

D. Delegation

The Restatement (Third) of Trusts has loosened the rules on delegation by trustees.[414] Corporate directors already enjoy considerable power to delegate.[415] As laws change to reflect changes in investment theory, the changes should not undermine the duty of care for trustees and directors of charities with respect to significant policy matters.

The trustees of the Bishop Estate delegated their duty of care to an extreme degree, in breach of their duties under trust law and in violation of the terms of the will that created the trust.[416] The trustees used a "lead trustee" system of management in which each trustee took responsibility for an aspect of the trust's administration.[417] For example, Trustee Lokelani Lindsey served as the lead trustee for education, and the other trustees delegated the management of the Kamehameha Schools to her. The other trustees did not supervise Ms. Lindsey's management of the schools. Despite growing problems, the other

---

[413] *See* Hansmann, *Reforming*, *supra* note 214, at 609-10.

[414] *See supra* notes 75-84 and accompanying text.

[415] *See supra* notes 122-28 and accompanying text.

[416] Princess Bishop's will requires the trustees to act by majority vote and requires that at least three trustees join in all acts. *See* Petition of Attorney General, *supra* note 10 (citing article 14 of the Will).

[417] *See id.*

trustees did not intervene until public criticism forced them to remove Ms. Lindsey as lead trustee.[418]

Trustee Henry Peters served as lead trustee for asset management and, in that capacity, concealed financial information from the other trustees.[419] The lack of supervision enabled Mr. Peters to engage in several self-dealing transactions with the trust.[420]

Despite the central role of the Kamehameha Schools in the trust and the importance of investment management for any trust, the trustees failed to supervise the delegated activities. The trustees ignored the probate master's recommendation that they abandon the lead trustee system.[421] The attorney general of Hawai'i determined that the delegation was a breach of the trustees' duties to the trust.[422] The Bishop Estate situation provides an extreme example of delegation by charitable trustees who went even beyond the relaxed delegation rules. The case presents a cautionary look at excessive delegation and points to the need for continued legal restrictions on delegation in the charitable context.

E. Continue to Improve the Efficacy of Nonlegal Constraints

Although the law must provide for enforcement of fiduciary duties of directors and trustees, in the charitable sector nonlegal constraints are also important. The lawyers that write about this area have recognized that laws alone cannot ensure a healthy charitable sector.

Professor Hansmann has suggested that normative constraints serve to reinforce the legal constraints.[423] The social norms against stealing, especially important in the charitable sector, may guard against abuses. Professor Brody adds that charities have an incentive to operate at a level of behavior higher than the law requires to maintain the public trust and thereby discourage the adoption of more restrictive legislation.[424]

---

[418] *See id.*

[419] *See id.*

[420] *See id.*

[421] *See* Master's Report, *supra* note 291 (describing the problems with the lead trustee system, including the lack of oversight by other trustees, and recommending that the court order the trustees to end use of the lead trustee system and adopt a CEO-based management system). The probate master noted that the lead trustee system benefits the trustees financially. The trustees can argue that they deserve a high level of compensation due to their management duties as lead trustee and due to the lack of a CEO. *See id.*

[422] *See* Petition of the Attorney General, *supra* note 10.

[423] *See* Hansmann, *Role, supra* note 1, at 875.

[424] *See* Brody, *Limits, supra* note 7, at 1414-15 (arguing that "a laissez-faire structure for charity fiduciary law makes sense" because courts would be no better than corporate boards in

But norms also cut the other way. Social constraints in the boardroom may operate against proper exercise of the duty of care. Directors may serve for social reasons, and proper etiquette may proscribe questioning the executive director, the staff, or other board members.[425] Charitable directors may be overcommitted and inattentive.[426] Some directors view a charitable board position as a mark of social status.

Nonlegal constraints may become more important as charities face increasing government regulation and increasing public awareness through the Internet. Charities themselves must take the lead in establishing oversight procedures within the charities and in educating their directors.[427] Charities must be certain that new directors understand their responsibilities and fiduciary duties. Having procedures in place to deal with conflict of interest transactions will make it less likely that directors will take advantage of the charity in a conflict situation. Lawyers and others who work with charities can also play a role in educating and in helping the directors and trustees supervise the charity properly.

The trustees of the Bishop Estate had an opportunity to obtain expert advice about their fiduciary duties.[428] The newspaper article Broken Trust noted that a "nationally recognized authority on the law of trusts and fiduciary duties"[429] offered to meet with the trustees and explain their fiduciary duties.[430] The trustees never met with the expert, Professor Edward C. Halbach, Jr., and never "had a single session in which their fiduciary duties have been systematically explained to them."[431] The authors of Broken Trust describe this failure by the trustees to educate themselves as "reckless, at the least."[432]

VII. THE BISHOP ESTATE

The Bishop Estate provides an example of charitable trustees accused of engaging in self-dealing and conflict of interest transactions with the large charitable organization they manage.[433] Princess Bernice Pauahi Bishop created a trust under her will to provide educational benefits to Hawaiian

---

running charities and the need to retain the public's trust provides incentive for proper behavior).

[425] *See* FISHMAN & SCHWARZ, *supra* note 7, at 186.

[426] *See* Shenk, *supra* note 5, at 9.

[427] *See* Brody, *Limits*, *supra* note 7, at 1501.

[428] *See Broken Trust*, *supra* note 10.

[429] *Id.*

[430] *See id.*

[431] *Id.*

[432] *Id.*

[433] United Way and Adelphi University faced similar problems. *See supra* notes 2-9 and accompanying text.

children, particularly those with aboriginal Hawaiian ancestors.[434] The trust operates the Kamehameha Schools and a number of other educational programs.[435] Five trustees, appointed by the Supreme Court of Hawai'i, administer the trust.[436]

The Bishop Estate trust is unique, with a history tied to the history of Hawai'i itself.[437] Its size[438] and the politics surrounding the trust[439] make the Bishop Estate an anomalous case study in some ways, and yet the fiduciary standards that apply to all trustees apply to the Bishop Estate trustees. The enforcement of these standards by the attorney general of Hawai'i, the IRS and the public serves as an example of the way in which the enforcement mechanisms work. Yet, the Bishop Estate may also serve as a warning about how egregious fiduciary conduct must be before enforcement of fiduciary duties actually happens.

The Bishop Estate demonstrates both the difficulty of holding charitable trustees accountable and the power of existing constraints to control wayward fiduciaries. Action was taken against the trustees only after years of allegations and after escalating abuses.[440] Yet, eventually the attorney general petitioned the probate court to remove the trustees and the court did so.[441] The size of the Bishop Estate probably made uncovering and understanding the problems more difficult,[442] but in the end, the size and public importance of the trust created some of the needed scrutiny.[443] A review of the Bishop Estate is instructive both to understand how the existing monitoring process worked and to consider what improvements can be made.

---

[434] *See* Master's Report, *supra* note 291. The will did not exclude non-Hawaiian boys and girls from the schools, but Princess Bishop's intent was to benefit primarily these children with some aboriginal blood. The trustees have honored the spirit of the will by limiting admission to the Kamehameha Schools to children of Hawaiian ancestry. *See* Gladys Brandt, Samuel P. King, Walter Heen & Randall Roth, *Renewed Trust*, HONOLULU STAR-BULLETIN, Oct. 23, 1999, at B-3, reprinted in Appendix D.

[435] *See id.*

[436] *See Broken Trust*, *supra* note 10.

[437] *See* Master's Report, *supra* note 291.

[438] The Master's Report sets the value of the trust at more than $6 billion. *See id.*

[439] *See Broken Trust*, *supra* note 10 (suggesting that politics play a role in the selection of the Supreme Court Justices and in their selection of the trustees).

[440] The trustees received arguably unreasonable compensation since 1987. *See* Petition of Attorney General, *supra* note 10. The probate master had recommended changes in the management structures as early as 1985. *See* Master's Report, *supra* note 291.

[441] *See* Daysog, *supra* note 11.

[442] *See Broken Trust*, *supra* note 10.

[443] Public complaints made a difference in addressing the problems in the Bishop Estate. Whether the mechanisms in place would have uncovered theft in a much smaller charity remains an open question.

A. Breaches of Fiduciary Duties

As trustees of a charitable trust, the trustees of the Bishop Estate are subject to the fiduciary standards of trust law.[444] The trust law duty of loyalty applies a strict standard to self-dealing by trustees, permitting trust beneficiaries to undo any transaction involving self-dealing by a trustee.[445] In the trust context, self-dealing should be minimal, and preferably nonexistent. In the Bishop Estate, it appears to have been rampant.

The Master's Report and the Petition of the Attorney General describe numerous examples of alleged self-dealing and conflict of interest transactions by the trustees of the Bishop Estate.[446] In one example, the trustees invested personally in a Texas methane gas deal in which the trust also invested.[447] The trust lost money on the deal and the decisions the trustees made for the trust could have been influenced by their personal interests in the deal.[448]

In one rather bizarre example of conflict of interest, the trustees authorized the use of trust funds to lobby against enactment of the intermediate sanctions provisions.[449] These provisions protect charities by penalizing those who obtain benefits in excess of services rendered to the charity. Lobbying *against* these rules is clearly in the interests of the trustees in their individual capacity and counter to the interests of the trust. The attorney general identified this lobbying effort as an attempt by the trustees to preserve their excessive compensation.[450]

In yet another transaction, two trustees, Mr. Peters and Mr. Wong, entered into a condominium project which benefited Mr. Wong's brother-in-law.[451] The two trustees then received kickbacks by selling apartments at inflated prices to an entity connected with the brother-in-law.[452] In addition, Trustees Peters, Wong, and Lindsey benefited friends and family members by arranging for jobs or consulting contracts with the trust.[453] The trustees even used trust employees and resources on personal matters.[454] These breaches of trust

---

[444] *See* Master's Report, *supra* note 291 (discussing Hawai'i cases acknowledging the duty of loyalty imposed on trustees).

[445] *See* BOGERT, *supra* note 32, § 95.

[446] *See* Master's Report, *supra* note 291; Petition of the Attorney General, *supra* note 10; *see also Broken Trust*, *supra* note 10.

[447] *See Broken Trust*, *supra* note 10.

[448] *See id.*

[449] *See* Master's Report, *supra* note 291.

[450] *See* Petition of the Attorney General, *supra* note 10.

[451] *See id.*

[452] *See id.*

[453] *See id.*

[454] *See id.*

became counts in the Attorney General's petition to remove the trustees.[455] The petition also seeks to recover from the trustees amounts the trust lost due to their breaches.[456] It should be noted that these breaches are alleged and not yet proven, but the scope of the allegations is staggering.

B. Problems of Accountability

The Broken Trust article raises the important issue of accountability.[457] Harvey Goldschmid has described fiduciary duties in the charitable context as aspirational.[458] The duties exist, but if no accountability mechanisms enforce those duties, then compliance depends on the good intentions of the trustees.[459]

In the Bishop Estate, the trustees violated their fiduciary duties, initially, at least, with impunity. The probate court supervises the trust and each year appoints a master to review the annual account filed by the trustees.[460] Although the master could provide some oversight, the authors of the Broken Trust article explain that the master had not been able to effectively review the performance of the trustees of a trust as large and complicated as the Bishop Estate.[461] Further, the trustees simply ignored recommendations made by the master in the 1992, 1993, and 1995 reports.[462]

In Hawai'i, as elsewhere, the attorney general has the authority to supervise charities. But in Hawai'i, as in only six other states, the governor appoints the attorney general.[463] If, as the Broken Trust article alleges, political considerations played a role in the Bishop Estate situation,[464] a politically appointed attorney general may be reluctant to investigate the trustees of a politically well-connected charity. The Broken Trust article noted that despite

---

[455] *See id.*

[456] *See id.*

[457] *See Broken Trust*, *supra* note 10 ("In the case of the Bishop Estate, we believe that accountability is almost totally missing.").

[458] *See* Goldschmid, *supra* note 2, at 632.

[459] *See* Hansmann, *Role*, *supra* note 1, at 875 (explaining that in the charitable sector, "ethical constraints may be far more important than legal sanctions in causing the managers of nonprofits to adhere to their fiduciary responsibilities."); *see also* Shenk, *supra* note 5, at 10 (describing the lack of legal constraints and adding, "So, aside from personal virtue, there's often no incentive whatsoever for a board member to act responsibly.").

[460] *See* Master's Report, *supra* note 291.

[461] *See Broken Trust*, *supra* note 10. It is possible that a probate master provided with necessary funding could adequately review the trust, but in practice that had not been happening.

[462] *See id.*

[463] *See id.*

[464] *See id.*

allegations of abuse, no attorney general had investigated the trust.[465] Just days after the article appeared, however, the attorney general announced an investigation.[466] The investigation led to an action for removal of the trustees[467] and ultimately to the resignation or removal of the trustees.[468]

Other than the attorney general, the only persons who potentially have standing to sue a charity are those with "special interests" in the charity.[469] In general, courts grant standing infrequently to those who benefit from charitable trusts.[470] Na Pua a Ke Ali'i Pauahi ("Na Pua"), an organization created to enforce the will of Princess Bishop,[471] argued in court that students, parents and alumni should be recognized as the beneficiaries of the Bishop Estate trust.[472] The trustees challenged this request for standing, arguing that the physical school was the beneficiary.[473] The issue of standing was not resolved,[474] but the students and faculty, in particular, appear to have the special interests that sometimes lead to the granting of standing in connection with a charitable trust.

Na Pua staged a march on May 15, 1997, to publicize the group's concerns about the management of the Bishop Estate.[475] The group kept up the public pressure, and on June 6, 1997, the Kamehameha Schools faculty "went public."[476] On July 20, the *Honolulu Advertiser* published a story in which Trustee Stender detailed his concerns about mismanagement by the other trustees.[477] Finally, on August 9, 1997, the *Honolulu Star-Bulletin* published

---

[465] *See Broken Trust*, *supra* note 10.

[466] *See AG Expects Inquiry Plan This Week*, HONOLULU STAR-BULLETIN, Aug. 19, 1997, at A-1. The article states that the Governor instructed the Attorney General to make a preliminary investigation "last week," presumably just after the article appeared. The Attorney General met with the five authors of the Broken Trust article and then announced she would investigate. *See id.*

[467] *See* Petition of the Attorney General, *supra* note 10.

[468] *See supra* note 13.

[469] *See supra* notes 281-90 and accompanying text.

[470] *See supra* notes 259-63 and accompanying text.

[471] See the homepage of Na Pua a Ke Ali'i at <http://www.napua.com>. Na Pua organized in 1997 in response to concerns of faculty, students, parents and alumni about Trustee Lindsey's management of the Kamehameha Schools. *See The Timeline*, *available at* <http://www.napua.com/time_line.htm>.

[472] *See id.*

[473] *See id.*

[474] *See id.*

[475] *See id.*

[476] *See Kamehameha Faculty Goes Public*, HONOLULU STAR-BULLETIN, June 6, 1997, at A-1.

[477] *See* Greg Barrett, *Kamehameha Board Criticized*, HONOLULU STAR-BULLETIN, July 20, 1997, at A-1.

the Broken Trust article.[478] That article, written by five respected and prominent public figures, got the Governor's attention and led, almost immediately, to an investigation by the Attorney General.[479]

In the Bishop Estate, the enforcement mechanisms worked, but only after years of mismanagement and only after significant publicity, first through Na Pua's public demonstrations, and then through publication of the Broken Trust article.[480] Thus, the role of the public in triggering the investigation cannot be underestimated. Those who were closest to the problems, the student beneficiaries of the trust, and the employees of the trust, had the information that the trustees were not carrying out their duties properly. Their willingness to take public steps to address the problems resulted, ultimately, in the removal of the trustees.[481] The lesson, if one can be drawn, is that even if the attorney general and the IRS must actually enforce the trustees' duties, the public plays a critical role in monitoring charities.

VII. CONCLUSION

This Article's analysis of the law of fiduciary duties of charitable trustees and directors and a review of the Bishop Estate yields several recommendations. Some of these recommendations have been suggested elsewhere by other authors. This Article advocates their adoption and recommends some additional proposals.

1. Heighten the standard of the duty of loyalty to provide that a charity can void any self-dealing transaction unless the proponent of the transaction can prove that the transaction was fair to the charity at the time the charity entered into the transaction.[482] This change in the law that applies to directors of nonprofit corporations would not have affected the Bishop Estate because trust law holds trustees to a stricter standard, permitting the trust to void any self-dealing transaction. Ideally, the same standard should apply to both charitable trusts and nonprofit corporations, since there is no reason to distinguish between charities based on organizational form. Given that most charities now organize as nonprofit corporations, tightening the standard that applies to nonprofit corporations will be a good start.

---

[478] *See Broken Trust*, *supra* note 10.

[479] *See AG Expects Inquiry Plan This Week*, *supra* note 466.

[480] *See* Daysog, *supra* note 13. Following the probate court's temporary removal of the four remaining trustees, Randall Roth, one of the authors of the Broken Trust article, was quoted as saying, "This legal system is slow but it does deliver." *Id.*

[481] The reports of the probate master had for years identified problems, but the trustees simply ignored the reports. *See Broken Trust*, *supra* note 10.

[482] *See supra* notes 351-53 and accompanying text (describing Deborah DeMott's proposal).

2. Prohibit trustees and directors of charities with assets in excess of $10,000,000 from engaging in self-dealing transactions. This prohibition, applicable to charitable trusts and nonprofit corporations, would prevent self-dealing transactions of the type involved in Bishop Estate, assuming that the trustees understand their duties and do not act in breach of those duties.[483] The Bishop Estate is instructive of the types of problems that can develop in a large charity and provides an example of why fiduciary law should prohibit trustees and directors of large charities from self-dealing.
3. Increase the monitoring of charities at the state level, either by increasing the number of attorneys, paralegals, investigators, and accountants devoted to charitable work in state attorney general offices or by creating a new agency or commission dedicated to supervising charities. Regardless of whether a state increases the charities section of the attorney general's office or creates a separate agency to monitor charities, more resources should be devoted to supervision of charities at the state level. In addition, providing for the use of relators or permitting suits by beneficiaries under the special interests doctrine will allow interested members of the public to supplement the resources of the attorney general's office. Tapping into the public's monitoring of charities can improve enforcement by the attorney general. Greater Internet access to information about charities should make public monitoring easier, and the attorneys general should work to harness the public's interest and concern.
4. Heightened scrutiny for sensitive transactions. The sale of a charity or the conversion of a nonprofit charity into a for-profit business should be subject to increased disclosure. Requiring that charities provide information to the attorney general and the public before the sale takes place could help curb abuses.
5. Improve disclosure by requiring uniform financial reporting, at least for large charities. Requiring charities to report financial information using GAAP would aid those who review the charities' disclosures in analyzing the data. One of the probate masters who reviewed the Bishop Estate described the difficulties of reviewing the trustees' performance.[484] Arthur Andersen LLP, the probate master and the attorney general of Hawai'i all requested that the Bishop Estate trustees follow GAAP and make other modifications in the

---

[483] The trustees of the Bishop Estate trust acted in breach of their fiduciary duties under current law and appeared not to understand the scope of those duties. *See Broken Trust, supra* note 10.

[484] *See id.* (quoting Jim Duffy, a former Bishop Estate master, "You really can't get your arms around everything, especially the mainland deals.").

presentation of the financial data to make the data easier to understand.

6. Educate charitable trustees and directors and improve the efficacy of nonlegal constraints. This recommendation is a nonlegal one, one which charities themselves must embrace for the health of the nonprofit sector. Charities have a significant self-interest in maintaining the trust of the public.

Creating training sessions for new directors[485] and seeking legal advice when appropriate can keep charitable trustees, directors, and managers from inadvertently violating their fiduciary duties. The Bishop Estate trustees claimed that they did not understand that some of their actions breached their fiduciary duty of loyalty. Yet, the trustees declined an offer from an expert in trust law to educate them about those duties. Trustees and directors must take an active role in educating themselves.

Many charitable trustees and directors do keep the interests of the charity and the interests of the public in mind. The sector as a whole accomplishes a great deal of good, and ethical constraints serve to guide most directors and trustees. The Bishop Estate, like United Way and Adelphi University, reminds those that monitor charities that not all trustees, directors, and managers will comply with their fiduciary duties. The monitoring system must keep in mind that charities should be subject to the same level of supervision, regardless of their organizational structure as a trust or a corporation. The laws governing charities can draw from those governing private trusts or business corporations, but these laws must be tailored to the needs of the charitable sector. As the sector continues to grow and evolve, more effective enforcement mechanisms and more effective use of enforcement mechanisms can ensure its continued viability.

---

[485] *See* Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries, 381 F. Supp. 1003 (D.D.C. 1974)(requiring new directors to read the court's opinion outlining the directors' duties as an attempt to ensure that directors understood their fiduciary duties).

Why the Justices Should Stop Appointing Bishop Estate Trustees

Hazel Beh*

I. INTRODUCTION

Public confidence in the judicial system is critical to a free society. The court is a manifestation of society's conscience, compassion and wisdom and when judges speak, they are society's voice. Hawai'i's Code of Judicial Conduct ("Code") prohibits certain conduct merely because that conduct "appears" wrong.[1] Nothing more is needed than that. It requires a judge to curtail personal activities based on appearances alone because it recognizes that public confidence in the judiciary must be placed above all else.[2] It is only confidence in the integrity and impartiality of the court that allows the public and litigants to say, "I don't agree with the decision, but I accept it as fairly and honestly rendered and will abide by it."[3]

The justices of the Hawai'i Supreme Court appoint the trustees under the will of Bernice Pauahi Bishop,[4] which empowered the justices of the supreme court to select trustees[5] to the charitable trust established under the will. The

---

* Assistant Professor of Law, William S. Richardson School of Law. This Article originally appeared in the *Hawaii Bar Journal*, February 1998. The Article has been edited and updated from the original.

[1] *See* HAW. REV. CODE OF JUDICIAL CONDUCT CANON 2A (1992).

[2] Professor Abramson notes:

> For generations . . . it has been taught that a judge must possess the confidence of the community; that [the judge] must not only be independent and honest, but equally important, believed by all . . . to be independent and honest. . . . "[J]ustice must not only be done, it must be seen as done." Without the appearance as well as the fact of justice, respect for the law vanishes in a democracy.

Leslie Abramson, *Canon 2 of the Code of Judicial Conduct*, 79 MARQ. L. REV. 949, 962-63 (1996)(alterations in original except for first ellipsis)(quoting *In re* Del Rio, 256 N.W.2d 727, 753 (Mich. 1977)).

[3] *See* Alan B. Morrison & D. Scott Stenhouse, *The Chief Justice of the United States: More Than Just the Highest Ranking Judge*, 1 CONST. COMM. 57 (1984)(describing the power of the office).

[4] Princess Bernice Pauahi Bishop died on October 16, 1884. Her will was executed on October 31, 1883, with codicils executed on October 4, 1884. The will established a perpetual charitable trust with income used for establishing and maintaining an educational facility described elsewhere in her will.

[5] The Will provides:

> I further direct that the number of my said trustees shall be kept at five; and that vacancies shall be filled by the choice of a majority of the Justices of the Supreme Court, the selection made from persons of the Protestant religion.

court has ruled that the justices act in their individual capacity in selecting trustees.[6] This decision is itself controversial. The power to appoint is a perquisite of office, which power the justices receive upon their appointment to the court and are divested from upon their departure.[7] In the eyes of the public, it is one of the trappings of their judicial position.[8] Kamehameha

---

Will of Bernice Pauahi Bishop, art. 14 [hereinafter *Will*], reprinted in Appendix B to this issue of the *University of Hawai'i Law Review*. *See* Kekoa v. Supreme Court, 55 Haw. 104, 516 P.2d 1239 (1973)(holding that appointment is not state action). The will of William Charles Lunalilo also vested such authority in the justices by will dated January 31, 1874. *See Will of William Charles Lunalilo*, sec. 3. Since that time, the justices have apparently declined other requests to nominate trustees under a will. *See* Samuel King, Msgr. Charles Kekumano, Walter Heen, Gladys Brandt & Randall Roth, *Broken Trust*, HONOLULU STAR-BULLETIN, Aug. 9, 1997, at B-1 [hereinafter *Broken Trust*], reprinted in Appendix C to this issue of the *University of Hawai'i Law Review*.

[6] *See* King v. Smith, 250 F. 145 (9th Cir. 1918); *Kekoa*, 55 Haw. 104, 516 P.2d 1239.

[7] "[T]he Hawaii Supreme Court Justices select the trustees specifically because of their status as Supreme Court Justices, and not as named individuals or because of anything they have accomplished or attained as individuals outside the court." Jon M. Van Dyke, *The Kamehameha Schools/Bishop Estate and the Constitution*, 17 U.HAW.L.REV. 413, 421 (1995). The potential for both personal and governmental liability for negligent appointments is certainly conceivable. Personal liability for negligent selection seems possible under a negligent hiring theory. *See* Janssen v. American Haw. Cruises, Inc., 69 Haw. 31, 731 P.2d 163 (1987)(holding that negligent hiring depends on foreseeability). As to governmental liability, the court has held that an employer can be liable for negligent conduct of an employee if "the employee's conduct was related to the employment enterprise *or* if the enterprise derived any benefit from the activity." Wong-Leong v. Hawaiian Indep. Refinery, Inc., 76 Haw. 433, 441, 879 P.2d 538, 546 (1994). The power to appoint is an incident of their employment as justices, a point reinforced by the fact that the selection committee considered how judicial candidates would exercise their power to appoint Bishop Estate trustees if selected. Although they purportedly serve as individuals and the justices are free not to participate, their philosophy on selection was apparently a regularly explored topic during the justice selection process. "Hare [Michael Hare, a member of the Judicial Selection Committee] said he recalled asking similar questions of potential candidates . . . His questioning, he said, was along the lines of criteria and process for picking trustees." *Bishop Estate Critics Press for Answers*, HONOLULU ADVERTISER, Aug. 17, 1997, at B3. Moreover, the cloak of absolute judicial immunity cannot shield the government because it applies only for their judicial actions. *See* Seibel v. Kemble, 63 Haw. 516, 521, 631 P.2d 173 (1981).

[8] *See King*, 250 F. 145 (affirming *In re* Estate of Bishop, 23 Haw. 575 (1917) and holding that the terms of the will called for appointment by the justices individually). When the will was made, granting to the holder of a certain judicial position the power to appoint was not an entirely unusual term in a will. *See* Moore v. Isbel, 40 Iowa 383, 388 (1875)("[A]cting county judge . . . conferred the power of appointment upon the individual who filled the office of county judge at the time the appointment should be demanded"); National Webster Bank v. Eldridge, 115 Mass. 424, 427 (1874)(providing that in default of appointment by trustees, the vacancy was to be filled by "the judge of probate or by any justice of the Supreme Judicial Court"); Shaw v. Paine, 12 Allen (Mass.) 293 (1866)(specifying that trustee was to be "appointed by said judge of probate, or by one or more of the justices of the supreme judicial court"). When the several justices of the Hawai'i Supreme Court were divested of original

Schools Bishop Estate ("Bishop Estate" or the "Estate") is an important charitable institution with significant wealth, land and influence in Hawai'i; its activities impact the lives of all citizens of Hawai'i.

The Bishop Estate regularly appears before the courts of Hawai'i, including the supreme court. From time to time, but not always, the justices have recused themselves from hearing some Bishop Estate matters.[9] Moreover, the supreme court reviews the actions of the probate court, which in turn hears matters related to charitable trusts.[10] Finally, the state's attorney general, who must oversee, regulate, and prosecute the conduct of trustees appointed by the

---

jurisdiction in probate and equity by the Judiciary Act of 1892, their power of appointment might have been transferred to the appropriate court with jurisdiction over trust appointments rather than finding the will granted the power to the individuals. *See In re* Estate of Bishop, 11 Haw. 33 (1897)(deciding that although will directs accounting to the "Chief Justice of the Supreme Court, or other highest judicial officer in this country," the Master's report should be filed with the probate court); *see also In re* Lovejoy, 227 N.E.2d 497, 500 (Mass. 1967)(holding that trustee to be appointed by the "appropriate court" was governed by statute and not within the discretionary power of the court); Harvey v. Fiduciary Trust Co., 299 Mass. 457 (1938)(ruling that power to appoint guardian vested in probate court and not individually in the judge).

Several authors have questioned the role of the justices as state actors because of the Bishop Estate's racial and religious preferences in admission and hiring. *See* Leigh Caroline Case, Note, *Hawaiian Eth(n)ics: Race and Religion in Kamehameha Schools*, 1 WM. & MARY BILL RTS. J. 131 (1992); Van Dyke, *supra* note 7, at 420 (noting that at time of publication, justices had not made clear that they will consider non-Protestants as trustees). The teacher hiring preferences were struck down in *Equal Employment Opportunity Comm'n v. Kamehameha Schools/Bishop Estate*, 990 F.2d 458 (9th Cir. 1993).

[9] Recusal is a problem, not a solution. If important matters arising out of the current controversy are appealed, Hawai'i's citizens will either see a supreme court tainted by a relationship to the Bishop Estate or one wholly sitting by designation, and thereby be deprived of the judicial wisdom of its highest judicial officers. One observer criticized the Hawai'i Supreme Court justices' decision to appoint trustees, noting:

> The fact that an entire court felt compelled to disqualify (in Kekoa v. Supreme Court, 55 Haw. 104, 516 P.2d 1239 (1973)) itself may indicate that an appointment power was exercised that should have been declined. A judiciary generally should not accept additional duties that may result in recusation unless the duties are of such a nature that judicial performance is required and alternatives do not suffice.

Michael P. Cox, *Application of "Sunset Principles" to State Judicial Functions: The Power to Appoint*, 33 OKLA. L. REV. 204, 299-303 (1980).

[10] The dual roles are plagued by conflict. In the justices' response to the "Broken Trust" article, they stated that one reason they abandoned the blue ribbon committee's list was "[b]ecause we were not assured that the panel reached out to all potential applicants, regardless of race, religion or political persuasion." Ronald T.Y. Moon et al., *Justices Reject 'Broken Trust' Criticisms*, HONOLULU STAR-BULLETIN, Aug. 21, 1997, at A-19. When the justices abandoned the religious criteria for trustees set in the will were they required to seek permission of the probate court? The Commission on Judicial Conduct had issued a ruling that the justices could not participate in discriminatory practices. *See* Commission on Judicial Conduct, Formal Advisory Opinion #14-93, Apr. 7, 1994.

justices, must also appear before those justices in matters concerning the state and its people.[11] The justices should stop appointing the trustees of the Bishop Estate because exercising the appointment power bestowed by the will raises an appearance of impropriety, bias and conflict under the Code and has the potential to undermine the confidence of the public in our judicial system.

CANON 2: A Judge Shall Avoid Impropriety and the Appearance of Impropriety in All of the Judge's Activities

A judge must "avoid impropriety and the appearance of impropriety in all of the judge's activities" and act at all times in a manner that "promotes public confidence in the integrity and impartiality of the judiciary."[12] Yet, publicity, controversy and criticism[13] have long followed the justices as they fulfill their appointment duties to Bishop Estate.[14] Criticism is not new; citizens twice have tried to block the current justices' predecessors from appointing trustees.[15]

---

[11] As one commentator noted:

> The Bishop Estate is fully entangled with the state . . . . The legislative, executive, and judicial branches regulate the trust: the legislature sets the salaries of the trustees, the Governor appoints the Supreme Court Justices, the Attorney General is parens patriae of the trust, and the judiciary nominates and confirms the trustees."

Case, *supra* note 8, at 135 (citations omitted).

[12] HAW. REV. CODE OF JUDICIAL CONDUCT Canon 2A (1992).

[13] Case, *supra* note 8, at 135, concludes that the justices' participation in the selection process constitutes state action, in part because the factors they would consider in appointing trustees are considered when the candidates for justice are considered. "The imprimatur of the state is found not only in this obligation of the State Attorney General to enforce the appointment of the trustees, but also in the action of the Governor and State Senate in nominating and confirming the Supreme Court justices." *Id.* Retired Judge Walter Heen alleges that when he was interviewed as an applicant for justice of the Hawai'i Supreme Court, he was asked what kind of person he would select for Bishop Estate trustee. *See Broken Trust*, *supra* note 4.

[14] *See* Van Dyke, *supra* note 7, at 418, nn. 21-26 (describing public criticism during appointment process of Gerard Jervis); *see also, e.g.*, Dan Boylan, *Courting Disaster in Bishop Business*, MIDWEEK, Sept. 10, 1997, at A-9 ("Indeed the honorable court's choices over the last quarter-century have been so singularly political in appearance that in the public's mind they've turned the Bishop Estate into the ultimate 'high three' retirement of Hawaii politics."); John Flanagan, *Break the Circle of Patronage*, HONOLULU STAR-BULLETIN, Aug. 23, 1997, at B-1; Desmond Byrne, *High Court Must Stop Picking Bishop Trustees*, HONOLULU ADVERTISER, Aug. 22, 1997, at A12; A.A. Smyser, *'Broken Trust' Report Was Sorely Needed*, HONOLULU STAR-BULLETIN, Aug. 14, 1997, at A-24 (describing the "collusive cob web linking the estate trustees, the justices of the state Supreme Court, and the Judicial Selection Commission and former Gov. John Waihee."); Robert R. Midkiff, *Bishop Estate Has Outgrown Its Status as a Trust*, HONOLULU STAR-BULLETIN, Aug. 22, 1997, at A-19 ("[T]he appointment of individual trustees by the Hawaii Supreme Court is no longer appropriate.").

[15] Both challenges were the result of an outcry over a nominee. *See, e.g.*, Kekoa v. Supreme Court, 55 Haw. 104, 516 P.2d 1239 (1973)(regarding objection to Matsuo Takabuki; a court

Speculation concerning political influence demeans the image of the court and its justices and cheats well-qualified trustees of public respect they may otherwise deserve.[16] In 1993-1994, the justices unsuccessfully attempted to cure the appearance of conflict and political influence from their selection process[17] by appointing a "blue ribbon" panel to screen applicants.[18] In the

---

sitting by designation following recusal of justices rules that the justices' action is not state action because they serve in their individual capacity); King v. Smith, 250 F. 145 (9th Cir. 1918)(regarding objection to William Williamson; justices select trustees in their individual capacity and are not disqualified from reviewing cases).

Of import, in *King*, the court explained that the justices "get nothing, can expect nothing, . . . and derive no benefit from the act whatsoever." *Id.* at 150. However, in 1994, when the justices appointed Gerard Jervis, they appointed a person who had served on the selection committee that had appointed several of them to the Supreme Court. *See Broken Trust*, *supra* note 3. Moreover, Bishop Estate trusteeship has long been criticized as a "political plum" awarded to loyal friends of the state's most powerful. Thus, the appointment of politicians, confidantes of politicians and, in one case, a former supreme court justice, suggests that an unquantifiable amount of influence is bestowed on one who can appoint another to a post boasting a yearly paycheck just under a million dollars.

[16] In light of Bishop Estate's influence in the state, Canon 5's admonition against "engag[ing] in political activity" is also applicable. *See* Commission on Judicial Conduct, Formal Advisory Opinion #14-93, Apr. 7, 1994. The appointment of trustees with interests aligned with the political power of the current government broadens the power of both the Bishop Estate and the incumbent political party. *See* Case, *supra* note 8.

> Such suspicions, however unfounded, will be inevitable as long as the Hawaii Supreme Court continues to select the trustees. It would be fairer both to the trustees and to the justices if a different process were used, and ultimately the Hawaiian beneficiaries should play a central role in this process.

Van Dyke, *supra* note 7, at 425.

[17] The appointment of retiring supreme court justice William S. Richardson by his colleagues certainly raises questions as well. After all, he had shared the power of appointment with his fellow justices for years. They necessarily struggled, debated, compromised and negotiated to reach consensus and act as one court as they administered justice. Now, in their private capacity, they elevated one of their peers to a position of wealth and power. It raises, at best, "an appearance of impropriety." While Justice Richardson's career and service to Hawai'i made him well-qualified to serve the trust, his affiliation to the body that appointed him overshadowed his qualifications.

[18] The 1993-94 selection process was described as follows:

> In 1993-94, the Hawaii Supreme Court Justices went through an elaborate process to pick a new trustee, and received widespread criticism for their actions. The Court first appointed an 11-member panel of citizens who nominated five candidates. Then the Justices received a ruling from the Commission on Judicial Conduct stating that it does not violate the law or judicial ethics for them to select the Bishop Estate Trustees.
>
> . . . .
>
> After the Justices received this qualified green light, they reopened the process, but this time without the help of the blue-ribbon citizens panel . . . and added ten new names to the list of candidates to make a list of 15.

Van Dyke, *supra* note 7, at 418 (footnotes omitted).

end, the justices did not select an appointee from the list generated by their blue ribbon panel. Instead, they selected a person who was both a friend of Governor John Waihee and had served and chaired the Judicial Selection Commission during the time several of them were appointed to the bench by Governor Waihee.

In response to recent criticism concerning their role in the last trustee appointment, the justices recently publicly explained why they disregarded the panel's recommendations and assured the public that their decision was not politically motivated.[19] However, it is nevertheless inescapable that the interwoven relationships of key people in the appointment process raise questions as to the motives that might lie behind various appointments, first of the justices to the bench and then of the individuals to the Estate.[20] Regardless of either the justices' or the trustees' qualifications, the process employed in 1994 raised questions as to whether *either* judicial nominees or trust appointees were appointed based on political connections rather than merit.

The appointment of an unpopular appointee also reflects on the justices' judgment and integrity in the eyes of the appointee's detractors, and thus unnecessarily draws the justices into a controversy unrelated to their judicial office.[21] The public outcry following the justices' choices, whether justified or not, has the potential to, and has, demeaned the judiciary in the eyes of the public.[22] When the public is drawn into a debate over the qualifications of the trustees, the judgment of those hiring them may also be questioned. The latest

---

[19] *See* Moon et al., *supra* note 10.

[20] *See* Van Dyke, *supra* note 7, at 418 (describing public criticism of the appointment process).

[21] Despite the importance of selection of trustees to the success of the Estate, no particular process to select trustees has been articulated by justices over the past 100 years. Apparently, the last appointive round marked the first attempt to articulate a procedure. The process apparently has not included beneficiary input. The secrecy of the process makes the justices even more vulnerable to criticism. The cure calls for institutional reform because ad hoc changes by the current justices to improve and open the process could easily be abandoned by their successors.

[22] The Hawai'i Supreme Court is noted for landmark rulings sparking public controversy. Public questions concerning the justices' ability to appoint qualified trustees to this highly visible trust may equate to the justices' general competence in the eyes of some. Thus, it seems prudent that a court making innovative legal rulings should especially eschew controversy in its extra-judicial activities, lest the public make misplaced generalizations about the justices. *See* Robert J. Albers & Kenneth C. Fonte, *Is Section 2C of the Model Code of Judicial Conduct Justified? An Empirical Study of the Impropriety of Judges Belonging to Exclusive Clubs*, 8 GEO. J. LEGAL ETHICS 597 (1995)(arguing that the public perceives judge's biases in light of judge's affiliations); Abramson, *supra* note 2, at 949; Stephen Lubet, *Participation by Judges in Civic and Charitable Activities: What Are the Limits?*, 69 JUDICATURE 68, 80 (1985) [hereinafter *Charitable Activities*].

publicity has battered public confidence in the justices' ability to make sound appointments.[23] Because the Code asks judges to guard the image of the judiciary, the mere fact that the public perceives the current appointees negatively and questions both the propriety and competence of the justices' role in the appointment process is reason enough for them to shun future appointments.

CANON 4: A Judge Shall So Conduct the Judge's Extra-Judicial Activities as to Minimize the Risk of Conflict with Judicial Obligations

The fact that the justices do not act in their official capacity when appointing the trustees is irrelevant. Chief Judge Benjamin Cardozo once wrote, "[a judge should not accept] as an individual what the judge must reject. At least this is so when what is done is official and not personal in its quality and incidents."[24] Under the Code, a judge must avoid extra-judicial conduct which "(1) cast[s] doubt on the judge's capacity to act impartially as a judge; (2) demean[s] the judicial officer; or (3) interferes with the proper performance of judicial duties."[25] The court's selecting of trustees raises all three issues. First, the justices' faithful obedience to the will raises doubts as to whether the justices can be unbiased toward the Bishop Estate when Estate matters come before the court. Second, the controversial nature of the appointments, especially of politically well-connected nominees, potentially tarnishes the perception that the judiciary in this private act or in its judicial decision making is independent and free of political influence. Finally, the necessity to recuse itself in matters concerning the management of the largest private landowner in the State, the awkward role of oversight over the justices by their own inferior probate court, and the attorney general's regulatory oversight of their activity in the Bishop Estate all interfere with performance of their judicial duties.

The Code's commentary reminds a judge to "regularly reexamine the activities of each organization with which the judge is affiliated to determine

---

[23] A full 69% of the public in a September 1997 public opinion poll believe that the justices' current trustee appointments are NOT doing a good job. Sixty four percent also feel that the Bishop Estate "has too much power" in Hawai'i. Most telling, 48% want the justices out of the business of appointing trustees. Thirty-two percent believe the justices should continue to appoint the trustees and 20% are not sure. *See* Jim Witty, *90 Percent Back Bishop Inquiry*, HONOLULU STAR-BULLETIN, Sept. 23, 1997, at A-1. While the justices must never yield to public opinion in their judicial role, they must yield in their extra-judicial role because they are the guardians of public confidence in the independence and integrity of the system.

[24] *In re* Richardson, 160 N.E. 655, 662 (N.Y. 1928)(quoted in Cox, *supra* note 9, at 300 n.98 (1980), criticizing decisions of Hawai'i Supreme Court justices to appoint trustees).

[25] HAW. REV. CODE OF JUDICIAL CONDUCT Canon 4A (1992).

if it is proper for the judge to continue the affiliation."[26] The Code justifies intruding into a judge's personal activities in recognition that public confidence in the judiciary is imperative to public cooperation, and thus essential to a free society. "A judge must therefore accept restrictions on the judge's conduct that might be viewed as burdensome by the ordinary citizen and should do so freely and willingly."[27] The reason for this stricture is clear:

> The need for the judiciary to avoid the appearance of partiality exists even in the absence of actual wrongdoing or favoritism. Judges are customarily assisted only by bailiffs; like the Pope, they have no regiments. Consequently, in a democracy the enforcement of judicial decrees and orders ultimately depends on public cooperation.[28]

The regulation of a judge's extra-judicial charitable conduct serves three broad policies related to public perception of the judiciary. First, a judge must avoid the appearance of partiality toward organizations finding his or her personal favor.[29] Second, the association of a judge with specific organizations may erode public confidence in the judge's independence or judgment.[30] Third, a judge must not allow personal endeavors to distract from his or her judicial activities.[31]

The general rule is that "judges must refrain from service in organizations which are regular or likely litigants . . . ."[32] The Code discourages a judge from having a key extra-judicial role in organizations precisely because of the kind of perceptions here.[33] The dual role of appointing the trustees and ruling

---

[26] *Id.* Canon 4C(3)(a) commentary. For example, Canon 4's commentary cautions that as "charitable hospitals are now more frequently in court than in the past[,]" a judge should examine the propriety of any affiliation. *Id.*

[27] *Id.* Canon 2A commentary.

[28] *Charitable Activities*, *supra* note 22, at 69-70; Stephen Lubet, *Judicial Ethics and Private Lives*, 79 NW. U. L. REV. 983, 986 (1985)("Should the citizenry conclude, even erroneously, that cases were decided on the basis of favoritism or prejudice rather than according to law and fact, then regiments would be necessary to enforce judgments.").

[29] *See Charitable Activities*, *supra* note 22, at 69; *see also Nielson v. Nielson*, No. 03A01-9506-CV-00186, 1996 WL 16018 (Tenn. Ct. App. Jan. 18, 1996)(requiring recusal and acknowledging violation of code of conduct; judge's participation on the advisory board of a civic organization is improper, non-legal advice where the organization's membership may occasionally be called as expert witnesses in proceedings before the court).

[30] *See Charitable Activities*, *supra* note 22, at 69.

[31] *See id.*

[32] *Id.* at 80.

[33] Although each justice does not serve as an "officer, director, trustee or non-legal advisor," roles specifically prohibited on behalf of charities which might come before the court or in a court over which the judge has appellate jurisdiction under Canon 4C(3)(a), the justices' unique power to appoint is certainly a substantial and key role in an organization frequently appearing before them or their inferior courts. "The provisions of this Code are to be construed

on trust business[34] raises an appearance of conflict and bias. As one critic commented, "[w]hen the Supreme Court is the ultimate arbiter of what's okay and what isn't with respect to trustee liability, it's most unfortunate to have them be the ones who have picked the trustees . . . ."[35] Certainly a litigant in a lease-to-fee conversion suit or other lawsuit against the Bishop Estate might have justifiable concern when learning that the supreme court selected the trustees with whom the litigant now quarrels.

Canon 4E discourages a judge from accepting fiduciary roles generally and especially as to parties likely to come before them.[36] A fiduciary relationship exists "wherever a trust, continuous or temporary, is specially reposed in the skill or integrity of another . . . and it may exist in the absence of a specific or technical trust or agency."[37] It arises "in all cases where there has been a special confidence reposed in one who in equity and good conscience is bound to act in good faith, and with due regard to the interests of the one reposing the confidence . . . ."[38]

The justices enjoy an extremely important power under the will, and when exercising their appointment power, they owe a fiduciary duty to the trust's beneficiaries. The beneficiaries, like the Princess before them, place their trust in the justices to exercise this power wisely. The Code generally prohibits judges from engaging in fiduciary activities because of the dual and conflicting roles of fiduciary and judge. By placing the interests of the beneficiaries first, they necessarily must place the public and their judicial role second. When the justices' appointees are ones with close ties to the government or to the judiciary, one might logically ask whose interests their appointments served—the state's or the Bishop Estate's?

---

and applied to further [the integrity and independence of the judiciary]." HAW. REV. CODE OF JUDICIAL CONDUCT Canon 1A (1992).

[34] *See, e.g.*, Murray v. Kobayashi, 50 Haw. 104, 431 P.2d 940 (1967)(providing instructions on interpreting provision in will requiring religious hiring practices); Richards v. Midkiff, 48 Haw. 32, 396 P.2d 49 (1964)(involving suit by one of several trustees against others); *In re* Estate of Bishop, 37 Haw. 111 (1945)(concerning dispute between trustees and attorney general over trustee commissions); *In re* Estate of Bishop, 36 Haw. 728 (1944)(involving a dispute over accounting); *In re* Bishop Estate, 36 Haw. 403 (1943)(involving compensation of trustee); Collins v. Hodgson, 36 Haw. 334 (1943)(regarding dispute over expenditures).

[35] Stephen G. Greene, *Misplaced Trust?*, CHRON. PHILANTHROPY, Oct. 2, 1997, at 1. The article continues, "What's more, the attorney general's ability to oversee and regulate charities is potentially hampered when that official must also argue cases periodically before the same body that has appointed the trustees of a charity that he or she may wish to investigate." *Id.* (quoting "Ed Halbach, a former dean at the University of California at Berkeley law school and an expert on trust law.").

[36] *See* HAW. REV. CODE OF JUDICIAL CONDUCT Canon 4E (1992).

[37] 36A C.J.S. *Fiduciary* (1961).

[38] *Id.*

II. 1994 COMMISSION ON JUDICIAL CONDUCT OPINION #14-93

In 1994, the Commission on Judicial Conduct issued an advisory opinion commenting on the propriety of the justices' involvement in the appointment of trustees.[39] Ironically, the Commission commended the justices for attempting to remove political influence from the process by using a blue ribbon committee to screen applicants. Unfortunately, history shows that the process failed and the justices rejected the panel's work. Moreover, even were these particular justices able to devise a selection process free of political influence and other conflicts, the justices have no power to ensure that the changes would endure beyond their tenure. The controversial role of the justices in the selection process spans decades and calls for institutional reform.

The 1994 opinion largely neglected analysis under Canon 4 governing extra-judicial conduct; nevertheless, the Commission's cautious pronouncements as to the propriety of continuing under Canons 1, 2, and 5 were hardly an endorsement of continued involvement in appointing trustees. First, the Commission noted that its own members were divided as they began their deliberations—a telling comment, for it mirrors how the people of Hawai'i view the justices' role. The Commission also cautioned the justices that they must revisit the appropriateness of their role if public perceptions place the image of the judicial system at risk.[40] The opinion further warned:

> The Commission understands that the uniqueness of Hawaii's socio-economic and geographical features renders the question presented here in Hawaii significantly distinguishable from those settings in other jurisdictions, which do not have the unique cultural conditions present in our State. However, such factors cannot and do not serve as the basis for our conclusion. Of much greater importance to this Commission is the fact that public confidence in, respect for, and perception of the integrity of our judicial system, greatly outweighs the importance of the Bishop Estate trustee selection.[41]

---

[39] Commission on Judicial Conduct, Formal Advisory Opinion #14-93, Apr. 7, 1994.

[40] Specifically, the Commission stated:

> The Commission recognizes that there is a question about whether or not public perception in Hawai'i is that the trustee appointment process may be significantly and improperly influenced by political factors. This Commission concludes that the allegation that such a perception exists, to the extent it significantly and detrimentally affects the integrity of the judicial system is not supportable, certainly not to the extent that such a finding would require immediate disqualification or prohibition against the Justices from further participation in the appointment of Bishop Estate trustees. On the other hand, it is equally important to recognize and understand that public perception on this matter is extremely difficult to measure and determine. Consequently, to give the benefit of the doubt to the present Justices in this initial inquiry is more appropriate than it might be upon any future consideration of this matter.

Id.

[41] *Id.*

The opinion then concluded that justices who choose to participate must "avoid or eliminate" acts or activities which are likely to create a perception that the selection process:

1) is in any way influenced by political factors or favors,

2) will influence or otherwise affect the judicial process to the extent Bishop Estate is involved in litigation,

3) utilizes judicial resources to the detriment of the judiciary,

4) is influenced in anyway by religious or racial discrimination,

5) is lending the prestige of the court to the benefit of the Bishop Estate or its trustees.[42]

Finally, the Commission predicted that if such negative effects could not be removed from the process, then the Commission expected the matter to "be before the Commission again."[43]

III. CONCLUSION

The current loud and public debate has overshadowed the justices' service to our judicial system, and it is time for the justices to reevaluate their service to the Bishop Estate. While their sense of responsibility to the terms of the will is admirable, they must weigh these activities against the detrimental effects their participation has upon citizen confidence in the judiciary. The Code asks all judges to put aside their private, extra-judicial activities for the sake of public respect for, and confidence in, our judicial system. Regardless of their good intent, under the Code, they must acquiesce to public opinion against their involvement in this extra-judicial activity, so that all who come before them will have trust and confidence in the integrity of the court.

UPDATE

Since this Article was written, four of the five justices of the Hawai'i Supreme Court announced that they would no longer participate in the selection of the Bishop Estate Trustees.[44] The justices cited a desire to combat the growing distrust and cynicism toward the judiciary as their prime motive.

---

[42] *Id.*

[43] *Id.*

[44] *See* Rick Daysog, *Selection of Trustees Explored*, HONOLULU STAR-BULLETIN, Dec. 22, 1997, at A-1.

Justice Robert Klein did not concur, emphasizing the Hawai'i Supreme Court's long history and tradition of appointing trustees.[45]

Deciding how trustees should be appointed remains an unsettled and urgent concern because "interim" trustees serve in place of the variously permanently or temporarily ousted trustees at the present. Now that this provision in the will has failed (at least for the time being), the probate court needs to establish a process for the selection and appointment of trustees.

Although the four justices have bowed out of the process, the propriety of judges appointing the trustees in their unofficial capacity remains a vital topic. In September 1999, the Hawai'i State Attorney General ("Attorney General") recommended to the probate court that the four sitting members of the Intermediate Court of Appeals ("ICA") fill future vacancies.[46]

The Attorney General informed the probate court that the ICA judges were willing to assume this responsibility.[47] The Attorney General reasoned that using the ICA judges would best approximate the process prescribed in the Princess' Will now that a majority of the Supreme Court had elected not to participate in appointing trustees.[48] The Attorney General further reasoned that employing the ICA judges rather than the supreme court justices cured most, if not all, of the ethical and practical problems associated with judicial involvement in the appointment process.[49] The Attorney General noted that historically the ICA did not hear Bishop Estate cases and so its recusal from Bishop Estate matters would not interfere with the delivery of judicial services to the state.[50]

The Attorney General attributed the perception of impropriety and politics in the appointment process to the compensation issue, explaining:

> The perception of political influence will exist even if the appointment power is, contrary to the Will, removed from members of the judiciary. So long as KSBE trustees are overpaid in relation to their skills or experience or in relation to their contribution to society, an appointment will be perceived as political no matter who makes it.[51]

The Attorney General's view is simplistic. Bishop Estate trusteeship will always be prized because of the Estate's great wealth, land, and status as an important Hawaiian institution.

---

[45] *See id.*

[46] *See* Attorney General's Response to Petition for the Establishment of a Procedure for Selection of Future Trustees, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Sept. 13, 1999).

[47] *See id.* at 11.

[48] *See id.* at 7.

[49] *See id.* at 7-11.

[50] *See id.* at 8, 10.

[51] *Id.* at 9-10.

The court rejected the Attorney General's position, calling it "unpersuasive" and "illogical."[52] The court instead appointed a seven-member selection committee comprised of community leaders to identify candidates for final selection by the probate court.[53] However, the court also noted that the supreme court may one day resume the practice of appointing trustees if it so chose.[54]

Finally, an important question lingers. In 1993, the justices abandoned the religious preference toward Protestants prescribed in the will because they could not discriminate on the basis of religion, even when acting unofficially. If an independent selection process is developed and judicial involvement is limited to appointing the trustee selected and recommended by others, then may the Protestant qualification within the will be honored?[55] Certainly a court will need to visit this issue.

---

[52] *See* Rick Daysog, *Judge Appoints Panel to Nominate Future Trustees*, HONOLULU STAR-BULLETIN, Jan. 7, 2000, at A-8.

