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IN THE CIRCUIT COURT OF THE FIRST CIRCUIT

STATE OF HAWAI'I

In the Matter of the Estate of BERNICE P. BISHOP, Deceased.	EQUITY NO. 2048 TRUSTEE HENRY HAALILIO PETERS' PREHEARING STATEMENT RE: INTERIM REMOVAL OF TRUSTEES; CERTIFICATE OF SERVICE Hearing: Date: March 29, 1999 Time: 9:00 a.m. Judge: Colleen K. Hirai

TRUSTEE HENRY HAALILIO PETERS' PREHEARING STATEMENT RE: INTERIM REMOVAL OF TRUSTEES

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COMES NOW Trustee HENRY HAALILIO PETERS, by and through his attorney above-named, and respectfully submits his pre-hearing brief on the Attorney General's request for interim removal as set forth in her Response to the Master's Consolidated Report on the 109th. 10th and 111th Annual Accounts filed herein on September 9, 1998.

I. INTRODUCTION

The period between 1984 to the present has been an era of dramatic changes for the Kamehameha Schools/Bishop Estates ("KSBE"). Over these past 15 years, KSBE has grown from a landlord passively collecting lease rents into a complex business organization with wide-ranging and highly sophisticated domestic and international financial investments. It is not pure coincidence that this is the same 15-year period in which Henry Haalilio Peters has served as a dedicated, involved, and loyal Trustee of KSBE. During Trustee Peters' tenure, KSBE has gracefully weathered a stunning and complex organizational character change, the influx of foreign land purchasers into Hawaii, a depressed state economy, plummeting land values, and

rapidly changing social and cultural needs. Beyond mere survival in this era, KSBE has flourished. Yet the Attorney General seeks to oust the Trustees, particularly Trustee Peters, who have guided KSBE successfully through the most complicated period of its 115 year history.

The Kamehameha Schools are healthy and growing. In 1996, scholarships increased by $3.1 million, a pilot Neighbor Island satellite school opened on Maui and East Hawai'i and a model preschool opened in Waianae. In August 1997, the Education Strategic Plan for 1997-2005 was approved and the Maui School Master plan was completed. The Trustees continue to maintain a large portfolio of liquid assets that are poised to be strategically redeployed in order to meet the operational and capital requirements of the expanding Kamehameha Schools into the next millennium.

Today, even in the worst economic environment Hawai'i has experienced in recent history, the modern KSBE is the best that it has ever been in its long and venerable history – far larger and far more progressive than what Ke Alii Pauahi could ever have imagined. These are the fruits of the Trustees' labor, particularly senior Trustee Peters.

It is on this background, and for reasons which appear to be more cultural and political than legal and rational, that the Attorney General has rushed to judgment. She has mistakenly been swayed by the flawed Master's Reports, which themselves are based upon the defective observations of a corporate auditing firm bereft of any cultural understanding. However, in order to appreciate the cultural backdrop, one must first gain a historical perspective on the KSBE.

II. THE HISTORICAL PERSPECTIVE

A. Ke Alii Pauahi's Legacy

During the lifetime of Ke Alii Pauahi, Hawai'i was an independent nation which was undergoing radical social, economic, cultural and demographic changes. At the time of her birth

the indigenous population of Hawai'i had declined to 124,449 and, in her lifetime, that number fell as low as 51,531 By the time of her death, the native Hawaiian population had further declined to 44,232.

Concerned for the future of native Hawaiian people in an environment that was undergoing such drastic change, Ke Alii Pauahi sought to leave a legacy of educational opportunity to assist native Hawaiians in coping with hostile social, economic and cultural forces which were taking hold in Hawaiian society.[2] With no universal public education system in place in 1884, that educational legacy was an important one to the native Hawaiian people.

B. KSBE's Educational Mission

Ke Alii Pauahi left the bulk of her estate in trust for the establishment, erection, administration, maintenance and operation of the Kamehameha Schools.

> I give, devise and bequeath all of the rest, residue and remainder of my estate real and personal, wherever situated unto the trustees below named, their heirs and assigns forever, to hold upon the following trusts, namely: to erect and maintain in the Hawaiian Islands two schools, each for boarding and day scholars, one for boys an one for girls, to be known as, and called the Kamehameha Schools.
>
> I direct my Trustees to expend such amount as they may deem best, not to exceed however one-half of the fund which may come into their hands, in the purchase of suitable premises, the erection of school buildings, and in furnishing the same with the necessary and appropriate fixtures furniture and apparatus.
>
> I direct my Trustees to invest the remainder of my Estate in such manner as they may think best, and to expend the annual income in the maintenance of said schools; meaning thereby the salaries of teachers, the repairing buildings and other incidental expenses; and to devote a portion of each years income to the support and education of orphans, and others in indigent circumstances, giving the preference to Hawaiians of pure or part aboriginal blood; the proportion in which

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[1] Master's Consolidated Report on the 109th, 110th and 111th Annual Accounts filed herein on August 7, 1998, p. 9 citing Native Hawaiian Data Book 1996, Office of Hawaiian Affairs Report (April 1996) (hereinafter, "Master's Consolidated Report").
[2] Id. (emphasis added).
[3] Id.

said annual income is to be divided among the various objects above mentioned to be determined solely by my said Trustees they to have full discretion.

I desire my trustees to provide first and chiefly a good education in the common English branches, and also instruction in morals and in such useful knowledge as may tend to make good and industrious men and women; and I desire instruction in the higher branches to be subsidiary to the foregoing objects.

