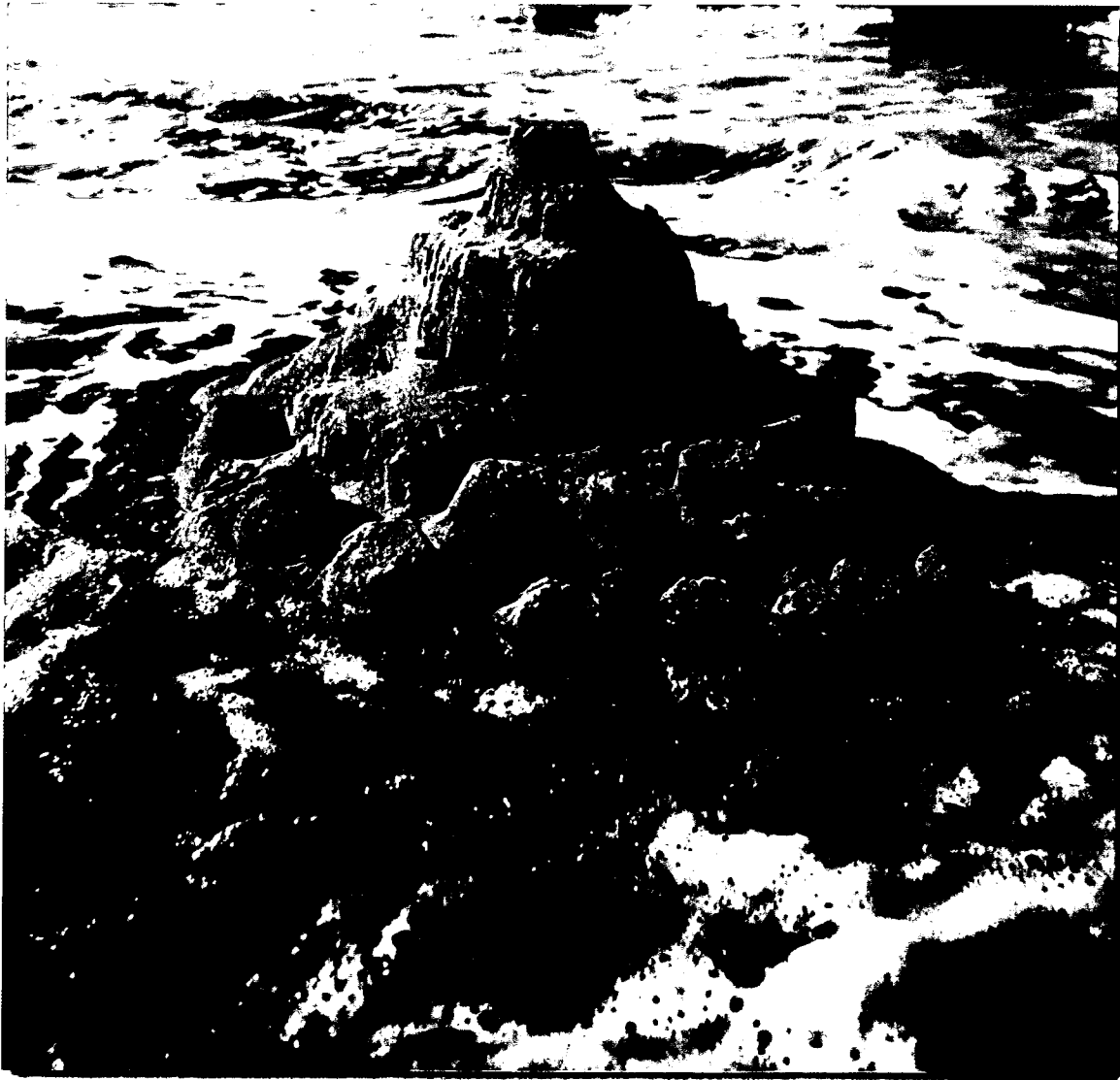


ABA CONNECTION

# Erosion of Trust

Hawaii's Bishop Estate: a cautionary tale of  
mismanagement at a charitable organization

BY SAMUEL P. KING AND RANDALL W. ROTH



**A**RROGANCE WAS JUST ONE INGREDIENT—but a crucial one—in the trouble at Hawaii’s powerful Bishop Estate. It finally boiled over in 1999, when all five trustees were removed from office after the Internal Revenue Service threatened to strip the estate of its status as a tax-free charitable organization.

