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CIVIL ENFORCEMENT DIVISION

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PUBLIC AUDIT REPORT
Evergreen Aviation and Space Museum and the Captain Michael King Smith Educational Institute
DOJ File No. 137300/XCT0045-12

Dear Board of Directors:

This letter constitutes the final report of our investigation into the Evergreen Aviation and Space Museum and the Captain Michael King Smith Educational Institute ("Museum") as a non-profit charitable organization governed by ORS Chapter 128. Despite serious concerns about the operation and future of the Museum, the Department of Justice (the "Department") is not pursuing any enforcement actions at this time. Based on the findings and conclusions detailed below, however, the Department recommends substantial changes to the Museum's governance and oversight (some of which the Museum has implemented during this audit), including a review of the Museum's articles, bylaws, and operations, an overhaul of the executive committee and board, the adoption of a "whistleblower" protection policy, and implementation of budgetary reforms.

This report is based on the records provided by the Museum, interviews with former employees, current employees, volunteers, counsel, documents and testimony presented at the property tax trial before the Oregon Tax Court, and the Department's own research. This report is the public record of our investigation and should be shared with all board directors for the organization.

I. INTRODUCTION

The Attorney General is responsible for supervising charitable organizations holding or soliciting assets in Oregon. *See* ORS 180.060(1)(d) and (6), ORS 128.610 *et seq*., and ORS Chapter 65. This responsibility includes the power and duty to investigate whether charitable organizations are carrying out their charitable mission or breaching any fiduciary duties arising under statutory or common law. ORS 128.680. The Charitable Activities Section of the Oregon Department of Justice ("Department") performs these duties on behalf of the Attorney General.

In October 2012, the Department opened an investigation into the Museum in response to a confidential complaint regarding a conflict-of-interest transfer of more than $700,000 from the Museum to a for-profit Evergreen International Aviation entity.[1] During the investigation, the Museum confirmed that it had "loaned" $725,000 to an Evergreen for-profit company, although

[1] For the purposes of this report, we will use the term "Museum" to refer to the nonprofit organization and will use the term "Evergreen" to refer to Evergreen International Aviation and its various for-profit affiliates and subsidiaries.

the loan was repaid with interest shortly after the Department's inquiry. As a result of concerns about this transaction, the Department continued its investigation into the Museum's general operations and governance.

In any investigation of a charitable entity, the Department's overriding goals are to protect charitable assets and preserve valuable community resources. During our review, the Department expressed concerns that Evergreen's deteriorating financial condition, evident from media and other public sources, posed risks to the Museum's assets and operations. With Evergreen's closure and bankruptcy those concerns have manifested into tangible and serious consequence for the Museum, including increased costs, a loss of a major source of support, and changes in board composition.[2]

The Museum was built and exists as the result of Mr. Smith's efforts and funding. Through the companies and private foundation he controls, Mr. Smith has likely spent over $150 million dollars on the construction of the buildings that house the Museum and waterpark. The Department is concerned that aspects of the Museum's structure and operations place the viability of the Museum at risk. As described in more detail below, the risk factors include a pattern of activity that jeopardizes the Museum's tax-exempt status and a precarious financial structure. The Museum does not separately own its buildings and land but has depended on the free lease of buildings, land, and numerous exhibit items from Evergreen and Mr. Smith's private foundation, thereby making it difficult for Museum to operate as an independent institution whose fate is separate from that of these entities.

In response to the Department's investigation, the Museum's board adopted significant governance reforms. These reforms represent a substantial and appropriate step toward better governance. While we believe the enactment of such reforms is an important and necessary step in the Museum's development, the board will face challenges in their implementation and in safeguarding the Museum's future. This report is intended to help the board understand the Department's concerns about past operations and governance with the goal of helping the board avoid similar problems in the future. In addition, this report describes the legal framework in which charitable, tax-exempt organizations operate because that framework should guide the board's decisions in exercising its fiduciary obligations to the Museum.

II. SUMMARY OF FINDINGS AND CONCLUSIONS

The Department's investigation revealed significant governance issues arising from an overly close relationship between the Museum, on the one hand, and Evergreen and Mr. Smith on the other. Although the Museum declined to provide certain documents and did not allow interviews

[2] In November 2013, Evergreen announced that it was closing, although Mr. Delford Smith, the primary owner of Evergreen and financial supporter of the Museum, initially disputed that the closure was permanent. On December 19, 2013, creditors filed a petition in New York seeking to force certain Evergreen companies, namely Evergreen International Airlines, Inc., Evergreen International Aviation, Inc., and Evergreen Holdings, Inc., into bankruptcy. On December 31, 2013, other Evergreen entities filed a voluntary petition for Chapter 7 bankruptcy in Delaware. The New York bankruptcy petition has been dismissed, but the petitioners in that action have filed adversary proceedings in the Delaware bankruptcy. Between the Evergreen petition and the adversary proceeding, all Evergreen entities appear to be encompassed by the Delaware bankruptcy proceeding.

of Museum staff persons involved in the transaction giving rise to the investigation, the Department was able to identify areas of concern:

1. Members of the Museum's board appear to have failed in their duties to the Museum. The Evergreen executives serving on the board appear to have breached their fiduciary duties by failing to act in the best interests of the Museum. It appears that other board members have failed to be engaged or exercise active oversight, largely deferring to Mr. Smith's plans and decisions for the Museum;
2. Some specific transactions suggest that charitable assets may have been mismanaged; and
3. The overall activities of the Museum raise significant questions about whether the Museum is properly pursuing a tax-exempt purpose or whether the Museum is properly reporting to the IRS taxable "unrelated business income."

The Department considered potential enforcement actions including removal of Museum directors and actions against individuals to recover diverted charitable assets and damages for other losses. The Department ultimately decided against pursuing either of these options for a number of reasons. First, the Museum has adopted significant governance changes in response to this investigation, we have made additional suggestions in this report, and other changes are occurring as the result of Evergreen's bankruptcy. The existing board deserves an opportunity to implement their changes, consider our additional suggestions, respond to recent and evolving events, and demonstrate its ability to pursue the independent interests of the Museum. Enforcement action is not the ideal method to effectuate such change, given these other options.

Second, a number of the potentially improper financial transactions reported to the Department happened many years ago and the lapse of time would pose significant impediments to pursuing them. With respect to two more recent loan transactions discussed below, in one case the Museum has been repaid and in the other the Museum may be repaid by Mr. Smith personally. In light of the potential but uncertain impact on the Museum from Evergreen's bankruptcy and the uncertain outcome of discussions between Mr. Smith and the Museum regarding his continued support, we believe the appropriate course of action is for the Department to continue to monitor these matters.

Third, the Department has concerns about certain tax issues discussed below, which are best addressed by the Internal Revenue Service (IRS). The Department intends to relay our concerns to the IRS.

III. INVOLVED ORGANIZATIONS AND PARTIES

The Museum's history and operations are intertwined with a number of related parties and entities. An understanding of these relationships is important background in assessing the Museum's operations and future and in conveying the Department's concerns.

The Museum "campus" as many people refer to it consists of the Aviation museum building, the Space museum building, the theater building which houses a large screen theater and administrative offices for the Museum and Evergreen, the Wings & Waves waterpark, the newly finished chapel, and a Boy Scout campground. A section in front of and in between the aviation building and waterpark is now fenced off for the construction of a five story hotel to be called the Red Hawk Lodge, although we understand construction has been suspended for the time being. In addition, there is a vineyard in front of the museum buildings and recently an Evergreen 747 was moved and parked in front of the museum buildings with plans to repurpose it as a youth hostel somewhere on the campus. The Museum campus is on the north side of Highway 18 in McMinnville.

Directly across the street from the Museum campus, on the south side of Highway 18, are a number of buildings owned and operated by the Evergreen International Aviation for-profit companies. Evergreen International Aviation is a privately owned company, founded and owned primarily by Mr. Smith.[3] The company has a number of affiliates or subsidiaries, including Evergreen Vintage Aircraft Inc., Evergreen Agricultural Enterprises, Inc., Evergreen Trade, Inc., Ventures Acquisition Co., LLC, and Evergreen Holdings, Inc.,[4] which we will refer to interchangeably and collectively as "Evergreen."