[53] *See id.*

[54] *See id.*

[55] *See* Shelley v. Kraemer, 334 U.S. 1 (1948)(holding that judicial enforcement of a discriminatory provision in a private contract violates the Fourteenth Amendment). Whether enforcement of discriminatory testamentary provisions constitute improper state action likely depends on the extent of state involvement. *See In re* Estate of Wilson, 452 N.E.2d 1228 (N.Y. 1983); *In Re* Estate of Laning, 339 A.2d 520 (Pa. 1975); *In re* Certain Scholarship Funds, 575 A.2d 1325 (N.H. 1990).

Appendix A

Chronology of Events in the Kamehameha Schools Bishop Estate Controversy 1997-2000

1997

May 15, 1997:	More than 500 Kamehameha Schools parents, students, alumni, and supporters march on the headquarters of Kamehameha Schools Bishop Estate ("KSBE") to protest the trustees' micromanagement of the school.
August 9, 1997:	The *Honolulu Star-Bulletin* publishes the "Broken Trust" article, which alleges mismanagement of KSBE assets and conflicts of interests by the trustees, and criticizes selection of the trustees by Hawai'i Supreme Court justices.
August 12, 1997:	Governor Benjamin Cayetano orders Hawai'i State Attorney General Margery Bronster to begin preliminary inquiry into KSBE to see if there is a need for a wider investigation.
August 29, 1997:	Bronster submits a preliminary report on the investigation, calling for the investigation to continue.
October 8, 1997:	Hawai'i Circuit Judge Kevin Chang orders the KSBE trustees to comply with a state subpoena and turn over all nonprivileged documents to the attorney general.
November 17, 1997:	Special Master Colbert Matsumoto files his "Master's Report on the One Hundred Ninth Annual Account of the Trustees." The report says that KSBE suffered losses for fiscal year 1993 that amounted to over twice the $100 million annual operating budget of Kamehameha Schools.

December 12, 1997: Fact-finder Patrick Yim alleges that trustee Lokelani Lindsey managed Kamehameha Schools by "intimidation."

December 20, 1997: Four Hawai'i Supreme Court justices announce they will no longer select KSBE trustees; one justice dissents.

December 29, 1997: Trustees Gerard Jervis and Oswald Stender petition for the removal of trustee Lokelani Lindsey.

1998

March 12, 1998: Five justices of the Hawai'i Supreme Court recuse themselves from any appeals on KSBE matters. The justices appoint five circuit court judges to take their place.

August 7, 1998: Special Master Colbert Matsumoto files his "Master's Consolidated Report on the One Hundred Ninth, One Hundred Tenth, and the One Hundred Eleventh Annual Accounts of the Trustees." The report criticizes KSBE's investment performance, calls for stronger conflict-of-interest policies, and recommends implementation of a management system headed by a chief executive officer instead of the "lead trustee" management system currently in place. The report also cites losses of $242.4 million during the 1993-1996 fiscal years.

September 9, 1998: Bronster petitions for the temporary removal of four trustees, alleging that they jeopardized the tax-exempt status of KSBE. Bronster files the "Attorney General's Response to Master's Consolidated Report on the 109th, 110th, and 111th Annual Accounts." The report alleges failure to plan for expansion of the educational mission with increased revenues, as required by Princess Bishop's Will and court orders; breaches of trust and violations of the trustees' duty of care; and failure to have a strategic plan to carry out the educational mission of the trust. The trustees file the "Trustees' Response to Master's

	Consolidated Report on the One Hundred Ninth, One Hundred Tenth, and the One Hundred Eleventh Annual Accounts of the Trustees." Their response focuses on the criticism in the Master's Consolidated Report regarding the lack of a strategic plan. The trustees agree to segregate income and corpus, report accumulated income separately, and complete the strategic planning process initated in 1993.
September 10, 1998:	Bronster calls for the permanent removal of trustees Richard Wong, Henry Peters, and Lokelani Lindsey, charging that they engaged in self-dealing and mismanagement of KSBE.
November 2, 1998:	Special Master Colbert Matsumoto discloses a letter from the Internal Revenue Service ("IRS") that cuts off communications with all five trustees due to their potential conflict of interest. The IRS continues conducting an audit of KSBE.
November 25, 1998:	A state grand jury indicts Peters on a charge of theft.

<u>**1999-2000**</u>

February 4, 1999:	Probate Judge Kevin Chang removes all five IRS trustees from matters involving the IRS audit of KSBE. The order calls for the appointment of a panel of five administrators to deal with the audit.
March 2-3, 1999:	Trustee Jervis and an attorney for the Estate are caught in a compromising position in a bathroom stall in a hotel; she commits suicide the next day.
March 11, 1999:	Trustee Jervis is rushed to a hospital after taking an overdose of sleeping pills.
April 12, 1999:	Trustee Wong is indicted by a state grand jury on charges of first-degree theft, perjury, and conspiracy.
April 27, 1999:	The IRS files a report threatening to revoke the tax-exempt status of the estate if the five trustees do not step down.

April 28, 1999:	The Hawai'i Senate rejects Margery Bronster's nomination to a second term as Attorney General.
April 30, 1999:	Probate Judge Kevin Chang orders a temporary freeze on any compensation to the trustees.
May 6, 1999:	Hawai'i Circuit Court Judge Bambi Weil permanently removes Lindsey as trustee.
May 7, 1999:	Probate Court Judge Kevin Chang temporarily removes four trustees and accepts trustee Stender's resignation on an interim basis. The panel of five special-purpose trustees are appointed as "Interim Trustees."
May 12, 1999:	The chairman of the Interim Trustees reports that the IRS insists on the permanent removal of the trustees.
June 16, 1999:	Circuit Judge Michael Town dismisses the indictment against trustee Wong.
July 1, 1999:	Circuit Judge Town dismisses indictments against trustee Peters.
July 6, 1999:	Governor Cayetano appoints Earl Anzai as Attorney General. The investigation is to continue under Anzai.
August 4, 1999:	A state grand jury indicts trustee Peters again.
August 20, 1999:	Gerard Jervis offers to resign as trustee.
August 31, 1999:	Probate Judge Colleen Hirai grants the Attorney General's request for interim removal of trustees Peters and Wong at least until March 28, 2000.
September 13, 1999:	The Attorney General petitions the Probate Court to assign the task of selecting KSBE trustees to the Hawai'i Intermediate Court of Appeals.
September 27, 1999:	Oswald Stender offers his unconditional resignation as trustee.

December 1, 1999:	Probate Judge Kevin Chang approves a $9 million settlement between KSBE and the IRS.
December 3, 1999:	Richard Wong offers to resign permanently as trustee.
December 9, 1999:	Former trustee Wong is indicted by a state grand jury for perjury.
December 16, 1999:	Lokelani Lindsey offers to resign as trustee.
December 17, 1999:	KSBE officially changes its name to "Kamehameha School." Circuit Judge Michael Town dismisses the indictment against former trustee Peters.
January 6, 2000:	Probate Judge Kevin Chang issues an order outlining the selection process for trustees: A panel of seven committee members will screen applicants and make recommendations to the probate judge, who will make the selection. Judge Chang appoints the members of the panel. Hamilton I. McCubbin is named the first chief executive officer of Kamehameha School.

Appendix B

The Will of Bernice Pauahi Bishop*

Know all Men by these Presents, That I, Bernice Pauahi Bishop, the wife of Charles R. Bishop, of Honolulu, Island of Oahu, Hawaiian Islands, being of sound mind and memory, but conscious of the uncertainty of life, do make, publish and declare this my last Will and Testament in manner following, hereby revoking all former wills by me made:

First. I give and bequeath unto my namesakes, E. Bernice Bishop Dunham, niece of my husband, now residing in San Joaquim County, California, Bernice Parke, daughter of W. C. Parke Esq., of Honolulu, Bernice Bishop Barnard, daughter of the late John E. Barnard Esq. of Honolulu, Bernice Bates, daughter of Mr. Dudley C. Bates, of San Francisco, California, Annie Pauahi Cleghorn of Honolulu, Lilah Bernice Wodehouse, daughter of Major J. H. Wodehouse, of Honolulu, and Pauahi Judd the daughter of Col. Charles H. Judd of Honolulu, the sum of Two hundred Dollars ($200.) each.

Second. I give and bequeath unto Mrs. William F. Allen, Mrs. Amoe Haalelea, Mrs. Antone Rosa, and Mrs. Nancy Ellis, the sum of Two Hundred Dollars ($200.) each.

Third. I give and bequeath unto Mrs. Caroline Bush, widow of A.W. Bush, Mrs. Sarah Parmenter, wife of Gilbert Parmenter Mrs. Keomailani Taylor, wife of Mr. Wray Taylor, to their sole and separate use free from the control of their husbands, and to Mrs. Emma Barnard, widow of the late John E Barnard Esq. the sum of Five hundred dollars ($500.) each.

Fourth. I give, devise and bequeath unto H. R. H. Liliuokalani, the wife of Gov. John 0. Dominis, all of those tracts of land known as the "Ahupuaa of Lumahai," situated on the Island of Kauai, and the "Ahupuaa of Kealia", situated in South Kona Island of Hawaii; to have and to hold for and during the term of her natural life; and after her decease to my trustees upon the trusts below expressed.

Fifth. I give and bequeath unto Kahakuakoi (w) and Kealohapanole, her husband, and to the survivor of them, the sum of Thirty Dollars ($30.) per month, (not $30. each) so long as either of them may live. And I also devise

---

* The original will is kept by the Hawai'i State Archives and is handwritten on ruled legal stationery that fills approximately 40 pages. The will is amended by Codicil 1 and Codicil 2.

unto them and to their heirs of the body of either, the lot of land called "Mauna Kamala", situated at Kapalama Honolulu; upon default of issue the same to go to my trustees upon the trusts below expressed.

Sixth. I give and bequeath unto Mrs. Kapoli Kamakau, the sum of Forty Dollars ($40.) per month during her life; to my servant woman Kaia the sum of Thirty Dollars ($30.) per month during her life, and to Nakaahiki (w) the sum of Thirty Dollars ($30.) per month during her life.

Seventh. I give, devise and bequeath unto Kapaa (k) the house-lot he now occupies, situated between Merchant and Queen Streets in Honolulu, to have and to hold for and during the term of his natural life; upon his decease to my trustees upon the trusts below expressed.

Eighth. I give, devise and bequeath unto Auhea (w) the wife of Lokana (k) the house-lot situated on the corner of Richard and Queen Streets, now occupied by G. W. Macfarlane & Co; to have and to hold for and during the term of her natural life; upon her decease to my trustees upon the trusts below expressed.

Ninth. I give, devise and bequeath unto my husband, Charles R. Bishop, all of the various tracts and parcels of land situated upon the Island of Molokai, comprising the "Molokai Ranch", and all of the live-stock and personal property thereon; being the same premises now under the care of R. W. Myer Esq.; and also all of the real property wherever situated, inherited by me from my parents, and also all of that devised to me by my aunt Akahi, except the two lands above devised to H. R. H. Liliuokalani for her life; and also all of my lands at Waikiki, Oahu, situated makai of the government main road leading to Kapiolani Park; to have and to hold together with all tenements, hereditaments, rights, privileges and appurtenances to the same appertaining, for and during the term of his natural life; and upon his decease to my trustees upon the trusts below expressed.

Tenth. I give, devise and bequeath unto Her Majesty Emma Kaleleonalani, Queen Dowager, as a token of my good will, all of the premises situated upon Emma Street in said Honolulu, known as Kaakopua, lately the residence of my cousin Keelikolani; to have and to hold with the appurtenances for and during the term of her natural life; and upon her decease to my trustees upon the trusts below expressed.

Eleventh. I give and bequeath the sum of Five thousand Dollars ($5000.) to be expended by my executors in repairs upon Kawaiahao Church building in Honolulu, or in improvements upon the same.

Twelfth. I give and bequeath the sum of Five thousand Dollars ($5000.) to be expended by my executors for the benefit of the Kawaiahao Family School for Girls (now under charge of Miss Norton) to be expended for additions either to the grounds, buildings or both.

Thirteenth. I give, devise and bequeath all of the rest, residue and remainder of my estate real and personal, wherever situated unto the trustees below named, their heirs and assigns forever, to hold upon the following trusts, namely: to erect and maintain in the Hawaiian Islands two schools, each for boarding and day scholars, one for boys and one for girls, to be known as, and called the Kamehameha Schools.

I direct my trustees to expend such amount as they may deem best, not to exceed however one-half of the fund which may come into their hands, in the purchase of suitable premises, the erection of school buildings, and in furnishing the same with the necessary and appropriate fixtures furniture and apparatus.

I direct my trustees to invest the remainder of my estate in such manner as they may think best, and to expend the annual income in the maintenance of said schools; meaning thereby the salaries of teachers, the repairing buildings and other incidental expenses; and to devote a portion of each year's income to the support and education of orphans, and others in indigent circumstances, giving the preference to Hawaiians of pure or part aboriginal blood; the proportion in which said annual income is to be divided among the various objects above mentioned to be determined solely by my said trustees they to have full discretion.

I desire my trustees to provide first and chiefly a good education in the common English branches, and also instruction in morals and in such useful knowledge as may tend to make good and industrious men and women; and I desire instruction in the higher branches to be subsidiary to the foregoing objects. For the purposes aforesaid I grant unto my said trustees full power to lease or sell any portion of my real estate, and to reinvest the proceeds and the balance of my estate in real estate, or in such other manner as to my said trustees may seem best.

I also give unto my said trustees full power to make all such rules and regulations as they may deem necessary for the government of said schools and to regulate the admission of pupils, and the same to alter, amend and publish upon a vote of a majority of said trustees.

I also direct that my said trustees shall annually make a full and complete report of all receipts and expenditures, and of the condition of said schools to the Chief Justice of the Supreme Court, or other highest judicial officer in this country; and shall also file before him annually an inventory of the property in their hands and how invested, and to publish the same in some Newspaper

published in said Honolulu; I also direct my said trustees to keep said school buildings insured in good Companies, and in case of loss to expend the amounts recovered in replacing or repairing said buildings.

I also direct that the teachers of said schools shall forever be persons of the Protestant religion, but I do not intend that the choice should be restricted to persons of any particular sect of Protestants.

Fourteenth. I appoint my husband Charles R. Bishop, Samuel M. Damon, Charles M. Hyde, Charles M. Cooke, and William O. Smith, all of Honolulu, to be my trustees to carry into effect the trusts above specified.

I direct that a majority of my said trustees may act in all cases and may convey real estate and perform all of the duties and powers hereby conferred; but three of them at least must join in all acts.

I further direct that the number of my said trustees shall be kept at five; and that vacancies shall be filled by the choice of a majority of the Justices of the Supreme Court, the selection to be made from persons of the Protestant religion.

Fifteenth. In addition to the above devise to Queen Emma, I also give, devise and bequeath to her (said Emma Kaleleonalani Queen Dowager [sic] the Fish-pond in Kawaa, Honolulu near Oahu Prison, called "Kawa", for and during the term of her natural life; and after her decease to my trustees upon the trusts aforesaid.

Sixteenth. In addition to the above devise to my husband, I also give and bequeath to him, said Charles R. Bishop all of my personal property of every description, including cattle at Molokai; to have and to hold to him, his executors, administrators and assigns forever.

Seventeenth. I hereby nominate and appoint my husband Charles R. Bishop and Samuel M. Damon, executors of this my will.

In witness whereof I, said Bernice Pauahi Bishop, have hereunto set my hand and seal this thirty-first day of October A. D. Eighteen hundred and eighty-three.

BERNICE P. BISHOP (SEAL)

The foregoing instrument, written on eleven pages, was signed, sealed, published and declared by said Bernice Pauahi Bishop, as and for her last will and testament in our presence, who at her request, in her presence, and in the

presence of each other, have hereunto set our names as witnesses thereto, this 31st day of October A. D. 1883.

F.W. MACFARLANE

FRANCIS M. HATCH

Codicil No. 1

This is a Codicil to the last Will and Testament of me, Bernice P. Bishop, dated October thirty-first A. D. Eighteen hundred and eighty-three:

1st. I give and bequeath unto Mrs. William F. Allen the sum of One thousand Dollars ($1000.) in place of the amount given to her in my said will.

2nd. I revoke the devise to Her Majesty Emma Kaleleonalani of the premises situated upon Emma Street in Honolulu, known as "Kaakopua", contained in the tenth article of my said will; and in place thereof I give, devise and bequeath unto her, said Emma Kaleleonalani, all of those parcels of land situated in Nuuanu Valley, Oahu, on both sides of the road, known as "Laimi"; to hold for and during the term of her natural life; and upon her decease to my trustees upon the trusts expressed in my said will. Said Emma to also have the fish pond known as "Kawa", as provided in the fifteenth article of my said will.

3rd. In addition to the bequests to my husband named in my said will I also give, devise and bequeath unto my said husband, Charles R. Bishop, the land known as Waialae-nui, as well as Waialae-iki and also the land known as "Maunalua", Island of Oahu; and also all of the premises situated in said Honolulu, known as the Ili of "Kaakopua", extending from Emma to Fort Street and also all kuleanas in the same, and everything appurtenant to said premises; to hold for his life, remainder to my trustees.

4th. I give, devise and bequeath unto Kuaiwa (k) and Kaakaole (w), old retainers of my parents, that piece of land now occupied by them, situated in upper Kapalama, in said Honolulu, called ""Wailuaakio""; to have and to hold for and during the term of their natural lives and that of the survivor of them; remainder to my trustees upon the trust named in my said will.

5th. I give, devise and bequeath unto Kaluna (k) and Hoopii, his wife, those premises now occupied and cultivated by them in Kauluwela, Liliha Street, Honolulu; to have and to hold for and during the terms of their natural lives and that of the survivor of them; remainder to my trustees upon the trusts named in my said will.

6th. I give, devise and bequeath unto Naiapaakai (k) and Loika Kahua his wife, that lot of land now enclosed and occupied by them, in Kauluwela in said Honolulu, the size of said lot not to exceed one acre; to have and to hold

for and during the term of their natural lives, and that of the survivor of them; remainder to my trustees upon the trusts named in my said will.

7th. I give and bequeath unto Lola Kahailiopua Bush, of said Honolulu, the sum of Three hundred Dollars ($300.) per year during her minority, to be applied towards her education and clothing; and upon her becoming of age the sum of One thousand Dollars, ($1000.) to her sole and separate use, free from the control of any husband she may marry.

8th. I give and bequeath unto Bernice B. Barnard, of said Honolulu the sum of Three hundred Dollars ($300.) a year during her minority, to be applied towards her education and clothing; and upon her becoming of age the sum of One thousand Dollars ($1000.) to her sole and separate use, free from the control of any husband she may marry. This in lieu of the $200. given by my will.

9th. I give, devise and bequeath unto my friend Samuel M. Damon, of said Honolulu, all of that tract of land known as the Ahupuaa of Moanalua, situated in the District of Honolulu, Island of Oahu; and also the fishery of Kaliawa; to have and to hold with the appurtenances to him, his heirs and assigns forever.

10th. I give and bequeath unto my servants Kaleleku (k) and (k) his brother, each the sum of Twenty Dollars ($20.) per month, during the term of the natural life of each of them.

11th. I revoke so much of the fifth article of my said will as devises the land known as "Mauna Kamala" to Kahakuakoi (w) and Kealohapanole her husband; and in lieu thereof I give, devise and bequeath unto said Kahakuakoi (w) and Kealohapanole (k) all of that tract of land known as Hanohano, situated at Ewa, Island of Oahu, formerly the property of Puhalahua; to have and to hold as limited in said fifth article of my said will.

12th. I give and bequeath unto the Bishop's School in Honolulu, called "Iolani College", the sum of Two thousand Dollars ($2000.); and to the English Sisters School called "St. Albans Priory" the sum of Two thousand Dollars ($2000.); and to "St Andrews Church" the sum of Two thousand Dollars ($2000.).

13th. I give, devise and bequeath unto Kaiulani Cleghorn, daughter of A. S. Cleghorn, of Honolulu, all of that parcel of land and spring situated at Waikiki-uka, Oahu, known as Kanewai; to have and to hold for and during the

term of her natural life; remainder to my trustees upon the trusts named in my said will.

14th. I give and bequeath unto the Rev. Henry H. Parker, of Honolulu, the sum of Five hundred Dollars ($500.)

15th. I give and bequeath unto Mary R. Collins, if she be with me at the time of my death, the sum of Two hundred Dollars ($200.); and unto Maggie Wynn, if she be then with me, the sum of One hundred Dollars ($100.)

16th. I hereby give the power to all of the beneficiaries named in my said will, and in this codicil, to whom I have given a life interest in any lands, to make good and valid leases of such lands for the term of ten years; which said leases shall hold good for the remainder of the several terms thereof after the decease of said devisees; the rent however, after such decease to be paid to my executors or trustees; provided however that no rent be collected for a longer period in advance at any one time than for six months, and no bonus be taken by said devisees, or any of them, on account of such leases or lease; in either of which cases such lease or leases shall cease and determine, at the option of my executors or trustees, upon the death of such devisee or devisees, who shall have collected rent for a longer period in advance than for six months, or who shall have taken such bonus.

17th. I give unto the trustees named in my will the most ample power to sell and dispose of any lands or other portion of my estate, and to exchange lands and otherwise dispose of the same; and to purchase land, and to take leases of land whenever they think it expedient, and generally to make such investments as they consider best; but I direct that my said trustees shall not purchase land for said schools if any lands come into their possession under my will which in their opinion may be suitable for such purpose; and I further direct that my said trustees shall not sell any real estate, cattle ranches, or other property, but to continue and manage the same, unless in their opinion a sale may be necessary for the establishment or maintenance of said schools, or for the best interest of my estate.

I further direct that neither my executors, nor trustees shall have any control or disposition of any of my personal property, it being my will that my husband, Charles R. Bishop, shall have absolutely all of my personal property of every description.

And I give unto my executors named in my said will full power to sell any portion of my real estate for the purpose of paying debts or legacies without obtaining leave of Court; and to give good and valid deeds for the same, the

purchasers under which are not to be responsible for the application of the purchase money.

In witness whereof I, said Bernice P. Bishop, have here-unto set my hand and seal this fourth day of October A. D. Eighteen hundred and eighty-four. The words "to hold for his life, remainder to my trustees" interlined on 2d page before signing.

BERNICE P. BISHOP (SEAL)

Signed, sealed, published and declared by the said Bernice P. Bishop as and for a codicil to her last will and testament, in our presence, who at her request, in her presence and in the presence of each other, have subscribed our names as witnesses thereto. Oct. 4, 1884

WILLIAM W. HALL

FRANCIS M. HATCH

Codicil No. 2

This is a second Codicil to the last Will and Testament of me, Bernice P. Bishop, dated thirty-first October A. D. Eighteen hundred and eighty three:

1st. In addition to the lands devised in the fourth article of my said will to H. R. H. Liliuokalani, the wife of John O. Dominis, I also give, devise and bequeath unto her, said Liliuokalani, all of that tract of land situated in the District of Honolulu, Island of Oahu, adjoining Waialae nui, known as "Kahala", together with the buildings thereon, and the fishing rights appurtenant thereto; to have and to hold for and during the term of her natural life, remainder to my trustees upon the trusts named in my said will.

2nd. In addition to the house lot devised to Kapaa (k) in the seventh article of my said will, which house lot was formerly the property of his wife Akahi, I also give, devise and bequeath unto him, said Kapaa (k) all of that parcel of land adjoining said houselot, fronting on Queen Street and extending to Richards Street, and now under lease to Henry R. Macfarlane; he, said Kapaa, to pay the taxes upon the same and upon the parcel devised by me to Auhea; to have and to hold for and during the term of the natural life of him said Kapaa, remainder to my trustees, upon the trusts named in my said will.

3rd. I revoke the devise to Auhea (w) wife of Lokana, set forth in the eighth article of my said will. And I give, devise and bequeath unto said Auhea, that house lot situated on said Richards Street (not on the corner of Queen Street) formerly occupied by said Auhea, and which was formerly the dwelling of Akahi; the same adjoining the premises under lease to Henry R. Macfarlane but not included in said lease; to have and to hold for and during the term of the natural life and her, said Auhea, free from the control of her husband; remainder to my trustees upon the trusts named in my said will.

4th. Of the two schools mentioned in the thirteenth article of my said will, I direct the school for boys shall be well established and in efficient operation before any money is expended or anything is undertaken on account of the new school for girls.

It is my desire that my trustees should do thorough work in regard to said schools as far as they go; and I authorize them to defer action in regard to the establishment of said school for girls, if in their opinion from the condition of my estate it may be expedient, until the life estates created by my said will have expired, and the lands so given shall have fallen into the general fund.

I also direct that my said trustees shall have power to determine to what extent said school shall be industrial, mechanical, or agricultural; and also to determine if tuition shall be charged in any case.

In witness whereof I, said Bernice P. Bishop have hereunto set my hand and seal this ninth day of October A. D. 1884.

BERNICE P. BISHOP

Signed, sealed, published and declared by the said Bernice P. Bishop as and for a codicil to her last will and testament in the presence of us, who at her request, in her presence and in the presence of each other have hereunto subscribed our names as witnesses thereto.

October 9th 1884.

O. TROUSSEAU

J. BRODIE

Appendix C

Broken Trust*

Samuel King, Msgr. Charles Kekumano, Walter Heen,
Gladys Brandt and Randall Roth**

The community has lost faith in Bishop Estate trustees, in how they are chosen, how much they are paid, how they govern. The time has come to say "no more." The web of relationships between the Judiciary and our beloved Kamehameha Schools/Bishop Estate has pushed two great institutions to an absolute critical point. Immediate action must be taken. To understand the underlying causes, readers must piece together the following stories. Think of them as puzzle parts.

TRUSTEE COMPENSATION

Some people think the Bishop Estate trustees are highly compensated because that's what Princess Bernice Pauahi Bishop provided for in her will. Actually, the will is silent on this issue, and the princess probably expected her trustees to serve without compensation. That was the tradition for charitable trusts then, as it is now, not just in Hawaii, but in every other jurisdiction with an English common law tradition. As stated in a 1945 Supreme Court opinion, "the law in Hawaii in existence prior to Jan. 1, 1928 made no provision for compensation of trustees." Clearly, the princess intended a sacred trust. But what we ended up with is a political plum.

Since 1987, the year in which the trustees were forced to make public the amount of their fees, they have received in excess of $40 million. Fees paid over the past three years have averaged $900,000 per trustee, per year.

---

* This essay was originally published in the HONOLULU STAR-BULLETIN, Aug. 9, 1997, at B-1.

** Samuel King is a Senior federal District Court judge and former state Circuit Court judge.

Msgr. Charles Kekumano was Chairman of the Queen Liliuokalani Trust, a retired Catholic priest and former chairman of the Police Commission. Msgr. Kekumano passed away in early 1998.

Walter Heen is a retired judge of the Hawai'i Intermediate Court of Appeals and formerly a state legislator and City Councilman. Currently, he is Chairman of the Democratic Party of Hawai'i and active with the Native Hawaiian Advisory Council.

Gladys Brandt is a former principal of Kamehameha School for Girls and director of the secondary division of Kamehameha Schools. She was chairwoman of the University of Hawai'i Board of Regents.

Randall Roth is a Professor of Law at the University of Hawai'i School of Law where he teaches courses on wills, trusts, and taxes.

The distracting thing about this piece of the mosaic is that people made responsible for preserving $5 to $10 billion of wealth, and carrying out an educational mission that is as important as it is unique, arguably ought to be highly paid.

We think the more important issue is the credentials of the specific individuals who are being paid these large sums of money. Given the estate's ability to pay big-league compensation, one would expect to find an array of phenomenally talented trustees. Yet somehow, with the exception of Oswald Stender, the Bishop Estate trustees simply don't measure up to the job.

TRUSTEE SELECTION

Many people are under the impression that the justices of Hawaii's Supreme Court are legally obligated to select Bishop Estate trustees because that's what the princess put into her. Not so. Clearly, they don't have to do it. The justices acknowledged as much in 1989 when they refused the request of a woman named Sadie Smith to pick the trustees of her charitable trust.

Acknowledging the obvious impropriety of making trustee selections in their official capacity, the justices tell us they are acting as individuals when they select Bishop Estate trustees. This is a distinction without meaning. To be blunt, it's a dodge.

The reality is that Bishop Estate trustees are selected by five individuals who through no coincidence are also justices of the state Supreme Court. The further reality is that these same five individuals are virtually certain to be called upon to decide cases involving the trustees they select (the estate has been before the Supreme Court at least 18 times in the last 13 years). At a minimum, this creates the appearance of a conflict.

Some people wonder why the justices would stretch logic and judicial ethics to the breaking point just to do something they clearly don't have to do, and then do it poorly.

Can we be blamed for questioning the justices' collective judgment in other areas? After all, if the justices exercise questionable judgment in their individual capacity when selecting trustees, why shouldn't we expect equally questionable decisions in their official capacity? Worse, if selection of trustees is influenced by politics (as we believe it is), why shouldn't the public assume that judicial decisions are equally political?

It is imperative that the Supreme Court enjoy the trust and respect of the entire community. According to Democratic Rep. Ed Case, "The Supreme Court's trustee appointment role has the real potential of undermining and perverting our judicial system, starting with the judicial selection process. Getting out of the Bishop Estate trustee selection business is the single biggest

thing the court could do to enhance the court's standing with the public." We agree.

BECAUSE THAT'S WHAT THE WILL SAYS

More than 100 years have passed since Mrs. Bishop's death, and if she were here today, she unquestionably would decide some things differently. For example, the princess named five men, who happened to be haole, as the initial trustees of her trust. Does that mean she wanted all future trustees to be of that same make up? Of course not.

In fact, the justices and trustees have themselves occasionally ignored the language of the will—perhaps with good cause. For example, the will says the schools should be primarily vocational, and only secondarily college preparatory. That's changed. The will also specifically expresses a desire that the schools benefit orphans and others in indigent circumstances, and makes no mention of admissions based on academic ability. Again, the will's instructions have been modified to deal with the demands of the time.

The will specifically provides that the trustees must be "persons of the Protestant religion," and no court case has said that such a requirement is invalid. Yet the current justices of Hawaii's Supreme Court, acting as individuals and not as a court, have indicated that they will ignore the will in this respect when selecting new trustees.

Taking refuge in the literal words of the will is more of an excuse than a reason.

JUDICIAL SELECTION COMMISSION

To understand why each member of the court would insist upon doing something that we consider unethical, it helps to consider the circumstances of their own selection. The Judicial Selection Commission is an attempt to take politics out of the selection of judges and justices. A "reform" idea out of the 1978 Constitutional Convention, the commission is a bipartisan group that reviews potential applicants and submits a list to the governor for selection. Previously, the governor alone nominated judges.

One of the most powerful duties of the commission is to decide—by itself—whether any judge, or justice, will be retained for another term of 10 years. We believe that most of the people who served on the commission over the years have been public spirited, well intentioned and capable. But no process, no matter how well designed, will work properly when individuals are determined to manipulate it. For instance, we believe that during the period John Waihee was governor it was common for him to confer ahead of

time with several commission members who then would strive to get a predetermined name on each list.

In the words of someone who served on the commission during those years, "If a few members decided ahead of time to do their best to get a particular name on a list, they probably were able to do that. No one is so naive as to think there isn't a certain amount of horse trading going on."

According to a prominent Democratic politician, "The commission always seemed to have at least a few people whose first and foremost allegiance was to Governor Waihee. With people like Warren Price, Tom Enomoto, Michael Hare and Gerry Jervis on the commission, it was easy to get one particular name on a list. The thing, though, is that it already had been determined who was going to get the appointment."

This was the era when the commission put 36-year-old Sharon Himeno on a list for the Supreme Court, from which she was selected by Governor Waihee. It bothered some people that Himeno was Attorney General Warren Price's wife and that she wasn't considered an exceptional lawyer.

But the bigger concern for many was an allegation of a serious ethical lapse in connection with a family corporation's apparent $3 million profit on a back-to-back purchase/sale of a mainland golf course involving Himeno's client, the state Employees' Retirement System. Her nomination to the state's highest court seemed to be based on the fact that she and Price had directed their good friend John Waihee's gubernatorial campaign.

When Judge Walter Heen was interviewed as an applicant for the Hawaii Supreme Court, he was asked by Hare "what kind of person" he might select as Bishop Estate trustee, if he ever had the opportunity to do so. According to David Fairbanks, a current member of the commission, such a question, if asked, would have been "totally improper."

That this question was asked of a candidate for the Supreme Court, by a member of the Judicial Selection Commission, illustrates how the trustee-selection power of justices played a significant role (with respect to some members of the commission) in the consideration of candidates for the state's highest court.

Hare's law firm has been paid more than $10 million in legal fees by the Bishop Estate since 1992. It's an excellent firm, but we find it hard to believe that's the reason it was selected by the trustees.

HOW JUSTICES GET CHOSEN

When there is an opening on the state Supreme Court, the Judicial Selection Commission agrees upon a list of up to six names. The governor then selects someone from this list, and the Senate either confirms or rejects that selection. At least that is the way it's supposed to work.

A little known fact is that when Justices Robert G. Klein and Steven H. Levinson were selected in 1992, both names were not on the first list submitted by the commission. According to our sources, Waihee simply sent the list back, saying he wanted either a new list or an expanded one. A number of commission members were bothered by this, but Gerard Jervis insisted that the group give in to the governor's demands, and in the end, his importuning prevailed. Both names were on the revised list and they were the ones who got appointed. Several years later, Jervis was selected by the justices to be a Bishop Estate trustee. Other trustees selected during this era include former Speaker of the House of Representatives Henry Peters and former President of the Senate Dickie Wong, who by virtue of their positions had a hand in the selection of individual commission members.

We would like to believe that a primary ingredient in the nomination and selection of Supreme Court justices has never been how willing they would be to appoint the "right" person to the Bishop Estate, but the circumstantial evidence to the contrary seems overwhelming.

AN UNPREDICTABLE COURT

The current justices are issuing decisions that often surprise and sometimes shock observers. A retired Supreme Court justice expressed it this way, "Nobody has any idea how these justices will rule. It's disgraceful. There's absolutely no predictability, absolutely none. They are heightening conflicts rather than resolving them. They don't understand the importance of precedent and restraint—they just do what they want."

Some of the people we polled, including a retired Supreme Court justice, attributed this unpredictability to a perceived lack of ability. Others, including a different retired Supreme Court justice, expressed a belief that these justices "aren't independent—at least not when it comes to the selection of Bishop Estate trustees."

We believe this unpredictability stems more from the way these five justices view the world than it does from any lack of ability or independence on their part. And we support Chief Justice Ronald Moon's attempts to improve the judiciary and its reputation with the public. That's a big reason why we believe the justices should stop selecting trustees. We are convinced that their role in selecting trustees undermines public confidence in the Supreme Court and the entire judiciary.

HOW TRUSTEES GET SELECTED

In the words of a former Supreme Court justice, here's how the process worked: "The way we went about picking trustees was different each time.

The time we named Chief Justice Richardson, for example, Justice Lum suggested that we select him, and we all agreed. It was just that simple. Another time, we must have gotten over 100 applications. It was pretty informal then too, but we did read through everything. It's really hard to generalize about how we did things because it just depended on the circumstances."

In the words of a different former justice, "When Os Stender was picked, we got lucky. Two of the justices wanted Larry Mehau very badly, another two were just as adamant about Anthony Ramos. The fifth justice, who was for Jimmy Ahloy, refused to switch to either of the other two candidates. Once it became crystal clear that we had a stalemate, someone—and I wish I could remember who—brought up Os' name. We all knew he was Hawaiian and that he was the CEO at Campbell Estate, and it didn't take long to agree on him. Chief Justice Lum immediately called and asked him to come over right away. When Os arrived 10 minutes later, we told him he had just been chosen to be a Bishop Estate trustee. He just sat there for a good minute. You know, a minute is a pretty long time to just sit there in a situation like that. Anyway, after that long pause, he just said thank you,' and that was that. Just about everyone agrees that Os has been a great trustee. Like I said, we got lucky."

Here's the same scene as seen through the eyes of Os Stender: "You know, when they picked me, they practically picked my name out of a hat. Can you believe it? There was no process, not even an interview. I was speechless."

We can't knock good luck, but would rather rely upon clearly articulated criteria and a coherent selection process. Otherwise, the selectors cannot effectively be held accountable.

THE BLUE-RIBBON PANEL

We believe the justices intended to name Waihee to replace Myron "Pinky" Thompson when his term as a Bishop Estate trustee expired in 1994. But this was sure to strike many as being too obviously political. After all, Waihee had personally appointed every one of the justices. So, rather than just do it and take all the heat, the justices decided to ask a blue-ribbon panel of community leaders to provide a list from which a selection could be made. It never occurred to them that Waihee's name would not be on that list.

When Chief Justice Moon first met with the panel, one of its members, Bobby Pfeiffer, asked him, "Will you choose from the list we submit even if we have only five names on it?" Moon said "yes," and the panel took him at his word. They then proceeded to work hard, eventually coming up with the names of five very impressive people. Putting the list together was a relatively smooth, harmonious process, except for their discussion of Waihee. Most of

the panel members said "no" but a few (primarily United Public Workers union chief Gary Rodrigues and Al Shim, a partner in the law firm of Shim, Tam, Kirimitsu & Chang), fought long and hard to get the then-governor's name on the list. Rodrigues, in particular, got quite irritated with the others, but they stood firm. Most of them simply felt there already were too many politicians as trustees.

The next day, the panel's chairperson, Gladys Brandt, walked the list over to the court, intending to just drop it off. But the justices were there and assembled, so she gave each of them a copy and sat quietly to the side. A complete silence fell over the room as they stared at the list. Finally, one of them said simply: "Where's his name?"

The justices refused to use that list, and eventually chose Waihee's friend and confidant, Gerard Jervis.

While Waihee didn't get appointed, he did manage to establish lucrative ties to the estate. Shortly after leaving office in 1995, he joined the Washington, D.C.-based law firm, Verner Liipfert Bernhard McPherson & Hand, which already was doing some legal work for the estate in Washington. Since then, this firm has been paid millions of dollars by the Bishop Estate, mostly for lobbying activity in opposition to the Intermediate Sanctions law (among other things, this law empowers the IRS to force individuals to repay any charity that is found to have paid them excessive compensation). The word "intermediate" reflects the fact that the sanction would be something short of revoking the charity's tax-exempt status.

We think money spent in opposition to this particular law cannot possibly be seen as being in the best interests of the estate's beneficiaries, as opposed to those of the trustees. In fact, repeal of the law easily could backfire on the estate. Without an "intermediate sanction" at its disposal, if the IRS were to conclude that excessive compensation was being paid, it might be forced to bring out the heavy artillery—revocation of the estate's tax exempt status.

In a letter dated May 29, 1990, a deputy attorney general, Cynthia Unwin, stated that "any lobbying by the trustees against legislation to reduce trustee commissions could be a misuse of estate property for the personal benefit of the trustees, and thus, a violation of the trustees' duty of loyalty to the trust's beneficiaries."

FIDUCIARY AND RELATED DUTIES

Trustees have what is called a "fiduciary" responsibility. This means, among other things, that they must act at all times solely in the beneficiaries' best interests and that they will be held to an unusually high standard of care and conduct in doing so.

The first of these duties often is expressed in terms of a duty of undivided loyalty and an absolute prohibition against self-dealing. Because the responsibility and legal exposure is so great, the law of trusts everywhere provides that no one can be forced to serve as a trustee of any trust.

It's not at all clear that most of the current trustees understand their fiduciary duties. For example, the Bishop Estate trustees in 1989 personally invested more than $2 million in a Texas methane gas deal in which the estate also invested. Eventually, the estate's investment grew to $85 million. The estate's lawyer in Texas was quoted as saying that the estate can only hope to recover $20 million, at most, of its $85 million investment. He went on to call it a "disaster," according to court records.

The trustees' decisions regarding the estate's investment might have been influenced by their desire not to see their own investments go bad. Even if that was not the case, people with a fiduciary duty are legally prohibited from putting themselves into that kind of situation. Eventually, the probate court ordered the trustees never again to invest personally in estate deals.

In a more recent transaction, this one involving a golf course, trustee Henry Peters actually found himself negotiating a multimillion-dollar deal in which the Bishop Estate was the other party. One can only wonder if he gave any thought to the obvious ethical and serious legal implications of someone with a fiduciary duty moving from one side of the table to the other.

In reaction to situations like the methane gas and golf course deals, a nationally recognized authority on the law of trusts and fiduciary duties was asked several years ago if he would be willing to meet with Bishop Estate trustees to help them understand their duties. He indicated his willingness to do so, yet for reasons never explained, the meeting was never scheduled. To this day, the current trustees have not had a single session in which their fiduciary duties have been systematically explained to them. This strikes us as reckless, at the least.

JUSTICES HAVE DUTIES TOO

Before moving on from the subject of legal liability, it needs to be pointed out that the trustees are not the only ones in this mosaic who could potentially be held personally liable for damages incurred by the estate.

Anyone who agrees to select trustees also owes a duty to trust beneficiaries. If, for example, selections are made based on considerations other than what's in the best interests of trust beneficiaries, the ones who select a trustee could find themselves legally liable for any harm caused by that trustee. Since Hawaii's justices are acting in their individual capacity when they select trustees, judicial immunity would not apply.

What this means is that Hawaii's five justices have a vested interest of sorts in each trustee that they select. It makes it unlikely that the five justices will be perceived as objective and even-handed (even if they are) when the estate has a matter in front of them, as is regularly and predictably the case.

ACCOUNTABILITY

In the case of the Bishop Estate, we believe that accountability is almost totally missing. For instance, many charitable trusts are held accountable through contributions. That's a powerful mechanism: If the people who run them don't do a good job, donations will stop. But this doesn't apply to the Bishop Estate since its trustees do not solicit contributions.

It's true that each year a court-appointed master reviews the trustees' performance. But about all this is designed to do is determine if the trustees have committed a crime. The job is simply overwhelming. According to former Bishop Estate master Jim Duffy, "You really can't get your arms around everything, especially the mainland deals. It really isn't a feasible way to review the performance of the trustees. Plus, there is a feeling that the trustees can simply outlast any master, and they really can."

Not surprisingly, the master's report has not been an effective mechanism of accountability. For example, Duffy recommended in his 1992 report, and again in 1993, that the trustees develop a long-term financial and educational plan, and that they stop using the statutory compensation scheme in setting their own fees. The next master, Ben Matsubara, reiterated Duffy's call for a "strategic" plan in his 1995 biennial report (the next biennial master's report is expected to be made public soon). To this day, the trustees have not adopted a strategic plan. Given that the trustees have been able to repeatedly ignore these and other recommendations, we question if any master can be expected to make the trustees accountable.

How about a lawsuit? Historically, individual beneficiaries of a charitable trust have not been able to sue. Standing to do so typically has resided in the state attorney general, or in fellow trustees if a breach is serious enough. Hawaii is one of only six states with an appointed attorney general and it's a plain fact that no attorney general has initiated a lawsuit to sanction or remove a trustee.

Some members of the public seem to think the Supreme Court has the power to hold the trustees' feet to the fire. This might have been the case at the time of the princess' death since in those days the Supreme Court had jurisdiction over all probate matters.

But that changed many years ago. Consequently, if a lawsuit to sanction or remove a trustee is to be filed now, it must originate in the probate court.

One possible way to make the trustees accountable would be a lawsuit by a group of individuals who fall within the class of intended beneficiaries. Normally, the courts only permit charities to be sued by a state attorney general, but it's not unheard of that they would grant "standing" (the legal ability to sue) to groups of individuals when that appears to be the only way to achieve accountability. Our Supreme Court did this in a 1989 case involving Kapiolani Park and Honolulu County, but hasn't yet been asked to do it in a case involving the Bishop Estate.

To whom do the trustees think they are accountable? Alan Murakami, a highly regarded lawyer with the Native Hawaiian Legal Corp., recently put it this way: "The trustees say they just have a fiduciary duty to the school, and not to the students, faculty, alumni or even to native Hawaiians as a group. If that's true, it means no one can hold them accountable. How do they have the nerve to even say that?"

NA PUA A PAUAHI

We admire the way members of the Na Pua a Pauahi group have conducted themselves during the recent, on-going difficulties at Kamehameha Schools. Their courageous actions have been widely reported by the media. What has not been fully communicated yet, at least not publicly, is the anguish they feel over the situation. To them, Kamehameha Schools is more than an educational institution. It's a dream, a beacon, a promise to future generations of Hawaiian children.

The specific requests made of the trustees by the Na Pua group are surprisingly modest: (1) formulate a plan for the school, but do so only after having listened to the concerns of affected parties, (2) reinstate "talk story" sessions to facilitate better communications, and (3) agree not to take punitive action against students, faculty and others who participated in the walk or voiced concerns publicly. Nevertheless, say several of the Na Pua leaders, the group has been "stonewalled and lied to."

Why are the trustees fighting this group? In the words of Na Pua's lawyer, Beadie Dawson, "The trustees are fighting hard now because if they lose on the standing issue, they're afraid that will lead to other suits, and, of course, they are right. They've never had to be accountable to anyone, and they don't want to start now."

ATTITUDE PROBLEMS

Rather than hire a top-notch chief executive officer (CEO) to run the day-to-day affairs of the estate, each of the trustees tends to function as a separate CEO of a separate part of the estate's activities. They actually brag about it.

In the words of Ed Halbach, the nation's preeminent authority on the law of trusts and fiduciary duties, "This might not be an impermissible delegation, but it certainly isn't a sound practice in a trust of this scale."

What about the manner in which the trustees go about doing their jobs?

We asked many people, who have had to work with or for them, how they would describe the trustees' management style. To us, the responses boil down to "secretive," "dictatorial" and "vindictive."

High-level staff members have had individual trustees walk into their offices, giving orders to do something that required majority approval without first having submitted it to a vote. (Even if a majority of trustees would have voted to approve that matter, it's still a breach of trust to overlook that essential step.) Staff members have been left in the unenviable position of either refusing to carry out the order, or following the order and thereby participating in what they believe to be a breach. The level of intimidation at the estate is such that staffers routinely have chosen to go along with the order.

It's been widely reported that trustee Lokelani Lindsey used Bishop Estate people to survey her North Shore property, process her permits and supervise the rebuilding of her house. To our knowledge, she hasn't repaid the estate. More so than any other charitable trust, the Bishop Estate has been quick to engage in deal making, as opposed to plain old investing. For example, how many charities have tried to develop a championship-caliber golf course for the rich and famous? We're talking about one with initiation fees of $70,000, annual dues of $4,000, and a membership list that reads like a "Who's Who" publication. This one must have been exciting for the trustees, at least for a while, but eventually it got into financial trouble. That's when the trustees decided to sell the course to the club's members.

Henry Peters negotiated the transaction, not on behalf of the Bishop Estate, but on behalf of the buying members, of whom he was one. According to Peters, this was perfectly appropriate since he had "recused" himself from negotiating on behalf of the selling Bishop Estate. Disgruntled members have since sued the estate, alleging fraud, conflict of interest and breach of fiduciary duty.

The most recent Master's Report (made public in 1995) states that the estate had "$44 million of write-offs and reserves for troubled investments for the fiscal year." To appreciate the magnitude and meaning of these losses, one must know that educational and other charitable expenditures for that year totaled just $84 million. Just imagine what could have been accomplished with another 50 percent.

Buried in a footnote to the estate's 1996 financial statements (made public just two weeks ago): "During fiscal 1996, a study was conducted which necessitated a reduction in carrying value of . . . working interest investments

by $21,015,037, which is net of taxes of $13,436,000." This means the trustees were forced to acknowledge that investments in their deal-making subsidiary have gone down in value by $34,451,037.

After some effort, we determined that this $34 million loss is on top of the $44 million write-off mentioned in the 1995 Master's Report. Bishop Estate financial statements are notoriously difficult to interpret, largely because the trustees have been slow to adopt generally accepted accounting principles and, in fact, still haven't completely done so. Besides rendering the statements unnecessarily hard to understand, this makes meaningful comparison to other organizations virtually impossible.

Seeing these huge losses is especially painful for those of us who last year watched as the trustees completely eliminated the estate's early education program, among others. We felt at the time that many of the decisions about which programs to keep, and which to cut, had been made more on the basis of personalities than merits. The trustees insisted that it all had to do with conserving resources but, to our knowledge, neglected to mention these staggering losses.

YUKIO, TOM AND THE BOYS

We are greatly disturbed that the trustees would hire Yukio Takemoto as their director of Budget and Review after he left the state as director of Budget and Finance under Waihee. This was in the wake of serious questions involving investments of the $5 billion state Employees' Retirement System and a $150,000 airport consulting contract that was increased to $52 million without competitive bidding or outside review.

Here's how Oswald Stender has described the circumstances and consequences of Takemoto's hiring: "When Dickie indicated that he wanted to hire Yukio Takemoto for Gil Tam's old job, I told him I didn't think it was a good fit. That was true, but I also was thinking of the fact that Yukio had just left the state under a cloud.

"Besides, we already had some really good people on staff and I like to hire from within when possible. But as I raised these additional objections, Dickie got upset and said, hey, I've already hired him, so none of that matters.' It didn't take Yukio long to hire a bunch of 'his people.' Can you believe it, now he's got it up to 13 people and an operating budget of $1.6 million.

"Already, I've spotted a few nonbid contracts involving Dura (Tom Enomoto's company) for over a million dollars each. Usually something like that would go out for a bid. It's the same kind of stuff they did when Yukio was director of the state budget."

AN OUTSIDE EXPERT'S THOUGHTS

Ed Halbach, the nation's foremost authority on the law of trusts and fiduciary duties, has this to say about the Bishop Estate: "I'm very troubled by what I've heard and read. The trustees appear to have a low total return and particularly a low income yield to be spent on the schools.

"This aspect of the estate's management needs to be thoroughly reviewed now, and periodically in the future, to determine current value of assets. Only then could someone ascertain the rates of income yield and principal growth, both of which need to be known in order to evaluate the critical matter of investment performance.

"At a minimum, when trustees rely on the active management of assets, as opposed to passive investing, they have a greater burden to justify the resulting increase in management and transaction costs. Furthermore, there's far more potential for patronage, unnecessary or unwise expenditures and that sort of thing than if they invested mainly in the stock market for example.

"On the other hand, the performance and integrity of the investment programs of some other trusts show that properly managed active investment and development of property can pay off well. The attorney general needs to find a way to look into these aspects of management periodically to determine overall investment performance and efficiency.

"It's entirely conceivable that the estate is not effectively serving its charitable purpose. The mere fact that it funds the school doesn't immunize it from IRS scrutiny. I cannot help but wonder if the estate is generating the income that it should, and if all of the properly determined trust accounting income is being spent for the school as directed by the terms of the princess' will.

"As an outsider, it's hard for me to understand why the people of Hawaii, not to mention its public officials, haven't been more concerned about all of these matters."

RECENT ACTION IN NEW YORK

Adelphi University, like the Bishop Estate, is a nonprofit educational organization that enjoys various public benefits such as tax-exempt status. Last year, an irate group of faculty, students, alumni and former trustees of Adelphi accused the current trustees of neglect of duty, misconduct and failure to carry out the educational purposes of the school. Allegations included failure to implement an educational plan, conflict of interest and excessive compensation to the school's president ($837,113).

On Feb. 5, after an investigation, the state agency that oversees educational organizations removed 18 of the school's 19 trustees and referred the case to

the state attorney general to determine if additional civil proceedings against the trustees are in order. The ousted trustees included an educator and former speaker of the state legislature.

Less than two months later, the attorney general filed a lawsuit "to hold (the former trustees) financially accountable for mismanagement of assets and violation of fiduciary duties." One of the attorneys close to the matter has stated that this case awakened the public to "the high degree of care, diligence and loyalty required of trustees of nonprofit educational institutions."

If it can happen in New York, why not in Hawaii?

CONCLUSION

Hawaii has a tradition of tolerance and quiet acceptance of others. In the island way, it often is considered disruptive—even rude—to speak out. So silence is understandable.

But we recently were moved by Kamehameha President Michael Chun's remarks to this year's graduating class: "As I look at you now, I see a maturity that allows you to recognize problems when you see them, and a determination to be a part of their solution. You are willing to speak up and take risks. You are ready to stand by the people and the institutions in which you believe. And for this, I am forever proud of you."

By demanding accountability now, the community can illustrate to all the keiki o ka aina the true meaning of these inspiring words.

STEPS TO REGAIN THE TRUST

Recommendations made by the authors of this article:

1. The Bishop Estate trustees should draft and widely distribute a strategic plan with clearly stated vision, goals and objectives for both protection of the endowment and operation of Kamehameha Schools. The planning process should be marked by openness and a genuine interest in input from those individuals most directly affected by the legacy of Princess Bernice Pauahi Bishop.
2. The state attorney general, and the Supreme Court justices, if they elect to participate, should authorize a blue-ribbon panel of community leaders to develop written criteria and procedures for the selection of future Bishop Estate trustees.
3. The state attorney general immediately should begin a comprehensive review of trustee conduct and trust performance in recent years, with respect to both operation of Kamehameha Schools and management of the Bishop Estate endowment. If the trustees do not cooperate fully, a

lawsuit should be filed and subpoenas issued. If it is determined that one or more trustees have violated a fiduciary duty, such trustee or trustees should be held personally accountable for any damages and, if the violations were serious or repeated, removed from office.

4. The term of appointment for trustees of charitable trusts should be limited to a fixed number of years, with no expectation of reappointment. These are supposed to be public institutions, not personal fiefdoms.
5. The Hawaii state Legislature should repeal the current statutory scheme for determining trustee compensation (with respect to all trusts in Hawaii), and replace it with a statute providing for reasonable compensation, as is prevalent in other states. This already is the law in Hawaii with respect to the administration of private estates, and there is no reason to have a different rule for trustees of trusts, especially charitable trusts.
6. The Legislature also should appoint and adequately fund an independent watchdog (perhaps patterned along the lines of the legislative auditor) whose sole function is to regularly monitor the performance of all charitable trusts in Hawaii.