No one was ever convicted of wrongdoing. In fact, the trustees continue to deny they did anything that wasn’t in the best interest of the Bishop Estate. But for years, the trustees—all well-connected members of Hawaii’s tight-knit power structure—had run Bishop Estate as their own fiefdom. Though they paid themselves \$1 million each, they had no job descriptions, no agreed-upon objectives, no annual reviews, no staff executive and no oversight to speak of.

Our 2006 book, *Broken Trust: Greed, Mismanagement and Political Manipulation at America’s Largest Charitable Trust*, chronicled the controversies that have swirled around the Bishop Estate. While much remains in dispute, based on our years of observation there are clear lessons that we believe lawyers who represent nonprofits can draw from how the charity’s affairs were handled—or mishandled.

One trustee, appearing at a deposition in one of the many legal proceedings that arose out of the scandal, was asked who within the estate’s management structure was responsible for holding him and the other trustees accountable for their actions. “Nobody,” he replied, before changing his answer to “us.”

At one point, the board of trustees claimed to be the inheritors of the power once held by Hawaii’s early monarchs, whose crown lands were the source of Bishop Estate’s vast wealth. Hawaii still was an independent nation in 1884 when Princess Bernice Pauahi Bishop died. She was the great-granddaughter and last acknowledged descendant of Kamehameha I, a warrior who united the Hawaiian islands into one kingdom starting in the late 18th century. In her will, the childless princess devised her estate in charitable trust to erect and maintain two schools, “one for boys and one for girls, to be known as and called the Kamehameha Schools.”

By the mid-1990s, Bishop Estate’s value had become enormous. The *New York Times* described the estate as “a feudal empire so vast that it could never be assembled in the modern world.” And in 1995, the *Wall Street Journal* tabbed it as the nation’s wealthiest charity, larger than the combined endowments of Harvard and Yale. By then, Bishop Estate also was arguably the most powerful institution in Hawaii, with long arms reaching into all branches of the state government, and all corners of politics and business. Nor did those elements hesitate to reach back into the estate and its enormous resources.

So perhaps it shouldn’t have been surprising that the trustees claimed royal origins for their power in a brief filed in 1995 as part of a dispute over Bishop Estate’s power to control water rights, a precious commodity in Hawaii. “Kamehameha I, by right of conquest, became lord paramount of these islands,” the brief stated. “He was an absolute monarch. His will was law. He was the lord of life and death. Then logically to the same extent, if not more, the trust of Bernice Pauahi, the legacy of the Kamehamehas, must be entitled to those traditional and customary prerogatives enjoyed by the Kamehameha [dynasty].”

For a long time, few in Hawaii were inclined to argue with that view. Even so, hubris alone would not necessarily have been fatal, but the trustees were operating under a deeply flawed governance structure that was introduced by another set of trustees in the early 1970s.

#### **SEPARATION OF POWER**

GENERALLY, EFFECTIVE INTERNAL CONTROLS AT A NON-profit organization include a significant degree of separation between staff management and a board of trustees or directors with oversight powers. But the governance structure at Bishop Estate called for individual “lead trustees” to function like chief executives in designated areas, often making important decisions unilaterally.

In this operating environment, the trustees were later alleged to have made investments based on “relationships” without proper due diligence, failed to follow key provisions of the governing document, invested personal funds in business opportunities involving the trust, used trust funds to lobby extensively for changes in laws affecting their personal interests, involved the trust in state and federal political campaigns, nurtured a cozy relationship with the trust’s longtime outside auditor, ordered staff accountants to improve financial results through “creative” accounting, left the position of internal auditor vacant indefinitely and pursued an obsession with secrecy.

