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

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* 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

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[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?

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[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

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[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.

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[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

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[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.

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[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

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[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.