Appendix D

Renewed Trust[*]

After two years of legal investigations, changing policies and reforms are beginning to heal Bishop Estate's broken trust

Gladys Brandt, Samuel P. King,
Walter Heen and Randall Roth
Authors of "Broken Trust"[**]

—Written with inspiration from the late Monsignor Charles Kekumano

It began with a simple request. In 1997, a group of concerned Hawaiians asked for a meeting to air complaints about the actions of certain Bishop Estate trustees. Two years later, the result has been major changes in the governance of the estate, the fortunes and reputations of the estate's trustees and the procedures of the state judiciary. More changes are in the making. Most observers view the changes so far as positive, but the quality of change will continue to be positive only if we remember the past and remain vigilant.

A LOOK BACK

British explorer Captain James Cook estimated a native population of 300,000, or more, when he happened upon Hawaii in 1778. By 1831, the year of Princess Bernice Pauahi's birth, the number had declined to 130,000. Just 52 years later, in 1883, the year this last descendant of Kamehameha the Great wrote her will, the native population barely exceeded 44,000. Her race was not just in decline, but quickly on its way to extinction.

---

[*] This essay was originally published in the HONOLULU STAR-BULLETIN, Oct. 23, 1999, at B-3.

[**] Gladys Brandt is a former principal of Kamehameha School for Girls and director of the secondary division of Kamehameha Schools. She was chairwoman of the University of Hawai'i Board of Regents.

Samuel King is a Senior federal District Court judge and former state Circuit Court judge.

Walter Heen is a retired judge of the Hawai'i Intermediate Court of Appeals and formerly a state legislator and City Councilman. Currently, he is Chairman of the Democratic Party of Hawai'i and active with the Native Hawaiian Advisory Council.

Randall Roth is a Professor of Law at the University of Hawai'i School of Law where he teaches courses on wills, trusts, and taxes.

How insightful yet logical that she would bequeath the bulk of her immense estate in trust, so the educational opportunity and religion that gave her strength and hope could do the same for countless others. Specifically, she instructed trustees "to erect and maintain in the Hawaiian Islands two schools, each for boarding and day scholars, one for boys and one for girls, to be known as, and called the Kamehameha Schools."

They would be run by "persons of the Protestant religion," and dedicated to producing "good and industrious men and women." The princess—once described as "the brightest, the gentlest and the purest of (Hawaii's) daughters"— who had no children of her own, effectively adopted the children of Hawaii.

While the letter of the will does not exclude non-Hawaiian boys and girls as direct beneficiaries of her largess, common sense dictates that Princess Pauahi intended primarily to benefit children of Hawaiian ancestry for as long as a special need exists. This intention was confirmed by her husband, Charles Reed Bishop. In a 1901 letter to Samuel Damon, he wrote:

> . . . it was intended that the Hawaiians having aboriginal blood would have preference, provided that those of suitable age, health, character and intellect should apply in numbers sufficient to make up a good school . . . The Schools were intended to be perpetual, and as it was impossible to tell how many boys and girls of aboriginal blood would in the beginning or thereafter qualify and apply for admissions, those of other races were not barred or excluded."

The will authorizes the trustees "to regulate the admission of pupils," and trustees have used that power to limit admission to boys and girls with some quantum of Hawaiian blood, thus honoring the intent, or "spirit," of the princess' will.

Even so, the benefits of this legacy have touched only a small percentage of the school-age Hawaiian population.

LAND-BASED TRUST

One reason for this is that the initial trust corpus consisted almost entirely of land—375,569 acres in all. A substantial infusion of cash and additional land from the princess' widower made it possible for the schools to be built in a matter of years, rather than the decades it would have taken for estate land to generate the needed cash.

The letter of the will clearly authorized trustees to sell land as they deemed necessary "for the best interest of (the) estate," but the will also expressed Princess Pauahi's desire that they not sell land. The current inventory of land—362,833 acres—is reasonably close to the original number of 375,569, but well below a peak of 440,184.

Some wonder why Pauahi strongly preferred that the land not be sold. The will of her cousin Lunalilo had actually ordered the sale of his land after his death. Perhaps the princess believed that over time land would maintain what today might be called inflation-adjusted or real value.

Her instruction that income be expended annually suggests that she wanted maximum sustainable spending. Her goal was "good and industrious men and women," not accumulation of money for the sake of accumulation.

WILL NOT ALWAYS FOLLOWED

Ironically, the ousted trustees now accuse the attorney general, master, probate judge, IRS and others of trying to destroy the will. The truth is that these and other trustees deviated from the will on numerous occasions. For example, the will clearly calls for separate schools, one for boys and one for girls. Yet many years ago trustees got permission to combine them. Princess Pauahi also wanted the schools' curriculum to be primarily vocational and only secondarily college preparatory: "I desire instruction in the higher branches to be subsidiary . . ." That, too, has not been honored for many years.

If the princess were here today, she probably would agree with those decisions, just as she probably would favor today's policy of giving college students of Hawaiian ancestry financial assistance from her trust. The point is that these decisions, for better or worse, go directly against the letter of the will.

Provisions of the will that have been violated over the years include a requirement that a detailed list of assets and expenditures be published each year in a Honolulu newspaper (this hasn't been done for many years) and that income not be accumulated indefinitely. (The recently ousted trustees not only accumulated $351 million of income, they transferred it to corpus and actively hid this breach from the probate court.)

A requirement that only Protestants serve as teachers was declared invalid by a federal court in 1993. The instruction that all trustees be Protestant has not been honored since 1994 when a judicial conduct commission reminded the justices that they could not discriminate on the basis of religion, even when functioning in an individual capacity.

The ousted trustees and the Supreme Court justices who appointed them followed the will when doing so served their purposes, but deviated when it did not.

HOLDING TRUSTEES ACCOUNTABLE

No individual has a right to benefit personally from a charitable trust, neither does any ordinary citizen or any group of individuals have the legal

standing of a beneficiary. When trustees of charitable trusts deviate from the governing instrument or breach other fiduciary duties, it's primarily the job of the state attorney general to bring this to the probate court's attention. This centuries-old legal arrangement is called parens patriae.

The probate court also can take action sua sponte (on its own), based on its review of an annual master's report.

For whatever reason, a succession of probate judges, masters and attorneys general failed as watchdogs of Bishop Estate actions for many years. This enabled arrogant trustees to breach their fiduciary duties with impunity.

Things began to change only when Kamehameha students, parents, alumni and faculty began to question the highly intrusive manner in which the trustees were managing the school. In the typical Hawaiian manner, these parties, individually and collectively, quietly and unobtrusively attempted to achieve pono at the school.

Only when their efforts were frustrated by an obdurate majority of the trustees did they march in protest from Mauna 'Ala to the Supreme Court building. An overwhelming sense of duty to Princess Pauahi and the children pushed them forward, despite the likelihood of retaliation by embarrassed trustees.

Inspired by the marchers' passion and courage, the four of us, along with Monsignor Charles Kekumano, decided to point out that more was broken than even the marchers might have realized. Evidence strongly suggested that the selection of Supreme Court justices had been influenced by the justices' role in selecting Bishop Estate trustees. The end result was a tainted judiciary and a politicized Bishop Estate.

People who didn't understand what it means to be a trustee were on the verge of losing the estate's tax-exempt status, not to mention the confidence of the Hawaiian community. By pointing out all of this, we hoped to spark needed reform within both institutions.

Writing "Broken Trust" was easy compared to getting it published in the Honolulu Advertiser. Editor Jim Gatti gave us the runaround for weeks despite being told by members of his staff that it was a "blockbuster" and by his predecessor George Chaplin that the essay was sure to be "the biggest thing to hit Hawaii since statehood." After three weeks of unsuccessful attempts to get the go-ahead from Gatti, we took it across the hall to the Star-Bulletin, which published it the next day.

That was Saturday, Aug. 9, 1997. Three days later, Governor Cayetano called for an investigation of the trustees.

REACTION TO "BROKEN TRUST"

The state Supreme Court justices' initial response to "Broken Trust" was to question our facts and motives. The justices, who, according to Pauahi's will, appointed the Bishop Estate trustees, also swore never to turn their backs on their "sacred duty to Ke alii Pauahi."

Indeed, during the next few months they had secret communications with the trustees and took no action on requests that they recuse themselves from appeals involving the trustees they had selected.

Attorney General Margery Bronster heeded the governor's call for an investigation, and quickly proved to be fiercely independent, uncowed by the trustees or their lead attorney. She also told the justices that unless they agreed to be questioned separately, she would issue subpoenas and take their depositions. According to two separate sources, all five justices refused, insisting that she talk to all of them at the same time, or not at all.

Patrick Yim, deputized by the probate court so that he could determine the nature and extent of the problems on campus, submitted a report that supported trustee Oswald Stender's claims about the adverse impact trustee Lokelani Lindsey was having on the school's administrative staff, faculty and students. Yim also reported board-wide negligence: "Though the alarms were being sounded by the actions of one of the trustees, the others either ignored it, or failed to grasp the consequences of it."

By far the greatest role in the removal of trustees and reform of the estate was played by the court-appointed master, Colbert Matsumoto. His reports to the court were absolutely brilliant in their precision and clarity.

It was just a few days after the issuance of Matsumoto's first report that the justices changed their tune. Without mentioning their earlier statements to the contrary, or explaining the timing, all five publicly pledged not to hear any of the many appeals already being generated by the attorney general's investigation. And all but Justice Robert Klein added that they would have nothing to do with the selection of future Bishop Estate trustees.

JUDICIARY MOVES SLOWLY

Probate Judge Colleen Hirai was asked by the attorney general to remove the trustees temporarily but she declined to say yes or no without a full-blown trial. Legal matters only began to move when Judge Kevin Chang was assigned to the probate calendar in early 1999. While he didn't actually take the question of removal away from Hirai, he did the next best thing. Pointing to Matsumoto's recommendation, Chang ruled that the trustees had a conflict of interest in the on-going IRS audit. He then appointed five special-purpose trustees to represent the estate's interests in that audit.

These five were told by IRS senior personnel that the estate's tax-exempt status was in jeopardy if the five sitting trustees weren't removed permanently. Information discovered over the course of the four-year audit convinced the IRS that the sitting trustees could not be trusted.

Chang immediately ordered the sitting trustees to show cause as to why they shouldn't be removed as had been recommended by Matsumoto. He did so because of the IRS threat, but also because the trustees deliberately had ignored stipulated court orders. One such order was that the trustees develop and implement a chief executive officer business structure, and hire a CEO.

Judge Chang temporarily replaced all five trustees with the special-purpose trustees the day after another judge removed Lindsey permanently. Since then, Stender and Gerard Jervis have resigned.

As a practical matter, all five of the former trustees are gone for good. Henry Peters, Richard Wong and Lindsey continue to battle in court, but the case for their permanent removal is overwhelming. The foreseeable future of the former trustees will be spent defending against the attempts of various bodies to assess them with millions in surcharges, taxes, intermediate sanctions, damages and ordered reimbursements to the trust.

SETTLEMENT AGREEMENT

Judge Chang has been asked to approve of a settlement tentatively agreed to by both the IRS and interim trustees. It would require that the estate pay about $13 million in taxes and interest, which is manini compared to the $750 million estimated cost of losing tax-exempt status. It also is much smaller than the amount likely to be assessed at the for-profit subsidiary level. That set of issues is being negotiated separately.

Ousted trustees and their followers now attack the proposed settlement agreement because it calls for the permanent removal of all the former trustees. They argue that this amounts to the IRS trying to take over the job of the probate court. They also contend that the agreement will strip trustees of power and lead to the hiring of a mainland CEO who will sell the land and destroy the estate. According to them, Princess Pauahi wanted trustees to function as highly paid, full-time CEOs.

All of this is nonsense. Pauahi's will says nothing about compensation. At the time it was written, the law and expectation was that trustees of charitable trusts would serve without any compensation. The will also says nothing about the need for trustees to devote full-time efforts to managing the estate. None of the princess' handpicked trustees worked full time on the trust.

The former trustees agreed more than a year ago to hire a CEO to run estate operations on a day-to-day basis. The new CEO may or may not come from outside Hawaii, but he or she clearly will take marching orders from the

estate's trustees. If the CEO does not do the job the way they want it done, he or she will be dismissed. It's just that simple.

As for the contention that a CEO will sell land, it must be remembered that this is a trust, not a corporation. The land is owned by the trustees, not some bloodless legal entity. If it's to be sold, it will be by trustees, not an employee of theirs.

The proposed settlement includes the interim trustees' agreement to increase significantly the amount of money spent each year educating Hawaii children. The suggestion that this so-called spending plan would necessitate the sale of land is simply wrong. The proposal calls for a flexible "unitrust" approach. Rather than spend income, as that term currently is defined by Hawaii's Principal & Income Act, the trustees would use their best efforts to spend amounts that over time would average 4 percent of a base amount. In any one year, the percentage might be as low as 2½ percent, or as high as 6 percent, according to the plan.

Other public charities typically spend more than 4 percent of their corpus. Harvard's target is 4½ percent; Yale's is 5 percent. Private charities, by comparison, are required to expend a minimum of 5 percent each year. Few of these are "land-based," but that doesn't really distinguish them from the Bishop Estate because of a unique feature of the proposed spending plan which excludes from the base the value of all land classified as agriculture or conservation.

The trustees would have to spend only whatever net income might be generated by these 362,000 acres of land. Residential and commercial real estate would be included in the 4 percent calculation, but because it is subject to leases that generally are renegotiated regularly, it reasonably can be expected always to yield more than 4 percent of current value.

The proposed spending policy is in perfect harmony with the spirit of Pauahi's will. She wanted land to be retained, if possible, and she wanted maximum sustainable spending. That's what this approach is all about.

TRUSTEE SELECTION

At the time of Princess Pauahi's death, justices of the Supreme Court of the Kingdom of Hawaii had jurisdiction over wills and trusts. Official duties included the selection of trustees. More importantly, the princess' will specifically empowered them to select her replacement trustees. Presumably, she wanted group decisions by respected and knowledgeable individuals who themselves had been selected by members of her ohana. That's how justices were selected in those days.

Now that four of the current Supreme Court justices have stated that they will not select new trustees, the probate court must approve of a process that will honor the spirit of Princess Pauahi's will.

People who call for selection by a single justice, retired justices or judges of the intermediate court of appeals, effectively are calling for a rewriting of the will. That's unnecessary. Since the probate court already has jurisdiction, the probate judge has the power to appoint new trustees without doing damage to the letter of the will.

To honor its spirit, he or she can allow the actual selection to be made by majority vote of a panel of respected individuals. Just as Supreme Court justices at the time of Princess Pauahi's death were chosen by members of her ohana, many if not most members of future selection panels should come from Pauahi's adopted ohana. This would include Kamehameha alumni, students, parents, teachers and staff.

The work of the interim trustees should be greatly facilitated because of the existing court order to develop and implement a CEO management structure in which trustees can function mainly as policy makers. With such a format, the necessary qualifications to be a trustee can change considerably. That, combined with the fact that trustees would not be required to quit their current jobs, should result in an abundance of qualified candidates. New trustees should be expected to put far more resources into educating children.

WE ALL BENEFIT

The Bishop Estate is and must remain one of the most valued assets of our community. The education provided to young people of Hawaiian ancestry by the Kamehameha Schools benefits all of us as well as them. It gives them the knowledge and skills necessary to compete in the modern world and makes them an important part of the work force we need to sustain our islands' economy.

Additionally, the grounding in their native culture received at the school and spread by them throughout the community preserves for all of us the once-endangered heritage of their ancestors.

In that sense we are all beneficiaries of the princess' wisdom and generosity. For these reasons, and many more, we all share in the need to preserve the vision and the legacy of the princess.

Problems at the Bishop Estate are being resolved. This is happening only because good and industrious men and women stood up to trustees who didn't understand the meaning of stewardship. It is fitting that the direct inheritors of Princess Pauahi's legacy are now its protectors. The princess would be proud.

Imua Kamehameha.

Recreational Activity Liability in Hawai'i: Are Waivers Worth the Paper on Which They Are Written?

I. INTRODUCTION 715
II PRE-STATUTE RECREATIONAL ACTIVITY LIABILITY 719
A. *Implied Assumption of Risk* 720
B. *Express Assumption of Risk* 724
C. *Perceived Industry Crisis: The Context for Change* 729
III. HAWAI'I'S RECREATIONAL ACTIVITY LIABILITY STATUTE 732
A. *Legislative History* 732
B. *Recreational Activity Liability Defined* 733
C. *Unprecedented Liability* 735
IV. IMPACT OF HAWAI'I'S RECREATIONAL ACTIVITY LIABILITY STATUTE 736
A. *Increased Liability for Activity Providers* 737
B. *Inherent Risks Can Be Waived; Negligence Cannot* 738
C. *Jury Determination of "Inherent Risk" May Eliminate Summary Judgment* 740
V. CONCLUSION 744

I. INTRODUCTION

In July of 1991, David Wheelock, a visitor to Hawai'i, died while paragliding over Kualoa Ranch on the island of Oahu.[1] At a height of 1,000 to 1,500 feet, the lines connecting him to the canopy simultaneously broke, and Wheelock plunged to his death.[2] As in most recreational activity settings,[3] Wheelock's use of the paragliding facilities and equipment was preconditioned upon his signing a waiver releasing Kualoa Ranch, from liability for any injuries which might result from paragliding.[4] When Wheelock's widow

---

[1] *See* Wheelock v. Sports Kites, Inc., 839 F. Supp. 730, 733 (D. Haw. 1993).

[2] *See id.*

[3] *See id.* at 735. The release that Wheelock signed "was the sort commonly used in recreational settings." *Id.*; *see also e.g.*, Saenz v. Whitewater Voyages, Inc., 276 Cal. Rptr. 672, 673 (App. 1990)(noting that decedent signed a "Release and Assumption of Risk Agreement prior to whitewater rafting); Coates v. Newhall Land & Farming, Inc., 236 Cal. Rptr. 181 (App. 1987)(noting that decedent voluntarily signed a "release" prior to entering the dirt bike park); Boyce v. West, 862 P.2d 592 (Wash. App. 1993)(noting that student was required to sign "Affirmation and Liability Release" prior to participating in scuba diving course); Harbert v. Po'oku Stables, Inc., No. 19933, slip op. (Haw. App. May 14, 1997)(noting that plaintiffs were presented with form releases to sign upon arrival at horse stables).

[4] *See Wheelock*, 839 F. Supp. at 733.

sued the activity company that sold the paragliding excursion to the decedent, a court for the first time in Hawai'i in a recreational setting, considered whether an express release of liability bars all claims of negligence.[5]

Hawai'i courts have traditionally permitted individuals to waive negligence claims absent a public interest.[6] The court's ruling in *Wheelock* was no exception.[7] Despite a standard fairly well-grounded in common law and clearly articulated in *Wheelock*, increased litigation and rising insurance premiums drove activity providers in Hawai'i to seek legislation aimed at decreasing their liability and validating releases.[8] Activity providers pooled their resources and lobbied the Hawai'i State Legislature to enact a bill recognizing releases for negligence liability.[9] Ironically, the statute enacted[10]

---

[5] *See id.* at 734-36.

[6] *See id.* at 736 (citing Krohnert v. Yacht Sys. Haw., Inc., 4 Haw. App. 190, 198, 664 P.2d 738, 744 (1983)(citing RESTATEMENT (SECOND) OF CONTRACTS § 195 cmt. a (1981); 15 WALTER H.E. JAEGER, WILLISTON ON CONTRACTS § 1750A (3d ed. 1972)). Most courts also agree, however, that contracting out of negligence is not favorable, and where possible, such agreements should not be construed to confer immunity. *See* JAEGER, supra, § 1750A.

[7] *See Wheelock*, 839 F. Supp. at 736.

[8] *See Supplemental Testimony to H.B. No. 581 (S.D. 1), A Bill for an Act Relating to Tort Liability: Before the House Comm. on the Judiciary*, 19th Leg., Reg. Sess. (Haw. 1997) [hereinafter *Supplemental Testimony to H.B. No. 581*] (written testimony of Mike and Julie Turkington, owners, Zip-Purr Catamaran Charters)("We know that the passing of this bill will ease the huge liability burden we as a small business are now experiencing. This bill is greatly needed for our small business to survive . . . ."); *Supplemental Testimony to H.B. No. 581, supra* (written testimony of Randolph S. Coon, co-founder, Trilogy Excursions)("[S]mall business represents the economic engine of Hawaii. And yet, we [activity owners] are continually under attack from either an avalanche of regulatory paper work, or, from a steady stream of nuisance Law Suits. . . . Those of us out here in the trenches need [the legislature's] help!"); *Supplemental Testimony to H.B. No. 581, supra* (written testimony of Toni Marie Davis, Pride Charters, Inc.)("Our insurance has gone from $38K in 1992 to $69K annually . . . due mostly to sue crazy attorney's [sic]. . . . If allowed to continue, it will end up running our business out of business.").

An additional reason for clarification on the validity of releases might have been that Hawai'i courts are not bound by the federal standard set forth in *Wheelock*. *See* Rana v. Bishop Ins. of Haw., Inc., 6 Haw. App. 1, 10, 713 P.2d 1363, 1369-70 (1985)("[T]he [state] courts are the final arbiters of the State's own law[.] Thus, 'we are not bound by the federal . . . court's interpretation of our statutes.'")(alterations in original and citations omitted).

[9] *AOA Successfully Passes Liability Tort Reform Bill: Liability Waivers to Be Upheld by Hawaii State Law*, COCONUT WIRELESS (Activity Owners Association of Hawai'i (AOA), Maui, HI), 1997 at 1 (on file with author). AOA represents 135 activity provider businesses in Hawai'i. Their newsletter claimed a "legislative victory" on behalf of its members after eight of its members submitted testimony in favor of House Bill 581 which would become Hawai'i's new Recreational Activity Liability Statute, Hawaii Revised Statute ("HRS") § 663-1.54. *See id.*; *see also infra* notes 137-142 and accompanying text.

[10] HAW. REV. STAT. § 663-1.54 (Supp. 1998)(applying to causes of action based on acts or omissions occurring after June 30, 1997).

at the backing of those recreational companies not only falls short of its goal, but actually places those corporations in a less advantageous legal position than did *Wheelock* and other critical Hawai'i cases applicable to recreational activity liability and assumption of risk.[11]

For example, the statute defines a provider's continuing duty to ensure the safety of its patrons and the public in the absence of a very narrowly defined valid waiver.[12] The statute allows only inherent risks to be waived[13] and precludes providers from obtaining valid waivers of liability for negligence, as traditionally permitted by common law.[14] The statute also precludes summary judgment determination of waiver validity by requiring that a trier of fact determine whether a risk is "inherent."[15] Ultimately, this legislation, enacted at the behest of activity providers, will likely increase the cost of litigation, and consequently the cost of recreational activities, without any substantial safety benefits accruing to consumers.[16]

The newly-expanded recreational industry liability has the potential to seriously impact the economy in the state of Hawai'i. As an island state

---

[11] *See* discussion *infra* Part II (explaining the pre-statute case law in Hawai'i) & Part IV (analyzing the potential impacts of the statute).

[12] *See* H.R. STAND. COM. REP. NO. 98, 19th Leg., Reg. Sess. (1997), *reprinted in* 1997 HAW. HOUSE J. 1155.

Section 1(a) of HRS § 663-1.54 provides:

> Any person who owns or operates a business providing recreational activities to the public, such as, without limitation, scuba or skin diving, sky diving . . . shall exercise reasonable care to ensure the safety of patrons and the public and shall be liable for damages resulting from negligent acts or omissions of the person which cause injury.

HAW. REV. STAT. § 663-1.54(1)(a).

[13] The narrow definition of "inherent risk" in HRS § 663-1.54 specifically excludes risks resulting from the negligence of the activity provider and allows liability for inherent risks (other than negligence) to be released only with a proper waiver, upon full disclosure, and if reasonable care is given. *See* HAW. REV. STAT. § 663-1.54(b), (c).

[14] *Compare* HAW. REV. STAT. § 663-1.54(1)(a) *with* Tancredi v. Dive Makai Charters, 823 F. Supp. 778 (D. Haw. 1993), *overruled on other grounds by* McClenahan v. Paradise Cruises, Ltd., 888 F. Supp. 120 (D. Haw. 1995). The court in *Tancredi* held:

> Although *defendants generally have no legal duty to eliminate* (or protect a plaintiff against) *risks inherent in the sport* itself, it is well established that defendants generally do have a duty to use due care not to increase the risks to a participant over and above those inherent in the sport.

Id. at 789 (citing Knight v. Jewett, 834 P.2d 696 (Cal. 1992))(emphasis added). The new statute, however, specifically states that providers "*shall exercise reasonable care to ensure the safety of patrons . . . and shall be liable for damages resulting from negligent acts . . . .*" HAW. REV. STAT. § 663-1.54(1)(a) (emphasis added). In defining the providers' duty to patrons and liability for negligence, and by specifically excluding negligence from the definition of inherent risks, the new statute ignores the holding in *Wheelock* which allowed express waivers of provider negligence. *See Wheelock*, 839 F. Supp. at 736.

[15] *See* HAW. REV. STAT. § 663-1.54(c).

[16] *See infra* notes 203-23 and accompanying text.

renown for its incomparable beaches, mountains, surf, and trade winds, Hawai'i hosts an estimated 6.8 million tourists each year.[17] Those tourists spend an estimated eleven billion dollars, making tourism the most lucrative industry in the state.[18] The natural features that attract tourists to the state of Hawai'i also provide tourists with activities such as scuba diving, mountain biking, hangliding, whitewater rafting, surfing, windsurfing, horseback riding, kayaking, parasailing, and much more. These tourist activities generate revenue in excess of 800 million dollars per year for the businesses operating to provide these activities.[19]

On July 1, 1997, Hawai'i's new recreational activity liability law took effect.[20] This statute was intended to promote and encourage recreational business activity in the state of Hawai'i.[21] The potential for this new law to have a converse effect on the industry prompts this closer look at the issue of recreational activity liability in Hawai'i.[22]

This Comment analyzes the new statute in light of pre-existing case law, highlighting the changes and identifying the possible impacts. Part II begins with an examination of common law prior to the passage of the Recreational Activity Liability Statute,[23] and the circumstances which led the legislature to propose a statutory solution.[24] Part III then describes the new statute and its intended scope and requirements.[25] Part IV analyzes the statute's potential impact upon recreational activity liability in Hawai'i.[26] The Comment concludes by identifying unresolved issues and offering modest recommendations for change.[27]

---

[17] *See* DEPT. OF BUSINESS, ECONOMIC DEVELOPMENT AND TOURISM, 1997 STATE OF HAWAII DATA BOOK, 195 (1997).

[18] *See id.* at 215, 355. The industry generates more than 160,000 jobs. *See id.* at 215.

[19] *See Supplemental Testimony to H.B. No. 581*, *supra* note 8, (written testimony of Jan Pinney, Executive Director, Activity Owner's Association of Hawaii).

[20] *See* HAW. REV. STAT. § 663-1.54.

[21] H.R. STAND. COM. REP. NO. 98, 19th Leg., Reg. Sess. 3 (1997), *reprinted in* 1997 HAW. HOUSE J. 1155. "Your committee believes that clarifying the liability of owners and operators of recreational activities and allowing voluntary written waivers to limit that liability will promote and encourage recreational business activity in the State." *Id.*

[22] This statute has the potential to increase insurance premiums due to greater liability. *See* discussion *infra* section IV. Increasing liability and insurance costs in an industry that generates $800 million per year in visitor revenue is cause to re-examine the issue of recreational liability.

[23] HAW. REV STAT. § 663-1.54. *See infra* notes 35-113 and accompanying text.

[24] *See infra* notes 114-36 and accompanying text.

[25] *See infra* notes 137-70 and accompanying text.

[26] *See infra* notes 171-227 and accompanying text.

[27] *See infra* notes 228-35 and accompanying text.

II. PRE-STATUTE RECREATIONAL ACTIVITY LIABILITY

Responsibility for recreational risks has traditionally been apportioned between the participant and the provider under negligence law.[28] An activity provider's legal duty of care owed to a participant has often been relieved under the common law principle *volenti fit non injuria*—one who consents cannot be injured.[29] This doctrine, also known as assumption of risk, holds that "one who takes part in [a risky activity] accepts the dangers that inhere in it so far as they are obvious and necessary" and is precluded from recovering for injuries which may result.[30] Although at common law assumption of risk relieves a provider of any duty to protect the participant from inherent risks and affords waivers of negligence, courts have gradually increased the duty of care owed by providers.[31] The exposure to increased liability has prompted activity providers throughout the United States to lobby their legislatures for protection from the onerous burdens judicially imposed.[32] The doctrine of assumption of risk has confused attorneys, courts, and law professors for some time, in part because it "has been used by the courts in several different senses, which traditionally have been lumped together under the one name, often without realizing that any differences exist."[33] The doctrines most often used to analyze and apportion recreational activity liability include: primary implied, secondary implied, and express assumption of risk.[34]

---

[28] *See* Cathy Hanson & Steve Duerr, *Recreational Injuries & Inherent Risks: Wyoming's Recreation Safety Act*, 28 LAND & WATER L. REV. 149, 150 (1993).

[29] BLACK'S LAW DICTIONARY 1746 (4th ed. 1968).

[30] Murphy v. Steeplechase Amusement Co., 166 N.E. 173, 174 (1929)(holding that a plaintiff could not recover for an injury sustained on a ride at an amusement park). Judge Cardozo held that the plaintiff assumed the risk of his injuries "just as a fencer accepts the risk of a thrust by his antagonist or a spectator at a ball game the chance of contact with the ball." *Id.* at 174 (citations omitted). He continued:

> The antics of the clown are not the paces of the cloistered cleric. The rough and boisterous joke, the horseplay of the crowd, evokes its own guffaws, but they are not the pleasures of tranquillity. The plaintiff was not seeking a retreat for meditation. Visitors were tumbling about the belt to the merriment of onlookers when he made his choice to join them. He took the chance of a like fate, with whatever damage to his body might ensue from such a fall. *The timorous may stay at home.*

Id. (emphasis added).

[31] *See* Hanson & Duerr, *supra* note 28, at 151.

[32] *See id.* at 152.

[33] W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 68 (5th ed. 1984); *see also* Hanson & Duerr, *supra* note 28, at 164.

[34] *See* KEETON ET AL. *supra* note 33, § 68; *see also* Hanson & Duerr, *supra* note 28, at 164 ("Comparative negligence laws have contributed to the continued confusion between the inherent risk doctrine and the secondary assumption of risk.").

A. Implied Assumption of Risk

Under common law, courts have relieved activity providers of legal liability for injury to patrons under the doctrine of implied assumption of risk.[35] In one of the first cases to apply this doctrine, a patron at an amusement park stood in line at a ride, observing those before him laughing, falling, and having fun.[36] Asserting the common law principle *violenti non fit injuria*,[37] the court determined that when it was his turn, he knowingly consented to the risk that he too would fall.[38] In other words, the patron *implicitly* waived any liability on the part of the ride operator.[39] This doctrine of implied assumption of risk has produced two distinct theories under which a defendant may avoid liability: primary[40] and secondary.[41]

In a recreational activity setting, primary implied assumption of risk exists when the plaintiff participates voluntarily and reasonably in an activity he

---

[35] For a complete description of primary implied assumption of risk for recreational sports in Hawai'i, see Tancredi v. Dive Makai Charters, 823 F. Supp. 778, 788 (D. Haw. 1993), *overruled on other grounds by* McClenahan v. Paradise Cruises, Ltd., 888 F. Supp. 120 (D. Haw. 1995)(stating that although the defense of primary implied assumption of risk is still applicable in an appropriate recreational case, it did not apply in *Tancredi*).

[36] *See* Murphy v. Steeplechase Amusement Co., 166 N.E. 173, 174 (N.Y. 1929). The ride, known as "the Flopper," was a moving belt running upward on an incline. Passengers sitting or standing on the belt, unable to keep their balance, were thrown backward and aside into padded walls. *See id.* at 173-74.

[37] Literally, "[One] who consents cannot [be injured]." BLACK'S LAW DICTIONARY 1746 (4th ed. 1968).

[38] *See Murphy*, 166 N.E. at 174.

[39] *See id.*

[40] *See Tancredi*, 823 F. Supp. at 787. Primary assumption of risk involves a two-prong test in deciding whether to negate the defendant's liability: 1) whether the defendant owed a legal duty to protect the plaintiff from the particular risk of harm that caused the injury; and 2) whether the defendant voluntarily and deliberately exposed himself to the risk. *See id.* at 788. It arises where:

> [T]he plaintiff voluntarily enters into some relation with the defendant, with the knowledge that the defendant will not protect him against one or more future risks that may arise from the relation. He may then be regarded at tacitly or *impliedly* consenting to the negligence, and agreeing to take his own chances.

KEETON, *supra* note 33, § 68.

[41] *See Tancredi*, 823 F. Supp. at 788. Secondary implied assumption of risk analyzes whether the plaintiff's conduct was unreasonable, and compares the plaintiff's reasonableness to the defendant's fault to determine relative responsibilities in apportioning contributory negligence. *See id.* at 790; *see also* KEETON ET AL., *supra* note 33, § 68. Secondary implied assumption of risk arises where "plaintiff is aware of a risk that has already been created by the negligence of the defendant, yet chooses voluntarily to proceed to encounter it." *Id.*

knows to involve risk.[42] "It is an alternate expression of the proposition that a defendant owes no duty to a plaintiff."[43] If a defendant can successfully show that the plaintiff reasonably assumed a known risk, the plaintiff is precluded from proving a breach of duty.[44] Primary assumption of risk is thus a complete defense, barring any recovery.[45]

Secondary implied assumption of risk, also known as unreasonable assumption of risk, focuses on the plaintiff's conduct and whether the plaintiff unreasonably encountered a known danger.[46] This doctrine has merged with comparative negligence in jurisdictions such as Hawai'i that have rejected the old common law doctrine that contributory negligence bars any recovery.[47] Now, unreasonable assumption of risk merely serves to decrease the damage award by the plaintiff's percentage of fault, rather than completely barring recovery.[48]

Tancredi v. Dive Makai Charters[49] illustrates the distinction between primary and secondary implied assumption of risk. While on vacation in Hawai'i in June of 1988, Louis Tancredi booked a chartered dive with Dive

---

[42] *See* Larsen v. Pacesetter Sys., Inc., 74 Haw. 1, 35, 837 P.2d 1273, 1290 (1992); *see also Tancredi*, 823 F. Supp. at 788.

> The court has considered the position taken by California courts that the defense of primary implied assumption of the risk survived the adoption of California's comparative negligence statute, the position of the Hawai'i Supreme Court in *Larsen*, and Hawai'i's comparative negligence statute, and believes that the Hawai'i Supreme Court would allow the defense in an appropriate sports-related case."

Tancredi, 823 F. Supp. at 788.

[43] *Larsen*, 74 Haw. at 35, 837 P.2d at 1290 (citing RESTATEMENT (SECOND) OF TORTS § 496A cmt. c (1965); Meistrich v. Casino Arena Attractions, Inc., 155 A.2d 90, 93 (N.J. 1959)) (cited in *Tancredi*, 823 F. Supp. at 788).

[44] *See Larsen*, 74 Haw. at 35, 837 P.2d at 1290.

[45] *See id.*

[46] *See id.*

[47] *See id.* For a discussion on the abolition of the defense of assumption of risk, see generally KEETON, *supra* note 33, § 68; Hanson & Duerr, *supra* note 28, at 164.

Many question whether assumption of risk survived the adoption of comparative negligence in Hawai'i. *See Larsen*, 74 Haw. at 36, 837 P.2d at 1291. The Hawai'i Supreme Court clarified that even though "the doctrine has been criticized as duplicative of more widely understood concepts such as duty and as adding 'nothing to modern law except confusion,'" "express assumption of risk is essentially contractual in nature and does not conflict with the basic concept of apportionment under comparative fault involving negligence and thus did survive the merger with comparative negligence and is available as a separate defense that may bar plaintiff's recovery in tort." *Id.* (citing KEETON ET AL., *supra* note 33, § 68; A. BEST, COMPARATIVE NEGLIGENCE LAW § 4.20[2] (1992)).

[48] *See Larsen*, 74 Haw. at 36, 837 P.2d at 1291.

[49] 823 F. Supp. 778, 778 (D. Haw. 1993), *overruled on other grounds by* McClenahan v. Paradise Cruises, Ltd., 888 F. Supp. 120 (D. Haw. 1995).

Makai Charters.[50] Tancredi was certified in basic open-water diving, and had minimal experience diving in Hawai'i.[51] The dive planned by Dive Makai was the "Deep Reef," a dive suitable only for experienced divers because of the depth and complexity of the dive.[52] Tancredi, nevertheless, joined the dive party.[53] During the dive, Tancredi experienced difficulty in breathing when he ran out of air 120 feet below the surface.[54] This was probably due to an inadequate supply of air, combined with nitrogen narcoses,[55] both attributable to lack of experience.[56] Tancredi panicked, ultimately became hypoxic and unconscious, and eventually died.[57]

The court in *Tancredi* noted that "[t]he Hawai'i Supreme Court has not yet addressed implied assumption of risk, either secondary or primary, in the context of recreational sports."[58] Although the Hawai'i Supreme Court had abolished primary assumption of risk in strict products liability cases and implied warranty actions for personal injury,[59] the court in *Tancredi* predicted that the state supreme court would allow the defense in an appropriate sports-related case.[60] Because Tancredi had not knowingly and reasonably assumed

---

[50] *See id.* at 781.

[51] *See id.*

[52] *See id.*

[53] *See id.*

[54] *See id.*

[55] Nitrogen narcosis is a condition that often occurs in deep water diving; it often manifests in a state of euphoria and disorientation where a person may act irrationally and be unable to perform the simplest of tasks such as writing their own name. Experienced divers learn to recognize and avoid the effects of becoming "narked," whereas an inexperienced diver may panic. Likewise, an inexperienced diver will have a tendency to breath more rapidly and irregularly and thus use up prematurely what, for an experienced diver, would be an adequate air supply. *See* INTERNATIONAL PADI, INC., PADI OPEN WATER DIVER MANUAL 190 (Drew Richardson ed., 1990).

[56] *See Tancredi*, 823 F. Supp. at 782.

[57] *See id.* Hypoxia is a condition that exists when oxygen is not reaching the tissues of the body. *See* MERRIAM-WEBSTERS COLLEGIATE DICTIONARY 572 (10th ed. 1993). Tancredi was hypoxic because he had used up his air supply, becoming unconscious as a result. *See Tancredi*, 823 F. Supp. at 782.

[58] *Tancredi*, 823 F. Supp. at 788.

[59] *See* Larsen v. Pacesetter Sys., Inc., 74 Haw. 1, 36, 837 P.2d 1273, 1291 (1992).

[60] *See Tancredi*, 823 F. Supp. at 788. The emphasis on the "appropriateness" of the case is consistent with the California Supreme Court's decision in *Knight v. Jewett*, 834 P.2d 696 (Cal. 1992). Regarding the application of implied assumption of risk in the sports setting, the court in *Knight* said:

> [C]onditions or conduct that otherwise might be viewed as dangerous often are an integral part of the sport itself. Thus, although moguls on a ski run pose a risk of harm to skiers that might not exist were these configurations removed, the challenge and risks posed by the moguls are part of the sport of skiing, and a ski resort has no duty to eliminate them. In this respect, the nature of a sport is highly relevant in defining the duty of care owed by the particular defendant.

the risk of the defendant's negligence, primary implied assumption of risk was not applicable.[61]

The federal district court in Hawai'i held that the provider was negligent for not inquiring into Tancredi's qualifications, not informing him of PADI[62] and NAUI[63] recommendations against diving to that depth, not providing him with enough air, not assigning him a buddy, and inadequately planning the dive.[64] The court explained that Tancredi could not have voluntarily assumed the risks of the dive because he had not been fully informed.[65] As such, the defense of primary implied assumption of risk was inapplicable.[66] As a fairly inexperienced diver, he could not completely understand or appreciate the inherent dangers of the type of dive that caused his death.[67] Because his decision was not fully informed, it could not be considered one hundred percent voluntary.[68] As an unreasonable assumption of risk, it fell into the category of secondary implied assumption of risk, and thus, comparative negligence principles applied.[69] The court found Tancredi to be twenty percent contributorily negligent and reduced the damage award accordingly.[70]

Thus, whether a patron completely assumes liability for the risk of injury or only partially assumes liability for those risks depends entirely on a court's determination of whether the patron acted reasonably in participating in the activity. Without the benefit of hindsight, a provider may have difficulty ensuring that a patron is acting reasonably under the circumstances. To avoid ambiguous risk assumption, parties may expressly agree to allocate liability for risk to the patron.[71]

Knight, 834 P.2d at 708.

[61] *See infra* text accompanying notes 68-70.

[62] PADI (Professional Association of Diving Instructors) is the world's largest diver training organization. They establish standards for diver training, train and certify instructors, and provide support and services to its members. *See* INTERNATIONAL PADI, INC., PADI OPEN WATER DIVER MANUAL 3 (Drew Richardson ed., 1990).

[63] NAUI (National Association of Underwater Instructors) is the world's second largest diver training organization whose functions are essentially the same as PADI's. *See supra* note 62; *Tancredi*, 823 F. Supp. at 786.

[64] *See Tancredi*, 823 F. Supp. at 782.

[65] *See id.* at 789-90.

[66] *See id.*

[67] *See id.*

[68] *See id.*

[69] *See id.*

[70] *See id.*

[71] *See* KEETON ET AL., *supra* note 33, § 68.

B. Express Assumption of Risk

Express releases of liability that assign the risk of injury to the participant are prevalent in recreational activities.[72] Rarely does a bungee jumper pay to be strapped to a giant rubber band and flung more than 200 feet without signing something first. The release usually states that if the participant is injured or killed, he or she will not hold responsible the company supplying him or her the equipment and assistance.[73] This is true for whitewater rafters,[74] skiers,[75] sky divers,[76] scuba divers,[77] and most other participants in high-risk sports.[78] Recreational activity providers require releases as a method of allocating risk to the customer and relieving themselves of the costs of personal injury.[79] Prior to the enactment of Hawai'i's Recreational Activity Liability Statute, these types of waivers were generally considered valid in the absence of a valid contractual defense.[80] Without some type of release from liability, businesses providing these types of activities would soon fail.[81]

Hawai'i is no stranger to risk-taking thrill-seekers.[82] Island recreation providers commonly seek signed releases.[83] Although the Hawai'i Supreme Court had not yet ruled on the validity of waivers in recreational settings, at

---

[72] *See supra* note 3.

[73] *See* Noreen L. Slank, *The Evolving Tort Law of Participant Sports*, 75 MICH. B.J. 238, 238 (1996).

[74] *See, e.g.*, Krazek v. Mountain River Tours, Inc., 884 F.2d 163 (4th Cir. 1989); Saenz v. Whitewater Voyages, Inc., 276 Cal. Rptr. 672 (Ct. App. 1990).

[75] *See, e.g.*, Ford v. Gouin, 834 P.2d 724 (Cal. 1992)(en banc)(water skiing); Korsmo v. Waverly Ski Club, 435 N.W.2d 746 (Iowa Ct. App. 1988)(water skiing); Harmon v. Mt. Hood Meadows Ltd., 932 P.2d 92 (Or. Ct. App. 1992)(snow skiing).

[76] *See, e.g.*, Jones v. Dressel, 623 P.2d 370 (Colo. 1981); Schutkowski v. Carey, 725 P.2d 1057 (Wyo. 1986).

[77] *See, e.g.*, Madison v. Superior Court, 250 Cal. Rptr. 299 (Ct. App. 1988); Mann v. Wetter, 785 P.2d 1064 (Or. Ct. App. 1990); Boyce v. West, 862 P.2d 592 (Wash. Ct. App. 1993); Hewitt v. Miller, 521 P.2d 244 (Wash. Ct. App. 1974).

[78] *See* cases cited *supra* note 3; *see also* Chieco v. Paramarketing, Inc., 643 N.Y.S.2d 668 (1996)(paragliding).

[79] *See* KEETON ET AL., *supra* note 33, § 68.

[80] *See* Wheelock v. Sports Kites, Inc., 839 F. Supp. 730, 735 (D. Haw. 1993).

[81] *See* Korsmo v. Waverly Ski Club, 435 N.W.2d 746 (Iowa Ct. App. 1988)(granting defendant's summary judgment motion based on release signed by plaintiff prior to a water-skiing tournament in which plaintiff was injured)(citing Dunn v. Paducah Int'l Raceway, 599 F. Supp. 612, 6131 (W.D. Ky. 1984)).

[82] Of the 11 billion dollars per year generated by tourism in the State of Hawai'i, 800 million dollars is generated by the recreation activity industry. *See supra* notes 17 and 19 and accompanying text.

[83] *See* Wheelock, 839 F. Supp. at 736; *see also Supplemental Testimony to H.B. No. 581*, *supra* note 8 (written testimony of Jan Pinney, Executive Director, Activity Owner's Association of Hawaii and Toni Marie Davis, Pride Charters, Inc.).

the time the statute was enacted, the federal district court in *Wheelock* had affirmatively held that waivers of liability for injuries from recreational activities were valid and enforceable.[84] As the first and only reported case to examine the validity of recreational activity liability waivers in Hawai'i, *Wheelock*, and its articulation of the common law standard for waivers at the time of the statute's enactment, is instructive.[85]

Prior to paragliding over Kualoa Ranch, David Wheelock signed a waiver releasing the provider from liability for any injuries that might result from the activity. When Wheelock's widow sued, the court granted defendant's motion for summary judgment, rejecting the notion that the public interest was at stake and concluding that Wheelock could, and did, waive his right to sue.[86] His widow was barred from bringing any claims of negligence.[87] The court held, however, that an agreement which releases a defendant from liability for actions which are *grossly* negligent is contrary to the public interest and, therefore, invalid.[88] The court further restricted the validity of releases, explaining that risks falling outside of the reasonable expectations of the releasing party may also render a release unenforceable under the doctrine of unconscionability.[89]

Even when waivers are formally drafted and executed, their validity may be subject to challenge on several grounds: 1) whether they are void as against public policy;[90] 2) whether the releasor knew and understood the risk being assumed;[91] and 3) whether the waiver was clear and unambiguous as to what was being waived.[92] As a result of court challenges to the validity of waivers, many activity providers in Hawai'i believe that waivers are not enforceable.[93] Despite their disbelief in the legal validity of those waivers, providers

---

[84] *See Wheelock*, 839 F. Supp. at 736.

[85] *See id.*

[86] *See id.* (citing Saenz v. Whitewater Voyages, Inc., 276 Cal. Rptr. 672 (Ct. App. 1990)); *see also* Madison v. Superior Court, 250 Cal. Rptr. 299 (Ct. App. 1988). The court in *Madison* stated that scuba diving does not involve a question of public interest any more than does motorcross racing, sky diving, or motorcycle dirtbike riding. *See id.* at 305-06.

[87] *See Wheelock*, 839 F. Supp. at 736.

[88] *See id.* Summary judgment was denied as to Wheelock's claims for gross negligence and strict liability, as the court held that the release was void as to those claims. *See id.* at 739.

[89] *See id.* at 735.

[90] *See infra* notes 99-102 and accompanying text.

[91] *See infra* note 104 and accompanying text

[92] *See* 4 FOWLER V. HARPER ET AL., THE LAW OF TORTS, § 21.6 (2d ed. 1986).

[93] *See Supplemental Testimony to H.B. No.* 581, *supra* note 8 (written testimony of Toni Marie Davis, Pride Charters, Inc.)("We've been told . . . [a waiver is] not worth the paper it's written on.").

continue to execute releases to deter injured participants from seeking legal recourse.[94]

A typical liability release waiver is all-inclusive with a description of any and all possible risks followed by language such as the following:

> I hereby RELEASE AND DISCHARGE [the activity provider] . . . from any and all liability, claims, demands or causes of action that I may have for injuries and damages arising out of my participation in [the recreational activity], including but not limited to, losses CAUSED BY THE NEGLIGENCE OF THE RELEASED PARTIES.
>
> 2. I further agree that I WILL NOT SUE OR MAKE A CLAIM against the Released Parties for damages or other losses sustained as a result of my participation in [the recreational activity].
>
> 3. I understand and acknowledge that [the recreational activity has] inherent dangers that no amount of care, caution, instruction, or expertise can eliminate and I EXPRESSLY AND VOLUNTARILY ASSUME ALL RISK OF DEATH OR PERSONAL INJURY SUSTAINED WHILE PARTICIPATING IN [THE RECREATIONAL ACTIVITY] WHETHER OR NOT CAUSED BY THE NEGLIGENCE OF THE RELEASED PARTIES.
>
> . . . .
>
> 5. I hereby expressly recognize that this Agreement & Release of Liability is a contract pursuant to which I have released any and all claims against the Released Parties . . . .
>
> . . . .
>
> I HAVE READ THIS AGREEMENT & RELEASE OF LIABILITY, FULLY UNDERSTAND ITS CONTENTS AND MEANING, AND SIGN IT OF MY OWN FREE WILL.[95]

---

[94] *See id.* Activity providers hope that signing a waiver deters suits as much as it prevents adverse outcomes. Even if activity providers are successful in defending a waiver, the filing of the suit alone is costly for the provider. *See id.*

[95] Wheelock v. Sports Kites, Inc., 839 F. Supp. 730, 733 (D. Haw. 1993)(emphasis in original)(citing the waiver signed by the deceased in *Wheelock*). This waiver is comparable to the waiver used by PADI (Professional Association of Diving Instructors) which was referred to in testimony from Activity Owners Association to Senate Committee on Judiciary of 2/18/97. *See Supplemental Testimony to H.B. No. 581*, *supra* note 8 (written testimony of Jan Pinney, Executive Director, Activity Owner's Association of Hawaii). This waiver is also similar to many of the waivers cited in the cases throughout this Comment. *See, e.g.*, Krazek v. Mountain River Tours, Inc., 884 F.2d 163 (4th Cir. 1989)(whitewater rafting); Saenz v. Whitewater Voyages, Inc., 276 Cal. Rptr. 672 (Ct. App. 1990)(whitewater rafting); Madison v. Superior Court, 250 Cal. Rptr. 299 (Ct. App. 1988)(scuba diving); Coates v. Newhall Land & Farming, 236 Cal. Rptr. 181 (Ct. App. 1987)(dirt bike riding); Jones v. Dressel, 623 P.2d 370 (Colo. 1981)(parachuting); Harmon v. Mt. Hood Meadows Ltd., 932 P.2d 92 (Or. Ct. App. 1992)(snow skiing); Mann v. Wetter, 785 P.2d 1064 (Or. Ct. App. 1990)(scuba diving); Boyce v. West, 862 P.2d 592, 596 (Wash. Ct. App. 1993)(scuba diving); Hewitt v. Miller, 521 P.2d 244, 245

Participants who sign waivers may nonetheless recover damages for personal injuries if they can invalidate their release of liability. Exculpatory clauses are contractual in nature and are subject to customary contract analysis.[96] When interpreting the contract, courts will take into account the intent of the parties.[97] Intent alone, however, is not controlling. Exculpatory clauses are strictly construed against the promisee and are not enforced if the promisee enjoys a bargaining power superior to the promisor and the enforcement would be contrary to public policy.[98]

An agreement, such as a waiver, may be contrary to public policy if it unfairly requires a person with little bargaining power to undertake unreasonable risks which the person did not fully understand.[99] Although recreational releases are often adhesion contracts,[100] they are generally not void on public policy grounds.[101] Participants in recreational activities are generally aware of what they are undertaking and, because it is usually spelled out in the agreement they sign, courts generally do not find such express agreements to be unconscionable or against public policy.[102] Likewise, courts generally take into account the fact that participants have a choice as to whether they will participate in an activity, and thus, courts are not likely to

---

(Wash. Ct. App. 1974)(scuba diving); Schutkowski v. Carey, 725 P.2d 1057 (Wyo. 1986) (skydiving).

[96] *See* Larsen v. Pacesetter Sys., Inc., 74 Haw. 1, 36, 837 P.2d 1273, 1291 (1992)(citing KEETON ET AL., *supra* note 33, § 68; BEST, *supra* note 47, § 4.20[2]).

[97] *See* Hohe v. San Diego Unified Sch. Dist., 274 Cal. Rptr. 647, 651 (Ct. App. 1990)(stating "[w]hether a release bars recovery against a negligent party 'turns primarily on contractual interpretation, and it is the intent of the parties as expressed in the agreement that should control'"); *see also infra* note 104 and accompanying text.

[98] *See* Krohnert v. Yacht Sys. Hawaii, Inc., 4 Haw. App. 190, 199, 664 P.2d 738, 744 (1983)(citing Lynch v. Santa Fe Nat'l Bank, 627 P.2d 1247, 1249 (N.M. 1981))(some citations omitted); *see also* Pacific Adventures, Inc. v. Tropical Hydro Inc., 5 F. Supp. 2d 874 (1998) *clarified by* 27 F. Supp. 1223 (1998)(holding that "Hawai'i law permits [a] release from liability for ordinary negligence, but [not for gross negligence].").

[99] *See* 4 HARPER, *supra* note 92, § 21.6.

[100] Recreational liability releases are often on standardized forms, offered to participants on a "take it or leave it" basis without affording the participant the opportunity to bargain. Generally signing the contract is a precondition to participation. *See generally* BLACK'S LAW DICTIONARY 40 (6th ed. 1990); *see also Wheelock*, 839 F. Supp. at 735.

[101] *See Wheelock*, 839 F. Supp. at 735 ("Adhesion contracts are fully enforceable provided that they are not unconscionable and do not fall outside the reasonable expectation of the weaker or adhering party."); *see also supra* notes 87-89 and accompanying text.