Along with a governance structure that gave the trustees power without accountability, a unique trustee appointment process added to the recipe for disaster at Bishop Estate. Normally, a lower court fills vacancies on a charitable trust’s governing board unless the trust document provides for another mechanism. Princess Pauahi’s will had given that power to the “majority of the justices of [Hawaii’s] supreme court,” who later ruled unanimously on several occasions that when selecting Bishop Estate trustees, they were functioning unofficially. While acting officially, however, the five justices did not hesitate to rule on legal controversies involving the trustees they had unofficially selected.

The Bishop Estate trusteeships became prized politi-

cal chits under this appointment process, which became intertwined with the state's judicial appointment system: Seven of the nine members of the Hawaii Judicial Selection Commission are appointed by the chief justice, House speaker, Senate president and governor. In recent decades of management abuses at Bishop Estate, the justices filled trustee vacancies with a chief justice, a House speaker, a Senate president and a governor's closest adviser—who also, coincidentally, chaired the Judicial Selection Commission at the time—as well as various other cronies of the political establishment.

Eventually, the figurative castle the Bishop Estate trustees had constructed began to crumble under the pressure of complaints about conditions and policies at Kamehameha Schools, especially from its 'ohana, or family of supporters, followed by increased scrutiny from Native Hawaiian community leaders and the local press; investigations by a master fact-finder and the state attorney general; and, finally, the IRS ultimatum.

Even after retreating from the brink of losing its status as a tax-exempt charity, however, the problems at Bishop Estate were never fully addressed. A number of lawsuits stemming from abuses by the trustees were cut short after the trustees stepped down.

Debate continues about the management structure of Bishop Estate, which still is governed by the will Princess Pauahi executed more than 120 years ago. Some experts have suggested that the trustees convert the trust to a not-for-profit corporation to remove the judiciary from the trustee-selection process and to allow the charitable mission to evolve with the times.

The admissions policy for the Kamehameha Schools remains controversial. While Princess Pauahi's will did not address the issue specifically, the decision of the very first board of trustees to admit only Native Hawaiian children has been largely followed ever since. While the schools are cherished by the Native Hawaiian community, the admissions policy has spawned its own controversies over the years.

### THE HALO SLIPS

THE TROUBLES AT BISHOP ESTATE DEMONSTRATE IN DRAMATIC fashion what can happen to a charitable organization when internal controls are missing, individuals responsible for governance operate in secrecy, outside overseers fall short of their responsibilities and lawyers fail to report egregious abuse.

But if Bishop Estate represents a perfect storm of misconduct at a nonprofit organization—it has been referred to as “the Enron of charities”—it is far from the only one to experience serious problems in recent years.

Charitable organizations long have enjoyed a “halo effect”—an assumption that they operate in the best in-

terest of the public. And most of the time, that is what they do. Yet the opportunities for abuse are there. Charitable organizations often lack proper internal controls, or fail to follow them, and the extent of oversight often is minimal.

In the post-Enron age, nonprofit organizations—both large and small—are coming under increased scrutiny, just like their counterparts in the for-profit sector. In recent years, well-publicized problems have occurred at United Way, the American Red Cross, Princeton University, the Smithsonian Institution and the Getty Trust. In 2003, the *Chronicle of Philanthropy* reported the results of a study showing that officers and directors had misappropriated more than \$1 billion from more than 150 nonprofit organizations.

These scandals have prompted a reassessment of the current system

of controls and oversight in the nonprofit sector, conducted by lawmakers in Congress and in state legislatures, by the IRS and some state attorneys general, among others. The tentative conclusions draw an alarming picture of the oversight that charitable institutions receive.

Stephen E. Merrill, the president of Bingham Consulting Group in Boston, says some of the wrongdoing at nonprofits that he encountered as New Hampshire's attorney general came as a surprise. “I was stunned,” he said at a program on nonprofits held during the 2006 ABA Annual Meeting. “I thought people who were attracted to nonprofits were people who wanted to do the right thing.”

All this comes at a time when there is a growing awareness of the social and economic impact of charities and other nonprofit organizations in the United States.

“Charitable organizations are an indispensable part of American society, offering relief from disasters, nurturing our spiritual and creative aspirations, caring for vulnerable people, protecting our natural and cultural heritage, and finding solutions to medical and scientific challenges,” states the Panel on the Nonprofit Sector in a 2005 report to Congress proposing steps to improve accountability.

