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Trustees under the Will and of the Estate of
Bernice Pauahi Bishop, Deceased

IN THE CIRCUIT COURT OF THE FIRST CIRCUIT

STATE OF HAWAII

In the Matter of the Estate of BERNICE P. BISHOP, Deceased.	Equity No. 2048 (KSCC) RESPONSE OF THE INTERIM TRUSTEES OF KAMEHAMEHA SCHOOLS TO REPORT OF MASTER ROBERT RICHARDS REGARDING RETENSION OF NON-STAFF COUNSEL; AFFIDAVIT OF COLLEEN I. WONG; EXHIBITS "A"-"B"; CERTIFICATE OF SERVICE Hearing: Date: November 17, 2000 Time: 10:00 a.m. Judge: Kevin S.C. Chang

RESPONSE OF INTERIM TRUSTEES OF KAMEHAMEHA SCHOOLS TO REPORT OF MASTER ROBERT RICHARDS REGARDING RETENTION OF NON-STAFF COUNSEL

I. Introduction

On May 18, 2000, Master Richards filed his Report Regarding Retention of Non-Staff Counsel (the "Richards Report"). Master Richards Report was prepared as a result of a petition filed by former Trustees Jervis and Stender on November 25, 1998, concerning the Board of Trustees decision to retain non-staff legal counsel at Trust expense. The petition asserted that such retention was (a) a waste of Trust assets, (b) a breach of Trustees' duties, and/or (c) constituted a conflict of interest between the personal interests of the Trustees and the best interests of the Trust Estate.

The Richards Report addresses these issues for the time period August 1998 to May 1999. August 1998 is the beginning of the period reviewed by Master Richards because on August 7, 1998, Master Matsumoto filed a report critical of the Trustees' past conduct and in early September the Attorney General ("AG"), acting in her role as *parens patriae*, sought interim removal, permanent removal, and surcharges for alleged past misconduct. May 1999 was selected as the end date for the Richards' review period because that date corresponds to the date on which the former Trustees were temporarily removed and the Interim Trustees were appointed.

Prior to the filing of the Richards Report in May 2000, the Interim Trustees had begun their own review of the services provided by certain outside providers, including some of the providers addressed in the Richards Report. The Interim Trustees' review was broader than the Richards Report, both in terms of the review period and the issues reviewed. The Interim Trustees' review covered the period July 1, 1989 through May 7, 1999, which corresponds to the beginning of the period examined by the IRS through the date on which the former Trustees were temporarily removed and the Interim Trustees were appointed. All of the issues considered by Master Richards were considered in the Interim Trustees independent review, and the independent review also reviewed issues not examined in the Richards Report.

Master Richards concludes that all of the fees expended by the former Trustees in responding to the IRS audit issues, as well as the fees expended with regard to the AG's investigation and the AG's removal and surcharge petition, are surchargeable to the former Trustees. He further states that, should surcharges be ordered and one or more of the former Trustees is unable to pay, a refund might be in order with respect to certain services provided by two outside law firms, Verner, Liipfert, Bernhard, McPherson & Hand ("Verner Liipfert") and Cades Schutte Fleming & Wright ("Cades Schutte"), should "an interested party file an appropriate action."

All surcharge claims against the former Trustees have now been settled. That settlement was approved by the Probate Court on October 12, 2000. As a consequence, the question of surcharge claims addressed in the Richards Report is now moot, and we offer no comments on that particular question. Under the terms of the settlement, all claims that the former Trustees or the Attorney General, acting as *parens patriae*, have against any outside provider of professional services have been assigned to the Interim Trustees. Thus, the remaining issue is whether the Interim Trustees, as the only "interested party," have claims against any of the outside providers and, if so, whether such claims should be pursued.

The Probate Court requested comments on the Richards Report by November 3, 2000. Before providing their comments on the Richards Report, the Interim Trustees will first describe the independent review that they undertook with respect to various outside service providers.