I also give unto my said Trustees full power to make all such rules and regulations as they may deem necessary for the government of said schools and to regulate the admission of pupils, and the same to alter, amend and publish upon a vote of a majority of said Trustees.

I also direct my said trustees to keep said school buildings insured in good Companies, and in case of loss to expend the amounts recovered in replacing or repairing said buildings.

I also direct that the teachers of said schools shall forever be persons of the Protestant religion, but I do not intend that the choice should be restricted to persons of any particular sect of Protestants.

Will Bernice Pauahi Bishop (hereinafter, the "Will"), Art 13

I direct the school for boys shall be well established and in efficient operation before any money is expended or anything is undertaken on account of the new school for girls.

I also direct that my said trustees shall have power to determine to what extent said school shall be industrial, mechanical, or agricultural; and also to determine if tuition shall be charged in any case.

Will, Codicil No. 2.

C. <u>Selection Of Trustees</u>

To ensure her vision of an educated and strong Hawaiian population would be accomplished, Ke Alii Pauahi was specific and clear in her Will as to the method for selection and number of Trustees. Drawing upon the wisdom and traditional group decision-making

process of those deemed wisest in the sovereign nation of Hawai'i, she directed the Supreme Court of Hawai'i to select KSBE's five Trustees.

D. Management Of KSBE

Ke Alii Pauahi directed that the Trustees have full control over all facets of managing her Estate and the schools. She gave her Trustees complete discretion in all phases of management including establishment, operation and governance of the Kamehameha Schools, real estate conveyance and other asset and investment management.

> I direct my Trustees to expend such amount as they may deem best, not to exceed however one-half of the fund which may come into their hands, in the purchase of suitable premises, the erection of school buildings, and in furnishing the same with the necessary and appropriate fixtures furniture and apparatus. I direct my Trustees to invest the remainder of my Estate in such manner as they may think best, and to expend the annual income in the maintenance of said schools; meaning thereby the salaries of teachers, the repairing [of] buildings and other incidental expenses; and to devote a portion of each years income to the support and education of orphans, and others in indigent circumstances, giving the preference to Hawaiians of pure or part aboriginal blood; the proportion in which said annual income is to be divided among the various objects above mentioned to be determined solely by my said Trustees they to have full discretion.
>
> I also give unto my said Trustees full power to make all such rules and regulations as they may deem necessary for the government of said schools and to regulate the admission of pupils, and the same to alter, amend and publish upon a vote of a majority of said Trustees.

Will, Art. 13 (Emphasis added).

> I direct that a majority of my said Trustees may act in all cases and may convey real estate and perform all of the duties and powers hereby conferred. . . .

Will, Art. 14 (Emphasis added)

> I give unto the Trustees named in my will the most ample power to sell and dispose of any lands or other portion of my Estate, and to exchange lands and otherwise dispose of the same; and to purchase land, and to take leases of land whenever they think it expedient, and generally to make such investments as they

> consider best; but I direct that my said Trustees shall not purchase land for said schools if any lands come into their possession under my will which in their opinion may be suitable for such purpose; and I further direct that my said Trustees shall not sell any real estate, cattle ranches, or other property, but to continue and manage the same, unless in their opinion a sale may be necessary for the establishment or maintenance of said schools, or for the best interest of my Estate.

Will, Codicil No. 1 (Emphasis added).

Previous Masters have recognized that the Will calls on the Trustees to be much more than policy makers or figureheads who rubber-stamp approval of the daily operations of the schools and KSBE. The Trustees have taken their duties seriously and have been commended for their dedicated day-to-day involvement in fulfillment of Ke Alii Pauahi's vision.

> The Trustees are full-time, hard-working professionals who take their dual roles and responsibilities for policy-making and hands on-daily operation of KSBE very seriously.

Duffy Report I, p. 21 filed on April 21, 1992 by James E. Duffy, Jr. on the Trustees' 105th Annual Account (emphasis added).

E. KSBE's Investment Mission

The Trustees are specifically directed by Ke Alii Pauahi's Will ". . . to invest the remainder of [her] Estate in such manner as they may think best, and to expend the annual income in the maintenance of said schools. ." Will, Art. 13 (emphasis added). KSBE is unique, and as such, calls for a unique vision. Unlike corporations that must continually strive to improve their processes in order to maximize profitability and prevent market share erosion, KSBE's goal is to prevent erosion of the corpus and maintain the corpus of the Trust into perpetuity Moreover, the Trustees are specifically directed against selling the land. Will, Codicil No.

III. LAW AND ARGUMENT

As Trustee Peters will demonstrate at trial, the Attorney General's request for interim removal fails because as structured, it violates due process, fails to meet the higher evidentiary standards of a removal proceeding, and simply fails on the merits. However, before addressing these points, it is important to realize that removal is not a matter that courts take lightly.

A. Removal Generally

It is universally recognized that removal of a trustee is a harsh and drastic remedy. The court's power of removal is exercised sparingly and used only where the trust estate is actually endangered. See e.g., Bogert, The Law of Trusts and Trustees, (Rev. 2d Ed., 1978) § 528 (hereinafter "Bogert") and authorities cited therein. See also, Schildberg v. Schildberg, 461 N.W.2d 186, 191 (Iowa 1990) (the power to remove a trustee can be used only when the objects of the trust are endangered); Wolosoff v. CSI Liquidating Trust, 500 A.2d 1076, 1082 (N.J. 1985) (it is recognized that removal of a trustee should be granted only sparingly); In re Croessant, 393 A.2d 443, 446 (Pa. 1978) (removal of a trustee is a drastic action and proof of the need for this remedy must be clear); Morrison v. Asher, 361 S.W.2d 844, 852 (Mo. 1962) (power of the court to remove a trustee must be used sparingly and before it is exercised there should be such misconduct as to evidence want of capacity or fidelity which has put the trust in jeopardy); In re Corr's Estate, 58 A.2d 347, 350 (Pa. 1948) (removal of a trustee is a drastic action, which should only be taken when the estate is actually endangered and intervention is necessary to save the trust property).