While the Museum's campus and displays are impressive, in fact, the Museum owns relatively little of what the public sees. The Museum's assets consist largely of the Spruce Goose (the H-4 Hercules aircraft designed and flown by Howard Hughes), a limited number of exhibits, leasehold improvements, and office equipment. The buildings and land on which it operates are owned by other entities. The aviation museum, theater, and waterpark buildings and land are owned by Evergreen. The space museum building and land are owned by the Michael King Smith Foundation ("MKS Foundation"), a charitable trust created by Mr. Smith in 2006.[5] The land on which the chapel, Boy Scout camp, and winery are located is owned by Evergreen.[6] The Museum operates the buildings and programs at all these facilities pursuant to written lease agreements with Evergreen or MKS Foundation. Under the leases, the Museum pays no rent, but is responsible for all operational costs including utilities, maintenance, and repairs.[7]

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[3] Bankruptcy filings indicate that a small percentage of the company is owned by a trust for the benefit of Mr. Smith's surviving son, Mark Smith.

[4] Evergreen Helicopter, Inc. was sold to Erickson Air-Crane, Inc. in March 2013 to generate funds to repay Evergreen debts.

[5] MKS Foundation is a private foundation for which Mr. Smith is the sole trustee. It has 501(c)(3) tax-exempt status.

[6] Ownership is stated as reflected in recorded county property tax records. According to county tax officials, deeds have been executed conveying the land on which the waterpark, Boy Scout camp, and chapel are located to MKS Foundation for $0, but the county has not processed the deeds due to delinquent property taxes totaling just over $1 million. The Museum and the county are currently in litigation over whether the property qualifies for exemption from property taxes. Assuming recognition of the noted conveyances, all of the Museum campus is owned by MKS Foundation, except for the aviation building, theater building, and the site designated for the lodge, which continue to be owned by Evergreen.

[7] There appears to be some uncertainty regarding past lease arrangements for the theater building, the occupancy of which was shared with Evergreen. Museum counsel has recently advised that the lease agreement for the theater building included in the Museum's property tax application may have been an unexecuted draft. In any event, as of November 2013, the Museum no longer occupies that space rent-free. he Museum has agreed, at least temporarily, to pay $50,000 a month to rent the theater building.

IV. THE MUSEUM

A. Formation

The Museum was incorporated by Captain Michael K. Smith, the oldest son of Mr. Smith, in 1991 as a public benefit nonprofit corporation with members and named the Evergreen Museum. In the beginning, the Museum operated out of Evergreen hangar space on the south side of Highway 18. Its collection consisted primarily of items owned by Mr. Smith and his son. Though it was open to the public, relatively few people knew of its existence.

In 1992, Evergreen acquired the Spruce Goose from the Aero Club of Southern California. The Spruce Goose was purchased through a stock purchase agreement, promissory note, and security agreement executed by Mr. Smith on behalf of Evergreen. Evergreen immediately assigned the contractual rights and obligations to the Museum. The Spruce Goose was disassembled and moved to Oregon in 1993 and its segments placed in temporary hangars until a permanent structure could be built. In 1993, the Museum also changed its name to Evergreen Airventure Museum. After plans for reassembly and construction stalled, the aviation building, where the Spruce Goose is displayed, opened in June 2001. In 1999, the Museum's name was changed to The Captain Michael King Smith Evergreen Aviation Educational Institute. The Museum adopted its current name in 2009.

B. Dependence on Evergreen

In many respects, the opening of the aviation museum building and the public display of the reassembled Spruce Goose represented the real launch of the Museum. In September 2000, as the Museum was preparing for the opening of the aviation building and poised for significant growth, Mr. Smith hired attorney William Schaub to serve as the Museum's Executive Director.

The Department interviewed Mr. Schaub about the Museum's governance and operations during the period he served as Executive Director. Mr. Schaub served in that capacity from September 2000 to November 2003.[8] Although Mr. Schaub's tenure and the related events were some time ago, the Department believes this historical perspective is informative to all involved. It is important for the Museum board to recognize situations in which the Museum's relationship to Evergreen may have interfered with the Museum's obligations to operate independently from Evergreen and recognize situations that require additional investigation by the board.

When he was hired, Mr. Schaub understood that his efforts were to focus on making the Museum more independent from Evergreen and Mr. Smith, which included obtaining public charity status

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[8] Mr. Schaub's employment was terminated by the Museum, which resulted in subsequent litigation between the parties. In connection with this employment dispute, the trial court granted summary judgment in favor of the Museum and other defendants. The lawsuit was resolved through a confidential settlement after Mr. Schaub appealed. The Department reviewed some of the trial court pleadings, including affidavits and deposition excerpts, as some of the allegations in the proceeding concerned management of the Museum and its governing documents. The Museum declined to voluntarily produce the deposition transcripts or to make Evergreen executives who are board members available for interviews to enable to the Department to more fully evaluate the organization's past governance and history..

for the Museum, which was then classified as a private foundation. Although construction of the aviation building was being completed around the Spruce Goose, the aviation building was neither constructed nor owned by the Museum. As indicated previously, Evergreen owns the land and the aviation building. The Museum's revenue for 2000, including donations, was around $300,000.[9] The Museum staff consisted of five employees who were housed at the Evergreen premises. Evergreen paid Mr. Schaub's salary for the first year and continued to pay part of his salary thereafter. In addition, Museum employee benefits were paid through Evergreen throughout Mr. Schaub's tenure.

According to Mr. Schaub and others, the Museum was treated and operated as if it was a division of Evergreen.[10] This culture was epitomized by the practice of Evergreen holding daily management meetings which Museum representatives were required to attend, along with representatives from Evergreen's various for-profit companies. The Museum's participation in Evergreen management meetings continued throughout the Department's investigation and after we raised concerns about the practice. The Department has been informed that the practice ended in October 2013, just before the closure of Evergreen was announced.

The Evergreen overlay was further reflected in the Museum's board composition. Throughout the Museum's existence, Evergreen executives have had an ongoing presence on the Museum board and substantial influence over Museum business, particularly because the board met infrequently, leaving Evergreen executives to participate in and direct its daily operations. Museum staff and volunteers consistently perceived and portrayed the role of the Evergreen executives as relaying or carrying out directives from Mr. Smith.

The reality is that the Museum exists because of Evergreen and Mr. Smith. As a result, Evergreen and Mr. Smith exerted tremendous control over the Museum. Mr. Schaub reported examples of Evergreen's control or influence during his tenure (2000-2003) including the following.

- Evergreen and/or Mr. Smith personally owned at least one-third of the planes exhibited at the Museum and an exhibit outlining the history of Evergreen was installed at Mr. Smith's direction. Evergreen planes were prominently displayed, and the Museum facility was routinely used to woo Evergreen business contacts and vendors. As part of Mr. Smith's personal purchase of a helicopter collection, he obligated the Museum staff to construct a reproduction of an antique plane for the seller of the helicopter collection.

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[9] The Department does not have access to the Museum's Form 990PF for the years 2000 and 2001 or to financial statements for years prior to 2004. The revenue figure is based on the October 2000 Management Review Report, which reported revenue, including donations, totaling $297,800 through September 2000.

[10] The attitude that the Museum is one of the Evergreen companies is also reflected in recent comments by Mr. Smith to the media. In response to an inquiry regarding the petition to force Evergreen into bankruptcy, Mr. Smith was quoted as saying, "The trading company is doing very well, the museum's doing very well, the ground handling company is doing very well, . . . We're just going to shut that airline down and we'll crank it up when the military has a need." Richard Read, Creditors Try to Force Evergreen International Airlines into Involuntary Chapter 7 Bankruptcy, Oregonian, Dec. 19, 2013.