II. The Interim Trustees' Review of Outside Service Providers

KS's Chief Executive Officer (Dr. Hamilton I. McCubbin) requested outside counsel (Morgan Lewis & Bockius ("Morgan Lewis")) to conduct a comprehensive review of the work done by certain outside providers of professional services to the former Trustees. (Hereinafter the provider review commissioned by the Interim Trustees will be referred to as the "Provider Review.") The Provider Review focused on Verner Liipfert, Cades Schutte, Ashford & Wriston, McCorriston Miller Mukai MacKinnon, Pitluck Kido Sato & Stone, and PricewaterhouseCoopers (hereinafter referred to collectively as the "Providers").

The focus of the Provider Review was somewhat different than that of Master Richards' review. Master Richards focused principally on whether the fees paid to outside providers of professional services should be surcharged to the former Trustees. Dr. McCubbin asked Morgan Lewis to provide the Interim Trustees with its legal opinion as to whether there is a basis, under rules of professional responsibility and other ethical rules, applicable statutory and case law, and relevant principles of trust law, for the KS Trustees to conclude that they should discontinue using the services of one or more of the providers and whether, as a result of the prior services, KS has any monetary claims, including claims for disgorgement of fees, that should be pursued against any of these providers.

To define the scope of the Provider Review, outside counsel reviewed all available documents that raised allegations of misconduct by the former KS Trustees during the ten-year review period. These documents included the following:

1. Interim Trustees' Amended Petition for Removal;
2. Interim Trustees' Trial Memorandum and Proposed Findings of Fact and Conclusions of Law;
3. IRS Forms 5701, Notices of Proposed Adjustment:
    a. Primary Purpose;
    b. Inurement;
    c. Private Benefit;
    d. Unreasonable Compensation; and

e. Pauahi Holding Company and Subsidiaries.

4. Second Amended Petition of the Attorney General on Behalf of Trust Beneficiaries to Remove and Surcharge Former Trustees;

5. Judge Hirai's Findings of Fact, Conclusions of Law, and Order Granting the Attorney General's Request for Interim Removal of Henry Haalilio Peters and Richard Sung Hong Wong (August 31, 1999);

6. Judge Weil's Findings of Fact and Conclusions of Law with Respect to Judge Weil's Order Reaffirming the May 6, 1999 Order Granting the Petition for the Removal of Trustee Marion Mae Lokelani Lindsey (June 10, 1999);

7. Patrick Yim's Final Report of Fact Finder (December 4, 1997);

8. The Report of the Visiting Committee of the Western Association of Schools and Colleges, March 9-12, 1998;

9. Master's Report on the 109th Annual Account of the Former Trustees;

10. Master's Consolidated Report on the 109th, 110th, and 111th Annual Accounts of the Former Trustees;

11. Master's First Supplemental Report on the 109th, 110th, and 111th Annual Accounts of the Former Trustees;

12. Master's Second Supplemental Report on the 109th, 110th, and 111th Annual Accounts of the Former Trustees;

13. Master's Third Supplemental Report on the 109th, 110th, and 111th Annual Accounts of the Former Trustees;

14. Attorney General's Campaign Spending Report (April 13, 2000); and

15. Report of Master Regarding Retention of Non-Staff Counsel (May 18, 2000).

Based on its review of these documents, Morgan Lewis catalogued all of the activities of the former Trustees alleged to have been improper. Outside counsel also sought and obtained input from the current and former AG's, and from other interested third parties, regarding additional areas that should be examined as part of the review. Once this initial review process was complete, outside counsel focused their review on the following key areas:

1. Excessive Trustee compensation;
2. Investigations into change of domicile and tax status;
3. Lobbying with respect to proposed legislation affecting compensation;
4. Instances of alleged and documented self-dealing;
5. Non-compliance with Orders of the Probate Court;
6. Neglect of the Trust's educational mission and mismanagement of the Schools;
7. Deficiencies in financial and educational strategic planning for the Schools;
8. Mismanagement of Trust assets;
9. Allegations of private inurement;
10. Failure to operate the Trust exclusively for educational purposes;
11. Allegations of private benefit; and
12. Miscellaneous allegations and information received during interviews.

