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IN THE CIRCUIT COURT OF THE FIRST CIRCUIT

STATE OF HAWAII

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| In the Matter of the Estate<br><br>of<br><br>BERNICE P. BISHOP,<br><br>Deceased. | EQUITY NO. 2048<br><br>**INTERIM TRUSTEES' PROPOSED FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER; ATTACHMENTS "A" - "D"; CERTIFICATE OF SERVICE**<br><br>**Hearing Date: December 13, 1999**<br>**Time: 9:00 a.m.**<br>**Judge: The Honorable Colleen Hirai** |

# INTERIM TRUSTEES' PROPOSED FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER

## I. FINDINGS OF FACT

### A. Background.

1 In 1884, Princess Bernice Pauahi Bishop (the "Princess"), the great-granddaughter and last surviving heir of King Kamehameha the Great, died. The Princess' Will (the "Will") created the Bishop Estate, a perpetual charitable trust, and provided for the establishment of two schools "in the Hawaiian Islands . . . one for boys and one for girls, to be known as and called the Kamehameha Schools." The two schools were later merged and now operate as a coeducational institution at the principal campus at Kapalama Heights in Honolulu and at other locations in the Hawaiian Islands. The Bishop Estate is now known as and referred to as Kamehameha Schools Bernice Pauahi Bishop Estate (the "Trust Estate" or "KSBE"). [**Exh. 181, 188, and 304**].

2. On February 9, 1939, KSBE was granted an exemption from federal income tax under Section 101(6) of the Internal Revenue Code of 1939 as a school. This status is the same as the current Section 501(c)(3) of the Internal Revenue Code (the "Code"). This original determination of exempt status was reconfirmed on November 28, 1952 and April 16, 1969, and at all pertinent times KSBE has operated as a Section 501(c)(3) organization under the Code. **[Exh. 185 and 217]**.

3. Section 501(c)(3) of the Code exempts from federal taxation organizations organized and operated exclusively for religious, charitable, scientific, or educational purposes whereby no part of the net earnings inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation and which does not intervene on behalf of (or in opposition to) any candidate for public office. **[Exh. 214 and 230 at Tab J.1] [Testimony of R.L. Moore, B. Hopkins, and D. Cornwell]**.

4. These restrictions are placed on Section 501(c)(3) organizations to ensure that the benefit that is conferred by exempting an organization from Federal taxation is used for the public good. Thus, in exchange for accepting the benefits of tax-exempt status, an organization must operate "exclusively" for its exempt purpose, must not permit any of its income to "inure" to the benefit of private individuals, and must not use its funds to engage in political activities for or against any candidate. **[Testimony of R.L. Moore]**.

B. The IRS audit and resolution of IRS audit issues.

5. In 1995, the Internal Revenue Service ("IRS") began an audit of KSBE's tax years for 1992-1996. The IRS had previously audited the Trust Estates's tax years 1990 and

1991 and some issues from the earlier audit, including the reasonableness of the KSBE's Trustees compensation, remained open. These open issues for tax years 1990 and 1991 were included in the audit that began in 1995. KSBE is on a July 1 - June 30 fiscal year. As a consequence, KSBE's tax years 1990-1996 cover the calendar period July 1, 1989 through June 30, 1996. (Hereinafter this period will be referenced to as the "audit period") **[Exh. 184, 185 and 186].**

6. The IRS audit examined not only whether KSBE had properly reported various income and expense items during the audit period, it also examined whether KSBE's activities during the audit period were in compliance with the restrictions applicable to tax-exempt organizations. In this regard, the IRS examined whether KSBE was operated "exclusively for . . . educational purposes," whether any part of the Trust Estate's net earnings "inured to the benefit of any individual," and whether there was any evidence that KSBE had attempted to "influence legislation" or had "intervene[d] on behalf of (or in opposition to) any candidate for public office." **[Exh. 185].**

7. At the conclusion of the audit, on December 31, 1998, the IRS issued a series of Forms 5701 to KSBE. A Form 5701 is a Notice of Proposed Adjustment issued by the IRS to taxpayers during or after an audit. The Form 5701 informs the taxpayer of taxable adjustments that the IRS proposes to make as a result of the audit and explains the basis for those proposed adjustments. The Form 5701 is designed to be mechanism to enable the IRS and the taxpayer to attempt to resolve audit issues short of litigation. **[Exh. 184, 185, and 186] [Testimony of R.L. Moore].**

8. The Forms 5701 issued to KSBE asserted that the Incumbent Trustees had failed to operate the Trust Estate exclusively for educational purposes, and that they had engaged

in private inurement by paying themselves unreasonable compensation and by using Trust monies in other ways for their private benefit. As a consequence, the IRS proposed the revocation of KSBE's tax-exempt status retroactive to July 1, 1989. The Forms 5701 issued to KSBE also proposed various adjustments to KSBE income and expense items. **[Exh. 184, 185, and 186] [Testimony of R.L. Moore].**

9. Prior to the issuance of the Forms 5701, but when the issuance of the Forms 5701 was expected, the Court's Master, (Colbert Matsumoto), anticipated that the issues in the Forms 5701 could raise conflicts of interest between the interests of the Incumbent Trustees and the interests of the Trust Estate. As a consequence, on December 9, 1998, the Court appointed a panel (the "Conflicts Panel") consisting of the Master (Mr. Matsumoto), the Trust Estate's General Counsel (Nathan Aipa), and the Trust Estate's long-time tax advisor (Mark McConaghy), to review the Forms 5701 when they were issued and to advise the Court whether such conflicts existed. On January 21, 1999, the Conflicts Panel unanimously concluded that there were actual, apparent, and material conflicts of interest that existed between the interests of the Incumbent Trustees and the interest of the Trust Estate. On February 26, 1999, the Conflicts Panel so informed the Court. **[Exh. 189].**

10. In response to the report of the Conflicts Panel, Incumbent Trustees Stender and Jervis voluntarily recused themselves from participation in the resolution of the IRS audit issues and asked the Probate Court to recuse the other Trustees and appoint a special panel to handle the IRS audit issues for the Trust Estate. Incumbent Trustees Wong , Peters, and Lindsey opposed the appointment of such a special panel. **[Exh. 189].**

11. On February 26, 1999, after reviewing the Forms 5701 in camera, the Court relieved all of the Incumbent Trustees "of all powers, authority, duties and responsibilities with respect to exercising any trust powers related to the IRS audit, and all issues thereof" and appointed Robert K. U. Kihune, Constance Hee Lau, Francis A. Keala, David P. Coon, and Ronald D. Libkuman as Special Purpose Trustees ("SPTs") to act for the Trust Estate with respect to the IRS issues. The court "authorized and empowered [the SPTs] to exercise trust powers related to the IRS audit in all respects . . . including . . . (i) the conduct of communications with the IRS; (ii) coordination of the work of the Trust Estate's [staff]; (iii) retention of consultants and professionals, including attorneys and accountants; (iv) reaching and achieving a final resolution of the IRS audit in the best interest of the Trust Estate; (v) agreeing to pay or contest any claim against the Trust Estate . . . [and] (vii) executing and delivering all instruments necessary to accomplish or facilitate a final resolution of the IRS audit . . ." **[Exh. 189]**.

12. The SPTs retained the services of Arthur Andersen, PricewaterhouseCoopers, and Miller & Chevalier to advise them as to the IRS audit issues. Arthur Andersen had been retained jointly by the Incumbent Trustees and the Court's Master in 1998 to examine and evaluate the IRS audit issues. PricewaterhouseCoopers was the Trust Estate's long-time tax advisor and was familiar with many of the transactions that were the subject of the IRS audit. Miller & Chevalier is a nationally recognized law firm located in Washington, D.C., specializing in tax litigation. (Collectively, Arthur Andersen, PricewaterhouseCoopers, and Miller & Chevalier will be referred to as the "tax advisors.") **[Testimony of R. Kihune, R.L. Moore, and D. Cornwell]**.