- Mr. Schaub reported that Evergreen employees would regularly appear on the Museum's books and payroll as the Museum's accounting system was connected to and/or operated by Evergreen.
- The Museum owned the rights to the Spruce Goose name for licensing purposes. Evergreen used the Spruce Goose name on its wine and retained all proceeds. Mr. Schaub's efforts to get a licensing agreement in place with the Museum were rebuffed. In 2004, after Mr. Schaub's employment had been terminated, the Museum did execute a two-year licensing agreement with Evergreen which provided for one-year renewals by mutual agreement. It is not known if any payments were made to the Museum under the agreement or whether the licensing agreement was renewed.
- At Mr. Smith's insistence, an ice cream parlor was installed in the Museum facility for the benefit of his minor grandchildren and was done without any board review or approval. Mr. Smith refused to execute a lease for the space and Museum staff operated the ice cream parlor for two years, with all proceeds distributed to the family. The ice cream parlor is no longer in operation.
- Mr. Schaub and others reported that Evergreen periodically removed and scrapped donations, exhibit materials and the like without consulting with Museum staff.
- Mr. Schaub and others reported that Evergreen executives and/or Mr. Smith were involved with, directed, and interfered with daily operations at the Museum. They could and would take employees and volunteers away from tasks, summon them to their offices, and redirect them to other matters.
- Mr. Smith repeatedly represented to Mr. Schaub that Evergreen and/or Mr. Smith would cover all of the Museum's expenses prior to the opening of the aviation building as a donation and that once the opening occurred and the Museum could support itself going forward, it would start with a clean slate. Yet after the aviation building was opened, Evergreen required the Museum to pay $483,000 to reimburse Evergreen for covering the Museum's payroll in prior periods and to pay $140,000 to Hoffman and Benge for outstanding construction bills related to the aviation building. When Museum staff protested, they were variously informed that the Evergreen was carrying a "note" in excess of $500,000 which no one had ever seen, were informed the board approved the payment when no board minutes existed reflecting any discussion on the topic, and told that the Museum would simply be shut down if it did not pay the money. Mr. Schaub indicated the unexpected depletion of more than $600,000 from the Museum's funds significantly impacted their planned marketing, educational, and exhibit programs. (The Museum's IRS 990PF from 2003 reflects the Museum's repayment of significant indebtedness to unidentified parties).
- Mr. Schaub reported that Mr. Smith decided that the Museum should begin paying rent for the space they occupied at Evergreen (before the aviation building was completed) and insisted on $17,500/month, though Mr. Schaub obtained information indicating that the fair market rent for the space was closer to $3,300/month. Mr. Schaub insisted the matter be presented to the board for review. Before the board could review the matter, a $17,500 line item was inserted in the Museum's accounting ledger. This was eventually reversed without board intervention. (Financial statements provided to this office indicate that in 2004-2006, after Mr. Schaub was no longer employed by the Museum, the Museum leased warehouse and office space from a related party, variously identified as

Venture Holdings, Inc. and Ventures Acquisition Co., LLC, for $17,500 per month. In 2006 alone, the Museum paid $210,000 in connection with this lease).

C. Efforts at Independence

1. Board Involvement

Mr. Schaub indicated he worked hard at recruiting Museum board members to improve its profile, independence, and expertise. He felt he made significant strides on that front. The earliest board minutes the Department obtained are from January 2002. The board met five times in 2002 and four times in 2003 (though one meeting appears to have been an executive committee meeting for which there are no minutes). The minutes reflect the board was engaged and focused on how to promote and grow the Museum. Discussions were held about developing an endowment, promotional efforts with the board of tourism and others, the need for fundraising and control of expenditures, and opportunities for acquisitions and exhibits.

Certain entries in the Museum's minutes are noteworthy. In 2002, the board commented that no more funds should be expended on capital projects until the funds were actually raised and that it would be important to have final drawings and preferably models prepared to show potential donors in fundraising efforts. The board contributed ideas regarding contacts for fundraising, promotional efforts, and exhibits.

In the May 30, 2002 meeting, it appears there were some questions raised about a "loan" from Evergreen that was reflected in the financial report. The minutes described the "loan" as relating to expenditures Evergreen fronted when the Museum was unable to pay its own expenses and though it's not entirely clear from the minutes, this would seem to relate to Evergreen's claim for reimbursement as described by Mr. Schaub. The board's response was to indicate that a reserve fund should be established. The general impression from the minutes is that the board was only informed about the loan after the fact; the board had an appropriate awareness that such transactions are not advisable, and wanted to institute plans to avoid similar situations in the future.

Starting in 2004, the board began meeting less often. In 2004, there was one executive committee meeting and two full board meetings. In 2005, there were two executive committee meetings and two full board meetings. Thereafter, the board met once a year and there are no minutes for any executive committee meetings.

2. Voting Members

The Museum's governing documents with respect to the voting rights of members and handling of related issues are troubling.

Mr. Schaub reported that updating the Museum's articles and bylaws to include voting members was part of the Museum's overall transition from a private foundation to a public charity. He reports this change was discussed repeatedly with Mr. Smith and the board tasked him with drafting new governing documents.

At the March 28, 2002 board meeting, the final version of the amended articles and bylaws were presented to and approved by the board. Changes in the March 2002 governing documents included increasing the minimum size of the board, giving members voting rights to elect and remove directors and approve amendments to governing documents, increasing the number of board meetings to at least 4 times a year, requiring an annual meeting of the members, and establishing a number of committees.

After board approval of the amendments to the articles and bylaws, a member meeting was held on November 2, 2002 at the Museum and ballots were mailed to members. Mr. Schaub and others attended the member meeting and recall that Mr. Smith and other Evergreen executives were also present, although this was disputed. The board met on November 7, 2002, a few days after the membership meeting. Yet the board minutes make no mention of the recently held member meeting or election. Moreover, at the November 7, 2002 board meeting, a new director was nominated by Mr. Schaub and Mr. Smith and voted onto the board by the other directors. There appears to be a complete disconnect between the member meeting, the board meeting, and the new articles and bylaws.

In 2003, the March 2002 amended articles and bylaws were submitted to the IRS as part of the Museum's request to change its tax-exempt status from a private foundation to a public charity. Mr. Schaub also filed the March 2002 amended articles and bylaws with the Oregon Secretary of State ("SOS") in 2003.

Another annual members meeting was scheduled for November 28, 2003. Ballots were prepared and mailed to members beforehand, though the member meeting did not take place. Mr. Schaub's employment was terminated on November 6, 2003 and thereafter, Mr. Smith, in his stated capacity as chairman of the Museum board, sent a letter to the Oregon SOS stating that the 2002 amended articles and bylaws did not have the proper approval of the Museum's board, that their filing was a mistake, and that the Museum wanted to withdraw the filing.[11] Mr. Smith's retraction letter and accompanying documents were also attached to the Museum's 2004 Form 990, which asked if the organization had made any changes to its governing documents. There is no record in the Museum minutes that the board ever voted to rescind the amended articles or bylaws that they approved in March 2002.[12] Despite the rescission, on its 2008-2010 Forms 990, the Museum reported it had members with voting rights.

The Museum has not offered an explanation as to how the Board could approve amendments to articles and bylaws that contained voting membership provisions in 2002, submit those amended

[11] Although Mr. Smith identifies himself as Chairman of the Board in the 2003 retraction letter, the position of Chairman was only created as part of the 2002 amendments he asserted were invalid.

[12] Museum counsel has advised the Department that despite the lack of any record in the board minutes, the board did in fact vote to rescind the 2002 amended articles and bylaws in the November 2003 meeting, although we were not provided with any documentation to supplement the minutes provided. Museum counsel states that the vote to approve the 2002 amended articles and bylaws was invalid because the board thought the documents had been reviewed by the Museum's New York counsel, when that was not the case.

documents to the IRS in 2003 in connection with its request to be reclassified as a public charity, send ballots to members in 2002 and 2003, subsequently conclude that the decision to allow members voting rights was invalid, and then drop the project to substantively update the organization's governing documents, which was not pursued again until the Department began this investigation. The handling of the membership issue raises concerns because once a nonprofit corporation opts to have voting members any decision to terminate their voting rights must be approved by the members.

D. Continued Expansion and Evergreen Control

After the construction and opening of the aviation building, the construction of the theater building, the space building, and waterpark quickly followed. The board seemed to have little to no input on those matters. Although the Museum did not own any of the land on which the buildings were constructed, it seems that it was always understood that the Museum would assume responsibility for operating the buildings once completed and adapt its programs accordingly.