[102] *See* Madison v. Superior Court, 250 Cal. Rptr. 299, 304-05 (Ct. App. 1988); Korsmo v. Waverly Ski Club, 435 N.W.2d 746, 749 (Iowa Ct. App. 1988); Boyce v. West, 862 P.2d 592, 596 (Wash. Ct. App. 1993); Blide v. Rainier Mountaineering, Inc., 636 P.2d 492, 493 (Wash. App. 1981), *review denied*, 96 Wash. 2d 1027 (1982); Hewitt v. Miller, 521 P.2d 244, 245 (Wash. Ct. App. 1974).

decide that there has been coercion or duress.[103] In order for a release to be valid in Hawai'i, however, the released party must show that the participant knows and understands the risk he is assuming and "unequivocally" agrees to waive the provider's liability for that risk.[104]

Aside from challenging waivers with the procedural contract defenses, there are substantive arguments for the invalidity of waivers as well.[105] Courts vary on what is waivable in a recreational activity release.[106] Most agree,[107] however, that a distinction should be made between waiving liability for simple negligence[108] and waiving liability for gross negligence.[109] Although Hawai'i state courts have not addressed the issue of whether a party can contract away liability for his own gross negligence, the federal district court in *Wheelock* predicted that the Hawai'i Supreme Court would decide that potential tortfeasors may contract out of simple negligence,[110] but may not contract out of gross negligence, as that would be contrary to public interest.[111]

---

[103] *See Madison*, 250 Cal. Rptr. at 304-05; *Korsmo*, 435 N.W.2d at 749; *Boyce*, 862 P.2d at 596; *Hewitt*, 521 P.2d at 245.

[104] *See Wheelock*, 839 F. Supp. at 738 (citing Krohnert v. Yacht Systems Hawai'i, 4 Haw. App. 190, 200, 664 P.2d 738, 744-45 (1983)). *Krohnert* held that for an exculpatory clause to be enforceable, it is the burden of the activity provider to assure that the consumer is aware of what he is signing and that he has a reasonable understanding of the risk to which he consents. *See id.* In some jurisdictions, there is no subjective understanding requirement; all that is required is a signature on the waiver. *See, e.g.*, Coates v. Newhall Land & Farming, 236 Cal. Rptr. 181 (Ct. App. 1987); *Korsmo*, 435 N.W.2d at 749; Lee v. Allied Sports Assocs., Inc., 209 N.E.2d 329 (Mass. 1965); Church v. Seneca County Agric. Soc'y, 341 N.Y.S.2d 45 (App. Div. 1973).

[105] The distinction between procedural and substantive challenges may be likened to the analysis of unconscionability, where substantive issues are focused on the unreasonable terms of the contract, and procedural issues are those which involve the manner in which the contract was executed. *See* E. ALLEN FARNSWORTH, CONTRACTS § 4.28 (2d ed. 1990).

[106] *See* cases cited *infra* note 112.

[107] *See id.*

[108] Simple negligence is the "failure to use such care as a reasonably, prudent, and careful person would use under similar circumstances." *Wheelock*, 839 F. Supp. at 736.

[109] Gross negligence implies a "failure to perform a manifest duty in reckless disregard of consequences." *See id.*

See also, e.g., Saenz v. Whitewater Voyages, Inc., 276 Cal. Rptr. 672 (Ct. App. 1990); Harmon v. Mt. Hood Meadows, 932 P.2d 92 (Or. Ct. App. 1997); Newman v. Tropical Visions, Inc., 891 S.W.2d 713 (Tex. Ct. App. 1994); Boyce v. West, 862 P.2d 592 (Wash. Ct. App. 1993).

[110] *See Wheelock*, 839 F. Supp. at 736 (citing *Krohnert* v. Yacht Sys. Hawaii Inc., 4 Haw. App. 190, 664 P.2d 738 (1983).

[111] *See id.*; *see also* Pacific Adventures, Inc. v. Tropical Hydro, Inc., 5 F. Supp. 2d 874 (D. Haw. 1998), *clarified by* 27 F. Supp. 2d 1223 (D. Haw. 1998)(holding that the waiving of gross negligence is contrary to public policy and invalidating a release on that basis). The federal district court in *Pacific Adventures* also concluded that, under Hawai'i law, because the language of the release did not manifest an intention by the parties to sever the contract, the

The rules of law set forth in *Wheelock* that have been followed by Hawai'i courts to date are consistent with the holdings in many similar cases in other jurisdictions.[112] Across the United States, courts have consistently held that recreational activity providers can contract out of liability for personal injuries where the participant expressly agrees to assume legal liability for his or her risk.[113]

C. Perceived Industry Crisis: The Context for Change

Increased litigation and rising insurance premiums drove activity providers in Hawai'i to seek legislative protection, despite fairly well-grounded common law defenses to liability.[114] When Hawai'i's recreational activity liability statute was being considered, some members of the industry doubted whether waivers were valid at all;[115] others believed that the cost of proving the validity of waivers was too high.[116] In any case, the activity industry was

---

entire release was invalid, including the portion that waived ordinary negligence. *See id.*

[112] *See, e.g.*, Krazek v. Mountain River Tours, Inc., 884 F.2d 163, 166 (4th Cir. 1989)(whitewater rafting); *Saenz*, 276 Cal. Rptr. at 678 (whitewater rafting); Madison v. Superior Court, 250 Cal. Rptr. 299, 301 (Ct. App. 1988)(scuba diving); Coates v. Newhall Land & Farming, 236 Cal. Rptr. 181, 182 (Ct. App. 1987)(dirt bike riding); Heil Valley Ranch, Inc., v. Simkin, 784 P.2d 781, 785 (Colo. 1990)(horseback riding); Korsmo v. Waverly Ski Club, 435 N.W.2d 746, 749 (Iowa Ct. App. 1988)(water skiing); Lee v. Allied Sports Assocs., Inc., 209 N.E.2d 329, 333 (Mass. 1965)(car racing); Church v. Seneca County Agric. Soc'y, 341 N.Y.S.2d 45, 47-48 (App. Div. 1973)(car racing); Mann v. Wetter, 785 P.2d 1064, 1066 (Or. Ct. App. 1990)(scuba diving); *Newman*, 891 S.W.2d at 715 (scuba diving); Scott v. Pacific West Mountain Resort, 834 P.2d 6, 16 (Wash. 1992)(skiing); *Boyce*, 862 P.2d at 596 (scuba diving); Hewitt v. Miller, 521 P.2d 244, 245 (Wash. Ct. App. 1974)(scuba diving); Milligan v. Big Valley Corp., 754 P.2d 1063, 1069 (Wyo. 1988)(skiing); Schutkowski v. Carey, 725 P.2d 1057, 1058 (Wyo. 1986)(skydiving).

[113] *See* cases cited *supra* note 112.

[114] *See Supplemental Testimony to H.B. No. 581*, *supra* note 8 (written testimony of Randolph S. Coon, co-founder, Trilogy Excursions)("[S]mall business represents the economic engine of Hawaii. And yet, we [activity owners] are continually under attack from . . . a steady stream of nuisance Law Suits . . . Those of us out here in the trenches need [the legislature's] help!"); *Supplemental Testimony to H.B. No. 581*, *supra* note 8 (written testimony of Toni Marie Davis, Pride Charters, Inc.)("Our insurance has gone from $38K in 1992 to $69K annually . . . due mostly to sue crazy attorney's [sic] . . . If allowed to continue, it will end up running our business out of business.").

[115] *See Supplemental Testimony to H.B. No. 581*, *supra* note 8 (written testimony of Toni Marie Davis, Pride Charters, Inc.)("We currently do utilize a waiver . . . [though] it's not worth the paper its written on. We use in hopes that is will be defer [sic] passengers from suing.").

[116] *See Supplemental Testimony to H.B. No. 581*, *supra* note 8 (written testimony of Jan Pinney, Executive Director, Activity Owner's Association of Hawaii)("In our 'sue now - get the facts later' society, many providers find themselves embroiled in liability lawsuits that have little or no merit but cost the provider thousands of dollars to hire lawyers to address.").

dissatisfied with the level of protection afforded providers under common law, and urged a legislative solution.[117]

The fear of being run out of business due to rising insurance premiums and litigation costs is justified.[118] In the climbing industry, "one of the oldest and most respected equipment manufacturers" was forced into bankruptcy by the pressure of lawsuits and the corresponding rise in insurance premiums.[119] The Sierra Club suspended all mountaineering activities due to an increase in the cost of liability insurance.[120] Many of the rafting companies in Colorado were closed or sold due to rising liability costs.[121] Companies providing horseback riding,[122] ice skating,[123] bungee jumping,[124] and skateboarding[125] have all been forced to close due to rising insurance premiums and litigation costs.

The state of Hawai'i is certainly not the first to address this issue legislatively.[126] More than half of all states have legislation in place to allocate the responsibilities between recreational providers and participants.[127]

---

[117] *See AOA Successfully Passes Liability Tort Reform Bill: Liability Waivers to Be Upheld by Hawaii State Law*, COCONUT WIRELESS (Activity Owners Association of Hawai'i (AOA), Maui, Haw.), 1997 at 1 (on file with author)("The AOA can claim another legislative victory . . . [the new recreational activity liability statute] is an exciting legislative milestone which will help to protect activity provider business from frivolous lawsuits and hopefully begin to strengthen the industry's position to eventually lower liability insurance premiums.").

[118] *See* Donald P. Judges, *Of Rocks and Hard Places: The Value of Risk Choice*, 42 EMORY L.J. 1, 31-32 (1992). The Sierra Club stopped all mountaineering activities in 1988 due to a $325,000 increase in liability insurance following several climbing accidents that resulted in law suits. *See id.* (citations omitted). "[N]one of the 250 or so parachute dropzones in the country was able to obtain liability insurance" in 1987. *Id.* (citations omitted). Rising costs of liability insurance were responsible for the closure of 40% of the white-water rafting companies in Colorado. *See id.* (citations omitted). The same is true of bungee jumping, horseback riding, and non-thrill sports as well. *See id.*

[119] *See* Judges, *supra* note 118, at 30 n.90 (citing Denise Hamilton, *In Wake of 4 Suits, Chouinard Seeks Chapter 11*, L.A. TIMES, May 23, 1989, at E9).

[120] *See id.* at 30 n.92 (citing Bettina Boxall, *Climbing Insurance Cited; Ban on Mountaineering Causes Rift in Sierra Club*, L.A. TIMES, Feb. 17, 1989, at 1).

[121] *See id.* at 31 n.97 (quoting Marcia Chambers, *Whatever Happened to the Sandlot?*, NAT'L L.J., Apr. 22, 1991, at 16).

[122] *See id.* at 32 n.108 (citing Elena Brunet & Susan D. Greene, *Stable Situation*, L.A. TIMES (Orange County ed.), Jan. 18, 1990, at N2).

[123] *See id.* at 32 n.109 (citing Steve Parks, *Ice Skating's HOT6Go Figure*, NEWSDAY, Nov. 29, 1991, at 92).

[124] *See id.* at 32 n.99 (citing *For Thrills, Lovers and Others Leap*, N.Y. TIMES, July 31, 1991, at A13; Matt Lait, *Leap or Faith; Bungee Jumping Offers New Thrill by Stretching the Limits of Daredevilty*, L.A. TIMES, Aug. 6, 1990, at B1).

[125] *See id.* at 32 n.111 (citing John Geis, *Things People Do*, L.A. TIMES, July 7, 1990, at C11A).

[126] *See* Hanson & Duerr, *supra* note 28, at 167 (analyzing similar statutes in effect across the country).

[127] *See id.*

Most statutes addressing the allocation of recreational activity liability deal with a specific activity, such as skiing.[128] Only three states, aside from Hawai'i, have enacted legislation addressing recreational activity liability generally.[129] Slightly fewer than half of all states, including California, rely on common law doctrines to allocate risk and liability in recreational activities.

Some scholars identify the decision in *Sunday v. Stratton Corp.*[130] as the turning point that undermined activity providers' faith in the validity of waivers and sent them in search of legislative relief.[131] In *Sunday*, the Vermont Supreme Court affirmed an award of 1.5 million dollars in favor of a plaintiff who sustained injuries when he fell over snow-covered brush while skiing on the defendant's property.[132] The Vermont Supreme Court boldly stated, "the timorous no longer need stay at home."[133] In truth, the Vermont court's ruling recognized and acknowledged the assumption of risk doctrine.[134] The court simply refused to hold that the snow covered brush, over which the plaintiff tripped, was an inherent risk.[135]

The confusion surrounding the various assumption of risk doctrines and their application in recreational activity settings, together with rising costs of insurance premiums, easily explains the activity industry's desire for clarification. In this context and with the belief that common law protections in Hawai'i were inadequate, the recreational activity industry urged the Hawai'i state legislature to clarify the duty of activity providers and to allow voluntary written waivers in order to limit their exposure to liability. Hawai'i's Recreational Activity Liability Statute[136] was the result.

---

[128] *See id.*

[129] *See* WYO. STAT. ANN. 1-1-122 (a)(iii) (Michie Supp. 1991); VT. STAT. ANN. tit. 12, § 1037 (1973 & Supp. 1991); WIS. STAT. § 895.525 (2) (1991).

[130] 390 A.2d 398 (Vt. 1978).

[131] *See, e.g.*, Hanson & Duerr, *supra* note 28, at 161-62.

[132] *Sunday*, 390 A.2d at 400.

[133] *Id.* at 402. Perhaps the perception that the assumption of risk doctrine was no longer valid may be explained by this statement by the Vermont Supreme Court. It is precisely opposite that said by Cardozo in 1929: "[t]he timorous may stay at home." Murphy v. Steeplechase Amusement Co., 166 N.E. 173, 174 (N.Y. 1929); *see also supra* note 37 and accompanying text.

[134] *See Sunday*, 390 A.2d at 403.

[135] *See id.* Instead, the court determined that the defendant in the case had assumed an obligation to protect its participants from such risks by its representations that the novice ski trail was meticulously groomed and had top quality cover. *See id.* Furthermore, the provider, by cultivating a world-wide reputation for its trail maintenance, had assumed the duty to either remove the snow covered brush or warn against it. *See id.*; *see also* Hansen & Duerr, *supra* note 28, at 161.

[136] HAW. REV. STAT. § 663-1.54 (Supp. 1998).

III. HAWAI'I'S RECREATIONAL ACTIVITY LIABILITY STATUTE

A. *Legislative History*

On April 29, 1997, the Hawai'i State Legislature passed the Recreational Activity Liability Statute.[137] This statute is the result of pressures from the recreational activity industry, represented by its state-wide association: Activity Owners Association of Hawai'i ("AOA").[138] The motive of the AOA, as evidenced in the testimony from the association's members,[139] was to grant

---

[137] HAW. REV. STAT. § 663-1.54 provides in full:

> (a) Any person who owns or operates a business providing recreational activities to the public, such as, without limitation, scuba or skin diving, sky diving, bicycle tours, and mountain climbing, shall exercise reasonable care to ensure the safety of patrons and the public, and shall be liable for damages resulting from negligent acts or omissions of the person which cause injury.
>
> (b) Notwithstanding subsection (a), owners and operators of recreational activities shall not be liable for damages for injuries to a patron resulting from inherent risks associated with the recreational activity if the patron participating in the recreational activity voluntarily signs a written release waiving the owner or operator's liability for damages for injuries resulting from the inherent risks. No waiver shall be valid unless:
>
> (1) The owner or operator first provides full disclosure of the inherent risks associated with the recreational activity; and
>
> (2) The owner or operator takes reasonable steps to ensure that each patron is physically able to participate in the activity and is given the necessary instruction to participate in the activity safely.
>
> (c) *The determination of whether a risk is inherent or not is for the trier of fact.* As used in this section an "inherent risk":
>
> (1) Is a danger that a reasonable person would understand to be associated with the activity by the very nature of the activity engaged in;
>
> (2) Is a danger that a reasonable person would understand to exist despite the owner or operator's exercise of reasonable care to eliminate or minimize the danger, and is generally beyond the control of the owner or operator; and
>
> (3) Does not result from the negligence, gross negligence, or wanton act or omission of the owner or operator.

Id. (emphasis added).

[138] *See also AOA Successfully Passes Liability Tort Reform Bill: Liability Waivers to Be Upheld by Hawaii State Law*, COCONUT WIRELESS (Activity Owner's Association of Hawai'i (AOA), Maui, HI), 1997 at 1 (on file with author)(describing its role in the passing of this legislation, the AOA newsletter stated: "The AOA can claim another legislative victory on behalf of its members and the activity industry in the State of Hawaii.").

[139] *See Supplemental Testimony to H.B. No. 581*, *supra* note 8 (written testimony of, Jan Pinney, Executive Director, Activity Owner's Association of Hawaii)("Activity Owners Association of Hawaii represents over 135 activity provider businesses in the state. The industry provides services to millions of visitors per year on a wide variety of air, land, and sea activities adding to their enjoyment of our destination . . . [the industry] is responsible generating over $800 million per year of visitor revenue for the State."); *Supplemental Testimony to H.B. No. 581*, *supra* note 8 (written testimony of Randolph S. Coon, co-founder,

greater protection from frivolous lawsuits,[140] thereby lowering the continually escalating liability insurance premiums.[141] The legislature believed that clarifying the liability of the recreational activity industry by establishing the legal effect of voluntary written waivers would promote and encourage recreational business activity in the state by limiting the industry's exposure to liability.[142]

B. Recreational Activity Liability Defined

The Recreational Activity Liability Statute defines the liability of all businesses providing recreational activities to Hawai'i's public.[143] The statute became effective on July 1, 1997, and applies only to causes of action based on acts or omissions that occur on or after that date.[144] Although the statute

---

Trilogy Excursions)("[S]mall business represents the economic engine of Hawaii. And yet, we [activity owners] are continually under attack from either an avalanche of regulatory paper work, or, from a steady stream of nuisance Law Suits.... Those of us out here in the trenches need [the legislature's] help!"); *Supplemental Testimony to H.B. No. 581*, *supra* note 8 (written testimony of Toni Marie Davis, Pride Charters, Inc.)("Our insurance has gone from $38K in 1992 to $69K annually... due mostly to sue crazy attorney's [sic]... If allowed to continue, it will end up running our business out of business.").

[140] *See Supplemental Testimony to H.B. No. 581*, *supra* note 8 (written testimony of Jan Pinney, Executive Director, Activity Owner's Association of Hawaii)("In our 'sue now - get the facts later' society, many providers find themselves embroiled in liability lawsuits that have little or no merit but cost the provider thousands of dollars to hire lawyers to address."); *Supplemental Testimony to H.B. No. 581*, *supra* note 8 (written testimony of Cindy Roehne, Administrative Manager, Maui-Molokai Sea Cruises)("There needs to be some measure of protection for the activity owner/operator... this legislation... protects many owners/operators of activities from unfair lawsuits.").

[141] *See Supplemental Testimony to H.B. No. 581*, *supra* note 8 (written testimony of Mango Mitch, Owner, Mango Mitch Ecotours)("I encourage the Senate to pass [the bill which, if enacted,]... would help lower our escalating industry insurance premiums."); *Supplemental Testimony to H.B. No. 581*, *supra* note 8, (written testimony of Toni Marie Davis, Pride Charters, Inc.)("Our insurance has gone from $38K in 1992 to $69K annually.... due mostly to sue crazy attorney's [sic]... [i]f allowed to continue, it will end up running our business out of business.... [p]lease stop it before it stops us.").

[142] *See* H.R. STAND. COMM. REP. NO. 98, Committee on Economic Development and Business, 19th Leg., Reg. Sess. (1997), *reprinted in* 1997 HAW. HOUSE J. 1155 ("[C]larifying the liability of owners and operators of recreational activities and allowing voluntary written waivers to limit that liability will promote and encourage recreational business activity in the State."); H.R. STAND. COMM. REP. NO. 753, Committee on the Judiciary, 19th Leg., Reg. Sess. (1997), *reprinted in* 1997 HAW. HOUSE J. 1401-02 ("[L]iability insurance is one of the single most expensive costs of operating a recreational activity business. This bill limits the exposure to liability of recreational activity providers....").

[143] *See* HAW. REV. STAT. § 663-1.54(a) (Supp. 1998).

[144] *See id.* § 663-1.54.

enumerates certain recreational activities,[145] it does so without limitation.[146] Those enumerated include scuba or skin diving, sky diving, bicycle tours, and mountain climbing.[147]

The duty owed by the recreational activity industry, as set forth in the statute, extends to patrons and to the public and requires the exercise of reasonable care to ensure safety.[148] The providers' duty exists irrespective of the execution of an express waiver by the participant.[149] Liability for inherent risks only may be waived if the person participating in the activity voluntarily signs a written release of the provider's liability for those inherent risks.[150] Because the statute's definition of inherent risks excludes negligent acts or omissions, the provider remains liable where damages result from its own negligent acts or omissions, even if the participant signed a waiver.[151] Moreover, a provider who obtains a waiver for inherent risks must ensure that the waiver is given voluntarily[152] and that the inherent risks are fully disclosed in the waiver in order for the waiver to be valid.[153] The statute also provides that the waiver is not valid unless the provider takes reasonable steps to ensure that the patron is physically able to participate and is given the necessary instruction for safe participation.[154]

---

[145] *See id.* § 663-1.54(a).

[146] *See id.* Under the doctrine of *ejusdem generis*, the words in section (a) of the statute "such as, without limitation," mean that the body of recreational activity businesses to which this statute applies is greater than those enumerated, but can only include recreation activities of "like" class or kind as those enumerated. BLACK'S LAW DICTIONARY 517 (6th ed. 1990).

[147] *See* HAW. REV. STAT. § 663-1.54(a).

[148] *See id.*

[149] *See id.*

[150] *See id.* § 663-1.54(b)(1).

[151] *See id.* § 663-1.54(c)(3). It is unclear whether the damages discussed in section (b) are for only injuries to a patron or to the public as well. Section (b) specifically refers to "damages for injuries to a patron" as being waivable by express release. The Conference Committee Report that acknowledges a change in the language of the statute does not shed any light on whether the legislators intended that liability extend only to patrons, or whether the industry was not liable only when patrons executed voluntary waivers. *See* H.R. AND SEN. CONF. COMM. REP. NO. 29, 19th Leg., Reg. Sess. (Haw. 1997), *reprinted in* 1997 HAW. SEN. J. 861, *also reprinted in* 1997 HAW. HOUSE J. 1049. The language of the statute, prior to amendment by committee did not specify to whom damages applied in either section (a) or (b). *See* SEN. STAND. COMM. REP. NO. 1537, Committee on the Judiciary, 19th Leg., Reg. Sess. (Haw. 1997), *reprinted in* 1997 HAW. SEN. J. 1476.

[152] *See supra* text accompanying notes 99-104.

[153] *See* HAW. REV. STAT. § 663-1.54(b)(1). This is consistent with the waiver requirement under *Wheelock* and *Krohnert* that only a known risk can be assumed. *See* Wheelock v. Sport Kites, Inc., 839 F. Supp. 730, 735 (D. Haw. 1993); Krohnert v. Yacht Sys. Hawaii, Inc., 4 Haw. App. 190, 200, 664 P.2d 738, 745 (1983).

[154] *See* HAW. REV. STAT. § 663-1.54(b)(2). This portion of the statute is likely to be construed as ambiguous. The legislature gives no guidance as to what constitutes reasonable

Although activity providers may be released from liability for those risks which are inherent in the activity,[155] the determination of whether a risk is inherent in an activity is to be made by a trier of fact.[156] Thus, the determination of what risks activity providers may be relieved from will not occur until long after a waiver is signed and an individual is injured. However, the statute limits inherent risk to that which a reasonable person would understand to be dangerous based on the very nature of the activity.[157] That danger must exist beyond the control of the provider and in spite of the provider's reasonable care to eliminate or minimize it.[158] Importantly, a provider's negligent, grossly negligent, or wanton act or omission cannot be an inherent risk of a recreational activity.[159] This signifies that the traditional common law rule that liability for negligence can be waived has been abrogated by the statute.

C. Unprecedented Liability

Hawai'i's statute is unlike any other recreational activity liability statute, although intended modeling other jurisdictions was what the industry arguably intended.[160] The statute is unique because it specifically addresses written waivers.[161] Enactments in other states address the assumption of inherent risks in general terms to include implied consent to inherent risks.[162]

Generally, two statutory approaches have been used to address the definition of inherent risks in recreational activities.[163] "Under the first approach, the legislature defines the legal duty and the scope of inherent risks, or both, and the trier of fact decides factual issues. . . . Under the second approach, the judge determines the legal duty and scope of inherent risks and

---

steps to ensure physical capabilities. The "reasonable" requirement might be construed as a question of fact to be determined at trial, requiring all waivers in which there was a question regarding the physical characteristics of the plaintiff to be examined at trial, rather than be upheld on summary judgment. *See* discussion *infra* section IV.C.

[155] *See* HAW. REV. STAT. § 663-1.54(b).

[156] *See id.* § 663-1.54(c). This requirement in the statute is unique to Hawai'i civil statutes, as well as unique to other recreational statutes.. A Westlaw search of all statutes nationwide turned up no language identical or similar to "to be determined by the trier of fact."

[157] *See id.* § 663-1.54(c)(1).

[158] *See id.* § 663-1.54(c)(2).

[159] *See id.* § 663-1.54(c)(3).

[160] *Supplemental Testimony to H.B. No. 581*, *supra* note 8 (written testimony of Jan Pinney, Executive Director, Activity Owner's Association of Hawaii)(noting the existence of other statutes and proven waivers, and stating: "We don't need to reinvent the wheel . . . .").

[161] *See* HAW. REV. STAT. § 663-1.54(b). *See* Hanson & Duerr, *supra* note 28, at 167-68.

[162] *See* Hansen & Duerr, *supra* note 28, at 167-68.

[163] *See id.* at 168.

the trier of fact decides factual issues."[164] The first approach is more common in statutes which apply to only one specific activity, such as skiing, or horseback riding.[165] Where a statute encompasses all recreational activities, such as Hawai'i's, it is not as feasible for the legislature to define the scope and definition of "inherent risk" comprehensively.[166] Only three other states have attempted to cover all recreational activities in a single statutory scheme.[167] Among these states, Hawai'i's statute is unique because it addresses waivers specifically,[168] and although it uses the judicial approach (as opposed to legislative) for determining inherent risks,[169] it assigns the determination of "inherent risk" specifically to the trier of fact in apparently all instances, rather than assigning the responsibility to the judge as a matter of law.[170]

IV. IMPACT OF HAWAI'I'S RECREATIONAL ACTIVITY LIABILITY STATUTE

Hawai'i courts have yet to interpret the recreational activity liability statute. Until they do, the effects the statute may have on the activity industry and tourism cannot be known. The goals of the industry and the legislature, however, are not likely to be realized. The purpose of the statute was to clarify activity provider liability and, if anything, to limit it.[171] In reality, however, the statute seems to place a higher standard of care on activity providers than that which previously existed.[172] Although the statute does validate waivers under narrowly defined circumstances, the statute precludes the waiving of negligence.[173] Furthermore, inherent risks, which may be validly waived under the statute, may be determined only by the trier of fact, effectively precluding summary judgment.[174] Without summary disposition

---

[164] *Id.* Wyoming, Vermont, and Pennsylvania are the only states that allow the courts to determine the scope of inherent risks. *See id.* Hawai'i has joined them but inherent risks are currently to be determined by the trier of fact rather than the judge. *See* HAW. REV. STAT. § 663-1.54(c).

[165] *See* Hansen & Duerr, *supra* note 28, at 168.

[166] *See id.*

[167] *See* WYO. STAT. ANN. 1-1-122(a)(iii) (Supp. 1991); VT. STAT. ANN. tit. 12, § 1037 (1973 & Supp. 1991); WIS. STAT. § 895.525(2) (1991).

[168] *See supra* note 125.

[169] *See supra* note 128 and accompanying text.

[170] *See* HAW. REV. STAT. § 663-1.54(c) (Supp. 1998); *see also* discussion *infra* section IV.C.

[171] *See* discussion *supra* section III.A.

[172] *See* discussion *infra* section IV.A.

[173] *See* discussion *infra* section IV.B.

[174] *See* HAW. REV. STAT. § 663-1.54(c); *see also* discussion *infra* section IV.B.

of claims, the intent to reduce litigation by giving legal effect to waivers is lost and increased costs for all parties is ensured.[175]

A. Increased Liability For Activity Providers

Prior to the enactment of the statute, activity providers in Hawai'i generally had no legal duty to eliminate risks inherent in the sport or activity which they provided, but did have a duty to use due care not to increase those risks.[176] The statute heightens the duty activity providers owe to their patrons.[177] This is despite the fact that the statute was intended to limit the liability of providers.[178] Activity providers are required by the new statute to "exercise reasonable care to ensure the safety of patrons and the public."[179] Furthermore, providers are also statutorily liable for their own negligent acts and omissions.[180] In the absence of a validly executed waiver, the statutorily imposed duty appears to require activity providers to keep patrons and the public safe even from inherent risks.[181]

---

[175] *See infra* note 178 and accompanying text; discussion *infra* section IV.B.

[176] *See* Tancredi v. Dive Makai Charters, 823 F. Supp. 778, 789 (D. Haw. 1993), *overruled on other grounds by* McClenahan v. Paradise Cruises, Ltd., 888 F. Supp. 120 (D. Haw. 1995) (citing Knight v. Jewett, 834 P.2d 696, 708 (Cal. 1992))(recognizing that reckless conduct by others in sport can be inherent in the activity). The court in *Knight* held that a participant in a social game of touch football had no legal duty to protect the plaintiff from reckless play. *See Knight*, 834 P.2d at 789 (cited *in Tancredi*, 823 F. Supp. at 779).

[177] *See* HAW. REV. STAT. § 663-1.54(a) ("Any person who owns or operates a business providing recreation activities to the public, . . . *shall exercise reasonable care to ensure the safety of patrons and the public*, and shall be liable for damages resulting from negligent acts or omissions of the person which cause injury.").

[178] H.R. STAND. COM. REP. No. 753, 19th Leg., Reg. Sess. 3 (1997), *reprinted in* 1997 Haw. HOUSE J. 1401-02.

> This bill limits the exposure to liability of recreational activity providers by recognizing that participants have a duty to take responsibility for their own actions when participating in an activity. By signing a release waiving an owner's or operator's liability for damages for injuries resulting from participation in certain inherently risky recreational activities, patrons acknowledge those risks and accept responsibility for their actions. This bill establishes the legal effect of such waivers.

Id.

[179] *See* HAW. REV. STAT. § 663-1.54(1)(a).

[180] *See id.* § 663-1.54(1)(a) & (b). "[Activity providers] shall be liable for damages resulting from negligent acts or omissions of the [activity provider] which cause injury." *Id.*

[181] *See id.* § 663-1.54(1)(a). Section (a) creates a duty of care, section (b) provides that "notwithstanding" the duty in section (a), providers shall not be liable for inherent risks if a valid waiver is executed. Thus, the plain reading of the statute reveals that if no waiver is executed, liability for inherent risks exists.

The effect this heightened duty will have on providers depends, in part, on whether the defense of assumption of risk survives the statute.[182] If an activity provider still can be relieved of its statutory duty by a patron's reasonable assumption of risk, then the heightened duty may have no effect at all.[183] Courts, however, are generally unwilling to make decisions which give the language of a statute no effect at all.[184] On the other hand, if assumption of risk is no longer a viable defense under the statute, the heightened standard of care would significantly increase the liability of providers.[185] The activity providers' duty of care under the statute could only be relieved as to inherent risks with the execution of a valid waiver.[186]

B. Inherent Risks Can Be Waived; Negligence Cannot

The recreational activity liability statute acknowledges the limited validity of liability waivers,[187] but the limitations that it places on waivers make them less likely to be enforceable than they were prior to the enactment of the statute.[188] For example, only risks inherent in the activity may be waived.[189] The definition of inherent risk specifically excludes risks resulting from the negligence of the owner or operator.[190] The elimination of negligence as an inherent risk appears to negate the validity of any waiver which releases liability for negligence.[191]

---

[182] The statute and its legislative history are silent on the applicability of the assumption of risk doctrine. Whether assumption of risk can survive the statute will depend on whether Hawai'i courts choose to allow the defense in recreational activity cases. *See supra* notes 58-60 and accompanying text.

[183] Any duty the statute places on the activity provider could be effectively assumed under the doctrine of assumption of risk. *See supra* notes 42-45 and accompanying text.

[184] *See, e.g.*, Keliipuleole v. Wilson, 85 Hawai'i 217, 221, 941 P.2d 300, 304 (1997)("[C]ourts are bound to give effect to all parts of a statute, and . . . no clause, sentence, or word shall be construed as superfluous, void, or insignificant if a construction can be legitimately found which will give force to and preserve all words of the statute.")(citations omitted); Gatri v. Blane, 88 Hawai'i 108, 114, 962 P.2d 367, 373 (1998)("A fundamental principle of statutory construction is that 'courts are bound to give effect to all parts of a statute . . . .'")(citations omitted); *see also, e.g.*, Young v. Planning Comm'n, 89 Hawai'i 400, 407, 974 P.2d 40, 47 (1999).

[185] *See supra* text accompanying notes 171-75; *see also* discussion *supra* section II.A.-B.

[186] *See supra* notes 35-70 and accompanying text.

[187] *See* HAW. REV. STAT. § 663-1.54(b) (Supp. 1998).

[188] *See Wheelock*, 839 F. Supp. 730 (D. Haw. 1993). See discussion *supra* section II.A., for what was enforceable prior this statute; see discussion *supra* section III.B. for limitations on waivers.

[189] *See* HAW. REV. STAT. § 663-1.54(b).

[190] *See* § 663-1.54(a).

[191] A defendant may argue that the statute is silent as to waiving negligence and thus common law applies. However, a plaintiff may just as well argue that the legislature specifically

Although exculpatory clauses are "generally disfavored" by the courts,[192] activity providers in Hawai'i have traditionally been able to exempt themselves from liability for harm caused by their own negligence.[193] Wheelock waived negligence.[194] The PADI waiver, presented to the legislature as evidence of what works in the industry, waives negligence.[195] Almost all enforceable waivers in recreational settings waive liability for negligence on the part of the provider.[196]

Commentators have argued that negligence is one of the inherent risks of a dangerous sport.[197] Participants, in fact, choose these activities precisely

---

did not authorize waivers of negligence, thereby making clear their intent. The elimination of negligence from inherent risks supports the plaintiff's assertion.

[192] *See* Krohnert v. Yacht Sys. Hawaii, Inc., 4 Haw. App. 190, 198, 664 P.2d 738, 744 (1983)(citing Great Am. Ins. Co. v. Bureau Veritas, 338 F. Supp. 999, 1010 n.6 (S.D.N.Y 1972)).

[193] *See id.* (citing 15 JAEGER, *supra* note 6, § 1750A).

[194] *See* Wheelock v. Sports Kites, 839 F. Supp. 730, 733 (D. Haw. 1993).

[195] *Supplemental Testimony to H.B. No. 581*, *supra* note 8 (written testimony of Jan Pinney, Executive Director, Activity Owners Association of Hawaii)("[PADI] has developed a standardized . . . release . . . . we don't need to reinvent the wheel . . . .").

The standarized release developed by PADI includes the following language:

> I . . . hereby affirm that I have been advised and informed of the inherent hazards of scuba diving . . . I understand and agree that neither my instructor(s), the facility through which I receive my instruction, nor International PADI, Inc. . . . may be held liable or responsible in any way for any injury, death, or other damages to me or my family, heirs, or assigns that may occur as a result of my participation in this diving program *or as a result of the negligence of any party, including the Released Parties, whether passive or active.*

"Discover Scuba Diving Liability Release and Express Assumption of Risk" form required by PADI of all activity providers and participants utilizing PADI's Discover Scuba Course (emphasis added)(copy on file with author).

[196] *See, e.g.*, Krazek v. Mountain River Tours, Inc., 884 F.2d 163, 166 (4th Cir. 1989)(whitewater rafting); Saenz v. Whitewater Voyages, Inc., 276 Cal. Rptr. 672, 678 (Ct. App. 1990)(whitewater rafting); Madison v. Superior Court, 250 Cal. Rptr. 299, 301 (Ct. App. 1988)(scuba diving); Coates v. Newhall Land & Farming, 236 Cal. Rptr. 181, 182 (Ct. App. 1987)(dirt bike riding); Heil Valley Ranch, Inc. v. Simkin, 784 P.2d 781, 785 (Colo. 1990)(horseback riding); Korsmo v. Waverly Ski Club, 435 N.W.2d 746, 749 (Iowa Ct. App. 1988)(water skiing); Lee v. Allied Sports Assocs., Inc., 209 N.E.2d 329, 333 (Mass. 1965)(car racing); Church v. Seneca County Agric. Soc'y, 341 N.Y.S.2d 45, 47-48 (App. Div. 1973)(car racing); Mann v. Wetter, 785 P.2d 1064, 1066 (Or. Ct. App. 1990)(scuba diving); Newman v. Tropical Visions, Inc., 891 S.W.2d 713, 715 (Tex. App. 1994)(scuba diving); Scott v. Pacific W. Mountain Resort, 834 P.2d 6, 16 (Wash. 1992)(skiing); Boyce v. West, 862 P.2d 592, 596 (Wash. Ct. App. 1993)(scuba diving); Hewitt v. Miller, 521 P.2d 244, 245 (Wash. Ct. App. 1974)(scuba diving); Milligan v. Big Valley Corp., 754 P.2d 1063, 1069 (Wyo. 1988)(skiing); Schutkowski v. Carey, 725 P.2d 1057, 1058 (Wyo. 1986)(skydiving).

[197] *See, e.g.*, Judges, *supra* note 118, at 106.

> A moment's reflection shows that at least in one sense, all skydiving, rock climbing, flying, and scuba diving students or participants inevitably take the risk that their

because risk is involved.[198] "The decision to take such [risks] is an integral part of the experience."[199] Legislators have chosen to ignore the possibility that, as an inherent risk, negligence may be valued as a choice.[200]

Counter to the consideration of risk as a choice is the concern for public safety. Although the legislature was concerned with the liability of the provider, the safety of patrons and public was also at issue.[201] However, despite the good intentions of any legislature to preserve public safety, a recreational injury that could not in some way be blamed on negligence is hard to imagine.[202] If plaintiffs are successful in arguing that negligence can no longer be waived, the effect of the statute proposed by the industry and passed unanimously by the legislature will leave activity providers vulnerable to liability for their own negligence where they otherwise would not have been.

C. Jury Determination of "Inherent Risk" May Eliminate Summary Judgment

After heightening the duties of activity providers and preventing the release of liability for negligence, the statute does recognize valid waivers of inherent

---

> instructors, guides, or outfitters will make a mistake that could lead to serious injury or death. Even the accomplished instructor can have a momentary lapse of attention . . . .

Id.

[198] *See generally* Judges, *supra* note 118 (evaluating the value of the choice of risk in recreational activities). Even in 1929, people were choosing risk. In Cardozo's words: "There would have been no point to the whole thing, no adventure about it, if the risk had not been there." Murphy v. Steeplechase Amusement Co., 166 N.E. 173, 174 (N.Y. 1929); *see also* Karl Taro Greenfeld, *Life on the Edge: Is Everyday Life Too Dull? Why Else Would Americans Seek Risk As Never Before?*, TIME, Sept. 6, 1999, at 29.

[199] Judges, *supra* note 118, at 27.

[200] *See generally*, Judges, *supra* note 118 (analyzing the value of risk choice in recreational activities).

[201] *See* SEN. STAND. COMM. REP. No. 1537, Committee on Judiciary, 19th Leg., Reg. Sess. (1997), *reprinted in* 1997 HAW. SEN. J. 1476 ("[I]t is the intent of your committee that this clarification in the law will appropriately reduce frivolous suits without increasing risks to participants.").

[202] For example, the plaintiff in *Wheelock v. Sports Kites, Inc.*, 839 F. Supp. 730 (D. Haw. 1993), could have pointed to defendant's negligence in failing to maintain equipment (despite the inherent risk of equipment failure); the plaintiff in *Tancredi v. Dive Makai*, 823 F. Supp. 778 (D. Haw. 1993), *overruled on other grounds by* McClenahan v. Paradise Cruises, Ltd., 888 F. Supp. 120 (D. Haw. 1995), pointed to negligence in planning the dive according to the plaintiffs qualifications (despite the facts that (1) it is ultimately every certified diver's respon-sibility to monitor their dive plans and (2) diving at any depth has the inherent risk of drowning from lack of air). *See also, e.g.*, Halpern v. Wheeldon, 890 P.2d 562 (Wyo. 1995)(reversing the trial court's determination that "getting thrown off and falling from a horse is an inherent risk in riding any horse," and holding that genuine issues of material fact remained as to whether defendant could have provided better assistance or training in mounting the horse).

risks.[203] Unfortunately, the determination of whether a risk is inherent is now statutorily assigned to the trier of fact.[204] This assignment by legislators not only muddles the roles of judge and jury, but also virtually ensures that there will always be a genuine issue of material fact, effectively eliminating summary disposition of waiver validity.

Under the statute, the activity providers are not liable for inherent risks that are validly waived.[205] Their standard of care—or duty—is dependent on whether an inherent risk has been waived. The determination of whether a risk is inherent must be made by the trier of fact, typically the jury in personal injury trials.[206] However, the existence and scope of legal duties has traditionally been determined by courts as a matter of law in the early stages of litigation.[207] By requiring the trier of fact to determine what is considered an inherent risk, the legislature has effectively turned over the analysis of duty to juries, muddling the distinction between law and fact.[208] Although this confusion between law and fact (or judge and jury) may be considered by

---

[203] *See* HAW. REV. STAT. § 663-1.54(b) (Supp. 1998).

[204] *See id.* § 663-1.54(c).

[205] *See id.* § 663-1.54(b).

[206] *See* THOMAS A. MAUET, TRIAL TECHNIQUES 14 (1996)("Plaintiff's lawyers in personal injury cases usually demand jury trials on the theory that most of their cases have emotional appeal; thus, a jury in such a case is more likely to find liability and award substantial damages, while a judge who has heard it all before will have a more detached view of the evidence and take a harder look at the issues of liability and pain and suffering damages.").

[207] Matters of law are often determined at the pre-trial stage in the form of summary judgment motions. Once it is determined by the court that a duty exists, as a matter of law, the trier of fact (whether jury or judge) determines whether that duty has been breached—that is, whether the defendant was negligent, as a matter of fact. *See* Hao v. Campbell Estate, 76 Hawai'i 77, 80, 869 P.2d 216, 219 (1994); Knodle v. Waikiki Gateway Hotel, Inc., 69 Haw. 376, 386, 742 P.2d 377, 385 (1987)(citing Bidar v. Amfac, Inc., 66 Haw. 547, 553, 669 P.2d 154, 158 (1983)(quoting W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 37 (4th ed. 1971))).

[208] *See* Hansen & Duerr, *supra* note 28, at 176-77 (analyzing Wyoming's recreational activity liability statute). The basic problem with turning over the determination of which risks are inherent to the trier of fact is that the determination is central to the analysis of whether a duty exists, and duty is primarily a question of law. *See id.* at 176. Wyoming's original recreational activity statute, like Hawai'i's, defined inherent risk such that the determination encompassed a question of fact. *See id.* Wyoming has since corrected this problem by amending their statute to define inherent risk as "those dangers or conditions which are characteristic of, intrinsic to, or an integral part of any sport or recreational opportunity." WYO. ST. ANN. § 1-1-122 (Michie Supp. 1991). This eliminates the need for a trier of fact to engage in any analysis prior to a judicial determination that a duty exists. *See* Hanson & Duerr, *supra* note 28, at 176. An amendment to Hawai'i's statute eliminating the trier of fact designation in section (c) would allow a waiver to be declared valid or invalid at the outset and preclude a jury from determining whether the defendant owed a duty to the plaintiff.

some to be benign or even beneficial,[209] its practical effect of eliminating summary judgment is likely to be favored by no one.[210]

Summary judgment is an "integral part" of the "just, speedy, and inexpensive determination of every action."[211] Rule 56 of both the Hawai'i Rules of Civil Procedure and the Federal Rules of Civil Procedure require the moving party to show that no genuine issue of material fact exists in order for summary judgment to be granted.[212] To defeat summary judgment, the responding party must set forth specific facts that show that there is a genuine issue of fact for trial.[213] If the court finds that a question of fact exists, summary judgment cannot be granted.[214] Summary judgment serves the courts' interests of efficiency by reducing the number of frivolous lawsuits, and by obtaining more immediate determinations of claims where there are no factual disputes.[215]

The construction of the recreational activity liability statute ensures that a genuine issue of material fact will always preclude summary judgment on the issue of whether a risk is inherent because the trier of fact must always make that determination.[216] The effect of this requirement will be longer, more

---

[209] *See* Hansen & Duerr, *supra* note 28, at 192 n.221 ("[S]ome commentators believe that the trier of fact should decide whether the injury results from an inherent risk, and thus, whether the provider owes a legal duty.")(citing Dillworth v. Gambardella, 776 F. Supp. 170, 173 (D. Vt. 1991).

[210] The elimination of summary judgment precludes the quick, less expensive summary determination of the validity of a release waiver, increasing costs for all sides.

[211] Celotex Corp. v. Catrett, 477 U.S. 317, 327 (1986)(explaining that the use of summary judgment coincides with the goals of the Federal Rules of Civil Procedure)(citing FED. R. CIV. P. 1). Hawai'i courts have used federal case law analogously to construe Hawai'i rules which are similar or identical to their federal counterparts. *See, e.g.*, TBS Pacific Inc. v. Tamura, 5 Haw. App. 222, 227, 686 P.2d 37, 43 (1984)(applying federal case law relating to Federal Rule 54 analogously to construe HRCP 54); Criss v. Kunisada, 89 Hawai'i 17, 22, 968 P.2d 184, 189 (App. 1998)(applying federal case law relating to Federal Rule 68 analogously to construe the Hawai'i Rules of Civil Procedure (HRCP) Rule 68); Ellis v. Harland Bartholomew & Assocs., 1 Haw. App. 420, 425, 620 P.2d 744, 748 (1980)(applying federal case law relating to Federal Rule 41 analogously to construe HRCP 41). Thus, *Celotex* provides persuasive authority for construing Hawai'i's summary judgment rule. HAW. R. CIV. P. 56.

[212] *See* FED. R. CIV. P. 56; HAW. R. CIV. P. 56.

[213] *See* Arimizu v. Financial Sec. Ins. Co., 5 Haw. App. 106, 679 P.2d 627 (App. 1984).

[214] *See* FED. R. CIV. P. 56; HAW. R. CIV. P. 56.

[215] *See Celotex*, 477 U.S. at 327. See *supra* note 211 for the applicability of *Celotex* in Hawai'i courts.

[216] *See* HAW. REV. STAT. § 663-1.54 (c) (Supp. 1998). "The determination of whether a risk is inherent or not is for the trier of fact." *Id.* One of the requisite components of a valid the waiver is that the risks waived must be inherent in the sport or activity. Under section (1)(c) of the statute, inherent risks must be determined by a trier of fact. Thus, the determination of whether there is a duty in this case, contrary to common law principles, necessarily requires the determination of a question of fact.

complicated and more costly litigation, in direct contradiction to the legislative and industry intent.[217] When the cost of litigating the waivers increases, that cost will likely be borne by the consumer. The price of recreational activities will rise until they become uninsurable or until consumers are no longer willing to pay. Furthermore, the Hawai'i State Legislature's effective removal of summary judgment as an option in recreational activity litigation is contrary to the United States Supreme Court's statement in *Celotex* that summary judgment is not "a disfavored procedural shortcut, but an integral part of the [rules of civil procedure]."[218]

From the legislative testimony, it is apparent that the industry did not intend, nor was it aware, that this new law might eliminate summary judgment determinations of whether waivers are valid.[219] In their testimony, activity operators stated that the bill "supports the summary judgments handed down

---

[217] *See* SEN. STAND. COMM. REP. NO. 1537, Committee on the Judiciary, 19th Leg., Reg. Sess. (1997), *reprinted in* 1997 HAW. SEN. J. 1476 ("[I]t is the intent of your committee that this [legislation] will . . . reduce frivolous suits . . . ."); *see also Supplemental Testimony to H.B. No. 581*, *supra* note 8 (written testimony of Jan Pinney, Executive Director, Activity Owner's Association of Hawaii)("In our 'sue now - get the facts later' society, many providers find themselves embroiled in liability lawsuits that have little or no merit but cost the provider thousands of dollars to hire lawyers to address.").

[218] *Celotex*, 477 U.S. at 327. Hawai'i courts have cited *Celotex* for the mechanics of summary judgment. *See* GECC Fin. Corp. v. Jaffarian, 79 Hawai'i 516, 521, 904 P.2d 530, 535 (App. 1995)(citing *Celotex* for movant's burden of proof) *aff'd by* 80 Hawai'i 118, 905 P.2d 624 (1995); Heatherly v. Hilton Hawaiian Village Joint Venture, 78 Hawai'i 351, 367, 893 P.2d 779, 795 (1995)(citing *Celotex*; First Hawaiian Bank v. Weeks, 70 Haw. 392, 396-97, 772 P.2d 1187, 1190 (1989)(citing *Celotex* for the proposition that the moving party need only point out an absence of evidence to succeed); Hall v. Hawaii, 7 Haw. App. 274, 284, 756 P.2d 1048, 1055 (1988)(citing *Celotex* for burden of moving party)).

Evidence suggests, however, that Hawai'i courts may reject the *Celotex* policy approach to summary judgment. *See Jaffarian*, 79 Hawai'i at 521, 904 P.2d at 535 ("Summary judgment is a drastic remedy; to avoid improperly depriving party to lawsuit of right to trial on disputed factual issues, summary judgment should be cautiously invoked."); Miller v. Manuel, 9 Haw. App. 56, 65, 828 P.2d 286, 292 (1991)(cited in Wagatsuma v. Patch, 10 Haw. App. 547, 561, 879 P.2d 572, 582 (1994))("Summary judgment must be used with due regard for its purpose and must be cautiously invoked so that no person will be improperly deprived of trial of disputed factual issues.").

For background on the Hawai'i courts' somewhat "muddled" approach to summary judgment, see Eric K. Yamamoto et. al, *Summary Judgment at the Crossroads: The Impact of the Celotex Triology*, 12 U. HAW. L. REV. 1 (1990).

[219] *Supplemental Testimony to H.B. No. 581*, *supra* note 8 (written testimony of Jan Pinney, Executive Director, Activity Owner's Association of Hawaii)("In our own State, the courts are also recognizing that liability change is needed. In Maui County, summary judgments were handed down in two separate activity industry cases. Both . . . upheld the validity of two different activity industry company's written release waivers.").

by the State District Courts" where waivers were held enforceable.[220] The testimony also refers to the "PADI waiver" as an example of a standardized release that has been upheld nationwide.[221] What the testimony does not say and what remains unconsidered is that PADI's releases not only waive liability for negligence,[222] but are generally validated via summary judgment.[223]

If Wheelock's widow were to try her case today, summary judgment would be no obstacle to her claim.[224] Instead, the contract which Wheelock signed, releasing Kualoa Ranch from liability for negligence, would be valid only as to risks found to be inherent in the sport of paragliding absent any negligent act or omission on the part of Kualoa Ranch.[225] Under the newly enacted statute, the court's legal conclusion that equipment failure was inherent in paragliding[226] would now be a question of fact statutorily-assigned to a trier of fact.[227] Mrs. Wheelock would get a trial and Kualoa Ranch, the activity provider, would be far less likely to prevail.

V. CONCLUSION

Ironically, Hawai'i's new recreational activity liability statute, championed by the activity providers to protect the industry has instead eroded the common law protection it otherwise enjoyed. Activity providers can benefit where the inherent risks are thoroughly spelled out in a validly executed

---

[220] *Supplemental Testimony to H.B. No. 581*, *supra* note 8 (written testimony of Richard Goodenough, President, Maui Downhill).

[221] *See supra* note 195 and accompanying text.

[222] *See supra* note 190 and accompanying text.

[223] *See supra* note 195 and accompanying text.

[224] *See supra* text accompanying notes 1-5.

[225] Under HRS § 663-1.54, waivers of inherent risks are valid; however, the statute limits those waivers by excluding operator negligence from that which can be considered as an inherent risk. *See* HAW. REV. STAT. § 663-1.54(1)(b) (Supp. 1998); *see also supra* notes 179-202 and accompanying text.

[226] *See* Wheelock v. Sports Kites, Inc., 839 F. Supp. 730, 736 (D. Haw. 1993).

[227] *See* HAW. REV. STAT. § 663-1.54(c)(1)-(3). Prior to this statute, decisions on whether equipment failure was inherent were made by the trial judge based on supporting memoranda in the summary judgement phase. *See, e.g.*, Harbert v. Po'oku Stables, Inc., No. 19933, mem. op. (Haw. Ct. App. May 14, 1997)(affirming the denial of summary judgment due to the defendant's failure to prove that plaintiff knowingly accepted the risk of being injured by the negligent acts of defendant's own employees, but relying on *Wheelock* for the standard of analysis); Mudry v. Captain Nemo's Ocean Emporium, Civ. No. 94-0265 (Haw. Cir. Ct., 2d Cir. Feb. 13, 1996)(granting motion for summary judgment in an action for negligence arising from a scuba diving injury where valid release was executed). Noting that scuba diving is "classed among those [activities] for which recreational releases have been upheld," the court found that *Wheelock* was applicable and that the release barred claims against defendants for negligence. *See id.*

waiver, but they will still have to go to court to determine whether a risk is "inherent."[228] Because the statute is unlike any other, it is difficult to predict exactly how Hawai'i's appellate courts will interpret its requirements. Until interpreted, the effects of the statute on the industry cannot be known. However, the statute appears to be wholly inconsistent with both case law nationwide and with similar statutory provisions in other jurisdictions.[229]

Although a creative first attempt at addressing the concerns of recreational activity liability, the statute needs to be reevaluated.[230] If amended to eliminate the trier of fact as the preliminary adjudicator of inherent risk, the scope of the provider's duty would again be a question of law determined by the court, and juries would apply the facts only after the court has determined that a duty exists.[231] This would allow defendants to continue to move for summary judgment, and prevent non-meritorious claims from becoming needless, costly litigation.[232] If amended to recognize the value of waiving negligence in some circumstances, the statute will be more consistent with current case law and will support the value of high-risk sports and of the freedom to choose to participate in them.[233] Finally, if the statute were amended to address the issue of implied consent to risks in the absence of a waiver, it would represent a more complete allocation of liability between the provider and the participant, and would be more consistent with comparable statutes around the country.[234] Certainly, some change is necessary to accomplish the goals of lowering activity provider liability while still protecting consumer safety and the choice of risk.