Once the key areas for review were identified, outside counsel determined whether any of the Providers had been involved in any of these areas by interviewing each of the Providers, as well as third parties, and by reviewing each Provider's files of work performed for KS during the ten-year review period. The files reviewed included retention letters, billing records, internal memoranda, correspondence and pleadings files, files maintained by the KS Legal Group relevant to each Provider and each area under review, the personal logs of the former General Counsel of KS, all outside legal opinions provided to KS and/or the former Trustees during the review period, and investment files and due diligence files relating to investment losses suffered by KS and its taxable subsidiaries during the review period. Counsel also reviewed all of the files that were made available to Master Richards for his review. In total, counsel reviewed approximately 370 bankers boxes of files (approximately 930,000 pages of material).

In addition, outside counsel interviewed more than 50 individuals who possessed potentially relevant information. In total, counsel conducted over 200 hours of interviews. In addition to the principal professionals at each of the Providers, the interviews included the Interim Trustees, counsel for some of the former Trustees, current and former KS employees, members of the Hawaiian community, representatives of KS alumni groups, the current AG and his staff, the former AG, persons identified by the current and former AG as having potentially relevant information, KS's current and former internal auditor, persons familiar with the scope and purpose of Probate Rule 42, and the current and former court-appointed Masters. To encourage candor, these interviews were conducted on a not-for-attribution basis.

Based on the documents that were reviewed and the interviews that were conducted, outside counsel determined the material facts on which reliable conclusions could be drawn. To ensure that they applied the proper legal standards in drawing conclusions from these facts, counsel retained the services of Professor John Langbein of Yale Law School and Professor John Leubsdorf of Rutgers Law School. Professor Langbein is a nationally recognized expert on trust law and trust administration. Professor Leubsdorf is a nationally recognized expert on legal malpractice and professional responsibility issues, and served as Associate Reporter for the Restatement of the Law Governing Lawyers. Early on in the review process, outside counsel met with Professors Langbein and Leubsdorf separately for day-long discussions of the legal principles applicable to the activities under review. Thereafter, counsel requested and received written reports from each of these professors articulating the legal standards applicable to the

Provider Review. Finally, to ensure that counsel correctly applied these legal standards in reaching the conclusions set forth in the report, counsel provided a draft of its report to Professors Langbein and Leubsdorf for their review, and ultimately received letters from each of them agreeing with the manner in which the applicable legal standards were applied to the findings of fact contained in the Report.

At the conclusion of its review, Morgan Lewis determined that there were no claims against any of the Providers, or that where potential claims existed, pursuit of such claims would not be in the best interest of the Trust Estate. Morgan Lewis also determined that, except with respect to Verner Liipfert, there was no reason why the Trust Estate could not continue to use the services of these firms in the future. Thereafter, Morgan Lewis briefed Dr. McCubbin and the Interim Trustees on its findings and conclusions; the AG also has received a briefing. Morgan Lewis' Final Report, dated October 31, 2000, was then forwarded to Dr. McCubbin. Based on his review of the Final Report, Dr. McCubbin sent a memorandum to the Interim Trustees, recommending that they adopt the findings and conclusions set forth in Parts V and VI of the Final Report. At a meeting of the Interim Trustees held on November 2, 2000, the Board of Trustees approved a resolution, adopting the findings and conclusions reached in the Final Report, including the findings and conclusions that there were no claims against the Providers or that any potential claims not be pursued. *See* Exhibit A hereto (November 2, 2000 Board Resolution). The Interim Trustees also directed that the Board Resolution and the Final Report be filed with the Probate Court and that copies be made available to the Attorney General, Masters Matsumoto, Matsubara, and Richards, as well as the Providers reviewed in the Final Report. A copy of the Final Report is attached hereto as Exhibit B.