As the United States Supreme Court has stated, the basis for the court's discretion to remove a trustee rests in the court's paramount duty to see that trusts are properly executed and not placed in jeopardy by the trustee's actions. May v. May, 167 U.S. 310, 320-21, 17 S.Ct. 824,

827-28, 42 L.Ed. 179 (1897). Thus, in general, courts have not removed a trustee where the net asset value of the trust has continued to increase as this is evidence of the trusts proper execution, and that the trustee's actions have not placed the trust in jeopardy. See, In re Francis Edward McGillick Foundation, 642 A.2d 467 (Pa. 1994) (removal of a trustee is a drastic measure that should only be used when the estate is actually endangered and intervention is necessary to save the trust property; a trustee will not be removed for mismanagement of the trust assets, when the value of the trust continues to increase. See also, In re McCune, 705 A.2d 861 (Pa. 1997) (denying petition for surcharge and removal of trustees for self-dealing where trust assets increased from $85 million to $400 million); Perry v. Perry, 160 N.E.2d 97, 100 (Mass. 1959) (Substantial increase in trust worth cited as a factor in justifying non-removal of trustees).

In general courts will not remove a trustee unless the trust assets are placed in jeopardy. For example, a court will not remove a trustee unless there has been a serious breach of trust that impairs or endangers trust assets (i.e., the trustee has engaged in material conflict of interest transactions, self-dealing, and appropriate of trust assets that harm the trust). Mere technical breaches of trust do not justify removal. Schildberg, 461 N.W.2d at 191 Similarly, removal is not warranted unless the trustee has grossly mismanaged the trust assets. Smith v. Board of Pensions of the Methodist Church, 54 F. Supp. 224, 238 (E.D.Mo. 1944) (emphasis added). Moreover, a court will not remove a trustee on the grounds of hostility unless the hostility interferes with the administration of the trust. Wolosoff, 500 A.2d at 1082. Finally, where less drastic alternatives are available, or where the breach does not cause irreparable harm, removal is inappropriate. See generally, Donovan v. Bierwirth, 680 F.2d 263 (2nd Cir. 1982); Stuart v. Continental Illinois National Bank and Trust Company of Chicago, 369 N.E.2d 1262, 1272 (Ill. 1977); III Austin W. Scott and William F. Fratcher, Scott on Trusts §§ 199-199.4 (4th ed. 1988)

(hereinafter "Scott; Attorney General's Response to Master's Consolidated Report on the 109th, 10th, 111th Annual Accounts at § III(c)(2) (hereinafter, "AG's Response'

As demonstrated by the cases above, the courts have set a high hurdle for those parties seeking to remove a trustee. However, where, in addition, a party seeks interim removal, the hurdle is placed even higher.

B. A Party Seeking Interim Removal Must Satisfy The Higher Burden Required For Injunctive Relief

As set forth in the Attorney General's Pre-Hearing Statement, interim removal of a trustee is judged on the same standard as a motion for injunctive relief. See, Pfeiffer v. Pfeiffer, 394 S.W.2d 679 (Tex. Ct. App. 1965); Pre-Hearing Statement, footnote 3, p.3. In order to prevail on a motion for injunctive relief, the Attorney General must prove all of the following: 1) that she is likely to prevail on the merits of the underlying matter; 2) that there is likely irreparable harm; and 3) to the extent public interest is affected, that an injunction is in the public nterest. Penn v. Transportation Lease Hawaii, Ltd., 2 Haw. App. 272, 630 P.2d 646 (1981); Life of the Land v. Ariyoshi, 59 Haw. 156, 577 P.2d 16 (1978).

In other words, the Attorney General must at least show that she has a well-grounded fear of immediate invasion of a clear or equitable right, and that the acts complained of are either resulting in or will result in actual and substantial injury. Injury is irreparable only where it is of such a character that a fair and reasonable redress may not be had in a court of law.

> As ordinarily understood, an injury is irreparable, ... where it is of such a character ... that to refuse the injunction would be a denial of justice; *** The term 'irreparable damage' does not have reference to the amount of damage caused, but rather to the difficulty of measuring the amount of damages inflicted.***

Klausmeyer v. Makaha V.F. Ltd., 41 Haw. 287 (1956) (quoting 28 Am. Jur. Injunctions, § 48).

C. The Burden Of Proof

The Attorney General fails to recognize that there are two distinct parts to this proceeding. The first is the actual settlement of the 109th, 110th and 1th Annual Accounts of the Trustees or the accounting proceeding The second, which is at issue here and the subject of this prehearing statement, is the Attorney General's request for interim removal. This difference is fundamental in determining which party bears the burden of proof and the quality of the proof offered. This difference also determines the outcome of this case

In a removal hearing, where the property rights of a trustee are threatened, strict due process requirements and evidentiary standards must be strictly observed. See, Goldberg v. Kelly, 397 U.S. 266 (1970) (the fundamental requisite of due process is the opportunity to be heard) See also, Klinger v. Kepano, 64 Haw. 4, 635 P. 2d 938 (1981) (citing Mullane v. Central Hanover Bank and Trust Co., 339 U.S. 306, 313, 70 S.Ct. 652, 656 (1950) for the proposition that an elementary and fundamental requirement of due process is notice reasonably calculated and an opportunity to present objections); In re Kilgore, 22 N.E. 104, 106 (Ind. 1889) (trustee cannot be removed unless charges are preferred and he is given opportunity to be heard); In re Trust created by Hormel, 163 N.W.2d 844,.851 (Minn. 1968) (where no emergency existed and no violation or threatened violation was claimed, Court's removal of trustee without opportunity to be heard was a denial of due process).

