PART III: KEY AREAS UNDER REVIEW

I. INTRODUCTION

Prior to our review of each Provider, we identified areas of alleged misconduct by the former Trustees during the Review Period and determined whether each Provider had any involvement in those areas. To identify those key areas, we examined various documents made public during the past three years that raised allegations of misconduct by the Trustees during the Review Period. Moreover, we reviewed the findings made by Judges and Masters in the proceedings in the Probate Court involving KS and the Former Trustees.[6] Finally, we examined carefully the findings and conclusions contained in the Report of Master Regarding Retention of Non-Staff Counsel, filed by Master Robert Richards.

We believe that this Part of our Report provides the reader with the context necessary to understand the issues on which we focus our analysis, in Part V of this Report, of services rendered by the Providers. In Part V of this Report, we do not address each of the following allegations with respect to each Provider; rather, we limit our discussion to those areas in which each Provider's representation intersected with these key areas.

II. ALLEGED AND DOCUMENTED BREACHES OF FORMER TRUSTEES' DUTIES OF LOYALTY AND PRUDENCE

A. Excessive Compensation

1. Allegations that the Former Trustees breached their fiduciary duties by paying themselves excessive compensation.

Until January 1, 1999, the compensation of the Former Trustees was limited by state statute, which contained a percentage schedule prescribing the maximum commissions payable

[6] Part I of this Report provides a list of most of these documents. We also note additional documents throughout the rest of this Report.

to trustees based on varying percentages of revenue or income. Master's Consol. Rpt. at 114-15. The Master asserted that, because of major growth in the Trust Estate's revenues since the early 1980's, the statutory formula "consistently yielded a maximum permitted commission substantially in excess of what the Trustees actually received." *Id.* at 115. For example, applying the statutory schedule, the Former Trustees as a group were entitled to a statutory maximum of $11,377,484 for fiscal year 1994, $7,514,218 for fiscal year 1995, and $5,810,214 for fiscal year 1996. *Id.* at 116. The court-appointed Master had first voiced concerns about the potential of KS Trustees to take excessive compensation during his review of the 1990 and 1991 annual accounts for the Trust Estate's 1990 and 1991 fiscal years. ITTM at 7. In his approval of these accounts, the Master noted that the state law formula for computing trustee commissions was yielding consistently higher and higher permissible amounts of KS Trustee commissions owing to the aforementioned significant increase in Trust Estate income. *Id.* at 7. The Master advised the KS Trustees to consider voluntarily adopting another mechanism for determining annual compensation—one that was independent of the statutory formula and would ensure that Trustee compensation was reasonable and appropriate. *Id.* at 7-8. "For many years, the Former Trustees "waived" commissions and paid themselves (amounts) less than the maximum amounts permitted by statute." Master's Consol. Rpt. at 115. According to Master Matsumoto, this practice presumably reflected an attempt by the Former Trustees to pay themselves a "reasonable" compensation, notwithstanding what the statutory formula permitted. *Id.*

In 1993, Mark McConaghy of PWC briefed the Former Trustees on a recent U.S. House of Representatives Ways and Means Subcommittee hearing on abuses by tax-exempt organizations. ITTM at 8; ITFF at 16, ¶ 46. During this briefing, the Former Trustees were informed that members of the U.S. Congress had raised concerns about the high levels of compensation paid to insiders of charitable organizations, including KS Trustees. ITTM at 8; ITFF at 16, ¶ 46. In early 1994, the IRS Los Angeles District Office questioned the reasonableness of the Former Trustees' compensation in a request for technical advice submitted to the IRS National Office. ITTM at 8; ITFF at 16, ¶ 47. In the wake of this scrutiny by the IRS, the Former Trustees raised their compensation from $823,974 each for fiscal year 1993 to $915,238 each for fiscal year 1994. ITTM at 8; ITFF at 15-16, ¶ 45.

Although it declined to provide technical advice on the reasonableness of the Former Trustees' compensation, the IRS National Office informed the Former Trustees that the IRS would conduct a formal audit of KS and that the reasonableness of their compensation would be one of the issues examined. ITTM at 8; ITFF at 17, ¶ 49. The National Office also advised the Former Trustees that the IRS would not defer to maximum commission levels set by state statute, nor would it accept compensation studies that did not use comparable data from other educational institutions (as opposed to exclusively for-profit comparables). ITTM at 8; ITFF at 17, ¶ 49. The Former Trustees once again increased their compensation, from $915,238 to $938,047 each for fiscal year 1995. ITTM at 8; ITFF at 15-16, ¶ 45.

Following the passage of the intermediate sanctions legislation in 1996, Mark McConaghy of PWC briefed the Former Trustees on the legislation's provisions and the limits it placed on trustee compensation. ITTM at 11; ITFF at 18, ¶ 52; *see also* AG Petition at 32, ¶ 169. McConaghy informed the Former Trustees that, in examining trustee compensation, the IRS would examine the reasonableness of each Trustee's compensation individually. McConaghy also informed the Former Trustees that the qualifications of each Trustee would be examined and would be a factor in the IRS's consideration of the reasonableness of their compensation. The Interim Trustees alleged that, despite this briefing, the Former Trustees took no action to comply with the applicable federal tax law standards. ITTM at 11; ITFF at 18, ¶ 52. Rather, they paid themselves over $843,000 each in fiscal years 1996 and 1997, and more than one million dollars each in fiscal year 1998. ITTM at 7-8; ITFF at 15-16, ¶ 45. Moreover, for the first nine months of Fiscal Year 1999, the Former Trustees each took approximately $735,420 in compensation, which if continued through the end of the fiscal year would have resulted in individual Trustee compensation exceeding $1 million. IT Removal Petition at 20, ¶ 74. The AG alleged that the Former Trustees violated federal and state law by accepting excessive compensation after the effective date of the intermediate sanctions provision and after the revision of the Hawaii state statute governing trustee compensation that implemented a "reasonableness" standard. AG Petition at 64, ¶ 301.a.

The Interim Trustees asserted that the levels of compensation that the Former Trustees paid themselves could not be justified on the basis that the compensation paid was within the amount allowed under state statutory law. ITTM at 12. The power to take compensation up to the statutory maximum is not the same thing as the prudent exercise of that power. The Interim Trustees' expert in trust law and trust administration opined that:

> the standard of reasonable compensation in the common law of trusts speak[s] directly to the fiduciary duty of the trustees to limit their compensation when the ceiling under a state-law formula would be higher . . . Statutes such as [the statute setting maximum allowable trustee commissions under Hawai'i state law], which merely set a ceiling on trustee compensation, are permissive rather than directory in character. They constitute a species of trustee power. But there is a critical difference between having a power and exercising it properly.

ITTM at 13; *see also* AG Petition at 32, ¶ 167.[7]

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[7] The AG also alleged that the Trustees changed their interpretation of how losses were treated in applying the statutory commission formula in order to increase their level of "permissible" commissions. AG Petition at 33, ¶ 173.

In sum, allegations have been made that since the early 1990s, the Former Trustees paid themselves excessive levels of compensation despite clear concerns about the imprudence or impropriety of such practices raised by the court-appointed Master, the IRS, the United States Congress, and the Hawaii State AG. ITTM at 7; AG Petition at 34, ¶ 176. The AG asserted that the Former Trustees' compensation was "unreasonable and excessive both in the abstract and for these particular Trustees." AG Petition at 34,¶ 176. By way of comparison, the compensation study prepared by the Interim Trustees' compensation expert for the removal proceeding established a reasonable range of compensation for the period 1992-98 of $217,000 to $317,750 per Trustee per year. ITTM at 15; ITFF at 19, ¶ 54. The AG and the Interim Trustees alleged that the Former Trustees breached their fiduciary duties by taking unreasonable compensation. ITTM at 13, 23; AG Petition at 32, ¶ 167; 36, ¶ 183.

2. Allegations that the compensation studies that the Former Trustees commissioned were deficient.

Pursuant to a court order, the Former Trustees were required, beginning with fiscal year 1993, to commission compensation studies every three years. Master's Consol. Rpt. at 117. In 1993, the Former Trustees commissioned Strategic Compensation Associates ("SCA") to perform an assessment of trustee compensation. SCA issued its report on trustee compensation on April 30, 1993. *Id.* at 117. During fiscal year 1996, the Former Trustees commissioned two compensation studies: the Towers Perrin Report (March 15, 1996) and the SCA Consulting Report (June 1996). *Id.* at 117. Master Matsumoto was unable to determine why two compensation studies were commissioned and paid for at considerable expense to the Trust Estate for fiscal year 1996. *Id.* at 117-18 n.39. The Master asserted that, pursuant to the applicable order of the Probate Court, KS Trustees were to commission "a single study to be done by one or more experts." Master's 1st Rpt. at 32.

The Towers Perrin Report opined that "the competitive annual compensation for KSBE Trustees" was within a range of \$683,000 to \$758,000 at the median (or 50th percentile) and \$921,000 to \$1,021,000 at the 75th percentile for each of the five Former Trustees. Master's Consol. Rpt. at 118. The SCA Consulting report concluded that "a cumulative annual compensation range of \$3.5 million to \$5.5 million (for the five Former Trustees as a group) appears reasonable and appropriate." *Id.* "Both studies employed measures based on an aggregation of governance and management functions by the (Former) Trustees." *Id.* The SCA Consulting Report is premised on the Former Trustees functioning as "both senior operating executives and as a Board of Directors." *Id.* The Towers Perrin Report is premised on the Former Trustees collectively performing "what would be five distinct and separate roles in other organizations: Board of Directors; Chief Executive Officer (CEO); Chief Operating Officer (COO); Chief Financial Officer (CFO); and Treasurer (investment function)." *Id.* The Master asserted that in the absence of this collective-governance-and-management premise, the conclusion reached by the two studies would be different. *Id.* at 119. The Master asserted that "neither report examined qualifications, experience, nor performance as a criteria for compensation." *Id.* at 118 n.40.

Moreover, owing to the collective-governance-and-management premise upon which each compensation study was based, the Master suggested that the issue of compensation may have improperly influenced decision-making by the Former Trustees regarding what constitutes the most appropriate and effective organizational structure for the management and operation of the Trust Estate. *Id.* at 119-21. For example, establishing a CEO-based management structure would undermine the collective-governance-and-management argument that the Former Trustees proffered to support their high levels of compensation. *Id.* at 110.

Given the impact that such decisions could have on the level of their compensation, the Master asserted that the Former Trustees faced an inherent conflict of interest in making organizational decisions affecting the management and operation of the Trust Estate. *Id.* at 121.

The AG, the IRS, and the Interim Trustees also alleged that these compensation studies were flawed. In addition to the deficiencies in these studies that Master Matsumoto pointed out, the Interim Trustees asserted that none of the reports mentions that the Former Trustees employed a lead trustee system (which calls into question their collective-government-and-management premises). ITTM at 14. Furthermore, the SCA and Towers Perrin studies both determine compensation based exclusively on for-profit comparables, such as private real estate investment trusts, even though KS is a public charity. ITTM at 14; Unreasonable Compensation NOPA at 58-62; AG Petition at 34-35, ¶ 179. By contrast, the Report on Trustee Compensation, prepared by the Interim Trustees' compensation expert, Mr. Martin L. Katz of William Mercer, Inc., considers the factors required for determining the reasonableness of compensation for federal tax law purposes. Mr. Katz's report also accounts for both nonprofit and for-profit market comparables in determining the reasonableness of compensation. Like Master Matsumoto, his analysis criticizes the aggregate approach to determining compensation used in the Former Trustees' compensation studies. Mr. Katz's report concludes that while the Former Trustees were qualified for governance roles, they were not qualified (with the possible exception of Trustee Stender) to act as CEOs, CFOs, CIOs, etc. ITTM at 15; ITFF at 19-20, ¶ 54. The AG also alleged that the compensation the Former Trustees received "cannot be justified by their qualifications, experience, expertise, performance, or other positive qualities." AG Petition at 35, ¶ 181.

Nor did the Former Trustees completely follow the advice of Towers Perrin, which concluded that compensation at levels in excess of $758,000 could not be justified absent pre-established performance criteria. Although the Former Trustees had no established performance criteria, they proceeded to pay themselves well in excess of Towers Perrin's stated upper limit of $758,000 in fiscal years 1996 through 1998. ITTM at 7-8; ITFF at 15-16, ¶ 45; 18, ¶ 51.

3. Allegations that asset transfers were made to preserve Trustee commissions.

The IRS and the AG alleged that the Former Trustees caused a number of the Trust Estate's losing investments to be transferred from the Trust Estate to its taxable subsidiaries to prevent a negative impact on trustee commissions. Primary Purpose NOPA at 164; PHC NOPA at 132, 138; AG Petition at 14, ¶ 61; 33, ¶ 173. As discussed above, Hawaii statutory law in effect at the time of the transfers provided a formula that produced a ceiling on trustee commissions. The statutorily determined commission was based on a percentage of (1) monies received from revenue or income of the Trust Estate and (2) monies received into or disbursed out of the Trust Estate's principal. PHC NOPA at 84-85. According to the IRS, KS developed policies and practices for computing trustee commissions based on this statutory formula. *Id.* at 84. Under these policies and practices, total commissionable capital transactions were reduced by any capital losses realized from the sale or disposition of an investment. *Id.* at 85. The IRS thus argued that the Former Trustees transferred loss-producing investments to taxable subsidiaries to avoid a negative impact on the level of allowable commissions under the statutory formula (and established KS practices) for determining trustee commissions. The IRS further implied that the Former Trustees chose not to write down a number of the investments for which a loss was expected because, under KS commission policies and practices, "[a] permanent write-down or write off of the investments by KS/BE could have resulted in a reduction in the amount of allowable commissions payable to the five trustees." *Id.* at 138. Moreover, the AG alleged that the Former Trustees failed to decrease their commissions when some of the investments were transferred back to the Estate. AG Petition at 33, ¶ 173.

The IRS identified the following as being transferred for non-bona-fide business reasons: Pembridge; Tribeca, L.P.; Best Products, Inc.; Accessory Place, Inc.; Hanford's/Nationwide; SNAP Products, Inc.; Kukui, Inc.; and Autofuel (or "AFCO").

B. Investigations Into Change of Domicile and Tax Status

The Interim Trustees asserted that the Former Trustees expended Trust Estate assets to investigate ways in which they might avoid monitoring of their conduct by the Hawaiian courts, the state legislative and executive branches (specifically, the AG), and the IRS. Beginning in early 1995, the Former Trustees expended over a quarter of a million dollars of Trust Estate funds to examine: (1) whether they could move the domicile of the Trust Estate out of Hawaii to avoid what they perceived as undesirable interference in Trust Estate affairs by the court-appointed Master and the Office of the AG; and (2) whether they could change the tax status of the Trust Estate from tax-exempt to taxable, to avoid the monitoring of their conduct by the IRS and the limitations that the federal tax law placed on their ability to engage in activities that did not exclusively further KS's educational mission. IT Removal Petition at 18, ¶ 65; 21, ¶ 76; ITTM at 16-17.

In January 1995, before beginning their lobbying efforts with respect to the proposed intermediate sanctions legislation, the Former Trustees retained Verner Liipfert to investigate the possibility of changing KS's domicile. ITTM at 17; ITFF at 20, ¶ 55. The Former Trustees informed Verner Liipfert that they were interested in moving the Trust Estate out of Hawaii because of increased scrutiny of their actions by the AG, the legislature, and court-appointed Masters who reviewed KS's annual accounts. The Former Trustees were also concerned that the state legislature might reduce their compensation. ITFF at 20, ¶¶ 55-56; ITTM at 17. The Former Trustees asked Verner Liipfert to determine if the Trust Estate could be moved to a more "favorable" jurisdiction, one with less government oversight, fewer restrictions on trustee compensation, and more limited personal liability. ITTM at 17.

The Former Trustees also instructed Verner Liipfert to explore moving the trust to a tribal reservation because Indian nations were ostensibly able to operate without interference from state or federal law. Douglas Adler, the partner at Verner Liipfert in charge of the project, contacted the Cheyenne River Sioux Nation and informed its general counsel that KS was considering a change in its domicile. Adler relayed the Former Trustees' concern that KS was currently subject to intense scrutiny by the state legislature and AG in its present location. Adler identified a number of factors that were important to the Former Trustees in determining hospitable alternative domiciles, including: the degree of trustee liability; the required scope of fiduciary duties; restrictions on trustee compensation; the scope of the state AG's review; the extent of intervention by the state legislature; and restrictions on trust involvement in business transactions. ITFF at 20-21, ¶ 58; ITTM at 17-18. In September 1995, Adler met with Trustee Wong, who described the transfer of domicile project as "an explosive issue, political dynamite." Trustee Wong instructed Adler to prepare all of the papers necessary for the transfer, but to "leave [it] on [the] shelf" until the Former Trustees made a decision whether to go forward with the transfer. ITTM at 18; ITFF at 22, ¶ 62.

The Interim Trustees also alleged that, in conjunction with its domicile project, Verner Liipfert also examined converting KS to a taxable entity. In a June 2, 1995 memo, Verner Liipfert identified benefits to converting to taxable status, which included: the avoidance of federal and state scrutiny as a public charitable organization; the ability to pursue aggressively the production of income; and the evaluation of trustee compensation solely by reference to state law. ITTM at 18; ITFF at 21, ¶ 59. The Former Trustees' concern over the "exit tax," which the Former Trustees attempted to use to justify their lobbying efforts against the proposed intermediate sanctions legislation—discussed below—first arose during their consideration of a voluntary conversion of KS from tax-exempt to taxable status—not in the context of intermediate sanctions. IT Removal Petition at 19-20, ¶ 70; ITTM at 10; ITFF at 25, ¶ 71. The Former Trustees' wished to voluntarily relinquish KS's tax-exempt status to escape the restrictions imposed by federal tax law on their levels of compensation and on their freedom to engage in unfettered commercial and political activities. ITTM at 11. The possibility that Congress might include an "exit tax" in upcoming legislation was viewed as an impediment to converting KS to a taxable entity. ITTM at 11; ITFF at 25, ¶ 71.