The first mention of the theater building in the board minutes was in August 2002 where it was reported that the board was updated regarding prospective plans for a facility designed to play IMAX films and informed that Mr. Smith would look into obtaining a market analysis to determine if the theater would be beneficial and financially feasible. If any such analysis was done, it was not reported in any subsequent minutes. The next mention of the theater building was in the August 2004 minutes, when the final design plans were presented to the board. There was no discussion of budget, costs, projected income or the role of the Museum with the IMAX.

Nonetheless, the August 2004 minutes reflect that the board was engaged in making the IMAX a success, using it as a launching pad for further promotion of the Museum, and a fundraising opportunity. The IMAX theater opened in April 2007. Evergreen originally leased the equipment from IMAX, but in 2010, the Museum entered into a sublease, signed by John Irwin on behalf of the Museum and Blythe Berselli on behalf of Evergreen. Both individuals were employed by Evergreen and on the board of the Museum at the time. The Museum minutes do not reflect any discussion or independent review regarding the sublease or financial impact to the Museum. Over time, the Museum determined that operating the IMAX system was not financially viable and decided to switch to a digital format. In 2012, the Museum entered into a negotiated settlement with IMAX to terminate the agreement, which involved a significant payment to IMAX. Museum counsel recently informed the Department that Evergreen, not the Museum, paid IMAX under this negotiated settlement.

Construction of the Space building began in 2006 and is located on land owned by the MKS Foundation. At the 2008 board meeting, held shortly before the Space building's opening, Ms. Berselli reported that the Museum had entered into a \$2.5 million contract with Kansas Cosmosphere for the construction and installation of certain exhibits at the Space building, that the Museum had paid \$1.64 million on the contract but was unable to pay the balance, and that it had been determined it was best to allow the MKS Foundation to assume all rights and liabilities under the contract, but allow the Museum to use the displays in the Space building. The

Museum's 2007 audited financial statement described the agreement as creating joint ownership of the exhibits and gallery in proportion to the ratio each organization bore under the Cosmosphere contract. No prior board minutes contain any discussion of the Cosmosphere contract with the Museum and the 2008 minutes do not reflect any meaningful discussion by the board before it voted to ratify the assignment. It appears that as result of its obligations under the Cosmosphere contract, the Museum was unable to pay all of its ongoing administrative and operating expenses, which Evergreen covered or contributed to. Over time, the Museum's debt to Evergreen for these ongoing administrative expenses approached $1 million; the Museum was able to pay off this debt fully by 2012, but there was no mention of this arrangement or liability in any of the board minutes.

At the 2008 board meeting, the board was also presented with a five-year, $0 rent lease between the Museum and the MKS Foundation for the Space building. Ms. Berselli then presented a proposal to sublease part of the Space building to Evergreen Agriculture for retail space, which included a wine bar, at a rate of $1.50 per square foot for an initial term of 3 years. Again, the minutes do not reflect any discussion by the board before it approved both transactions.

Though the board minutes do not reflect any discussions about long-term plans to construct and operate the waterpark and hotel, such plans were in the works no later than 2009. In order to begin construction, Evergreen had to obtain Yamhill County voter approval to annex the land into the urban growth boundary. The matter was placed on the ballot in May 2009 and passed. In the lead-up to the vote, the development plans were described as building a 50,000-square-foot water park and a 80- to 90-room resort lodge. At the October 2009 board meeting, Evergreen's president informed the Museum board that Hoffman Construction had been commissioned to build the waterpark, which would be the Museum's next activity. At the 2010 board meeting, Hoffman Construction gave an update on the waterpark construction and explained that it was being built first because of its ability to generate revenue. Ms. Berselli indicated the focus of the waterpark would be education and explained that the MKS Foundation would own the waterpark, but the Museum would operate it. Plans for the lodge were also outlined and included a 54-room Northwest style facility with a restaurant, spa/exercise facility, wine bar, and 8-9 rooms for student housing.

The waterpark opened in June 2011. The Museum entered into a month-to-month lease agreement with the MKS Foundation regarding the operation of the waterpark. Like the other lease agreements, the Museum pays $0 rent, but is responsible for paying maintenance and utilities. John Irwin, who also was an officer of Evergreen at the time, signed the lease on behalf of the Museum. There is no evidence from the documents provided to the Department that the lease was presented to the Museum board for review or approval.

In November 2012, the News-Register reported that construction on a chapel, campground, Boy Scout memorial, and adventure park behind the aviation building had commenced. Since the Department initiated this review, Evergreen has completed construction of the chapel and the Museum has entered into a lease to operate it. When asked why the Museum would build a chapel, Mr. Wood has responded "Because Del Smith wanted it."[13] More recently, the Museum

[13] Molly Walker, *New Evergreen Chapel to Hold First Memorial Service*, News-Register, Oct. 11, 2013.

has reported that the chapel will be used not only for weddings and special events, but as a nondenominational sanctuary for staff, volunteers, and community members.

An Evergreen 747 was recently moved over to the Museum campus and the Department was informed that the plan is to convert it into student housing akin to a youth hostel. Construction of the lodge was underway, but is reportedly now on hold. Mr. Smith and Evergreen representatives have indicated that there are long-term plans to establish an orphanage on the property, though the Department has not seen any formal plans to that effect. It is not known what role, if any, the Museum will have in operating the youth hostel and lodge though Mr. Wood has promoted the lodge in various articles in his capacity as Executive Director of the Museum and has been involved in promoting the Museum in connection with finding potential lenders for the lodge.

E. 2012 Transfer of Funds

As indicated above, the Department's investigation was prompted by a report, subsequently confirmed by the Museum, that substantial funds were transferred from the Museum's account to Evergreen. Although Evergreen repaid the funds with interest after the Department initiated this review, additional facts regarding the transaction bear discussion.

The Museum's former Financial Director, Ms. Mery, was interviewed in the presence of Museum counsel about this specific transaction in December 2012, immediately before she left the Museum's employment and moved out-of-state. The former Financial Director was helpful and forthcoming. She explained that she was contacted by John Irwin, then president of Evergreen and the Museum's treasurer, on October 2, 2012 and asked how much cash the Museum had on hand. She reported that the Museum had $750,000 in its winter savings.[14] She indicated the Museum needed the funds to cover payroll and the negotiated settlement with IMAX. Mr. Irwin indicated Evergreen may need $400,000 to make an interest payment on its debt. The following day, Mr. Irwin contacted Ms. Mery again and requested the Museum's bank balance and indicated that Evergreen would need all of the funds, but would repay it in three days. Ms. Mery expressed skepticism regarding repayment, noting she was aware of Evergreen's financial condition.[15]

Ms. Mery refused to make the transfer. As a result, on October 3rd, Mr. Irwin and Ms. Berselli, both Evergreen executives and Museum board members, who also had signing authority on the Museum accounts, went to the bank themselves and wired $725,000 from the Museum's account to Evergreen. After the transfer had been made, Ms. Mery was told to work with Evergreen counsel to work out the terms of a note for the funds. Although Mr. Irwin originally told Ms.

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[14] The Museum has significant seasonal fluctuation in its attendance and revenue and relies on its savings from summer revenue to carry it through the winter.

[15] The Department has not requested or obtained any internal financial information for Evergreen, a privately-held for-profit company. Nonetheless, information regarding Evergreen's financial condition has been publicly reported. In October 2012, Standard & Poor's Rating Services placed Evergreen on CreditWatch with negative implications because of the company's liquidity problems and weak performance, gave it a credit rating of CCC, and noted that it had an interest payment due October 31st. It further stated that Evergreen was in violation of its interest coverage and leverage covenants, but had obtained a waiver from its lenders. At that same time, there were a number of articles published regarding lawsuits filed against Evergreen for breach of contract and/or failure to pay vendors.

Mery that repayment would be made in three days, Evergreen counsel informed her that the repayment term was 30 days and suggested the note have a 15-day repayment term, given the dispute. Yet, within the hour, Ms. Mery received a fully executed 30-day promissory note, signed by Mr. Irwin, on behalf of the Museum, and Ms. Berselli, on behalf of Evergreen. The promissory note is dated October 4, 2012, and includes 9.0% interest. When asked about this transaction, Mr. Wood acknowledged that he had not been consulted beforehand and was not particularly pleased with how it had been handled, but indicated he never had any serious concerns about the impact on the Museum. Mr. Woods was confident that Mr. Smith and/or Evergreen would ultimately do right by the Museum, given their long-term investment in and commitment to the Museum.