In addition, the party seeking removal bears the burden of proof and must prove their case by clear and convincing evidence. Manchester v. Cleveland Trust Co., 168 N.E.2d 745, 751 1960). See also Willson v. Kable, 15 S.E.2d 56, 60 (Va. 1941) (charges of fraud, breach of trust, and gross neglect must be proven by clear, strong, and cogent evidence). The party seeking removal cannot simply rely on mere hearsay, and certainly not on confidential informants,

speculation or conjecture. IFS Industries, Inc. v. Stephens, 159 Cal.App.3d 740, 753 - 754, 205 Cal.Rptr. 915 (1984) (showing made by plaintiff of the existence of grounds for removal of trustees inadequate as it consisted almost entirely of hearsay on hearsay, conclusionary statements, and unproven findings). The evidence must meet basic guarantees of trustworthiness and foundation must be properly laid for its admission. Moreover, the trustees must be allowed to rebut with similarly competent evidence such as live witnesses, documentary evidence and expert testimony.

The Attorney General does not intend to call any witnesses "except as necessary for rebuttal." Attorney General's Pre-Hearing Statement for Removal filed 2/16/99, footnote 8, p. 11 (hereinafter "Pre-Hearing Statement). Instead, she relies exclusively on the alleged "undisputed facts and findings of Master Colbert Matsumoto" in conjunction with a misleading citation to Nawahi v. Trust Co., 31 Haw. 958, 973 (1931) for the proposition that the "master's findings of fact are presumptively correct." The Attorney General's disingenuous attempt to shift the burden of proof by relying on the unadopted findings of the Master as "undisputed facts" is fatal to her case.

The Master's Consolidated Report was produced as a part of the accounting proceeding. When presented to the court in an accounting proceeding, a master's findings are presumed to be correct.[4] Nawahi, 31 Haw. at 973. A master may rely on hearsay, confidential informants, or agents hired to assist the master in his accounting because he is presumed to be an extension of the court[5] and a neutral fact finder who is able to distinguish between credible and suspect information. However, in the accounting proceeding, there are two safety mechanisms that have

[4] On the other hand, a master's conclusions of law are not deemed presumptively correct and are subject to plenary review by the court. Apex Foundation Sales, Inc. v. Kleinfeld, 818 F.2d 1089, 1097 (3d Cir. 1987).

been established to protect the trustees. First, the master is required to presume regularity and good faith on the part of the Trustees. Estate of Campbell, 42 Haw. 586, 608 (1958). Second, the trustees are afforded the opportunity to rebut that presumption in a statement of exceptions and the ultimate facts are determined after a hearing by the court. See Estate of Campbell, 42 Haw. at 608 (the trustees have the right to present evidence to defend themselves against the factual findings contained in the master's report). In this case, no hearing has yet been had in the accounting proceeding on the "findings and conclusions" contained in the Master's Consolidated Report.[6] As such, they are not undisputed facts.

In addition, the unadopted findings of the Master in the accounting proceeding cannot be automatically imported for use as established facts in the removal proceedings because the evidentiary standards applicable to the accounting proceeding are significantly lower than that for the removal proceeding. In a removal proceeding, the Court views the evidence de novo. Masters v. Bissett, 790 P. 2d 16, 22 (Or. App. 1990). To allow otherwise would do violence to all notions of due process.

None of the cases cited by the Attorney General allow a claimant to shift the burden of proof as the Attorney General attempts here. To the contrary, in a separate action against a trustee, the claimant retains the burden of proof. Id. The Attorney General simply cannot prevail in her request for interim removal as the primary evidence she has relied upon, the Master's

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[5] Hawai'i Probate Rules, Rule 29 comment.

[6] Although the Parties entered into a Stipulation Concerning Master's Recommendations for the 109th, 110th, and 111th Annual Accounts, these stipulations were merely for the purpose of implementing a number of the Master's recommendations in future Accountings. As the stipulation makes clear, "*[t]he parties acknowledge that there are material differences of opinion concerning the statements and contentions in the Master's Consolidated Report.... Without conceding the accuracy of any such statements and contentions, the parties have agreed that it is in the best interest of the Trust Estate that the Stipulations hereinafter set forth be implemented.*" (emphasis added). As such, none of the Master's "findings" have been stipulated to as fact.

Consolidated Report, fails to meet the higher evidentiary standards required in a removal proceeding and because she has failed to carry her burden of proof.