But, the report notes, charitable organizations “can fulfill these missions only by maintaining the trust of the public. Accountability is crucial to our sector.”

### WHERE LIES LOYALTY?

THERE ARE SOME 1.4 MILLION ORGANIZATIONS IN THE United States that qualify as public charities under section 501(c)(3) of the Internal Revenue Code, including religious congregations, which generally don't have to file with the IRS, according to figures cited by Independent Sector, a coalition of nonprofit groups that convened the Panel on the Nonprofit Sector. Not counting most religious congregations, charitable organizations

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control some \$3 trillion in total assets, even though most of them have annual budgets well under \$1 million.

Support for charitable organizations continues to rise. In 2006, Americans gave nearly \$300 billion to charitable organizations, a 1 percent increase over contributions in 2005, according to a report issued in June by the Glenview, Ill.-based Giving USA Foundation in conjunction with Indiana University's Center on Philanthropy. Including bequests, 83.4 percent of that total came from individuals.

Most nonprofit organizations are structured as corporations, but there also are a large number of trusts and unincorporated associations. No one structure is inherently superior to the others. Lawyers who specialize in nonprofit organizations frequently recommend incorporation (for very good reasons), yet some high-profile benefactors—including Bill and Melinda Gates, as well as Warren Buffett—chose to use trusts as the primary vehicle for their charitable work. But the best legal structure in one set of circumstances can be the worst in another.

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

To qualify for tax-exempt status under IRC § 501(c)(3), a nonprofit entity must be organized and operated exclusively for charitable purposes, must not provide excess benefits to its insiders other than reasonable compensation for services actually rendered, must limit any activities intended to influence legislation, and must not campaign for political candidates.

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

In the for-profit sector, corporate shareholders and trust beneficiaries have an enforceable right to meaningful information and legal means for getting evidence of wrongdoing in front of a judge. But donors and intended beneficiaries of charities almost never have the legal standing needed to seek accountability when there is evidence of misconduct or to force insiders to provide reliable information about operations.

State regulators—usually the attorney general—often fail to detect insider abuse of charitable organizations, or they fail to act on abuses in a timely

and effective manner. Resources available for this function have tended to be quite limited, and few attorneys general have made charities a priority. Some appear to have been influenced at times by political considerations. Some have looked the other way when community leaders fell short in fulfilling their fiduciary duties, and others have used their regulatory role to score political points.

When the trustees of the Hershey Trust tried to sell control of the Hershey Food Corp. to an out-of-state buyer, the Pennsylvania attorney general stepped in and sought an injunction in state court to protect the local economy. After a few months of litigation, the Hershey trustees announced they were dropping plans to sell.

### THE NUCLEAR OPTION

TRADITIONALLY, THE IRS PLAYED A MINOR ROLE IN REGULATING public charities, partly because its enforcement resources were spread fairly thin, but also because the service's enforcement arsenal consisted primarily of "nuclear weapons" but hardly anything less powerful.

Until the mid-1990s, the IRS could either revoke a charity's tax-exempt status when it discovered abuses—thereby hurting the entity's intended beneficiaries—or do nothing. That all-or-nothing option changed in 1996, when Congress enacted an intermediate sanctions law [IRC § 4958] that empowers the IRS to levy fines directly on wrongdoers, thus reducing the necessity for the IRS to impose its "doomsday" punishment. The law also requires directors or others who commit financial wrongdoing to reimburse the charity for their plunder—what tax law calls "excess benefits."

To critics, the IRS was an unexpected hero in the Bishop Estate scandal. At a time when the state attorney general's investigation was hopelessly bogged down, and it looked as though Hawaii's judiciary would never take definitive action, senior IRS officials made it known that they had decided to exercise their nuclear option by revoking the estate's tax exemption retroactively. The move would cost the estate (to the detriment of its intended beneficiaries) nearly \$1 billion up front, with untold additional costs down the road.