13. The SPTs asked their tax advisors to evaluate the Forms 5701, to advise them of the strength of the IRS's position on the issues, and to assist the SPTs in negotiating a resolution of these issues with the IRS. **[Testimony of R. Kihune, R.L. Moore, and D. Cornwell].**

14. On March 3, 1999, the SPT's tax advisors along with Robert Kihune, Chair of the SPTs, met with IRS representatives in Los Angeles to discuss the Forms 5701. This meeting was designed to give the Trust Estate's tax advisors an opportunity to clarify issues raised by the Forms 5701 and to enable the IRS and the Trust Estate to discuss a schedule for discussion of the Forms 5701 to determine whether the issues raised in the Forms 5701 could be resolved short of litigation. **[Testimony of R. Kihune].**

15. There are standard procedures available for taxpayers to contest issues raised in an IRS audit if the audit issues cannot be resolved at the Form 5701 stage. However, these procedures are time consuming and costly and, where the issues are as numerous and complex as those arising out of the IRS audit of KSBE, the administrative and judicial proceedings to resolve such issues can take years to complete at a cost of millions of dollars. **[Testimony of R.L. Moore and B. Hopkins].**

16. In this case, the IRS offered KSBE the opportunity to utilize a special consolidated procedure that could enable KSBE and the IRS to attempt to resolve the KSBE audit issues on an expedited basis. The special consolidated procedure consisted of bringing together representatives of the IRS District Office, the Exempt Organizations Division of the IRS National Office, and the IRS Office of Chief Counsel to form a single IRS negotiating team with

whom KSBE could attempt to negotiate a resolution of the IRS audit issues. **[Testimony of R.L. Moore].**

17. The SPT's tax advisors advised the SPTs that the special consolidated approach offered by the IRS presented a unique opportunity for the Trust Estate to explore resolution of the IRS audit issues on an expedited basis. **[Exh. 193, 196, and 197] [Testimony of R. Kihune, R.L. Moore, and D. Cornwell].**

18. At the March 3, 1999 meeting with the IRS in Los Angeles, and in subsequent telephone conferences in early and mid-March, the IRS and KSBE agreed to negotiate the issues raised by the Forms 5701 in three issues "clusters": (1) revocation issues; (2) unrelated business income issue; and (3) KSBE taxable subsidiary issues. It was agreed to hold the first meeting to discuss the revocation issues on April 19, 1999, in Los Angeles. **[Testimony of R.Kihune].**

19. During February, March and April, the SPT's tax advisors analyzed and evaluated the issues in the Forms 5701. They interviewed KSBE staff familiar with the issues and reviewed documents relevant to these issues. They also obtained additional information from the IRS. **[Testimony of R.L. Moore and D. Cornwell].**

20. On April 19, 1999, the SPTs and representatives of PricewaterhouseCoopers and Arthur Anderson met with representatives of the IRS to begin a discussion of the issues that formed the basis of the IRS's proposed revocation of KSBE's tax exempt status. At the April 19, 1999 meeting, the IRS representatives advised the SPTs that the IRS was prepared to revoke KSBE's tax-exempt status unless fundamental changes in the Trust Estate's governance could be agreed upon that would ensure that adequate safeguards were in

place to prevent the abuses of the past from reoccurring in the future. The IRS also stated that a non-negotiable condition of any settlement that would preserve the Trust Estate's tax-exempt status was the permanent resignation or removal of all five of the Incumbent Trustees. The IRS also advised the SPTs that unless they received a "clear signal" that appropriate action was being taken to satisfy this condition, it would discontinue negotiations with the SPTs and begin the process to revoke KSBE's tax-exempt status. **[Exh. 192, 195, 204 and 206] [Testimony of R. Kihune and D. Cornwell].**

21. The IRS subsequently confirmed the requirement that all five of the Incumbent Trustees must resign or be permanently removed before the IRS would execute a Closing Agreement preserving the Trust Estate's tax-exempt status. **[Exh. 192, 204, and 206].**

22. Following the meeting with the IRS on April 19, 1999, the SPTs met with their tax advisors. They asked the tax advisors to explain the options. They asked for an explanation of the procedures available for contesting the IRS audit issues in the event settlement discussions were not feasible. They asked for estimates of the cost and time required to resolve these issues through litigation. They also asked for their advisors' evaluation of the risk that the tax-exempt status of the Trust Estate would be lost if the issues were litigated and the financial impact to the Trust Estate if the tax-exempt status was lost. **[Testimony of R. Kihune and D. Cornwell].**

23. The SPTs' tax advisors unanimously agreed that litigating the revocation issues would be a lengthy and costly process, that there was a significant risk that the tax-exempt status of the Trust Estate could be lost if the issues were to be litigated, that the financial cost to the Trust Estate from a loss of its tax-exempt status would be significant, and that it was in the

best interest of the Trust Estate to continue to explore a settlement of the IRS audit issues. **[Exh. 193, 196, and 197] [Testimony of R.Kihune, R.L. Moore, and D. Cornwell].**

24. The SPTs asked their tax advisors to provide this advice in writing. On April 27, 1999, following receipt of letters from each of their advisors, the SPTs filed a report with the Probate Court informing the Court of the IRS's non-negotiable demand for a "clear signal" on resignation or removal of the Incumbent Trustees in order to enable negotiations to continue, and the advice of their tax advisors that continued negotiation would be in the best interest of the Trust Estate. **[Exh. 193, 195, 196, and 197] [Testimony of R. Kihune].**

25. On April 29, 1999, the Court issued an Order to Show Cause why the Incumbent Trustees should not be temporarily removed to allow the IRS negotiations to continue. Trustee Stender agreed to resign temporarily to enable such negotiations to continue, but the other four Incumbent Trustees refused to resign temporarily to allow the SPTs to attempt to negotiate a settlement that would preserve the Trust Estate's tax-exempt status. **[Exh. 206].**

26. Following a hearing on May 7, 1999, the Court temporarily removed the Incumbent Trustees, appointed the SPTs as Interim Trustees "with full and complete direction, power and authority to exercise all trust powers . . .," and gave the Interim Trustees 90 days within which to seek the permanent removal of any Incumbent Trustee who did not resign. **[Exh 206 and 207].**

27. In so doing, the Court found that the IRS had made a non-negotiable demand that the Incumbent Trustees resign or be removed in order to enable KSBE to maintain its tax-exempt status, that continued settlement discussions with the IRS were in the best interest of the Trust Estate, and that revocation of the Trust Estate's tax-exempt status would have a

major financial impact on the Trust Estate. The Court further found that "the loss of the ability of the Trust Estate . . . to negotiate with the IRS . . . poses a threat of imminent harm to the Trust Estate" and that "the inaction and indifference of the Incumbent Trustees to the potential loss of the opportunity to engage in. . . settlement negotiations . . . and the potential loss of the Trust Estate's tax-exempt status might thereby result because of their refusal to offer their resignation as Trustees . . . constitutes a breach of duty." (Emphasis added). The Court also found that the failure of the Incumbent Trustees to comply with the Court's order to appoint a CEO was a breach of their fiduciary obligation. **[Exh. 206]**.

28. Following the May 7, 1999 hearing, the Interim Trustees had further negotiations with the IRS with respect to the proposed revocation of KSBE's tax-exempt status. On May 10 and 11, 1999, the SPTs and their advisors met with representatives of the IRS in Los Angeles to discuss the governance issues that would need to be addressed as part of any settlement. During these meetings, the Interim Trustees and the IRS reached a tentative agreement on a number of conceptual principles that could form the basis for a resolution of the governance issues. At the conclusion of the meeting, the Interim Trustees told the IRS that they would attempt to draft a Closing Agreement that would provide the details of how the Interim Trustees would propose to implement the tentative agreements in principle that had been reached. **[Testimony of R. Klhune]**.

29. On May 27, 1999, the SPTs provided the IRS with an initial draft of a Closing Agreement detailing how the Interim Trustees proposed to address the governance issues raised by the IRS. In early June, the SPTs received a favorable response from the IRS to the May

27 draft Closing Agreement, and a second negotiation was scheduled in Washington, D.C. on June 30 and July 1, 1999. **[Testimony of R. Kihune]**.

30. After receiving a positive reaction to their May 27 draft Closing Agreement, the SPTs in early June, 1999, asked their tax litigation counsel, Miller & Chevalier, to prepare an opinion letter containing a thorough assessment of the hazards of litigating the proposed revocation of KSBE's tax-exempt status. Miller & Chevalier asked Arthur Andersen to calculate the financial impact to KSBE that would result from the retroactive revocation of KSBE's tax-exempt status as proposed by the IRS. **[Testimony of R. Kihune, R.L. Moore, and D. Cornwell]**.

31. On June 30 and July 1, 1999, the Interim Trustees met with the IRS in Washington, D.C. The Interim Trustees were represented at these meetings by Trustees Kihune and Lau. Issues were discussed with Trustees Libkuman, Coon, and Keala by telephone as necessary. During the meetings, all of the tax issues relating to KSBE were resolved, and the Interim Trustees received further comments on the draft Closing Agreement from the IRS. **[Testimony of R. Kihune, R.L. Moore, and D. Cornwell]**.