D. The Attorney General Cannot Prevail On The Merits Of The Case

Even if this Court were to ignore the due process violations inherent in the Attorney General's interpretation of the law, and the fact that the evidentiary standard is higher is the removal proceeding, the Attorney General must still meet the high burden of showing a likelihood of prevailing on the merits of the permanent removal action and irreparable harm in order to prevail on this petition for injunctive relief. As Trustee Peters will demonstrate below and at trial, the Attorney General will be unable to prevail on the merits. In order to understand why the Attorney General will be unable to prevail, one must first understand the structure within which the parties must operate. As Trustee Peters will demonstrate below, both the Attorney General and Master have very delimited roles, and both have, with the help of a flawed analysis by Arthur Andersen, exceeded the scope of their authority

1 General Trust Principles

Charitable trusts are governed by well established case law, and all parties must act within the confines of this body of law. The following general principles of trust illustrate the obligations of the parties in ensuring that the charitable intent of Ke Alii Pauahi is fulfilled.

a. The Trust Instrument

The instrument creating the trust typically describes a process for appointing trustees, defines the scope of the trustees' powers and duties, and designates a procedure for distributing trust property (whether income or principal) to trust beneficiaries. The trust instrument may grant trustees broad discretionary powers in managing the trust estate as in this case.

b. Trustee's Duties to the Trust

A trustee's duties are derived from the trust instrument. If the instrument is silent as to a trustee's powers and duties, the trustees may resort to statutory or common law to establish the extent of such powers and duties. All states, including Hawaii, use either common law rules or statutory provisions that impose a standard of conduct that a trustee must observe in administration of a trust.

i. The Duty of Loyalty

Trustees must operate the trust in the sole interest of the beneficiaries and may not engage in self-dealing or conflict-of-interest transactions.

ii. The Duty Not to Delegate

Generally, a trustee of a charitable trust has a duty personally to perform the responsibilities of the trusteeship, except as a prudent person might delegate those responsibilities to others. The following general principles govern delegation:

- Certain duties may be delegated to professionals, agents, or co-trustees, as long as the delegating trustees exercise general supervision over the delegatee's conduct.[8]

  A trustee may delegate certain duties to co-trustees based upon diversification of qualification, or for purely ministerial acts.

  A trustee may delegate to a co-trustee or professional the authority to select trust investments, the management of specialized investment programs, or other

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[7] Restatement (Third) Trusts § 171
[8] Id. at § 171 cmt. k.
[9] 76 Am Jur 2d, Trusts § 378.

activities of administration involving significant judgment.[10]

- Trustees may rely upon reports, presentations, and recommendations prepared by staff, accountants, investment advisors, lawyers and other professionals without violating the duty of non-delegation.[11]

iii. *The Duty of Care*

Generally, trustees are under a duty to exercise such care and skill as men of ordinary prudence would exercise in dealing with their own property.[12] The following general principles govern the duty of care.

- A trustee does not breach the duty of care if deliberate, informed and experienced attention and professional judgment are exercised by the trustee in decisions regarding the retention or disposition of trust assets.[13]
- Prudence is judged by the circumstances as they reasonably appear at the time a trustee engages in a transaction and not at some subsequent time when his conduct is called into question.

  A trustee's performance is not to be judged by success or failure (i.e., right or wrong) and while negligence may result in liability, a mere error in judgment will not.

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[10] Restatement (Third) of Trusts at § 171 cmt. f.

[11] Richards v. Midkiff, 48 Haw. 32, 54, 58, 61, 396 P.2d 49 (1964) (Trustees can safely rely on counsel on legal questions which arise in management of estate when ordinarily diligent and careful men would do so in respect to that own property); Restatement (Second) of Trusts § 188 cmt. c.

[12] Ahuna v. Department of Hawaiian Home Lands, 64 Haw. 327, 640 P.2d 1161 (1982); Restatement (Second) of Trusts at § 174.

[13] Stark v. United States, 445 F. Supp. 670, 678, 681 (S.D.N.Y. 1978.

[14] Id. at 678-679 (neither prophecy nor prescience is expected of the trustees and their performance must be judged not by hindsight but by facts which existed at the time of the occurrence); Hartman v. Bertelmann, 39 Haw. 619 (1952).

[15] Stark; 445 F. Supp. at 678.

iv. *The Duty to Preserve Trust Assets*

- Trustees are under a duty to use reasonable care and skill to preserve trust assets.[16] In preserving trust assets, each trustee must adhere to the ordinary prudent person standard.
- If trust property diminishes in value, the trustee is not subject to surcharge unless he failed to exercise the care and skill of an ordinary prudent person.[17]
- A trustee violates his fiduciary duties if he sells trust property that is required to be retained under the provisions of the trust instrument.[18]
- Contrary to the Attorney General's mistaken belief, trustees can properly charge the an estate with the expense of defending a proceeding for removal brought by the beneficiaries.[19]

c. The Court's Role In Trust Administration

Generally, if an instrument creating a charitable trust confers broad discretionary powers to the trustees, a court will not interfere with the exercise of the trustees' discretion absent abuse, based on a failure to exercise the required degree of care, skill, or caution.[20] A trustee's discretionary powers include powers over investments of trust assets and decisions involving delegation of duties. In determining whether a trustee has abused his discretionary powers, a court considers:

- the purpose of the trust;

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[16] Restatement (Second) of Trusts. at § 176.
[17] IIA Scott at § 176.
[18] Steiner v. Hawaiian Trust Co., 47 Haw. 548, 562, 393 P.2d 96 (1964) (it is the specific investment duty of a trustee to diversify trust investments unless absolved from so doing by express direction in the trust instrument, such as a mandate to retain specified assets); Restatement (Second) of Trusts § 208.
[19] See generally, Scott at § 188.4.
[20] Miller v. First Hawaiian Bank, 61 Haw. 346, 604 P.2d 39, 42 (1980).

the existence or nonexistence, the definiteness or indefiniteness, of an external standard by which the reasonableness of the trustee's conduct can be judged; and

- the motives of the trustee in exercising or refraining from exercising the power

If there is no standard by which to judge the reasonableness of the trustee's conduct and the trustee acts honestly and from proper motives, a court cannot interpose its judgment for that of the trustee.[21] A party asserting an abuse of trustee discretion bears the burden of proof.[22]