Ammie I. Roseman-Orr[235]

---

[228] *See* discussion *supra* section IV.C.

[229] *See* discussion *supra* Part II.

[230] Changing the framework of activity provider liability to give greater protection to the consumer is a legislative move that should be done intentionally, not accidentally.

[231] *See* discussion *supra* section IV.C.

[232] *See* discussion *supra* section IV.C.

[233] *See* discussion *supra* section IV.B.

[234] *See* discussion *supra* section II.B.

[235] William S. Richardson School of Law, Class of 1999. Many thanks to Professor Hazel Beh for her comments and her time.

Re-Evaluating the Limits of the Full Faith and Credit Clause After *Baker v. General Motors Corporation*

I. INTRODUCTION

The Full Faith and Credit Clause of the United States Constitution,[1] a doctrine long left untouched and unquestioned by courts and Congress alike,[2] has recently undergone some reassessment and change. On January 13, 1998, the United States Supreme Court addressed the role of the Full Faith and Credit Clause in *Baker v. General Motors Corp.*[3] Although the facts in *Baker* concerned a products liability dispute, the legal issues of the case were largely based on res judicata principles.[4] Adhering to those principles, the *Baker* Court unanimously held that a court in one state could not prevent a former General Motors Corporation ("GM") engineer from testifying elsewhere on an unrelated matter.[5] Then, stepping outside of the res judicata context, a majority of the Court went further and elaborated on the public policy exception to the Full Faith and Credit Clause.[6] Arguably, the facts of *Baker* did not demand the majority opinion's extended analysis.[7] Nevertheless, the

---

[1] U.S. CONST. art. IV, § 1 ("Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State. And the Congress may by general Laws prescribe the Manner in which such Acts, Records, and Proceedings shall be proved, and the Effect thereof.").

[2] *See infra* notes 22 and 23 and accompanying text.

[3] 522 U.S. 222 (1998).

[4] *See* Tim Poor, *Supreme Court Lets Worker's Testimony Against GM Stand—Judge in One State Can't Silence Witness in Another; Plaintiffs Applaud Verdict*, ST. LOUIS POST, Jan. 14, 1998, at A14. The ruling was immediately viewed as a victory for consumer advocates. *See* Edward G. Lance IV, *Former GM Engineer Allowed to Testify Despite Non-Disclosure Agreement*, 10 LOY. CONSUMER L. REV. 114 (1998); Edward Felsenthal, *High Court Says Ex-GM Engineer Can Testify Against Auto Maker*, WALL ST. J., Jan. 14, 1998, at B11; Frank J. Murray, *Witness Can Testify Outside Michigan*, WASH. TIMES, Jan. 14, 1998, at A6. The Court's decision significantly curbs the power of major companies to silence corporate whistle-blowers, including tobacco companies highly susceptible to lawsuits. *See, e.g.*, Lyle Denniston, *Court Curbs Power to Gag Witnesses*, ST. PETERSBURG TIMES, Jan. 14, 1998, at 7A; Roger K. Lowe, *Injunction in GM Case Not Binding, High Court Rules*, COLUMBUS DISPATCH, Jan. 14, 1998, at 06A. Thus, in the products liability context, plaintiffs seem poised to do battle with corporate America. *See* Felsenthal, *supra* (noting that the "decision could significantly shift the balance of power between plaintiffs and defendants in corporate litigation, because it hampers companies' ability to muzzle the testimony of disgruntled former employees").

[5] *See Baker*, 522 U.S. at 231-41.

[6] *See id.* at 232-38.

[7] *See id.* at 243 (Kennedy, J., concurring).

majority's emphasis on the public policy exception may have effectively changed the bounds of the full faith and credit doctrine.

According to widely accepted precedent, the public policy exception should generally apply only when another state's law violates "some fundamental principle of justice, some prevalent conception of good morals, some deep rooted tradition of the common weal."[8] Despite this stringent requirement, the exception has been liberally applied and thus abused by courts.[9] This has resulted in a wide range of different outcomes from which no clear pattern has emerged.[10]

These incidents of disparity may change as a result of *Baker*, due to the majority opinion's firm declaration that there is "no roving 'public policy exception' to the full faith and credit due *judgments*."[11] On the surface, *Baker* immediately limits the usefulness of the exception; however, this limitation leads to a deeper inquiry regarding the extent to which the exception should be used.

Part of the inquiry focuses on the role the exception might play in the nation's current same-sex marriage debate.[12] Specifically, same-sex marriage supporters and opponents alike[13] ask whether full faith and credit requires the recognition of same-sex marriages by sister states once they are legalized by the forum state, and if so, whether the public policy exception in light of *Baker* may be exercised by a state to avoid recognizing the same-sex marriage deemed legal by another.[14] As the legalization of same-sex marriage plays

---

[8] Loucks v. Standard Oil Co., 120 N.E. 198, 202 (N.Y. 1918). This definition by Judge Cardozo has been characterized as a "classic definition of public policy as a valid reason for closing the forum to suit." Larry Kramer, *Same-Sex Marriage, Conflict of Laws, and the Unconstitutional Public Policy Exception*, 106 YALE L.J. 1965, 1970 n.17 (1997)(citing RUSSELL J. WEINTRAUB, COMMENTARY ON THE CONFLICT OF LAWS § 3.6 (3d ed. 1986)).

[9] *See, e.g.*, Jon-Peter Kelly, *Act of Infidelity: Why the Defense of Marriage Act is Unfaithful to the Constitution*, 7 CORNELL J.L. & PUB. POL'Y 203, 215 (1997); Andrew Koppelman, *Same-Sex Marriage, Choice of Law, and Public Policy*, 76 TEX. L. REV. 921, 934-37 (1998).

[10] *See* Larry Kramer, *The Public Policy Exception and the Problem of Extra-Territorial Recognition of Same-Sex Marriage*, 16 QUINNIPIAC L. REV. 153 (1996)(concluding that the public policy exception is nothing more than an easy way for courts to apply their own law with no discernible patterns).

[11] *Baker*, 522 U.S. at 233 (emphasis in original).

[12] *See, e.g.*, Editorial, *What Doesn't Travel*, 151 N.J.L.J. 658 (1998)(predicting that if and when same-sex marriages are authorized by a state, judgments stemming therefrom, such as same-sex divorce decrees and related settlements, will necessarily be enforceable as a result of *Baker*); *Two Men and a Wedding—Same-Sex Marriage Q & A*, FRESNO BEE, May 25, 1997, at E6 (explaining that the Full Faith and Credit Clause on its face would require recognition of Hawai'i's same-sex marriages).

[13] *See infra* notes 16-18 and accompanying text.

[14] *See* discussion *infra* sections V.A & B.

itself out in the courts,[15] both supporters and opponents of legislation prohibiting same-sex marriage have invoked the Full Faith and Credit Clause.[16] Advocates supporting the legalization of same-sex marriage argue that if same-sex marriage is ultimately legalized in one state, the Full Faith and Credit Clause requires the recognition of such marriages in sister states, as it does for heterosexual marriages.[17] In contrast, supporters of traditional marriage look to the public policy exception as reason to ignore another state's legalization of same-sex marriage.[18] In the end, some states might feel compelled to recognize same-sex marriage, while others might cite a public policy exception to invalidate the marriages, which may again ultimately lead to conflicting results.[19]

---

[15] *See, e.g.*, Brause v. Bureau of Vital Statistics, No. 3AN-95-6562 CI, 1998 WL 88743 (Alaska Super. Ct. Feb. 27, 1998)(finding that marriage is a fundamental right, thereby requiring the state to show a compelling interest that supports the state's decision to refuse to recognize same-sex marriage); Dean v. District of Columbia, 653 A.2d 307 (D.C. 1995)(holding that same-sex marriage is not a fundamental right and is therefore prohibited by the District of Columbia marriage statute); Singer v. Hara, 522 P.2d 1187 (Wash. Ct. App. 1974)(holding that the statutory provision against same-sex marriages is not unconstitutional). "Lawsuits that could lead to the recognition of same-sex marriages have reached the state supreme courts in Hawaii and Vermont. Similar cases are at the trial court level in Alaska and New York." Toni Heinzl, *State Can Ignore Others' Same-Sex Unions, Experts Say*, OMAHA WORLD-HERALD, June 20, 1998, at 15.

[16] *See, e.g.*, Erik J. Toulon, *Call the Caterer: Hawaii to Host First Same-Sex Marriage*, 3 S. CAL. REV. L. & WOMEN'S STUD. 109, 128-29 (1993)("The Full Faith and Credit Clause requires a state to recognize valid marriages from another state, even if those marriages would be invalid in the forum state."); Heather Hamilton, Comment, *The Defense of Marriage Act: A Critical Analysis of its Constitutionality Under the Full Faith and Credit Clause*, 47 DEPAUL L. REV. 943, 987 (1998)("While states may disagree with same-sex marriages, recognition is required under the Full Faith and Credit Clause . . . .").

[17] *See* H.R. REP. NO. 104-664, at 7 (1996), *reprinted in* 1996 U.S.C.C.A.N. 2905, 2911. The Judiciary Committee, in describing the interstate implications of *Baehr v. Lewin*, quoted an excerpt from a memorandum submitted by the Lambda Legal Defense and Education Fund, Inc. in support of the same-sex plaintiffs: "Many same-sex couples in and out of Hawaii are likely to take advantage of what would be a landmark victory. The great majority of those who travel to Hawaii to marry will return to their homes in the rest of the country expecting full legal recognition of their unions." *Id.* (quoting *Baehr v. Lewin*, 74 Haw. 645, 852 P.2d 44 (1993)).

[18] *See* Heinzl, *supra* note 15, at 15 (quoting law professor Lynn D. Wardle as saying that "[i]t would violate the strong public policy of Nebraska and other states (to protect the conventional marriage between a man and a woman).").

[19] *See generally* Thomas M. Keane, Note, *Aloha, Marriage? Constitutional and Choice of Law Arguments for Recognition of Same-Sex Marriages*, 47 STAN. L. REV. 499 (1995)(predicting a high degree of nonconformity in state marriage laws for the foreseeable future); Kramer, *supra* note 8, at 1978 (noting that the Full Faith and Credit Clause does not prevent states from applying their laws, but does not dictate any particular choice among interested states, leaving choice of law almost entirely in the hands of state courts, "with somewhat chaotic results.").

To add to the confusion, Congress enacted the Defense of Marriage Act ("DOMA")[20] in 1996.[21] Claiming to exercise its power pursuant to the Effects Clause,[22] Congress has given states the right to deny the recognition of a same-sex marriage that is recognized as valid in a sister state.[23] Nevertheless, due to Congress' limited use of the Effects Clause in the past,[24] coupled with the lack of debate surrounding its creation,[25] there has never been a clear

---

[20] DOMA provides:

> No State, territory, or possession of the United States, or Indian tribe, shall be required to give effect to any public act, record, or judicial proceeding of any other State, territory, possession, or tribe respecting a relationship between persons of the same sex that is treated as a marriage under the laws of such other State, territory, possession, or tribe, or a right or claim arising from such relationship.

28 U.S.C. § 1738C (Supp. III 1997).

[21] *See* Defense of Marriage Act, Pub. L. No. 104-199, 110 Stat. 2419 (1996)(codified at 28 U.S.C. § 1738C).

[22] The "Effects Clause" is embodied in the second sentence of the Full Faith and Credit Clause: "And the Congress may by general Laws prescribe the Manner in which such Acts, Records, and Proceedings shall be proved, and the Effect thereof." U.S. CONST. art. IV, § 1. It is through the purported exercise of this power that Congress enacted the Defense of Marriage Act ("DOMA"), heading off the anticipated legalization of same-sex marriage. *See* discussion *infra* notes 235-39 and accompanying text. Scholars and commentators dispute, however, whether the Effects Clause actually grants or limits Congressional power to prescribe the effect of one state's Acts, Records and Proceedings in all other states. *See, e.g.*, Daniel A. Crane, *The Original Understanding of the "Effects Clause" of Article IV, Section 1 and Implications For the Defense of Marriage Act*, 6 GEO. MASON L. REV. 307, 334 (1998)(asserting that by exploring the original understanding of the Effects Clause, it is clear that the Full Faith and Credit Clause does not limit Congress' power under the Effects Clause). *But see* 142 CONG. REC. S5931-01, S5932 (daily ed. June 6, 1996)(letter from Professor Laurence H. Tribe to Senator Edward M. Kennedy, May 24, 1996)(arguing that DOMA is unconstitutional because it goes beyond the enumerated powers of Congress and invades the powers reserved to the states by the Tenth Amendment).

[23] *See* James M. Patten, Comment, *The Defense of Marriage Act: How Congress Said "No" to Full Faith and Credit and the Constitution*, 38 SANTA CLARA L. REV. 939, 940 (1998). DOMA was enacted to permit states to disregard the Full Faith and Credit Clause as it would apply to same-sex marriages, if they became legal in any state. *See id.*

[24] *See* Hamilton, *supra* note 16, at 947-50 (noting that Congress has exercised its Article IV power only intermittently in the past, most recently with the Defense of Marriage Act); *see also* Scott Ruskay-Kidd, *The Defense of Marriage Act and the Overextension of Congressional Authority*, 97 COLUM. L. REV. 1435, 1437 (1997)("Legislation under [the Full Faith and Credit] Clause has so seldom been drafted that the potential for legitimate congressional action has been inadequately explored.").

[25] *See, e.g.*, Rex Glensy, Note, *The Extent of Congress' Power Under the Full Faith and Credit Clause*, 71 S. CAL. L. REV. 137, 146-48 (1997)("Because of the lack of debate surrounding the incorporation of [the Full Faith and Credit Clause] and the speed with which it was adopted, the intended purpose behind its enactment remains speculative"); James R. Pielemeier, *Why We Should Worry About Full Faith and Credit to Laws*, 60 S. CAL. L. REV. 1299, 1302 (1987)("The constitutional history of the full faith and credit clause is sparse.").

consensus on the actual scope of the Full Faith and Credit Clause's command.[26] This lack of clarity questions the existence of Congress's power to enact legislation pursuant to the Effects Clause and casts doubt on the actual force of the public policy exception.

Baker v. General Motors Corp. may resolve some of these important questions. Altogether, it seems as though the Supreme Court went out of its way to address the public policy exception issue. In light of the impending legalization of same-sex marriages at least in Hawai'i,[27] the limitation of the exception's power may have lessened the threat of a once formidable obstacle to the continuing battle that same-sex advocates are waging.[28]

This Note argues that by electing to address the public policy exception in *Baker*, the United States Supreme Court may have provided same-sex marriage advocates with a possible "constitutional weapon" in addition to the Full Faith and Credit Clause itself.[29] This Note examines the Court's rationale and suggests how the decision has affected the bounds of the full faith and credit doctrine. In addition to applying res judicata principles,[30] the Court addressed the full faith question, perhaps prematurely because the issue was raised only indirectly. This may consequently limit the application of *Baker*

---

[26] *See* Pielemeier, *supra* note 25, at 1302.

[27] *See* Baehr v. Lewin, 74 Haw. 530, 852 P.2d 44 (1993). The Hawai'i Supreme Court struck down a statute requiring that marriage applicants be of the opposite sex based on equal protection grounds, thereby subjecting the State's policy to a "strict scrutiny" test in order to justify its use of the classification. The Hawai'i Supreme Court's review stemmed from a lower court's ruling on December 3, 1996, that the government had failed to show justification for denying same-sex couples the freedom to marry. *See* Baehr v. Miike, 80 Hawai'i 341, 910 P.2d 112 (1996). *See generally* Kramer, *supra* note 8 (discussing the implications of *Baehr v. Lewin* and same-sex marriage on the Full Faith and Credit Clause and the public policy exception).

[28] There is a history to same-sex couples' attempts to obtain legal recognition of their unions. *See, e.g.*, Baker v. Nelson, 191 N.W.2d 185 (Minn. 1971), *appeal dismissed*, 409 U.S. 810 (1972). However, prior to *Baehr*, courts routinely rejected the notion that the right to marry included same-sex marriages. *See* Hamilton, *supra* note 16, at 943. *See generally*, David G. Savage, *Combustible Cases: Will a Car Crash Ruling Lead to Recognition of Gay Marriage?*, A.B.A. J., Mar. 1998, at 42 (discussing the impact of *Baker v. General Motors Corp.* on the possible legalization of same-sex marriage).

[29] *See* Crane, *supra* note 22, at 308 (describing the Full Faith and Credit Clause as a constitutional weapon for gay rights advocates, for use against prophylactic measures preventing intra-state recognition of same-sex marriages).

[30] *See* 18 CHARLES ALAN WRIGHT ET AL., FEDERAL PRACTICE AND PROCEDURE, § 4467 (3d ed. 1981 & Supp. 1999). Generally, state res judicata policies are implemented in other states through federal statute created pursuant to the Full Faith and Credit Clause. The full faith and credit doctrine requires that substantial portions of preclusion policies be applied between the individual states. Preclusion doctrine includes claim preclusion, which may also occur through merger, and issue preclusion. *See id.* The *Baker* opinion discusses the claim preclusion and merger aspects of res judicata. *See* Baker v. General Motors Corp., 522 U.S. 222, 237-41 (1998).

to later same-sex marriage issues. By its limiting language, the Court hinted at the approach it might take if and when the issue comes before it.

Part II describes the background of the Full Faith and Credit Clause and the development of the public policy exception. Part III discusses the background of *Baker*, including a detailed explanation of the underlying cases leading to it. Part IV focuses on the majority's rationale in *Baker* as well as the approaches endorsed by each concurring opinion. Part V analyzes the current situation that exists after *Baker*, explores the significance and possible implications of DOMA, and considers the possible application of *Baker* to the same-sex marriage debate.

II. BACKGROUND

A. The Full Faith and Credit Clause

The Full Faith and Credit Clause of the United States Constitution provides:

> Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State. And the Congress may by general Laws prescribe the Manner in which such Acts, Records, and Proceedings shall be proved, and the Effect thereof.[31]

The clause has been generally interpreted to require each state to "give to a judgment at least the res judicata effect which the judgment would be accorded in the State which rendered it."[32]

The purpose of the clause, according to the Court in *Milwaukee County v. M.E. White Co.*,[33] is to bring together the various and independent sovereign states to create a single nation.[34] In *Sherrer v. Sherrer*,[35] the Court added that

---

[31] U.S. CONST. art. IV, § 1. Pursuant to this Clause, Congress enacted the following provision:

> Such Acts, records and judicial proceedings or copies thereof, so authenticated, shall have the same full faith and credit in every court within the United States and its Territories and Possessions as they have by law or usage in the courts of such State, Territory or Possession from which they are taken.

28 U.S.C. § 1738 (1994).

[32] Durfee v. Duke, 375 U.S. 106, 109 (1963).

[33] 296 U.S. 268 (1935).

[34] *Id.* at 277. Specifically, the *Milwaukee County* Court stated:

> The very purpose of the full-faith and credit clause was to alter the status of the several states as independent foreign sovereignties, each free to ignore obligations created under the laws or by the judicial proceedings of the others, and to make them integral parts of a single nation throughout which a remedy upon a just obligation might be demanded as of right, irrespective of the state of its origin.

Id.

[35] 334 U.S. 343 (1948).

states sometimes must sacrifice their local public policies in order to further uphold this unifying purpose.[36] It has also been recognized that the clause serves the useful purpose of bringing an end to litigation.[37] Full faith and credit is distinguishable from comity in that only the former involves a constitutionally imposed obligation, while the latter is based on a concept of deference.[38]

Although the language of the Clause itself does not contain any exceptions to its command,[39] there are limits to the Full Faith and Credit Clause and its binding effects on state courts.[40] The Supreme Court has interpreted the clause to impose certain minimum requirements rather than imposing absolute requirements.[41] The clause does not apply to procedural matters, laws, records, or acts of sister states that would violate the "public policy" of the state where recognition is desired.[42] Additionally, the Court has recognized that "[v]ery narrow exceptions" to the command of full faith and credit exist in certain situations.[43] The following section examines the development of the public policy exception and discusses the courts' varying attitudes toward the exception's function.

---

[36] *See id.* at 355.

[37] *See* Riley v. New York Trust Co., 315 U.S. 343, 348-49 (1942).

[38] *See* Mark Strasser, *Judicial Good Faith and the Baehr Essentials: On Giving Credit Where It's Due*, 28 RUTGERS L.J. 313, 317-18 (1997). Strasser observes that:

> The difference between comity and full faith and credit is important to consider in precisely those cases in which the court is tempted not to recognize a foreign judgment. If the judgment of a foreign state court is at issue, the Constitution may preclude a court from refusing to credit that judgment.

Id.; *see also* Habib A. Balian, *'Til Death Do Us Part: Granting Full Faith and Credit to Marital Status*, 68 S. CAL. L. REV. 397, 398-99 (1995)(describing comity as "a discretionary tool of the state; merely a courtesy extended from one state to another so that the union will function more efficiently.").

[39] *See* Hamilton, *supra* note 16, at 954-55.

[40] *See, e.g.*, Alaska Packers Ass'n v. Industrial Accident Comm'n, 294 U.S. 532, 546 (1935). The Supreme Court has recognized that "there are some limitations upon the extent to which a state will be required by the full faith and credit clause to enforce even the judgment of another state, in contravention of its own statutes or policy." *Id.* (citations omitted).

[41] *See* Wells v. Simonds Abrasive Co., 345 U.S. 514, 516 (1953); *see also* Hamilton, *supra* note 16, at 954-55.

[42] *See* Nevada v. Hall, 440 U.S. 410, 422 (1979); *see also* Hamilton, *supra* note 16, at 955.

[43] WRIGHT ET AL., *supra* note 30, § 4467. For example, a clear exception is that a judgment need not be honored if it was entered by a court that lacked personal or property jurisdiction. *See id.* at 634. In specific substantive areas, strong local policies can justify some reduction of full faith and credit. *See id.* at 634-35. Finally, in some cases full finality simply cannot be reached, such as in child custody disputes. *See id.* at 636. As an overarching requirement, full faith and credit "order[s] submission by one State even to hostile policies reflected in the judgment of another State" in the absence of a state's "considerable interest" to permit otherwise. Estin v. Estin, 334 U.S. 541, 546 (1948).

B. The Public Policy Exception

In general, public policy exceptions to the clause should be narrowly construed and applied only when fundamental policies of the forum state are offended.[44] Beyond specific areas already eligible for exception to the Full Faith and Credit Clause, there are areas in which the application of exceptions still remains uncertain.[45] United States Supreme Court precedent provides a test for balancing the interests of full faith and public policy.[46] Generally, the test examines whether the requirements of the Full Faith and Credit Clause violate the public policy of a state; if so, the mandate of the clause will not apply to that particular situation.[47]

For example, in *Nevada v. Hall*,[48] the Court faced a matter of first impression that required it to decide whether a state court could claim sovereign immunity in the courts of another state.[49] The *Hall* Court ruled that sovereign immunity only extends to the courts of the state and not beyond.[50] To permit otherwise would infringe on the rights of the other state.[51] Although the Full Faith and Credit Clause requires states to recognize the official acts of other states, California was not required to recognize Nevada's statutory liability limit if the limit violated a legitimate public policy of California.[52]

---

[44] *See* Koppelman, *supra* note 9, at 935; EUGENE F. SCOLES & PETER HAY, CONFLICT OF LAWS § 3.15 (1982).

[45] *See* Jean A. Mortland, *Interstate Federalism: Effect of Full Faith and Credit to Judgments*, 16 U. DAYTON L. REV. 47, 53 (1990). Exceptions to the straightforward application of the clause arise in cases involving primarily non-monetary relief or where money judgments are only affected collaterally. This includes title to land, statutes of limitations, and probate matters. *See id.* at 52-66. Areas of uncertainty include modifiable decrees, custody, injunctions of foreign suits, tax judgments and penalties, and claim preclusion. *See id.* at 66-75.

[46] *See* Hamilton, *supra* note 16, at 954-56, 957-59; Timothy Joseph Keefer, Note, *DOMA as a Defensible Exercise of Congressional Power Under the Full-Faith-and-Credit Clause*, 54 WASH. & LEE L. REV. 1635, 1666-77 (1997).

[47] *See* Hamilton, *supra* note 16, at 957.

[48] 440 U.S. 410 (1979).

[49] *See id.* at 414; *see also* Hamilton, *supra* note 16, at 958; Keefer, *supra* note 46, at 1666-67 n.230 (describing the creation of a public policy exception in *Hall*).

[50] *See Hall*, 440 U.S. at 414-27.

[51] *See id.* at 421. In this case, the State of Nevada maintained that Nevada's statutory waiver of its immunity from suit required recognition by the California court due to the Full Faith and Credit Clause. However, the *Hall* Court noted that the waiver only gave Nevada's consent to suits in its own courts. The Court then noted that if the Nevada waiver were treated as a consent to be sued in California, California would have to limit the plaintiffs' recovery to $25,000, the maximum amount recoverable in a Nevada court according to statute. *See id.*

[52] *See id.* at 426. Specifically, the policy involved California's interest in providing both physical and economic protection to those injured on California's highways due to negligence

The Court in *Estin v. Estin*[53] considered the effect of full faith and credit on conflicting divorce decrees. The *Estin* Court first stated the general principle that the Full Faith and Credit Clause requires a state to adhere to another state's judgment, even when the policies involved are hostile to the forum state.[54] In *Estin*, however, the Court had to determine whether a New York divorce decree that included a provision for monthly alimony payments to the ex-wife survived a subsequent Nevada divorce decree obtained separately by the ex-husband.[55] The Nevada decree did not include a provision for alimony.[56] The Court permitted New York to disregard Nevada's judgment and enforce alimony payments against the ex-husband because the Nevada judgment was not based on proper jurisdiction.[57] Thus, the *Estin* Court found an exception to the Full Faith and Credit Clause based on the conclusion that the Nevada court lacked proper jurisdiction to render an enforceable judgment.[58]

In contrast, the compelling force of full faith and credit accompanying a judgment rendered under proper jurisdiction is demonstrated by the Court's decision in *Fauntleroy v. Lum*.[59] In this case, the Court's interpretation of the Full Faith and Credit Clause did not permit any exception to the final judgment entered by the sister state, which possessed both personal and subject matter jurisdiction, by the forum state, although the judgment was based on a mistake of law.[60] The *Fauntleroy* Court held that "[a] judgment is

---

by both residents and nonresidents. Additionally, California waived its own immunity and authorized full recovery for torts committed by its own agents. *See id.* at 424. The California courts decided that "to require California either to surrender jurisdiction or to limit respondents' recovery to the $25,000 maximum of the Nevada statute would be obnoxious to its statutorily based policies of jurisdiction over nonresident motorists and full recovery." *Id.* As the *Hall* Court stated, "[t]he Full Faith and Credit Clause does not require this result." *Id.*

[53] 334 U.S. 541 (1948).

[54] *See id.* at 546.

[55] *See id.* at 542.

[56] *See id.* at 543.

[57] *See id.* at 548-49. The Court ruled that Nevada lacked the power to determine the personal rights of the ex-wife in its subsequently issued decree when the ex-wife did not receive personal notice or appear in the Nevada proceeding. *See id.*

The language of the opinion indicates concern for the state's interest in overseeing marriages within its province. *See id.* at 546-49. Nevertheless, according to one commentator, the opinion generally suggests that the holding is based upon the ex-wife's right not to be deprived of her property (the New York judgment granting alimony rights) without due process. Thus, nonrecognition of the sister state's judgment was based on the petitioner's due process rights, not out of concern for the policy interests of the forum state. *See* William L. Reynolds, *The Iron Law of Full Faith and Credit*, 53 MD. L. REV. 412, 439 (1994).

[58] *See Estin*, 334 U.S. at 548-49.

[59] 210 U.S. 230 (1908).

[60] *See id.* In this case, the plaintiff and defendant were both residents of Mississippi. *See id.* at 234. After entering into a "futures" commodities contract, deemed illegal as a form of

conclusive as to all the media concludendi;[61] and it needs no authority to show that it cannot be impeached either in or out of the State by showing that it was based upon a mistake of law."[62] Notwithstanding Mississippi's conflicting social policy considerations, the opinion emphasized the importance of reaching finality in judgments.[63]

In *Alaska Packers Ass'n v. Industrial Accident Commission*, the Court explored whether full faith and credit required California to give effect to an Alaskan workman's compensation statute rather than its own when the employee's injury occurred in Alaska but the employment contract was entered into in California.[64] In this context, the Court commented on the occasional impropriety of a literal interpretation of the clause.[65] It found that if the clause were followed without exception, California would be compelled to follow Alaska's laws to the exclusion of its own.[66] The Court decided

---

gambling under Mississippi law, the parties disputed the effect of the contract and submitted the dispute to an arbitrator, who found for the plaintiff. *See id.* at 233-34. Plaintiff sued defendant in a Mississippi court to recover the award. *See id.* at 234. However, Plaintiff ended the lawsuit after the Mississippi court discovered that the contract was illegal. *See id.* He later sued the defendant in Missouri. The Missouri court rejected the defendant's evidence on the illegality issue and rendered judgment for the plaintiff based on the arbitrator's award. *See id.* When plaintiff sought enforcement of the Missouri judgment in Mississippi, the Mississippi Supreme Court refused to grant the judgment full faith and credit because the contract was unenforceable under Mississippi law. *See id.* However, the United States Supreme Court reversed, even though Mississippi's own policy was violated by the Missouri judgment. *See id.* at 237; *see also* Reynolds, *supra* note 57, at 413-15.

[61] *See* BLACK'S LAW DICTIONARY 981 (6th ed. 1990)(defining media concludendi as "[t]he steps of an argument . . . [t]he theory or basis of facts upon which a legal conclusion is reached").

[62] *Fauntleroy*, 210 U.S. at 237.

[63] *See* Reynolds, *supra* note 57, at 413-15 (characterizing the principle expressed in *Fauntleroy* as "the Iron Law of Full Faith and Credit").

[64] *See* Alaska Packers Ass'n v. Industrial Accident Comm'n, 294 U.S. 532, 546 (1935). Following an award of compensation in favor of the injured employee, the employer asserted on appeal that the California courts denied full faith and credit to the Alaska statute by refusing to recognize it as a defense to the application for an award under the California statute. *See id.* at 539. The California Supreme Court, however, determined that the Alaska statute provided a remedy to the employee in Alaska (not California), and because the employer's defense came into direct conflict with the California statute, that the court had the power to apply its own law notwithstanding the due process clause or the full faith and credit clause. *See id.* The United States Supreme Court agreed, reasoning that in such a situation, "the conflict is to be resolved, not by giving automatic effect to the full faith and credit clause, . . . but by appraising the governmental interests of each jurisdiction, and turning the scale of decision according to their weight." *Id.* at 547.

[65] *See id.*

[66] *See id.* (noting that if a literal enforcement of the Full Faith and Credit Clause were followed, there would be an "absurd result" where a forum state would have to enforce another state's laws, but could not enforce its own).

against this result by weighing various factors, including California's interest in enforcing its own compensation statute for the purpose of providing a remedy to the employee versus Alaska's interest in the same matter when the employee was only within Alaska temporarily.[67]

Similarly, in *Pacific Employers Insurance Co. v. Industrial Accident Commission*,[68] the Court recognized that a state's "legitimate public policy" could prevent a sister state's laws from being enforced in another.[69] In *Pacific Employers*, the issue was whether the Full Faith and Credit Clause required California to apply a Massachusetts workmen's compensation statute in a suit filed in California as a result of injuries sustained by a Massachusetts employee while in California in the course of his employment.[70] The Massachusetts workmen's compensation statute, which limited the employer's liability unless the employee gave notice not to be bound by the statute, was directly at odds with that of California, which held the employer liable without regard to negligence and medical costs.[71]

The Supreme Court of California held that the Full Faith and Credit Clause did not deny a California court the right to apply the California statute.[72] The court recognized that "'it would be obnoxious to [the workmen's compensation] policy to deny persons who have been injured in this state the right to apply for compensation[.]'"[73] The United States Supreme Court agreed, concluding that "full faith and credit does not here enable one state to legislate for the other or to project its laws across state lines so as to preclude the other from prescribing for itself the legal consequences of acts within it."[74] Through its holding, the Court affirmed that the requirements of the Full Faith and Credit Clause do not extend to those acts, records, or proceedings which would violate the "public policy" of a state.[75]

---

[67] *See id.* at 549-50.

[68] 306 U.S. 493 (1939). The Court recognized that "there are some limitations upon the extent to which a state may be required by the full faith and credit clause to enforce even the judgment of another state in contravention of its own statutes or policy." *Id.* at 502. Thus, the Court explicitly acknowledged the availability of the public policy exception to the California courts, reasoning that "[f]ew matters could be deemed more appropriately the concern of the state in which the injury occurs or more completely within its power." *Id.* at 503.

[69] *See supra* note 8 and accompanying text.

[70] *See id.* at 497.

[71] *See id.* at 499. The employee in this case did not notify his employer that he did not intend to be bound by the Massachusetts statute. *See* id.

[72] *See id.* at 501.

[73] *Id.* at 504 (citation omitted).

[74] *Id.* at 504-05.

[75] *See* Nevada v. Hall, 440 U.S. 410, 421-24 (1978); *see also* Hamilton, *supra* note 16, at 955, 957.

In marriage situations, discrepancies in policy exceptions exist due to variations in each state's independent approach toward the different scenarios that can develop.[76] Generally, the "place of celebration" rule applies: a marriage that satisfies the requirements of the state where the marriage was contracted will be recognized as valid by every other state.[77] The general exception to this rule centers on the violation of a state's "strong public policy" when that state has "the most significant relationship to the spouses and the marriage at the time of the marriage."[78] Thus, in cases concerning the recognition of foreign marriages, choice of law principles come into play.[79]

The Court generally accepts invocations of the public policy exception as valid, provided that the foreign state's law is "obnoxious to the policy" of the reviewing state.[80] This does not mean, however, that a state is entitled to refuse to enforce the judgment of a foreign state simply because the forum state has a legitimate interest in applying its own law.[81] In the absence of an "important rather than a merely legitimate state interest" and "a particular judgment that is *in fact* obnoxious to public policy," states will be required to enforce foreign states' judgments.[82]

A state may refuse to recognize a marriage validly promulgated in a foreign state only when recognition of that marriage would be obnoxious to an important public policy of the forum state.[83] Some typical examples of marriages deemed obnoxious to the policy of a reviewing state include incest, polygamy, marriage by minors, and cutting short any waiting period required before remarrying after a divorce.[84] Thus, marriages promulgated under such circumstances will be held invalid, thereby allowing the court to ignore

---

[76] *See* Kramer, *supra* note 8, at 1968-70 ("[E]very state recognizes situations in which it abandons the place of celebration rule.").

[77] *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 283 (1971); Kramer, *supra* note 8, at 1969. Policy reasons generally supporting the place of celebration rule include: the need to protect the justified expectations of marriage partners (i.e., enabling them to know with certainty whether their marriage is valid); and perpetuating the values of certainty, predictability, and uniformity of result. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 283; Kramer, *supra* note 8, at 1969.

[78] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 283 cmt. b ("The extent of the interest of a state in having its rule applied should be determined in the light of the purpose sought to be achieved by the rule . . . and of the issue involved . . . and by the relation of the marriage and the parties to the state.").

[79] *See* Strasser, *supra* note 38, at 327.

[80] *See, e.g.*, Pacific Employees Ins. Co. v. Industrial Accident Comm'n, 306 U.S. 493, 501-02 (1939); *see also* Hamilton, *supra* note 16, at 958-59; Kramer, *supra* note 8, at 1968-70.

[81] *See* Strasser, *supra* note 38, at 318.

[82] *Id.* at 319 (emphasis added).

[83] *See id.* at 335.

[84] *See* Kramer, *supra* note 8, at 1970; *see also* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 283 cmt. k; Strasser, *supra* note 38, at 337.

another state's decree.[85] This exception, however, is not to be used when one state's policy merely differs from the forum state's policy; otherwise, "the exception would swallow the rule."[86]

There are times when the Court requires the recognition of marriages validly performed in sister states by a forum state. For example, in *Sherrer v. Sherrer*,[87] the Court recognized the special interests of the states in regulating their domestic affairs, yet deemed those interests still subject to the requirements of the Full Faith and Credit Clause.[88]

In *Sherrer*, the petitioner moved from Massachusetts to Florida, while the respondent, the petitioner's husband, remained domiciled in Massachusetts.[89] While in Florida, the petitioner filed for and obtained a divorce decree from a circuit court of the State of Florida.[90] Soon after the Florida divorce decree was entered, the petitioner re-married in Florida.[91]

The respondent subsequently instituted an action in the Probate Court of Berkshire County, Massachusetts, where he alleged that the Florida divorce decree was invalid for lack of proper jurisdiction and that the petitioner's subsequent marriage was void.[92] The probate court granted the respondent the relief he sought and found that the petitioner was never domiciled in Florida.[93] The Supreme Judicial Court of Massachusetts affirmed the probate court's ruling.[94] It reasoned that the requirements of full faith and credit did not preclude the Massachusetts courts from re-examining the finding of domicile made by the Florida court.[95]

On appeal, the United States Supreme Court reversed the Massachusetts courts' ruling. The Court held that the Massachusetts courts erred in permitting the Florida divorce decree to be subjected to attack on the ground that the petitioner was not domiciled in Florida at the time the decree was entered.[96] The Court reasoned that because the Florida court had proper

---

[85] *See* Strasser, *supra* note 38, at 334-36.

[86] Kramer, *supra* note 8, at 1970.

[87] 334 U.S. 343 (1948).

[88] *See id.* at 354 (requiring Massachusetts to adhere to the Full Faith and Credit Clause and recognize a Florida divorce decree).

[89] *See id.* at 345.

[90] *See id.* at 345-46. The Florida court determined that it had jurisdiction over the matter, and that due process had been served in that the respondent appeared personally to testify in the divorce proceedings. *See id.* at 346.

[91] *See id.* at 347.

[92] *See id.*

[93] *See id.* at 348.

[94] *See id.* at 348.

[95] *See id.* at 347-48.

[96] *See id.* at 352.

jurisdiction over the matter, the "litigation should end in the courts of the State in which the judgment was rendered."[97] The Court stated:

> We do not conceive it to be in accord with the purposes of the full faith and credit requirement to hold that a judgment rendered under the circumstances of this case may be required to run the gantlet [sic] of such collateral attack in the courts of sister States before its validity outside of the State which rendered it is established or rejected.[98]

The *Sherrer* Court adhered to the purpose of the clause and emphasized the importance of putting an end to litigation.[99]

In light of the Court's apparent willingness to require full faith and credit despite open conflicts between state marriage laws, opponents of same-sex marriage have expressed concern that the same recognition will be required of same-sex marriages.[100] DOMA,[101] discussed below, addresses this concern, and attempts to prevent these issues from reaching the Court by creating its own exception to the rule of full faith and credit. For now, it is sufficient to note that DOMA creates a means of bypassing the Court's current requirement of full faith and credit and the Court's subsequent limitation of the public policy exception.[102]

The following Part provides a discussion of the events leading to the *Baker* Court's attempt to define the parameters of full faith and credit. Through its reasoning, the Court may have altered the effectiveness of the public policy exception and its implications for the full faith and credit requirement with regard to the same-sex marriage issue.

III. BAKER V. GENERAL MOTORS CORPORATION

The issue of full faith and credit in *Baker* developed as a result of two lawsuits brought by two different parties in different states.[103] The first suit involved a dispute between former GM employee Ronald Elwell and GM. Elwell worked for GM for thirty years from 1959 until 1989.[104] For fifteen of those years, he was a member of GM's Engineering Analysis Group, where

---

97 *Id.* at 356.

98 *Id.*

99 *See id.* at 354-56.

100 *See* discussion *infra* section V.B.

101 28 U.S.C. § 1738C (Supp. III 1997).

102 *See generally* Andrew Koppelman, *Dumb and DOMA: Why the Defense of Marriage Act is Unconstitutional*, 83 IOWA L. REV. 1, 15-18 (1997)(discussing how DOMA will "plainly alter [the] preexisting law" that generally requires the recognition of judgments by allowing states to ignore foreign states' judgments regarding same-sex marriages).

103 *See* Baker v. General Motors Corp., 522 U.S. 222, 225-31 (1998).

104 *See id.* at 226.

he studied the performance of GM vehicles with a particular focus on vehicular fires.[105] In that capacity, Elwell would testify in product liability suits brought against GM as GM's expert witness on fuel line designs.[106]

The relationship between GM and Elwell deteriorated in 1987 until Elwell's termination in 1989.[107] In 1991, Elwell was deposed by plaintiffs in a products liability action pending in Georgia against GM.[108] Over the objection of counsel for GM, Elwell offered testimony contrary to testimony he had previously given in GM's defense in earlier lawsuits.[109] Elwell testified that GM's pickup truck fuel system was inferior to that of competing products.[110]

Following this drastic change in his testimony, Elwell sued GM in 1991 in a Michigan county court for wrongful discharge and other tort and contract claims.[111] GM counterclaimed, asserting that Elwell breached his fiduciary duty to GM by disclosing privileged and confidential information.[112] Acting on a motion filed by GM for a preliminary injunction, the Michigan court enjoined Elwell from making further disclosures.[113]

Nearly one year later, GM and Elwell reached a settlement where Elwell received an undisclosed amount of money.[114] In exchange, Elwell agreed to a stipulation and a permanent injunction filed with the Michigan court.[115] In addition to conditions imposed by the preliminary injunction, the permanent injunction enjoined Elwell from

> testifying, without the prior written consent of General Motors Corporation, either upon deposition or at trial, as an expert witness, or as a witness of any kind, and from consulting with attorneys or their agents in any litigation already filed, or to be filed in the future, involving General Motors Corporation as an owner, seller, manufacturer and/or designer of the product(s) in issue.[116]

The injunction also contained an exception: that the injunction "shall not operate to *interfere with the jurisdiction of the Court in . . . Georgia*," where the litigation involving the fuel tank was still pending.[117] The separate settlement agreement also included a more general limitation. This limitation

---

[105] *See id.*
[106] *See id.* at 226-27.
[107] *See id.* at 227.
[108] *See id.*
[109] *See id.*
[110] *See id.*
[111] *See id.*
[112] *See id.*
[113] *See id.*
[114] *See id.* at 228.
[115] *See id.*
[116] *Id.*
[117] *Id.* (emphasis in original).

provided that if a court or other tribunal ordered Elwell to testify, his testimony would not constitute a violation of the injunction or the settlement agreement.[118]

The second suit leading to the *Baker* decision involved a wrongful death claim brought by the Bakers against GM in a Missouri state court.[119] Beverly Garner was killed while riding as a passenger in a 1985 Chevrolet S-10 Blazer that collided head-on with another car.[120] The Bakers, who were the decedent's young sons, alleged that GM's defective fuel pump design caused the engine fire that caused their mother's death.[121] They sought to depose Elwell and call him as a witness at trial.[122] After removing the case to the United States District Court for the Western District of Missouri based on diversity jurisdiction, GM contended that the injunction it previously secured against Elwell prevented him from testifying as a witness for the Bakers.[123]

One of the questions presented to the Missouri district court at trial was whether the court was required to enforce the Michigan injunction against Elwell, thereby precluding Elwell's testimony in the Baker action.[124] The Missouri district court concluded that its own "public policy" of shielding from disclosure only privileged or otherwise confidential information would be violated by prohibiting Elwell's testimony.[125] The district court refused to enforce the injunction and permitted Elwell to testify against GM.[126]

The United States Court of Appeals for the Eighth Circuit reversed the district court's ruling.[127] The court noted the district court's finding that the Michigan injunction violated Missouri's public policy, which favors full disclosure of all nonprivileged, relevant information.[128] The court concluded, however, that the district court had erroneously relied on that particular policy.[129] The court reasoned that if a public policy exception existed to the command of full faith and credit, Missouri's policy in favor of full faith and credit was "equally strong."[130]

---

[118] *See id.* at 228-29 (citing Baker v. General Motors Corp., 86 F.3d 811, 820 n.11 (8th Cir. 1996)).

[119] *See id.* at 229.

[120] *See id.*

[121] *See id.*

[122] *See id.*

[123] *See id.* at 229-30.

[124] *See id.* at 230.

[125] *See id.*

[126] *See id.*

[127] *See* Baker v. General Motors Corp., 86 F.3d 811, 814 (8th Cir. 1996).

[128] *See id.* at 819.

[129] *See id.*

[130] *Id.* The court of appeals also reversed on the grounds that the district court improperly held that because the injunction was modifiable in Michigan, it need not be given full faith and

On appeal, the United States Supreme Court disagreed with the decisions of both the district court and the court of appeals. The Court first noted that the district court "misread our precedent" when the lower court applied its "ubiquitous 'public policy exception.'"[131] The Court also rejected the appellate court's view that the settlement agreement, which was executed in a Michigan court, had to be upheld in light of Missouri's "equally strong public policy in favor of full faith and credit."[132] Therefore, the Court reversed and remanded.[133]

The *Baker* Court held that the Michigan judgment was not entitled to full faith and credit because it interfered with Missouri's control of litigation brought by parties who were not before the Michigan court.[134] In reaching its conclusion, the Court examined the issues that had been resolved by the Michigan injunction, and whether those extended into the Missouri courtroom.[135] It found that the injunction only went so far as to conclude those issues in Michigan, thereby permitting Elwell to testify in the Missouri action.[136]

The Court also endeavored to make clear that its decision did not create a public policy exception to the Full Faith and Credit Clause.[137]

IV. THE *BAKER* OPINION

A. Background Principles

The majority opinion, written by Justice Ruth Bader Ginsburg, based its analysis heavily upon the Court's precedent. Joined by Chief Justice William Rehnquist and Justices John Paul Stevens, David Souter, and Stephen Breyer, Justice Ginsburg declared that there is "no roving 'public policy exception' to the full faith and credit due *judgments*."[138] The Court began its analysis with a recitation of the "animating purpose" of the full faith and credit

---

credit in Missouri, but only the same faith and credit as that given by the issuing state's courts. *See id.* at 819-20. The court noted that although the Michigan court "has been asked on several occasions to modify the injunction, [it] has yet to do so." *Id.* at 820. The court also noted that if the Michigan court did not intend to block Elwell's testimony in cases like the Bakers', "the injunction would . . . have been unnecessary." *Id.* at 820. The court concluded that the Bakers failed to establish that the Michigan injunction was not entitled to full faith and credit. *See id.*

131 Baker v. General Motors Corp., 522 U.S. 222, 234 (1998).

132 *Id.* at 230.

133 *See id.* at 241.

134 *See id.* at 233-41.

135 *See id.* at 237.

136 *See id.* at 237-41.

137 *See id.* at 239.

138 *Id.* at 233 (emphasis in original).

provision.[139] It quoted language from *Milwaukee County v. M.E. White Co.*,[140] which explained that the purpose of the clause is to bring together the various and independent sovereign states to create a single nation.[141]

The majority opinion then differentiated between the credit owed to laws versus the credit owed to judgments.[142] "Laws" are equated with legislative measures and common law, while "judgments" are final decisions in a matter rendered by courts with proper jurisdiction.[143] With the definitions provided in *Pacific Employers Insurance Co. v. Industrial Accident Commission*[144] and *Phillips Petroleum Co. v. Shutts*,[145] Justice Ginsburg explained that the full faith and credit command does not require a state to follow the laws of a sister state when they are the type of laws "dealing with a subject matter concerning which it is competent to legislate."[146] In contrast, when it comes to judgments, the Full Faith and Credit Clause is unwavering: "[a] final judgment in one State, if rendered by a court with adjudicatory authority over the subject matter and persons governed by the judgment, qualifies for recognition throughout the land."[147]

Justice Ginsburg then explained the extent to which "public policy" applies when a state is considering whether enforcement of a sister state's judgment is required.[148] In general, a court may use public policy for guidance;[149] however, Justice Ginsburg pointed out that "our decisions support no roving 'public policy exception' to the full faith and credit due judgments."[150] Justice

---

[139] *See id.* at 232.

[140] 296 U.S. 268 (1935).

[141] *See Baker*, 522 U.S. at 232 (stating that the animating purpose of the full faith and credit command "'was to alter the status of the several states as independent foreign sovereignties . . . and to make them integral parts of a single nation throughout which a remedy upon a just obligation might be demanded as of right, irrespective of the state of its origin.'")(citing *Milwaukee County v. M.E. White Co.*, 296 U.S. 268, 277 (1935)); *see also supra* note 34.

[142] *See Baker*, 522 U.S. at 232-33.

[143] *Id.*

[144] 306 U.S. 493, 501 (1939)(acknowledging that while the purpose of the Full Faith and Credit Clause is to require recognition of one state's laws in other states, resort to the Full Faith and Credit Clause in order to compel a state to use another state's laws is precluded when it is dealing with a subject matter on which it is competent to legislate).

[145] 472 U.S. 797, 818-19 (1985)(explaining that the Full Faith and Credit Clause requires a forum state to respect the laws and judgments of other states, subject to the forum's own interests in furthering its public policy).

[146] *Baker*, 522 U.S. at 232 (quoting Pacific Employers Ins. Co. v. Industrial Accident Comm'n, 306 U.S. 493, 501 (1939)).

[147] *Id.* at 233.

[148] *See id.* at 233-36.

[149] *See id.* at 233 (citing Nevada v. Hall, 440 U.S. 410, 421-24 (1979)).

[150] *Id.*

Ginsburg's statement relied on the precedent set in *Nevada v. Hall*,[151] *Estin v. Estin*,[152] and *Fauntleroy v. Lum*.[153]

The majority opinion also clarified that equity decrees were always included within the realm of full faith and credit.[154] That is, decrees, once settled upon, are always deserving of nationwide recognition.[155] The majority saw no reason for questioning the preclusive effects extended through res judicata, regardless of the type of relief sought in civil actions.[156]

Nevertheless, the majority opinion acknowledged that the full faith and credit scheme does have an exception.[157] Justice Ginsburg emphasized that the full faith and credit mandate does not require states to follow a sister state's method of enforcing a judgment.[158] Termed "enforcement measures," the power to determine the "time, manner, and mechanisms for enforcing judgments" is reserved for the forum state and does not travel with a sister state's judgment.[159]

Notwithstanding Justice Ginsburg's in-depth discussion and analysis of the public policy exception, the *Baker* holding ultimately turned on a different issue. The following section describes how the majority reached its holding despite its acute attention to this counterpart issue.

B. A Departure From the Lower Courts' Rationale

In light of the background principles outlined in its opinion, the *Baker* majority asserted that the district court "misread [the Court's] precedent" when it decided the Bakers' wrongful death action.[160] As discussed above, the

---

[151] 440 U.S. 410, 421-24 (1979)(explaining that "[t]he Full Faith and Credit Clause does require each State to give effect to official acts of other States" however, it "does not require a State to apply another State's law in violation of its own legitimate public policy.").

[152] 334 U.S. 541, 546 (1948)(holding that Full Faith and Credit Clause "ordered submission . . . even to hostile policies reflected in the judgment of another State, because the practical operation of the federal system, which the Constitution designed, demanded it.").

[153] 210 U.S. 230, 237 (1908)(holding that judgment of Missouri court entitled to full faith and credit in Mississippi even if Missouri judgment rested on a misapprehension of Mississippi law).

[154] *See Baker*, 522 U.S. at 234; *see also supra* note 45.

[155] *See Baker*, 522 U.S. at 234.

[156] *See id.* at 234 ("We see no reason why the preclusive effects of an adjudication on parties and those 'in privity' with them, i.e., claim preclusion and issue preclusion (res judicata and collateral estoppel), should differ depending solely upon the type of relief sought in a civil action.").

[157] *See id.* at 235.

[158] *See id.* at 235 ("Enforcement measures do not travel with the sister state judgment as preclusive effects do; such measures remain subject to the even-handed control of forum law.").

[159] *See id.*

[160] *Id.* at 234.

district court had alternative grounds for permitting the Bakers to depose Elwell and to call him as a witness at trial.[161] The district court reasoned that: (1) Michigan's injunction did not need to be enforced because blocking Elwell's testimony would violate Missouri's "public policy," which precluded the disclosure only of privileged or otherwise confidential information, and (2) because the injunction could be modified in Michigan, "a court elsewhere could [also] modify the decree."[162]

The Supreme Court determined that the order issued by the Michigan county court was claim preclusive between Elwell and GM.[163] Although there were no issues joined, litigated, or determined in the Michigan proceeding, the claims brought by Elwell "merged in the judgment," barring Elwell from further suing GM to recover more.[164] Likewise, GM was also barred from bringing suit against Elwell on its counterclaim.[165]

However, the Court reasoned that the Michigan order could not extend beyond the controversy before it to control proceedings elsewhere when different parties brought suit.[166] The Court agreed with the district court, which recognized that the order only precluded Elwell from "*volunteering*" his testimony.[167] However, in the event that Elwell was summoned to appear as a witness, the Michigan court could not "dictate to a court in another jurisdiction that evidence relevant in the Bakers' case—a controversy to which Michigan is foreign—shall be inadmissible."[168] The Court emphasized that this ruling did not permit the conclusion that a general exception to the full faith and credit requirement exists.[169] Instead, the Court reasoned that because enforcement measures could not travel with a sister state's judgment, the Michigan order could not determine evidentiary issues in an action brought by different parties in different states.[170]

The majority's analysis also differed from the Eighth Circuit's in that the court of appeals assumed that a public policy exception to the full faith and credit requirement existed.[171] The Eighth Circuit thus based its reversal on the "equally strong public policy in favor of full faith and credit" in contrast to the policy of nondisclosure cited by the district court.[172]

---

[161] *See supra* notes 124-26 and accompanying text.
[162] *See Baker*, 522 U.S. at 230.
[163] *See supra* notes 131-33 and accompanying text.
[164] *See Baker*, 522 U.S. at 237-38.
[165] *See id.* at 238.
[166] *See id.*
[167] *Id.* at 239 (emphasis in original).
[168] *Id.*
[169] *See id.*
[170] *See id.*
[171] *See supra* notes 127-30 and accompanying text.
[172] *Baker*, 522 U.S. at 230.