The Interim Trustees and the AG asserted that these investigations into relocating KS's domicile and relinquishing its tax-exempt status were not in the Trust Estate's best interest. Rather, the Former Trustees' investigations into relocating KS's domicile and changing its tax status were motivated by their desire to rid themselves of the external checks on their behavior, at both the state and federal level. ITTM at 18-19; ITFF at 22, ¶ 63; AG Petition at 59-60, ¶ 287.r. The Interim Trustees alleged that the Former Trustees breached their duties of loyalty and prudence by pursuing these investigations. ITTM at 19.[8]

[8] The AG also alleged that Trustee Jervis received a personal benefit in the form of free legal advice in exchange for directing Trust legal work to Verner Liipfert. AG Petition at 68-69, ¶ 313.

C. Lobbying with Respect to Proposed Legislation Affecting Trustee Compensation

1. Allegations and findings that the Former Trustees lobbied against the passage of, or for self-serving modifications to, the proposed intermediate sanctions legislation.

Legislation was introduced into Congress in September of 1995 that provided for "intermediate sanctions" that could be imposed directly on insiders of tax-exempt organizations—such as KS Trustees—who received income or assets from a charity that exceeded the value of the consideration provided in return (for example, through the taking of excessive compensation). The legislation was intended to benefit tax-exempt organizations by providing an alternative to revocation, but was also intended to personally penalize organization insiders who inappropriately made use of an organization's assets for their personal gain. ITTM at 9; ITFF at 22-23, ¶ 64. Consequently, the Master and the AG asserted that this proposed legislation was beneficial to the Trust Estate in that it would better insulate its tax-exempt status from the consequences of any improper actions by its Trustees. AG Petition at 36, ¶ 184; Master's Consol. Rpt. at 136. The Master found that, without prior court approval, however, the Former Trustees engaged the services of lobbyists and otherwise expended Trust Estate funds to oppose enactment of the intermediate sanctions legislation. Master's Consol. Rpt. at 136; *see also* ITTM at 23; ITFF at 23, ¶ 65.

The Former Trustees retained ex-Governor John Waihee's law firm, Verner Liipfert, and paid Verner Liipfert almost one million dollars to lobby Congress with respect to the intermediate sanctions legislation. ITTM at 9; ITFF at 23, ¶ 65. The Former Trustees' lobbying efforts were initially aimed at removing intermediate sanctions from the legislation in their entirety; later, when it became obvious that the bill could not be defeated, they lobbied for various modifications to the bill. ITTM at 9; ITFF at 24-25, ¶¶ 68-69; AG Petition at 36, ¶ 185.

For example, the Former Trustees unsuccessfully attempted to eliminate language in the Committee Report that clarified that, for purposes of determining whether their compensation was reasonable, "the mere fact that a State or local legislative or agency body may have authorized or approved of a particular compensation package . . . would not be determinative of the reasonableness of [the] compensation paid." Master's Consol. Rpt. at 137.

In 1998, Master Matsumoto sought information from the Former Trustees to evaluate whether the expenditure of funds and other Trust Estate resources for the purposes of initially opposing enactment of the proposed intermediate sanctions legislation and later seeking modifications to the Committee Report were necessary, or appropriate and reasonable, to carrying out the educational purposes of the Trust Estate. In response, the Master received two letters from Ms. Susan Temkin of Verner Liipfert, dated August 3, 1998 and September 18, 1998, respectively, but was not successful in "obtaining the pertinent documents related to the legislative efforts of the [Former] Trustees." Master's 1st Supp. Rpt. at 37. In these letters, the Former Trustees argued that they supported intermediate sanctions, and that they lobbied to defeat the bill only because the legislation as originally proposed contained an "exit tax," which would have required tax-exempt organizations that terminated their exemption to return all of the financial benefits that they had received as a consequence of their tax-exempt status. ITTM at 10; ITFF at 25, ¶¶ 70-71. The Interim Trustees asserted that the Former Trustees continued to try to defeat the legislation, however, even after the "exit tax" provision was removed from the legislation in November of 1995. ITTM at 11; ITFF at 25-26, ¶ 71.

Notwithstanding the attempt by the Former Trustees to justify these lobbying expenditures, the Master concluded that the legislative efforts of the Former Trustees with respect to the proposed intermediate sanctions legislation were "predominately directed at preserving the historical procedure for determining compensation of the Trustees under state statutory law and minimizing the potentially adverse impact that the Intermediate Sanctions legislation would have on their continued ability to receive compensation in accordance with and at the levels permitted under state law." The Master found that the expenditures of funds and other Trust Estate resources for such efforts were therefore not necessary, or appropriate and reasonable, to carrying out the purposes of the Trust Estate; consequently, the Master recommended that the Former Trustees be surcharged for these expenses. Master's 1st Supp. Rpt. at 38.

In a report filed with the Probate Court, the Interim Trustees' expert on the law applicable to exempt organizations noted that the Former Trustees asked Verner Liipfert to respond to this conclusion of the Master. The firm produced a thirteen-page memorandum, which was submitted to the Probate Court on October 15, 1998, along with an affidavit prepared by Trustee Wong attesting to the accuracy of the memorandum. The memorandum states:

> [W]e are not aware of any facts which support the Master's conclusion or the imposition of a surcharge on the KSBE Trustees. On the contrary, an objective, unbiased consideration of the facts demonstrates that their aim was to defeat the disastrous "exit tax" and gain for the Trust objective guidance that the Trust's transactions with disqualified persons, including transactions involving Trustee compensation, would comply with the new statutory requirements.[9]

As noted above, however, the Interim Trustees asserted that the Former Trustees continued to try to defeat the legislation even after the "exit tax" provision was removed. ITTM at 11; ITFF at 25-26, ¶ 71. Accordingly, like the Master, the Interim Trustees asserted that by lobbying against the proposed intermediate sanctions legislation, or for self-serving modifications thereto, the Former Trustees placed their own interests ahead of those of the Trust

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[9] *See* Expert Report of Bruce R. Hopkins, Appendix G, Ex. 49 at 1-2.

Estate and the furtherance of its educational mission, thereby breaching their duties of loyalty and prudence. ITTM at 6-11; ITFF at 26, ¶ 72.

The AG alleged that the Former Trustees also lobbied, advertised, and testified extensively against any change to H.R.S. § 607-20—the state statute setting commissions for trustees of charitable trusts. The AG alleged that Trust Estate resources expended to lobby against the proposed intermediate sanctions legislation and against changes to the state statutory compensation formula were spent "entirely for the benefit of the Trustees and to protect their excessive compensation and not at all for the interests of the Beneficiaries of the Trust." AG Petition at 36-27, ¶¶ 186-87.

D. Other Instances of Alleged and Documented Self-Dealing

1. Allegations that the Former Trustees engaged in political activities.

In its Campaign Spending Report, the AG alleged that the evidence obtained during the AG's investigation indicated that Namlyn Snow, Director of KS's Government Relations Division, "might have violated one or more statutes in her attempts to assist politicians, Bishop Trust Estate trustees, and Bishop Trust Estate employees." CSR at 3. The AG implied that a KS Principal Executive, Yukio Takemoto, used his position at the Trust Estate to leverage financial support for Milton Holt's campaign. *Id.* at 4. The AG also alleged that Milton Holt (also a KS Employee) and Namlyn Snow participated in schemes involving KS vendors that used the vendors to pay for approximately $48,000 in campaign printing expenses of Holt and another Senator, Marshall Ige. "These payments were disguised to appear to be legitimate business expenses for the five vendors," all of which provided architectural or engineering work to the Trust Estate on a non-bid basis. Bogus invoices were sent to these non-bid contractors, who paid them at the direction of Trust Estate employees. The AG alleged that the vendors agreed to pay the invoices because "[t]heir contracts with the Bishop [Trust] Estate were so large that they were worth protecting by paying money to help politicians when Bishop [Trust] Estate employees made requests for the firms to do so." *Id.* at 6-7; *see also* AG Petition at 37, ¶ 188; 38-41, ¶¶ 192-214.

The AG further asserted that the Trust Estate "had an institutional plan for handling fundraiser tickets [that] employees received." According to the AG, employees who received fund raising tickets from politicians "were instructed to forward the tickets to Namlyn Snow," who "would distribute the tickets to Bishop [Trust] Estate Trustees, Bishop [Trust] Estate Employees, or Bishop [Trust] Estate vendors." CSR at 10. The Report also alleges that Milton Holt used his KS credit card to entertain fellow legislators. *Id.* at 12.

The AG further alleged that KS employees were directed to engage in the following political activities, not on their own time, but as part of their official KS duties:

a. Drafting legislative proposals;

b. Creating and/or nurturing key legislative networks;

c. Making personal monetary contributions to campaign committees;

d. Paying for supplies, resource materials and refreshments for special political activities and legislative strategy meetings;

e. Arranging for introduction of state party and civic club convention resolutions;

f. Coordinating and writing legislative committee reports;

g. Drafting legislative amendments and compromise legislation;

h. Writing and submitting letters to the editor;

i. Writing floor speeches for key legislators;

j. Maintaining membership in private clubs and organizations who share similar Hawaiian and property rights interests;

k. Drafting testimony for support network members;

l. Planning, coordinating, and implementing demonstrations, rallies and legislative receptions;

m. Establishing, maintaining, and mobilizing a legislative network;

n. Implementing phone trees, recruiting call-in, letter-writing and/or in-person legislative visits on key issues;

o. Maintaining copies of any correspondence sent or received by members of the networks regarding a number of special issues;

p. Providing manpower for sign holding, door-to-door canvassing, coffee hours, district-wide dinners, membership and strategy meetings;

q. Drafting campaign literature, newspaper ads and radio commercials;

r. Stuffing envelopes; and

s. Undertaking a variety of other campaign-related activities for various federal, state and local candidates.

CSR at 13-15.

The Interim Trustees alleged that to the extent that the Former Trustees directed, or knowingly allowed KS employees to engage in political activities that benefited them personally (*e.g.*, by increasing their political clout), or benefited their former colleagues in the Hawaii legislature or other local political offices, the Former Trustees breached their fiduciary duties. The AG has alleged that all or some of the Former Trustees had knowledge of the Trust Estate's participation in the foregoing, but failed to act to correct the illegal behavior. *Id.* at 18-20; AG Petition at 36-38, ¶¶ 186-91; 41, ¶ 218. The AG also alleged that the Former Trustees expended Trust Estate monies on political polling for the benefit of various politicians, including Joseph "types of expenses reported were unchanged." The IRS asserted that expenses in the amount of $42,875 were composed of personal expenses, unsubstantiated expenses, and expenses that were not "ordinary and necessary for the operation of an exempt school." Expense justifications were "vague at best" and documentation showed that "payments were made to restaurants, strip clubs, and Las Vegas casinos." Private Benefit NOPA at II.C.4; AG Petition at 23-24, ¶¶ 199-20; 24, ¶ 122.

The AG asserted that senior Trust executives informed Trustees Peters and Wong "of the improper nature of the charges and of the difficulties in obtaining payment from Holt and were informed that Holt's employment should be terminated." Trustees Wong and Peters concealed Holt's actions from the other Trustees, however, and rejected suggestions to confiscate the card and to terminate Holt. Rather, in 1994, the Trust gave Holt a retroactive pay increase of $12,325, which, according to the AG, "was not related to the value of Holt's services to the Trust but, rather, was calculated to pay off the improper expenses charged by Holt." The IRS noted that KS reported that $8,328 of the expenses were repaid "through a retroactive pay increase." Private Benefit NOPA at II.C.4; AG Petition at 24, ¶¶ 123-25.

The IRS further asserted that Holt's position summary was "at best vague" and that "he spent a majority of his time influencing Representatives and Senators." The AG asserted that although Holt was paid as a full-time employee, he did not work full time for the Trust Estate. The AG also alleged that the Trust "paid $14,984 to Farella Braun & Martel in San Francisco for Holt's legal bills and paid approximately $600 for Holt's psychologist bills." Private Benefit NOPA at II.C.4; AG Petition at 24, ¶¶ 121, 126.

e. Kalele Kai

In 1990, the Trust Estate leased certain land in Hawaii Kai to Kapalele Associates ("Kapalele"), a Hawaiian limited partnership, for development of a leasehold condominium project to be known as Kalele Kai. The Trust Estate later exchanged its fee simple interest with Kapalele for a $21.9 million recourse note. The development was completed in 1993, but condominium units did not sell at the anticipated rate. Kapalele conveyed the improvements on the property to One Keahole Partners ("OKP") for $36.5 million in 1995. Jeffrey Stone, Trustee Wong's brother-in-law, owns Pacific Northwest, Ltd. ("Pacific Northwest"), which owns a 50% interest in OKP. OKP's purchase of the Kalele Kai condominium project was partially financed through a restructuring of the note held by the Trust Estate. The AG alleged that the value of the restructured note to the Trust Estate was millions of dollars less than that of the original note and, therefore, that the restructuring conferred a significant personal benefit on OKP and Jeffrey Stone. AG Petition at 17-19, ¶¶ 75-84. The AG further alleged that OKP and Pacific Northwest paid Trustees Peters and Wong inflated prices for their condominiums at 1015 Wilder as a *quid pro quo* for conferring financial benefits on Trustee Wong's brother-in-law, Jeffrey Stone, in connection with the Kalele Kai project. *Id.* at 19-20, ¶¶ 85-96.

f. Investment in KDP Technologies

KDP Technologies ("KDP") was a "fledgling software development and production company trying to develop an Internet database . . . for aspiring models, actors, and entertainers to showcase their talents over the Internet." Weil Decision at 23, ¶ 69. KS invested a total of $1,338,000 in KDP: $500,000 as a direct loan from KS, and $838,000 as debt and equity from KS's for-profit subsidiary, Pauahi Management Corp. *Id.* at 29, ¶ 88. The AG alleged that the investment "was made without adequate due diligence and in disregard of an internal staff report"; moreover, KDP "was managed by principals with no proven business track records, was a highly speculative start up company, and the soft-porn nature of the investment was not suitable for a charitable educational Trust." AG Petition at 21, ¶ 103. Judge Weil found that KS received no return on this investment and faces potential lender liability claims arising out of it. Weil Decision at 29, ¶ 88.

The investment opportunity was presented to KS by Ben Bush III, who was one of five shareholders in KDP and owned a two percent share. *Id.* at 23, ¶ 69. Trustee Lindsey had prior business dealings with Mr. Bush; at the time that the investment was presented, Trustee Lindsey was a co-plaintiff with Mr. Bush in litigation arising out of a previous co-investment with Mr. Bush. *Id.* at 24, ¶ 71. Although she was required by KS's conflict of interest policy to disclose to her fellow Trustees any potential conflicts of interest, Trustee Lindsey did not advise them of her past and present relationships with Mr. Bush. *Id.* at 24, ¶ 71; 25, ¶ 75. Moreover, despite her obligation to protect the interests of the Trust Estate while an officer and manager of the KDP entities, Trustee Lindsey failed to timely disclose her knowledge that Bush was a target of a criminal investigation. *Id.* at 27, ¶ 83; 176, ¶ 10. Judge Weil found that the failure to disclose came at a time when Trustee Lindsey "knew the investment was in trouble and yet [was] receiving additional funding from KS sources." *Id.* at 176, ¶ 10. Trust money continued to be advanced to KDP until Bush was indicted for federal mail fraud and money laundering crimes (for which he was subsequently convicted and sentenced). AG Petition at 22, ¶ 109.

Moreover, Judge Weil found that Trustees Lindsey, Wong, and Peters all had knowledge of a consulting contract between KDP and Randy Stone, Trustee Wong's brother-in-law, although this was not brought to the attention of the other two Former Trustees. Weil Decision at 28, ¶¶ 84-85. The AG alleged that Trustees Peters and Wong used their positions as KS Trustees to help Jeffrey Stone obtain the consulting contract with KDP and to secure payments under the contract with Trust Estate funds. AG Petition at 22, ¶ 110.

g. Creation of Positions for and Hiring of Friends and Relatives

The AG alleged that the Former Trustees "misused their positions as Trustees, misused Trust [Estate] assets, and benefited themselves by directing the Trust [Estate] to hire or contract with their friends and relatives without regard to qualifications and without regard to the disproportionality between the compensation paid and the work, if any, actually performed." *Id.* at 28, ¶ 150. The AG further alleged that "[o]n numerous occasions, the Trustees have arranged for the Trust, including its subsidiary organizations, to hire Trustee friends and relatives" and that in some cases "unbudgeted positions were created to accommodate these hirings." *Id.* at 26, ¶¶ 137-138. According to the AG, the Former Trustees also "entered into consulting and other agreements with three former trustees, and paid the former trustees compensation disproportionate to the services, if any, actually rendered." *Id.* at 25, ¶ 134. Some of these arrangements are described in more detail below.