Ms. Mery reported that after the transfer, the Museum lacked the funds to meet its upcoming payroll mid-month and contacted Evergreen for repayment and/or assistance. On October 10th, Evergreen transferred $125,000 to the Museum to help cover its payroll. The Museum was also instructed to renegotiate the payment terms of its settlement with IMAX. The Museum was due to pay the settlement in full on or by November 19th, but Ms. Berselli informed Ms. Mery that the Museum would not be able to do so because the promissory note from Evergreen would not be paid by then. Ms. Berselli then directly renegotiated payment terms with IMAX to extend the settlement payments until August 2013.

On October 19, 2012, the Department issued its first letter to the Museum inquiring about the transaction. The Museum, through counsel, responded by letter dated October 29, 2012 that the note had been paid in full as of that date. The letter also asserted that the transaction was good for the Museum as it received 9.0% interest, which far exceeded any interest it would have otherwise earned, that the Museum was never in financial stress as a result of the loan since it had roughly $12 million in assets, that the Museum would not exist but for the support of Evergreen, and that this was the only time the Museum has ever loaned money to Evergreen. On November 9, 2012, the Museum board met and passed a resolution ratifying the $725,000 transaction, finding the transaction was fair to and benefitted the Museum and was appropriate under the circumstances, particularly in light of the long history of support received from Evergreen.[16]

F. Contract to Purchase Airplanes from Evergreen

In the course of its investigation, the Department also reviewed a transaction involving a Museum contract to purchase $500,000 in equipment from Evergreen (the "Airplane Contract"). In its review, the Department learned that in May 2012, Mike Hines, then President of Evergreen Trade who also serves on the Museum board, presented Mr. Wood with a $500,000 contract for the purchase of a DC-9 and a 747 cutaway from Evergreen for use as Museum exhibits. Mr. Smith had seen a 747 cutaway exhibit overseas and believed the Museum should have a similar exhibit. There was no independent review by the board or input from other Museum staff regarding the purchase, including whether or not the Museum could afford the purchase and

[16] Neither the note, nor the resolution describes Evergreen's purpose in requesting the loan. Reuters reported that Evergreen made its October 31st interest payment and as a result, S& P did not immediately downgrade Evergreen's credit rating, although it was subsequently downgraded in January 2013.

whether such an exhibit fit within the Museum's priorities. The agreement was signed by Mike Hines on behalf of Evergreen. Mr. Wood signed the agreement on behalf of the Museum.

When presented with the Airplane Contract, Mr. Wood indicated that $500,000 was a significant amount of money and that the Museum did not have the funds. Mr. Wood reported he was told by the Evergreen executive(s) that he need not worry about the figure because the Museum was not going to pay anything on the contract anyway. He asked for clarification and was just told the Museum would not have to pay it. Mr. Wood felt he had no real choice but to sign the contract under the circumstances.

Ms. Mery, the former Financial Director of the Museum, stated she did not "book" the Airplane Contract on the Museum ledger before leaving the Museum in December 2012. When she learned of the contract, she raised questions about it because both she and the curator would ordinarily review and approve such contracts before they were executed. Ms. Mery reported she was aware of rumors circulating among employees and volunteers that Mr. Hines had purchased a group of DC-9s for Evergreen at $5,000 or $7,000 apiece. She asked for verification of the $500,000 value, but never received it.[17] At one point during her inquiries, Evergreen indicated it would add value to the contract by constructing part of the exhibit for the plane and Ms. Mery asked that this provision be put in writing, which was never done.

Because Ms. Mery indicated the contract had never been booked on the Museum's ledger, the Department was under the impression there had been no financial impact from the contract. Before the Department interviewed Mr. Wood, Museum counsel also informed the Department that the contract had been rescinded. However, when the Department interviewed Mr. Wood in July 2013, he disclosed that the Museum had paid approximately $250,000 to Evergreen on the contract because the contract has been booked in the accounting system. He assumed that Ms. Mery had done that, though he didn't know why; Mr. Wood did not book the contract or direct anyone to do so. However, Ms. Mery was very clear and adamant that she had not done this. Mr. Wood was aware that payments were being made, but did not raise the issue. From his perspective, the Museum regularly owed Evergreen money each month because of shared administrative expenses and he did not pursue it further.

The Department asked for any documents regarding the rescission and payments. The Museum provided redacted minutes from the meeting of the board's newly formed Governance Committee, which is comprised of three independent directors without financial ties to Evergreen. (The formation of this committee is one of the changes implemented by the Museum since the Department's review was initiated, discussed in further detail below). The June 2013 minutes reflect that when Mr. Wood was asked about the contract, he informed the Governance Committee that the Museum no longer wanted the DC-9 because a more historically significant

[17] The Museum produced to the Department a summary desktop appraisal obtained by Evergreen dated November 6, 2012, six months after the contract was entered into. The appraisal valued a 747 cutaway exhibit at $760,000, using a cost approach. The appraisal did not include inspection of the actual 747 being sold, which is believed to be at an Evergreen facility out-of-state. So far as the Department is aware, no Museum staff has seen the actual plane that is the subject of the contract. The appraisal contains no details or breakdown describing how the figure was calculated. An internal cost summary prepared by Evergreen valued the 747 cutaway at $691,100, including costs for transportation and exhibit installation.

plane, a VC-9 ("Air Force Two") was available for $25,000 plus $30,000 in shipping costs, that the 747 cutaway was too expensive for the Museum, and that he preferred the entire agreement be rescinded. The committee was informed by Mr. Irwin that approximately $250,000 had been paid on the contract and that Evergreen could repay that amount by the end of the year. A formal agreement to rescind the transaction was executed in July 2013 and, in August 2013, Evergreen executed an unsecured promissory note payable to the Museum for $249,673, which sum was due on or before December 31, 2013, with interest accruing at the federal short-term interest rate. Shortly before the bankruptcy filings, Evergreen informed the Museum that it would not be able to pay the promissory note.

G. Museum Revenue and Support

A chart summarizing the Museum's revenue streams, based on its Forms 990 and financial statements, is marked Exhibit 1 and attached hereto. The Museum's financial situation is unusual in a number of respects. While the physical facilities of the Museum are massive compared to organizations such as OMSI and Portland Art Museum, its yearly revenue has generally been less than half that of those organizations.

In addition, the Museum engages in very little traditional fundraising. A relatively small proportion of its revenues are from donations. In recent years, donated income ranged from a high of 23 percent in 2009 to as little as 7 percent in 2012. Instead, the Museum relies heavily on admission fees at its various facilities as well as special events, gift shop sales, and food sales to generate revenue. In particular, the Museum saw a dramatic increase in revenue following the opening of the Wings and Waves Waterpark in June 2011.

Admission fees to the aviation and space building generate roughly $2 million annually. Membership fees have steadily increased, but in recent years, have stabilized at approximately $300,000. In 2011, the Wings and Waves Waterpark alone generated $2.6 million for half a year's operations. Another area of growth for the Museum has been the special events and café, which operates food concession for visitors and caters special events at the Museum. Revenue from special events and the café have increased to approximately $600,000 and $1,000,000, respectively. Meanwhile, theater revenue has steadily declined from its initial peak of more than $500,000.[18]

Some of these revenue streams may be construed as unrelated business income for which the entity must pay taxes ("UBIT"). Yet the Museum has reported minimal amounts of UBIT. The Museum appears to take a different position from other museums regarding UBIT. Portland Art Museum and OMSI report virtually all of their special event revenue and substantial portions of their gift shop revenue on their Forms 990-T. In contrast, the Museum has not reported any

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[18] The fact that the Museum currently enjoys minimal occupancy overhead has allowed it to maintain its operations. If the Museum were required to pay more in rent, it is doubtful it could remain in operation without significant changes to its revenue streams. Moreover, it is not clear that increased revenues from the waterpark will result in greater financial stability for Museum programs. The Museum's 2012 Form 990 raises serious questions about the sustainability of the Museum's existing operations. While the Museum's 2011 Form 990 showed its revenues exceeded its expenses by $1.4 million, its 2012 Form 990 indicates its expenses are increasing even more rapidly than revenue and the Museum reported a loss of more than $400,000 last year.

income from the leases for the Evergreen wine bars, special events, the arcade in the waterpark, or the waterpark in general. The Museum reports minimal amounts of UBIT for the theater operations and gift shop sales.