C. Justice Scalia's Approach

In a brief opinion concurring in the judgment, Justice Scalia agreed with the Court that enforcement measures do not travel with sister-state judgments in the same way that preclusive effects do.[173] However, Justice Scalia deemed that the injunction only established a rule of evidence rather than jurisdiction[174] under the key principle that "the judgment of a state Court cannot be enforced out of the state by an execution issued within it."[175] He emphasized that the full faith and credit requirement only applied to lend judgments "a general validity, faith, and credit to them, *as evidence*."[176]

Under Justice Scalia's approach, the only way the Michigan judgment would become enforceable in Missouri is if a new action were taken in Missouri to establish it as a judgment there.[177] Therefore, he concluded that the Clause and its implementing statute did not require Missouri to execute the injunction as issued by the Michigan court.[178]

D. Justice Kennedy's Concurrence

In his opinion concurring in the judgment, Justice Kennedy, joined by Justices O'Connor and Thomas, criticized the majority's approach.[179] He asserted that the case was "controlled by well-settled . . . principles which render[ed] the majority's extended analysis unnecessary," and that the majority's decision constituted two broad exceptions to full faith and credit that had "a potential for disrupting judgments."[180]

According to Justice Kennedy's opinion, the majority went against traditional res judicata principles when it suggested that: (1) courts outside the issuing state would be permitted to refuse to enforce those sister states' judgments "purport[ing] to accomplish an official act within the exclusive province of [a sister] State;"[181] and (2) basic full faith and credit coverage would not extend to injunctions "interfer[ing] with litigation over which the

---

173 *See id.* at 241 (Scalia, J., concurring).

174 *See id.* at 242 (citing Wisconsin v. Pelican Ins. Co., 127 U.S. 265, 291-92 (1888)).

175 *Id.* at 241 (citing McElmoyle *ex rel.* Bailey v. Cohen, 38 U.S. (13 Pet.) 312, 325 (1839)). Justice Scalia asserted that "to recite that principle is to decide this case." *Id.*

176 *Id.* (citing Thompson v. Whitman, 85 U.S. (18 Wall.) 457, 462-63 (1873))(emphasis in original).

177 *See id.* at 242.

178 *See id.*

179 *See id.* at 243-51 (Kennedy, J., concurring).

180 *Id.* at 243, 244.

181 *Id.* at 243 (alterations in original).

ordering State had no authority."[182] He noted that "[the Court's] decisions have been careful not to foreclose all effect for the types of injunctions the majority would place outside the ambit of full faith and credit."[183] He went on to assert that "[t]he Court's reliance upon unidentified principles to justify omitting certain types of injunctions from the doctrine's application leaves its decision in uneasy tension with its own rejection of a broad public policy exception to full faith and credit."[184]

According to Justice Kennedy, the majority's approach was inappropriate because the full faith and credit issue was not before the Court.[185] In his view, the threshold matter should have simply been the determination of the extent to which Michigan law gave preclusive effect to the injunction.[186] Then, by reaching the conclusion that Michigan would not give the prior judgment preclusive effect, Missouri could ignore the judgment as well.[187]

Under Justice Kennedy's approach, it would have been unnecessary for the Missouri court to give Michigan's injunction any more force or effect than Michigan gave it.[188] Although the court of appeals and the parties involved assumed that Michigan would apply its injunction with full force against the Bakers, Michigan law did not actually support that assumption.[189] Because the Bakers were not parties to the Michigan lawsuit, and because Michigan would not assert that its order prevented the Bakers from summoning Elwell, the Bakers would not be bound by the judgment.[190] Thus, in this situation, the question of full faith and credit did not need to be addressed.[191]

V. ANALYSIS

In light of the foregoing, what possible effect will *Baker* have on the full faith and credit doctrine and the public policy exception? Furthermore, what implications, if any, might *Baker* have on the same-sex marriage issue and

---

[182] *Id.* (alterations in original).
[183] *Id.* at 244.
[184] *Id.* at 245.
[185] *See id.*
[186] *See id.* at 247.
[187] *See id.*
[188] *See id.*
[189] *See id.*
[190] *See id.* at 247-48.
[191] *See id.* at 251 (Kennedy, J., concurring). Justice Kennedy concluded that

> determining as a threshold matter the extent to which Michigan law gives preclusive effect to the injunction eliminates the need to decide whether full faith and credit applies to equitable decrees as a general matter or to the extent to which the general rules of full faith and credit are subject to exceptions.

Id.

DOMA? The majority addressed the full faith and credit issue when, as Justice Kennedy's concurrence pointed out, the case could have been resolved on clear res judicata principles alone. Even Justice Ginsburg herself acknowledged in a footnote that "the Michigan judgment has no preclusive effect on the Bakers, for they were not parties to the Michigan injunction."[192] Perhaps in anticipation of further misuse of the clause and its exception, the majority sought to shed some light on its interpretation of the rarely used Full Faith and Credit Clause. The majority's message, found peripherally in its discussion rather than in a direct holding, indicates that the application of a public policy exception as a reason to ignore another state's law will be subject to limitations.[193]

This aspect of *Baker* arguably is the most controversial part of the Court's analysis, due to the potential effect that the decision may have on the issue of same-sex marriage. As described in Section I,[194] same-sex marriage supporters see a stronger foundation upon which to lay their basic assertion that the Full Faith and Credit Clause requires sister states to recognize as valid a same-sex marriage that has been procured in another state. Through the apparent limitations imposed by *Baker*, there may be less reason for a sister state to deny recognition of another state's marriage decree. At the very least, after *Baker*, a "ubiquitous" public policy exception no longer exists.[195]

Same-sex marriage opponents, however, have yet another exception that lurks out there, created out of anticipation and anxiety.[196] While *Baker* may have precluded the application of the public policy exception, Congress's DOMA extends to individual states the ability to take detours around this obstacle.[197] In response to this sidestep of full faith and credit, commentators and critics have strongly voiced their opinion that DOMA is inherently unconstitutional.[198] The following sections discuss the public policy

---

[192] *Id.* at 237 n.11.

[193] *See id.* at 233-36.

[194] *See supra* note 17 and accompanying text.

[195] *See Baker*, 522 U.S. at 234.

[196] *See, e.g.*, Julie L.B. Johnson, *The Meaning of "General Laws": The Extent of Congress's Power Under the Full Faith and Credit Clause and the Constitutionality of the Defense of Marriage Act*, 145 U. PA. L. REV. 1611, 1636-37 (1997)(discussing the legislative history of DOMA); Kramer, *supra* note 10, at 159; Mark Strasser, *DOMA and the Two Faces of Federalism*, 32 CREIGHTON L. REV. 457, 457 (1998) [hereinafter "*DOMA*"] (speculating that by enacting DOMA, Congress either wanted to forestall changes in current law, or "was trying to do something else.").

[197] States also have the option of enacting legislation or amending existing marriage laws to make certain marriages voidable or prohibited. *See* Strasser, *supra* note 38, at 352-54.

[198] *See, e.g.*, Kelly, *supra* note 9, at 203; Koppelman, *supra* note 102; Ruskay-Kidd, *supra* note 24.

exception as it exists after *Baker* and how the Supreme Court might react to the conflict between DOMA and the full faith and credit command.

A. *The Effect of Baker on Full Faith and Credit*

By declaring that there is no "roving 'public policy exception' to the full faith and credit due *judgments*,"[199] Justice Ginsburg limited the scope of the public policy exception. This admonishment restricting the public policy exception was in response to misapplications by both lower courts.[200] Justice Ginsburg apparently sought to eliminate a large area of confusion about the ability of state courts to rely on such exceptions when disregarding other states' judgments.[201] Thus, after *Baker*, a court may be guided by its own "public policy" in determining what law is applicable to a controversy.[202] It may not, however, invoke a public policy exception to avoid enforcing a final judgment from another state.[203] Additionally, Justice Ginsburg made it clear that equity decrees, like final judgments, are entitled to full faith and credit.[204]

It is important to note that Justice Ginsburg's express limitation of the public policy exception is specifically aimed at final judgments and not laws. In differentiating between "laws" and "judgments," Justice Ginsburg explicitly stated that "[r]egarding judgments, . . . the full faith and credit obligation is exacting."[205] This express language indicates that once a final judgment is reached under proper jurisdiction, "the judgment of the rendering State gains nationwide force."[206] Justice Ginsburg acknowledged that full faith and credit is not required when a state is "'dealing with a subject matter concerning which it is competent to legislate[.]'"[207] That is, when a state is confronted with the "laws" (i.e., legislative measures and common law) of a sister state, it has some flexibility in choosing which law to apply.[208]

---

[199] *Baker*, 522 U.S. at 233 (emphasis in original).

[200] *See id.* at 233-34.

[201] *See* Polly J. Price, *Full Faith and Credit and the Equity Conflict*, 84 VA. L. REV. 747, 765 (1998).

[202] *See Baker*, 522 U.S. at 233.

[203] *See id.* at 232-33; *see also* Price, *supra* note 201, at 766.

[204] *See Baker*, 522 U.S. at 234 (stating that "[t]he Court has never placed equity decrees outside the full faith and credit domain"). In a later footnote, Justice Ginsburg acknowledges that although the Court "has held it impermissible for a state court to enjoin a party from proceeding in a federal court," it "has not yet ruled on the credit due to a state court injunction barring a party from maintaining litigation in another State." *Id.* at 665 n.9 (citations omitted).

[205] *Id.* at 233; *see also supra* notes 142-47 and accompanying text.

[206] *Baker*, 522 U.S. at 233.

[207] *Id.* at 232 (quoting Pacific Employers Ins. Co. v. Industrial Accident Comm'n, 306 U.S. 493, 531 (1939)).

[208] *Baker*, 522 U.S. at 232.

At the outset, it seems as though *Baker* attempted to shut the door on inconsistent applications of full faith and credit by reiterating the Supreme Court's precedent. The majority opinion refers to the original purpose of the Full Faith and Credit Clause, which is to bring the individual states together as one nation.[209] This reaffirmation of the clause's unifying force continues to require states to recognize another state's final judgment.[210]

Nevertheless, the majority may have invitingly left the door ajar for inconsistencies by addressing two situations where full faith and credit is not required. According to the majority opinion, full faith and credit does not extend to orders "purport[ing] to accomplish an official act within the exclusive province of that other State," nor does it apply to injunctions "interfer[ing] with litigation over which the ordering State had no authority."[211] Applying these exceptions, the Court held that Elwell's testimony was not barred because (1) Michigan lacked the authority to control the admissibility of evidence in the Missouri lawsuit;[212] and (2) the Michigan order interfered with the Missouri litigation when the Michigan court lacked jurisdiction over such matters.[213]

The apparent gap left by Justice Ginsburg's exceptions may prove to be disruptive to future judgments, as suggested by Justice Kennedy's concurrence.[214] Justice Kennedy hinted at the possibility of a situation arising in the future in which the Court would be required to hold that an otherwise valid judgment may not intrude upon "essential processes" of courts outside the issuing state in "certain narrow circumstances."[215] The *Baker* case, according to Justice Kennedy, did not require such a holding.[216]

Justice Kennedy's cautious approach indicates his belief that the full faith and credit doctrine has been expanded to ill-defined borders. He opined that "[t]he exceptions the majority recognizes are neither consistent with its rejection of a public policy exception to full faith and credit nor in accord with

---

[209] *See id.* (describing the "animating purpose" of the Full Faith and Credit Clause); *see also supra* notes 33-36 and accompanying text.

[210] *See Baker*, 522 U.S. at 233 (stating that "[a] final judgment in one State, if rendered by a court with adjudicatory authority over the subject matter and persons governed by the judgment, qualifies for recognition throughout the land.").

[211] *Id.* at 235; *see also* discussion *supra* section IV.B.

[212] *See Baker*, 522 U.S. at 238 (noting that doing so would permit Michigan to dictate the mechanism for enforcement of the Michigan judgment).

[213] *See id.* at 237-38. The majority explained that "Michigan's judgment . . . cannot reach beyond the Elwell-GM controversy to control proceedings against GM brought in other States, by other parties, asserting claims the merits of which Michigan has not considered." *Id.* at 238.

[214] *See id.* at 243-44 (Kennedy, J., concurring).

[215] *See id.* at 245 (Kennedy, J., concurring).

[216] *See id.*

established rules implementing the Full Faith and Credit Clause."[217] Evidently, what troubled Justice Kennedy the most was the vague language employed by the majority in describing the two situations when full faith and credit would not be required.[218]

It must be remembered that the *Baker* holding was premised upon res judicata principles and not the Full Faith and Credit Clause.[219] Arguably, the extensive coverage of the full faith and credit issues was warranted, in the eyes of the majority, by the lower courts' misuse of the public policy exception.[220] In this light, it seems that Justice Ginsburg saw an opportunity to clarify exactly when full faith and credit is due and when a public policy exception is justifiable.[221]

Nevertheless, by subtly combining the full faith and credit discussion with the "official acts" and "interference" rationale underlying the ultimate holding,[222] Justice Ginsburg may have created an area of ambiguity that will, as Justice Kennedy predicts, render the rationale vulnerable to later misinterpretation. In the context of *Baker*, where different parties were involved in different lawsuits, it is relatively easy to reach the conclusion that the Michigan injunction could not apply to the Missouri litigation. However, the *Baker* holding relied on res judicata principles even after rendering its full faith and credit analysis. Such reliance, intertwined with full faith and credit, may mislead or even encourage later courts to decline to recognize foreign judgments because those judgments purportedly "interfered with litigation" or attempted to "accomplish an official act."[223] In the end, an alter ego of the public policy exception may have been created.

Thus, although *Baker* clearly limited the availability of the public policy exception as it pertains to judgments, *Baker* may also have left an opening for courts to deny enforcement of another state's orders. The vague language employed by Justice Ginsburg leaves room for individual courts' interpretation and application. In light of this possible vulnerability, the following section explores the effect of *Baker* on the same-sex marriage issue and how courts may use *Baker* to avoid recognizing such unions.

---

[217] *Id.* at 243 (Kennedy, J., concurring).

[218] *See id.* at 245 (Kennedy, J., concurring)(stating that the majority's "broad review" of the two exceptions "does not articulate the rationale underlying its conclusions.").

[219] *See id.* at 231-41.

[220] *See id.* at 233-34, 239-41.

[221] *See id.* at 231-36.

[222] *See id.* at 239-41.

[223] *See id.* at 235.

B. Baker, Same-Sex Marriage, and the Public Policy Exception

Generally, *Baker*'s outright limitation on public policy exceptions would only become pertinent in the same-sex marriage debate in the absence of prohibitive legislation voiding the marriage.[224] Even then, the public policy exception would apply only if a state found the marriage, regardless of its same-sex nature, obnoxious to an important state public policy.[225] Alternatively, states could adopt DOMA, which allows states to sidestep the strict full faith and credit requirement.

In the first instance, if a state had not already adopted legislation that outlaws same-sex marriage,[226] a same-sex marriage that is legally recognized in one state could still be rejected by a sister state if such a union is considered obnoxious to the sister state's public policy.[227] This state would liken same-sex marriage to marriages stemming from incest, polygamy, and the like.[228] Due to the general acceptance of such specific exceptions, a public policy finding same-sex marriages obnoxious would not be objectionable at first blush. After *Baker*, a state may still extend its public policy exception to avoid full faith and credit in such a context. This is because the holding in *Baker* did not pertain expressly to marriage decrees; rather, it denounced the applicability of public policy exceptions to final judgments.[229]

Nevertheless, in the absence of prohibitive legislation, choice of law principles regarding marriage require the balancing of the state's public policy against the justified interests of the issuing state and the partners seeking recognition of their marriage.[230] In the marriage context, the place of celebration rule generally governs and public policy exceptions are rarely used.[231] However, on the rare occasion when a court opts not to apply the

---

[224] *See* Kramer, *supra* note 8, at 1977-78 (citing Phillips Petroleum Co. v. Shutts, 472 U.S. 797, 818-19 (1985); Pacific Employers Ins. Co. v. Industrial Accident Comm'n, 306 U.S. 493, 502 (1939)).

[225] *See id.*

[226] *See* Strasser, *supra* note 38, at 345-46. When legislation that prohibits certain marriages does exist, "the majority is presumed to disapprove of it" and may be considered a reflection of "a pervading feeling of moral shock within the whole community . . . even if validly celebrated in another state." *Id.*

[227] Again, this reflects the place of celebration rule found in section 283 of the Restatement (Second) of Conflict of Laws, which states "marriage which satisfies the requirements of the state where the marriage was contracted will everywhere be recognized as valid unless it violates the strong public policy of another state which had the most significant relationship to the spouses and the marriage at the time of the marriage." RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 283 (1971).

[228] *See supra* notes 83-85 and accompanying text.

[229] *See* discussion *supra* section V.A.

[230] *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 283 cmt. b (1971).

[231] *See* Kramer, *supra* note 8, at 1971.

place of celebration rule, public policy is most often the reason cited.[232] Accordingly, "[a]s same-sex marriages become an issue, then, we can expect reluctant states to turn to the public policy doctrine to protect their interests."[233]

Although the public policy exception has been criticized as a means for courts to avoid making thoughtful choice of law decisions,[234] it is likely that most of the same-sex marriage debates will be decided on public policy grounds. As long as the public policy exception remains available in a choice of law context, states will be free to decline to enforce another state's legally recognized same-sex marriage. Therefore, the language describing "official acts" and "interference with litigation" in the *Baker* majority opinion will probably remain insignificant with respect to the same-sex marriage issue. Moreover, despite *Baker*'s limitation on the use of the public policy exception, same-sex marriages will continue to be subjected to each state's preferences and policies. Although the normal choice of law framework for conflicting marriage laws requires a step by step analysis of which state's laws apply,[235] states rejecting same-sex marriages will ultimately rely upon their statutes or assert public policy. However, the analysis in this Note assumes that states will automatically deem that same-sex marriages are objectionable. It does not account for the possibility that some states might feel compelled to recognize such marriages in the absence of legislation.

Recognizing this possibility, states resisting same-sex marriages have sought congressional protection through DOMA.[236] DOMA enables a state to avoid a sister state's judgment for the sake of the reviewing state's important public policy.[237] Essentially, DOMA permits a state to refuse to recognize a

---

[232] *See id.*

[233] *Id.*

[234] *See id.* at 1972; *see also* L. Lynn Hogue, *State Common-Law Choice-of-Law Doctrine and Same-Sex "Marriage": How Will States Enforce the Public Policy Exception?*, 32 CREIGHTON L. REV. 29, 32-33 (1998).

[235] *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 6 (1971).

[236] *See* Koppelman, *supra* note 9, at 1001 n.4. Those states are: Alaska, Arizona, Arkansas, Delaware, Florida, Georgia, Hawai'i, Idaho, Illinois, Indiana, Kansas, Maine, Michigan, Minnesota, Mississippi, Missouri, Montana, North Carolina, North Dakota, Oklahoma, Pennsylvania, South Carolina, South Dakota, Tennessee, Utah, and Washington. *See id.*

[237] When *Baehr v. Lewin*, 74 Haw. 530, 852 P.2d 44 (1993), was decided, the idea that same-sex marriages would become legalized in Hawai'i sent shockwaves across the nation. *See, e.g.*, Joan Biskupic & John E. Yang, *Gay Marriage is Allowed by Hawaii Court; Trial Judge Says Ban Fails Key Test Under State Constitution*, WASH. POST, Dec. 4, 1996, at A01 (describing the *Baehr v. Miike* decision and the public's reaction to it). In addition to the enactment of statutes in twenty-six states, *see* Koppelman, *supra* note 9, at 923-24 the most noticeable and extreme reaction came from Congress through its Defense of Marriage Act (DOMA) of 1996. 28 U.S.C. § 1738C (Supp. III 1997).

valid same-sex marriage performed in another state.[238] The purpose of DOMA, according to the Act's legislative history, is "to defend the institution of traditional heterosexual marriage" and "to protect the right of the States to formulate their own public policy regarding the legal recognition of same-sex unions, free from any federal constitutional implications that might attend the recognition by one State of the right for homosexual couples to acquire marriage licenses".[239] However, under the Effects Clause, Congress arguably does not possess the power to create such an Act, therefore making DOMA unconstitutional.[240]

Criticism has focused on the actual function of the Act, which permits one state to ignore another state's laws, resulting in a "categorical exemption" from the Full Faith and Credit Clause.[241] Supreme Court precedent[242] shows that Congress' Article IV power only permits Congress to create legislation in effectuating the Full Faith and Credit Clause rather than remove requirements of the clause.[243]

Additionally, DOMA circumvents the purpose of the Full Faith and Credit Clause as interpreted by the Supreme Court.[244] As discussed above, the Court determined that the purpose of the clause was to "alter the status of the several states" and bring them together as a "single nation."[245] However, with

---

[238] *See* 28 U.S.C. § 1738C.

[239] H.R. REP. NO. 104-664, at 1, 2 (1996), *reprinted in* 1996 U.S.C.C.A.N. 2905, 2906.

[240] *See* 142 CONG. REC. S5931-01 (daily ed. June 6, 1996)(letter from Professor Laurence H. Tribe to Senator Edward M. Kennedy, May 24, 1996)(asserting that Congress enacted DOMA without a valid source of power).

To justify its creation of DOMA, Congress claimed that it exercised its power pursuant to the second half of Article IV, § 1, which states: "And the Congress may by general Laws prescribe the Manner in which such Acts, Records and Proceedings shall be proved, and the Effect thereof." U.S. CONST. art. IV, § 1; *see also* Glensy, *supra* note 25, at 140-42 (asserting that Congress "conveniently latched onto the Full Faith and Credit Clause . . . and in particular, to the second sentence of the clause.").

[241] *See* 142 CONG. REC. S5931-01, at S5932 (calling the provision "plainly unconstitutional" due to the congressional exercise of a non-existent power).

[242] *See, e.g.*, Thompson v. Thompson, 484 U.S. 174, 183 (1988)(holding that congressional legislation mirroring the language of the Full Faith and Credit Clause has no additional substantive impact.); Thomas v. Washington Gas Light Co., 448 U.S. 261 (1980)(stating that the Court will question the constitutionality of congressional attempt to pass legislation that authorizes states to ignore the acts of sister states.); Hamilton, *supra* note 16, at 952-54.

[243] *See* Hamilton, *supra* note 16, at 947, 952-54 (concluding that "there is at least some question whether Congress may cut back on the measure of faith and credit required by a decision of this Court.").

[244] *See* Glensy, *supra* note 25, at 151-56, 178-80 (concluding that DOMA goes against all of the purposes and goals served by the Full Faith and Credit Clause).

[245] *See* Allstate Ins. Co. v. Hague, 449 U.S. 302, 322-24 (1981); Sherrer v. Sherrer, 334 U.S. 343, 355 (1948); Milwaukee County v. M.E. White Co., 296 U.S. 268, 276-77 (1935); *see also supra* note 34 and accompanying text.

DOMA, the nation is divided into separate sovereignties once again in that each state is permitted to disregard the acts or proceedings of other states with regard to marriages.[246]

In light of these indications that DOMA may be unconstitutional, it is unlikely that the Supreme Court will decide otherwise in the future. Thus, if and when the issue comes before the Court, it will most likely strike the statute down. As one commentator predicts, to do otherwise would cause the Court to lose its ability to prevent future violations of the Full Faith and Credit Clause by congressional legislation.[247] In essence, by upholding DOMA and permitting Congress to reduce the extent of the command of the Full Faith and Credit Clause, the Court would effectively give its approval to other constitutional violations by congressional legislation and deprive itself of the power to stop such unconstitutional acts.[248]

VI. CONCLUSION

The majority, in its extended analysis of the public policy exception, has set the stage for full faith and credit disputes. Currently, courts generally have broad discretion to exercise the public policy exception to the Full Faith and Credit doctrine.[249] The exception is meant for rare circumstances when the foreign judgment is undesirable or contrary to the important public policy of the forum.[250] Nevertheless, courts have abused the flexibility offered by the public policy exception and have objected to foreign states' final judgments even when the judgments adhered to constitutional standards.[251] From this perspective, the public policy exception should be a narrow one, and used infrequently.[252] In light of past "exceptions" that have been premised on "public policy," however, at least one commentator predicts that public policy will become the basis for invalidating same-sex marriages performed in Hawai'i.[253]

It is possible that the majority in *Baker* wanted to establish concrete rules after sensing that courts may abuse the public policy exception with ease. The

---

[246] *See* Patten, *supra* note 23, at 954.

[247] *See* Hamilton, *supra* note 16, at 985-86.

[248] *See id.* at 986-87.

[249] *See* Kramer, *supra* note 8, at 1975.

[250] *See id.* at 1971-73.

[251] *See id.* at 1972-73 (explaining that laws viewed as constitutional are rarely characterized as violating "fundamental principles of justice"); *see also* Reynolds, *supra* note 57, at 449 (asserting that judgments that comply with constitutional requirements satisfy basic fairness and policy norms, thereby rendering it difficult to accept a state's policy objection to a sister state's judgment).

[252] *See* Kramer, *supra* note 8, at 1972-73.

[253] *See id.* at 1971, 1998.

rules that the *Baker* opinion established, however, are not entirely clear. As a result, even after *Baker*, courts may continue to invoke the exception and refuse to recognize sister states' laws.[254] Regardless of the strong language of the Full Faith and Credit Clause, courts have created their own form of exceptions.[255] Perhaps to curb such abuse, the Court declared that no roving public policy existed.[256] In attempting to limit the public policy exception, the Court arguably opened up other areas to which the states may turn should they find offense with another state's policy.

Baker might be considered a prelude to the highly anticipated same-sex marriage debate. However, to address the same-sex marriage question prematurely would be, as Justice Kennedy put it, to "announce rules which will not be sound in later application."[257] It is unlikely that those concerned with same-sex marriage issues will be able to find any sure footing in terms of limiting or eliminating a public policy exception. Altogether, the *Baker* opinion did not add anything particularly new to the full faith and credit debate, except perhaps a clearer definition of when such credit is due.

In terms of DOMA and litigation that is sure to arise disputing its authority, the Court is likely to find the Act unconstitutional. In turn, this will again force each state to examine exactly what policies are at stake in the same-sex marriage debate, and may yet again ignite an entire new debate on defining the scope of the Full Faith and Credit Clause and the ever-present public policy exception.

Nevertheless, the majority has spoken. As both sides on the issue of legalized same-sex marriage take stock of their ammunition, the issue will come down to whether the Court can find a logical basis for a public policy exception to recognizing a same-sex marriage made valid in one state but repugnant to another.

Kaleen S. Hasegawa[258]

---

[254] *See id.* at 1975.

[255] *See id.* at 1972-75 (arguing that the public policy doctrine operates selectively based on the content of foreign law).

[256] *See* discussion *supra* section IV.A.

[257] Baker v. General Motors Corp., 118 S. Ct. 657, 670 (1998)(Kennedy, J., concurring).

[258] Class of 2000, William S. Richardson School of Law.

From *Mago* to *Duffield*: Recent Developments in the Enforceability of Mandatory Arbitration Agreements of Title VII Claims in the Ninth Circuit

I. INTRODUCTION

Employment litigation has increased by 400% in the past twenty years.[1] Eighty thousand claims of discrimination in employment were pending before the Equal Employment Opportunity Commission ("EEOC") in 1996.[2] From 1991 to 1995, there was a 128% increase in the number of employment-related civil rights lawsuits filed in federal court.[3] One controversial group of these lawsuits involves challenges to arbitration agreements by employees who have signed or are otherwise subject to pre-dispute arbitration agreements.

This Recent Development classifies Ninth Circuit case law dealing with challenges to mandatory arbitration agreements of Title VII[4] claims into three phases. In the first phase, the Ninth Circuit held that Title VII claims are arbitrable.[5] In the second phase, the Ninth Circuit, by requiring "a knowing waiver," became most restrictive in construing mandatory arbitration agreements concerning employment discrimination claims.[6] The third phase is represented by *Duffield v. Robertson Stephens & Co.*,[7] where the Ninth Circuit disagreed with other circuits by holding that employers cannot require individual employees to arbitrate discrimination claims under Title VII.[8]

By examining each phase of the Ninth Circuit's interpretation closely, and in comparison to the interpretations of other circuits, this Recent Development will demonstrate that the best approach in determining the enforceability of

---

[1] *See Discharge Is Now Major Focus of Job Discrimination Suits*, 164 Daily Lab. Rep. (BNA) at A-3 (Aug. 23, 1991).

[2] *See* Kevin McKenzie, *Crush of Complaints Straining EEOC*, ROCKY MTN. NEWS (Denver), Oct. 16, 1996, at 30A.

[3] *See id.*

[4] Title VII of the Civil Rights Act of 1964 makes it an "unlawful employment practice for an employer . . . to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin." 42 U.S.C. § 2000e-2(a)(1) (1994).

[5] *See* Mago v. Shearson Lehman Hutton, 956 F.2d 932 (9th Cir. 1992); *see also infra* note 89.

[6] *See* Prudential Ins. Co. of Am. v. Lai, 42 F.3d 1299 (9th Cir. 1994); Renteria v. Prudential Ins. Co. of Am., 113 F.3d 1104 (9th Cir. 1997); Nelson v. Cyprus Bagdad Copper Corp., 119 F.3d 1106 (9th Cir. 1997); *see also infra* notes 97, 98, and 99.

[7] 144 F.3d 1182 (9th Cir.), *cert. denied*, 525 U.S. 982 (1998).

[8] *See id.*

mandatory arbitration agreements is to construe such agreements as narrowly as possible, the approach the Ninth Circuit took in a case from the second phase, *Nelson v. Cyprus Bagdad Copper Corp.*[9] Further, this Recent Development will show that courts should not find all pre-dispute mandatory arbitration agreements of Title VII claims automatically unenforceable, an approach taken by the Ninth Circuit in its third-phase case, *Duffield*.[10]

Part II compares arbitration and civil litigation, focusing on the advantages and disadvantages of arbitration. Part II then examines the historical development of court enforcement of mandatory arbitration in the employment context, and the basic principles underlying mandatory arbitration. Part III begins by describing the first phase of the Ninth Circuit's interpretation of mandatory arbitration agreements of employment disputes. It then discusses the second phase, where the Ninth Circuit imposed the strict standard on employers when construing mandatory arbitration agreements. Part III compares the Ninth Circuit's reasoning in the second phase with that of other circuits and concludes that the Ninth Circuit's approach is the most reasonable and fair. Part III analyzes the third phase of the Ninth Circuit's case law development, focusing on the recent controversial *Duffield* case. Examining *Duffield* in comparison to decisions from other circuits, Part III finally points out the problems inherent in the *Duffield* decision. Part IV argues for the strict interpretation of mandatory arbitration agreements.

II. BACKGROUND

A. Arbitration v. Litigation

1. What is arbitration?

Arbitration is a dispute resolution process in which the parties agree to submit their controversy to a neutral third party for a binding decision.[11] There are two types of arbitration agreements which are of interest. In a "pre-dispute" agreement, the parties contract to arbitrate any disputes that may arise in the future. In a "post-dispute" agreement, the parties agree to arbitrate when a dispute actually arises.[12] Not much controversy exists over post-

---

[9] 119 F.3d 756 (9th Cir. 1996).

[10] *See* 144 F.3d at 1185.

[11] *See* Stuart H. Bompey et al., *The Attack on Arbitration and Mediation of Employment Disputes*, 13 LAB. LAW. 21, 27 (1997). Not all arbitration is binding, however. For example, Hawai'i's Court Annexed Arbitration Program is a mandatory, but nonbinding arbitration program for all tort cases with a probable jury award of $150,000 or less. *See* HAW. REV. STAT. §§ 601-620 (1992)(requiring litigants to be subject to Hawai'i Arbitration Rule 26).

[12] *See* Bompey et al., *supra* note 11, at 27.

dispute agreements. This Recent Development addresses arbitration agreements which prospective employees must sign as a condition of employment, waiving their rights to bring future claims in a judicial forum.

2. Procedural similarities to civil litigation

Arbitration is similar to civil litigation in a number of ways. The arbitrator, like a judge in a non-jury trial, decides both issues of law and fact. Legal counsel represents the parties, who are the "claimant" and "respondent."[13] As in civil litigation, the parties present their positions using pleadings. The claimant first submits a "demand" or "statement of claim."[14] Following this, the respondent files a "response" or "answer."[15] Depending on the arbitration agreement, the parties may engage in limited discovery, including document requests, interrogatories, and depositions.[16]

Following the arbitration "hearing," at which the arbitrator hears the parties' oral arguments and presentation of evidence, the arbitrator issues an "award."[17] The arbitrator is usually not required to issue a written opinion justifying the decision, but has the option to do so or may be required by contracts, association rules, or state law.[18] The parties usually share the costs of the arbitration, which consist primarily of the arbitrator's fees and possible attorneys' fees.[19]

3. Procedural differences from civil litigation

Arbitration also differs from civil litigation in important ways, however. First, the arbitrator has broad discretion to decide cases without strict application of legal principles and to fashion remedies other than those available in civil court.[20] Also, arbitration is conducted privately and much more informally than a court proceeding.[21] There are no jurors, court

---

[13] *See id.*

[14] *See id.*

[15] *See id.*

[16] *See id.* at 29. In Hawai'i, the extent to which discovery is allowed, if at all, is usually at the sole discretion of the arbitrator. *See* HAW. ARB. R.

[17] *See* Bompey et al., *supra* note 11, at 29.

[18] *See id.* at 29.

[19] *See id.*

[20] *See, e.g.*, Advanced Micro Devices, Inc. v. Intel Corp., 885 P.2d 994 (Cal. 1994)(holding that a court may not vacate an arbitration award merely because the arbitrator exceeded the power that a court would have had if parties had chosen to litigate rather than arbitrate).

[21] For example, under Rule 11 of the Hawai'i Arbitration Rules, arbitrators have the general powers of a court and may relax all applicable rules of evidence and procedure to effectuate a

personnel, or uninvited members of the public.[22] Pleadings are not made public and the arbitrator's decision, if contained in a written opinion, may be limited to review by the parties.[23]

Other important differences between arbitration and civil litigation include limited prehearing discovery and limited judicial review of arbitration awards.[24] Courts will not vacate or modify an award unless it results from a party's corruption, fraud, or undue means, from the arbitrator's bias, corruption, or misconduct, or from the arbitrator exceeding his or her power.[25] While cases involving statutory claims, such as Title VII claims, may be subject to a more substantive review,[26] a party usually has little or no option to challenge an award it believes is unjust or inconsistent with the law.[27]

B. Impact of Arbitrating Employment Disputes on Employers and Employees

Other than the inherent similarities and differences between arbitration and litigation, there are certain advantages and disadvantages in arbitrating claims rather than litigating them. The primary advantages are savings in time and money.[28] Because of its informality, limited discovery, and motion practices, arbitration can resolve a case in less than six months, which is considerably less time than a civil trial requires.[29] Arbitration also gives the parties more control over the dispute resolution process.[30] They can select an expert in the

---

speedy and economical resolution of the case. In other words, arbitrators are not required to follow rules of evidence and procedure. *See* HAW. ARB. R. 11.

[22] *See* Boyd A. Byers, *Mandatory Arbitration of Employment Disputes*, 67-APR J. Kan. B.A. 18, 29 (1998).

[23] *See id.* at 29.

[24] *See id.*

[25] *See* Bowles Fin. Group, Inc. v. Stifel, Nicolaus & Co., 22 F.3d 1010, 1012 (10th Cir. 1994) (citing 9 U.S.C. § 10(a)-(e) (1988), which covers general provisions (vacation, grounds, and rehearing) of arbitration).

[26] *See* Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 636-38 (1985).

[27] *See* 9 U.S.C. § 10 (1994). A court's unwillingness to challenge an arbitration award comes from its deferral policy. *See, e.g.*, First Options v. Kaplan, 514 U.S. 938, 942 (1995)("[C]ourt will set [the arbitration] decision aside only in very unusual circumstances."); Moncharsh v. Heily & Blase, 832 P.2d 899 (Cal. 1992)(absent contractual language expressly providing for judicial review, arbitrator's decision is not reviewable by courts even when error is manifest).

[28] *See* Martin J. Oppenheimer & Cameron Johnstone, *Con: A Management Perspective: Mandatory Arbitration Agreements Are an Effective Alternative to Employment Litigation*, 52 DISP. RESOL. J. 19, 22 (1997).

[29] *See id.*

[30] *See* Bompey et al., *supra* note 11, at 35.

subject matter of the dispute as the decision-maker.[31] The parties can choose the time and place most convenient to them as well as the process by which the dispute will be resolved.[32]

The outcome of arbitration is more predictable because arbitrators are less likely to be influenced by sympathy for a plaintiff or antipathy for a corporate employer than jurors are.[33] Arbitration is confidential and is more likely to preserve on-going relationships.[34] Furthermore, since the decision is final, arbitration brings speedy closure because decisions are not subject to the lengthy appeals that often follow court trials.[35]

Not all elements of arbitration are positive, however. Many employees believe they are seriously disadvantaged due to the pool of arbitrators. A study of arbitration panel members in the securities industry shows that arbitrators tend to be white males over sixty years old.[36] In 1992, approximately ninety-seven percent were white; eighty-nine percent were men; and the average age for men was sixty.[37] Some employees might fear that older Caucasian males would be more sympathetic to employers than they are to employees who allege discrimination based on their race and sex.

Another disadvantage that concerns employees is the "privatization" of alternative dispute resolution ("ADR").[38] ADR, once done mainly by not-for-profit firms and pro-bono neutrals, has become a for-profit enterprise.[39] Some may legitimately fear that the best and brightest of the bench and bar will leave litigation for private ADR. In addition, employees are afraid that "neutral" arbitrators may begin to favor institutional clients in order to increase their chances of selection for future arbitration.[40]

---

[31] *See id.*

[32] *See id.* at 34-35.

[33] *See* Oppenheimer & Johnstone, *supra* note 28, at 22.

[34] *See* Byers, *supra* note 22, at 20.

[35] *See* Oppenheimer & Johnstone, *supra* note 28, at 22.

[36] *See* UNITED STATES GENERAL ACCOUNTING OFFICE, REPORT; *EMPLOYMENT DISCRIMINATION: HOW REGISTERED REPRESENTATIVES FARE IN EMPLOYMENT DISCRIMINATION DISPUTES*, GAO/HEHS 94-17 (1994) [hereinafter ACCOUNTING REPORT].

[37] *See id.*

[38] Even though arbitrators interpret legal issues, they are not required to be trained in the law. According to NYSE rules, arbitrators can be retirees from the industry or attorneys, accountants, or other professionals who have devoted 20 percent or more of their professional work to securities industry clients within the last two years. *See* ACCOUNTING REPORT, *supra* note 36.

[39] *See* Bompey et al., *supra* note 11, at 37-38.

[40] *See id.* Bompey et al. cite one case in which a plaintiff argued that his lawsuit against the Judicial Arbitration and Mediation Services ("JAMS") was dismissed because the judges hearing the case had an "interest in securing positions with JAMS . . . ." The Ninth Circuit, however, rejected this argument. *See id.* at 38 n.84 & 85.

Both employers and employees are concerned about the limited judicial review and discovery available in arbitration.[41] The lack of effective judicial review offers little protection from "runaway" arbitrators, and provides little guidance for the employer's future conduct.[42] The virtual absence of discovery prevents both sides from knowing the other party's theory of the case and corroborating evidence, thus inhibiting their ability to prepare counter-arguments.[43]

For employers, adopting a company-wide mandatory arbitration system may not necessarily achieve overall cost and time savings because arbitration offers a lower barrier to employees and might encourage more claims.[44] The last important disadvantage is that arbitration awards do not establish precedent, and thus the law will stagnate.[45] If all Title VII claims in the employment context were arbitrated, the law would never change.

C. The History of Mandatory Arbitration in Employment Disputes

The Supreme Court has handed down several important decisions relating to the enforceability of mandatory arbitration agreements in the employment context. *Alexander v. Gardner-Denver Co.*[46] was the Supreme Court's first decision addressing arbitration of statutory claims in the labor context. Courts have interpreted *Gardner-Denver* as prohibiting mandatory arbitration

---

[41] *See id.* at 36.

[42] *See* Joseph D. Garrison, *Pro: The Employee's Perspective: Mandatory Binding Arbitration Constitutes Little More Than a Waiver of a Worker's Rights*, 52 DISP. RESOL. J. 15, 18 (1997). Garrison cites DiRussa v. Dean Witter Reynolds, Inc., 121 F.3d 818 (2d Cir. 1997), *cert. denied*, 522 U.S. 1049 (1998)(refusing to correct arbitrator's omission of mandatory fee award in successful age-discrimination case). *See id.* at 18 n.2.

[43] *See* Bompey et al., *supra* note 11, at 36.

[44] *See* Bryer, *supra* note 22, at 28.

[45] The EEOC argues:

> Arbitral decisions may not be required to be written or reasoned, and are not made public without the consent of the parties. Judicial review of arbitral decisions is limited to the narrowest of grounds. As a result, arbitration affords no opportunity to build jurisprudence through precedent. Moreover, there is virtually no opportunity for meaningful scrutiny of arbitral decision-making. This leaves higher courts and Congress unable to act to correct errors in statutory interpretation. The risks for the vigorous enforcement of the civil rights laws are profound.

EEOC Notice No. 915.002 (July 10, 1997), *reprinted in Excerpts from Text: EEOC Rejects Mandatory Binding Employment Arbitration*, 52 DISP. RESOL. J. 11, 12-13 (1997).

[46] 415 U.S. 36 (1974).

agreements in all Title VII cases.[47] *Gilmer v. Interstate/Johnson Lane Corp.*[48] held that in the individual context, as opposed to the collective bargaining context, Age Discrimination in Employment Act ("ADEA") claims are arbitrable.[49] Courts have extended the *Gilmer* holding to Title VII claims.[50]

1. Alexander v. Gardner-Denver Co. and the Mitsubishi Trilogy

In *Gardner-Denver*, the Supreme Court held an arbitration clause contained in a collective bargaining agreement could not bar a plaintiff from seeking Title VII remedies in federal court.[51] After the defendant-employer terminated his employment, the employee, an African-American, filed a claim for racial discrimination under the collective-bargaining agreement's contractual nondiscrimination clause.[52] The employer's grievance procedures subjected the employee to binding arbitration under a broad clause in the collective-bargaining agreement, but the procedures did not explicitly address whether statutory claims were waived.[53] After the employer rejected the employee's claim, an arbitration hearing was held. Prior to this hearing, the employee also filed a Title VII complaint with the Equal Employment Opportunity Commission ("EEOC").[54] The arbitrator ruled that the employee had been discharged for "just cause," and the EEOC determined that no reasonable

[47] *See, e.g.*, Alford v. Dean Witter Reynolds, Inc., 905 F.2d 104 (5th Cir. 1990); Utley v. Goldman Sachs & Co., 883 F.2d 184 (1st Cir. 1989); Swenson v. Management Recruiters Int'l, Inc., 858 F.2d 1304 (8th Cir. 1988); Rosenfeld v. Department of Army, 769 F.2d 237 (4th Cir. 1985); EEOC v. Children's Hosp. Med. Ctr., 719 F.2d 1426 (9th Cir. 1983).

[48] 500 U.S 20 (1991)

[49] *Id.* at 35.

[50] *See, e.g.*, Seus v. John Nuveen & Co., 146 F.3d 175 (3d Cir. 1998), *cert. denied*, 525 U.S. 1139 (1999); Paladino v. Avnet Computer Techs., Inc., 134 F.3d 1054 (11th Cir. 1998); Gibson v. Neighborhood Health Clinics, Inc., 121 F.3d 1126 (7th Cir. 1997); Patterson v. Tenet Healthcare, Inc., 113 F.3d 832, 837 (8th Cir. 1997); Cole v. Burns Int'l Sec. Servs., 105 F.3d 1465 (D.C. Cir. 1997); Austin v. Owens-Brockway Glass Container, Inc., 78 F.3d 875 (4th Cir. 1996); Metz v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 39 F.3d 1482 (10th Cir. 1994); Willis v. Dean Witter Reynolds, Inc., 948 F.2d 305 (6th Cir. 1991); Alford v. Dean Witter Reynolds, Inc., 939 F.2d 229 (5th Cir. 1991).

[51] 415 U.S. at 60-61.

[52] *See id.* at 39. Under the collective-bargaining agreement at issue, the company retained the right to hire, suspend or discharge employees for proper cause, but it also provided that "there shall be no discrimination against any employee on account of race, color, religion, sex, national origin or ancestry." *Id.*

[53] *See id.* at 40-42 & n.3.

[54] *See id.* at 42.

basis existed for the Title VII claim.[55] The employee then brought an action in federal district court.[56]

The Supreme Court first noted that Congress enacted Title VII to assure equal employment opportunities by eliminating practices and devices that discriminate on the basis of race, color, religion, sex, or national origin.[57] Considering the purpose, procedures, and legislative history of Title VII, the Court concluded that an employee does not forfeit his private statutory cause of action by pursing his grievance to final arbitration under the nondiscrimination clause of a collective-bargaining agreement.[58] The Court emphasized the distinction between Title VII, which establishes an individual's right to equal employment opportunities, and rights—such as the right to strike—which the union confers on employees collectively; an employee's Title VII claims are not susceptible to prospective waiver.[59]

Every circuit court of appeals interpreted *Gardner-Denver* as prohibiting mandatory arbitration agreements of Title VII claims, both in the collective bargaining context and in the employment context.[60] In the late 1980s, however, the Supreme Court in the so-called "Mitsubishi Trilogy" cases reversed the long-standing presumption against arbitration of statutory claims.[61] The

---

[55] *See id.*

[56] *See id.* at 43.

[57] *See id.* at 44 (citing McDonnell Douglas Corp. v. Green, 411 U.S. 792, 800 (1973))("The language of Title VII makes plain the purpose of Congress to assure equality of employment opportunities and to eliminate those discriminatory practices and devices which have fostered racially stratified job environments to the disadvantage of minority citizens."); *see also* Griggs v. Duke Power Co., 401 U.S. 424, 429 (1971); Castro v. Beecher, 459 F.2d 725 (1st Cir. 1972); Chance v. Board of Examiners, 458 F.2d 1167 (2d Cir. 1972); Quarles v. Philip Morris, Inc., 279 F.Supp. 505 (E.D. Va. 1968)).

[58] *See Gardner-Denver*, 415 U.S. at 47-49.

[59] *See id.*, 415 U.S. at 51-52. The Court stated that "[i]n no event can the submission to arbitration of a claim under the nondiscrimination clause of a collective- bargaining agreement constitute a binding waiver with respect to an employee's rights under Title VII." *Id.* at 52 n.15.

[60] *See, e.g.*, Alford v. Dean Witter Reynolds, Inc., 905 F.2d 104, 105-08 (5th Cir. 1990); Utley v. Goldman Sachs & Co., 883 F.2d 184, 185-87 (1st Cir. 1989); Swenson v. Management Recruiters Int'l, Inc., 858 F.2d 1304, 1305-07 (8th Cir. 1988); Rosenfeld v. Department of the Army, 769 F.2d 237, 239 (4th Cir. 1985); EEOC v. Children's Hosp. Med. Ctr., 719 F.2d 1426, 1431 (9th Cir. 1983)(en banc)(Fletcher, J., concurring).

[61] *See* Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614 (1985); Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987); Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477 (1989). These cases did not involve arbitration of statutory claims in the labor context, but statutory claims under the Sherman Act, the Securities Exchange Act of 1934, and the Racketeer Influenced and Corrupt Organizations Act ("RICO"). *See Mitsubishi*, 473 U.S. at 616-19; *McMahon*, 482 U.S. at 223-25; *Rodriguez*, 490 U.S. at 478-79. These are commercial cases ,not employment-related cases. They are, however, similar to mandatory arbitration cases in that an issue in both lines of cases is whether statutory claims are arbitrable.

Court stated that the Federal Arbitration Act[62] established a federal policy favoring arbitration agreements in the absence of contrary substantive or procedural policies.[63] The Court emphasized that "[b]y agreeing to arbitrate a statutory claim, a party does not forego the substantive rights afforded by the statute," but "trades the procedures and opportunity for review of the courtroom for the simplicity, informality, and expedition of arbitration."[64] The Court concluded that "[h]aving made the bargain to arbitrate, the party should be held to it unless Congress itself has evinced an intention to preclude a waiver of judicial remedies for the statutory rights at issue."[65] The Court placed the burden on the party opposing arbitration to show that Congress intended to limit or prohibit such waiver.[66]

2. Gilmer v. Interstate/Johnson Lane Corp.[67]

Following the Mitsubishi Trilogy cases, the United States Supreme Court, in its 1991 *Gilmer* decision, held that employees could be required to arbitrate age discrimination claims brought under the Age Discrimination in Employment Act of 1967 ("ADEA").[68] The employer required Gilmer to register as a securities representative with the New York Stock Exchange ("NYSE") when hiring him as a manager.[69] His registration application contained an agreement to arbitrate "any dispute, claim or controversy" with his employer as required under the rules, constitutions, or bylaws of the NYSE.[70] One of the NYSE's rules provided for arbitration of "[a]ny controversy between a registered representative and any member or member organization arising out of the employment or termination of employment of such registered representative."[71]

When Interstate terminated Gilmer's employment at age sixty-two,[72] Gilmer filed a charge with the EEOC and brought suit in federal court alleging a vio-

---

[62] 9 U.S.C. §§ 1-16 (1994).

[63] *See McMahon*, 482 U.S. at 226 (citing Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1987)).

[64] *Mitsubishi*, 473 U.S. at 628.

[65] *Id.*

[66] *See McMahon*, 482 U.S. at 227.

[67] 500 U.S 20 (1991).

[68] *See id.* at 35. Congress enacted the ADEA in 1967 "to promote employment of older persons based on their ability rather than age; to prohibit arbitrary age discrimination in employment; [and] to help employers and workers find ways of meeting problems arising from the impact of age on employment." *Id.* at 27 (citing 29 U.S.C. § 621(b) (1994)).

[69] *See id.*

[70] *See id.*

[71] *Id.*

[72] *See id.* at 23.

lation of the ADEA.[73] Interstate moved to compel arbitration of the ADEA claim based on the arbitration agreement in his NYSE registration application.[74] The district court denied the motion, based on *Alexander v. Gardner-Denver Co.*[75] The Fourth Circuit Court of Appeals reversed.[76]

The Supreme Court held that a claim under the ADEA was subject to arbitration, making three arguments and distinguishing its decision in *Gardner-Denver* without overruling it.[77] First, the Court noted that statutory claims may be the subject of an arbitration agreement under the Federal Arbitration Act ("FAA"), based on the Mitsubishi Trilogy cases.[78] The court concluded that since the FAA manifests a liberal federal policy favoring arbitration,[79] and since neither the text nor the legislative history of the ADEA explicitly precludes arbitration, Gilmer was bound by the arbitration agreement unless he could show an inherent conflict between arbitration and the ADEA's underlying purposes.[80] The Court found nothing in the text of the statute or its legislative history that specifically precluded arbitration.[81] Second, the Court rejected the plaintiff's challenges to the adequacy of the arbitration procedure.[82] The Court refuted each of Gilmer's challenges, noting that in the Mitsubishi trilogy it had rejected those attacks as insufficient to preclude arbitration of statutory claims.[83] Third, the Court held the "[m]ere inequality in bargaining power" between the parties is not a sufficient reason to hold that arbitration agreements are never enforceable in the employment context.[84]

In refusing to follow *Gardner-Denver*, the Supreme Court recognized three distinctions between *Gardner-Denver* and *Gilmer*. First, the Court noted that *Gardner-Denver* did not address the enforceability of an agreement to arbitrate statutory claims, but rather addressed the issue of whether arbitration of contract-based claims precluded the adjudication of subsequent statutory

---

[73] *See id.* at 23-24.

[74] *See id.* at 24.

[75] *See id.*

[76] *See* Gilmer v. Interstate/Johnson Lane Corp., 895 F.2d 195, 197 (4th Cir. 1990).

[77] *See Gilmer*, 500 U.S. at 35.

[78] *See id.* at 24-27; *see also* discussion *infra* section III.C.2.

[79] *See* Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983)(stating that the FAA "is a congressional declaration of a liberal federal policy favoring arbitration agreements, notwithstanding any state substantive or procedural policies to the contrary").

[80] *See Gilmer*, 500 U.S. at 22-23.

[81] *See id.*

[82] *See id.* at 30-32.

[83] *See id.* The Court rejected Gilmer's arguments as to the biased arbitration panels, limited discovery in arbitration, limited issuance of written opinions, and lack of equitable relief. *See id.*

[84] *See id.* at 33.

claims.[85] Second, the arbitration in *Gardner-Denver* occurred in the context of a collective-bargaining agreement. Thus, there was concern about the tension between collective representation and individual statutory rights that was not present in *Gilmer*.[86] Third, the Court noted that unlike *Gardner-Denver*, *Gilmer* was decided under the FAA, which reflected a liberal policy on favor of arbitration.[87] The Court distinguished *Gilmer* from *Gardner-Denver* in these three points and refused to hold that ADEA claims could not be subject to mandatory arbitration.