32. While they were in Washington, D.C., for the June 30-July 1 meetings, Interim Trustees Kihune and Lau met with Robert L. Moore, senior tax litigation partner at Miller & Chevalier. Mr. Moore advised the Interim Trustees that, while the drafting of his firm's opinion letter was not complete, he had concluded his analysis of the risk of litigating the proposed revocation of KSBE's tax-exempt status. Mr. Moore advised the Interim Trustees that in his opinion there was a significant risk that the tax-exempt status of the Trust Estate would be lost were the issues to be litigated. **[Testimony of R. Kihune and R.L. Moore]**.

33. By early July 1999, Arthur Andersen's calculations on the financial cost that would result from a loss of KSBE's tax-exempt status had progressed to the point that it advised the Interim Trustees that the financial impact could be in the hundreds of millions of dollars. **[Testimony of R. Kihune and D. Cornwell].**

34. On July 16, 1999, the Interim Trustees sent a letter to each of the Incumbent Trustees. The letter advised the Incumbent Trustees that the Interim Trustees had concluded, based on the advice of their advisors, that there was a significant risk that the Estate would lose its tax-exempt status if the IRS's proposed revocation of KSBE's tax-exempt status were to be litigated, that such litigation would result in significant expense and disruption to the Estate, that the Interim Trustees were negotiating a settlement with the IRS that would preserve the Trust Estate's tax-exempt status, but that a condition of preserving that tax-exempt status was the permanent resignation or removal of all of the Incumbent Trustees. The Interim Trustees advised the Incumbent Trustees that their actions and breaches of fiduciary duty had put the tax-exempt status at risk and called upon the Incumbent Trustees to resign. The Interim Trustees advised the Incumbent Trustees that absent such resignation, the Interim Trustees were prepared to file a petition with the Probate Court seeking their permanent removal. **[Exh. 210] [Testimony of R. Kihune].**

35. Incumbent Trustees Stender and Jervis resigned before the Petition for Permanent Removal was filed. Incumbent Trustee Wong resigned after the Petition for Permanent Removal was filed, but before the hearing on the Petition commenced. Incumbent Trustees Peters and Lindsey have refused to resign. **[Exh. 212, 219, and 339] [Testimony of R. Kihune].**

In early August 1999, the Interim Trustees agreed on the final terms of a Closing Agreement with the IRS. Under the terms of the Closing Agreement, the tax-exempt status of KSBE will be preserved for all past periods and on a going-forward basis. A condition precedent to the execution of the Closing Agreement, however, is the permanent resignation or removal of all five of the Incumbent Trustees. **[Exh. 217 and 221] [Testimony of R. Kihune].**

37. On August 12, 17 and 19, 1999, Miller & Chevalier, PricewaterhouseCoopers, and Arthur Andersen provided the Interim Trustees with their respective opinions that the proposed settlement agreement with the IRS was reasonable. **[Exh. 213, 222 at Tab 8, and 223].**

On August 12, 1999, Robert L. Moore, senior tax litigation counsel at Miller & Chevalier, provided the Interim Trustees with an extensive opinion letter assessing the risk that the tax-exempt status of the Trust Estate would be lost if the proposed revocation of its tax-exempt status were litigated. Mr. Moore's letter confirmed the oral advice that he had provided to the Interim Trustees in Washington, D.C. in early July that "[s]hould the matter proceed to litigation, we conclude that the Estate faces a significant risk that the [IRS's] revocation of KSBE's Section 501(c)(3) status would be sustained." As a consequence, Mr. Moore recommended that "weighing these costs and the significant risks involved with this litigation . . . it is our opinion that avoiding litigation of the revocation issues through a settlement . . . that would preserve the Estate's tax-exempt status, on terms that are acceptable to the Interim Trustees, would be in the best interest of the Estate." **[Exh. 214 at 21-22 and Exh. 231] [Testimony of R.L. Moore]. (A copy of Mr. Moore's August 12, 1999 opinion and his October 9, 1999 supplementary opinion are contained in Attachments A and B hereto).**

39. On August 16, 1999, the Interim Trustees asked the IRS to confirm its non-negotiable condition that the Incumbent Trustees resign or be permanently removed before the IRS would execute the Closing Agreement preserving KSBE's tax-exempt status. The IRS provided written confirmation of its position on August 19, 1999. **[Exh. 215 and 221] [Testimony of R. Kihune].**

40. On August 19, 1999, the Interim Trustees voted unanimously to approve the Closing Agreement as being reasonable and in the best interests of the Trust Estate and found that such an agreement would benefit the charitable purposes of KSBE. The Interim Trustees also voted unanimously to petition the Probate Court for the permanent removal of the Incumbent Trustees who had not resigned. **[Exh. 222] [Testimony of R. Kihune].**

41. In so doing, the Interim Trustees acted on the unanimous advice of their tax advisors that there was a significant risk that the tax-exempt status would be lost were that issue to be litigated and that loss of the Trust Estate's tax exempt status would result in substantial financial cost to the Trust Estate. Arthur Andersen calculated that cost at in excess of $750 million for the period July 1, 1989 through June 30, 1999. (This figure was later revised to be in excess of $900 million). Additional millions of dollars would be lost in future periods were the tax-exempt status to be revoked. **[Exh. 213, 214, 216, 222, 223, and 227] [Testimony of R. Kihune].**

42. On August 24, 1999, the Interim Trustees filed a Petition for Approval of the Closing Agreement and a Petition for Removal of the Remaining Incumbent Trustees. **[Testimony of R. Kihune].**

The Petition for Approval of the Closing Agreement was heard on October 8, 1999. [Exh. 306].

44. On December 1, 1999, the Probate Court entered an order approving the Closing Agreement. In so doing, the Probate Court found that "loss of the tax exempt status of the Trust Estate could result in a financial loss to Kamehameha Schools Bishop Estate in excess of $750 million and would have immediate, permanent and adverse consequences on the future operation of the Trust Estate, its subsidiaries and affiliated organization, the beneficiaries of the Trust Estate and the Hawaiian Community." [Exh. 306]. The Probate Court found that "the proposed settlement avoids costly and lengthy administrative appeals and litigation with the IRS over issues arising out of the IRS audit of the Trust Estate . . . [and] that there is no certainty (or even a probability) that the Trust Estate would ultimately prevail in the litigation with the IRS." [Exh. 306]. The Probate Court further found that "the expert opinions of Arthur Andersen, PriceWaterhouseCoopers and Miller & Chevalier, on which the Interim Trustees relied in passing their August 19, 1999 Resolution agreeing to the IRS settlement and to the filing of a petition to remove the Incumbent Trustees, <u>are credible and supported by the relevant facts and circumstances."</u> (Emphasis added.) [Exh. 306].

C. <u>The misconduct of the remaining Incumbents has placed the tax-exempt status at risk</u>

1. <u>Excessive Trustee Compensation</u>

During the late 1980's and early 1990's, the appreciation of Hawaiian real estate, coupled with the forced conversion of trust land, resulted in dramatic increases in revenues flowing into the Trust Estate. These increases were accompanied by increases in KSBE trustee commissions, as reflected in the data for fiscal years 1992-1998.

| | |
|---|---|
| 1992 | $ 860,653 |
| 1993 | $ 823,974 |
| 1994 | $ 915,238 |
| 1995 | $ 938,047 |
| 1996 | $ 843,109 |
| 1997 | $ 844,600 |
| 1998 | $1,037,012 |

**[Exh. 244] [Testimony of W. Chin].**

46. By 1993, the level of Trustee compensation drew the attention of the United States Congress. Hearings were conducted on private inurement abuses by Section 501(c)(3) charitable organizations, and the commissions paid to KSBE Trustees were discussed. On September 13, 1993, Mark McConaghy, the Trust's outside tax adviser, briefed the Incumbent Trustees on the Congressional hearings and advised them of Congressional concerns with specific reference to the level of KSBE trustee compensation. **[Exh. 16] [Testimony of L. Lindsey].** Despite these concerns, the Incumbent Trustees took no action to moderate their compensation and instead either maintained or increased that level of compensation in subsequent years.

47. In early 1994, the IRS District Office formerly questioned the reasonableness of KSBE Trustee compensation in a Request for Technical Advice submitted to the IRS National Office from the Los Angeles District Office. The IRS District Office raised the following specific issues.

1. Is the compensation paid to KSBE trustees excessive?

2. If the compensation is excessive, does it constitute private inurement?

3. If there is private inurement, how does it affect the tax-exempt status of KSBE?

[Exh. 20 at 10].

48. On April 8, 1994, the Incumbent Trustees submitted a response to the Request for Technical Advice and attached a 1993 study prepared by Strategic Compensation Associates ("SCA"). The SCA study was based entirely on data from for-profit organizations and did not include any compensation data from non-profit institutions or educational institutions. [Exh. 21].