(1) Terrance Tom

The IRS alleged that $97,760 of professional fees paid to Terrance Tom in the form of a monthly retainer for the period of March 1994 through June 1996 constituted a private benefit. During the IRS audit, KS explained to the IRS that "Mr. Tom was paid a monthly retainer during the subject period to be available to Trustees and staff or provide legal and business advice regarding current and upcoming federal and state legislation, legal and community trends of various matters that could potentially impact KSBE." The IRS argued, however, that the retainer fees were not paid for actual services rendered, but for "contingencies that may, in fact, never occur." KS provided the IRS with billing invoices related to Tom's services, but the invoices were significantly redacted pursuant to a claim of attorney client or attorney work product privilege. Based on the absence of expenses for photocopying, postage, and similar items on the billing invoices, the IRS concluded that Tom provided "no specific services." Similarly, the AG alleged that Tom provided "negligible, if any, legal services to the Trust." The IRS also pointed out that Tom was the Democratic Representative of the 47th District, State of Hawaii Chair of the Judiciary Committee, and a member of the Consumer Protection & Commerce and Public Safety & Military Affairs Committees. The IRS insinuated and the AG alleged that Tom provided political favors rather than legal services, including supporting Trustee efforts to preserve their excessive compensation.[10] The IRS also argued that Tom's services were unnecessary because KS already had "an ample supply of legal talent." The AG characterized Tom's employment as a "monthly legal retainer without providing meaningful legal services." Private Benefit NOPA at II.C.6; AG Petition at 25, ¶ 133; 37-38, ¶¶ 188-90.

(2) George Lindsey, Jr.

The IRS and the AG asserted that the professional fees paid to George Lindsey, Jr. (for a monthly retainer for the period January 1995 through June 1996) in the amount of $56,160 constituted a private benefit to George Lindsey, Jr. The IRS asserted that the payment of compensation in the form of a retainer for non-specific services, or for services that were never performed, results in a private benefit. During the IRS audit, KS explained that "Lindsey was paid a monthly retainer to be available to Trustees, General Counsel and staff to provide general legal advice, review documents and perform legal research on various matters impacting KSBE, including, but [not] limited to Native Hawaiian rights, water rights, access rights and sovereignty issues." KS asserted that, because of "the heavy workload within the Legal Group, Mr. Lindsey was retained by KSBE to provide general backup legal services." The IRS argued that this explanation was vague and failed to demonstrate that the fees bore a direct relationship to the

[10] The AG made similar allegations with respect to Robert Herkes and Joseph Sokui.

organization's exemption. In addition to reiterating many of the same arguments and conclusions that it had asserted and reached with respect to KS's retainer of Terrance Tom, the IRS also asserted that KS did not address the conflict of interest raised by the family relationship of George Lindsey, Jr. to Trustee Lindsey's husband. Private Benefit NOPA at II.C.7; AG Petition at 26, ¶ 136.

(3) Albert Jeremiah, Jr.

The IRS argued that $66,156 of professional fees paid to Albert Jeremiah, Jr. as a monthly retainer in the amount of $5,000 per month for the period November1995 through June 1996 constituted a private benefit. According to the AG, Albert Jeremiah, Jr. is a friend of Trustee Peters, who was "instrumental in the Trust entering into a consulting services contract with Jeremiah...without regard to whether any work was performed." Albert Jeremiah, Jr. was retained to provide legal services to KS in the area of government relations, including the review of legislative bills, county ordinances, resolutions, committee reports, etc., which may have an impact on KS. Jeremiah was also assigned to facilitate the acquisition and due diligence pertaining to the Baker/Van Dyke collection. The AG alleged that "Jeremiah was paid at least $35,000 at his attorney rate of $125/hour for performing menial and clerical labor in connection with inventorying the Baker/Van Dyke collection." The IRS argued that payment of these legal fees did not contribute to the program services of the organization and that there was no direct causal relationship to an exempt purpose for the work requested. In concluding that Jeremiah had received a private benefit, the IRS again reiterated many of the same arguments and conclusions that it had asserted and reached with respect to KS's retainer of Terrance Tom and George Lindsey, Jr. Private Benefit NOPA at II.C.8; AG Petition at 24-25, ¶¶ 127-28; 25, ¶ 130.

3. Trustee Co-investments

The Master asserted that the involvement by some of the Former Trustees in the McKenzie Methane Gas investment raised potential conflicts of interest between the Trustees' personal interests and those of the Trust and its beneficiaries and could constitute a breach of their fiduciary duties. Masters' 109th Rpt. at 82-85. The IRS also asserted that certain Former Trustees in their individual capacities, as well as KS Staff, co-invested in the McKenzie Methane gas investment through various entities known as the HAK Partnerships. KS's initial investment in these programs totaled approximately $61.7 million; the Former Trustees and KS Staff collectively invested over $2 million in the same venture. PHC NOPA at 115.

The Master concluded that despite the fact that the co-investments of certain Former Trustees in the McKenzie Methane venture raised serious potential conflict of interest, the manner in which the Former Trustees addressed the issue was inadequate and unsatisfactory. The Master "found no attempt by the [Former] Trustees to obtain a specific legal opinion regarding the appropriateness of their McKenzie Methane co-investments." Master's Consol. Rpt. at 126-27.

E. Noncompliance with Orders of the Probate Court

1. Allegations and finding that the Former Trustees violated a 1966 court order preventing commissions on FDOC.

Under an order entered by the Probate Court in 1966, the KS Trustees and the AG agreed that KS Trustees would take no commissions on final payments involving the construction of buildings and improvements at Kamehameha Schools. Until 1994, KS Trustees abided by the court order and did not take commissions on final disbursements of capital ("FDOC"). After the close of fiscal year 1994, however, Trustee Peters learned that KS had to write off approximately $18 million dollars in capital losses, which would have the effect of reducing the commissions payable to the Former Trustees by approximately $96,000 per Trustee. Staff advised the Former Trustees that they would need to forego commissions on a going-forward basis to make up for the excess commissions taken. ITTM at 27; ITFF at 34-35, ¶¶ 95-96; AG Petition at 32-33, ¶¶ 170-71; Hirai Decision at 27-29, ¶¶ 173-81.

Instead of foregoing commissions, however, the Former Trustees retroactively took commissions for 1994 on FDOC, totaling approximately $492,000. ITTM at 27; ITFF at 35, ¶ 96; AG Petition at 33, ¶ 172. The AG alleged that the retroactive reversal of the FDOC waivers "were made at the direction of Peters, general counsel Nathan Aipa, and the principal executive of the administration group, Rodney Park." AG Petition at 33, ¶ 172. This allegation compelled the Master to withdraw his initial conclusion that the commissions payable to the Former Trustees were properly determined. Master's 1st Supp. Rpt. at 30. Judge Hirai held that this action was in direct violation of the Probate Court's 1966 order that no commissions were to be paid on FDOC. Hirai Decision at 30, ¶ 186.

2. Allegations and finding that the Former Trustees violated a court order requiring implementation of a CEO-based management system.

On October 2, 1998, the Former Trustees agreed to adopt and implement a CEO-based system of management for the Trust Estate and hire a CEO by March 31, 1999. On May 3, 1999, the Probate Court ordered the Former Trustees to show cause why they should not be found in breach of the stipulation and order.[11] On May 6, 1999, one day before the hearing on the order to show cause, the majority Trustees (over the objections of Trustees Stender and Jervis) offered Gilbert Tam a position as "Interim Chief Executive Officer." Mr. Tam was not selected from any list of candidates developed by the executive headhunter firm retained by the

[11] *See* Order to Show Cause and Setting Time and Place of Hearing on Master's Report Regarding New CEO Management Based System Filed on April 27, 1999 (May 3, 1999).

Trust Estate, and no CEO-based management system had been submitted for the Probate Court's approval, as required by the stipulation and order. The Probate Court found that, with the exception of Trustee Stender, the other Former Trustees knowingly failed to adhere to the stipulation and order and concluded that sanctions were appropriate for their noncompliance. ITTM at 28; ITFF at 33, ¶¶ 92-93; AG Petition at 64-65, ¶ 301.b.[12]

3. Allegations and findings that the Former Trustees violated other binding court orders.

Judge Hirai also found that the Former Trustees (specifically Trustees Wong and Peters) violated several other binding orders of the Probate Court, requiring them to, *inter alia*: segregate income and corpus accounts of the Trust Estate; disclose the total amount of accumulated income in the 109th, 110th, and 111th Annual Accounts; plan for the expenditure of the Trust Estate's accumulated income; and terminate the lead trustee system of governance. ITTM at 28; ITFF at 34, ¶ 94; AG Petition at 65, ¶ 301.c; Hirai Decision at 33, ¶¶ 5-6.

III. ALLEGED AND DOCUMENTED BREACHES OF FORMER TRUSTEES' DUTY OF PRUDENT DELEGATION

A. The Lead Trustee System

The Former Trustees employed a lead trustee system, which essentially divided responsibility for the Trust Estate's affairs into various subject areas and designated one KS Trustee to provide oversight with respect to his or her appointed area. Master's Consol. Rpt. at 105-06; Yim Rpt. at § 15; Master's 109th Rpt. at 76-78. At the time of Trustee Lindsey's appointment as a KS Trustee on February 26, 1993, the other serving KS Trustees were Henry Peters, Oswald Stender, Myron Thompson, and Richard S.H. Wong. Weil Decision at 2, ¶ 1.

12 *See* Order Regarding Order to Show Cause Regarding Special Purpose Trustees' Report and Order to Show Cause Regarding New CEO Based Management System (May 7, 1999).

Gerard A. Jervis replaced Trustee Thompson as a KS Trustee on December 1, 1994. *Id.* Within six months of her appointment, Trustee Lindsey was designated lead trustee for Education Affairs, which essentially consisted of the oversight of the Kamehameha Schools. *Id.* at 4, ¶ 9; Yim Rpt. at 15. Trustee Peters was the lead trustee for Asset Management, Trustee Wong was the lead trustee for Governmental Affairs, and Trustee Stender was assigned "special responsibility for specific investments," but otherwise had no specific oversight responsibilities. Weil Decision at 4-5, ¶ 10; Yim Rpt. at 15. Upon his appointment to the Board of Trustees, Trustee Jervis became the lead trustee for Legal Affairs. Weil Decision at 4, ¶ 10; Yim Rpt. at 19.

In implementing the lead trustee system, the Former Trustees:

1. Did not screen and select specific lead trustee candidates based on their individual qualifications and whether the person selected was best able to carry out the duties and responsibilities involved for each lead trustee position;

2. Failed to identify qualification requirements for these various positions, failed to define the duties and responsibilities of the positions, and failed to integrate them into the formal organizational hierarchy of the Trust Estate and its divisions; and

3. Instituted no procedure for monitoring or reviewing the performance of their co-trustees.

Master's Consol. Rpt. at 104-05; Yim Rpt. at 16-17, 23. The Master found that, under the lead trustee system, there was no procedure for holding individuals accountable. Master's Consol. Rpt. at 105. The Master further found that the Former Trustees were "reluctant to review performance of lead Trustees in an objective and appropriate manner." *Id.* at 110.

Patrick Yim (the "Fact Finder") and the Master both found that each lead trustee exercised broad, *ad hoc*, decision-making power over his or her assigned area and each carried out his or her responsibilities in their assigned area in a highly individualistic manner. Yim Rpt.

at 16; Master's Consol. Rpt. at 105-06. This created confusion among the KS Staff as to whether the actions of an individual Former Trustee represented individual actions or decisions approved by the full Board of Trustees. Yim Rpt. at 16, 22; Master's Consol. Rpt. at 106. The Fact Finder and the Master found that when clarification of a requested or demanded action was sought, there was a reluctance or refusal by the Former Trustees to put responses in writing, which meant that directives were, for the most part, issued orally. Yim Rpt. at 17; Master's Consol. Rpt. at 106. Although consensus decisions were recorded in the Board of Trustees minutes if and when they were actually discussed by the Former Trustees, dissents were not. Yim Rpt. at 19.

The Fact Finder and the Master found that the lead trustee system contributed to a "climate of confusion" and often led to misunderstandings, misdirections, miscommunications, misperceptions, and frustration on the part of those KS staff members charged with responsibility for implementing the Board of Trustees' actions. Yim Rpt. at 17, 22; Master's Consol. Rpt. at 106-07. As such, the Fact Finder and the Master found that the lead trustee system was inappropriate for the Board of Trustees to adopt as a means of oversight for KS." Yim Rpt. at 22; Master's Consol. Rpt. at 111. The WASC Visiting Committee determined that the lead trustee system of governance "weakened leadership and destroyed professional morale leaving a perceived leadership vacuum and lack of management procedures responsive to the needs of the staff." WASC Rpt. at 23.

The AG alleged that the lead trustee system violated "the clear directives of the Will that at least three Trustees must join in on all acts" and "the independent duty of all Trustees to participate in the administration of the Trust and to prevent any other Trustee from [committing a] breach of fiduciary duty." AG Petition at 15-16, ¶ 69. The AG further asserted that appointing Trustee Lindsey as lead trustee for education and Trustee Peters as lead trustee for asset management violated the Trustees' duty of prudent delegation. *Id.* According to the AG, Trustee Peters, as lead trustee for asset management, "purposely withheld information on existing and potential investments from his co-Trustees, dismantled the Trust's internal audit function, instructed staff employees to withhold information from the co-Trustees, and used his position to approve Trust payment of improper non-Trust expenditures." AG Petition at 15, ¶ 68. The AG alleged that despite "being advised repeatedly by court-appointed Masters, the court-appointed Fact Finder, and specially retained consultants to discontinue the lead trustee system," the Former Trustees "disregarded all such advice." *Id.* at 16, ¶ 16, ¶ 70; 42, ¶¶ 221-22.

B. The Neglect of the Trust's Educational Mission—Mismanagement of the Schools

1. Allegations and findings that as lead trustee for education, Trustee Lindsey mismanaged the Schools.

Judge Weil found that Trustee Lindsey, in operating within this lead trustee system, carried out her role as lead trustee for education according to a flawed perception of the role and duties of a trustee of an independent private school. Weil Decision at 63, ¶ 201. According to KS policy, and consistent with principles of good practice for independent private schools, Trustee Lindsey's role as lead trustee for education was to act as a facilitator between the Board of Trustees and the Education Group, thereby enabling the full Board of Trustees to set policy for the Kamehameha Schools. *Id.* Weil Decision at 37-38, ¶ 117. Contrary to KS policies and applicable principles of good practice, however, Trustee Lindsey became involved in specific management, personnel, and curricular issues of the Kamehameha Schools and thereby interfered with the day-to-day operational and management decisions of the Education Group. *Id.* at 37, ¶ 116; 48, ¶ 146; 49, ¶ 148; 78, ¶ 249; Master's Consol. Rpt. at 107. Judge Weil found that by giving directives to administrative staff who would normally report to the president of the Schools, Trustee Lindsey caused confusion in the administration of the Schools and undermined the president and the established hierarchy of the Education Group. Weil Decision at 77, ¶ 243; 79, ¶ 251; 181 at ¶ 25; *see also* Yim Rpt. at 19-20, 23.

Judge Weil found that by disregarding the proper chain of command, Trustee Lindsey diminished the effectiveness of President Chun and effectively stripped him of the authority to run the Schools. Weil Decision at 78, ¶¶ 247-48. Trustee Lindsey's undermining of the president of the Schools created hostility between the Former Trustees and the Trust Estate's beneficiaries, and caused extreme confusion among virtually all subordinates, including teachers, students, support staff, and alumni—which interfered with the proper administration of the Kamehameha Schools. *Id.* at 186, ¶ 36; Yim Rpt. at 23; Master's Consol. Rpt. at 112. The Fact Finder found that the duties, responsibilities, and functions of the president were further undermined by the sense of "direct supervision" of the Schools by the Former Trustees that was created by the physical existence on campus of an office for the Former Trustees and a parking stall. Yim Rpt. at 23.

The Fact Finder determined that Trustee Lindsey's interference with the operation and management of the Kamehameha Schools went as far as micromanagement of issues and activities that were inappropriate for trustee involvement. *Id.* at 26-27. For example, she insisted on reviewing and approving all external school communications such as programs, fliers, and T-shirt designs. Weil Decision at 68-69, ¶ 213; Yim Rpt. at 26-27. Her review included such matters as writing style, design, spelling, syntax, and formatting. Yim Rpt. at 26. Judge Weil and the Fact Finder found that Trustee Lindsey's review of communications resulted in "needless anxiety, frustration, and disappointment on the part of teachers, staff, alumni, parents and students," undermined student and faculty confidence in their ability to complete tasks on time, and caused "additional costs to be incurred on occasion." Weil Decision at 70, ¶ 216; Yim

Rpt. at 26. Moreover, since her appointment as lead trustee for education, the Board of Trustees allowed Trustee Lindsey to exercise final authority on all Kamehameha Schools hiring. Yim Rpt. at 23; Weil Decision at 73-74, ¶ 230; 76, ¶ 239. Judge Weil found that Trustee Lindsey's micromanagement of the Kamehameha Schools contributed to the dysfunctional governance of the Schools and the resulting public controversy and hostility in the community. Weil Decision at 83, ¶ 267; 148, ¶ 453.

Public controversy surrounding the Schools, and community hostility toward the Former Trustees regarding their mismanagement of the Schools, were intensified by Trustee Lindsey's release of her biased, inaccurate, and incomplete report of educational quality and personnel at Kamehameha Schools ("An Imperative for Educational Change"). *Id.* at 181, ¶ 25. Judge Weil found that at the time she released her educational report, Trustee Lindsey knew it would damage the reputation of the Kamehameha Schools; before her unilateral decision to release the report, she emphasized to her fellow Trustees the need to keep it strictly confidential. *Id.* at 100-02, ¶¶ 315-22; 181, ¶ 25. The report was unbalanced, failed to incorporate all of the available performance information, cited as problems matters already resolved by the Board of Trustees, contained inaccurate and damaging statistics on student performance, and alleged improprieties by President Chun and his wife. *Id.* at 113, ¶ 350; 117-45, ¶¶ 363-444. The document was released before receiving or considering President Chun's response, who along with his wife was personally attacked in the report. *Id.* at 113, ¶ 350. Judge Weil determined that Trustee Lindsey's deliberate release of the highly critical report was an imprudent, self-interested decision that she knew risked harm to Kamehameha Schools' personnel, students, and reputation. *Id.* at 113, ¶ 349; 183, ¶ 28. Despite the damage caused by Trustee Lindsey's education report, as of may 1999, the Board of Trustees had still not formally considered the contents of her report or President Chun's responses. *Id.* at 112, ¶ 347.