Equally shocking to the Bishop Estate trustees, IRS officials refused even to discuss the matter with them or their representatives, citing grounds of irreconcilable conflicts between the interests of the trustees and the charity itself. Those conflicts included the trustees' use of trust funds for legal representation of their personal interests. IRS officials then got word to the state court that they would be willing to reconsider the decision to revoke the charity's tax-exempt sta-

## ABA Connection



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Turn to page 53.

tus, but only if their nonnegotiable conditions were met—the first of which was the immediate resignation or removal of all five trustees. The other IRS demands related to various questionable operations policies in effect at the trust.

The trustees and their lawyers complained bitterly about this heavy-handed approach—even calling it extortion—but under these circumstances the local court had no real choice but to remove the trustees.

### **WHERE WERE THE LAWYERS?**

A COMMON RESPONSE TO THE BISHOP ESTATE STORY IS, “So where were the lawyers?” Many were there for decades at the trustees’ side, collecting fees amounting to tens of millions of dollars of the charity’s money for work that often benefited only the personal interests of the trustees.

The first thing a lawyer must be clear on is who the client really is.

Unless specifically engaged to represent the interests of insiders, the lawyer’s duty is to represent the charity. Setting forth the general ethics principle, Rule 1.13 of the ABA Model Rules of Professional Conduct states, “A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.”

Lawyers retained to provide legal services to a charitable organization would be wise to make that duty clear to members of the governing board. Lawyers might also remind board members that their own fiduciary duties to the organization suggest that they always use personal funds to pay for legal services representing their personal interests. In some states, the law requires that.

Unfortunately, that was not the law in Hawaii, where the Bishop Estate trustees spent millions of the charity’s dollars to defend their personal interests.

Exactly what lawyers working for Bishop Estate should have done once mismanagement and misuse of funds became apparent is a matter of continuing debate.

Some of those lawyers—including members of some of Hawaii’s top firms—have contended that they performed legally, ethically and honorably, and that it would have been a serious breach of their professional responsibility to have “ratted” on the trustees. They also have cited a policy consideration: Insiders at any organization who view lawyers as potential whistle-blowers will not seek legal advice in difficult situations, and this eventually will prove to be detrimental to the organization. Enron’s lawyers made similar arguments.

The general rule under agency law and ethics is that counsel for an organization is generally required to report misconduct by an officer or employee that is likely to be detrimental to the organization “up the ladder” of authority within the organization until the matter is addressed appropriately. There is less agreement among jurisdictions, however, about what the lawyer should do if the matter is not addressed inside the organization.

At the height of the Bishop Estate scandal in the late

1990s, many jurisdictions arguably gave the lawyer no other option in such a case but to resign from representing the organization. That was, for instance, the principle expressed at the time in Rule 1.6 (Confidentiality of Information) and Rule 1.13 (Organization as Client) of the Model Rules.

In a new environment influenced by Enron and other corporate scandals, and the subsequent passage of the Sarbanes-Oxley Act, the ABA House of Delegates amended Rule 1.13 to make it easier for lawyers to “report out” financial wrongdoing. At the same time, the ABA amended Rule 1.6 to allow lawyers, under certain circumstances, to reveal client confidences to prevent illegal actions resulting in financial losses, something that most state rules already permitted. As revised, the Model Rules give lawyers the option to report out financial wrongdoing.

To complicate matters further, agency laws in some jurisdictions are not in sync with ethics rules regarding the duty of a lawyer (acting as agent) to protect the interests of the principal. And it’s not uncommon for individual lawyers to interpret the standards differently or disagree on how to apply them in particular situations.

Those factors help explain why, in the real world, it’s rare for lawyers representing charitable organizations to report abuses to outside authorities. One solution worth considering would make the duty to report out mandatory once reasonable efforts to correct abuses internally have failed. This would align the ethics code with agency law and underscore that the lawyer owes a duty of loyalty only to the organization—not insiders.

Bishop Estate lawyers and trustees claimed that their communications regarding internal business at the charity were covered by the attorney-client privilege.

The rule that the right to assert attorney-client privilege belongs to the organization is not always as clear in the case of trusts as it is for corporations or other legal entities. In the Hawaii courts, for instance, judges have opined (but not ruled) that a former trustee controls the privilege. Many states do not have a clear rule on this.