III. <u>The Interim Trustees' Comments on the Richards Report</u>

The Final Report analyzes services provided by the two firms (Cades Schutte and Verner Liipfert) that Master Richards identified as possible candidates for refunds. After a thorough analysis of the applicable legal principles and of the underlying facts and documents, the Final Report concludes that no claims should be asserted against either firm.

In the case of Cades Schutte, Master Richards principally questions the work done in connection with the AG's investigation and the AG's subpoenas, particularly insofar as that work related to the production of KS documents. As reflected in the analysis of the Cades Schutte firm (Part V, Section Two of the Final Report), Cades Schutte was assigned the primary responsibility for document production to the AG. The work that Cades performed was not duplicative of the work of others, and Cades had the capacity to respond to the AG's voluminous document requests in a timely fashion. The hours billed and fees charged by Cades were not unreasonable given the massive volume of documents required under the AG's subpoenas. Without the effort undertaken by Cades, the response to AG subpoenas would have been delayed significantly. In addition, the determination and assertion of the attorney-client privilege were challenged by the AG and upheld by the Probate Court, but required significant effort on Cades' part. Furthermore, there is no question that the work undertaken by Cades was authorized by the General Counsel or the Board of Trustees acting as a collective body. Cades was entitled to rely upon the representations that this work was authorized, and no reason was found to question the legitimacy of the work. The conclusions reached in the Final Report are supported by opinions of Professors Langbein and Leubsdorf, which are attached to the Final Report as Appendices A-D and also described in Part IV of the Report.

In the case of Verner Liipfert, Master Richards states that much of the work that he reviewed was of no benefit to the Trust and was designed solely to address allegations of Trustee misconduct or errors of judgment. The principal work performed in the period covered by the Richards Report related to efforts to justify to the Master and the Probate Court the lobbying on intermediate sanctions legislation, including the review and indexing of files, evaluation of attorney-client privilege issues, and the drafting of documents for filing with the Master and the Probate Court. As reflected in the Final Report (Part V, Section Five), this work presents a difficult issue as to whether Verner Liipfert breached a duty of candor to the tribunal in the submissions made to the Master and the Court. The Final Report states that a potential claim exists, but recommends that KS not assert such a claim. The Final Report states that there are substantial legal and factual obstacles to sustaining a claim against Verner Liipfert for a lack of candor to the Master and the Court. After coupling those obstacles with the cost of prosecuting such an action, and then comparing this to the potential recovery, the Final Report recommends against pursuing the claim. The Final Report recommends, however, that Verner Liipfert not be considered for future work based on its past work for KS. The conclusions reached on Verner Liipfert are likewise supported by the Langbein and Leubsdorf opinions attached to the Final Report.

Matters of trust administration fall within the Trustees' "good faith discretion." Restatement (Second) of Trusts § 187 (1959). The decision whether to pursue a legal claim or claim for disgorgement is a matter of trust administration and falls with the Trustees' sound discretion. *See Richards v. Midkiff*, 48 Haw. 32, 54, 396 P.2d 49, 61 (1964).

In deciding whether to pursue a claim on the Trust Estate's behalf, the Interim Trustees must consider the likelihood of success and potential for recovery, as compared to the costs of bringing such an action. The Supreme Court of Hawaii has previously addressed this issue in a case involving KS:

> Trustees are under a duty to the beneficiaries to take all reasonable steps to realize claims held in trust. However, they have no duty to bring an action to enforce a claim pertaining to the trust property if it appears unreasonable to do so either because the action might be unsuccessful or would involve an expense disproportionate to the possibility of success. Restatement (Second), Trusts, § 177, comment c. The best interest of the trust estate is the criteria in all cases.