A trustee who learns of an issue facing the Kamehameha Schools has an obligation to bring it to the attention of the head of the Schools, or to the Chair of the Board of Trustees, but must not deal with the situation individually. Trustee Lindsey, however, unilaterally made major decisions concerning the management and operation of the Kamehameha Schools, which should have been brought to the attention of the full Board of Trustees. *Id.* at 41-63, ¶¶ 125-200. These major decisions included: (1) mandating that secondary and elementary school curricula be changed, without allowing sufficient time in which to change it, and without providing reasonable instructions as to how it was to be done. *Id.* at 42-49, ¶¶ 127-48; Yim Rpt. at 24-25; (2) deciding, without the input of the Kamehameha Schools' experienced Hawaiian language department, that faculty must teach only "traditional" Hawaiian language and confine the teaching of vocabulary to words in the Pukui-Elbert dictionary (despite the fact that Trustee Lindsey knew nothing about the study of the Hawaiian language) Weil Decision at 51-56, ¶¶ 157-72; Yim Rpt. at 26, 30-31; and (3) disapproving plans for and ending work on the Hawaiian Cultural Center project Weil Decision at 61-63, ¶¶ 194-200.

As with other instances of Trustee Lindsey's interference with the management of the Kamehameha Schools, Judge Weil found that these unauthorized unilateral actions led to public controversy and hostility. *Id.* at 83, ¶ 267. Trustee Lindsey "converted her authority as lead trustee for education to investigate matters at the [Kamehameha Schools] into one of control over major education decisions, inserting herself as a separate and independent decision-maker between the President of Kamehameha Schools and the Board of Trustees." *Id.* at 178, ¶ 17. She held a "*de facto* veto over school operational, budgetary, and policy matters intended for decision by the full Board of Trustees and exercised that *de facto* power without consulting or informing other Trustees." *Id.* Hostility between Trustee Lindsey and the faculty, staff, students, and alumni of the Kamehameha Schools was extensive, pervasive, and interfered with the proper administration of the Trust Estate. *Id.* at 186, ¶ 36; Yim Rpt. at 37. Judge Weil found that Trustee Lindsey's flawed perception as to her proper role as a Trustee, combined with the Former Trustees' designation of her as lead trustee for education, had tragic consequences for the ability of KS to carry out its educational mission. Weil Decision at 63-65, ¶ 201; *see also* AG Petition at 16, ¶ 71; 47, ¶ 245.

2. Allegations and findings that the Former Trustees inadequately monitored and failed to correct timely Trustee Lindsey's misconduct.

According to the Fact Finder, the Former Trustees acquiesced in Trustee Lindsey's oversight of the Kamehameha Schools, and were either inexplicably oblivious to or ignored the specific actions of Trustee Lindsey that had a negative effect on the administration of the Schools. Yim Rpt. at 20, 20. The AG asserted that the other Trustees "took no action to restrain Lindsey until December 1997, when they reacted to intense public criticism by removing Lindsey as lead trustee for education, and when Stender and Jervis petitioned the court to remove Lindsey as a Trustee." AG Petition at 15, ¶ 66. According to the Fact Finder:

> [A] number of [Trustee Lindsey's] actions . . . were or should have been known to the other four Trustees that comprise the Board. Given the problems that were fermenting on the campus leading up to the recent controversy, the Trustees knew or should have known that the Lead Trustee was engaged in actions that were detrimental to Kamehameha School and reflected poorly upon the Board of Trustees. It is inconceivable to the Fact Finder that her fellow Trustees acting in concert could not find out what the Lead Trustee was doing on campus. Though the alarms were being sounded by the actions of one of the Trustees, the others either ignored it, or failed to grasp the consequences of it.

Yim Rpt. at 32.

a. The Yim Report

Trustee Stender had raised concerns about the management of the Schools on various occasions dating back to 1994, but the Board of Trustees ignored these concerns. Weil Decision at 112, ¶ 347 n.22. By April of 1997, however, the morale problem and the issues raised by Trustee Lindsey's micromanagement of the campus had reached such a head that Trustee Stender insisted that the problem be addressed immediately. *Id.* at 84-85, ¶ 273. Trustee Stender recommended to the Board of Trustees that the management of the Schools be returned to the president and his staff, but the Board of Trustees took no action on this recommendation. *Id.* at 85-86, ¶¶ 273 and 276. Finally, in May of 1997, the hostility and unrest created by Trustee Lindsey's mismanagement of the Kamehameha Schools culminated in the Former Trustees' petition to the Probate Court for the appointment of a Fact Finder to investigate problems at the Schools and with the community. *Id.* at 89, ¶ 287. Judge Weil found that in the court order empowering retired Judge Patrick Yim to act as a fact finder, it was necessary to include a confidentiality guarantee to respond to issues of confidentiality and fear of retaliation raised by faculty, staff, alumni, and students. *Id.* at 92, ¶ 294.

The Fact Finder met with the Former Trustees on November 10, 1997, to discuss the recommendations that his report would contain. *Id.* at 93, ¶ 297; Yim Rpt. at 40. Specifically, he discussed with the Former Trustees: (1) the inappropriateness of the practice of having a lead trustee for education; (2) the need for Trustee Lindsey to "immediately relinquish her oversight of the Education Group;" and (3) the advisability of engaging an "organization [or] foundation above reproach and beyond KS's influence, to independently conduct an audit of both the management and the educational components of the Kamehameha School" to determine strengths and weaknesses of, and make recommendations for improving, the Education Group. Weil Decision at 93, ¶ 297; Yim Rpt. at 41. Despite subsequent urgings by Trustees Stender and

Jervis, Trustees Lindsey, Wong, and Peters vehemently rejected the Fact Finder's recommendation to mediate these matters. Weil Decision at 95, ¶ 301. Judge Weil found that Trustee Lindsey did not relinquish her role as lead trustee for education until after the Fact Finder filed his report on December 4, 1997. *Id.* at 94, ¶ 300.

b. The Peterson Report

The Probate Court adopted the Fact Finder's recommendation that the Former Trustees be required to engage an educational consultant to perform an evaluation of the Schools. *Id.* at 135, ¶ 418 n.32. Trustees Lindsey, Wong, and Peters, at Trustee Peters' recommendation, chose Peterson Consulting, LLC ("Peterson") to undertake the study. *Id.* The majority Former Trustees selected Peterson to perform the study over the objections of Trustees Stender and Jervis, who preferred instead to engage more recognizable educational consultants, such as Stanford University, UCLA, or Booz-Allen & Hamilton. *Id.*

c. The WASC Report

The 1998 Accreditation Report issued by the Western Association of Schools and Colleges ("WASC") sharply criticized the Former Trustees' governance of Kamehameha Secondary School ("KSS"). *Id.* at 147,¶451. The WASC Report notes that "[f]or many months preceding the visiting committee's service at Kamehameha, the [Former Trustees] were in a swirl of public controversy regarding budgets, expenditures, governance, relations with personnel, programs and oversight." WASC Rpt. at 4. Although the nature of KSS and the governance role of the Former Trustees made participation by the Former Trustees in a self-study portion of the WASC review "essential," Trustee Lindsey declined the WASC Visiting Committee's invitation to serve on the focus group addressing student learning." WASC Rpt. at 12.

Although the WASC Report generally praised the quality of KSS's programs and the professionalism and commitment of KSS's "highly qualified, dedicated, and conscientious staff" to the students, the report described the Former Trustees' form of governance as "a perverse application of top-down decision-making which has openly undervalued, if not scorned, the professional expertise, talent, and commitment of the non-administrative staff." *Id.* at 16, 19; Weil Decision at 146, ¶ 450; 147, ¶ 451. According to the WASC Report, the self-study and related documentation provided many examples of "top-down decisions" made by the Former Trustees "without adequate knowledge of the consequences of these decisions or their impact on the on-going responsibilities of faculty and their use of time." WASC Report at 17. In particular, the WASC Report cited seven decisions made by the Former Trustees that negatively affected KSS: (1) Trustee Lindsey's mandate to use only those Hawaiian words in the Pukui-Elbert Dictionary, to the exclusion of words in the modern Hawaiian language; (2) the Board of Trustees' non-recognition of administration and staff planning efforts in the early 1990's; (3) Trustee Lindsey's suddenly mandated curriculum project while the faculty was in the middle of self-study work required for WASC's review of KSS; (4) a suddenly mandated change in KSS's standardized testing program without consultation with faculty; (5) appointment of an extra administrator as an additional management layer between the president and KSS administrators; (6) purchase of an expensive collection of Hawaiiana (the Baker-Van Dyke Collection) for the library without consulting the staff or considering other financial priorities after Trustee Stender had judged the collection to be duplicative and not worth the investment; and (7) Trustee Lindsey's involvement in such minutia as T-shirt designs and communications between KSS and constituents. WASC Rpt. at 17; Weil Decision at 147, ¶ 451.

The WASC Report further notes that there was a "documentable lack of congruence between several of the Hawaiian values espoused by the Board . . . and elements in governance and decision-making," notably with regard to "Pono" (to be moral and proper), "Laulima" (to work cooperatively), "Na`au Pono" (to possess a deep sense of justice), and "Malama" (to care for each other). WASC Rpt. at 23. The faculty regarded the Former Trustees' incorporation of such values into the Mission Statement of the Schools with "cynicism," because "they did not see these values represented in governance and decision-making." *Id.* at 15. The result of the Former Trustees' approach to school governance was "an oppressive, intimidating, and fearful professional climate at the school." *Id.* at 16; Weil Decision at 147, ¶ 451. The governance issues raised in the WASC Report precipitated a reduced period of accreditation to three years—from the six-year period that KSS had customarily received since 1975. Weil Decision at 157, ¶ 479.

3. With the assistance of the McCorriston Miller Mukai MacKinnon, the Former Trustees conducted an investigation into the unauthorized disclosure of the WASC Report.

Judge Weil found that the investigation by the majority Trustees (*i.e.*, Trustees Lindsey, Wong, and Peters) into the unauthorized disclosure of the WASC Report to the public was a significant waste of KS assets that produced additional ill will on the campus and reduced campus morale. *Id.* at 156, ¶ 478. The majority Trustees authorized private counsel William McCorriston to investigate the release of the WASC Report. *Id.* at 150, ¶ 458. Trustees Stender and Jervis felt the investigation was "inappropriate because the release of the WASC Report caused no discernible harm to [KSS] and glowingly praised [KSS's] performance." *Id.* at 150, ¶ 458. In the presence of a court reporter, an attorney from the McCorriston firm questioned KSS employees, who were not represented by counsel, regarding the release of the WASC Report. *Id.* at 151, ¶ 460. Interviewees were asked whether they would submit to a polygraph test. *Id.* at 151, ¶ 460. After Trustee Jervis ordered that the questioning be stopped, Trustees Lindsey, Wong, and Peters voted to continue the investigation with the assistance of McCorriston, with Trustees Stender and Jervis dissenting. *Id.* at 152, ¶ 465. After reiterating their objection to the investigation into the leak of the WASC report, Trustees Stender and Jervis filed for a temporary restraining order, which the First Circuit Court granted. *Id.* at 153-54, ¶¶ 467-69. After the temporary restraining order was issued, the Former Trustees agreed that the use of the McCorriston firm would be discontinued and the investigation would be continued using KS's in-house staff. *Id.* at 154, ¶ 470. Trustees Lindsey, Wong, and Peters subsequently expanded the scope of the investigation, however, to include an inquiry into whether faculty and campus staff had manipulated students to sign a petition in support of the AG's petition to remove all five Former Trustees. *Id.* at 155, ¶ 474-75.

Judge Weil found that the initial method of conducting the WASC investigation, using the McCorriston firm, fueled controversy on the campus and caused morale problems. *Id.* at 154, ¶ 471. The subsequent investigation of the student petition did not promote any legitimate KS interest. *Id.* at 156, ¶ 478. Judge Weil determined that the investigations were mandated to suppress critics of the Former Trustees, the motivations behind them were wholly self-interested, and they were conducted to the detriment of the Trust Estate's beneficiaries. *Id.* at 156, ¶ 478; 183, ¶ 28. Judge Weil found that the alacrity with which the majority Trustees acted to investigate the student petition situation, along with the diligence they showed in trying to discover the individuals who leaked the WASC Report, contrasted sharply with their failure to actively address in any Board of Trustees meetings or in any other meaningful way the many substantive issues regarding education and presidential leadership at the Kamehameha Schools. *Id.* at 156, ¶ 478.

4. Trustee Lindsey was eventually removed as a KS Trustee pursuant to the petition of Trustees Stender and Jervis.

Despite the detrimental effect of Trustee Lindsey's actions on the Kamehameha Schools, Trustees Wong and Peters opposed the petition by Trustees Stender and Jervis to have Trustee Lindsey removed. *Id.* at 1; ITTM at 22. Notwithstanding the opposition of Trustees Wong and Peters, Judge Weil held that Trustees Stender and Jervis demonstrated by clear and convincing evidence that Trustee Lindsey should be removed because: (1) she failed to act and to administer the trust solely in the interest of the trust and its beneficiaries; (2) she failed to inform her fellow Trustees of all material facts relating to the administration of the trust and made unilateral decisions without the knowledge or approval of her fellow Trustees; (3) she used Trust Estate property and personnel for her personal benefit; and (4) she mismanaged Trust Estate property and the Kamehameha Schools, which justified her removal. Weil Decision at 190, ¶ 44. Her actions constituted breaches of the duty of loyalty, the duty to comply with the trust instrument, the duty of due care, and the duty to exercise sound discretion. *Id.* The Interim Trustees and the AG alleged that Trustees Peters and Wong breached their fiduciary duties by failing to use reasonable care to prevent and seek redress of fiduciary breaches of their co-trustee, Trustee Lindsey. ITTM at 21-22; AG Petition at 65, ¶ 301.d.

IV. ALLEGED AND DOCUMENTED BREACHES OF FORMER TRUSTEES' DUTIES OF LOYALTY AND PRUDENCE—CONTINUED

A. Deficiencies in Financial and Educational Strategic Planning for the Schools

1. Allegations and findings that the Former Trustees failed to adopt timely an appropriate strategic plan for education.

Judge Weil found that, from 1992 to July 1997, the Former Trustees failed to adopt an education strategic plan. Weil Decision at 141, ¶ 434. Kamehameha Schools completed an education strategic plan in 1992, which President Chun submitted to the Board of Trustees for approval, but was not acted on or approved. *Id.* at 137, ¶¶ 423-24; Master's Consol. Rpt. at 91-92; WASC Rpt. at 10. The Board of Trustees members at that time explained to School administrators that they were deferring action because three new KS Trustees (*i.e.*, Wong, Lindsey, and Jervis) would be appointed in the next few years. Weil Decision at 137, ¶ 424. Judge Weil found that with the exception of planning for the *Go Forward* expansion program (discussed *infra*), planning for the existing schools was left de facto to School staff and administration. *Id.* at 138, ¶ 426; 141, ¶ 434. The WASC Visiting Committee determined that the Former Trustees finally adopted a strategic plan in the summer of 1997, but without the active participation of the Schools' faculty and staff. WASC Rpt. at 43.

Although the Trust Estate enjoyed significant appreciation in its net assets from fiscal years 1994 to 1996, education program expenditures (which include both direct and indirect education expenses for all education programs, including scholarship and financial aid) remained relatively level at \$91,141,305, \$102,408,296, and \$99,819,224, for fiscal years 1994 through 1996, respectively. Master's Consol. Rpt. at 17-18 and 18 n.6. The WASC Report cites the Former Trustees' zero growth budget for the schools during the 1995-96 through 1997-98 school years as "an area of concern," because it "prohibits staff from planning ahead and from including equipment needs." WASC Rpt. at 43. Consequently, "[i]n view of increased enrollment and inflation, departments may have to forego some learning resource needs in order to operate within allocated amounts." WASC Rpt. at 43.

2. Allegations and findings that the Former Trustees directed the accumulation of income and its transfer to corpus.

According to the Will, the annual income of the Trust Estate is to be expended on the maintenance of the Schools. Master's Consol. Rpt. at 27-28; AG Petition at 8, ¶ 30. Thus, the

Master asserted that maintaining the distinction between the corpus account and the income account is critical to the fulfillment of the express direction of the Will as to how to provide for the Estate's educational purpose. Master's Consol. Rpt. at 27. Under the Will, KS Trustees are required to "clearly and separately account...for Trust income and Trust corpus." AG Petition at 9, ¶ 36. A 1970 court-ordered stipulation also requires that KS Trustees separately account for corpus and income. *Id.* at 9-10, ¶ 37; Hirai Decision at 13, ¶ 63. The AG alleged that the Former Trustees violated the Will and this binding court order by failing to account "clearly and separately for Trust income and corpus." AG Petition at 10, ¶ 39. The AG further alleged that the Former Trustees "calculated their compensation on the Trust income while it was classified as income and before it was later reclassified as corpus." *Id.* at 10, ¶ 42; 34, ¶ 177.