The Processes And Participants Involved

In order to fully appreciate the inferences and conclusions being asserted by the various participants to this proceeding, a brief summary of the processes, the participants and their qualifications and views are in order.

a. *The Attorney General And The Role Of Parens Patriae*

Where a charitable trust is involved, the Attorney General acts as *parens patriae*,[23] a role that is wholly independent of any statutory grant of authority to the Attorney General. See Van de Kamp v. Gumbiner, 221 Cal. App. 3d 1260, 270 Cal. Rptr. 907 (1990). The Attorney General's role as *parens patriae* is a matter of standing that entitles the Attorney General to be a party to judicial actions concerning charitable trusts and gives the Attorney General the right to institute actions when appropriate. Except where the role has been expanded by statute, the Attorney General's function as *parens patriae* merely empowers the Attorney General to enforce a charitable trust according to the terms of the trust instrument and to notify the court of abuses

[21] Richards, 48 Haw. at 58; Restatement (Second) at § 187 cmt. i.
[22] Colburn v. Grant, 181 U.S. 601, 608-609 (1901) (a party alleging that a trustee has abandoned his powers or negligently supervised the trust, must prove such abandonment or negligence, and this abandonment or negligence is not to be inferred without sufficiency of evidence to support the inference).
[23] Literally, "father of the country," *parens patriae* is a doctrine deeply rooted in the common law.

or administrative deviations from the trust instrument.

The Attorney General's "duty to enforce implies a duty to supervise (or oversee) in its broader sense. It does not. . . include a right to regulate, or a right to direct either the day-to-day affairs of the charity or the action of the court." Marion R. Fremont-Smith, *Foundations and Government* 198 (1965). It refers instead to the right to receive reasonable information concerning the trust and to seek judicial intervention as necessary. "The Attorney General's power to enforce charitable trusts is coextensive with, but not broader than, the power of enforcement enjoyed by beneficiaries of private trusts." State of Washington v. Taylor, 362 P.2d 247, 254 (Wash. 1961). The doctrine does not authorize the Attorney General to "regulate" charitable trusts, nor does it permit the Attorney General to authorize deviations from the trust instrument.

The Hawai'i Supreme Court has affirmed the Attorney General's *parens patriae* authority to enforce the terms of the trust instrument, but has established that there are limits to that authority.

> The function of the attorney general, as *parens patriae* of charitable trusts, is to oversee the activities of the trustees to the end that the trust is performed and maintained in accordance with the provisions of the trust document, and to bring any abuse or deviation on the part of the trustees to the attention of the court for correction. The authority of the attorney general over charitable trusts does not extend beyond the performance of that function. If a deviation from any trust provision is necessary in the interest of the trust, the power to authorize the deviation rests solely with the court.

Midkiff v. Kobayashi, 54 Haw. 299, 335-36, 507 P. 2d 724 (1973). See also, Takabuki v. Ching, 67 Haw. 515, 521, 530, 695 P. 2d 319 (1985).

The decision in Kobayashi demonstrates that the Attorney General's role is to enforce the terms of the trust to the same extent that a beneficiary may enforce the terms of a private trust.

Just as a private beneficiary may not direct or control the actions of the trustees, neither may the Attorney General authorize a deviation from the terms of the trust instrument or otherwise invade the discretionary function of the trustees.

In this case, the Attorney General in her asserted role as *parens patriae* has overstepped her bounds and appears to be laboring to support certain preconceived conclusions and effect certain preconceived results. Neither she nor her Department have exhibited any specialized expertise in any of the substantive areas involved over which she now attempts to substitute her discretion.

Even more frightening is the fact that the Attorney General appears to have embarked on a personal crusade to oust the Trustees who do not fit her vision of leadership. The evidence will show that this New York, Ivy League newcomer to Hawai'i has done more damage than good to the purposes of Ke Alii Pauahi and seeks to do more.

The Will provides for appointment of the Trustees by the Supreme Court. This necessarily infers that Ke Alii Pauahi envisioned that the selection of the Trustees would be performed by an esteemed group who could draw upon the wisdom of longevity, traditional values, cultural appreciation and scholarship while being immune to political processes. The Attorney General has managed to undo this process and now attempts to imprint a corporate template on KSBE which better fit her views. As weapons in this attack, the Attorney General has allied herself with many who share her corporate missionary mentality.

b. *The Master And His Process*

The task of a master is to provide the Court with a complete, objective, and factual commentary regarding the condition of the Bishop Estate for each annual accounting. The master's role is that of a fact finder, not an advocate, and as an agent of the Court he must aid and

assist the court in performing its specific judicial duties by clarifying the issues and making tentative findings.[24] The master is not merely an accountant; he is expected to exercise a degree of independent judgment and discernment.[25]

The master is to follow instructions from the Court, not instructions from others, and is to make a thorough and knowledgeable examination of all matters properly before the Court.[26] He must, however, limit the scope of his review to only those matters which may be dealt with by an equity court in an accounting proceeding.[27] Therefore, the master, like the court, is prohibited from interfering in matters of trust administration unless there has been an abuse of trustee discretion or a violation of the law.[28] Indeed, the master is not even to comment on his differing views upon the administration of the estate and the discretion exercised by the trustees unless he is of the opinion that the trustees in the exercise of their chosen course abused their discretion.[29]

Although a master's findings of fact are deemed to be presumptively correct in an accounting proceeding, such facts are not conclusive and may be set aside by a trial judge if upon the evidence he is satisfied that the truth requires a finding to the contrary.[30] The master's recommendations are not binding on the trustees unless ordered by the court in an accounting proceeding.