Richards, 48 Haw. at 53, 396 P.2d at 61. Accordingly, the Interim Trustees must evaluate whether, given all circumstances surrounding a legal claim or claim for disgorgement, the claim is worth pursuing. Because the decision whether to pursue a legal claim is within the Trustees' sound discretion, the decision "is not subject to review in the absence of a showing of an abuse of discretion." *Richards*, 48 Haw. at 56, 396 P.2d at 62.

As reflected in the attached Resolution (Exhibit A hereto), the Interim Trustees have exercised their discretion and adopted the findings and conclusions contained in Parts V and VI of Morgan Lewis' Final Report. The Interim Trustees believe that their action is reasonable, in the best interest of KS, and a sound exercise of their discretion.

As a final note, there is a tendency on the part of some to evaluate the actions of KS's professional advisors and the actions of the former KS Trustees under the same set of standards and to lump the actions of these separate actors together. Professional advisors are subject to different standards, however, and it is not in the long-term interests of KS to require outside legal advisors to second-guess the motives of clients seeking advice. As reflected in Part IV of the Final Report, outside advisors should be entitled to rely on requests for legal assistance and advice unless it is clear that there is no legitimate Trust Estate interest involved. As to the former Trustees, it is important to recognize that established mechanisms for monitoring, controlling, and correcting their improper actions functioned appropriately in this case. As Professor Langbein observed in his October 30, 2000 letter (Appendix C to the Final Report), the improper actions of the former Trustees were detected, and the former Trustees were relieved of their stewardship of the Trust Estate. In short, the legal system worked. The Interim Trustees are on record as strongly disapproving of the conduct of the former Trustees, and nothing in these comments is intended to minimize or condone that conduct in any respect.

IV. Conclusion

The surcharge claims against the former Trustees have been settled and the Interim Trustees, as the only remaining "interested party," have determined not to pursue any claims against Cades Schutte or Verner Liipfert. The Interim Trustees in the exercise of their discretion request that the Court consider the findings and recommendations contained in the attached Final Report, along with the Richards Report, and conclude the Interim Trustees reached a sound and reasonable decision not to pursue any claims against Cades Schutte or Verner Liipfert.

DATED: Honolulu, Hawaii, November 3, 2000.

Respectfully submitted,

MELVYN M. MIYAGI
Attorney for Robert Kalani Uichi Kihune, David Paul Coon, Francis Ahloy Keala, Constance Hee Lau and Ronald Dale Libkuman, Trustees under the Will and of the Estate of Bernice Pauahi Bishop, Deceased

IN THE CIRCUIT COURT OF THE FIRST CIRCUIT

STATE OF HAWAII

In the Matter of the Estate of BERNICE P. BISHOP, Deceased.	)	Equity No. 2048 **AFFIDAVIT OF COLLEEN I. WONG; EXHIBITS "A" - "B"**

AFFIDAVIT OF COLLEEN I. WONG

STATE OF HAWAII)
) SS:
CITY AND COUNTY OF HONOLULU)

COLLEEN I. WONG, being first duly sworn on oath, deposes and says:

1. I am an attorney licensed to practice law in the State of Hawaii and the Chief Legal Officer of the Kamehameha Schools.

2. That attached hereto as Exhibit "A" is a true and correct copy of the Resolution of the Interim Trustees of the Kamehameha Schools approving the findings and conclusions set forth in Parts V and VI of the October 31, 2000 Final Report of Morgan Lewis & Bockius LLP, executed November 2, 2000.

3. That attached hereto as Exhibit "B" is a true and correct copy of the Morgan Lewis & Bockius LLP Final Report, dated October 31, 2000.

FURTHER AFFIANT SAYETH NAUGHT.

Colleen I. Wong

COLLEEN I. WONG

Subscribed and sworn to before me
this 3rd day of November, 2000.

Sandra K. Kamiya

Type or Print Name: ______________
Notary Public, State of Hawaii

My commission expires:

SANDRA K. KAMIYA
Notary Public, State of Hawaii
My Commission expires January 20, 2002

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