On June 28, 1988, Nathan Aipa provided Rodney Park, KS's Controller, a legal opinion concluding that the Will permitted a transfer of accumulated income to the corpus account. Aipa recommended that if accumulated income was transferred, however, it should be earmarked specifically for maintenance and operation of the Schools. Beginning on June 30, 1988, unexpended income was reclassified and transferred to the corpus account. Hirai Decision at 13, ¶¶ 64-67; Master's Consol. Rpt. at 32; AG Petition at 8, ¶ 31. A zero unrestricted income balance in the revenue account was thereby maintained at the end of each fiscal year. Master's Consol. Rpt. at 32. The Master asserted that this practice of transferring income to corpus was unauthorized, improperly documented, and inadequately disclosed to the Probate Court during its review of the Trust Estate's annual accounts. *Id.* at 33. Judge Hirai found that the accumulated income that was transferred to corpus was not earmarked as Aipa had recommended. Hirai Decision at 17, ¶ 97. The Master and Judge Hirai were suspicious of the method of accounting for income and corpus that the Former Trustees purported to employ and concluded that it undermined the ability of the Probate Court to properly exercise its oversight function with respect to the Trust Estate. Master's Consol. Rpt. at 33; Hirai Decision at 17, ¶ 98. According to the Master, the AG, and the Interim Trustees, the extent of the accumulation of income—approximately $350 million by fiscal year-end 1997—raised a grave question regarding compliance with the Will's dictates on spending for education. Master's Consol. Rpt. at 34; AG Petition at 8, ¶31; 11, ¶ 44; ITTM at 22; ITFF at 30, ¶ 85.

3. Allegations and findings that the Former Trustees lacked a clearly defined plan for spending assets for educational purposes.

In addition to the lack of an education strategic plan, the Master found that the Former Trustees lacked a clearly defined policy to guide them in expending Trust Estate resources for educational purposes. Master's Consol. Rpt. at 40; AG Petition at 48, ¶ 250. The Master believed that such a policy is fundamental to the development of a strategic plan for investments and educational expenditures. Master's Consol. Rpt. at 40. Since at least 1985, KS Trustees have been under specific direction from the Probate Court to plan for the expenditure of accumulated income for educational purposes consistent with the educational mission of the Trust Estate. *Id.* at 37-38. Notwithstanding this specific direction, the ten-year projections provided to the Master in connection with the strategic plan that the Former Trustees finally adopted in 1997 "did not so much as hint at" planning for the expenditure of the Trust Estate's substantial accumulated income balance. *Id.* at 39. Even without taking into account the accumulated income balance as of fiscal year end 1997, ten-year projections forecasted an accumulated income balance by the year 2006 in excess of one billion dollars after expenses related to the *Go Forward* initiative. *Id.* at 39 n.19. The AG alleged that the Former Trustees violated the court's order by failing to plan "for the expenditure of accumulated income for educational purposes consistent with the Will." AG Petition at 10, ¶ 40.

4. Allegations and findings that the *Go Forward* Initiative announced by the Former Trustees was not a comprehensive plan.

In April of 1995, the Former Trustees publicly announced the *Go Forward* initiative, an educational expansion program designed to create neighboring-island campuses. Weil Decision at 81, ¶ 259. As approved, *Go Forward* proposed to add four new satellite elementary school campuses on the islands of Maui, Hawaii, and Oahu, expand the center-based preschool program to accommodate an eventual student enrollment of 1,840, and terminate almost all of KS's community outreach programs. Weil Decision at 80-81, ¶¶ 255, 256, 259-60; Master's Consol. Rpt. at 85, 94-95. The Master found that although *Go Forward* was touted as representing a bold new strategic vision for the Trust Estate, there was no integrated planning document that clearly sets out the specific objectives of *Go Forward* and the analysis underlying the development of the initiative. Master's Consol. Rpt. at 91. Instead, *Go Forward* appeared to be based on a disparate assortment of forty studies, surveys, and reports. *Id.* The Master found no contemporaneous documentation of the bases for the Former Trustees' decisions with respect to either *Go Forward* or the cancellation of the community outreach programs. *Id.* at 71. The Master also found that the Former Trustees inadequately analyzed critical and fundamental planning considerations. *Id.* at 97. Moreover, the Master found that a financial model to estimate the operating and capital costs for the proposed satellite Schools was not developed by Ernst & Young until April 16, 1996—almost one year after *Go Forward* was announced. *Id.* at 95.

Instead of hiring a strategic planning firm, the Former Trustees decided to direct the strategic planning process leading up to *Go Forward* themselves. *Id.* at 92. The WASC Visiting Committee found that the Former Trustees did not seek input and comment regarding the strategic planning process from faculty, staff, or key management employees at the Kamehameha

Schools, which led to frustration and disappointment on the part of staff members and employees. WASC Rpt. at 21-22; *see also* Master's Consol. Rpt. at 98. The Master found no evidence that the Former Trustees obtained the benefit of critical analysis by educational experts. Master's Consol. Rpt. at 93. The *Go Forward* planning process was undertaken on a "budget neutral" basis, which meant that "all planned programs, old and new, had to fit within the then-current annual direct educational expense budget of $55 million." *Id.* at 85. In order to add new programs, such as the center-based preschool program, choices had to be made to eliminate or scale back existing programs. *Id.* The Former Trustees took this approach despite the fact that, in fiscal year 1994, when *Go Forward* was in its nascent stages, the Trust Estate had an accumulated income balance of more than $316 million and ten-year projections showed considerable additional surplus income projected during the initial ten-year period in which *Go Forward* was to be implemented. *Id.* The decision to terminate the community outreach programs was based on a projected cost savings of $49 million from 1995-2002 and a projected severance cost of $5 million for phase out of those programs. Weil Decision at 81, ¶ 260. Although Trustee Stender asked the other Trustees to reconsider the termination of certain community outreach programs, including the summer school program, the adult education programs, the traveling pre-school program, the alternative education program, and financial aid for special needs students, the other Former Trustees refused. *Id.* at 138, ¶ 426 n.34.

Discontinuing the community programs greatly reduced the number of Hawaiians served by KS from approximately 30,000 in 1992 to 3,200 in 1996. *Id.* at 82, ¶ 262. The public announcement of the decision to terminate the bulk of KS's community outreach programs in the Summer of 1995 had an immediate impact on faculty, staff, and the community—approximately fourteen percent of the KS workforce was laid off. *Id.* at 82, ¶ 263; Master's Consol. Rpt. at 99.

concluded would have provided more diversification and liquidity in the portfolio. *Id.* at 61; AG Petition at 49, ¶ 252.

The Master determined that the Former Trustees had no clear asset-allocation policy incorporating risk and return objectives. Master's Consol. Rpt. at 62. According to the Master, the AG, and the IRS, investments were evaluated and considered based on opportunities presented from various sources (including reliance on tips from acquaintances) rather than being targeted to fit within an approved overall portfolio strategy. *Id.* at 79; Primary Purpose NOPA at 165; AG Petition at 49, ¶ 252. The Master concluded that such investment practices were opportunistic and highly unusual for a perpetual endowment. Master's Consol. Rpt. at 61-62. "Many of the investments required extensive allocations of human resources to unique individual investments; among other things, these investments had significant exposures to permanent principal impairment and liquidity risks." *Id.* at 62. The Master found that these types of investments severely limited any attempt to arrange an orderly diversification program and resulted in undependable cash-flow forecasts. *Id.* Moreover, the Trust Estate lacked a satisfactory system of monitoring and evaluating investment performance against appropriate benchmarks. *Id.* at 51; AG Petition at 49, ¶ 255. The Master found that this lack of reasonably frequent measurement against appropriate benchmarks precluded the Former Trustees from making "informed management decisions." Master's Consol. Rpt. at 51.

Despite the disproportionately large real estate component of the Trustee Estate's investment portfolio, the Former Trustees continued to invest substantial amounts in real estate investments both inside and outside of Hawaii. *Id.* at 67; AG Petition at 49, ¶ 253. The Master found that such investments further detracted from the goals of diversification and liquidity, which the Former Trustees were required to consider under the Prudent Investor Rule. Master's Consol. Rpt. at 66-67.

2. Allegations and findings that the Former Trustees lacked appropriate documentation and due diligence policies and practices.

The Master, the AG, and the IRS asserted that the quality of due diligence performed with respect to the investments made by the Former Trustees was inconsistent, and that documentation of investment and management decisions was inadequate. *Id.* at 68-70, 79; Primary Purpose NOPA at 165-66; AG Petition at 49, ¶ 254. Information was sometimes insufficient to make and support prudent investment decisions; moreover, justifications for investment decisions made by Former Trustees that were contrary to staff recommendations were not adequately documented and supported. Master's Consol. Rpt. at 79; AG Petition at 49, ¶ 254.

3. Allegations that the Former Trustees' investment policies and practices resulted in significant investment losses.

The AG alleged that owing to inadequate investment policies and lack of adequate due diligence, the Former Trustees engaged in numerous questionable investments and transactions that resulted in significant financial losses to the Trust Estate AG Petition at 48-51, ¶¶ 250-56. The Master concluded that these losses and the Trust Estate's loss-reserve experience "crie[d] out for an examination of the investment program of the Trust Estate." Master's 1st Supp. Rpt. at 24-25; Master's Consol. Rpt. at 56; Master's 109th Rpt. at 31-34. Our review encompasses the following investments, which each generated losses that are approximately equal to, or exceed, $2 million.

a. SNIP

b. Rock Capital – Drake

c. Rock Capital – Pandick

d. Rock Capital Partners

e. Rock Real Trust Estate

f. Rock Real Trust Estate #2

g. Accessory Place

h. Tribeca

i. AutoFuel

j. Best Products

k. Pembridge

l. RPA

m. DC Land Group

n. Hanford's/Hanford's Creation

o. Desert Springs

p. Kona Enterprises

q. Westfed

r. Atlanta Research Properties

s. Net loss from KIC

t. Snap Products

u. Invexco

v. Presidio Oil

w. Kukui Oil & Gas Property

x. Smith Offshore

y. Home Holdings

z. Nomura

aa. Unison Pacific Investment

bb. Cadillac Fairview

4. Allegations and findings that the Former Trustees spent Trust Estate funds on contracts that violated Trust Estate policies or provided no benefit to the Trust Estate.

The AG alleged that the Former Trustees routinely approved contracts, such as those with Educational Management Group, Dura and Rhino Roofing, and Hawaii Protective Association, which violated the Trust Estate's written procurement policy. According to the AG, this policy generally requires competitive bidding and signed written proposals for items over $1,000. AG Petition at 52, ¶¶ 260-61. The AG alleged that by entering into contracts that violated this procurement policy, and by entering into contracts without adequate due diligence, the Former Trustees wasted Trust Estate assets and violated their duty to act solely in the interests of the beneficiaries. *Id.* at 54, ¶ 278.

a. Hawaii Protective Association

In July 1996, the Trust Estate entered into a nonbid contract with Hawaii Protective Association Ltd. ("HPA") to provide additional security services at the Schools. According to the AG, "[t]here was no operational necessity to hire any outside security contractor." Moreover, the AG alleged that because HPA charged above-market rates, it was more expensive for the Trust Estate to use HPA than other outside security services. The AG also asserted that Larry Mehau, a principal shareholder of HPA, is a friend of Trustees Wong and Lindsey. *Id.* at 26-27, ¶¶ 140-143.

b. Dura Construction and Rhino Roofing

The AG alleged that beginning in 1995, the Trust Estate awarded non-bid construction contracts to Dura Construction ("Dura") in amounts exceeding $2.7 million. The AG asserted that Trustee Peters is a former Dura employee and that Dura renovated Trustee Peters' Maili residence. According to the AG, Dura received $465,000 for work on the locker room at the Schools that was "so deficient that the building was unsafe for student use." The AG asserted that the Trust Estate "corrected Dura's work itself rather than pursue Dura for the deficiencies." The AG alleged that the Trust Estate also awarded non-bid contracts to Rhino Roofing Inc. ("Rhino") in amounts exceeding $1.3 million. According to the AG, Rhino also worked on Trustee Peters' Maili home renovation. Trustee Peters' nephew owns Rhino. The AG asserted that proposed construction contracts with both Dura and Rhino "received expedited Trustee approval with reduced scrutiny." *Id.* at 27-28, ¶¶ 144-49.

c. Educational Management Group

Educational Management Group ("EMG") submitted a proposal to provide computer technology for the Schools. Weil Decision at 29-30, ¶ 90. Lance Tachino, a systems analyst supervisor in the Education Technology Production Division at Kamehameha Schools, concluded that the initial EMG proposal was too vague and too expensive. *Id.* at 30, ¶ 92; AG Petition at 52, ¶ 264. Judge Weil and the Fact Finder found that Trustee Lindsey suppressed Tachino's attempts to conduct objectively a cost-benefit analysis of the proposed contract and to bring forward concerns about the relative costliness of the hardware and the recurring annual program costs. Weil Decision at 180, ¶ 24; Yim Rpt. at 32-33; AG Petition at 52, ¶ 264. Over a five-year period (1994-1998), KS disbursed to EMG between $5 and $6 million for hardware, software, satellite time, and annual maintenance costs. Weil Decision at 34, ¶ 107. Payments were made out of the $18 million budget that the Board of Trustees approved for technology at the Schools. *Id.* at 31-32, ¶ 97. The project was ultimately scrapped at the end of 1998. *Id.* at 35, ¶ 108.

d. Baker/Van Dyke Collection

With the exception of Trustee Stender, who was not in attendance, the Former Trustees approved the purchase of the Baker/Van Dyke Collection at a Board of Trustees meeting on July 16, 1996. *Id.* at 16, ¶¶ 48-49. The Former Trustees approved the purchase for "educational purposes," subject to total or partial cancellation after the completion of due diligence, which was to include, at a minimum, an inventory and an appraisal of items in the collection. *Id.* at 16, ¶ 49; Yim Rpt, at 34. An escrow account was created in connection with the purchase. Weil Decision at 16, ¶ 50; Yim Rpt. at 34. Judge Weil found that in her drive to complete the transaction, Trustee Lindsey changed material provisions of the purchase agreement, ordered that escrow payments be made prematurely and contrary to the provisions of the sale contract, disregarded minimal requirements of due diligence, and rejected advice of KS counsel that the sale be recorded—all to KS's disadvantage. Weil Decision at 20, ¶ 59; Yim Rpt. at 34; AG Petition at 53, ¶¶ 270-71. Judge Weil found that the collection was of negligible educational value: (1) Ms. Southworth, the Hawaiian Collection librarian, found only one item out of 23,000 for which she had been actively searching Weil Decision at 20-21, ¶ 62; (2) Ms. Southworth had previously recommended to Trustee Stender that KS not purchase the collection, which recommendation Trustee Stender followed and thereafter informed the seller that KS was not interested Weil Decision at 13-14, ¶ 41; Yim Rpt. at 33; (3) Ms. Southworth's recommendation was based on her review of a sampling of forty-five titles from the collection, of which KS already held fifty-five percent of the titles, and only one book out of the remaining forty-five percent was educationally appropriate for the library's Hawaiian Collection. Weil Decision at 14, ¶ 41; Yim Rpt. at 33. The costs to KS of the collection included: (1) the purchase price of approximately $422,000 Weil Decision at 15, ¶ 43; Yim Rpt. at 33.; (2) approximately $174,886 to inventory, treat, and move the books and documents in the collection; (3) storage costs for the collection; and (4) approximately $125,000 to inventory photographs from the collection. Weil Decision at 21-22, ¶ 65; Yim Rpt. at 33, 35. As of May 1999 (the date of the Weil Decision decision), good title to the photograph collection remained undetermined. Weil Decision at 22, ¶ 65; 189, ¶ 43.

e. Shintani Diet

Judge Weil found that, without bringing the decision to the attention of the full Board of Trustees, Trustee Lindsey unilaterally made the decision to expend funds from the Kamehameha Schools' staff development budget on two sessions of the Shintani diet, in both of which she participated. *Id.* at 56-61, ¶¶ 174-93; *see also* AG Petition at 54, ¶¶ 275-77.

f. Hamakua Land Purchase

In September of 1994, the Former Trustees authorized the expenditure of $21 million at a bankruptcy auction for approximately 30,000 acres of land formerly owned by the Hamakua Sugar Company. The Former Trustees authorized the purchase at a price that varied from the written staff report on the proposed transaction and on a debt-financed basis, despite KS Staff's recommendation against a debt-financed purchase. The Master raised questions regarding how the Hamakua purchase benefited the Trust Estate and criticized the Former Trustees' failure to follow appropriate investment practices in deciding to make the investment. Master's Consol. Rpt. at 81-82. After receiving additional information regarding the purchase, the Master found that the Former Trustees' investment in the Hamakua lands failed to meet the standards imposed by the prudent investor rule. The Master found insufficient evidence that "the Trustees carefully analyzed and evaluated their investment . . . in light of considerations of the Trust Estate's liquidity, regularity of income, and preservation or appreciation of capital." Master's 1st Supp. Rpt. at 23-24.