III. THE THREE PHASES OF THE NINTH CIRCUIT'S INTERPRETATION

The development of the Ninth Circuit's treatment of mandatory arbitration agreements of Title VII claims emerges in three phases. This Part compares and contrasts each phase with other circuits' treatment of mandatory arbitration and concludes that the most appropriate approach in determining the enforceability of such agreements is the one taken by the Ninth Circuit in *Nelson v. Cyprus Bagdad Copper Corp.*[88]

A. *Extension of Gilmer to Title VII Claims*

The first phase in Ninth Circuit case law dealing with mandatory arbitration agreements in the labor context is a line of cases extending *Gilmer*, which dealt with the ADEA, to Title VII claims. In 1992, the Ninth Circuit, in *Mago v. Shearson Lehman Hutton*,[89] held that Title VII claims are arbitrable under the reasoning of *Gilmer*. The court extended the *Gilmer* rule to Title VII claims and held that the plaintiff failed to establish that Congress, in enacting Title VII, intended to preclude arbitration of Title VII claims.[90]

Other circuits shared the same view as the Ninth Circuit.[91] Also, courts in the Ninth Circuit and other circuits extended the application of *Gilmer* to a variety of other federal legislation, such as the Employee Retirement Income

---

[85] *See id.* at 35.

[86] *See id.*

[87] *See id.*

[88] 119 F.3d 756 (9th Cir. 1996).

[89] 956 F.2d 932 (9th Cir. 1992).

[90] *See id.* at 935.

[91] *See* Seus v. John Nubeen & Co., Inc., 146 F.3d 175, 182-83 (3d Cir. 1998), *cert. denied*, 525 U.S. 1139 (1999); Patterson v. Tenet Healthcare, Inc., 113 F.3d 832, 835 (8th Cir. 1997); Metz v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 39 F.3d 1482, 1487 (10th Cir. 1994); Alford v. Dean Witter Reynolds, Inc., 975 F.2d 1161, 1162 (5th Cir. 1992); Bender v. A.G. Edwards & Sons, Inc., 971 F.2d 698, 699 (11th Cir. 1992); Willis v. Dean Witter Reynolds, Inc., 948 F.2d 305, 307 (6th Cir. 1991).

Securities Act,[92] the Employee Polygraph Protection Act,[93] the Americans With Disabilities Act,[94] the Equal Pay Act,[95] and Section 1981.[96] In this first phase of the development, the Ninth Circuit Court adopted the same position as other circuit courts in terms of the extension of *Gilmer* to Title VII claims and other federal protections.

B. *The "Knowing Waiver" Requirement*

In the second phase, the Ninth Circuit departed from other circuits in interpreting mandatory arbitration agreements by requiring a "knowing waiver." The Ninth Circuit's interpretation of the "knowing waiver" requirement in *Prudential Insurance Co. of America v. Lai*,[97] *Renteria v. Prudential Insurance Co. of America*,[98] and *Nelson v. Cyprus Bagdad Copper Corp.*[99] demonstrated that the Ninth Circuit has been most restrictive in construing mandatory arbitration agreements for employment discrimination disputes. Through comparison and contrast with the interpretations of other circuits, this section argues that the Ninth Circuit's approach is superior to that of other circuits.

---

[92] 29 U.S.C. § 1001 (1994). *See, e.g.*, Laniok v. Advisory Comm. of the Brainerd Mfg. Co. Pension Plan, 935 F.2d 1360 (2d Cir. 1991). Alleging entitlement to pension benefits, a former employee brought an action under the Employee Retirement Income Security Act ("ERISA") against an advisory committee of his former employer's pension plan. *See id.* at 1362-64. The Second Circuit Court of Appeals held that the ERISA's age discrimination provision did not prohibit the employee from waiving pension plan participation. *See id.* at 1365.

[93] 29 U.S.C. § 2001 (1994). *See, e.g.*, Saari v. Smith Barney, Harris Upham & Co., Inc., 968 F.2d 877 (9th Cir. 1992). A former securities broker brought an action against his former employer alleging a violation of the federal Employee Polygraph Protection Act ("EPPA") and other claims. *See id.* at 878-79. The Ninth Circuit held that the federal EPPA did not prohibit arbitration of claims where required by contract. *See id.* at 883.

[94] 42 U.S.C. § 12101 (1994). *See, e.g.*, Solomon v. Duke Univ., 850 F. Supp. 372 (M.D.N.C. 1993). An employer moved to confirm arbitration award and to dismiss remaining counts of an employee's complaint. *See id.* at 372-73. The District Court held that the employee's claim under the Americans with Disabilities Act ("ADA") could be arbitrated. *See id.* at 373.

[95] 29 U.S.C. § 206 (1994). *See, e.g.*, Koveleskie v. SBC Capital Mkts., Inc., 167 F.3d 361 (7th Cir.), *cert. denied*, 120 S. Ct. 44 (1999). A former securities industry employee sued her former employer for sex discrimination. *See id.* at 363. The Seventh Circuit held that the employee's Equal Pay Act claim was arbitrable. *See id.* at 369.

[96] 42 U.S.C. § 1981 (1994). *See, e.g.*, Williams v. Katten, Muchin & Zavis, 837 F. Supp. 1430 (N.D. Ill. 1993). A noncapital African-American female partner in a law firm brought a suit alleging that the firm and a capital partner discriminated against her on the basis of her race, sex, and religion. *See id.* at 1431-33. The court held that an agreement requiring arbitration of all claims was enforceable as applied to Title VII and § 1981 claims. *See id.* at 1436-37.

[97] 42 F.3d 1299, 1304 (9th Cir. 1994).

[98] 113 F.3d 1104, 1106 (9th Cir. 1997).

[99] 119 F.3d 756, 762 (9th Cir. 1997).

1. The interpretation of the "knowing" requirement in the Ninth Circuit

In *Lai*, the Ninth Circuit held that the employees did not knowingly forego statutory remedies, and thus the arbitration agreement was not binding.[100] This case involved an arbitration agreement contained in a Uniform Application for Securities Industry Registration or Transfer, also known as a Form U-4, which the employees executed when they applied for their positions as sales representatives for Prudential Insurance Company.[101] The employees sued Prudential and their immediate supervisors on a variety of state law claims, alleging that the supervisors had sexually harassed and abused them.[102] In return, Prudential filed a motion to compel arbitration of the employees' claims, which the district court granted.[103]

First, the court stated that it was apparent from the text and legislative history of Title VII that Congress had intended there to be "at least a knowing agreement to arbitrate employment disputes before an employee may be deemed to have waived the comprehensive statutory rights, remedies, and procedural protections prescribed in Title VII and other related state statutes."[104] The court also stated that the public policy of protecting victims

---

[100] *See Lai*, 42 F.3d at 1305.

[101] *See id.* at 1301. The relevant part of the arbitration agreement stated:

> I agree to arbitrate any dispute, claim or controversy that may arise between me or my firms, or a customer, or any other person, that is required to be arbitrated under the rules, constitutions, or bylaws or the organizations with which I register . . . .

Id. at 1302 (citing Item number 5 on page 4 of the U-4 form).

The relevant part of the NASD manual stated:

> Any dispute, claim or controversy eligible for submission under part I of this Code between or among members and/or associated persons . . . arising in connection with the business of such member(s) or in connection with the activities of such associated person(s), shall be arbitrated under this code . . . .

Lai, 42 F.3d at 1302 (citing NATIONAL ASS'N OF SECURITIES DEALERS, NASD MANUAL, CODE OF ARBITRATION PROCEDURE ¶ 3708).

[102] *See id.* at 1301. Even though the employees in *Lai* based their claims on state law, Title VII's enforcement scheme was applicable. *See id.* at 1303 n.1 (noting that parallel state anti-discrimination laws are explicitly made part of Title VII's enforcement scheme).

[103] *See id.* at 1301.

[104] *Id.* at 1304. The court cited section 118 of the Civil Rights Act of 1991, which states that "[w]here appropriate and to the extent authorized by law, the use of alternative means of dispute resolutions including, . . . arbitration, is encouraged to resolve disputes arising under the Acts or provisions of Federal law amended by this title." Civil Rights Act of 1991, Pub. L. No. 102-166, § 118, 105 Stat. 1071, 1081 (1991). The court also cites Senator Dole's statement, in proposing Section 118. He declared that the arbitration provision encourages arbitration only "where the parties knowingly and voluntarily elect to use these methods." 137 CONG. REC. 15472, S15478 (daily ed. Oct. 30, 1991)(statement of Senator Dole).

against violations of Title VII and analogous state statutes is "at least as strong as our public policy in favor of arbitration."[105]

Examining the facts of this case, the Ninth Circuit concluded that the "knowing waiver" requirement was not satisfied.[106] The court emphasized that the U-4 form did not describe the types of disputes subject to arbitration, and that the NASD arbitration clause did not even refer to employment disputes.[107] The court held that the agreement was not enforceable because those clauses would not put employees on notice that they were bound to arbitrate Title VII claims.[108] Thus, *Lai* represents the Ninth Circuit's restrictive interpretation of mandatory arbitration agreements for employment discrimination disputes.

In *Renteria v. Prudential Insurance Co. of America*,[109] the Ninth Circuit reaffirmed the importance of the knowing waiver of Title VII claims.[110] The court stated that the facts in *Lai* and *Renteria* were substantially indistinguishable.[111] The plaintiffs in both *Lai* and *Renteria* signed the U-4 form as a condition of their employment with Prudential and registered with the NASD.[112] In addition, when Renteria signed the U-4 form and registered with the NASD, the arbitration provision in the NASD was identical to that in *Lai*.[113] According to the court, the only difference between the forms signed by Lai and Renteria was that Renteria's form stated that the agreement would bind the undersigned to arbitrate all disputes listed in the NASD Code, "as may be amended from time to time."[114] Even though the Code was amended to include claims "arising out of employment" after Renteria entered into the agreement but prior to her termination, the court reasoned that the "as amended" language would not make the agreement a "knowing waiver" and would not make it enforceable.[115] In *Renteria*, the Ninth Circuit adopted a much higher knowing waiver requirement than that of other circuits, discussed below.

---

105 *Lai*, 42 F.3d at 1305. In the Mitsubishi Trilogy, the Supreme Court reversed the long-standing presumption against arbitration of statutory claims and declared that the FAA established a federal policy favoring arbitration agreements in the absence of contrary substantive or procedural policies. *See* discussion *supra* section II.C. and note 61.

106 *See Lai*, 42 F.3d at 1305.

107 *See id.*

108 *See id.*

109 113 F.3d 1104 (9th Cir. 1997).

110 *See id.* at 1106.

111 *See id.*

112 *See id.*

113 *See id.*

114 *See id.*

115 *See id.*

Although *Lai* and *Renteria* were controversial decisions, *Nelson v. Cyprus Bagdad Copper Corp.*[116] was even more controversial. In *Nelson*, the Ninth Circuit held that signing a form acknowledging receipt of a revised employee handbook and continuing to work after receiving and reading the handbook was not a knowing agreement to the mandatory arbitration clause contained in the handbook.[117] During their employment, Nelson and other employees received Employee Handbooks, which contained a section describing "the sole and exclusive procedures for the processing and resolution" of employment-related disputes.[118] That section of the Handbook also provided that employees were precluded from filing any action in any court concerning any matter which could have been addressed through these procedures.[119] Nelson signed an acknowledgment that he had received the Handbook, and agreed to read and understand its contents and to contact his supervisor if he had any questions.[120] After Cyprus terminated his employment, Nelson initiated a complaint pursuant to the procedure contained in the Handbook.[121] During the process, Nelson filed a complaint in a federal district court alleging that Cyprus had violated the Americans with Disabilities Act ("ADA").

The Ninth Circuit first concluded that the acknowledgment form signed by Nelson was not a valid waiver under *Lai* because he agreed only to "read and understand" the Handbook.[122] According to the court, Nelson did not agree to be bound by its provisions.[123] Second, the court held that Nelson's continued employment after the receipt of the Handbook did not amount to the type of "knowing agreement" contemplated by *Lai* because nothing in the acknowledgment form or the Handbook itself put Nelson on notice that by not quitting his job he was somehow entering into an agreement to waive his statutory remedies under civil rights statutes.[124] Third, the court said that the

---

[116] 119 F.3d 756 (9th Cir. 1997).

[117] *See id.* at 762.

[118] *See id.* at 758.

[119] *See id.* Such matters included:

> [A]ny problem, controversy, complaint, misunderstanding or dispute that may arise concerning any aspect of your employment or termination of employment including any dispute arising out of or based upon any state or federal statute or law applicable to your employment, and including any dispute concerning a claim that the provisions of the Handbooks have been violated.

Id.

[120] *See id.* at 758.

[121] *See id.* at 759.

[122] *See id.* at 761.

[123] *See id.*

[124] *See id.* at 762.

right to a judicial forum is not waived even when the employee commences or continues to do his assigned work and accepts a paycheck in return.[125]

These three cases show that the Ninth Circuit, basing its interpretation on the legislative history of Title VII, firmly requires a "knowing waiver" when enforcing mandatory arbitration agreements of Title VII claims in the labor context. The agreement in *Lai* did not amount to a "knowing waiver" because it did not describe the types of disputes subject to arbitration.[126] Similarly, the *Renteria* agreement, which stated that the undersigned would be bound to arbitrate all disputes listed in the NASD Code "as may be amended from time to time", was insufficient to constitute a "knowing waiver."[127] Finally, under *Nelson*, the court found no knowing agreement where an employee signed a form acknowledging receipt of a revised employee handbook that listed Title VII claims as disputes to be arbitrated, and where the employee continued employment after receiving and reading the handbook.[128]

2. *The majority position*

Other circuits have disagreed with the Ninth Circuit's strict requirement of a knowing waiver and have attacked the Ninth Circuit's reasoning. The Third Circuit, in *Seus v. John Nubeen & Co.*,[129] disagreed with *Lai*.[130] The Eight Circuit appears to have done the same in *Patterson v. Tenet Healthcare, Inc.*[131] Citing *Gilmer*, the Eighth Circuit stated that "the use of neutral arbitrators, adequate discovery, adequate types of relief, and the reassurance that coercion which would allow the revocation of any contract would likewise relieve an employee from an arbitration agreement" would adequately assist victims of discrimination.[132] As to the public interest in enforcing Title VII, the court argued that law suits brought by employees who are not parties to arbitration

---

[125] *See id.*

[126] *See supra* notes 107-10 and accompanying text.

[127] *See supra* note 115 and accompanying text.

[128] *See supra* notes 123-26 and accompanying text.

[129] 146 F.3d 175 (3d Cir. 1998), *cert. denied*, 525 U.S. 1139 (1999).

[130] *See id.* at 184 n.2. The court said:

> Seus relies, as well, on *Prudential Ins. Co. of Am. v. Lai*, 42 F.3d 1299 (9th Cir. 1994). The court there held that a Form U-4 agreement to arbitrate under the NASD rules was unenforceable. The agreement was not "knowingly" entered insofar as employment disputes were concerned, according to the court, because the arbitration clause of the NASD rules did not specifically refer to employment disputes. We respectfully disagree with the decision of the court in *Lai*.

Id.

[131] 113 F.3d 882, 838 (8th Cir. 1997).

[132] *Id.* (citing Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. at 30-33 (1991) and Cole v. Burns Int'l Sec. Serv., 105 F.3d 1465, 1482 (D.C. Cir. 1997)).

agreements, EEOC actions, and the vindication of individual claims through arbitration would achieve that goal.[133] The Seventh Circuit recognized the knowing waiver issue in *Gibson v. Neighborhood Health Clinics Inc.*,[134] but found it unnecessary to resolve it. The First Circuit also found it unnecessary to resolve this issue in *Rosenberg v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*[135] This section will closely examine district cases disagreeing with the Ninth Circuit because the appellate decisions mentioned above do not address the "knowing waiver" issue in detail.

In *Beauchamp v. Great West Life Assurance Corp.*,[136] the United States District Court for the Eastern District of Michigan[137] rejected the plaintiff's claim that she did not knowingly relinquish her rights to a judicial forum for employment discrimination claims. Noting that *Lai* was "fortunately" not binding precedent, the court first stated that the portions of the legislative history on which the Ninth Circuit relied were "slender reeds" on which to base "the weighty and novel conclusion" that an arbitration clause is only binding when the claimant has actual knowledge that his particular employment discrimination claims will be covered by the agreement.[138] The court argued that *Lai* was contrary to the language of the Civil Rights Act of 1991, the Supreme Court's opinion in *Gilmer*, and fundamental principles of contract law.[139]

In *Maye v. Smith Barney, Inc.*,[140] the United States District Court for the Southern District of New York similarly criticized the Ninth Circuit's holding

---

[133] *See id.* at 838 (citing *Gilmer*, 500 U.S. at 31-32).

[134] 121 F.3d 1126, 1130 (7th Cir. 1997).

[135] 170 F.3d 1, 19 (1st Cir. 1999); *see also infra* note 208. Instead of following the Ninth Circuit's knowing waiver requirement, the First Circuit looked to the language of the 1991 Civil Rights Act and concluded that the test is whether, under the particular facts, the arbitration clause is "appropriate." *See Rosenberg*, 170 F.3d at 20.

[136] 918 F. Supp. 1091 (E.D. Mich. 1996).

[137] This section discusses district court cases because only one appellate court case has dealt with the knowing waiver issue and has disagreed with the Ninth Circuit. That case did not explain why it "disagreed" with *Lai*. *See* Seus v. John Nuveen & Co., Inc., 146 F.3d 175, 184 (3rd Cir. 1998), *cert. denied*, 525 U.S. 1139 (1999); *see also supra* note 111 and accompanying text.

[138] *See id.* at 1096.

[139] *See id.* at 1097-98. The court stated:

> It is well settled that the failure of a party to obtain an explanation of a contract is ordinary negligence. Accordingly, this estops the party from avoiding the contract on the ground that the party was ignorant of the contract provisions.... The stability of written instruments demands that a person who executes one shall know its contents or be chargeable with such knowledge... in the absence of circumstances fairly excusing his failure to inform himself.

Id. (citing Scholz v. Montgomery Ward & Co., 468 N.W.2d 845, 848-49 (Mich. 1991)).

[140] 897 F. Supp. 100 (S.D.N.Y. 1995).

and reasoning in *Lai*. Like the *Beauchamp* court, the court in *Maye* argued that the legislative history on which *Lai* was based was inadequate and contrary to Supreme Court precedent.[141] The court also cited cases that attacked *Lai*'s reasoning.[142]

3. The soundness of the Ninth Circuit's knowing waiver requirement

The Ninth Circuit's strict requirement of a "knowing waiver" is a minority view. The majority of courts have criticized this requirement as being based primarily on one line of legislative history.[143] However, the principles found in anti-discrimination laws that insure that workers are not discriminated against and that allow workers to explore different legal avenues of redress support the Ninth Circuit's interpretation.[144] While it is true that there is public policy favoring arbitration, as the *Lai* court found, the policies underlying discrimination laws and the desire to protect victims of discrimination are "at least as strong as our policy in favor of arbitration."[145] Since the rights that employees would relinquish are very important ones, it is better to err on the side of caution in the processing of mandatory arbitration agreements, as the Ninth Circuit has done.[146] The Ninth Circuit's strict knowing waiver standard is a more reasonable and fair interpretation than that adopted by most courts. Those courts have found it sufficient merely to require an express reference informing employees that the arbitration clause will apply to employment disputes.[147]

C. The Duffield Shock

The Ninth Circuit entered the third phase of construing mandatory arbitration agreements with its controversial decision in *Duffield v. Robertson Stephens & Co.*[148] In *Duffield*, the Ninth Circuit held that Congress intended that individually signed, pre-employment pre-dispute arbitration clauses be

---

[141] *See id.* at 107.

[142] *See id.* (citing Hall v. MetLife Resources, No. 94 Civ. 0358 (JFK), 1995 WL 258061 at *4 (S.D.N.Y. May 3, 1995); Lockhart v. A.G. Edwards & Sons, Civ. A. No. 93-2418-GTV, 1994 WL 34870, at *3-4 (D. Kan. Jan. 25, 1994)).

[143] *See* Tanya J. Axenson, *Mandatory Arbitration Clauses and Statutory Rights: The Legal Landscape After Nelson*, 3 HARV. NEGOTIATION L. REV. 271, 281 (1998); *see also* discussion *supra* section III.B.1.

[144] *See* Axenson, *supra* note 143, at 281.

[145] *See id.* (citing *Lai*, 42 F.3d at 1304).

[146] *See* discussion *supra* section III.B.1.

[147] *See* discussion *supra* section III.B.2.

[148] 144 F.3d 1182 (9th Cir. 1998), *cert. denied*, 119 S.Ct. 445 (1998).

unenforceable in Title VII cases,[149] which is a very different holding from the majority view.[150] The Ninth Circuit's decision in *Duffield* was incorrect because its interpretation of the language and legislative history of the Civil Rights Act of 1991 was skewed and result-oriented.[151]

1. Duffield v. Robertson Stephens & Co.

The plaintiff, Duffield, signed a Form U-4 containing an arbitration clause as a condition of her employment with the defendant, Robertson Stephens & Co..[152] The defendant was a member of the NYSE and the National Association of Securities Dealers ("NASD"), both of which had rules compelling employees to arbitrate any employment-related dispute at the request of their employer.[153] After Robertson Stephens terminated her employment, Duffield filed suit in federal court, alleging sex discrimination and sexual harassment under Title VII and California's Fair Employment Act.[154] Considering the language of the Act, its legislative history, and its purpose, the Ninth Circuit agreed with Duffield that the Civil Rights Act of 1991 precludes compulsory arbitration of Title VII claims.[155]

First, the court looked at the Act's purposes and at section 118 of the Act, which discusses the use of arbitration in Title VII claims.[156] The court cited two primary goals of the 1991 Civil Rights Act: to restore the civil rights protections that were dramatically limited by a series of 1989 Supreme Court decisions;[157] and to provide more effective deterrence and adequate compensation for victims of discrimination by strengthening existing protections and remedies available to employees under Title VII.[158] After stating that the Act represents a "significant enlargement of the substantive

[149] *See id.* at 1185.

[150] *See* discussion *supra* section III.C.2.

[151] *See* discussion *infra* section III.C.3.

[152] *See Duffield*, 144 F.3d at 1185-86.

[153] *See id.*

[154] *See id.*

[155] *See id.* at 1187.

[156] Section 118 of the 1991 Civil Rights Act, an amendment to Title VII, provides that: "Where appropriate and to the extent authorized by law, the use of alternative means of dispute resolutions including, . . . arbitration is encouraged to resolve disputes arising under the Acts or provisions of Federal law amended by this Title." Civil Rights Act of 1991, Pub. L. No. 102-166, § 118, 105 Stat. 1071, 1081 (1991).

[157] *See* Patterson v. McLean Credit Union, 491 U.S. 164 (1989); Price Waterhouse v. Hopkins, 490 U.S. 228 (1989); Martin v. Wilks, 490 U.S. 755 (1989); Lorance v. AT & T Techs., Inc., 490 U.S. 900 (1989).

[158] *See Duffield*, 144 F.3d at 1191 (citing H.R. REP. No. 102-40(II), at 1 (1991), *reprinted in* 1991 U.S.C.C.A.N. at 694, 694).

and procedural rights of victims of employment discrimination,"[159] the court then cited section 118, which provides that: "Where appropriate and to the extent authorized by law, the use of alternative means of dispute resolutions including . . . arbitration is encouraged to resolve disputes arising under the acts or provisions of Federal law amended by this Title."[160]

Second, the court considered the defendant's argument that the plain language of section 118 indicates Congress' intent to "encourage" the use of arbitration in Title VII disputes.[161] Noting that Congress directed courts to read Title VII broadly to most effectively advance its remedial purposes, the court found it would be "a paradox" to conclude that the Act, the purpose of which was to strengthen protections and remedies available under Title VII, "encouraged" the use of a process in which employees surrendered their rights to a judicial forum for future discrimination disputes as a condition of employment.[162] The court found it much more plausible to interpret the Act to mean that Congress encouraged voluntary agreements to arbitrate, i.e., post-dispute agreements, but not mandatory pre-dispute agreements.[163]

The Ninth Circuit concluded that the phrase "where appropriate and to the extent authorized by law" demonstrates Congress' intention to encourage arbitration only under legally permissible and appropriate circumstances.[164] The court interpreted "where appropriate" to mean situations where arbitration furthers the Act's purpose and objective, i.e., it expands and increases the remedies available to plaintiffs.[165] It read "to the extent authorized by law" as referring to the law as it existed at the time section 118 was drafted.[166] The Ninth Circuit concluded that, since Congress drafted the section prior to the Supreme Court's decision in *Gilmer*, the existing law applicable to section 118 was *Gardner-Denver*, which prohibited employers from compelling employees to arbitrate Title VII claims under a collective bargaining agreement.[167] Following *Gardner-Denver*, the circuits[168] had interpreted Title

---

[159] *See id.* at 1191.

[160] *Id.* at 1191 (citing Civil Rights Act of 1991, Pub. L. No. 102-166, § 118, 105 Stat. 1071, 1081 (1991)).

[161] *See id.*

[162] *See id.* at 1192-93.

[163] *See id.*

[164] *See id.* at 1193.

[165] *See id.*

[166] *Id.* at 1193-95.

[167] *See id.* The court stated that Congress enacted the 1991 Civil Rights Act a few months after the Supreme Court's issuance of *Gilmer*. *See id.* at 1189. However, the House Education and Labor Committee drafted and reported on the 1991 Act before the Court decided *Gilmer*. *See id.* at 1191.

[168] *See, e.g.*, Alford v. Dean Witter Reynolds, Inc., 905 F.2d 104, 105-08 (5th Cir. 1990); Utley v. Goldman Sachs & Co., 883 F.2d 184, 185-87 (1st Cir. 1989); Swenson v. Management

VII as prohibiting any form of mandatory arbitration, including that concerning individual employment claims.[169] The Ninth Circuit also emphasized that at the time the Act was enacted, it was still an open question whether *Gilmer*, which involved an ADEA claim, applied to Title VII claims.[170]

The Ninth Circuit then examined the legislative history of section 118. The court cited the Committee Reports, which state:

> [T]he committee believes that any agreement to submit disputed issues to arbitration, whether in the context of collective bargaining or in an employment contract, does not preclude the affected person from seeking relief under the enforcement provisions of Title VII. This view is consistent with the Supreme Court's interpretation of Title VII in *Alexander v. Gardner-Denver Co.* . . . ."[171]

The court also cited a part of the Report which stated that encouraging the use of arbitration is intended to "supplement, not supplant" the remedies provided by Title VII, and which rejected a Republican proposal that encouraged the use of arbitration "in place of judicial resolution."[172] The court stated that these statements supported the argument that Congress intended that mandatory agreements as conditions of employment be considered "inappropriate" and unenforceable.[173] According to the court, the fact that *Gilmer* narrowed *Gardner-Denver* did not alter Congress' intent because "[w]hen Congress codifies the policy of certain of the courts' holdings, [courts] are bound to follow the dictates of those cases regardless of whether [the courts] think they were correctly decided, and regardless of whether they are subsequently limited or overruled."[174]

2. The beginning of a new trend or an anomaly?

The Ninth Circuit's decision in *Duffield* has created a split between the circuits. Before *Duffield*, the overwhelming majority of circuit courts had

---

Recruiters Int'l, Inc., 858 F.2d 1304, 1305-07 (8th Cir. 1988); Rosenfeld v. Department of Army, 769 F.2d 237, 239 (4th Cir. 1985); EEOC v. Children's Hosp. Med. Ctr., 719 F.2d 1426, 1431 (9th Cir. 1983).

[169] *See Duffield*, 144 F.3d at 1194 (citing Prudential Ins. of Am. v. Lai, 42 F.3d 1299, 1303).

[170] *See id.* at 1194.

[171] *Id.* at 1195 (citing H.R. REP. No. 102-40(I), at 97 (1991), *reprinted in* 1991 U.S.C.C.A.N. 549, 635). In *Duffield*, the court interpreted "the enforcement provisions" as the right to litigate Title VII claims in a judicial forum. *See id.* at 1196.

[172] *See id.* at 1196 (citing H.R. REP. No. 102-40(I), at 104 (1991), *reprinted in* 1991 U.S.C.C.A.N. 549, 642).

[173] *See id.* at 1196.

[174] *Id.* at 1197.

found that Title VII claims were subject to compulsory arbitration.[175] Furthermore, as of March 24, 2000, the First, Second, Third, Fifth, and Seventh Circuit Courts of Appeals are in disagreement with the Ninth Circuit on the issue of whether the Civil Rights Act of 1991 precludes mandatory arbitration agreements of Title VII claims.[176]

To date, no appellate decisions have followed the Ninth Circuit's decision in *Duffield*. This section therefore analyzes district court cases that follow *Duffield*'s position. In *Martens v. Smith Barney, Inc.*,[177] a federal court in the South District of New York agreed with *Duffield*'s holding that agreements compelling arbitration of claims under Title VII are unenforceable.[178] The *Martens* Court pointed out that *Gilmer*'s approval of mandatory arbitration agreements for ADEA claims does not automatically lead to the conclusion that Title VII also allows such agreements.[179] The court explained that despite many similarities, important differences exist between the ADEA and Title VII.[180] For example, while Title VII provides that a prima facie showing of a disparate impact can support a claim of discrimination, under the ADEA, decisions made for reasons independent of age but which have a disparate impact on a certain age group are not actionable.[181] The court concluded that these kinds of differences between the ADEA and Title VII illustrate that Title VII claims may require more protections than ADEA claims.[182] Relying on

---

[175] *See* Cole v. Burns Int'l Sec. Serv., 105 F.3d 1465 (D.C. Cir. 1997); Austin v. Owens-Brockway Glass Container, Inc., 78 F.3d 875 (4th Cir. 1996); Metz v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 39 F.3d 1482 (10th Cir. 1994); Bender v. A.G. Edwards & Sons, Inc., 971 F.2d 698 (11th Cir. 1992); Willis v. Dean Witter Reynolds, Inc., 948 F.2d 305 (6th Cir. 1991); Alford v. Dean Witter Reynolds, Inc., 939 F.2d 229 (5th Cir. 1991).

[176] *See* Desiderio v. National Ass'n of Sec. Dealers, Inc., 191 F.3d 198, 201-02 (2d Cir. 1999); Koveleskie v. SBC Capital Mkts., Inc., 167 F.3d 361, 365 (7th Cir.), *cert. denied*, 120 S.Ct. 44 (1999); Rosenberg v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 170 F.3d 1, 10-11 (1st Cir. 1999); Mouton v. Metropolitan Life Ins. Co., 147 F.3d 453 (5th Cir. 1998); Seus v. John Nuveen & Co., 146 F.3d 175, 183 (3d Cir. 1998), *cert. denied*, 525 U.S. 1139 (1999)(disagreeing with *Duffield* and stating, "[n]or do we believe this straight forward declaration of the full Congress can be interpreted to mean that the FAA is impliedly repealed with respect to agreements to arbitrate Title VII claims which were executed by an employee as a condition of securing employment.").

[177] 181 F.R.D. 243 (S.D.N.Y., 1998).

[178] *See id.* at 258. In *Martens*, female employees of Smith Barney, Inc., an investment company, brought a class action against the company, the stock exchange, and the association of securities dealers, alleging gender-based discrimination and challenging the defendants' practice of conditioning employment on compulsory arbitration of all employment-related claims. *See id.* at 249-50.

[179] *See id.* at 254.

[180] *See id.* at 254-55.

[181] *See id.* at 254 (citing EEOC v. Francis W. Parker Sch., 41 F.3d 1073, 1077 (7th Cir. 1994)).

[182] *See id.* at 254-55.

Duffield's examination of the legislative history of the 1991 Civil Rights Act, the court found the House Committee Report to be clear on Congress's intent to preclude mandatory arbitration agreements for Title VII claims.[183]

Another case in agreement with the Ninth Circuit's interpretation of the 1991 Civil Rights Act is *Phillips v. CIGNA Investments, Inc.*[184] There, a federal district court in Connecticut held that the parties never entered into a valid agreement to arbitrate,[185] thus preventing the court from deciding whether Congress intended to preclude all mandatory pre-dispute arbitration agreements of Title VII claims.[186] The court, however, discussed the legislative history of the 1991 Civil Rights Act extensively and stated that Congress appeared to encourage the use of voluntary alternative dispute resolution but never intended arbitration to be used to deny Title VII claimants the right to a jury trial.[187] Citing *Duffield*, the *Phillips* court stated that it was unlikely that Congress would grant employees new rights, such as the right to a jury trial, by enacting the Civil Rights Act of 1991, and yet permit the erosion of those rights by sanctioning mandatory pre-dispute arbitration agreements.[188]

While some argue that *Duffield* and the two district court cases discussed above indicate the beginning of a new trend,[189] the majority of circuits have held that employment related claims, including those brought pursuant to Title VII, are arbitrable.[190] Furthermore, three circuits have already disagreed with

---

[183] *See id.* at 257-58. The court cited the part of the House Committee Report which it believed stated clear rejection of mandatory arbitration agreements for Title VII claims:

> The Committee emphasizes . . . that the use of alternative dispute mechanisms is . . . intended to supplement, not supplant, the remedies provided by Title VII . . . . [A]ny agreement to submit disputed issues to arbitration . . . in an employment contract, does not preclude . . . seeking relief under the enforcement provisions of Title VII. This view is consistent with the Supreme Court's interpretation of Title VII in Gardner-Denver. . . . The Committee does not intend this section to be used to preclude rights and remedies that would otherwise be available.

H.R. REP. No.102-40(I) at 97 (1991), *reprinted in* 1991 U.S.C.C.A.N. 549, 635.

[184] 27 F. Supp. 2d 345 (D. Conn. 1998).

[185] *See id.* at 358-59. In this case, the defendants, CIGNA Investments, Inc., and CIGNA Corporation moved to compel arbitration of Phillips's employment discrimination claims. *See id.* at 345.

[186] *See id.* at 359.

[187] *See id.* at 357-58.

[188] *See id.* at 358 (citing Duffield v. Robertson Stephen & Co., 144 F.3d 1182, 1192-93).

[189] *See* discussion *supra* section II.C.2.

[190] *See* Mouton v. Metropolitan Life Ins. Co., 147 F.3d 453, 455 (3d Cir. 1998); Thomas James Assocs., Inc. v. Jameson, 102 F.3d 60 (2d Cir. 1996); Armijo v. Prudential Ins. Co. of Am., 72 F.3d 793 (10th Cir. 1995); Kidd v. Equitable Life Assurance Soc'y, 32 F.3d 516 (11th Cir. 1994); *see also* Association of Inv. Brokers v. Securities & Exch. Comm'n, 676 F.2d 857, 861 (D.C. Cir. 1982)("NASD rules mandate arbitration of employer-employee disputes, and did so, to the same extent, as they do now, before the development of [U-4 forms].").

Duffield.[191] In *Seus v. John Nuveen & Co.*,[192] the Third Circuit declined to follow the Ninth Circuit.[193] The court first pointed out that the text of section 118 on its face evinces a clear congressional intent to encourage arbitration of Title VII and similar claims, not to preclude such arbitration.[194] The court also stated that the clause "where appropriate and to the extent authorized by law," in section 118, referred to the FAA.[195] Furthermore, the court stated that even if they were to read "authorized by law" to codify case law, the relevant case law would not be *Gardner-Denver* but *Gilmer* because Congress passed the Civil Rights Act of 1991 more than six months after *Gilmer* was decided.[196]

The Second Circuit also disagreed with *Duffield*'s analysis in *Desiderio v. National Ass'n of Securities Dealers, Inc.*[197] because the court found the text of section 118 clear on its face.[198] The court stated that where the text of a statute is unambiguous, it is not necessary to look at the legislative history.[199] The court also rejected *Duffield*'s conclusion that the purpose of the Civil Rights Act of 1991, namely expanding remedies against intentional discrimination, was at odds with mandatory arbitration, noting that an arbitrator is empowered to grant relief such as compensatory and punitive damages or fee shifting, which *Duffield* referred to as "additional remedies," against discrimination.[200]

The Fifth Circuit, in *Mouton v. Metropolitan Life Insurance Co.*,[201] similarly declined to follow *Duffield*.[202] The court found that "questions of

---

[191] *See* Seus v. John Nuveen & Co., 146 F.3d 175, 182-83 (3d Cir. 1998), *cert. denied*, 525 U.S. 1139 (1999); Desiderio v. National Ass'n of Sec. Dealers, Inc., 191 F.3d 198, 202 (2d Cir. 1999); Mouton v. Metropolitan Life Ins. Co., 147 F.3d 453, 455 (5th Cir. 1998).

[192] 146 F.3d 175 (3d Cir. 1998), *cert. denied*, 525 U.S. 1139 (1999).

[193] *Id.* at 182-83.

[194] *See id.* As the Third Circuit noted, "[n]ot surprisingly there is ample legislative history to support a straightforward reading of the text of § 118." *See id.* at 182 n.1. For example, the Report of the House Committee on the Judiciary explains section 118 as follows:

> This section "encourages" the voluntary use of conciliation, mediation, arbitration, and other methods of resolving disputes under Civil Rights laws governing employment discrimination. We agree that voluntary mediation and arbitration are far preferable to prolonged litigation for resolving employment discrimination claims .... We recognize that mediation and arbitration, knowingly and voluntarily undertaken, are the preferred methods of settlement of employment discrimination disputes.

H.R. REP. NO. 102-40(II), at 78, *reprinted in* 1991 U.S.C.C.A.N. 694, 764.

[195] *See id.* at 183.

[196] *See id.*

[197] 191 F.3d 198 (2d Cir. 1999).

[198] *See id.* at 202.

[199] *See id.*

[200] *See id.* at 203 (citing *Duffield*, 144 F.3d at 1191).

[201] 147 F.3d 453 (5th Cir. 1998).

[202] *See id.* at 455.

arbitrability must be addressed with a healthy regard for the federal policy favoring arbitration. . . . The Arbitration Act establishes that, as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration."[203] The court held that the employee was compelled to arbitrate Title VII claims under the NASD code.[204]

The First Circuit case *Rosenberg v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[205] is important because *Martens* and *Phillips*, two district court cases which agree with *Duffield*, cited the district court's holding in *Rosenberg* that the 1991 Civil Rights Act amendments to Title VII preclude enforcement of pre-dispute arbitration agreements relating to discrimination claims.[206] Focusing on the language "where appropriate and to the extent authorized by law," as *Duffield* did, the district court concluded that "to the extent authorized by law" referred to the Supreme Court's decision in *Gardner-Denver*.[207] *Gardner-Denver* held that an arbitration clause in a collective bargaining agreement did not preclude an employee from bringing Title VII claims in court.[208]

The First Circuit Court of Appeals rejected this argument for several reasons. First, neither the fact that Congress rejected a proposed amendment to the 1991 Civil Rights Act that would have explicitly permitted mandatory arbitration agreements, nor a statement by a Representative emphasizing the use of voluntary rather than mandatory arbitration,[209] are sufficient to overcome the presumption in favor of arbitration established by *Gilmer*.[210] As counter-examples, the court cited statements by members of Congress expressing the view that section 118 did not preclude mandatory arbitration[211]

---

[203] *Id.* (quoting Moses H. Cone Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24-25 (1983) and Rojas v. TK Communications, Inc., 87 F.3d 745, 747 (5th Cir. 1996)).

[204] *See id.* at 454.

[205] 170 F.3d 1 (1st Cir. 1999).

[206] *See id.* at 8.

[207] *See Gardner-Denver*, 995 F. Supp. at 201-04.

[208] *See* Alexander v. Gardner-Denver Co., 415 U.S. 36, 60-61 (1974).

[209] *See Rosenberg*, 170 F.3d at 7 (citing Representative Edwards' statement that the 1991 Civil Rights Act amendment "contemplates the use of voluntary arbitration to resolve specific disputes after they have arisen, not coercive attempts to force employees in advance to forego statutory rights." 137 CONG. REC. H9505-01, H9530 (daily ed. Nov. 7, 1991)(statement of Rep. Edwards)).

[210] *See id.* For discussion on *Gilmer*, see *supra* section II.C.2.

[211] *See id.* The court cited Senator Dole's statement:

> This provision encourages the use of alternative means of dispute resolution, including binding arbitration, where the parties knowingly and voluntarily elect to use these methods. In light of the litigation crisis facing this country and the increasing sophistication and reliability of alternatives to litigation, there is no reason to disfavor the use of such forums.

137 CONG. REC. S15, 472-01, S15,478 (daily ed. Oct. 30, 1991)(statement of Senator Dole).

and the fact that Congress had often rejected legislation that would explicitly bar mandatory arbitration agreements of employment discrimination claims.[212]

The First Circuit in *Rosenberg* then rejected the district court's reasoning that mandatory arbitration of Title VII claims would be inconsistent with the statutory framework and purposes of Title VII.[213] The court also disagreed with the district court's conclusion that *Gilmer* was distinguishable because the system used by the NYSE, unlike the system for arbitrary age discrimination claims in *Gilmer*, was inadequate to protect employee rights.[214] The court noted that the district court had misinterpreted certain facts regarding the structure of the NYSE arbitration system.[215] The district court had found that, as a member of the NYSE, the employer had inside access to the arbitration system which is "dominated by the securities industry, that is, by the employment side. From the rules that govern arbitral procedure and the selection of the arbitrators to the details of discovery practice, the system is dominated by the NYSE itself."[216] The First Circuit countered that the NYSE, rather than being controlled by the securities industry, plays a significant role in monitoring and disciplining exchange members for non-compliance with its rules.[217]

Rosenberg is important because it rejected the district court's agreement with *Duffield*, and implicitly, the district court cases following *Duffield* on which the *Rosenberg* district court decision relied.[218]

3. *Enforcing mandatory arbitration agreements in Title VII claims*

Although some argue that *Duffield* and the three district court cases discussed above indicate the beginning of a new trend, it is too early to determine if this is true. The overwhelming majority of courts supports the view that mandatory arbitration agreements regarding employment discrimination disputes are enforceable; four circuits have already disagreed with the Ninth Circuit's decision and reasoning in *Duffield*.[219] Examining the two lines

---

[212] *See Rosenberg*, 170 F.3d at 7 (citing Civil Rights Procedures Protection Act of 1997, H.R. 983, S. 63, 105th Cong. (1997); Civil Rights Procedures Protection Act of 1996, H.R. 3748, 104th Cong. (1996); Civil Rights Procedures Protection Act of 1994, H.R. 4981, S. 2405, 103rd Cong. (1994)).

[213] *See id.* at 9.

[214] *See id.* at 12-13; *see also supra* section II.C.2.

[215] *See Rosenberg*, 170 F.2d at 14.

[216] *Id.* at 13.

[217] *See id.* at 14.

[218] *See, e.g.*, Martens v. Smith Barney, Inc., 181 F.R.D. 243, 257 (S.D.N.Y., 1998); Phillips v. CIGNA Invs., Inc., 27 F. Supp. 2d 345, 355 (D. Conn. 1998).

[219] *See* Desiderio v. National Ass'n of Sec. Dealers, Inc., 191 F.3d 198, 201-02 (2d Cir. 1999); *Rosenberg*, 170 F.3d 1, 8 (1st Cir., 1998); Mouton v. Metropolitan Life Ins. Co., 147

of cases suggests that *Duffield* is probably an anomaly and that the Ninth Circuit's interpretation of the 1991 Civil Rights Act was contrary to congressional intent.

First, as the Third Circuit and the defendant in *Duffield* pointed out, the plain language of section 118 of the 1991 Civil Rights Act suggests that Congress intended to "encourage" arbitration "where appropriate and to the extent authorized by law."[220] Encouragement of arbitration is the main theme of this section of the Civil Rights Act. If Congress had intended to prohibit all mandatory arbitration agreements, it would have made that intention plain in the text by using language such as "the use of arbitration shall be prohibited unless parties agree to arbitrate voluntarily after a dispute arises."

Also, as the Third Circuit noted, the fact that Congress passed the 1991 Civil Rights Act six months after *Gilmer* was decided indicates that the more reasonable interpretation of section 118's clause "where appropriate and to the extent authorized by law" is the one that accords with *Gilmer*, not *Gardner-Denver*.[221] The Supreme Court's decision in *Gilmer* was a clear departure from *Gardner-Denver*.[222] If Congress had intended to exclude pre-dispute mandatory arbitration agreements from section 118, it would have amended the text of section 118, because the meaning of "law" in "to the extent authorized by law" had changed.[223]

In addition, although there is a strong public policy of protecting employees from discrimination and providing them with different legal avenues of redress, there is also a public policy in favor of arbitration.[224] Balancing these two policies suggests that the best way to deal with the enforceability of mandatory arbitration agreements regarding employment discrimination disputes is to apply the strict standard of a "knowing waiver," established by the Ninth Circuit in *Prudential v. Lai*, *Renteria v. Prudential*, and *Nelson v.*

F.3d 453 (5th Cir. 1998); Seus v. John Nuveen & Co., 146 F.3d 175, 183 (3d Cir. 1998), *cert. denied*, 525 U.S. 1139 (1999)(disagreeing with *Duffield* and stating, "[n]or do we believe this straightforward declaration of the full Congress can be interpreted to mean that the FAA is impliedly repealed with respect to agreements to arbitrate Title VII claims which were executed by an employee as a condition of securing employment."); *see also* section III.B.2.b.

[220] *See Seus*, 146 F.3d at 182-83; *Duffield*, 144 F.3d at 1189-90.

[221] *See supra* note 193 and accompanying text.

[222] *See* discussion *supra* section II.C.

[223] *See* discussion *supra* section III.C.

[224] *See* McDonnell Douglas Corp. v. Green, 411 U.S. 792, 800 (1973)("The language of Title VII makes plain the purpose of Congress to assure equality of employment opportunities and to eliminate those discriminatory practices and devices which have fostered racially stratified job environments to the disadvantage of minority citizens."); *see also* Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983)(stating that the FAA "is a congressional declaration of a liberal federal policy favoring arbitration agreements, notwithstanding any state substantive or procedural policies to the contrary.").

Cyprus, not to make all mandatory arbitration clauses unenforceable in discrimination cases as *Duffield* did.[225]

IV. CONCLUSION

This Recent Development focused on the development of the Ninth Circuit's interpretation of mandatory arbitration agreements of employment discrimination claims. The first phase of the Ninth Circuit's interpretation of these agreements demonstrated no departure from the law of other circuits: The Ninth Circuit extended the Supreme Court's holding in *Gilmer* to Title VII claims.[226] In the second phase, the Ninth Circuit imposed a strict requirement of a "knowing waiver" on employers when construing mandatory arbitration agreements. As compared to case law in the majority of the circuits that have criticized this view, the Ninth Circuit's requirement of a "knowing waiver" is the most fair and reasonable.[227] In the third phase, however, the Ninth Circuit went too far. Comparing the Ninth Circuit's recent controversial case, *Duffield v. Robertson Stephens & Co.*, with decisions from other circuits demonstrates that *Duffield*, which held that the 1991 Civil Rights Act completely precludes compulsory arbitration of civil rights claims, is probably an anomaly and is contrary to congressional intent underlying the Civil Rights Act of 1991.[228]

Naoko Miyamoto[229]

[225] *See* discussion *supra* sections III.B.1 and III.C.1.
[226] *See* discussion *supra* section III.A.1.
[227] *See* discussion *supra* section III.B.1.
[228] *See supra* Part III.C.1.
[229] Class of 2000, William S. Richardson School of Law.

Mitchell v. State and HRS § 386-3: Workers' Compensation Reform in the State of Hawai'i

I. INTRODUCTION

An employee violates a rule of a company and is punished in good faith by his employer for the act. The employee, distraught over being disciplined, is then unable to work. Should that employee be able to recover workers' compensation for his mental distress? To the average person the answer would seem to be "Of course not!" However, that is not the answer that the Hawai'i Supreme Court gave in a 1997 decision.

In *Mitchell v. State*,[1] the Hawai'i Supreme Court unanimously ruled that a public school teacher could receive workers' compensation benefits for the mental distress she suffered from disciplinary action taken against her after her alleged use of corporal punishment in disciplining a student.[2] The court's decision in *Mitchell* sparked a storm of controversy over the workers' compensation laws in Hawai'i.[3] The outcry however, was not just focused on the court's narrow holding in the case, but on the general attitude of the court in liberally granting workers' compensation benefits to employees.

There is an obvious and constant need to guard the workers' compensation statutes from any interpretation that might limit or impede an employee's right to workers' compensation. Hawai'i courts, however, in recent years have enlarged an employee's right to workers' compensation at a rate that appears neither sanctioned by the state legislature nor consistent with the general direction of workers' compensation law across the country.[4]

The *Mitchell* decision triggered the need for an amendment to Hawai'i's Workers' Compensation Law, section 386-3 of the Hawai'i Revised Statutes

---

[1] 85 Hawai'i 250, 942 P.2d 514 (1997).

[2] *See id.* at 251, 942 P.2d at 515. Basing its decision on a liberal interpretation of HAW. REV. STAT. § 386-3, the Hawai'i Supreme Court held that since the disciplinary action against Mitchell arose out of her acts as a school teacher, she qualified for workers' compensation for any mental stress suffered from the disciplinary action regardless of her guilt or innocence in the matter. *See id.* at 257, 942 P.2d at 521.

[3] *See infra* notes 112, 127 (listing the public and private organizations that testified in support of the bill amending HAW. REV. STAT. § 386-3).

[4] Complaints about the liberal interpretation by the Hawai'i Supreme Court echo related complaints across the country, aimed at similarly expansive interpretations of workers' compensation statutes. *See* Terry D. Lucy, *Workers' Compensation Laws: Act 796 of 1993 and the Definition of "Compensable Injury"*, 20 U. ARK. LITTLE ROCK L.J. 265 (1998); *see also* Editorial, *Court Stretches Workers Comp Law*, OMAHA WORLD-HERALD, Jan. 7, 1998, at 20.

("HRS").[5] The Hawai'i legislature, in response to the case, passed House Bill No. 2648, which became law on July 20, 1998.[6] The bill sought to eliminate an employee's right to collect workers' compensation benefits for any mental distress suffered as a result of a "good faith" disciplinary hearing conducted by an employer.[7] Critics of the bill, however, contend that the amendment to the workers' compensation law was too narrowly drafted.[8] These critics argue the bill should have been broadened to prevent an employee from receiving workers' compensation from any "good faith" personnel decision that an employer might make in the regular course of business.[9]

This Recent Development focuses on *Mitchell* as well as on national trends in the applicability of the workers' compensation laws to mental stress claims brought by an employee due to an employer's good faith personnel decisions.[10]

Part II explores the general theories and public policy choices behind the national workers' compensation system. Statutes and case law from other jurisdictions that have dealt with mental stress injuries suffered under conditions similar to the *Mitchell* case will be analyzed. This Part also explores the history and development of the workers' compensation laws in Hawai'i. The second half of Part II discusses the facts and the holding of *Mitchell*. The court's interpretation of the old version of HRS § 386-3 will be contrasted with the legislative bill that was drafted in response to *Mitchell*.

---

[5] *See* H.R. CONF. COMM. REP. No. 162, 19th Leg., Reg. Sess. (1998), *reprinted in* 1998 HAW. HOUSE J. 1029.

[6] *See* H.B. 2648, 19th Leg., Reg. Sess. (Haw. 1998)(enacted), 1998 Haw. Laws 768.

[7] *See* HAW. REV. STAT. § 386-3(c) (1998), was added which reads:

> A claim for mental stress resulting solely from disciplinary action taken in good faith by the employer shall not be allowed; provided that if a collective bargaining agreement specifies a different standard than good faith for disciplinary actions, the standards set in the collective bargaining agreement or other employment agreement shall be the standard set in lieu of the good faith standard[.]

H.B. 2648, 19th Leg., Reg. Sess. (Haw. 1998)(enacted), 1998 Haw. Laws 768.

[8] *See, e.g.*, Bruce Dunford, *Dissident Democrats and Minority Republicans . . .*, ASSOCIATED PRESS POL., Feb. 23, 1998, at 1, *available in* 1998 WL 7389385. Some critics derogatorily took to calling the new law a "shoo-shoo baby," which is a Hawaiian pidgin English reference to a firecracker that only creates smoke but that does not explode as it is supposed to. *See id.*

[9] *See id.* Critics of the amendment feel that it also should have denied workers compensation for an employee's claims of mental stress arising from an employee's demotion, transfer, layoff or termination by his or her employer. *See id.*

[10] Two questions about the current status of Hawai'i's workers' compensation laws need to be raised. The first question is whether workers' compensation laws are being interpreted too liberally by courts in Hawai'i and across the country when dealing with mental distress injuries. The second question is whether these developments in workers' compensation law concerning an employee's mental distress due to a employer's good faith personnel decision are contrary to the original intent of workers' compensation laws.

This Part also articulates the reasoning behind the legislature's modification of HRS § 386-3. Lastly, this recent development analyzes the possible need for further legislation concerning workers' compensation laws in Hawai'i due to the fact that 1998 amendment may not have addressed all the issues raised in *Mitchell*.

II. BACKGROUND

A. *The Development of the American Workers' Compensation System*

The development of the workers' compensation system in America dates from the early twentieth century when, as the industrial revolution progressed, the need to modify the common law rules for handling industrial workers injured on the job became apparent.[11] Prior to the development of workers' compensation laws, a lawsuit against an employer for negligence was the only recourse available to an employee injured on the job to recover lost wages and medical expenses.[12] This method of compensation was ineffective because the employer could use any number of legal defenses to a negligence action, such as assumption of the risk.[13] In other cases, the employer could simply prolong the litigation, making the suit too expensive for the employee to sustain.[14] In addition, the employee-employer relationship was damaged by the suit, often making it impossible for the employee to return to work after the injury had healed.[15] This need for reform resulted in the adoption of statutory workers' compensation laws across the country.[16]

From the start of the twentieth century, state legislatures across the United States abrogated the traditional common law system in employee injury cases by enacting workers' compensation laws.[17] In place of the common law was installed a statutory system in which an employee injured on the job would be paid compensation for lost wages, medical expenses, and rehabilitation without regard to the fault of the employee or employer.[18] In exchange for

---

[11] *See* Kenneth M. Berman, *The Current State of Workers' Compensation Law and Practice*, 584 PLI/LIT 327, 329 (1998).

[12] *See id.*

[13] *See id.*

[14] *See id.* at 329.