The waterpark is the single greatest source of revenue for the Museum. The waterpark is not separately incorporated or otherwise organized. It is not owned by the Museum, even though it is operated by the Museum. Since its initial opening, the facility has been altered to include more educational exhibits, to limit film screenings to educational material, and to eliminate the arcade, but it is unclear how operating a waterpark furthers the charitable mission of the Museum. The Museum has not sought formal legal advice or a private letter ruling from the IRS that the waterpark qualifies as an exempt activity. The Museum did obtain a single page memo from its accounting firm, which also serves as Evergreen's accounting firm, that summarily states the waterpark does not constitute UBIT.[19] The memo was obtained in February 2012, approximately eight months after the waterpark had been opened and was being operated by the Museum.

H. Accomplishments and Future, Long-Term Plans for the Museum

The facilities used by the Museum are impressive. The Museum has developed a remarkably committed and high caliber army of volunteers and has retained a dedicated Executive Director and staff who work diligently to help the Museum succeed. The Museum has developed a successful relationship with the McMinnville school district and provides tremendous support to the school district, its teachers, and students. The Museum unquestionably expends significant effort and resources on educational endeavors throughout the region and is generous in its efforts to support education and veterans.

When asked to describe the long term plans for the Museum, Mr. Wood candidly stated that there are long-term plans for the Museum and they were known only to Mr. Smith. Mr. Wood's personal goals for the Museum were to continue to grow the Museum so that it could reach more and more students and offer more and more educational opportunities at all levels. Mr. Wood's commitment to education and belief in its ability to improve the lives of everyone, particularly the young, was readily apparent and obviously heartfelt.

V. CHANGES IMPLEMENTED AT THE MUSEUM

During the course of the Department's review, the Museum implemented a number of changes.

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[19] The memo identified three other amusement parks or recreational facilities that operate as charitable tax-exempt entities – Oaks Park Association, Gilroy Gardens Family Theme Park, and Sports Outdoor and Recreation Park. These entities are distinguishable from the Museum. Oaks Park was established in 1905 and is of historic interest. See the National Amusement Park Historical Association, www.napha.org. Gilroy Gardens operates as a supporting organization to the City of Gilroy, which owns most of the land and assets used for the park. Interestingly, the CPA's memo omits any discussion of Gilroy Garden's troubled financial history prior to its sale to the City, which may have been a relevant to the board's consideration of the risks of expanding its operations to include a waterpark. Sports Outdoor and Recreation Park was specifically created and designed for the physically and cognitively disabled. We believe it would have been appropriate for the board to request more information about whether the listed examples were, in fact, closely comparable to the Museum's waterpark.

In November 2012, the Museum's board established a Governance Committee comprised of three long time board members who were not employed by or otherwise financially affiliated with Evergreen to review and approve or reject any transaction between the Museum and Evergreen or any other conflict-of-interest transaction and to work with the Museum's counsel in responding to the Department's investigation. The Governance Committee was further authorized and charged with determining whether any additional changes should be implemented by the Museum to improve the independent governance of the Museum.

In November 2012, the Governance Committee adopted a new banking policy providing that any transfers from the Museum to Evergreen must be approved by the Museum's Director of Finance and a disinterested board director. The Museum distributed the revised banking policy internally and to the Museum's bank. In March 2013, the Museum moved its bank account to another institution and eliminated Evergreen employees as authorized signers on the new account. The Governance Committee further refined the banking policy to require the approval of an authorized signer and disinterested board member for transfers exceeding $100,000 and for transfers in any amount to Evergreen. This policy was also distributed internally and to the financial institution.

In June 2013, the Museum adopted new bylaws and policies recommended by the Governance Committee. The changes included the following:

- The board will continue to be comprised of at least 3 directors with no maximum number set. At least two-thirds of the board members must be independent directors, *i.e.*, have no affiliation with or economic interest in Evergreen or Mr. Smith, was adopted.
- The board will meet at least twice a year. A quorum continues to be one-third of the board and action requires the vote of a majority present.
- The composition of the Executive Committee ("EC") was altered to require 9 members, at least 5 of which must be independent. The Museum indicated that at this time, the remaining 4 EC members will continue to be Evergreen executives, to wit, Ms. Berselli, Mr. Irwin, Mr. Hines, and Mr. Smith.
- The EC will meet at least four times per year. The EC cannot take any action unless a quorum is present and the majority present consists of independent directors.
- The independent members of the EC will review and approve or reject all conflict-of-interest transactions.
- No Evergreen employee, director or officer shall be an authorized signer on the Museum's bank accounts.
- An Audit Committee will be formed and will review and approve the Museum's Form 990. The majority of the Audit Committee members will be independent directors.
- The inter-company ledger account between the Museum and Evergreen will be zeroed out and closed by December 31, 2013.
- New Museum employees will receive training on Oregon law regarding nonprofit governance, management, and conflicts of interest within 90 days of hiring.
- New board directors will receive training on fiduciary duties under Oregon law, conflicts of interest, and good governance practices within 90 days of joining the board.

- The Museum will continue to employ the same financial auditor as Evergreen to prepare its audited financial statements because it is cost-effective.
- The new Finance Director of the Museum (to be hired) will not have any professional or economic relationship with Evergreen.

The Museum was insistent throughout the Department's review that altering the board composition to eliminate or reduce the number of Evergreen executives, particularly from the EC, was not an acceptable option. However, with the recent closure of Evergreen and the bankruptcy proceedings, the composition of the board and EC is already changing.

VI. RECENT DEVELOPMENTS

In November 2013, the Department received the Museum's 2012 IRS Form 990, which indicates that the Museum's financial health is deteriorating. The Museum's prior Forms 990 had not shown any operating losses and its 2011 Form 990 showed that its revenues exceeded expenses by more than $1.4 million. However, at the end of 2012, the Museum reported a loss of over $400,000. Between 2011 and 2012, it appears the Museum's personnel costs increased by approximately $800,000 and advertising and promotional costs increased by nearly $900,000. It appears the increased costs for advertising may be the result of the MKS Foundation paying for such expenses in 2011 but not subsidizing those costs to the same degree in 2012.

The Museum counsel also informed the Department in November 2013 that due to Evergreen's inability to cover its mortgage on the theater building, the Museum would temporarily rent the theater building for $50,000 a month while it explored its options. The Evergreen mortgage on the theater building is secured not only by that property, but also by the aviation building and Evergreen's default on the theater building mortgage raises issues with respect to the Museum's continued access to both facilities.

Also in November 2013, Museum counsel informed the Department that Evergreen will be unable to pay the $250,000 promissory note it issued in connection with the rescission of the 747 cutaway contract. Payment on the note was due on or before December 31, 2013. Though the Museum was exploring the possibility of accepting the Evergreen 747 currently parked in front of the Museum and the 747 cutaway located out-of-state in lieu of payment, those items are encumbered by liens.

These recent developments highlight concerns about whether the Museum's operations are sustainable and about its capacity to withstand financial setbacks. It will be necessary for the board to seriously evaluate its finances going forward and not to simply rely upon the fact that it reports having positive net worth. Unless the Museum receives substantial donations in the near future, the Museum does not appear to be in a position to incur additional expenses and expand its displays. Instead, the board will likely be faced with difficult decisions about how to maintain its core programs.

Making those decisions will require the board to evaluate fully the true costs of its various activities. To the extent that expenses associated with the Museum's activities, such as advertising and promotion, have been paid for by MKS Foundation, Mr. Smith or Evergreen, it may be difficult to develop accurate financial reports and projections for particular programs unless past support from other sources is factored into consideration. For example, it does not appear that revenues from the theater are sufficient to justify a monthly expenditure of $50,000 to rent the theater facility.

The board should also consult with the Museum's accountants to evaluate the accuracy of the information the Museum has provided to the IRS about its activities and governance. Focusing on the Forms 990 the organization has submitted for years 2008-2012, some of the reported information appears inconsistent or questionable when compared to the information gathered in the course of the Department's investigation.