V. ALLEGED AND DOCUMENTED BREACHES OF FORMER TRUSTEES' DUTY TO TAKE NO ACTION TO DEPRIVE THE TRUST ESTATE OF AN OTHERWISE AVAILABLE TAX EXEMPTION

A. The IRS's Arguments in General

In the draft Forms 5701 (Notices of Proposed Adjustment or "NOPAs") issued to KS, the IRS proposed that KS's tax-exempt status be revoked. The IRS's primary arguments supporting its proposed revocation of KS's tax-exempt status were based on various actions of the Former Trustees that: (1) caused the Trust Estate to cease being operated exclusively for educational purposes; and (2) resulted in prohibited private inurement to the Former Trustees and prohibited private benefits to others. With respect to the first of these arguments, the IRS asserted that revocation is appropriate because the Former Trustees neglected the educational mission of the Trust Estate and instead devoted their attention and Trust Estate resources to the Trust Estate's commercial and investment activities, as well as to their own private interests. The IRS asserted that the Former Trustees furthered these non-educational purposes at the expense of fulfilling the Trust Estate's educational mission. The IRS further argued that those actions that served to further their own private interests also resulted in private inurement to the Former Trustees, which, in the IRS's view, provided a second justification for revoking the Trust Estate's tax-exempt status. Primary Purpose NOPA at 164, 169-70.

B. Allegations of Private Inurement

An exemption from taxation based on section 501(c)(3) of the Internal Revenue Code (the "Code") is conditioned on "no part of the net earnings of [the organization] inur[ing] to the benefit of any private shareholder or individual." I.R.C. § 501(c)(3) (2000). The applicable regulations state that the words "private shareholder or individual" refer to "persons having a personal and private interest in the affairs of an organization." Treas. Reg. § 1.501(a)-1(c) (as amended in 1982). A private shareholder or individual includes a person, such as a trustee, who as an "insider" is in a position to control the disposition of an organization's income or assets for personal gain. *United Cancer Council, Inc. v. Commissioner*, 165 F.3d 1173, 1176 (7th Cir. 1999), *rev'g* 109 T.C. 326 (1997). Although *reasonable* compensation (either in the form of salaries or other benefits) does not constitute prohibited inurement (*e.g.*, *B.H.W. Anesthesia Found., Inc. v. Commissioner*, 72 T.C. 681, 685-86 (1979), *nonacq.*, 1980-2 C.B. 2 (1980)), *any* benefit received by an insider that is not reasonable in relation to the services provided to an organization in return—*regardless of the "amount or extent" of this unreasonableness*— provides a sufficient ground for revoking an organization's section 501(c)(3) status. *Founding Church of Scientology v. United States*, 412 F.2d 1197, 1202 (Ct. Cl. 1969), *cert. denied*, 397 U.S. 1009 (1970) (emphasis added).

1. Unreasonable Compensation

The IRS argued that the compensation paid to the Former Trustees during the Trust Estate's 1990 through 1998 tax years was "outside the upper range of reasonable compensation" and therefore constituted prohibited private inurement of Trust Estate assets to the Former Trustees. Unreasonable Compensation NOPA at 103. The IRS asserted that when the factors considered by the courts in determining what constitutes reasonable compensation are applied to the Trustees' compensation during these years, it is clear that such compensation was "excessive." *Id.* at 27-28, 103.

The IRS challenged the underlying assumptions of the SCA and Towers Perrin studies that the Former Trustees commissioned and concluded that the studies were "seriously flawed and failed to provide appropriate rationalization for the high pay [of the Former Trustees]," because their determinations of what constitutes reasonable compensation were premised on the Former Trustees performing the roles of a full-time CEO, CFO, COO, and Treasurer in addition to the governance role typically performed by a member of a corporate Board of Directors or by a trustee of a charitable trust. *Id.* at 66, 95. The IRS asserted that it was inappropriate to aggregate the compensation paid to "senior operating executives" of large investment banks or like enterprises and assume that it is reasonable to divide this total amount among the five trustees. *Id.* at 18, 55, 66.

Given the "overlapping" of the traditional trustee functions with the atypical management functions performed by each of the Former Trustees, the IRS argued that each had to spend a portion of his or her time on traditional governance functions, which necessarily reduced the time that each Former Trustee could spend performing management functions. *Id.* at 55. As such, the IRS asserted that it was inappropriate for the SCA and Towers Perrin compensation studies to compare "total compensation paid to the Trustees as a group" with the total compensation paid to the "combined senior management staff and board of directors . . . in other comparison organizations." *Id.* at 19. The IRS believed that the Former Trustees overstated the extent of the additional management responsibilities and duties they actually performed for KS, pointing to: (1) the seeming "overlap" of the Former Trustees' day-to-day management responsibilities with those of KS executives and other KS Staff members *Id.* at 30, 46, 68; (2) the Former Trustees' extensive use of outside professional consultants "in running the business affairs of the Trust Estate" *Id.* at 30, 51, 55; and (3) the reduction in time available for KS activities resulting from each Trustee's service on one or more boards of KS's for-profit subsidiaries, especially with respect to Trustee Peters, who held as many as fourteen directorships or "similar positions" in one year. *Id.* at 33 , 45; Primary Purpose NOPA at 52.

The IRS also asserted that the SCA and Towers Perrin compensation studies were flawed in their respective assumptions that "the most reasonable comparables for KSBE are not large educational trusts or other charitable trusts but rather large public investment banks or real estate development organizations" (in the case of the SCA study), or "manufacturing and service companies" (in the case of the Towers Perrin study). Unreasonable Compensation NOPA at 63, 66. Because some portion of the Former Trustees' time had to be spent on performing traditional governance functions, the IRS believed that the SCA and Towers Perrin studies should have included "foundations or other large exempt organizations" in the mix of comparable entities for purposes of determining what constituted reasonable compensation. *Id.* at 63. Finally, the IRS asserted that neither the Towers Perrin nor the SCA study "examined qualifications, experience, or performance as a criterion for compensation," each of which would be considered by a court in determining the reasonableness of compensation for federal income tax purposes. *Id.* at 62.

2. Lobbying with Respect to Proposed Legislation Affecting Trustee Compensation

Like the Interim Trustees, the AG, and Master Matsumoto, the IRS alleged that Trust Estate funds spent on lobbying against, or for self-serving modifications to, the proposed intermediate sanctions legislation served the Former Trustees' private interests, rather than Trust Estate interests. Because the expenditure of funds was for their benefit, not for the Trust Estate's, the IRS asserted that the amounts the Former Trustees expended for intermediate sanctions lobbying constituted substantial private inurement, sufficient to support revocation of the organization's tax-exempt status. Primary Purpose NOPA at 156; Inurement NOPA at II.B.2.-4. Such private inurement placed the Trust Estate's tax-exempt status in jeopardy and thereby constituted a breach of the Former Trustees' duty not to take any action that would deprive the Trust Estate of a valuable exemption. ITTM at 23.

3. Investigations into Change of Domicile and Tax Status

Because the Trust Estate funds spent on the Former Trustees' investigations into a change in domicile and tax status provided no benefit to KS, the Interim Trustees asserted that they are further instances of private inurement for federal tax law purposes. By increasing the risk that a federal court would conclude that revocation of KS's tax-exempt status was warranted, the Interim Trustees alleged that the Former Trustees again breached their duty to take no action to jeopardize the tax-exempt status of the Trust Estate. ITTM at 19.

4. Other Alleged Instances of Private Inurement

In addition to Trustee Lindsey's use of Trust Estate personnel to perform work with respect to her beach house, discussed above, the IRS alleged that the following constituted additional instances of private inurement.

a. Towers Perrin Professional Fees

The IRS alleged that professional fees paid to Towers Perrin by KS for the fiscal year ending June 30, 1996 constituted prohibited private inurement to the Former Trustees in the amount of $64,075. The IRS asserted that the payment of professional fees to have a second study on the reasonableness of trustee compensation performed, at considerable expense to the Trust Estate, served only to benefit the Former Trustees by attempting "to justify the amount of compensation they are currently being paid." This duplication of professional fees, according to the IRS, provided no corresponding value to the Trust Estate and therefore resulted in prohibited private inurement. Inurement NOPA at II.B.6. The Master also concluded that "expenditures on multiple studies at the expense of the Trust Estate cannot be reasonably said to be necessary or appropriate and reasonable to carrying out the purposes of the Trust Estate." Master's 1st Supp. Rpt. at 32.

b. Trustee Peters' Cellular Phone Expenditures

The IRS alleged that $22,849 paid by the Trust Estate on behalf of Trustee Peters for his cellular phone usage for the period June 30, 1992 through June 30, 1996 constituted prohibited private inurement. The IRS asserted that KS and/or Trustee Peters failed to document how the payment of Trustee Peters' cellular phone expenses contributed to the program services of the exempt organization. Inurement NOPA at II.B.3.

c. Trustee Peters' Mid-Ocean-Related Expenses

The IRS alleged that $26,450 that the Trust Estate paid for Trustee Peters' travel to and from Mid Ocean Ltd. board of director meetings constituted prohibited private inurement. The IRS argued that if Trustee Peters' position as a member of Mid-Ocean's board of directors was personal (that is, not as a result of his position as a KS Trustee), expenses related to travel to such meetings were personal and therefore their payment by the Trust Estate constituted private inurement to Trustee Peters. *Id.* at II.B.4. (Contrast the AG's position, discussed above, that the Mid-Ocean directorship was not personal, but rather an opportunity of the Trust Estate that Trustee Peters usurped.)

d. Other Personal Travel and Entertainment Expenses

The IRS alleged that $331,139 KS paid for various unsubstantiated travel and entertainment expenses and non-reimbursable personal expenses (*e.g.*, personal phone calls, personal car rentals, and in-room movies) of the Former Trustees constituted prohibited private inurement to the Former Trustees. The IRS asserted that the payments were "also made in violation of the Estate's own Policy and Procedures Manual." *Id.* at II.B.7.

C. Failure to Operate Organization Exclusively for Educational Purposes

To maintain tax-exempt status, federal law requires that the organization be operated "exclusively" for charitable purposes. I.R.C. § 501(c)(3) (2000). In the case of an educational organization such as KS, this means that "the presence of a single non-educational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes." *Better Business Bureau of Washington, D.C., Inc. v. United States*, 326 U.S. 279, 283 (1945).

1. Allegations that actions of the Former Trustees furthered substantial nonexempt purposes.

The IRS asserted that the Former Trustees subordinated the educational purposes of the Trust Estate to commercial or other non-educational purposes, thereby "fail[ing] the primary purpose of the Trust to educate children." Primary Purpose NOPA at 167. By delegating the management of the Kamehameha Schools to Trustee Lindsey, while the other four Trustees devoted their time to overseeing non-education functions, such as investments, legal affairs, and governmental affairs, the Trustees neglected the educational mission of the Trust Estate. *Id.* at 168-69. The IRS alleged that, as lead trustee for education, Trustee Lindsey's mismanagement of the schools "engendered ongoing controversy, confusion, fear, low morale, and hostility within the Kamehameha Schools community," which seriously compromised the ability of the Trust Estate to carry out its educational mission. *Id.* at 168. By failing to monitor or correct Trustee Lindsey's actions, the Former Trustees thereby undermined the well-being of the Schools, through both their actions or inactions, as observed by the Visiting WASC Committee. *Id.* at 8, 169. According to the IRS, the failure of the Former Trustees to take any action "to restrain Lindsey until December, 1997, when they reacted to intense public criticism by removing Lindsey as lead trustee for education, and when Stender and Jervis petitioned the court to remove Lindsey as a Trustee," is further evidence of the Former Trustees' neglect of the Trust Estate's educational purpose. *Id.* at 168.

The IRS also believed that the Former Trustees' failure to conduct appropriate educational and investment planning showed that the educational purpose of the Trust Estate was "relegated to a position of relative unimportance in the overall operation of the Trust Estate and to a position of relative unimportance to the Trustees." *Id.* at 7, 169. With respect to educational strategic planning, the IRS asserted that the Former Trustees' planning efforts were insufficient and the strategic planning that was undertaken was "fundamentally flawed," because it "failed to take into account the financial resources available and . . . failed to utilize appropriate professional expertise." *Id.* at 7, 12. According to the IRS, the lack of appropriate educational strategic planning demonstrated that the Former Trustees' "time, efforts, energy, and financial resources" were "disproportionately devoted to" investments and commercial activities, *i.e.*, the "investment function" of the Trust Estate, "rather than maintaining and benefiting the schools." *Id.* at 161, 169. The IRS further contended that the Former Trustees failed to spend enough on education programs; although asset values and revenues increased substantially over the audit period, expenses for "school operating costs" did not grow "proportionately," and the school operated on a "zero growth budget." *Id.* at 11, 15.

The IRS parroted the Master in asserting that the Former Trustees failed to develop a "coherent overall investment plan . . . based upon sound investment principles." *Id.* at 8. Rather, the Former Trustees made investment decisions on an *ad hoc* basis, "based on opportunities presented from various sources," rather than on the basis of whether they "fit within an approved portfolio strategy." *Id.* at 165; Unreasonable Compensation NOPA at 73. The Former Trustees' failure to adequately coordinate investment decisions with educational planning "result[ed] in a disconnect between the two key components of an overall plan." Primary Purpose NOPA at 8. According to the IRS, the Former Trustees "systematically ignored sound investment management techniques as well as . . . the advice of paid consultants, experts, court Masters, and their own staff" by investing primarily in illiquid investments. The Former Trustees' decision to acquire illiquid investments "prevent[ed] KSBE from being able to finance school activities at will." Unreasonable Compensation NOPA at 76; Primary Purpose NOPA at 165. The IRS further asserted that "poor investment decisions" by the Former Trustees "actually harmed the Trust Estate by depleting [the] financial resources" available for exempt-function expenditures. Primary Purpose NOPA at 6 and 97.

2. Allegations that furthering substantial private interests constituted another substantial nonexempt purpose.

Operating a charitable organization in such a way as to further substantial private interests furthers a substantial nonexempt purpose and will result in the revocation of an organization's exemption. *American Campaign Academy v. Commissioner*, 92 T.C. 1053, 1065-66 (1989). The IRS argued that the Former Trustees' desire to preserve the level of their compensation led them to focus most of their attention on investments, and not on KS's educational mission, because their compensation was commission based. Primary Purpose NOPA at 167. In the IRS's view, the Former Trustees "manipulated" the amount of the commissions to which they were entitled by taking the following actions: retroactively revoking previous waivers of commissions; transferring investments to subsidiaries before writing them down to reflect losses; including interest payments in the computation of commissions on loans that KS made to its subsidiaries; failing to reduce the commission base by losses incurred at the subsidiary level; including in the commission base income that was subsequently transferred to corpus; and including returns on capital as well as partnership distributions in the commission base. Unreasonable Compensation NOPA at 11-12, 77. Furthermore, the IRS asserted that the Former Trustees' lobbying activities constituted another example of the Former Trustees' efforts to further their personal interests to the detriment of the Trust Estate. In the IRS's view, these expenses were incurred by the Trust Estate solely because the Former Trustees wanted to protect their ability to continue to receive excessive compensation. Inurement NOPA at II.B.2.-7.

The IRS argued that these actions, as well as the Former Trustees' overall course of conduct, supported the IRS's contention that the Former Trustees "view[ed] themselves as the Trust Estate and the Trust Estate's corpus as theirs to do with as they pleased." Primary Purpose NOPA at 6. These actions demonstrated the significant focus of the Former Trustees on their own compensation and return on investments. *Id.* at 169; Unreasonable Compensation NOPA at 11. Coupled with the failure to monitor Trustee Lindsey's management of the Schools, the IRS believed that these actions evidenced a neglect of the Trust Estate's educational mission and indicated that the Former Trustees were not operating the Trust Estate exclusively for tax-exempt purposes. Primary Purpose NOPA at 169.

D. Allegations of Private Benefit

The IRS alleged that KS conferred a number of impermissible private benefits during the audit period. In addition to the Trust Estate's retainer agreements with Terrance Tom, George Lindsey, Jr. and Albert Jeremiah, Jr., and its payment of Milton Holt's credit card expenses, discussed above, the IRS argued that the following private benefits were conferred.

1. RTJ Debt Forgiveness

The IRS alleged that the forgiveness of $3,874,284 in accrued fees and interest that RTJ Acquisition, LP ("Acquisition") owed to KS constituted a private benefit to the debtor and to the taxable entities that controlled the debtor. Acquisition was formed on February 26, 1991 to acquire 210 acres of land for the purpose of developing the Robert Trent Jones Golf Club and related cottage sites. RTJ Acquisition Corporation (owned by Clay Hamner) was the 20% general partner, and Royal Hawaiian Shopping Center, Inc. ("RHSCI")—one of KS's taxable subsidiaries—was the 80% limited partner, of Acquisition. Acquisition was primarily funded through a $40 million development loan from a bank, which was supported by a "buy back" provision from KS in the form of a Mortgage Loan Purchase and Sale Agreement (the "Purchase Agreement"). KS provided the Purchase Agreement for the benefit of Acquisition in exchange for a fee. On December 31, 1993, pursuant to a previously agreed-upon reallocation of the partnership interests, Acquisition's general partner assigned its interest to Treyburn GP, Inc., a wholly owned subsidiary of RHSCI. Private Benefit NOPA at II.C.1-1.

On its partnership return for the period ended June 30, 1995, Acquisition reported $3,874,284 as "other income," which was identified as "forgiveness of credit fee income" on an attached schedule. This amount included $188,333 in interest due that was paid by KS when it purchased the bank loan from the original lender. The balance was attributable to credit enhancement fees that Acquisition owed to KS under the Purchase Agreement. *Id.* at II.C.1-1.

The IRS asserted that KS's forgiveness of these amounts that Acquisition was "legally required to paid [*sic*] to it" constituted a private benefit. The IRS concluded that the forgiveness of the fee "was a substantial benefit to the debtor and to the taxable entities that control the debtor." Moreover, the IRS asserted that "[t]he fact that KSBE directly or indirectly controls or owns [Acquisition] does not negate the fact that it is a separate taxable entity." Private Benefit NOPA at II.C.1-2.