49. In early 1995, the IRS National Office declined to provide Technical Advice on the Incumbent Trustees' compensation. The National Office advised KSBE that the SCA study was deficient because it was not based on data from educational institutions and that the IRS would not defer to state law for purposes of the reasonableness of compensation for IRS purposes. The National Office further advised KSBE that the IRS would conduct a formal audit of KSBE and that the reasonableness of trustee compensation would be one of the issues examined in that audit. [Exh. 45, 51] [Testimony of L. Lindsey]. Despite the IRS criticisms of the SCA study and the refusal to defer to state law, the Trustees took no action to revise their compensation. Instead, in fiscal year 1995, they increased their compensation from $915,238 to $938,047.

50. In April 1995, the Wall Street Journal published an article concerning KSBE and the level of compensation paid to its Trustees. **[Exh. 301]**. This article caused Counsel for the House Committee of Ways and Means (Michael Superata) to express his surprise in a public forum on the level of KSBE Trustee compensation. **[Exh. 55 at 2]**.

51. In 1996, the KSBE Trustees commissioned a compensation study by Towers Perrin. Absent pre-established performance goals, Towers Perrin set the highest defensible range of compensation at $683,000 to $758,000. **[Exh. 119 at 1-2]**. Despite the absence of pre-established performance goals at KSBE, trustee compensation exceeded the level set in the 1996 Towers Perrin report throughout the period 1992-98.

52. Following the passage of the Intermediate Sanctions legislation in the summer of 1996, Mark McConaghy briefed the KSBE Trustees on the new legislation. He informed them that the IRS would look at individual qualifications and responsibilities in determining the reasonableness of compensation. **[Exh. 139 and 143] [Testimony of L. Lindsey]** Despite these briefings, the KSBE Trustees took no action to evaluate whether their individual qualifications and responsibilities justified their level of compensation.

53. On November 13, 1998, the KSBE Trustees filed "A Plan for Determining Trustee Compensation" with the Probate Court. The plan acknowledges the applicability of Section 162 of the Internal Revenue Code for purposes of determining the reasonableness of compensation, the importance of independent studies and actual written job offers from similar institutions, and the significance of an independent committee in determining the reasonableness of trustee compensation. **[Exh. 183]**. This plan represents the first effort on the part of the KSBE Incumbent Trustees to apply IRS standards in determining their compensation and to have

their compensation determined by an independent body, as opposed to being determined by the Trustees themselves.

54. To examine the reasonableness of trustee compensation during the years 1992 to 1998, the KSBE Interim Trustees engaged Mr. Martin L. Katz, a principal of William M. Mercer, Inc., and a specialist in executive compensation, to review the prior compensation studies performed for the Incumbent Trustees, to perform an independent analysis of trustee compensation for the years in question, and to review trustee compensation under the criteria employed by the IRS and the courts in evaluating the reasonableness of compensation. Based on that analysis, Mr. Katz believes that a reasonable range of compensation for the years 1992-98 would be between $217,000 and $357,750 per trustee. Mr. Katz stated that "There is a significant risk that a Court would conclude that the ranges of compensation for the Incumbent Trustees established by those earlier studies are excessive." [Exh. 228 at 37]. Mr. Katz found the earlier compensation studies to be deficient in the following respects:

> -- The consultants compared the Estate strictly to for-profit organizations, excluded large private foundations and all charitable and other non-for-profit organizations as comparables, and misapplied the comparisons to university-owned investment management companies.
>
> -- The consultants overstated the Trustees' role by aggregating management and governance responsibilities that essentially ignored the roles and responsibilities of the Estate's top executives.
>
> -- The consultants allocated "the total cost of governance" of selected peer groups to the Trustees, which in effect attributed the total compensation of 15-20 people

to the five Trustees, creating an artificial value of compensation.

[*Id.* at 2.] Mr. Katz also criticized the consultants for assuming that the Incumbent Trustees were qualified to serve in management roles (e.g., Chief Executive Officer, Chief Financial Officer, and Chief Investment Officer) when they were really qualified only for a governance (e.g., Trustee) role. [*Id.* at 6.]

2. Possible change in domicile and tax status

55. At the same time that scrutiny of trustee compensation was increasing, the KSBE Trustees undertook an evaluation of whether to change the domicile and tax status of the Trust Estate. In January 1995, the Incumbent Trustees retained the law firm of Verner Liipfert Bernhard McPherson & Hand ("Verner Liipfert") to examine these possible changes. From the very outset, concern was expressed about the Hawaii State Legislature interfering with trustee compensation. **[Exh. 41] [Deposition of Douglas O. Adler].**

56. The Trustees explained to Mr. Adler that they were frustrated by "interferences" in the Trust Estate's affairs by the Attorney General and the Court's Master. A change in domicile to a location outside Hawaii was seen as a way of avoiding the scrutiny of Trustee activity. **[Exh. 41].**

57. The Trustees were also chafing under the IRS restrictions that govern tax-exempt organizations. Changing the Trust Estate's taxable status from tax-exempt to taxable was seen as a means of avoiding IRS restrictions on compensation, commercial activities, and political activities. **[Exh. 60].**

58. In connection with the domicile investigation, the Trustees instructed Verner Liipfert to examine the consequences of moving the trust to a tribal reservation. Douglas

Adler of Verner Liipfert contacted the Cheyenne River Sioux Nation and advised it that the Trust Estate was "considering a change in its domicile," noting that the Trust Estate was currently "subject to intense scrutiny by the State Legislature and Attorney General" in its present location. Verner Liipfert identified a number of "primary" factors that the Trust Estate was examining, including limitations on trustee liability, the scope of fiduciary duties of trustees, restrictions on trustee compensation, the scope of the Attorney General's review, intervention by the State Legislature, and restrictions on trust involvement in business transactions. **[Exh. 63]**.

59. In conjunction with the domicile project, Verner Liipfert also examined converting the Trust Estate to a taxable entity. In a June 2, 1995 memorandum, Verner Liipfert identified various benefits to converting to a taxable status, including: the "avoidance of various federal and state scrutiny as a public charitable organization," the ability to "aggressively pursue the production of income," and that "trustees' compensation will be governed by state law." **[Exh. 60 at 7]**.

60. As part of this project, memoranda were also prepared on trustee compensation. **[Exh. 59 and 61]**. These memoranda made clear that KSBE was aware of the IRS controversy concerning Trustee compensation as well as the potential threat it posed to KSBE's tax-exempt status. A June 2, 1995 memorandum states as follows:

> Due to the large dollar figures being paid to KSBE trustees, questions have been raised over whether the Internal Revenue Service (the "Service") will assert successfully that a trustee has received unreasonable compensation. The trustees compensation is established by a Hawaiian state statute, which provides that the trustees receive as annual compensation varying percentages of the estate's monies received in the nature of revenue or income. We have been asked to consider whether there is any doctrine of preemption or similar doctrine that would apply and necessitate the acceptance by the Service of this statutory compensatory formula as reasonable compensation.

> It is important to KSBE to explore this compensatory issue because the existence of unreasonable compensation presents the issue of whether the exempt organization is benefitting private interests. If KSBE was found to be benefitting private interest, then the Service could but by no means would be compelled to revoke KSBE's federal tax-exempt status. Therefore, we have considered the circumstances under which the Service has determined compensation paid by tax-exempt organizations to be reasonable.

**[Exh. 61 at 1-2].**

61. Further memoranda on possible changes in domicile and tax status were prepared in August 1995 and in November 1996. **[Exh. 69 and 147].**

62. In September 1995, Mr. Adler met with Trustee Wong and Gov. Waihee to discuss the change of domicile project. At the meeting, Mr. Wong described the transfer of domicile as "an explosive issue, political dynamite." He instructed Mr. Adler to "prepare all necessary papers for the transfer and put it on the shelf until we make a decision as to whether to go". **[Adler Deposition].**

63. KSBE expended almost $300,000 in evaluating a possible change in domicile and tax status. **[Testimony of S. Garnett; Exh. 307]** These expenditures were not in the interest of KSBE and instead related to the private interests and priorities of the Incumbent Trustees.

3. <u>Intermediate Sanctions Lobbying</u>

64. In September 1995, the Incumbent Trustees turned their attention to efforts to defeat the Intermediate Sanctions legislation that was introduced in Congress. This legislation was uniformly perceived as benefitting tax-exempt organizations by giving the IRS an option, other than revocation of the organization's tax-exempt status, that could be used directly against insiders, such as the KSBE Trustees, who used trust funds for their private inurement, such as

excessive compensation. [Exh. 214]. Despite the clear benefit that this legislation would provide the Trust Estate, the KSBE Trustees initially sought to defeat the legislation.