VII. LEGAL ISSUES

A. Tax-Exempt Status

1. Private Benefit/Inurement

Tax-exempt organizations must be organized and operated exclusively for religious, educational, or charitable purposes and no part of their earnings can inure to the benefit of private individuals.[20] The term "exclusively" has not been interpreted to mean solely, but the presence of a single nonexempt purpose, if substantial, will destroy the organization's exemption regardless of the number or importance of its exempt purposes. *American Campaign Academy v. Commissioner,* 92 TC 1053, 1065 (1989). Prohibited private inurement or benefits can take many forms such as advantage, profit, privilege, gain or interest. *Id.* Factors suggesting private benefit include "control by the founder over the entity's funds, assets, and disbursements; use of entity monies for personal expenses; payment of salary or rent to the founder without any accompanying evidence or analysis of the reasonableness of the amounts; and purported loans to the founder showing a ready private source of credit." *Rameses School of San Antonio, Texas v. Commissione*r, T.C. Memo 2007-85 at 7 (U.S. Tax Ct 2007).

A tax-exempt organization is not prohibited from entering into agreements or transactions with its founder, directors or officers, but any transaction in which a private individual appears to receive a disproportionate benefit in the exchange raises concerns about private inurement. Making unsecured loans at below-market rate is a form of private inurement. *Lowry Hospital Association v. Commissioner*, 66 T.C. 850 (1976). Indeed, the mere fact the tax-exempt organization acts as a source of loan credit to a private individual can constitute private inurement. *Easter House v. U.S.*, 12 Cl. Ct 476, 488 (1987).

A number of the transactions described in this report raise concerns about whether they might constitute private inurement. When donors donate to tax exempt organizations, they agree to

[20] Additionally, 501(c)(3) organizations are prohibited from intervening or participating in political campaigns on behalf of candidates, engaging in substantial lobbying or political activity, and having purposes that are contrary to public policy, *American Campaign Academy v. Commissioner*, 92 TC 1053, 1065 (1989), none of which are relevant to this review.

relinquish control over those donations. The fact Mr. Smith and/or Evergreen donated or invested sums far in excess of any benefits received does not negate the private inurement that may have occurred.

2. Nonexempt Activities

A tax-exempt organization jeopardizes its tax-exempt status "if it operates a trade or business as a substantial part of its activities even though the organization has certain exempt purposes and its profits do not inure to the benefit of individual members of the organization." Marilyn E. Phelan, Nonprofit Organizations: Law and Taxation § 7.33 (2011); *see also, Indiana Retail Hardware Association v. U.S.*, 366 F2d 998 (Cl Ct 1966). Substantial profits, use of commercial pricing structures, and competition with for-profit entities in the same field are seen as hallmarks of substantial involvement in nonexempt activities. Though there is no specific or easy mathematical test for ascertaining what constitutes a substantial involvement in nonexempt activities, some legal scholars have stated that nonexempt activities should not exceed 15% of the total activities. Phelan, *Nonprofit Organizations: Law and Taxation* § 7.33 at fn. 3.

A tax-exempt organization is required to report and pay tax on its unrelated business income ("UBIT"). UBIT is business income is that derived from a trade or business, regularly carried on, that is not substantially related to the charitable, educational, or other purpose that is the basis of the organization's exemption. The Museum appears to engage in extensive unrelated business activities. The special events, certain theater movies, gift store sales, and waterpark operations could potentially qualify as UBIT. And as of 2011, those figures far exceed 15% and would seemingly demonstrate that a substantial part of the Museum's activities are dedicated to nonexempt activity.

B. Board Fiduciary Duties

It is generally recognized that well-governed charitable organizations are more likely to comply with tax laws, safeguard charitable assets, and fulfill their charitable missions. In recognition of this dynamic, the IRS has published recommendations for charitable organization which can be found on its website - http://www.irs.gov/Charities-&-Non-Profits/Governance-of-Charitable-Organizations-and-Related-Topics.

The IRS recommendations include having independent board members who represent a broad public interest and are informed and active in overseeing the organization's operations and finances. Similarly, Independent Sector, a coalition of nonprofit leaders, convened a Panel on the Nonprofit Sector to prepare guidelines for good governance. The publication entitled *Principles for Good Governance and Ethical Practices: A Guide for Charities and Foundations* (2007) sets forth 33 principles, which includes the recommendation that a substantial majority of the board of a public charity, generally meaning at least two-thirds, should be independent members. The Museum's new bylaws conform to this recommendation. This principle and recommended practice is in furtherance of the board members' duty of loyalty to the nonprofit. The IRS reviews board composition of charitable organizations to assess the potential for insider transactions and misuse of charitable assets.

Under state law, board directors have fiduciary duties to the organization they serve – the duties of care, loyalty, and obedience. The duty of care requires a director to perform his duties in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances. This requires the director to actively participate in the management of the organization. Though a director is not required to make the "right" decision at all times, he is required to make informed decisions, including making reasonable inquiries when appropriate. The duty of loyalty requires a director to act solely in the best interests of the organization. Thus, decisions regarding the organization's funds and assets must promote the organization's public purposes rather than private interests. Conflict-of-interest transactions should be closely scrutinized and the directors should understand the public will be skeptical of any such arrangement. Organizations should adopt written conflict-of-interest policies and use them. Charitable organizations cannot loan money to its officers or directors. ORS 65.364. The duty of obedience requires a director to adhere to the organization's governing documents and mission and to comply with all relevant state and federal laws, including IRS rules and regulations for tax-exempt entities.

1. Evergreen Executives Serving on Museum Board

It appears that the Evergreen executives who also served as Museum directors have at times acted in the best interests of Evergreen, not the Museum. But when acting as directors of the Museum, they owed their fiduciary duties to the Museum, not Evergreen or Mr. Smith. The $725,000 transfer and the $500,000 contract are examples of such conduct.

While the $725,000 transfer was characterized as a loan, the money was taken without regard to the impact on the Museum because Evergreen needed it for purposes it never disclosed to the Department. The Department does not know what, if any, explanation for the loan was given to the board.[21] The transfer was imprudent and reckless on the part of the Museum. The Museum transferred virtually all of its cash to a company with a CCC credit rating that was reportedly in violation of its financial covenants and struggling to make an upcoming interest payment. The loan agreement included no security or guarantees and the interest rate bore no relation to the economics of the transaction. Though the Museum indicated it had roughly $12 million in assets and was never at risk in the transaction, that statement does not comport with the reality that the Museum's Finance Director had to obtain funds from Evergreen to cover its immediate payroll and was told to renegotiate the IMAX settlement because the Museum would not be repaid in 30 days. The $12 million figure cited by the Museum encompasses exhibits such as the Spruce Goose and restricted funds and inappropriately downplays the risks associated with the transfer of most of its liquid assets.

[21] It is of great concern to the Department that in the existing Museum culture, it may be that no reason whatsoever need be given for such transactions and the impact on the Museum bears no weight. In discussing the $725,000 transaction, the Museum's Executive Director recently said, "When the guy that owns your building asks you to loan some money, you do," Richard Read, *Aviation Museum Mired in Dubious Loan History*, Statesman Journal, Dec. 22, 2013.

In the $500,000 Airplane Contract, Evergreen executives who are also Museum directors appear to have insisted on a transaction the Museum could not afford. Their reasons for doing so are not known, but they do not appear to have been for the Museum's benefit. Despite the fact Mr. Wood was told the Museum would not actually have to pay anything on the contract and that Ms. Mery did not book the contract in the Museum's accounting system, Evergreen obtained $250,000 from the Museum for the contract during the Department's active investigation. And when the transaction was rescinded in response to the Department's inquiry, the Museum was not repaid, but was given an unsecured promissory note, which Evergreen has now acknowledged that it cannot pay. The Museum's ability to recover the funds or to otherwise be made whole is uncertain in light of the bankruptcy proceedings.

2. Board as a Whole

In recent years up until the Department's review, it appears the disinterested directors have exercised little oversight of the management or direction of the Museum, have not actively participated in the decisions regarding its future, or sought to be informed about such issues.[22] The failure to act and to be informed can be as damaging to an organization as an affirmative breach. The failure to be engaged enables affirmative breaches to occur and problems that could have been resolved or averted through active oversight can develop into crises from which it may be difficult to recover.