2. Field Debt Forgiveness

The IRS alleged that KS's forgiveness of accrued interest on a loan to Frederick Field constituted a private benefit to Field in the amount of $15,670,549. On January 29, 1991, KS loaned $29,310,577.21 to Field for a thirty-month period. *Id.* at II.C.2-1-.2. In September 1992, Field requested, and KS agreed, to restructure the loan. In addition, by a series of standstill agreements, KS agreed to stay the acceleration of these loans from February 11, 1993 until September 17, 1993. The IRS stated that the only consideration Field provided to KS for the benefit of the standstill agreements was his interest in the D.C. Land Group, Ltd., a partnership that both parties acknowledged to be valueless. The IRS also noted that the D.C. Land Group partnership interest "was originally listed as collateral for the notes" that KS was accelerating. Thus, "KSBE had a right to this partnership interest without entering into the standstill agreements." Private Benefit NOPA at II.C.2-3-4, -8.

On July 31, 1993, the parties entered into an agreement that restructured the 1991 notes and caused Field to relinquish part of the collateral for the original notes (the "1993 Restructuring Agreement"). Pursuant to the 1993 Restructuring Agreement, Field received a credit of $10 million toward the reduction of his indebtedness to KS in exchange for the transfer to KS of six partnership interests that comprised part of the collateral for the 1991 loan. The payment of the restructured notes was finally accomplished in 1997 as the result of a settlement agreement arising from "legal actions taken by Field to assert that the assets given up to obtain the 1993 settlement were worth more than KS allowed as a credit against the amount due on his notes." The IRS attributed a "delay in collecting the amounts owed to KSBE by Field under the terms of the 1993 Note/Loan Agreements...to legal actions taken by Field," and concluded further that the collection of the amounts owed under the 1993 Restructuring Agreement occurred because of Field's litigation, not as a result of actions "taken by KSBE in an effort to collect [on] the [restructured] Field notes." The IRS asserted that the Trust Estate provided no evidence "that would show that Field was unable to pay the amount due in 1993," and remarked that Field was able to cover fully the amount that KS determined was owing at the time of the final settlement payment. *Id.* at II.C.2-2, -5, -8-9.

The IRS concluded that

> The effect of entering into the standstill agreements, the 1993 Notes/Loan Agreements, the legal actions and the settlement was that the Acceleration process stopped and Field was able to forestall payment of the notes while lowering his interest rate from 20% to 12% at no cost to himself. Mr. Field realized a savings in interest that he owed but did not pay of more than $15,000,000.00 since the interest rate should have remained at 20% as provided in the 1991 Notes/Loan Agreements. In addition to the under accrual of Fixed interest for the period prior to the 1993 Note/Loan Agreement which was effective on August 1, 1993, KSBE waived the $146,553 credit facility fee that Field owed under the terms of the 1991 Note/Loan agreement. ...The accrual of interest due for the period ended June 30, 1994 did not include interest for the month of July, 1993. ...At the 20% fixed rate this interest would amount to $446,025.49.

Moreover, the IRS observed that, although it fell outside the audit period, KS's settlement of the $37,187,949.77 liability that Field owed under the 1993 Restructuring Agreement for $32.7 million "represent[ed] a loss of income to the Trust, based on KSBE's accounting for this debt, of $4,487,949.77." Thus, according to the IRS, "[t]he total private benefit to Fredrick W. Field during the audit periods totals $15,670,548.60 while the total including the 1997 [settlement] transaction totals in excess of $20,158,498.37." Private Benefit NOPA at II.C.2-8-9.

3. Smith and Gordy Debt Forgiveness

The IRS alleged that KS conferred a private benefit on Lester Smith and Russell Gordy of "at least $59,314,992" by failing to "take reasonable steps to seek recovery of funds invested with SG Methane, which was owned by Lester Smith and Russell Gordy, and with or for Lester Smith and Russell Gordy as individuals." Smith and Gordy established a joint venture, SG Methane, for the purpose of acquiring a 1/3 working interest in McKenzie Methane Company ("MMC"). MMC had acquired various coal seam gas leases giving MMC the right to explore for, develop, and market gas from areas in Alabama, Colorado, and New Mexico. Before forming SG Methane with Smith, Gordy approached Northwestern Mutual Life Insurance Company ("Northwestern") on behalf of MMC to discuss the MMC methane project, after which

Northwestern purchased a 20% working interest in MMC. MMC paid Gordy approximately $3.4 million for his brokerage services on behalf of MMC. *Id.* at II.C.3-1-2.

Smith approached KS to seek the financial backing necessary to acquire SG Methane's 1/3 working interest in MMC. (According to the IRS, "no evidence has been presented to show that Smith was also working on a brokerage basis for MMC.") "[B]ased on the conclusion by Trustee Matsuo Takabuki that this was a good investment," KS entered into a letter of intent to purchase an 80% net profits interest in SG Methane's working interest, which Smith represented as an interest "in a program involving exploration for and development of methane gas in commercial quantities from coal mine deposits." MMC was to be the "developer" of the project. Pursuant to three agreements dated March 31, 1989, August 2, 1991, and August 12, 1991, KS invested a total of $67,667,000 to acquire its net profits interest in SG Methane. Private Benefit NOPA at II.C.3-2-3.

Smith held a 75% interest and Gordy held a 25% interest in SG Methane. Although Gordy paid cash for his interest, Smith had to fund the purchase of his SG Methane interest with two loans from the Bank of Hawaii ("BOH"). KS backed up Smith's BOH loans with two Note Purchase Agreements ("NPAs") in the amount of $5.8 million and $6.6 million, respectively. SG Methane obtained another BOH loan in the amount of $11.3 million to pay "non-turnkey costs on its 1/3 working interest," which KS also backed up with an NPA. KS also accepted a promissory note from Smith in the amount of $366,000 to cover an extension fee on the NPAs associated with the BOH loans he used to acquire his 75% interest in SG Methane. *Id.*

From March 21, 1991 to January 1992, various legal actions were taken by SG Methane and other investors to try to force MMC out as the operator of the project. KS was not involved in the legal action to remove MMC as operator, because "KSBE had only a net profits interest in SG Methane's working interest." As KS explained in a response to an Information Document Request ("IDR") issued by the IRS, "the overriding royalty interest form of ownership . . . carried with it the attribute that KSBE could not exercise remedies or take actions with respect to its ownership interest, *i.e.*, it was 'passive.' Such control rights attached to the working interest owned by SG Methane Company out of which KSBE's overriding royalty interest was carved." KS further explained that the overriding royalty (or net profits) interest form of ownership was selected so as to qualify income from the MMC venture for an exception from the unrelated business income tax. Owing to the litigation, Smith, Gordy, and SG Methane elected to stop any additional payments on the BOH loans. Consequently, in early 1992, KS was required to purchase all three BOH loans for which it had entered into NPAs for a total of $24,066,000 plus accrued interest. *Id.* at II.C.3-4-6.

As KS explained in another IDR response, "KSBE made the decision in March 1992 that it would take an active role in the workout of its investment." According to this IDR response, KS "still held SG Methane accountable" for originally promoting the MMC drilling programs to KS; consequently, KS "required SG Methane to give up in favor of KSBE all of its working interests, its reversionary interest in KSBE's overriding royalty interest, its management rights and all employee overriding royalty interests, except for a small working interest retained by Russell Gordy corresponding to [Gordy's original cash investment in SG Methane]." After purchasing the BOH loans pursuant to the NPAs, KS "foreclosed on Mr. Smith's portion of SG Methane's interests in [MMC], as well as other collateral, including stock pledged by Mr. Smith in Smith Offshore, Inc." KS also informed the IRS that although SG Methane, Smith, and Gordy "were relieved of their obligations [on the BOH loans that KS purchased] in exchange for their interests in the McKenzie drilling programs (except the Gordy retained interest) and other collateral," KS released none of these parties "from liability (whether then existing or later discovered)." Private Benefit NOPA at II.C.5-7.

Effective March 23, 1992, KS set up a taxable subsidiary, KUKUI, Inc., as a wholly owned subsidiary of RHSCI, "to hold and manage a working interest in coal seam methane programs." On May 1, 1992, Nathan Aipa was elected to serve as Vice President of KUKUI. After KUKUI was established, KS transferred to KUKUI its Smith and SG Methane notes receivables. Under a series of contracts dated March 23, 1992, KUKUI succeeded to all interests of KS and SG Methane in the MMC methane programs. Gordy maintained his share of SG Methane's 1/3 working interest in MMC. A separate working interest held by Kamehameha Investment Corporation ("KIC") was also transferred to KUKUI. *Id.* at II.C.3-4-5.

From March 31, 1992, to the end of the audit period, KUKUI was involved in extensive litigation with MMC; total legal fees expended by KUKUI and KS during this period were "well over" $3 million. As KS explained in an IDR response, part of the consideration received from Smith and Gordy for releasing them and SG Methane from their obligations under the BOH loans that KS had purchased "was the perceived value of [their] continued cooperation . . . in the workout negotiations and possible litigation against [MMC and Smith and Gordy]." KS stated that it was concerned that these parties could assert a "contribution defense" to liability in any resulting litigation against them. *Id.* at II.C.3-5, -7.

On April 20, 1994, MMC declared bankruptcy; on March 30, 1995, KUKUI declared bankruptcy. Pursuant to the resolution of these bankruptcy proceedings and related litigation in other forums, KUKUI received substantially all of MMC's assets, including approximately 420 wells in the Cahaba Field area of Alabama. Based on poor profitability projections for these wells, KUKUI (and other involved parties) decided to plug and abandon the wells. KUKUI's obligation with respect to this well plugging and abandoning would have exceeded $3 million. KUKUI and Smith and Gordy agreed that KS and KUKUI would release them from all residual claims relating to KS's original investment in exchange for: (1) Smith and Gordy's assumption of all of KUKUI's share of the Cahaba Field plugging and abandonment liability; and (2) Gordy's assignment of his retained share of the working interest (discussed above). Private Benefit NOPA at II.C.3-7-8.

Based on the difference between what KS invested in the venture, or $85,876,491,[13] and the sum total of what KS (or KUKUI) received in return from Smith, Gordy, and SG Methane, or $26,561,499,[14] the IRS concluded that KS bestowed a private benefit on Smith and Gordy equal to at least $59,314,992.

> The net result of the agreements between KSBE/KUKUI and Smith, Gordy, and SG Methane is that KSBE invested in excess of [$85.8 million] in a highly speculative methane gas project and then failed to take steps to collect from the parties that promoted the projects when it was shown that the majority of the investment was worthless. Lester Smith and Russell Gordy realized substantial private benefit from KSBE's lack of action in the form of un-collected [*sic*] liability for the bad investment they sold to KSBE and the bank notes that KSBE was forced to pay for their benefit . . . . No evidence was presented by KSBE to show that Smith and Gordy would have been financially unable to meet the liabilities for their involvement in KSBE's huge losses. Yet the trustees elected to not pursue any recovery of the money advanced to these two promoters.

Id. at II.C.1-9-10.

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[13] This amount equals the sum of the amounts paid for the net profits interest, the purchase of the BOH loans held by Smith, Gordy, and SG Methane, and legal fees associated with the litigation (estimated by the IRS to be $3 million).

[14] This amount is the sum of the Smith Offshore stock, the net profits interest, the working interest, and the plugging and abandonment costs (all as calculated by the IRS) that KS/KUKUI received in exchange for releasing Smith, Gordy and SG Methane from any and all liability.

4. Rubin Put Guaranty

The IRS asserted that the amount of "at-risk liability" that KS assumed to guarantee Robert Rubin's partnership draws from his interest in Goldman Sachs when he left to enter government service constituted a private benefit to Robert Rubin (former Secretary of the U.S. Treasury) in the amount of $42,012,078. The IRS alleged that the Put Guaranty, executed as of February 9, 1993, was "in reality an insurance contract" and that KS had not shown that the rate charged for the insurance coverage (75 basis points) was reasonable in view of the level of exposure KS assumed. According to the IRS, Goldman Sachs could "for any reason" stop paying Rubin's partnership draws and KS would be liable to continue to pay the draws, with KS's sole recourse being against Goldman Sachs. According to the IRS, KS had not shown that the $1,201,523 that the Trust Estate received in income from the Put Guaranty arrangement through June 30, 1996 was "reasonable in light of the tremendous level of exposure that KSBE assumed," *i.e.*, $42,012,078 (the full amount of the guaranteed partnership interest). According to the IRS, "[t]he amount at risk for the Put Guaranty Agreement jeopardized the school operations with a contingent liability of $42,012,078 which, if incurred, would have taken funds away from the operation of the school." Based on this analysis, the IRS concluded that Rubin received a private benefit in the amount of $42,012,078. *Id.* at II.C.4-5-7.

5. Guido Giacometti Contractor Fees

The IRS asserted that the $159,000 that KS paid to Guido Giacometti pursuant to a one-year consulting agreement "exceed[ed] an amount that would be considered as reasonable and therefore constitute[d] private benefit." Giacometti resigned as the General Manager of KS's Asset Management Group on November 2, 1990. His salary for the year ended June 30, 1990 was $101,928 plus $12,836 in employee benefit contributions. Giacometti and KS entered into a consulting agreement dated September 28, 1990, under which Giacometti was to receive

$159,000 over a period beginning (approximately) on November 3, 1990 and ending on November 2, 1991. The consulting agreement provided for services "as needed" to assist the Trustees in the transition to a successor General Manager. The consulting agreement also included a lengthy confidentiality covenant, but according to the IRS, Giacometti "was subject to a very comprehensive confidentiality agreement [while employed by KS] that extends to restrictions during post employment periods." Because KS failed to show what services Giacometti performed under the consulting agreement, or "how those services could possibly be worth more than his full time services while he was an employee of KSBE," the IRS concluded that the fees paid to Giacometti under the consulting agreement were "clearly excessive and constitute[d] payments to a private individual that are not related to the exempt purposes of the organization." *Id.* at II.C.5-1-2.

E. Additional Allegations of Political Activities

On at least four separate occasions during the period 1990-1994, the Trustees were briefed on the federal tax law rules that prohibit tax-exempt organizations from engaging in political activities. The prohibition is absolute, and any amount of political campaign activity is sufficient to support revocation of an organization's tax-exempt status. I.R.C. § 501(c)(3) (2000); *Branch Ministries v. Commissioner, Inc.*, 40 F. Supp. 2d 15 (D.D.C. 1999), *aff'd* 211 F.3d 137 (D.C. Cir. 2000). Nevertheless, the Trustees ignored this advice. ITTM at 20 ITFF at 27, ¶ 75.

The Interim Trustees asserted that the Trustees violated this absolute prohibition by spending tens of thousands of dollars in 1992, 1994, and 1996 to conduct political polling of certain legislators' races under the guise that they were conducting polling on water and land use issues. The purported "water" and "land use" surveys were concentrated in key legislative districts of friends and allies of the Trustees. The Trustees commissioned a well-known and established polling organization to conduct these polls. Trustees Peters signed checks for these polling activities, and the Trustees took careful steps to ensure that these polling activities remained secret. ITTM at 20-21; ITFF at 27-28, ¶¶ 76-78.

The Interim Trustees also asserted that the Trustees, through Trustee Wong, lobbied to defeat Margery Bronster's reconfirmation as AG. Following Governor Cayetano's re-election in 1998, the Governor nominated Margery Bronster to serve a second term as AG, a position requiring Senate confirmation. After the 1999 Legislative Session began in January of 1999, Larry Mehau, a close personal friend of Trustee Wong and head of HPA, a KS contractor, called Trustee Wong and left a message indicating that Mehau thought "they have the votes to stop appointment." In January 1999, Wong and Mehau met with freshman Senators Jonathan Chun, Colleen Hanabusa, Jan Buen, and David Matsuura. Trustee Wong admitted that there was discussion about Ms. Bronster's retention. In April 1999, these freshman Senators voted against Bronster's reconfirmation, and Bronster was not reconfirmed as AG. ITFF at 28-29, ¶¶ 79-80.

F. Allegations of Excessive Commercial Activities/Lack of Arm's Length Dealings with Taxable Subsidiaries

The KS Trustees established seventeen taxable subsidiaries during the early and mid-1990s. In 1993, KS personnel and outside consultants of the Trust Estate briefed the Trustees on restrictions that the federal tax law imposes on charitable organizations engaging in nonexempt activities. The Trustees were informed that it was essential for them to deal with the subsidiaries on an arm's length basis, observing all corporate formalities. The Trustees were warned that if this were not done, the IRS might ignore the separate corporate structure of the taxable subsidiaries, attribute their nonexempt activities to KS, and propose revocation of KS's tax-exempt status on that basis. ITTM at 20; ITFF at 26, ¶ 73.

The IRS and the Interim Trustees asserted that the Trustees ignored this advice. Trustee Peters placed himself on the boards of fourteen of the taxable subsidiaries and directed their activities from the KS Boardroom. Moreover, when interviewed by the IRS in the course of the IRS audit, Trustee Peters *boasted* about the fact that *he* controlled the activities of the subsidiaries. Consistent with the earlier advice given to the Trustees, the IRS, in its draft Forms 5701, proposed to disregard the separate corporate structure and attribute the activities of the taxable subsidiaries to KS. ITTM at 20; ITFF at 26-27, ¶ 74; Primary Purpose NOPA at 171.