[15] *See* Amy S. Berry, *The Reality of Work Related Stress: An Analysis of How Mental Disability Claims Should be Handled Under the North Carolina Workers' Compensation Act*, 20 CAMPBELL L. REV. 321, 324 (1998).

[16] *See id.* For a discussion of the development of workers compensation laws in other jurisdictions, see also Alan S. Katkin, *Understanding the Concepts of Workers' Compensation*, 582 PLI/LIT 7, 9-10 (1998).

[17] *See* Berry, *supra* note 15, at 324.

[18] *See id.*

their right to automatic compensation, employees would surrender their right to sue an employer in tort, including suits for the employer's negligence.[19] This compromise, on one hand, resulted in a presumption of compensability for the employee, while on the other hand, made the workers' compensation process the sole recourse available to an injured employee.[20]

Compensation for mental injuries suffered in the "course of employment" has long been recognized in the American workers' compensation system.[21] Shortly after the development of the modern workers' compensation system, courts across the country also began to recognize and allow workers' compensation for the physical injuries sometimes associated with severe mental stress.[22] Admittedly, courts have often viewed suspiciously employees' claims of mental stress due to the difficulty in establishing objective criteria to validate and evaluate the employee's injury.[23] Nevertheless, mental injuries suffered by an employee are clearly recognized as compensable under the modern workers' compensation system and have evolved their own nuances and case law, distinct from that of general workers' compensation law.[24]

---

[19] *See* Christine L. Sommer, *Workers' Compensation and Company Sponsored Events: The High Cost of Employee Morale*, 39 CLEV. ST. L. REV. 181, 183 (1991).

[20] *See* Berman, *supra* note 11, at 329. The employer could factor into its costs the lower and more predictable sum of an injured worker's disability salary, without the threat of massive pay outs from a jury verdict, while an employee could be guaranteed compensation for any injury he or she suffered arising "in and out of the course of his or her employment," regardless of the question of fault in the employee's injury. *See id.* at 330.

[21] *See* Marvin E. Duckworth & Tina M. Eick, *Recent Developments in Mental/Mental cases Under the Iowa Workers' Compensation Law*, 45 DRAKE L. REV 809, 809-10 (1997).

[22] *See id.*; *see also* ARTHUR LARSON, LARSON'S WORKERS' COMPENSATION LAW § 42.22(a) (1997)("[W]hen there has been a physical accident or trauma, and claimant's disability is increased or prolonged by traumatic neurosis, conversion hysteria, or hysterical paralysis, it is now uniformly held that the full disability including the effect of the neurosis is compensable.").

[23] *See* Duckworth & Eick, *supra* note 21, at 809-10.

[24] *See, e.g.*, Teresa K. Lamaster, *Worker's Compensation*, 53 MD. L. REV. 1029, 1032 (1994); *see also* LARSON, *supra* note 22, § 42.20. Larson states:

> The cases may be thought of, for convenience, in three groups: mental stimulus causing physical injury; physical trauma causing nervous injury; and mental stimulus causing nervous injury. It must be understood that this use of such words as mental . . . and the like is only a rough expedient adopted in order to sort out an often infinite variety of subtle conditions and relationships for compensation law purposes[.]

Id.

B. Different Jurisdictions' Handling of the Mental Stress Issue in Relation to an Employer's Personnel Decisions

In recent years, the number of workers' compensation claims for mental injuries has skyrocketed across the country.[25] Physical-mental claims, as when a physical injury results in a mental injury,[26] and mental-physical claims, as when a mental injury manifests itself with physical symptoms,[27] are generally recognized as compensable under workers' compensation statutes.[28]

However, one area currently troubling practitioners of workers' compensation law are situations in which an employee claims mental-physical injuries arising from an employer's good faith discipline, transfer, demotion, or firing of that employee.[29] State courts across the country are divided on this issue.[30] The split of authority concerns whether an employee can recover workers' compensation in a situation such as that in *Mitchell*, where the mental distress resulted from a good faith disciplinary hearing by Mitchell's employer.[31]

---

[25] *See* LARSON, *supra* note 22 § 42.25(a). In California, one study has calculated that 17% of all lost time injuries in the state were due to mental stress claims. *See id.* § 42.25(a).

[26] It is generally accepted that a mental or emotional disorder stemming from an accidental injury is compensable when a causal relation between the physical injury and the mental disability is present. *See* Berman, *supra* note 11, at 332. *See generally e.g.* Baber v. John C. Knipp & Sons, 163 A. 862 (Md. 1993)(holding that a worker who suffered an injury and later allegedly committed suicide due to effects of the injury could recover workers' compensation if the proper link between the physical injury and the mental injury resulting in the suicide was established).

[27] *See, e.g.*, Montgomery County v. Grounds, 862 S.W.2d 35 (Tex. Ct. App. 1933)(holding that a sheriff's deputy who suffered a heart attack from stress, after the head sheriff did not assure the deputy that he would not be indicted for altering reports, could recover workers compensation benefits because the deputy's physical injury came about as a result of mental stress related to his job). Mitchell's injury could arguably be called a mental-physical injury because her feelings of stress over her disciplinary hearing manifested itself in the form of a low grade fever, insomnia, fatigue, and a loss of appetite. *See* Mitchell v. State, 85 Hawai'i 250, 252, 942 P.2d 514, 516 (1997).

[28] *See* LARSON, *supra* note 22 § 42.21. A great divergence in opinion exists over whether an employee can recover for mental-mental injuries, where both injury and effect are mental in nature. *See* Berman, *supra* note 11, at 334. Eleven states deny compensation entirely for mental-mental injuries. *See* Thomas R. Head, *Crochiere v. Board of Education of Enfield: Workers' Compensation for Job-Related Mental Disease Claims-Stress Reliever or Judicial Headache?*, 21 AM. J. TRIAL ADVOC. 131, 136 n.42 (1997). Connecticut, Alabama, Florida, Georgia, Kansas, Minnesota, Montana, Nebraska, Ohio, Oklahoma, and South Dakota all deny worker's compensation for mental-mental claims. *See id.*

[29] *See* LARSON, *supra* note 22, § 42.21, § 42.25(c); *see also* Head, *supra* note 28, at 136.

[30] *See* discussion *infra* section II.B.

[31] *See* discussion *infra* section II.B.

Some states, in their workers' compensation statutes, have directly addressed the specific issue of whether an employee can receive workers' compensation for mental stress due to a disciplinary hearing.[32] Among these states, a "no compensation" philosophy has emerged. The statutes in these states prohibit an employee from receiving workers' compensation when the employee's mental injury arise from good faith personnel decisions taken by the employer.[33]

Montana and New York are examples of states that have taken this no compensation approach. Both New York and Montana have modified their workers' compensation statutes by enacting language restricting an employee's right to recover under workers' compensation for mental injury caused by an employer.[34] For example, the Montana statute provides:

> A mental injury is not considered to arise in the course of the employment if it results from any disciplinary action, workers' evaluation, job transfer, layoff, demotion, termination or any similar action taken in good faith by the employer.[35]

New York's workers' compensation statute also takes a stance similar to Montana's:

> The terms "injury" and "personal injury" shall not include an injury which is solely mental and is based on work related stress if such mental injury is a direct consequence of a lawful personnel decision involving a disciplinary action, work evaluation, job transfer, demotion, or termination taken in good faith by the employer.[36]

Under the wording of these two statutes, Regina Mitchell would not have been able to recover workers' compensation benefits for her mental distress because her injury was caused by a good faith disciplinary action taken against her by her employer.

---

[32] *See Mitchell*, 85 Hawai'i at 257, 942 P.2d at 521 (citing N.Y. WORK. COMP. LAW § 2 (McKinney 1994); ALASKA STAT. § 23.30.265(17) (Michie 1992); MO. REV. STAT. § 287.120 (1994)).

[33] *See infra* notes 34-37 and accompanying text; *see also, e.g.*, N.Y. WORK. COMP. LAW § 2 (McKinney 1994); ALASKA STAT. § 23.30.265(17) (Michie 1992); MO. REV. STAT. § 287.120 (1994)(containing examples of state statutes that prohibit an employee from receiving workers' compensation when the employee's mental injury arose out of a good faith personnel decision by the employer).

[34] See MO. REV. STAT. § 287.120.8, which provides, "[m]ental injury resulting from work related stress does not arise out of and in the course of the employment, unless it is demonstrated that the stress is work related and was extraordinary and unusual. The amount of stress shall be measured by an objective standard and actual events."

[35] *Id.*

[36] N.Y. WORK. COMP. LAW § 2-7.

In contrast to Montana and New York, many states' workers' compensation statutes do not specifically mention mental injuries in their definition of injury or accident.[37] Accordingly, in states like Michigan and Hawai'i, courts have become increasingly involved in determining what mental stress claims are covered under the states' workers' compensation statutes.[38] Michigan law resembles Hawai'i law as it existed prior to the modification of HRS § 386-3, in that there is no statutory bar preventing an employee from recovering workers' compensation benefits due to an employer's good faith disciplining of that employee.[39] Therefore, in states like Michigan, a worker who suffers mental distress from a good faith disciplinary hearing by an employer can receive workers' compensation. In *Calovecchi v. State*,[40] the Michigan Court of Appeals held that a police officer could recover workers' compensation benefits for the mental distress he suffered from suspension for pulling a gun on his step-son.[41] The Michigan court reasoned that termination by an employer normally would not result in a compensable injury for mental stress suffered by the fired employee.[42] In *Calovecchi*, however, the mental stress injury suffered by the officer occurred in the course of being disciplined by his employer, thus making his injury compensable.[43] By distinguishing between a disciplinary hearing and a firing, the court held that the Michigan common law rule preventing workers' compensation for mental stress due to a termination did not apply in the case of a mere disciplinary hearing.[44]

Hawai'i's workers' compensation laws have been influenced by this on-going split in the laws of the fifty states. Traditionally a liberal state, Hawai'i has nevertheless moved its laws closer to the "no compensation approach" of New York and Montana in this limited area.[45]

---

[37] *See* Head, *supra* note 28, at 132.

[38] *See id.*

[39] In Michigan, like most jurisdictions, an injury must arise out of and in the course of employment to be compensable. *See* Calovecchi v. State, 566 N.W.2d 40, 41 (Mich. Ct. App. 1997)(citing MICH. COMP. LAW. § 418.301 (1996)).

[40] 566 N.W.2d 40 (1997).

[41] *See id.* at 41.

[42] *See id.* at 41-42.

[43] *See id.* at 42.

[44] *See id.* The court reasoned that the Michigan common law rule preventing compensation for mental stress due to a firing "is based on the simple proposition that an act of ending employment cannot be construed as being in the course of employment. However, this proposition does not naturally extend to an act of discipline that is not intended to end the relationship." *Id.* at 41. The Michigan court seemed satisfied with its decision in the *Calovecchi* case and did not invite a legislative amendment to the Michigan Worker's compensation laws, as the Hawai'i Supreme Court did in *Mitchell*. *See id.* at 43. *See* discussion *supra* section II.A.2.

[45] Hawai'i has had a tradition of awarding workers' compensation for mental distress claims since the 1970's. *See* discussion *infra* section II.C; *see also* Royal State Nat'l Ins. Co. v. Labor

C. Workers' Compensation Law in Hawai'i

Statutory workers' compensation laws arrived in the Hawaiian islands in 1915[46] when the Hawai'i Territorial legislature decided to modify the traditional common law.[47] The first workers' compensation law in Hawai'i followed the same general framework that was adopted nationally at the time.[48] As the Hawai'i Territorial Supreme Court stated in *In re Ichijiro Ikoma*,[49] in 1917:

> A first reading of the [workers' compensation] act gives the impression that one of its main purposes is to take from the employee the right of action for injuries received, whether such injuries are caused by the negligence of his employer, by the negligence of his fellow servant, or by any act of his own . . . but the paramount purpose appears to be to protect the workman and to provide compensation to him from his employer for all injuries received, regardless of questions of negligence and proximate cause.[50]

& Indus. Relations Appeals Bd., 53 Haw. 32, 487 P.2d 278 (1971). The court in *Royal State* held that:

> HRS § 386-3 makes no differentiation between organic and psychic injuries arising out of the employment relationship . . . [t]he humanitarian purposes of the Workmen's Compensation Law require that indemnification be predicated not upon the label assigned to the injury received, but upon the employee's inability to work because of impairments flowing from the conditions of his employment.

Id. at 38, 487 P.2d at 282.

[46] The traditional English common law was introduced to the Hawaiian islands in the first half of the 19th century. *See* Melody K. MacKenzie, *Historical Background*, NATIVE HAWAIIAN RIGHTS HANDBOOK 5 (Melody K. MacKenzie ed., 1991). Under the Hawaiian Monarchy, the law of the islands developed as a cross between native Hawaiian laws and the English common law with a Supreme Court as the final arbitrator of the laws in the archipelago. The Monarchy was overthrown in 1893 by American businessmen, and the islands were then annexed by the United States in 1900. *See id.* at 15. Hawai'i remained a territory of the United States until 1959 when it became the 50th state. *See id.* at 18. Large elements of the Kingdom of Hawai'i's laws were kept after the overthrow of the Hawaiian nation, through the territorial period, and now in the current State of Hawai'i's Constitution and statutes. *See id.* at 18-20.

[47] *See In re* Claim for Compensation of Ichijiro Ikoma, 23 Haw. 291, 293 (1916). The first section of the act amending the common law provided:

> Section 1. This Act shall apply to any and all industrial employment, as hereinafter defined. If a workman receives personal injury arising out of and in the course of such employment, his employer or the insurance carrier shall pay compensation in the amount and to the person or persons hereinafter specified."

Id. (quoting Act 221, S. L. 1915)

[48] *See id.* at 296. In *Iokoma*, the Territorial Supreme Court held that Oahu Sugar Company was liable to pay workers' compensation to the employee of a sub-contractor who was blinded in one eye while working on a road bed for the sugar company. *See id.*

[49] 23 Haw. 291 (1916).

[50] *Id.* at 295-96.

The court ruled that the workers' compensation laws were to be construed "broadly and liberally with the view of effecting the purpose of the act[.]"[51] Given the pro-business tendencies of the Hawaiian Territorial Government during this era,[52] the policy of a pro-employee interpretation by the Territorial Supreme Court marked the beginning of a tradition of interpreting workers' compensation law liberally that continues to this day.[53]

The modern era of workers' compensation law in Hawai'i was ushered in during the 1960's and 1970's through the tenure of Chief Justice William S. Richardson[54] and the largely employee-friendly, judicially activist justices on the state supreme court.[55] This liberal tradition continued during the term of Chief Justice Herman Lum[56] and persists to this day with the court headed by Chief Justice Ronald Moon.[57]

---

[51] *Id.* at 295.

[52] *See generally* GAVAN DAWS, SHOAL OF TIME: A HISTORY OF THE HAWAIIAN ISLANDS 312 (1968)(discussing the control of the Hawaiian islands by big business during this period).

[53] The original workers' compensation act recodified on July 1, 1963, was then amended by Act 296, SLH 1985. *See* Suzane T. Terada, *Iddings v. Mee-Lee: A Look at Workers Compensation*, HAW. BAR J., Nov. 1996, at 6; *see also* Silva v. Kaiwiki Milling Ltd., 24 Haw. 324, 330 (1918)(stating that, "[c]ompensation acts being highly remedial in character, though in derogation of the common law, should generally be liberally and broadly construed to effectuate their beneficent purposes.").

[54] The history of the Hawai'i Supreme Court since statehood in 1959 can be divided into four major periods each defined by the then sitting Chief Justice. *See* Robert M. Rees, *Hanging in the Balance: The Waihee Supreme Court*, HONOLULU WEEKLY, Feb. 22, 1995, at 4. The Tsukiyama era spanned from statehood until 1966, the Richardson era from 1966-1982, the Lum era from 1982-1993, and the Moon era from 1993 to the present. *See id.*

[55] *See* Richard S. Miller & Geoffrey K.S. Komeya, *Tort and Insurance "Reform" in a Common Law Court*, 14 U. HAW. L. REV. 55, 61-62 (1992). Professor Miller states:

> It would not have been a surprise to anyone following the recent political history of Hawaii that the Richardson Court would adopt a most liberal and activist posture in its decisions. Following years of domination by the 'Big Five' and conservative business interests, Hawaii's governmental structure shifted into the hands of the liberal Democrats.
>
> . . . .

Id. at 61-62 (citation omitted). For other examples of judicially active decisions by the Richardson Court, see Chung v. Animal Clinic Inc., 63 Haw. 642, 649, 636 P.2d 721, 726 (1981); Akamine v. Hawaiian Packing & Crating Co., 53 Haw. 406, 409, 495 P.2d 1164, 1166 (1972); Royal State Nat'l Ins. Co. v. Labor & Indus. Relations Appeal Bd., 53 Haw. 32, 38, 487 P.2d 278, 282 (1971); McBryde Sugar Co. v. Robinson, 54 Haw. 174, 504 P.2d 1330 (1973).

[56] *See* Ronald Brown, *The Hawaii Supreme Court Under the Lum Court: Commentary on Selected Employment and Labor Law Decisions*, 14 U. HAW. L. REV. 423 (1992).

[57] *See* Rees, *supra* note 54.

A number of key principles in interpreting the modern workers' compensation laws in Hawai'i were refined by the Richardson Court.[58] The first principle, stated by the court in *Royal State National Insurance Co. v. Labor & Industrial Relations Appeals Bd.*,[59] is that Hawai'i's workers' compensation statute, HRS § 386, is to be construed liberally in favor of conferring compensation on the employee because the state legislature had decided that work injuries were a cost of production which industry in Hawai'i was to bear.[60] Therefore, in *Royal State*, the court sustained the directed verdict in favor of an injured insurance agent seeking workers' compensation benefits for the alleged mental distress he sustained while working.[61] The court ordered workers' compensation paid to the agent even though the employer contended that his mental distress was not job related.[62]

A second key principle articulated by the Richardson Court, as stated in *Evanson v. University of Hawaii*,[63] is that questions of negligence and proximate cause are irrelevant because the law's "paramount purpose is to provide compensation for an employee for all work connected injuries . . . ."[64] Therefore, in all workers' compensation cases there is both a presumption of

---

[58] *See* cases cited *supra* note 55 (citing Hawai'i workers' compensation cases from 1966-1982).

[59] 53 Haw. 32, 487 P.2d 278 (1971). The court held that the trial court had properly awarded workers' compensation on directed verdict for the plaintiff who claimed mental distress caused by the pressures of his work. *See id.* at 39, 487 P.2d at 282.

[60] *See Royal State*, 53 Haw. at 38, 487 P.2d at 282; *see also Chung*, 63 Haw. at 649, 636 P.2d at 726 (quoting *Akamine*, 53 Haw. at 409, 495 P.2d at 1166); Mitchell v. State, 85 Hawai'i 250, 255, 942 P.2d 514, 519 (1997)).

[61] *See Royal State*, 53 Haw. at 39, 487 P.2d at 282.

[62] *See id.* The court stated that:

> HRS § 386-3 makes no differentiation between organic and psychic injuries arising out of the employment relationship and we do not believe that the court should impose such a distinction. . . . In today's highly competitive world it cannot be doubted that people often succumb to mental pressures resulting from their employment. These disabilities are as much a cost of the production process as physical injuries.

Id. at 38, 487 P.2d at 282.

[63] 52 Haw. 595, 483 P.2d 187 (1971).

[64] *Id.* at 600, 483 P.2d at 191. In *Evanson*, the Hawai'i Supreme Court ordered workers' compensation paid to the family of a University of Hawai'i student who was killed while working at a university agriculture station. The court held that because the student was a worker for the university and had signed a contract of hire, his family could not sue the university in tort for the student's death because the workers' compensation system was the only remedy for the family of an employee injured on the job. *See id.* at 600, 483 P.2d at 191.

compensability[65] and an understanding that the workers' compensation statutes are the sole remedy for an injured worker.[66]

Under Chief Justice Ronald Moon, the Hawai'i Supreme Court has continued to expand its tradition of interpreting Hawai'i's workers' compensation statutes liberally, while being virtually unchecked by the Hawai'i legislature.[67] As discussed, the Hawai'i Supreme Court has been protective of an employee's right to receive workers' compensation since the Territorial era.[68] This pro-employee course has continued into the modern era not only through the court's holding in *Mitchell*, but in another major workers' compensation case decided in 1996, *Iddings v. Mee-Lee*.[69]

In *Iddings*, the Hawai'i Supreme Court significantly expanded the right of an employee to sue his or her supervisors in tort for injuries the employee suffers in the course of employment.[70] The court allowed a nurse to sue her supervisor in tort for the injury she sustained while trying to control a violent

---

[65] *See Akamine*, 53 Haw. at 408, 495 P.2d at 1166 (stating "the legislature has decided that work injuries are among the cost of production which industry is required to bear; and if there is reasonable doubt as to whether an injury is work connected, the humanitarian nature of the statute demands that the doubt be resolved in favor of the claimant.").

[66] *See* HAW. REV. STAT. § 386-85(1) (1976); Chung v. Animal Clinic, Inc., 63 Haw. 642, 650, 636 P.2d 721, 727 (1981).

[67] There have been modifications to the Hawai'i workers' compensation statutes in the past couple of years by the legislature. However, no change was a major modification.

[68] *See* discussion *supra* section II.C.

[69] 82 Hawai'i 1, 919 P.2d 263 (1996). An even more recent expansion of employees' rights under the workers' compensation laws in Hawai'i is the Hawai'i Intermediate Court of Appeals ("ICA") case, *Frank v. Hawaii Planing Mill Found.*, 88 Hawai'i 465, 967 P.2d 662 (App.), *rev'd*, 88 Hawai'i 140, 963 P.2d 349 (1998). In *Frank*, the ICA ruled that Hawai'i's statutory laws were different from the common law rule on how a borrowing employer could cover temporary workers under its workers' compensation plan. *See id.* at 476, 967 P.2d at 673. The ICA, going against industry-wide policies and long held interpretations, narrowly read the statutory language of Hawai'i's workers' compensation laws to find that Hawai'i Planing Mill ("HPM") had not properly covered Frank, a temporary employee, under HPM's workers' compensation program. *See id.* at 477, 967 P.2d at 674. By doing so, the ICA exposed HPM to an action in tort by Frank for the injury he suffered while working as a temporary hire for HPM. *See id.* This ruling occurred despite HPM's attempts to be indemnified from this type of suit through workers' compensation payments to the temporary agency that had assigned Frank to HPM. *See id.* However, the Hawai'i Supreme Court in *Frank v. Hawaii Planing Mill*, 88 Hawai'i 140, 963 P.2d 349 (1998), overturned the ICA's decision, ruling that because "HPM secured workers' compensation coverage for Frank [via the temp agency], HPM is entitled to tort immunity." *Id.* at 147, 963 P.2d at 356.

[70] *See Iddings v. Mee-Lee*, 82 Hawai'i 1, 919 P.2d 263 (1996)(holding that "willful and wanton conduct," for purposes of exception to general rule under workers' compensation scheme that coemployees are immune from suit brought by employee to recover for workplace injury, includes conduct committed in circumstances indicating that injuring employee knew peril to be apprehended, knew that injury is probable as opposed to possible, and injuring employee consciously failed to avoid peril).

patient.[71] The court also allowed her to recover workers' compensation benefits from her employer while maintaining her tort suit against her supervisor.[72] The court reasoned that Hawai'i's "willful and wanton misconduct" exception to co-employee immunity did not require an intent to injure.[73] In holding as such, the court not only substantially increased an employee's chances of recovering money for a work related injury, but it also introduced a "reckless fault" standard into what was envisioned to be a no-fault workers' compensation system.[74] *Iddings* and *Mitchell* represent the expansion of employees' rights to workers' compensation by Hawai'i's courts. Based on the legislative reaction to *Mitchell*, however, it is evident that the legislature felt it necessary to check the court's steady judicial expansion of Hawai'i's workers' compensation laws. *Mitchell*, therefore, might represent the high water mark of pro-employee workers' compensation decisions by the Hawai'i Supreme Court.

III. RECENT DEVELOPMENTS IN HAWAI'I WORKERS' COMPENSATION LAW

A. *Mitchell v. State*

The facts of *Mitchell* provide a basis for understanding the Hawai'i Supreme Court's determination of the matter. The key issue on appeal was whether a teacher could collect workers' compensation benefits for her inability to work due to the mental stress she suffered from a disciplinary action taken against her by her principal.[75]

1. Facts

The claimant in the case, Regina M. Mitchell, was a sixth-grade public school teacher at Kealakehe Intermediate School.[76] Mitchell was in her first year of teaching at the school when she began to violate some of the rules implemented by her teaching team.[77] These infractions included using rewards to motivate students and the throwing of parties on Friday

---

[71] *See id.* at 4, 919 P.2d at 266.

[72] *See id.* at 6, 919 P.2d at 268.

[73] *See id.*

[74] *See* Terada, *supra* note 53, at 9. Under *Iddings*, an employee in Hawai'i has potentially two chances to obtain monetary recovery for the same injury because he or she can receive workers' compensation from the employer while at the same time sue his or her supervisor in tort for damages from the injury. *See generally Iddings*, 82 Hawai'i 1, 919 P.2d 263.

[75] *See* Mitchell v. State, 85 Hawai'i 250, 252, 942 P.2d 514, 516 (1997).

[76] *See id.* at 251, 942 P.2d at 515.

[77] *See id.* at 251-52, 942 P.2d at 515-16.

afternoons.[78] Mitchell's principal, Brian Nakashima, disapproved of her actions, and in an October 1989 meeting, he warned her against giving rewards.[79] Mitchell continued giving rewards and throwing parties, however, and Nakashima again expressed disapproval of Mitchell's teaching methods at a November 1, 1989, meeting.[80] After this meeting, Mitchell became distressed and developed flu-like symptoms which she attributed to her conflict with Nakashima.[81]

On January 18, 1990, Mitchell again planned a reward party.[82] Just prior to the party, Mitchell was informed that one of her students, Joseph, had stolen cookies intended for the party.[83] After confronting Joseph and recovering the cookies, Joseph became unruly and approached Mitchell's desk.[84] After this point, interpretations differed as to what happened. Joseph contended that Mitchell hit him for stealing the cookies, while Mitchell and a number of other students claimed that Mitchell incidentally bumped Joseph while trying to stop him from grabbing papers off her desk.[85]

Nakashima, after conducting his own investigation, recommended that Mitchell be suspended for violating the Department of Education's policy against corporal punishment.[86] Mitchell stopped working on February 5, 1990, complaining of fevers, insomnia, and disorientation that she believed resulted from her suspension; she did not return to her job after that date.[87] On April 6, 1990, Mitchell filed for workers' compensation benefits alleging that she suffered a work related injury from her conflicts with Nakashima and from her suspension.[88] On November 13, 1990, the Director of the Department of Labor and Industrial Relations denied Mitchell's claim, explaining that:

---

[78] The rules were developed by Mitchell's teaching team to guide and coordinate the team's teachers in the carrying out of their duties. *See id.* at 252, 942 P.2d at 516.

[79] *See id.*

[80] *See id.*

[81] *See id.*

[82] *See id.*

[83] *See id.*

[84] *See id.*

[85] *See id.* In Hawai'i, a teacher's use of force is justifiable if the teacher "believes that the force used is necessary to further such special purpose, including maintenance of reasonable discipline in a school, class, or other group, and that the use of such force is consistent with the welfare of minors. . . . " *Id.* at 256, 942 P.2d at 520 n.5 (quoting HAW. REV. STAT. § 703-309 (1985)).

[86] *See id.* The court, in footnote 5, stated: "There has been no allegation that Mitchell's alleged use of force was in violation of any provision of the penal code. Rather, the recommendation for suspension was pursuant to an alleged violation of the Department of Education policy against corporal punishment." *Id.*

[87] *See id.* at 252, 942 P.2d at 516.

[88] *See id.* Mitchell never served out her suspension because she stopped work before the suspension started. *See id.* at 252 n.1, 942 P.2d at 516 n.1.

> After reviewing the entire matter, we find claimant's condition, 'reactive depression' resulting from employer's pending disciplinary action to suspend claimant for striking a student, to be personal and outside the scope of employment.[89]

Mitchell appealed the director's decision, and after four years of legal and procedural developments,[90] the case was heard by the Hawai'i Supreme Court.

2. *The Hawai'i Supreme Court's analysis*

The Supreme Court relied on an expansive reading of HRS § 386-3 and its interpretation of past precedent in finding that Mitchell could receive workers' compensation.[91]

The specific workers' compensation statute on which Mitchell based her claim, former HRS § 386-3, provided:

> If an employee suffers injury either by accident arising out of and in the course of employment or by diseases proximately caused by or resulting from the nature of the employment, the employee's employer or the special compensation fund shall pay compensation to the employee or the employee's dependents as hereinafter provided.[92]

This statute continues to be the key in determining the compensability of an employee's injury under Hawai'i law.[93]

The first question the court addressed was whether Mitchell's mental stress met the requirement of a "nexus" between her employment and her injury.[94]

---

[89] *See id.* at 252, 942 P.2d at 516.

[90] The original appeal to the Hawai'i Supreme Court was denied in *Mitchell v. State*, 77 Hawai'i 305, 884 P.2d 368 (1994), for insufficient appellate jurisdiction since Mitchell had not appealed the final decision of the DLIR director to the entire DLIR board. *See Mitchell*, 85 Hawai'i at 253, 942 P.2d at 517.

[91] *See id.* at 255, 942 P.2d at 519. The court in *Mitchell* relied on a number of past Hawai'i workers' compensation cases. *Tate v. GTE Hawaiian Tel. Co.*, 77 Hawai'i 100, 881 P.2d 1246 (1994); *Wharton v. Hawaiian Elec. Co.* 80 Hawai'i 120, 906 P.2d 127 (1995); *Chung v. Animal Clinic Inc.*, 63 Haw. 642, 636 P.2d 721 (1981); and *Evanson v. State*, 52 Haw. 595, 483 P.2d 187 (1971), were the key Hawai'i cases the court turned to in deciding *Mitchell*.

[92] HAW. REV. STAT. § 386-3 (1985).

[93] *See* discussion *infra* section III.A.2.

[94] *See Mitchell*, 85 Hawai'i at 254, 942 P.2d at 518. The court in *Mitchell* explained:

> For an injury to be compensable under a workers' compensation statute, there must be a requisite nexus between the employment and the injury. The nexus requirement is articulated in Hawaii, as in the majority of jurisdictions, on the basis that, to be compensable, an injury must arise out of and in the course of employment.

Id.; *see also Tate*, 77 Hawai'i at 102, 881 P.2d at 1248.

Since Mitchell's stress problems were causally linked to the disciplinary hearing, the court held that the proper "nexus" was established.[95]

The next step in the court's analysis was whether the injury had arisen "in and out of the course of employment," as required by HRS § 386-3.[96] If the disciplinary hearing that sparked the mental distress was not linked to Mitchell's course of employment, then Mitchell's mental stress claim would be denied. Central to this part of the analysis was the court's decision in *Wharton v. Hawaiian Electric Co.*[97]

In *Wharton*, a Hawaiian Electric employee found to have improperly altered his time cards attempted to claim workers' compensation benefits for the mental distress he suffered as a result of the ensuing disciplinary hearing.[98] The court held that, in order to determine the issue of compensibility, the finder of fact had to determine:

> [W]hether [the employee's] "misconduct" was outside or within the bounds of his [or her] employment duties. To put it another way, a distinction must be made between (1) an unauthorized departure from the course of employment and (2) the performance of a duty in an unauthorized manner.[99]

The court found that altering time cards clearly fell outside the scope of the work Wharton had been hired to do.[100] Therefore, the Hawai'i Supreme Court

---

[95] *See Mitchell*, 85 Hawai'i at 254, 942 P.2d at 518.

[96] *See id.* at 256, 942 P.2d at 520. The court in *Mitchell* seemed to ignore or pass over the unitary test/work connection approach applied in *Tate*, in which the court stated:

> [T]he court has adopted a 'unitary' test that considers whether there is a sufficient work connection to bring the accident within the scope of the statute. First articulated in *Royal State National Insurance Co.*, [53 Haw. 32, 487 P.2d 278 (1971),] the work connection approach simply requires the finding of a causal connection between the injury and any incident or condition of employment.

Tate, 77 Hawai'i at 103, 881 P.2d at 1249. However, since the court still found a connection between Mitchell's mental injury and her employment, *see* discussion *infra* section III.A.2, the substitution of the "nexus" test for the "work connection approach" had no effect on the outcome of the case.

[97] 80 Hawai'i 120, 906 P.2d 127 (1995).

[98] *See id.* at 121, 906 P.2d at 129.

[99] *Id.* at 123, 130; *see also* LARSON, *supra* note 22, § 31.00. Larson states:

> When misconduct involves a prohibited overstepping of the boundaries defining the ultimate work to be done by the claimant, the prohibited act is outside the course of employment. But when misconduct involves a violation of regulations or prohibitions relating to the method of accomplishing that ultimate work, the act remains within the course of employment. Violations of express prohibitions relating to incidental activities, such as seeking personal comfort, as distinguished from activities contributing directly to the accomplishment of the main job, are an interruption of the course of employment.

Id.

[100] *See Wharton*, 80 Hawai'i at 121, 906 P.2d at 129. The court stated that Wharton was hired to maintain and repair electronic controls. *See id.*

held that Wharton could not receive workers' compensation benefits for any lost wages incurred due to the mental stress resulting from the disciplinary hearing.[101] In *Mitchell*, however, the court distinguished the nature of Mitchell's action from the employee's actions in *Wharton*.[102]

The court reasoned that Mitchell's alleged use of corporal punishment in disciplining her student was related or incident to her duty as a teacher to maintain order in her classroom.[103] Citing State of Hawai'i Department of Education regulations,[104] the court found that even if Mitchell had used corporal punishment, she had only performed her duties in an unauthorized manner.[105] Mitchell had not, however, committed an unauthorized departure from her course of employment which, under *Wharton*, would have prevented her from receiving compensation.[106] The court held that the disciplinary hearing that prompted Mitchell's mental stress qualified as "in the course of employment" as defined by HRS § 386-3, regardless of whether Mitchell had really struck the student.[107]

The Hawai'i Supreme Court, although finding that Mitchell's injury was compensable under HRS § 386-3, noted that many jurisdictions with statutes similar to HRS § 386-3 had amended their statutes to exclude from coverage psychological or stress-related injuries resulting from good faith disciplinary actions.[108] Nevertheless, the court held that:

> In the absence of an express exception in HRS § 386-3, we cannot unilaterally pronounce one.[109] To do so would run counter to the clear import of HRS

---

[101] *See id.* at 123, 130 (quoted in Mitchell v. State, 85 Hawai'i 250, 255, 942 P.2d 514, 519 (1997)).

[102] *See Mitchell*, 85 Hawai'i at 255-56, 942 P.2d at 519-20.

[103] *See id.* at 256, 942 P.2d at 520. The court in *Mitchell* stated that "[t]he dispositive question is whether the conduct that gave rise to the disciplinary action is conduct within or outside the course of employment." *Id.*

[104] *See supra* note 85.

[105] *See Mitchell*, 85 Hawai'i at 256, 942 P.2d at 520.

[106] *See id.*

[107] *See id.* As stated by the court in *Mitchell*:

> Mitchell was performing her duty as a teacher to maintain classroom control. Even assuming, arguendo, that she did indeed effectuate this purpose by striking Joseph, she was nonetheless performing her duty of her employment, albeit in an *unauthorized* manner. This is precisely the type of misconduct that is considered to be within the scope of employment under Wharton.

Id.

[108] *See id.* at 257, 942 P.2d at 521. The court noted that "[t]he workers' compensation statutes of Alaska, Maine, and Montana all provide that 'a mental injury is not considered to arise out of and in the course of employment if it results from any disciplinary action . . . taken in good faith by the employer.'" *Id.*; *see also* discussion *supra* section II.B.

[109] The court's statement that it was compelled to reach the result it did in *Mitchell* is interesting. Hawai'i courts, starting with the Richardson Court up to the very present have often

> § 386-3. If the legislature should deem it advisable in the future, it can . . . amend HRS chapter 386 to exclude from coverage those injuries resulting from disciplinary action taken in good faith by the employer.[110]

The court's invitation to the state legislature to amend the law was perhaps made in anticipation of the likely criticism that the court would receive due to its holding in *Mitchell*. The Hawai'i legislature took up the court's suggestion to rewrite the workers' compensation statute[111] in 1998, the very next session after *Mitchell* was decided.[112] The new law raises two questions: First, was the modification really necessary, or did the Hawai'i Supreme Court in *Mitchell* simply overextend the old HRS § 386-3? Second, does the new HRS § 386-3 go far enough to address the issues raised in *Mitchell*?

3. *Did the Mitchell decision exceed the scope of the old HRS § 386-3?*

In Hawai'i, there is always a presumption of compensibility in any workers' compensation claim.[113] Over the years, state courts have made it clear that

---

ignored or reinterpreted Hawai'i statutory law to fit the given case. *See* Pacheco v. Orchids of Hawaii, 54 Haw. 66, 502 Haw. P.2d 1399 (1972)(holding that the family of a women killed while on her coffee break from work could recover workers' compensation because the injury "arose in the course of business"); John Castle & Alan Murakami, *Water Rights*, in NATIVE HAWAIIAN RIGHTS HANDBOOK 160-63 (Melody K. MacKenzie, ed., 1991); see also McBryde v. Robinson, 54 Haw. 174, 504 P.2d 1330 (1972), where the state supreme court overturned 40 years of water rights laws in Hawai'i to pronounce a new doctrine determining who owned and controlled the surface water in the islands.

[110] *Mitchell*, 85 Hawai'i at 257, 942 P.2d at 521.

[111] Nationally, a growing number of cases have elicited quick legislative responses to a state court's liberal interpretation of a workers compensation statute. Following the Louisiana Supreme Court's decision in *Sparks v. Tulane Medical Center Hospital & Clinic*, 546 So. 2d 138 (La. 1989), the Louisiana legislature amended the state workers' compensation statute to exclude mental-mental claims "unless the mental injury was the result of a sudden, unexpected and extraordinary stress." LA. REV. STAT. ANN. § 23:1021(7)(b) (1991). Alaska, Wyoming, and Connecticut have also in the past decade amended their workers' compensation laws after expansive interpretation of their laws by their respective courts. *See* Head, *supra* note 28, at 136 n.46.

[112] The Department of Human Resource Development, the Department of the Attorney General, the Mayor of the County of Kauai, the City and County of Honolulu Department of Personnel, the National Federation of Independent Businesses, the Chamber of Commerce of Hawai'i, and 20 other federations, associations and state and county offices testified in support of the change. *See* SEN. STAND. COMM. REP. No. 2953, 19th Leg., Reg. Sess. (1998), *reprinted in* 1998 HAW. SEN. J. 1204.

[113] *See* HAW. REV. STAT. § 386-85 (1985). The statute provides in relevant part: "Presumption. In any proceeding for the enforcement of a claim for compensation under this chapter it shall be presumed, in the absence of substantial evidence to the contrary: (1) That the claim is for a covered work injury[.]" *Id.*

workers' compensation laws are to be interpreted liberally.[114] However, a key mission of workers' compensation laws is to balance the needs of the workers with those of the employers.[115] This balance appeared to have been disturbed by *Mitchell*, thus requiring a legislative response.[116]

In *Evanson v. University of Hawaii*,[117] the Hawai'i Supreme Court under Chief Justice Richardson explained that workers' compensation laws "represent a socially enforced bargain: the employee giving up his right to recover common law damages [in tort] from the employer in exchange for the certainty of a statutory award for all worker-connected injuries."[118] The fact that workers' compensation laws also benefited employers was a central reason for their adoption by legislatures nationally and in Hawai'i.[119] Therefore, the interpretation of the language "arising out of and in the course of employment" in the old version of HRS § 386-3 should be guided by the interests of employers as well.[120]

The legislature, in amending HRS § 386-3, evidently felt that consideration of the employer's interest was not given enough weight in *Mitchell*.[121] Payment of workers' compensation benefits to an employee whom the employer has disciplined in good faith does not benefit the employer.[122] The

---

[114] *See* Chung v. Animal Clinic, Inc., 63 Haw. 642, 649, 636 P.2d 721, 726 (1981)(holding that the "scope of HRS § 386-3 should not be unduly restricted"); *see also* Mitchell v. State, 85 Hawai'i 250, 255, 942 P.2d 514, 519 (1997)(stating "we have traditionally construed HRS § 386-3 liberally in favor of conferring compensation.").

[115] *See* Berry, *supra* note 15, at 324.

[116] *See* discussion *infra* section III.B.

[117] 52 Haw. 595, 483 P.2d 187 (1971).

[118] *Id.* at 598, 483 P.2d at 190; *see also* discussion *supra* section II.C.

[119] *See generally In re* Claim for Compensation of Ichijiro Ikoma, 23 Haw 291 (1916); Silva v. Kaiwiki Milling Ltd., 24 Haw. 324 (1918). The court states that:

> The administration of these [workers' compensation] laws necessitates an appreciation of the legislative purpose to abolish the common law relating to injuries to employees as inadequate to meet modern conditions and substitute . . . a system recognizing every personal loss to an employee, which is not self inflicted, as an element of the cost of production to be charged to the industry . . . so that the burden is finally borne by the community in general.

Silva, 24 Haw. at 330. *See generally* discussion *supra* section II.B, II.C.

[120] The state legislature, in amending HAW. REV. STAT. § 386-3, explicitly stated:

> It is essential for the economy to provide an environment where business is not threatened for making legitimate business decisions that may include disciplinary actions for just cause. This measure strikes a good balance between the concerns of Hawai'i's work force and the issues raised by the business community.

SEN. STAND. COMM. REP. No. 3203, 19th. Leg., Reg. Sess. (1998), *reprinted in* 1998 HAW. SEN. J. 1299.

[121] *See supra* notes 111-18 and accompanying text.

[122] Such a policy prevents a company from making sound business decisions by forcing the company to provide workers' compensation despite legitimate good faith attempts to discipline

purpose of workers' compensation is to compensate workers for injuries sustained "in the course of employment."[123] Workers' compensation laws were not created to serve as a system of general psychological insurance by the employer for the employee.[124] Therefore, the legislature attempted to restore balance to Hawai'i's workers' compensation laws by amending HRS § 386-3.[125]

B. *The Amended HRS § 386-3*

Mitchell prompted a number of legislative initiatives to amend Hawai'i's workers' compensation law. This movement resulted in a series of bills aimed at rewriting HRS § 386-3 to prevent the recovery of workers' compensation benefits for injuries sustained under circumstances similar to Mitchell's.[126] Although there was debate in the legislature on whether to further restrict an employee's access to workers' compensation for mental stress resulting from good faith personnel decisions by employers,[127] those efforts to expand the scope of protected employer actions eventually failed.[128]

The final changes approved by the Hawai'i legislature divided HRS § 386-3 into three sections.[129] The newly added section 386-3(c) reads:

---

or fire its workers. Furthermore, the court's interpretation of HAW. REV. STAT. § 386-3 suggests that an employer could be required to provide workers' compensation for any good faith attempt to transfer, layoff, or demote an employee due to legitimate business needs of the employer. *See* Mitchell v. State, 85 Hawai'i 250, 257, 942 P.2d 514, 521 (1997); *see also* Dunford, *supra* note 8.

[123] *See* HAW. REV. STAT. § 386-3(a) (Supp. 1998).

[124] *See* Berry, *supra* note 15, at 343 (stating, "[t]he purpose of workers' compensation has never been to replace general health insurance. To compensate mental disabilities as an occupational disease seems to make workers' compensation general psychological insurance."). Based upon the balance of interests built into the formation of the workers' compensation laws in Hawai'i, it could be argued that disciplinary hearings, transfers, and demotions taken in good faith by the employer fall into a legislatively implied area of protected employer actions for which workers' compensation benefits should not be available.

[125] *See supra* notes 112-19 and accompanying text; *see also* Dunford, *supra* note 8.

[126] H.B. 2648, 19th Leg., Reg. Sess. (Haw. 1998)(enacted), 1998 Haw. Laws 768.

[127] The Economic Revitalization Task Force, the United Public Workers, AFSCMCE, Local 646, AFL-CIO, and the Hawai'i State Teacher Association testified in support of the intent of the measure but wanted some modifications. *See* SEN. STAND. COMM. REP. No. 2953, 19th Leg., Reg. Sess. (1998), *reprinted in* 1998 HAW. SEN. J. 1204.

[128] *See* Dunford, *supra* note 8. A number of senators wished to expand the act to prevent any workers' compensation claim from arising from other acts of an employer, such as an employer's good faith firing, demotion and transfer of an employee. *See id.*

[129] *See* H.B. 2648, 19th Leg., Reg. Sess. (Haw. 1998)(enacted), 1998 Haw. Laws 768. Section 386-3(a) now contains the traditional standard and uses the same language from the previous statute that "personal injury arising out of and in the course of employment" shall be compensable. Section 386-3(b) states the rule that intentional acts by the employee are non-

> (c) A claim for mental stress resulting solely from disciplinary action taken in good faith by the employer shall not be allowed; provided that if a collective bargaining agreement or other employment agreement specifies a different standard than good faith for disciplinary actions, the standards set in the collective bargaining agreement or other employment agreement shall be applied in lieu of the good faith standard.[130]

Under the legislature's interpretation of the modifications, the new language in HRS § 386-3 is intended to exclude only mental stress claims relating solely to "disciplinary actions" for which there is "just cause."[131]

The new standard takes into account "all relevant factors to determine whether the disciplinary measure was for proper or sufficient reason and basis."[132] The language also reaffirms the legislature's commitment to provide workers' compensation benefits to those employees with legitimate work injuries[133] while maintaining an environment that does not threaten businesses for making legitimate business decisions, including disciplinary actions for just cause.[134]

1. Impacts of the new HRS § 386-3: The current status, and prospective effects of the amendment

The overall success of the additional language to HRS § 386-3 will not be clear until the Hawai'i Supreme Court or Hawai'i Intermediate Court of Appeals interprets the modification. Hawai'i's legislature has still left large areas of the workers' compensation law to the Hawai'i Supreme Court to interpret.[135] The current modification should, at a minimum, prevent results like the *Mitchell* decision.[136]

However, the fact that the legislature did not specifically address in its amendment to HRS § 386-3 actions by an employer other than disciplinary hearings creates a number of possibilities.[137] Other states also prohibit an

---

compensable and also uses the same language from the previous statute. *See id.*

[130] H.B. 2648, 19th Leg., Reg. Sess. (Haw. 1998)(enacted), 1998 Haw. Laws 768.

[131] *See* SEN. STAND. COMM. REP. NO. 2953, 19th. Leg., Reg. Sess. (1998), *reprinted in* 1998 HAW. SEN. J. 1204.

[132] *Id.*

[133] *See id.*

[134] *See* SEN. STAND. COMM. REP. NO. 3203, 19th. Leg., Reg. Sess. (1998), *reprinted in* 1998 HAW. SEN. J. 1299.

[135] *See* discussion *supra* section II.B. on Montana and New York statutes.

[136] That fact alone, however, might not be satisfactory to employers who wish to know if their workers' compensation package will be forced to cover other personnel decisions not addressed in the new HAW. REV. STAT. § 386-3.

[137] *See* discussion *supra* section II.B.

employee from receiving workers' compensation benefits for mental distress suffered due to an employer's good faith decision to transfer, demote, or terminate the employee.[138] No such language exists in the new Hawai'i statute.[139] Therefore, the statute as currently amended, under a narrow reading, still potentially renders employers liable under Hawai'i's law for any mental stress they cause an employee as a result of their good faith decisions to transfer, evaluate, or demote the employee.[140]

Hawai'i's workers' compensation law is more complete than the current law of states like Michigan, in that claims like Mitchell's are excluded in Hawai'i whereas in Michigan they are still allowed.[141] The new Hawai'i statute however, falls short of the more comprehensive laws of other states like New York and Montana, which bar an employee from claiming workers' compensation benefits for mental distress arising from any employer's good faith personnel decision.[142]

2. *Courtney v. Rent-A-Center*

Mitchell and the resulting legislative amendment to HRS § 386-3 has already impacted one Hawai'i Supreme Court case, *Courtney v. Rent-A-Center*.[143] In *Courtney*, the court originally held that an employee who suffered mental distress from a disciplinary hearing over his actions during a job evaluation could recover workers' compensation under *Mitchell*.[144] Under the new law, however, Courtney's claim for mental distress from the disciplinary action was non-compensable,[145] so the Hawai'i Supreme Court vacated and remanded the case.[146] Courtney might nevertheless be able to recover for any mental stress he suffered from the job evaluation since a narrow reading of HRS § 386-3 could limit it to apply only to disciplinary hearings.[147]

---

[138] *See* discussion *supra* section II.B.

[139] *See* discussion *supra* section III.B. Amended HAW. REV. STAT. § 386-3 states that a claim for mental stress resulting solely from "disciplinary action" taken in good faith by the employer shall not be allowed. *See* H.B. 2648, 19th Leg., Reg. Sess. (Haw. 1998)(enacted), 1998 Haw. Laws 768.

[140] *See* discussion *infra* section III.B.2.

[141] *See* discussion *supra* section II.B.

[142] *See* discussion *supra* section II.B.

[143] No. 18802, slip op. at 9 (Hawai'i 1997), *vacated and remanded*, 86 Hawai'i 17, 946 P.2d 971 (1997).

[144] *See id.*, slip op. at 9.

[145] *See* H.B. 2648, 19th Leg., Reg. Sess. (Haw. 1998)(enacted), 1998 Haw. Laws 768.

[146] *See Courtney*, 86 Hawai'i 17, 946 P.2d 971 (1998).

[147] *See* discussion *supra* section III.B.1.

Such an outcome in *Courtney* and other cases following *Mitchell* is not unlikely, given the liberal philosophy of the current court as shown by its holdings in *Mitchell* and *Iddings*.[148] Until more cases are decided, however, the exact ramifications of *Mitchell* remains to be seen. *Mitchell*, *Iddings*, and the general liberal tradition of the Hawai'i Supreme Court suggest that the court will continue to interpret workers' compensation statutes liberally in favor of conferring compensation to injured employees. Thus, the court will in all likelihood issue a narrow interpretation of the amended HRS § 386-3 when the opportunity arrives.

IV. CONCLUSION

The controversy over the Hawai'i Supreme Court's decision in *Mitchell* was caused in part by the silence of the law on the subject of employees' mental stress claims resulting from employers' personnel decisions.[149] The legislature felt that a modification was needed to the workers' compensation laws after *Mitchell*.[150] It remains to be seen, however, if the modifications to HRS § 386-3 went far enough in preventing a new round of criticism aimed at the workers' compensation law in Hawai'i.[151]

One question that perhaps should be asked is whether the area of workers' compensation law concerning mental stress injuries resulting from an employer's good faith personnel decisions should even remain in the current no-fault system. Under the current revised workers' compensation law, the employer's personnel actions are analyzed and workers' compensation benefits are allowed only if the employer was acting in bad faith.[152] Without this statutory protection, the employer would become an insurer of the general mental health and employability of the employee, potentially crippling the employer's ability to make good faith personnel decisions.[153]

---

[148] *See* discussion *supra* section II.C.

[149] A minority of courts in other jurisdictions have interpreted the omission of provision for mental stress claims in their state's workers' compensation statutes as an intent by their state legislature to exclude those claims. *See* Head, *supra* note 28, at 149. However, Hawai'i chose not to follow that interpretation. *See* Chung v. Animal Clinic Inc., 63 Haw. 642, 649, 636 P.2d 721, 726 (1981); Akamine v. Hawaiian Packing & Crating Co., 53 Haw. 406, 409, 495 P.2d 1164, 1166 (1972); Royal State Nat'l Ins. Co. v. Labor & Indus. Relations Appeal Bd., 53 Haw. 32, 38, 487 P.2d 278, 282 (1971).

[150] *See* discussion *supra* section III.B.

[151] *See* discussion *supra* section III.B.2.

[152] *See* HAW. REV. STAT. § 386-3 (Supp. 1998); *see also* H.B. 2648, 19th Leg., Reg. Sess. (Haw. 1998)(enacted), 1998 Haw. Laws 768.

[153] Depending on the Hawai'i Supreme Court's next interpretation of a claim under the new HAW. REV. STAT. § 386-3 this fear could already be a reality.

Perhaps what is needed is to abandon workers' compensation laws and its no fault system, and to return to common law tort liability principles for this narrow area concerning employees' mental injuries.[154] By doing this, the reasonableness of the employer's actions and the employee's response to those actions could be weighed fairly. Bad faith personnel decisions by an employer can be punished under the traditional tort system, while meritless employee claims of mental distress from legitimate personnel decisions by an employer will be discouraged or filtered out by summary judgment.[155]

The issue of an employer's liability for causing an employee mental stress is certain to arise again. The change to HRS § 386-3 by the Hawai'i legislature only decides the issue of the availability of workers' compensation benefits for mental stress resulting from a disciplinary hearing.[156] The new law leaves open the question of what happens when an employee requests workers' compensation for an employer's demotion, transfer, or firing of that employee.[157] Either the Hawai'i Supreme Court or the state legislature will eventually be forced to take action on the remaining issues and hopefully bring consistency to this area of workers' compensation law.

William Keoniakelelani Shultz[158]

---

[154] *See* Albert M. Drukteinis, *Should Workers' Compensation Remain a No-Fault System?*, 18 AM. J. FORENSIC PSYCHIATRY 3 (1997).

[155] Applied to *Mitchell*, if Mitchell had proven at trial that the disciplinary hearing that caused her mental injury was due to a willful tort action by her principal, she could have recovered damages from the state. The Department of Education, however, would have defended the disciplinary hearing as being conducted in good faith and, in all likelihood, no tort liability would have been found against the State. This result would have prevented the State of Hawai'i from paying workers' compensation benefits to Mitchell.

[156] *See* discussion *supra* section III.B.

[157] *See* discussion *supra* section III.B.1.

[158] Class of 2000, William S. Richardson School of Law. Special thanks to the Law Review Board and all my friends and ohana.