In most jurisdictions, the governing board and management staff of a charitable organization may not use the attorney-client privilege to deny relevant information about trust administration to a state attorney general investigating the charity when the communications involved lawyers who were representing either the charity or the governing members in their fiduciary capacity. The courts in the Bishop Estate controversy, however, allowed the trustees to protect such information even from the eyes of the attorney general.

There may be times when confidentiality is in the best interest of an individual charity. But transparency is too important in the regulation of charities to be optional. Bishop Estate trustees demonstrated how easy it is to “bury the bodies” by settling sensitive matters confidentially.

The Bishop Estate scandal also raised questions about whether the courts were too inclined to rule fa-

vorably on questionable actions by individual trustees. At numerous points as the scandal unfolded, judges issued rulings that severely hampered efforts by the press, the Kamehameha Schools' 'ohana and even the state attorney general to seek accountability from the Bishop Estate trustees.

One of the trust's liability insurance carriers eventually paid out the \$25 million coverage limit to facilitate an out-of-court settlement on the many charges of fiduciary malfeasance against trustees. Although court-appointed masters had earlier recommended that the trustees be ordered to reimburse the trust millions for legal fees that were paid with trust funds, and to pay millions more in surcharges, the settlement terms did not require the trustees to pay any of their own money to anyone.

The trustees did not even have to admit to any wrongdoing. The judge who encouraged and approved this settlement said he was doing so in the interests of "closure" and "healing."

#### LOOKING FOR SOLUTIONS

THE FACT THAT IT TOOK THE HEAVY HAND OF THE IRS TO finally break the legal logjam in the Bishop Estate scandal has not been lost on members of Congress and state legislators in their consideration of proposed measures to better protect charities from insider abuse.

Lawmakers in New York and Massachusetts have considered proposed legislation that would impose signifi-

cant new regulatory requirements on nonprofits. In California, the legislature enacted the Nonprofit Integrity Act of 2004, which focuses on disclosure, organizational governance and auditing reforms, including requirements for independent audits and audit committees.

Congress included a provision in the Pension Protection Act of 2006 that authorizes the IRS to provide taxpayer information to state-level regulators of charities. The provision has critics, however, who say it severely limits the ability of attorneys general and other regulators to actually use the information provided by the IRS.

While there is the need for regulatory measures for nonprofit organizations at both the state and federal levels, there also is reason to be concerned about the possibility of overkill. Congress hasn't yet gone very far. The only provisions of the Sarbanes-Oxley Act, for instance, that directly apply to nonprofit organizations concern whistle-blower protections and destruction of documents.

Some observers are concerned that Congress might overreact to recent oversight problems at nonprofits, enacting laws that would be burdensome to charities that operate on tight budgets with inexperienced volunteer boards. And even if Congress doesn't act, the IRS and state regulators may get tougher on nonprofits.

"The IRS and states are going to be increasingly pugnacious," said Merrill, a former New Hampshire attorney general, at last year's ABA Annual Meeting program on

*Continued on page 67*

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# Erosion of Trust

Continued from page 53

nonprofits (sponsored by the Section of Business Law). "This wave has not crested yet."

The IRS recently sent out thousands of surveys on compliance issues and proposed a number of new disclosure requirements: whether charities follow certain management and governance practices, whether they have policies on whistle-blowers and document retention, and a breakdown of executive compensation.

Because charities are already obligated to make public their Form 990s, such a user-friendly description of a charity's financial resources and charitable mission would be a major step forward.

Groups such as the Panel on the Nonprofit Sector also worry about overkill, but even they have expressed concerns about the status quo and have called for targeted in-

creases in federal funding to enable the IRS to step up its enforcement and oversight activities, as well as new funding to help states establish or increase oversight and education programs for charitable organizations.

Ultimately, public oversight may be the key to proper management of charitable organizations. In the case of Bishop Estate, Hawaii's attorney general and probate judges with oversight powers seemed not to notice allegations of impropriety until alumni from Kamehameha Schools conducted public protests against the trustees' actions.

Nevertheless, lawyers must take their duties seriously when representing nonprofits. The legal profession can and should assist in efforts to make it harder to abuse the trust that the public places in charities and in the people who run them. ■

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