65. The KSBE Trustees engaged the Verner Liipfert firm as their principal lobbyist in connection with Intermediate Sanctions. In a September 22, 1995 memorandum from John Waihee and other Verner Liipfert personnel to the Incumbent Trustees, Verner Liipfert noted that it was unlikely that they would be able "to kill the measure" in the House; their strategy therefore was to keep the votes "no" in the Senate. The strategy also involved "preparing an acceptable fall back position if it becomes an absolute political necessity for Congress for there to be some language in the bill that addresses the general issue of the accountability of charitable organizations." [*Id.*] Verner Liipfert also emphasized that "this strategy hopes to place Bishop Estate among others that will be affected." [*Id. at 2*].

66. A September 24, 1995 Verner Liipfert memorandum indicates that "coalition building is top priority for the next week since we have not yet found solid allies willing to come forward." [Exh. 80 at 2]. In the end, however, KSBE was the only charitable organization actively opposing the Intermediate Sanctions legislation. [Exh. 103 at 1].

67. In an October 1995 memorandum to the Incumbent Trustees, Verner Liipfert began to outline various "back-up positions" in the event Intermediate Sanctions legislation was ultimately passed. After stating that "our first objective is to remove the interim sanctions in their entirety from the proposed legislation," Verner Liipfert proposed a number of back-up positions, including creating a "safe harbor that is based on compliance with the conditions of a state statute," creating a presumption of reasonableness of compensation by using two independent professional studies, and making clear that compensation is reasonable if the

compensation package is comparable to "either tax-exempt or for-profit taxable organizations." [Exh. 87 at 2].

68. By mid-November 1995, Congress passed the Intermediate Sanctions legislation as part of the larger Balanced Budget Reconciliation Act. In a November 27, 1995 memo, Stu Spencer, a powerful Republican lobbyist with the firm of Hecht Spencer and Associates (whom the Incumbent Trustees had also retained), wrote to Trustee Wong to clarify the Incumbent Trustees' position regarding the intermediate sanctions legislation:

> In preparation for my meeting with Senator Dole during the first week in December 1, I want to make sure that I am going to present the message that the Trustees want me to carry. Following will be my understanding of where we are in the process and what I believe that the Trustees would like to see accomplished.
>
> ***
>
> Bishop's number one goal is elimination of the interim sanctions provision. This will be my mission with Senator Dole.

[Exh. 105 at 2].

69. When it became clear in late November 1995 that the Intermediate Sanctions legislation would be enacted, the Incumbent Trustees through Verner Liipfert shifted their strategy to attempting to modify the Conference Committee Report in order to employ the mechanisms established under state law for trustee compensation as being controlling for IRS purposes. The Incumbent Trustees sought to delete or modify what was known as the "state law footnote," which provided that the approval of a compensation package by a state or local legislative body or court would <u>not</u> be determinative of the reasonableness of the compensation. [Exh. 109 at 5]. Although this footnote was "clearly aimed at KSBE," the Incumbent Trustees

sought to clarify the Committee Report so that a rebuttable presumption of reasonableness of compensation would arise when the compensation package was approved by a state entity or under state law. **[Exh. 122 at 3]**. These efforts unquestionably related solely to trustee compensation, since state law provisions only affected trustee compensation.

70. In 1998, the Court's Master, Colbert Matsumoto, questioned the use of Trust funds for this lobbying effort. After receiving various explanatory memoranda from Verner Liipfert, the Master concluded that the Intermediate Sanctions lobbying was "predominantly directed at preserving the historical procedure for determining compensation of the Trustees under statutory law and minimizing the potentially adverse impact that Intermediate Sanctions law would have on their continued ability to receive compensation in accordance with and at levels permitted under state law." **[Exh. 181 at 38]**.

71. In filings with the Master in 1998, Verner Liipfert argued that the opposition to Intermediate Sanctions was based on the "exit tax," which would have required that a tax-exempt organization terminating its tax-exempt status would have to return all of the benefits that it had received as a result of that status. It appears that concerns about an "exit tax" related to the possible conversion of KSBE to a taxable entity. In a November 22, 1995 memorandum to the Trustees, Verner Liipfert noted that the bill no longer contained the exit tax, "which would have virtually prohibited the termination of an organization's tax-exempt status" as a result of its penalty provisions. **[Exh. 104 at 2]**. In a November 27, 1995 memorandum to Trustee Jervis, Verner Liipfert noted that the removal of the "exit tax" would no longer inhibit KSBE's consideration of conversion to taxable status. **[Exh. 106]**. Efforts to defeat Intermediate Sanctions because of an "exit tax" are further belied by the continued efforts to kill

that legislation even after the "exit tax" was removed in mid-November 1995. **[Exh. 105].**

72. The Intermediate Sanctions legislation was enacted in July 1996. Shortly thereafter, the KSBE Trustees were briefed on the implications of the Intermediate Sanctions Legislation in regard to Trustee compensation. **[Exh. 139 and 143].** The lobbying by Verner Liipfert on Intermediate Sanctions during 1995 and 1996 cost KSBE in excess of $800,000. **[Exh. 36] [Testimony of S. Garnett].** The expenditures of these funds was not in the interest of KSBE and instead related to the private interests and priorities of the Incumbent Trustees.

4. Excessive Commercial Activity

73. In July 1993, the Trustees received a briefing regarding the importance of maintaining an arm's length relationship between KSBE and its corporate affiliates. **[Exh. 12].** In addition, a follow-up memorandum was written to the Trustees, dated November 16, 1993, summarizing the July 19, 1993 briefing. **[Exh. 19].** These briefing materials highlight, among other things, the IRS restrictions on charitable organizations engaging in non-exempt activities. The materials explain that it is essential for Trustees to deal with the subsidiaries on an arm's length basis, observing all proper corporate formalities. If this is not done, the IRS could seek to ignore the separate corporate structure of the taxable subsidiaries, attribute their non-exempt activities to KSBE itself, and propose revocation of the tax-exempt status of KSBE on that basis.

74. Incumbent Trustee Peters served on the board of fourteen KSBE taxable subsidiaries and often attempted to direct their activities. When interviewed by the IRS in the course of the IRS audit, Mr. Peters boasted about the fact that he controlled the activities of the subsidiaries. Based on these interviews and other facts, the IRS in a Form 5701 proposed to

disregard the corporate structure, attributing the activities of the taxable subsidiaries to KSBE and revoking KSBE's tax-exempt status on that basis. [Exh. 185 at 9].

5. Political Activities

75. The Incumbent Trustees were also advised that a Section 501(c)(3) organization is prohibited from engaging in political activities. For example, a presentation was made at a strategic planning retreat on October 31, 1994, concerning "Lobbying Alternatives and Policies." **[Exh. 33]**. These materials made clear that KSBE could not engage in any campaign activities for candidates for political office. [*Id. at 11*].

a. Political Polling

76. It appears that KSBE funds were used in 1992, 1994 and 1996 to conduct political polling under the guise of conducting polling on water and land issues. This work was performed by Omnitrak and later Qmark (collectively referred to hereafter as "Qmark"). In 1996, for example, $81,973.92 was spent on polling concerning "land and water" issues, but available documentation indicates that $65,900.00 of that amount related to individual polling for candidates in the Primary and General Elections. **[Exh. 159]. [Testimony of B. Ankersmit].** The actual polling reports produced also reflect the fact that the vast majority of work performed related to individual candidate polls. [Exh. 113]. Indeed, a handful of pages related to land and water issues, and over 500 pages related to individual campaign polls. *Id.*

77. Of the districts polled, many of the legislators had close ties to the Estate, including Rep. Robert Herkes (representative from the Big Island and an employee of Kamehameha Investment Corp., a KSBE for-profit subsidiary); Sen. Whitney Anderson (wife of Hannie Anderson, KSBE travel coordinator); Rep. Terrance Tom (then-Chairman of the House

Judiciary Committee and an attorney on retainer with KSBE); Sen. Marshall Ige (Trustee Peters' Vice Speaker when Peters served as Speaker of the House of Representatives), and then-Speaker Joe Souki. **[Testimony of W. Chin, R. Park].**

78. KSBE's polling activities were a closely-guarded secret. Very few copies were made of the reports, and the reports did not contain Qmark's name or logo. Qmark personnel were instructed not to discuss the polls with other personnel from KSBE. Qmark was directed to describe the work performed as "housing" or "land and water" surveys on its invoices. Trustee Peters signed the check payable to Qmark for the services rendered in 1996 in the amount of $81,973.92. **[Exh. 161]. [Testimony of B. Ankersmit and W. Chin].**

b. Lobbying to Defeat Attorney General confirmation

79. Following Governor Cayetano's re-election in 1998, the Governor nominated Margery Bronster to serve a second term as Attorney General, a position requiring Senate confirmation. On January 22, 1999, one day after the 1999 Legislative Session began, Larry Mehau, a close personal friend of Trustee Wong and head of Hawaii Protective Association, a KSBE contractor, called Trustee Wong and left the following message with Trustee Wong's secretary: "Thinks they have the votes to stop appointment. Would like to meet next week some place private. Will call you let you know time and date." [Exh. 187]. Eleven minutes later on that same day, Sen. Matsuura's office called and left a message for Trustee Wong that "Senator Matsuura would like a lunch appointment with you some time next week. Also to be present will be Senator Hanabusa." [Exh. 187].