Like the Attorney General in this case, the Master has overstepped his bounds. First, the evidence will show that the Master is an attorney with no particular background in trust law,

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[24] Hustace Report, p. 4, filed on June, 1976 by Frank W. Hustace, Jr., on the Trustees' 85th Annual Account (hereinafter "Hustace Report").
[25] Estate of Campbell, 42 Haw. 586.
[26] Id.
[27] Estate of Bishop, 53 Haw. 604, 607 (1972).
[28] Id.
[29] Hustace Report at p. 9
[30] Nawahi, 31 Haw. at 973.

financial or management matters. Moreover, the evidence will show that the Master has close ties to the Governor of this State and, like the Attorney General, the Master has been laboring to support preconceived conclusions. In this quest, the Master has exceeded the bounds of his defined role and has instead come to symbolize the dangers inherent in allowing a highly politicized individual to draw inferences on matters of which he has only an elementary grasp.

Second, the Master has, from the commencement of his undertaking, been more than an arm of the Court. He has undertaken an adversary role, utilizing "confidential informants" and has attempted to reaudit KSBE. In the Master's initial efforts at reauditing KSBE, he displayed the limited depth of his understanding by engaging an unqualified accounting firm. To compound this error, the Master then proceeded to draw less than flattering conclusions about the Trustees and their performance based on that accounting firm's inadequate efforts. The gratuitous non-substantive prose used by the Master to describe his findings is also evidence of this attitude.

After stipulating to employ a qualified accounting firm, the evidence will show that the Master made every effort to direct their studies to bolster his convictions. Failing to uncover any malfeasance, the Master then infers evil by utilizing those findings in ways which will be proven to be perverse.

c. *Arthur Andersen And The Auditing Process*

Arthur Andersen was hired to conduct a full financial and management audit of the KSBE pursuant to a Stipulation Concerning Master's Recommendations signed by the parties on December 19, 1997. In its engagement letter,[31] Arthur Andersen defined among the "Overall

[31] Arthur Andersen letter January 28, 1998 to Colbert Matsumoto and Nathan Aipa.

Objectives" of its work the provisions of recommendations "to align the purpose(s) of the Estate to the proposed structure [sic]."[32] The "proposed structure", toward which Arthur Andersen developed implementation steps, represented the preconceived conclusions of the Master, not an independently derived structure to be developed by Arthur Andersen. Curiously, in its Management Audit Findings,[33] Arthur Andersen makes no reference to the "proposed structure" identified as such in its engagement letter; as a consequence, the Master and the Attorney General would have the Court believe that Arthur Andersen came to its conclusions independently of the preconceived conclusions of the Master.

Financial Audits

The accounting profession has promulgated a set of authoritative standards for conducting financial statement audits. These standards are defined as Generally Accepted Auditing Standards (GAAS) by the American Institute of Certified Public Accountants (AICPA) and are interpreted by individual Statements on Auditing Standards (SAS).

Generally accepted accounting principles (GAAP) also are represented by a set of authoritative standards published by the Financial Accounting Standards Board (FASB), its predecessor standard setting organizations, and the AICPA.

The objective of an audit " of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present, in all material respects, financial position, results of operations and its cash flows in conformity with generally accepted accounting principles."[34] An audit is a methodical review and objective examination, the purpose

[32] Idem.
[33] Arthur Andersen, Management Audit Findings, July 1988, p.2.
[34] AU Sec. 110.01

of which is to express an opinion on or reach a conclusion about what was audited.[35] The role of the auditor is simply to express an opinion on the fairness of the financial statements examined.[36]

The Attorney General notes the long-standing relationship of KSBE with the accounting firm of Coopers & Lybrand (now PriceWaterhouse Coopers), with the suggestion that the length of the relationship implies a conflict of interest on the part of the Trustees. This unsupported allegation, while typical of this Attorney General, has no basis in fact.

Accountants engaged in financial audits are bound by a Code of Professional Conduct, in particular, Rule 101 (ET101.1) promulgated by the AICPA. This Rule, and all of the interpretations of the Rule issued by the AICPA, are set forth in the GAAS Guide.[37] Neither the Rule nor any of its AICPA interpretations provide a basis for the Attorney General's assertions of a conflict of interest between the Trustees and KSBE's auditors.

To the contrary, the evidence will show that it was Arthur Andersen that made certain gratuitous findings which are not supported by the standards they are bound to uphold.

ii. *Management Audits*

In contrast to Generally Accepted Auditing Standards, which guide the accounting profession in its financial audit work, there are no "generally accepted" standards for performing "management audits". Indeed, the authoritative literature on auditing standards makes no mention of management audits or any standards related to such audits. Accordingly, unlike a financial audit, a management audit cannot serve as a basis for comparing one organization with any other. Nor can a management audit express meaningful observations of any deviation from

[35] GAAS Guide, 1.03.
[36] GAAS Guide, 2.03.
[37] GAAS Guide, 24.06 – 24.22

norms, for there are no "generally accepted" norms. In fact, the evidence will show that the term "management audit" is not even utilized within the accounting and management consulting industries. Moreover, the evidence will show that the study performed by Arthur Andersen was not conducted to fulfill the normal goals of management but to support the Master's pre-conceived and somewhat nefarious conclusions.