In recent years, board minutes do not reflect any substantive discussions about whether or why the Museum should lease or assume responsibility for the theater, the waterpark, the chapel or lodge under construction. The board appears to have had no input on the recruiting and hiring of any of its executive directors. All of the Museum's executive directors have been persons known by Mr. Smith and presented to the board.

Both the Evergreen executives and the board have failed to exercise appropriate care in handling conflict-of-interest transactions. The board's ratification of the $725,000 transfer and the insistence that the persons involved in the transaction remain on the board are also troubling. Conflicted board directors will not be held liable for an insider transaction if the transaction was fair to the nonprofit at the time it was entered into or if it was approved by a majority of disinterested directors with knowledge of all material facts. It appears to the Department that the transaction would not be deemed fair to the Museum when considered at the time of its execution.[23]

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[22] In describing the failure of the board of directors as a whole, we are referring to the board and directors as a collective entity. Board composition has changed over time and we do not have detailed information about each individual board member's participation or the information that they specifically considered in guiding their actions. Nonetheless, when viewed as a whole and based on the information presented to the Department, it does not appear the directors have exercised meaningful oversight.

[23] Based on the Museum's refusal to allow the Department to interview certain persons associated with the Museum, it is unclear whether the disinterested directors were given all the relevant facts regarding the transaction when they were asked to ratify it, including information about the scope of Evergreen's indebtedness, and whether their ratification was meaningful or reflected the due diligence that is expected of charitable fiduciaries.

Though the board did respond by removing Evergreen executives as signatories on Museum accounts, one might have expected a stronger reaction from an active and independent board upon learning that $725,000, virtually all the Museum's cash, was withdrawn from the Museum's accounts without the board's prior knowledge or consent and loaned to a company that by all public reports was in serious financial distress. For example, the board might have launched its own independent investigation or removed the person involved in the withdrawal from the board. Instead, the board ratified the transaction and insisted that the Evergreen executives responsible for the transaction maintain key roles on the Museum's Executive Committee.

The Airplane Contract and the board's rescission of the contract are similarly problematic. The original transaction does not appear to have been in the Museum's best interests. Even if the property was worth $500,000 or more, its purchase was a significant unbudgeted expenditure. The rescission does not appear fair to the Museum since it has not been made whole. It is unclear whether the board had all the relevant facts surrounding the execution of the agreement – *i.e.*, that the Museum was told it would not actually have to pay on the contract and that the Museum Finance Director did not book the contract in the Museum's ledger – when it approved the rescission and accepted the unsecured promissory note. And approximately three months after executing the promissory note, Evergreen informed the Museum it would not be able to pay the note. The Evergreen executives on the board should have foreseen such a possibility when the terms of the rescission were discussed and disclosed that. The Museum is now in the difficult position of waiting for resolution of the bankruptcy proceedings.[24]

These two transactions were opportunities for the board to embrace their role as directors, fully investigate what has occurred, and take definitive corrective action.

VIII. CONCLUSIONS

The Department has serious concerns regarding the operations and future of the Museum.

As discussed above, based on the information provided to us, the Department is of the opinion that members of the board of directors, to varying degrees, have failed to adhere to the standards expected of charitable fiduciaries, although as previously expressed, we do not believe enforcement action is appropriate under the circumstances. In response to the Department's investigation, the board began taking preliminary steps toward greater independence from Evergreen, and as the result of Evergreen's bankruptcy, by necessity, the Museum will be required to become even more independent. In addition, significant issues such as the full impact of bankruptcy proceedings, the Museum's tax-exempt status, and potential liability for UBIT and property tax have yet to be determined. The Museum now faces unique challenges. The board should be given an opportunity to pursue the independent interests of the Museum pursuant to its revised governance structure and current economic realities. The board will have to devote significant effort for the Museum to continue and we feel they should be given the opportunity to succeed.

[24] The Department believes that, in the interim, the Museum has received the VC-9, though we do not know what costs the Museum incurred or what commitments were made as part of the transaction.

Since the initiation of this review, the Museum has started to separate certain internal operations from Evergreen, such as ending the use of a linked accounting system. In addition, they have made the governance changes discussed above. Those efforts should continue. The Department believes the following additional changes would be beneficial.

- Review and address the 2002 articles and bylaws which provided for voting members.
- The Museum has indicated it plans to develop an Audit Committee to review the organization's Form 990 on a prospective basis. Once formed, the committee should also evaluate the accuracy of the Museum's prior filings and file amendments if appropriate or have its accounting firm undertake such a review.
- Reconstitute the executive committee to be comprised completely of disinterested directors, save and except for Mr. Smith, should he wish to continue serving on the board.
- Recruit additional board members and diversify its composition to include those with expertise in nonprofit matters, fundraising, and museum operations.
- Engage an independent law firm or expert in charitable taxation to assist the Museum's review of whether its operation of the waterpark, special events, and chapel constitute unrelated business income activities and whether these activities jeopardize the Museum's tax-exempt status.
- The reconstituted board should re-evaluate whether the Museum should operate the theater, waterpark, and chapel and whether it is consistent with its mission and its financial capacity.
- Adopt a "whistleblower" protection policy and develop methods by which Museum staff and volunteers can feel comfortable reporting concerns to one or more designated independent board directors.
- Substantially increase the focus on fund raising and donor development and engage in long-term strategic planning.
- Implement budgetary restrictions so that expenditures are not made or committed to absent a specific funding plan and make increased use of financial information and budgets in the board's decision making.
- Join the American Alliance of Museums and employ the guidelines and ethical rules promulgated by the organization.
- Continue the development of more specific policies and training documents and expand board training to include existing as well as new members. The Department has been informed that the development of training materials referenced in counsel's June 2013 letter are underway, but not yet complete.
- The board should immediately inform the Department about any litigation or bankruptcy filings associated with the Evergreen which impacts the Museum.

Charitable fiduciaries commit to operating their organization for exclusively charitable purposes and are required to operate within a legal framework that ensures a lack of private inurement and proper taxation of commercial activities. Some of the actions described in this report raise concerns about whether the organization is operating in accordance with IRS requirements for a

501(c)(3) public charity. Because that is a matter of federal tax law, the Department will refer this matter to the IRS for review.

The Department hopes the Museum can learn from this review and improve its governance and operations to ensure its long-term future.

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YEAR:	TOTAL REVENUE:	CONTRIBUTIONS:	AVIATION:	SPACE:	WATERPARK:	SPECIAL EVENTS:	IMAX/ THEATER:	GIFT SHOP:	CAFÉ/FOOD SALES:	CATERING:	MEMBER SHIPS:	EDUCATION/ TOURS:	TOTAL EXPENSES:
2004	$2,644,912	$249,936	$1,078,128			$138,878		$613,448	$180,403		$116,425	$25,613	$2,588,666
2005	$4,422,241	$1,183,122	$1,558,065			$232,174		$817,259	$294,190		$126,003	$29,143	$2,892,900
2006	$3,483,429	$528,993	$1,384,442			$181,593		$755,858	$285,582		$147,441	$41,553	$2,982,663
2007	$5,273,976	$976,965	$1,715,580			$428,979	$535,984	$759,631	$410,459		$183,651	$92,105	$4,337,249
2008	$5,735,515	$914,052	$1,652,725	$459,382		$514,521	$520,477	$682,409	$201,971		$237,879	$129,320	$5,099,589
2009	$5,776,888	$1,319,917	$1,566,464	$597,616		$592,361	$388,662	$531,163	$79,863		$293,024	$120,800	$4,960,144
2010	$5,202,906	$402,244	$1,211,565	$1,070,025		$373,664	$345,978	$573,604	$678,586		$324,236	$136,046	$5,051,436
2011	$9,160,436	$1,159,391	$1,162,766	$995,000	$2,621,222	$652,516	$290,797	$596,215	$1,065,006		$310,047	$217,910	$7,560,614
2012*	$8,436,122	$594,602	$1,985,963		$3,137,094	$699,086	$213,768	$519,665	$905,502	$263,899	$302,552	$286,807	$8,867,331

*2012 figures are dervived from the organization's 2012 Form 990 and unaudited Income Statement.

In 2012 Aviation and Space Admissions were combined and a new income catergory was created for Catering.

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