80. 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. **[R. Wong deposition]**. In April 1999, these freshman Senators voted against Bronster's confirmation, and Bronster was not reconfirmed as Attorney General.

6. Neglect of Educational Purpose.

81. In addition to the trustee misconduct described above that placed the tax-exempt status at risk, the Incumbent Trustees were also neglecting the educational mission of the Trust Estate, its exclusive charitable purpose. Bernice Pauahi Bishop directed that her Trust be used to establish and maintain the Kamehameha Schools. Her Will directs the Trustees "to provide first and chiefly a good education in the common English branches, and instruction in morals and such useful knowledge as may tend to make good and industrious men and women." **[Exh. 188]**.

82. In 1993, the KSBE Trustees made Mrs. Lindsey the lead Trustee of education. Mrs. Lindsey's actions as lead Trustee created a climate of fear and intimidation that pervaded Kamehameha Schools and is well documented. In May 1997, in response to the expanding controversy over the management and administration of the Kamehameha Schools, the Incumbent Trustees petitioned the Probate Court to appoint an independent fact finder to "ascertain the material and relevant facts" concerning the controversy. The Incumbent Trustees proposed that the court appoint Patrick Yim, a former Circuit Court Judge, as an independent fact finder. In December 1997, after an extensive fact finding process, Judge Yim filed his report and found that Mrs. Lindsey's actions combined to create an "oppressive and hostile atmosphere on campus" which created instability at the schools. He further found that "the Trustees knew or should have known that the lead Trustee was engaged in actions that were detrimental to the

Kamehameha Schools and reflected poorly upon the Board of Trustees," and that: "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." [Exh. 341 at 32].

In March 1998, the Western Association of Schools and Colleges ("WASC") Committee visited the Kamehameha Secondary School for their reaccreditation review. The WASC Committee also reported that 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 has produced an oppressive, intimidating, and fearful professional climate in this school." [Exh. 178 at 16].

84. In response to a petition filed by Trustees Stender and Jervis to remove Trustee Lindsey, the Probate Court on May 6, 1999 found that Ms. Lindsey breached numerous duties and ordered her removal. Throughout the trial, both Trustees Peters and Wong defended Lindsey's actions and opposed her removal. [Exh. 209].

During the same time that Mrs. Lindsey was mismanaging Kamehameha Schools, the Incumbent Trustees allowed more than $350 million to accumulate, without bothering to develop a comprehensive strategic plan for its use for education purposes. Moreover, in the face of this substantial accumulated income, they reduced the scope of the Trust Estate's educational activities by cutting various community outreach programs. Although the Trust Estate's budget for expenses that personally benefitted the Incumbent Trustees was seemingly limitless (such as for lobbying against intermediate sanctions, for investigating a change in domicile or tax status, or for excessive trustee compensation), the budget for the schools was apparently "zero growth." [Exh. 209, 304].

7. Risks of Litigation

86. As discussed in Part I-B above, the IRS has proposed to revoke the tax-exempt status of KSBE. If KSBE were required to litigate the revocation issue, there is a significant risk that the IRS's proposed revocation would be sustained in a judicial proceeding. An accurate assessment of the risk associated with litigating the issue of KSBE's tax-exempt status requires looking at the facts and circumstances in their totality, understanding how the various facts and issues relate to one another, and appreciating the compounding effect that this has on the assessment of litigation hazards.

87. Foremost among the issues raised by the IRS is the question of whether the Incumbent Trustees' compensation is within a range of reasonableness. As discussed above, Messrs. Moore and Katz have concluded that there is a significant risk that a court would conclude that the Incumbent Trustees' compensation for the years 1992-98 was unreasonable. Of particular concern is that the Incumbent Trustee compensation studies fail to use data from non-profit institutions and fail to address the applicable IRS criteria, including the qualifications (or lack thereof) and the actual performance of the Incumbent Trustees. Based on a review of the available facts and evidence, there is significant doubt about the reasonableness of Incumbent Trustees' compensation.

88. Very much related to the issue of excessive compensation is the effort of the Incumbent Trustees to defeat or modify the Intermediate Sanctions legislation. As the Master has already concluded in his September 29, 1998 Report, the primary, if not the sole, focus of these legislative efforts was initially to defeat and later to modify the legislative proposal in order

to protect the ability of the Incumbent Trustees to control the level of their compensation. [**Exh. 181**].

89. The documents concerning a possible change in domicile and tax status are equally alarming. Rather than demonstrating concern on the part of the Incumbent Trustees about complying with applicable state and IRS requirements, the relevant documents reflect an attempt to avoid state and federal scrutiny of their actions. These documents reflect an effort and desire to change the rules governing appropriate trustee conduct rather than seeking to comply with those rules, which only serves to enhance the risks of litigation. [**Exh. 60 and 63.**]

90. The risks of litigation are further increased by the allegations concerning excessive commercial activity (non-arm's length dealings), prohibited political activities, and the neglect of the educational mission of the Trust. When all the facts are viewed in their totality, there is substantial evidence that KSBE was not operated "exclusively" for exempt purposes and that there were more than "insubstantial" non-exempt purposes, including substantial private inurement to the Incumbent Trustees.

8. Potential Financial Loss

91. In her August 16, 1999 opinion letter, Diane Cornwell of Arthur Andersen estimated the financial impact of KSBE's potential loss of its tax-exempt status to be in excess of $750,000,000. [**Exh. 216**]. In her expert report of October 6,1999, Ms. Cornwell revised that figure and now estimates that the financial cost could exceed $900,000,000. [**Exh. 227**]. The evidence demonstrates that KSBE faces an enormous potential loss if it were to lose its tax-exempt status. **(A copy of Ms. Cornwell's October 6, 1999 expert report is contained in Attachment C hereto)**

D. Violations of Court Orders

1. Stipulation to institute CEO-based management system

92. Master Matsumoto, among others, was critical of the Incumbent Trustees' use of the "lead Trustee" system, under which each individual Trustee assumed oversight responsibility for certain subject matter areas. On October 2, 1998, the Incumbent Trustees agreed to "adopt and implement a CEO-based system of management for the Trust Estate consistent with the concept recommended in the [Arthur] Andersen report and hire a CEO" by March 31, 1999. The Incumbent Trustees also agreed to "seek comment from the Master and Attorney General, as parens patriae, regarding the CEO-based management system and the formal governance policy from the court through stipulation or order." **[Exh. 182].** A stipulation and order was signed and filed with the court. *Id.* Although the Trustees agreed to adopt the CEO-based management system, in the words of Trustee Wong, "this did not happen." **[R. Wong Deposition].**

93. On May 3, 1999, the court ordered the Incumbent Trustees to show cause why they should not be found in breach of the stipulation and order. One day before the order to show cause hearing, on May 6, 1999, the majority Trustees offered Gilbert Tam a position of "Interim Chief Executive Officer." Mr. Tam was not selected from a list of candidates developed by the executive headhunter firm retained by the Estate and no CEO-based management system had been submitted for approval by the court, as required by the stipulation. As discussed in Part 1-B above, the court in its May 7, 1999 order found that the Incumbent Trustees violated a court order.

2. <u>August 31, 1999 Ruling</u>

94. On August 31, 1999, Judge Hirai granted the Attorney General's request for the temporary removal of Incumbent Trustees Peters and Wong. The court found that the Peters and Wong had violated several binding court orders requiring them to, among other things:

-- Segregate income and corporate accounts of the Trust;

-- Disclose the total amount of accumulated income in the 109th, 110th and 111th annual accounts;

-- Plan for the expenditure of the Estate's substantial accumulated income;

-- Terminate the lead trustee system of governance; and

-- Waive commissions calculated on final distributions of capital.