VI. ALLEGED MISCONDUCT RELATED TO THE AG INVESTIGATION, THE MASTER'S REVIEW, AND THE IRS AUDIT

A. Master's Review

The AG alleged that the Former Trustees purposefully attempted to limit the Master's access to the Trust Estate's books and records and violated the Will by failing to make a full, accurate, and complete disclosure of the Trust Estate's financial condition. AG Petition at 9, ¶ 33; 12, ¶ 50. The AG also asserted that the Former Trustees terminated the internal auditor function in 1995 in order to conceal and protect improper transactions and conduct from being discovered by the Master. *Id.* at 13, ¶ 55. The AG further alleged that the Former Trustees purposefully administered the Trust Estate "by means of a labyrinthine maze of related organizations . . . to shield financial information from the Beneficiaries and the Master and to obscure the value, composition, and performance of the Trust's assets and investments." *Id.* at 13-14, ¶¶ 59-60.

B. AG Investigation and Petitions for Removal

The AG alleged that the Former Trustees expended substantial Trust Estate assets to protect the personal interests of the Former Trustees by withholding information of their misconduct from the AG during the AG's investigation. AG Petition at 57, ¶ 287.f. The AG alleged that the Former Trustees expended substantial Trust assets to pay the legal fees for employee-witnesses in ongoing legal proceedings to allow the Former Trustees to monitor employees and monitor the disclosure of information concerning Trustee misconduct. *Id.* at 57, ¶ 287.i. According to the AG, Trustees Peters, Wong, and Lindsey used Trust monies to protect their own personal interests by acting collectively as the "board of trustees" to hire counsel to protect alleged institutional interests. The AG alleged that Trustees Peters, Wong, and Lindsey authorized and approved excessive compensation to be paid to outside attorneys representing them as the "board of trustees" or similar collective entity. *Id.* at 58-59, ¶ 287.l. and m. The AG alleged that the Former Trustees approved spending Trust Estate assets on widespread advertising to protect their own image. *Id.* at 59, ¶ 287.o; *see also* Master's 1st Supp. Rpt. at 26 n.9. The AG further alleged that by failing at all times "even to comprehend the concept, meaning, or existence of a conflict of interest between themselves and the Beneficiaries," the Former Trustees violated H.R.S. § 554A-5(b), which requires any Trustee who has a conflict of interest with respect to the exercise of a trust power to obtain approval from the court before exercising that power. AG Petition at 60, ¶¶ 288-90.

The Master found that the Former Trustees faced a conflict of interest with respect to the AG's petitions for their removal and surcharge. Owing to this conflict of interest the Master recommended that an administrator *ad litem* be appointed to resolve issues with respect to litigation related to these proceedings. Moreover, the Master believed that the Former Trustees were in a position to control, and might restrict, access to relevant documents; had asserted evidentiary privileges and claims of confidentiality with respect to documents necessary to evaluate the merits of the AG's claims; and would use Trust Estate personnel and outside consultants paid with Trust Estate funds to advance personal interests. Master's 3rd Supp. Rpt. at 3-7.

C. Allegations of Master Richards

In a report filed with the Probate Court on May 18, 2000, court-appointed Master Robert Richards concluded that fees that the Trust Estate paid to certain consultants should be surcharged to the Former Trustees and in some cases disgorged. The primary basis for Master Richards' conclusions was that the services provided by these consultants furthered the personal interests of the Former Trustees rather than the interests of the Trust Estate. Master Richards asserted that all or a portion of the fees paid with respect to the following matters were not proper Trust Estate expenditures:

1. Fees relating to the petition for Trustee Lindsey's permanent removal filed by Trustees Stender and Jervis, as well as Trustees Peters' and Wong's opposition thereto, and fees charged in conjunction with other matters related to misconduct by the Former Trustees and Trustee Lindsey in particular (*e.g.*, the Yim Report and the WASC report and investigation) (Richards Rpt. at 35, 51, 62);

2. Fees paid for actions taken "to attempt to question and at least limit the authority of the Attorney General," with respect to the AG's investigation and removal and surcharge proceedings, including "Herculean efforts to avoid full disclosure of information" *Id.* at 5;

3. Fees paid to non-staff counsel to perform legal services with regard to the IRS audit (with respect to which a conflict existed between the interests of the Former Trustees and those of the Trust Estate) *Id.* at 9-10;

4. Fees paid for actions taken in response to subpoenas related to the grand jury proceedings involving Trustees Peters and Wong *Id.* at 52;

5. Fees paid to investigate certain individuals (*e.g.*, Judge Sam King and Rick Daysog) *Id.* at 58-59, 61, 73-74; and

6. Fees paid to prepare responses to requests and reports of the Master *Id.* at 73.

Master Richards asserted that the foregoing fees were all part of a "strategy" on the part of the Former Trustees "to obstruct the legal process, to delay where ever possible, to object wherever possible, to utilize so many lawyers and so many arguments that the opposition would be overwhelmed and would choose to give up." *Id.* at 11. Based on a review of billing invoices alone, Master Richards concluded that the Former Trustees dealt with the assets of the trust "as their own" to carry out this strategy. *Id.* at 11.

With respect to the legal services provided by Verner Liipfert, Master Richards alleged that "this firm did everything possible to delay production and, then, to attempt to limit the scope of that production" in response to subpoenas by the AG. *Id.* at 13. Master Richards asserted that "there was nothing of legal substance" in the work done by Verner Liipfert in 1998; rather, the work Verner Liipfert performed "simply represents the formulation and implementation of a strategy to delay and obstruct, discussed ad nauseum among a large number of firm personnel." *Id.* at 15. Master Richards concluded that the legal work done by Verner Liipfert was of "no benefit" to the Trust Estate. To the contrary, "it was designed solely to address allegations of past misconduct or at least errors of judgment made by individual trustees with regard to the earlier retention of [Verner Liipfert]." Richards Rpt. at 17. Consequently, Master Richards raised the prospect of "an interested party" seeking disgorgement of the fees paid to Verner Liipfert. *Id.*

Master Richards also alleged that the Former Trustees assembled a "team of lawyers" in 1997 to respond to the AG's investigation into their conduct. The "team" included the Cades firm (Michael Hare), the Ashford & Wriston firm (Bruce Graham), the Pitluck firm (Wayne Pitluck), and the McCorriston firm (William McCorriston). Master Richards alleged that the primary purpose of the team was "to defend the interests of the individual trustees from allegations of misconduct." As such, the attorneys' fees paid to these firms for such legal services were not a proper Trust Estate expense. *Id.* at 30-31.

With respect to the Cades firm in particular, Master Richards alleged (again based on his review of billing invoices) that "its purpose and goal more than any other law firm . . . was to represent the interests of the majority [Former Trustees]." Master Richards asserted further that the work of the Cades firm "was not only duplicative and wasteful, but also cannot be described in any fashion as benefiting the trust." *Id.* at 49. Master Richards alleged that Michael Hare participated in the "defense" of the Trust Estate against the AG's investigation as "a 'shadow' lead counsel," without documentation as to why this was necessary or advisable. *Id.* at 56. Master Richards also described as "troubling" a discussion that Hare had with Trustees Wong and Peters on the subject of a letter from Master Matsumoto endorsing Governor Cayetano and the AG's investigation of KS, which was followed by "an unsuccessful effort . . . to have that Master disqualified." *Id.* at 50. Based on his analysis, Master Richards recommended disgorgement of certain fees paid to the Cades firm. *Id.* at 58.

With respect to the McCorriston firm's work, Master Richards concluded that it was done in "defense of the trustees, not of the trust." The McCorriston firm also engaged in "monumental efforts," according to Master Richards, "to keep trustee conduct from coming to light or, if it did come to light, to rationalize it," and made additional efforts to "explain away" any conflicts between the interests of the Trust Estate and those of the Former Trustees. *Id.* at 67. Although he believed it to be a "'close' question," Master Richards concluded that disgorgement of the fees paid to the McCorriston firm for this work was not warranted. *Id.* at 75.

D. IRS Audit

1. Allegations that the Former Trustees failed to address conflicts of interest raised by the IRS audit.

As discussed above, the IRS proposed revocation of the Trust Estate's tax-exempt status on the basis that the Former Trustees: (1) failed to operate the Trust Estate exclusively for educational purposes; and (2) engaged in private inurement by paying themselves unreasonable compensation and by using Trust Estate monies in other ways for their private benefit. ITFF at 3-4, ¶ 8. Prior to the release of the draft Forms 5701, and based on the IDRs issued by the IRS, the Master concluded that "issues related to the individual Trustees and their conduct . . . may become subjects of the audit," thereby creating a conflict of interest between the interests of the individual Trustees and those of the Trust Estate in the context of the IRS negotiations. As such, the Master concluded that "it may become necessary for the Court to exercise oversight" of the negotiations between the IRS and the Trust Estate "to ensure that any conflicts of interest are dealt with appropriately and that the interests of the Trust Estate [are] properly protected." Master's Consol. Rpt. at 140.

Shortly after the IRS issued the draft Forms 5701, the Master recommended that the Probate Court authorize Mark McConaghy, Nathan Aipa, and the Master to communicate with the IRS to determine whether there was an actual conflict of interest between the individual interests of any of the Former Trustees and the interests of the Trust Estate with respect to the issues raised by the IRS audit. If a conflict were found, the Master recommended that the Probate Court appoint a panel of special administrators to resolve issues raised by the IRS audit. Master's 2nd Supp. Rpt. at 5-6. The Probate Court eventually appointed McConaghy, Aipa, and the Master to act as a special panel to review the Forms 5701 and determine whether there might be such a conflict with respect to resolving the issues raised by the audit. ITFF at 4, ¶ 9. The panel unanimously concluded that the Former Trustees faced actual, apparent, and material conflicts between their personal interests and those of the Trust Estate. *Id.*

Although Trustees Stender and Jervis proposed that the Former Trustees immediately recuse themselves from handling the IRS audit, Trustees Peters, Wong, and Lindsey refused to relinquish their control. The AG and the Interim Trustees asserted that this constituted a breach of Trustees' fiduciary duty of loyalty by putting their personal interests ahead of those of the Trust Estate. ITTM at 24; ITFF at 4, ¶ 10; AG Petition at 65, ¶ 301.e. The AG alleged that until February of 1999, the Former Trustees improperly oversaw the IRS audit despite the conflict between their interest in minimizing their personal liability and the obligation to minimize the Trust Estate's exposure to penalties and the possible revocation of the Trust Estate's tax-exempt status. AG Petition at 59, ¶ 287.q. Ultimately, in February of 1999, on petition by Trustees Stender and Jervis, the Probate Court removed Trustees Peters, Wong, and Lindsey from participation in the IRS audit. The Probate Court appointed a panel of Special Purpose Trustees to deal with the issues raised by that audit.[15] ITFF at 5, ¶ 11.

2. Allegations and findings that the Former Trustees failed to resign to preserve the Trust Estate's tax-exempt status.

a. Failure to Resign on an Interim Basis

On April 19, 1999, the Special Purpose Trustees ("SPTs") met with representatives from the IRS to open negotiations on the IRS audit. The IRS informed the SPTs that the permanent removal of all five Former Trustees was a non-negotiable condition for KS to retain its tax-exempt status through a closing agreement with the IRS. The IRS also informed the SPTs

[15] *See* Order Granting Trustees Oswald Kofoad Stender and Gerald Aulama Jervis' Petition for Approval of Voluntary Recusal with Respect to Pending Tax Audit and for Approval of a Panel of Special Administrators with Respect to Pending Tax Audit Filed January 21, 1999 (Feb. 26, 1999).

that if it did not receive a "clear signal" that appropriate action was being taken to satisfy this condition, the IRS would discontinue expedited negotiations and begin to seek summary revocation of the Trust Estate's tax-exempt status. ITFF at 8, ¶ 20. After conferring with their outside advisors, the SPTs filed a report with the Probate Court. Their report stated that the SPTs' tax advisors and litigation attorneys had unanimously concluded that continuing to negotiate with the IRS was in the best interest of the Trust Estate. These advisors and attorneys also concluded that lengthy and costly litigation with an uncertain outcome would ensue if KS failed to reach a negotiated settlement with the IRS on the proposed revocation of KS's tax-exempt status. ITTM at 25; ITFF at 8-9, ¶¶ 22-24.

Court-appointed Master Matsumoto subsequently submitted a report recommending, in part, that the Probate Court issue an order directing the Former Trustees to show cause why they should not be removed on an interim basis.[16] The Former Trustees, with the exception of Trustee Stender, refused to resign even temporarily despite the significant risk to KS's tax-exempt status. On May 7, 1999, the Probate Court ordered the temporary removal of Trustees Peters, Wong, Lindsey, and Jervis and accepted Trustee Stender's interim resignation. The Probate Court found that, with the exception of Trustee Stender, the refusal of the Former Trustees to resign even temporarily "create[d] an immediate and substantial risk of significant harm to the Trust Estate." Moreover, the Probate Court found that the "inaction and indifference" of Lindsey, Peters, Wong, and Jervis to the potential loss of the Trust Estate's tax-exempt status constituted a breach of duty. The Probate Court appointed the SPTs as Interim

[16] Master's Report Regarding Special Purpose Trustees' Report filed April 27, 1999, filed on April 29, 1999.

Trustees with the "full authority" to exercise all powers with respect to the Trust Estate.[17] ITFF at 9-10, ¶¶ 25-27.

b. Failure to Permanently Resign

The Interim Trustees negotiated a Closing Agreement with the IRS that preserved the tax-exempt status of KS (both retroactively and on a going-forward basis). The Probate Court concluded that the Closing Agreement was "in the best interests of the Trust Estate," and that "[a]bove all else, the settlement with the IRS protects and preserves the tax-exempt status and allows the charitable purposes and educational mission of the Trust Estate to continue into the future." The Closing Agreement resolution avoided "costly and lengthy administrative appeals and litigation with the IRS over issues arising out of the IRS Audit of the Trust Estate." In addition to being costly and lengthy, the Probate Court noted that there was "no certainty (or even a probability) that the Trust Estate would ultimately prevail in the litigation with the IRS."[18] ITFF at 15, ¶ 44.

The IRS's agreement to enter into the Closing Agreement was contingent, however, on the permanent resignation or removal of all five Former Trustees. The Probate Court concluded that without the resignation or removal of the Former Trustees, there was a significant risk that the "loss of the tax-exempt status of the Trust Estate could result in a financial loss to Kamehameha Schools Bishop Trust Estate in excess of $750 million and would have immediate, permanent adverse consequences on the future operations of the Trust Estate, its subsidiaries and

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[17] *See* Order Regarding Order to Show Cause Regarding Special Purpose Trustees' Report and Order to Show Cause Regarding New CEO Based Management System (May 7, 1999); Vesting Order (David Paul Coon, Francis Ahloy Keala, Ronald Dale Libkuman, Constance Hee Lau and Robert Kalani Uichi Kihune) (May 7, 1999).

[18] *See* Order Approving Petition for Approval of Settlement of IRS Audit Issues (December 1, 1999).

affiliated organizations, the beneficiaries of the Trust Estate and the Hawaiian community."[19] *Id.* Although Trustees Stender and Jervis resigned before the Interim Trustees filed their petition for the permanent removal of the Former Trustees, Trustees Peters and Lindsey refused to step down until the eve of the Probate Court hearing for their permanent removal. Trustee Wong resigned only a few weeks before the hearing. *Id.* at 12, ¶ 35. The Interim Trustees and the AG asserted that the failure of these Former Trustees to resign to preserve the tax-exempt status of the Trust Estate constituted a breach of their fiduciary duties. ITTM at 30; ITFF at 38-39, ¶ ¶ 6-7; AG Petition at ¶ 287.n.

VII. ADDITIONAL ALLEGATIONS (NOT FOR ATTRIBUTION)

During the course of our review, we conducted a number of interviews in which additional allegations and information were obtained concerning the employees and consultants under review. To encourage the interviewees to be frank and open regarding the matters under consideration, we agreed not to attribute the allegations and information provided to specific interviewees. Accordingly, the allegations and information set out below are provided on an anonymous basis.

A. Robert Bruce Graham, Jr. (Ashford & Wriston)

Graham is alleged to have argued, on behalf of the Former Trustees, that the Probate Court not suspend compensation paid to the Former Trustees for the fiscal year ending June 30, 1999. It was also asserted that Graham filed responses to the Master's Report on behalf of the Former Trustees that defended their intermediate sanctions lobbying efforts. Graham is also alleged to have defended the Former Trustees at the hearing to show cause why they should not be found to be in violation of the stipulated order requiring them to adopt a CEO form of

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[19] *Id.*

governance before March 31, 1999. It was further alleged that Graham took inconsistent positions regarding his representation of the Former Trustees and the Trust Estate—at first he argued that he represented the KS Trustees as fiduciaries and that the Trust Estate is not an "entity," but then later embraced an "entity theory" of representation.

It was also asserted that Graham provided bad advice, as follows: (1) he advised the Former Trustees that they had the power to rescind the waiver of commissions on FDOC, despite a binding stipulated order to the contrary; and (2) he suggested that the Former Trustees set compensation "aggressively" under the new State statute limiting compensation to a "reasonable" amount. It was further asserted that Graham offered misleading or false trial testimony when he testified that he did not know or could not approximate the compensation paid to the Former Trustees after January 1, 1999.

B. Cades Schutte Fleming & Wright

It was asserted that Cades should not have been given the responsibility of screening the documents to be produced in response to AG subpoenas because Cades had advised the Former Trustees about some of the transactions to which the subpoenas pertained, including the payment of Milton Holt's legal fees (as discussed above). Moreover, it was asserted that certain documents that Cades withheld from production to the AG were not subject to a bona fide privilege claim.

C. Mark McConaghy (PWC)

It was alleged that Mark McConaghy co-invested with the Trust Estate in a limited partnership with Ben Benson that acquired timberland in the upper peninsula of Michigan. It was asserted that McConaghy received a more favorable tax treatment than the Trust Estate did with respect to the investment and was given a preferred payout of partnership income.