**[Exh. 224].**

95. With respect to the waiver of commissions on final distributions of capital ("FDOC"), the facts are quite revealing. Under an order entered by this Court in 1966, it was agreed between KSBE Trustees and the Attorney General that KSBE Trustees would take no commissions on final payments involving the construction of buildings and improvements at Kamehameha Schools. Until 1994, all Trustees abided by the court order and did not take FDOC commissions. After the close of fiscal year 1994, however, Trustee Peters learned that the Estate had to write off approximately $18 million in capital losses, which would have the effect of reducing significantly the commissions payable to the Incumbent Trustees. **[Exh. 2, 3, 4, 5] [Testimony of W. Chin].**

96. Instead of foregoing commissions, Trustee Peters instructed staff to "be creative" in finding ways to reverse the reduction in the commissions payable to the Incumbent Trustees. The solution was that the Incumbent Trustees retroactively took commissions for 1994 on FDOCs, totaling approximately $449,178. When combined with amounts taken in 1995, the total commissions taken on FDOC was $615,844, or $123,168 per Trustee. This action was in direct violation of this Court's 1966 order that no commissions were to be paid on FDOC. **[Exh. 4 and 5] [Testimony of W. Chin].**

E. <u>The reasonableness of the IRS condition of removal or resignation of the Incumbent Trustees</u>

97. As already discussed above, the IRS's demand as to removal of the Incumbent Trustees is based on evidence that they "have a history of ignoring Probate Court orders, Master Report recommendations, Probate Court stipulations and the advice of independent experts whose opinions were sought out by KSBE at great expense to KSBE, relating to activities which impact KSBE's exempt status," and "have a history of pursuing activities which are inconsistent with furthering KSBE's exempt purpose." **[Exh. 221at 1].**

98. There is ample evidence that the Incumbent Trustees failed to adhere to prior court orders, stipulations and the opinions of independent experts. For example, the Probate Court on August 31, 1999, temporarily removed Incumbent Trustees Peters and Wong because they breached their fiduciary duties to the Estate by violating six different court orders and Hawaii's Uniform Prudent Investor Act. Similarly, although independent experts advised the Incumbent Trustees on the

requirements of the Intermediate Sanctions legislation, the importance of arm's length relationships with taxable subsidiaries and the ban on political activities, the Trustees nonetheless proceeded as though those requirements did not exist. The project to consider a possible change in domicile and tax status represents a reckless disregard for furthering KSBE's exempt purpose. Accordingly, the IRS's non-negotiable removal condition is based on the sound judgment that it will not enter into a closing agreement unless it is confident that the agreement will be complied with.

## II. CONCLUSIONS OF LAW

### A. Standing

1. The Interim Trustees, as Trustees Under the Will and of the Estate of Bernice Pauahi Bishop, Deceased, have standing to institute an action for removal of Trustees Lindsey and Peters. **[Exh. 206 at 12].**

### B. The court has the power to remove Trustees Lindsey and Peters

2. A court of equity has the discretionary power to remove a trustee, and a court's discretion to remove a trustee will not be disturbed on appeal unless the trial court has abused its discretion. In re Estate of Holt, 33 Haw. 352, 357 (1935); Restatement (Second) of Trusts § 107, comment a (1959). The Hawaii Supreme Court explained that:

> Whether a trustee should or should not be removed is a question addressed to the sound discretion of the court, and is dependent upon the circumstances of each particular case. . . A court of equity may and will remove a trustee who has been guilty of some breach of trust or violation of duty. The exercise of this function by a court of equity belongs to what is called its sound judicial discretion and is

> not controlled by positive rules except that the discretion must not be abused.

Holt, 33 Haw. at 357 (citations omitted) (emphasis in original).

C. The Interim Trustees' decision to enter into a closing agreement with the IRS (of which the permanent removal of the Incumbent Trustees is a condition) is reasonable and a proper exercise of their discretion

3. The discretionary decisions of trustees in administering a trust usually will not be subject to judicial interference in the absence of an abuse. *See* Takabuki v. Ching, 67 Haw. 515, 530, 695 P.2d 319, 328 (1985); In re Estate of Holt, 33 Haw. 352, 356 (1935). An abuse of discretion occurs when a decision clearly "exceeds the bounds of reason, all of the circumstances . . . being considered." Coll v. McCarthy, 72 Haw. 20, 28-29 804 P.2d 881, 887 (1991) (citations omitted). "Where discretion is conferred upon the trustee with respect to the exercise of a power, its exercise is not subject to control by the court, except to prevent an abuse by the trustee of his discretion." Takabuki, 67 Haw. at 530, 695 P.2d at 328 (quoting Restatement (Second) of Trusts § 187 (1959)).

4. The court vested the Interim Trustees with the "full and complete discretion, power, and authority to exercise all trust powers with respect to the Trust Estate and its subsidiaries and affiliated organizations in a manner consistent with the Will of Bernice Pauahi Bishop and the Codicils thereto and subject to such duties, responsibilities, and fiduciary obligations as are imposed by law and under the Will of Bernice Pauahi Bishop and the Codicils thereto." [Exh. 206 at 13]. The decision of the Interim Trustees to enter into the Closing Agreement with the IRS (of which permanent

removal of the Incumbent Trustees is a condition) is reasonable since the Closing Agreement preserves the Estate's tax-exempt status. The court approved the Closing Agreement and concluded that "the settlement between the IRS and the Trust Estate, as set out in the Closing Agreement. . . is reasonable and in the best interest of the Trust Estate, subsidiaries and affiliated organizations, the beneficiaries of the Trust Estate and the Hawaiian community." **[Exh. 306 at 7].**

5. The condition that Lindsey and Peters resign or be permanently removed is also reasonable one in view of the prior actions of the Trustees. See Proposed Findings ¶¶ 45 - 98. Lindsey and Peters have shown no willingness to abide by the rules and standards that govern their conduct as Trustees. Accordingly, their permanent removal is a reasonable condition to resolve the IRS audit on behalf of the Trust Estate.

D. Trustees Lindsey and Peters have a duty to resign to protect the tax-exempt status of the Trust Estate and to act in the best interest of the Trust Estate

6. Trustees have a duty "not to exercise any power under this chapter in such as way *as to deprive the trust of an otherwise available tax exemption* Haw. Rev. Stat. § 554A-3(b) (1993) (emphasis supplied). Trustees have a paramount duty of loyalty to the Estate. See Restatement (Second) of Trusts § 170(1) (1959); Ahuna v. Department of Hawaiian Home Lands, 64 Haw. 327, 340, 640 P.2d 1161, 1169 (1982).

7 John Langbein, a Yale law professor who specializes in the area of trust and fiduciary administration, has opined that:

> The trustees' duty of loyalty –their duty to administer the trust solely in order to maximize the interests of the beneficiaries of the trust–applies to every facet of the trustees' powers, including the power to resign.

* * *

> In the present case, the trustees' failure to vacate their trusteeships threatens to cost the trust its tax-exempt status, and hence, to trigger losses of the magnitude discussed above. In these circumstances, acceding to the IRS' demand for resignation is the course that maximizes the interests of the trust and its beneficiaries. The trustees have a fiduciary duty to take that step.

*John Langbein Letter, dated October 6, 1999, at page 3-4.* (A copy of the Langbein Letter is contained in Attachment D hereto.)

8. Removal of a trustee is appropriate when his/her continuance in office would be detrimental to the proper administration and best interests of the trust. Restatement (Second) of Trusts, § 107, comment a (1959); Estate of Malone, 597 P.2d 1049, 1050 (Colo. App. 1979) (In determining whether to remove a trustee "[t]he court's paramount regard must be for the interest of the trust". *See generally*, Bogert, The Law of Trusts and Trustees, § 527 (2d Ed. 1993 and Supp. 1997); Scott, The Law of Trusts, § 107 ($4^{th}$ Ed. 1987 and Supp. 1997). The detrimental effect of a trustee's continuance in office is not measured by a particular act, transaction, or alleged misdeed. Instead, removal of a trustee is appropriate when, considering the totality of the circumstances, such removal is in the best interests of the trust. Estate of Holt, 33 Haw. 352, 362 (1935); Comerica Bank v. City of Adrian, 446 N.W.2d 553, 561 (Mich. App. 1989).

9. In Estate of Holt, although the court found nothing in the record that specifically reflected on the trustee's honesty or impugned his integrity, the court held that removal of the trustee was nonetheless appropriate. Holt, 33 Haw. at 362. The court looked at the totality of the circumstances and concluded that there was sufficient

evidence that the removed trustee was "not sufficiently careful and diligent in the performance of his duties to meet the requirements of good stewardship" of the trust. Id.

Similarly, in Comerica Bank, the court considered several factors and held that the trustee's "hostile attitude," failure to timely pay out trust income, violation of a court order, and failure to timely file an accounting, taken together, justified removal of the trustee.

10. Removing Lindsey and Peters is clearly in the best interests of the Trust Estate. The IRS is unwavering in its position that their removal is a non-negotiable term of the settlement. The Trust Estate risks losing its tax-exempt status, with an estimated financial loss of over $900 million dollars. Under the circumstances, their continuance in office is detrimental to the proper administration and best interests of the trust, and they must be removed.

E. Lindsey and Peters have placed the tax-exempt status of the Trust at risk

1. Placing the tax-exempt status of the trust at risk is a breach of Peters' and Lindsey's duty of loyalty and prudence and H.R.S § 554A-3

11. The duty of loyalty requires trustees to administer the trust "solely" in the interest of the trust. Restatement (Second) of Trusts § 170(1) (1959); Ahuna, 64 Haw. at 340, 640 P.2d at 1169. The duty of loyalty "precludes a trustee from dealing with trust assets to his own advantage or benefit." Steiner v. Hawaiian Trust Co., 47 Haw. 548, 558., 393 P.2d 96, 103 (1964). A trustee "violates the duty of loyalty not only when the trustee purchases trust properly individually, but also when the trustee uses trust property for the trustee's own financial or other purposes." Restatement (Third) of Trusts

§ 170, comment l (1992). Moreover:

> In administering the trust the trustee is under a duty to the beneficiaries not to be influenced by the interest of any third person or by motives other than the accomplishment of the purposes of the trust.

Restatement (Third) of Trusts, § 170, (comment q) (1992).

12. A trustee's conflict of interest justifies his immediate removal. Hanson v. First State Bank & Trust Co., 385 S.E.2d 266, 267 (Ga. 1989). In Hanson, the court noted:

> The purpose of this rule is require a trustee to maintain a position where his every act is above suspicion, and the trust estate, and it alone, can receive not only his best services, but his unbiased and uninfluenced judgment. *Whenever he acts otherwise, or when he has placed himself in a position that his personal interest has or may come into conflict with his duties as a trustee, or the interests of the beneficiaries he represents, a court of equity never hesitates to remove him.*

*Id.* at 267 (emphasis supplied). This rule equally applies to charitable trusts. Leahy v. Commission for Blind, 456 P.2d 77 (Ore. 1969).

13. The duty of prudence requires a trustee to "observe the standards in dealing with the trust assets that would be observed by a prudent person dealing with the property of another, and if the trustee has special skills or is named trustee on the basis of representations of special skills or expertise, the trustee is under a duty to use those skills." Haw. Rev. Stat. § 560:7-302 (1993); *cf.* Restatement (Second) of Trusts § 174 (1959).

14. Hawaii's Uniform Trustees' Powers Act explicitly recognizes the trustee's duty to preserve the tax-exempt status of the trust:

> In the exercise of the trustee's powers including powers granted by this chapter, a trustee has a duty to act with due regard to the trustee's obligation as a fiduciary, including a duty not to exercise any power under this chapter in such as way *as to deprive the trust of an otherwise available tax exemption* . . . .

Haw. Rev. Stat. § 554A-3(b) (1993)(emphasis supplied).

15. Through their misconduct, Trustees Lindsey and Peters have breached their duties of loyalty and prudence and have violated H.R.S. §554A-3. They have placed the tax-exempt status at significant risk by claiming excessive compensation, seeking to avoid state and federal scrutiny, opposing the Intermediate Sanctions legislation, engaging in excessive commercial activity and prohibited political activity, and neglecting the primary purpose of the Trust.

16. Tax-exempt status is a privilege that the federal government confers on organizations that operate for charitable purposes. The federal government gives charitable organizations an exemption from federal income tax, however, only because it expects the income that would otherwise be taxed will be used for public, not private purposes. To ensure that exempt funds are used solely for public purposes, the qualification of an organization for tax-exempt status under the Internal Revenue Code is governed by explicit and long-established rules of federal law. These federal rules impose standards of conduct on trustees of a charitable organization that are substantively similar to the duties of loyalty and prudence imposed under state trust law.

17. To maintain tax-exempt status, federal law requires that the organization be operated "exclusively" for charitable purposes. I.R.C. § 501(c)(3). 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). Operating an organization in such a way as to further substantial private interests furthers a substantial non-exempt purpose and will destroy an organization's exemption. American Campaign Academy v. Commissioner, 92 T.C. 1053, 1065-66 (1989). Like the duty of loyalty, which requires the trustee to act solely in the interest of the trust, this federal tax law requirement prohibits a trustee from acting in his or her own self-interest and contrary to that of the charitable purposes of the trust.

18. In the case of a person who is in a position to exercise substantial influence over the activities of an organization, such as a KSBE Trustee, using trust assets to further private purposes -- such as through the receipt of excessive compensation -- will also result in private inurement for purposes of federal tax law. *See* Carter v. United States, 973 F.2d 1479, 1487 (9th Cir. 1992). Substantial private inurement provides an independent basis for revocation of the organization's tax-exempt status. I.R.C. § 501(c)(3); Carter, 973 F.2d at 1486-87. Thus, like the duties of loyalty and prudence, the prohibition against private inurement proscribes a trustee from dealing with the assets of the trust as if they were his or her own. The tax-exempt status may also be revoked for failing to deal with taxable subsidiaries at arm's length and for engaging in prohibited political activities. See, e.g., Orange County Agricultural Society v. Commissioner, 893 F.2d 529 (2d Cir. 1990); Branch Ministries v. Commissioner, 40 F.Supp.2d 15 (D.D.C. 1999).

2. Areas in which Trustees Lindsey and Peters have placed the tax-exempt status at risk

19. Trustees Lindsey and Peters have placed KSBE's tax-exempt status at risk by their actions in the following respects.

a. Excessive compensation -- see Proposed Findings ¶¶ 45-54.

b. Possible change in domicile and tax status -- see Proposed Findings ¶¶ 55-63.

c. Intermediate Sanctions lobbying -- see Proposed Findings ¶¶ 64-72.

d. Excessive commercial activity -- see Proposed Findings ¶¶ 73-74.

e. Prohibited political activity -- see Proposed Findings ¶¶ 75-80.

f. Neglect of Trust Estate's educational mission -- see Proposed Findings ¶¶ 81-85.

g. The totality of facts and circumstances demonstrate the failure to operate KSBE exclusively for its charitable purposes and to avoid non-exempt purpose of more than an "insubstantial" nature -- see Proposed Findings ¶¶ 86-90.

20. The Incumbent Trustees did not act with the care and caution required to protect the Estate's tax-exempt status. They ignored the Estate's charitable purpose and took unreasonable actions that placed the exempt status at serious risk. These actions provide independent grounds for their removal.

F. Removal for Violating Court Orders

21. "It is the duty of a trustee to comply with orders of the court, duly made in pursuance of the jurisdiction and control of the court over the trust estate. Violations of orders of the court in trust matters are punishable as contempt. . . The

failure or refusal of a trustee to obey lawful orders of the court with respect to the trust is ground for his removal." Re Hill's Estate, 75 N.W.2d 582, 591-92 (Wis. 1956). *See also* Willard v. McKnoe, 232 A.2d 322 (Conn. 1967).

22. In Willard, 232 A.2d 322 (Conn. 1967), a trustee of a testamentary trust submitted annual accounts to the probate court. The court ordered the trustee to reimburse the estate for two disapproved transactions, but the trustee failed to comply with the order. The court removed the trustee for neglecting to perform the duties of his trust. The Connecticut Supreme Court upheld the trustee's removal, reasoning that:

> The order of the Probate Court . . . was made within the court's jurisdiction and in the performance of its statutory duty. The trustee refused to comply with the order. He is not relieved from the burden of his default by the fact that he did not agree with the reasons for the court's order. *Obedience to the order of the court was the trustee's first duty*. An appeal would have protected his every right.

Id. at 325-326 (emphasis supplied).

23. Trustees Lindsey and Peters have blatantly disregarded court orders. Although they agreed to implement a CEO-based management system by March 31, 1999, they failed to do so. See Proposed Findings ¶¶ 92-93. These Trustees have also failed to comply with a number of other court orders, including restrictions on taking commissions on final distributions of capital. See Proposed Findings ¶¶ 94-96. These actions provide a final ground justifying the removal of these Trustees.

## III. ORDER

Based on the foregoing, Henry Haalilio Peters and Marion Mae Lokelani Lindsey shall be immediately and permanently removed as Trustees of the Kamehameha Schools Bishop Estate, effectively as of the date of this order.

DATED: Honolulu, Hawaii ______________________

______________________
JUDGE OF THE ABOVE ENTITLED COURT

Respectfully submitted this 13th day of December 1999.

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