The Arthur Andersen management audit is flawed for a number of reasons. First, in a fashion typical of the Big 5 accounting firms, Arthur Andersen immediately began its examination of KSBE as a business entity and set about to "solve" KSBE's financial and management "problems", and to "align the purpose(s) of the Estate to the proposed structure."[38] However, in its haste to "solve" KSBE's "problems," Arthur Andersen failed to ask itself the fundamental questions – who is KSBE and is it a business entity? Had Arthur Andersen taken the time to make this rudimentary initial assessment, it surely would have noted the fundamental fact that KSBE is a non-profit educational trust, with distinct non-corporate cultures and values. While Arthur Andersen acknowledges the tax-exempt, nonprofit nature of KSBE, its report fails utterly to take KSBE's heritage into account; Andersen's cookie cutter approach to evaluating KSBE based on a corporate American model results in a fundamentally flawed analysis.

iii. Arthur Andersen's Best Practices Analysis Relies On Benchmarking Against Organizations That Are Not Comparable

The evidence will show that Arthur Andersen performed its audit by "compar[ing] KSBE's business processes to those of best practices." According to Arthur Andersen, "[b]est practices describe the optimum ways to perform a business process. They are the means by which leading organizations have achieved top performance and serve as goals for other

[38] Arthur Andersen letter to Colbert Matsumoto and Nathan Aipa, January 28, 1998.

organizations striving for excellence." However, as Arthur Andersen concedes, often times there is no "best" way to do something. Every organization has unique goals, opportunities, and obstacles. Organizations have different missions, cultures, environments, and technologies. Best practices must be evaluated with these differences in mind. As such, the best practices of one organization may not be the best practices for another. Thus, Arthur Andersen's comparison of KSBE's business processes to those of "best practices" begs the question – whose best practices?

Arthur Andersen admits in its report (hereinafter the "Andersen Report") that it could not find any comparable entities organized like KSBE. However, in order to bolster the Master's preconceived notion, Arthur Andersen performed its best practices evaluation by comparing KSBE to a number of other structurally distinguishable organizations, including mainstream American, mainland-based organizations such as the Milton Hershey School – organizations that are the cultural antithesis of KSBE.[39] Based on a comparison to these structurally and culturally different organizations, Arthur Andersen arrives at the predictable and flawed conclusion that KSBE should be more like these other entities.

The Milton Hershey School was originally established by Milton S. Hershey, a turn of the century industrialist and businessman, to provide an education to orphaned white males. The original Deed of Trust executed by the Hersheys created a structure whereby the school was operated and managed by a group of managers that were authorized to incorporate as a Pennsylvania corporation. The school received funding from the Milton Hershey Trust

[39] Although the Arthur Andersen report also compares KSBE to a number of large Hawaiian estates, the report's suggestion that these estates are based on a corporate American CEO model is deceptive and misleading. Other large Hawai'i trusts have a variety of management structures, including reliance on a co-trustee which is also a licensed trust company; employment of an executive secretary to the trustees; and employment of individuals who have broad authority with respect to ministerial acts but whose limited authority over discretionary acts may only be exercised in conjunction with trustee approval. These entities are structurally distinct and thus provide no meaningful comparison.

Company, which was the sole Trustee. From its creation, the Milton Hershey School was intended to function like a corporation – in other words, like a business. The governance structure envisioned by Milton Hershey and as evidenced by the Deed of Trust was modeled after that of a corporation and is significantly different from the governance structure envisioned by Ke Alii Pauahi.

Unlike the Milton Hershey School, KSBE's governance structure was created with cultural considerations in mind. KSBE was formed not only for the purpose of educating native Hawaiians, but also for preserving Hawaiian culture and society. As the Master recognizes in the Master's Consolidated Report, KSBE was established during a period of drastic change in Hawai'i. Concerned for her people, Ke Alii Pauahi sought to leave a legacy of educational opportunity to assist native Hawaiians in coping with hostile social, economic, and cultural forces which were taking hold in Hawaiian society. Ke Alii Pauahi sought to achieve her goal of preservation by creating an organization that reflects and understands Hawaiian culture to implement her vision. Arthur Andersen's analysis of KSBE completely fails to account for these core values. To imply, as the Andersen Report suggests, that Ke Alii Pauahi intended KSBE to be governed as a corporate entity, the exact culture that she intended to shield her people from, is antithetical to the spirit and the intent of Ke Alii Pauahi's Will. Thus the best practices of Milton Hershey School can hardly be said to represent the best practices for KSBE.

Arthur Andersen's failure to account for KSBE's unique culture is clearly manifested in its suggestion of a CEO structure. Arthur Andersen envisions the CEO as a focal point of communications between the Trustees and KSBE staff and essentially as the Trustees' sole employee. In effect, Arthur Andersen suggests a model derived from corporate practice as evidenced by the term CEO – a term not found in the traditional trust context. Not only does this

structure raise the problems of creating yet another layer of bureaucracy and unnecessarily concentrating power in a single individual against the explicit instructions of the Will, the CEO also acts as a significant filter of information between the Trustees and their staff. A central element of Hawaiian culture is its oral tradition and group deliberative decision-making processes. Ke Alii Pauahi's instructions that the Trustees should be selected by some of the wisest members of Hawaiian society – the Hawai'i Supreme Court – and that they should make decisions as a group reflects this core aspect of Hawaiian culture. Thus, Arthur Andersen's recommendations run directly contrary to the Hawaiian culture's predisposition for group deliberative decision-making. Arthur Andersen's suggested "best practices" were derived from organizations that are significantly culturally different from KSBE and it is by no means clear that the best practices of white corporate America are necessarily the best practices for KSBE.

Despite Arthur Andersen's own philosophy that all fundamental change be implemented through "pilot programs," its recommendation for full implementation of a CEO-based structure for KSBE evidences its intent to support the Master's preconceived conclusions.

Arthur Andersen's comparison of KSBE's governance structure to that of a corporation is also flawed for a number of other reasons. KSBE is not a profit-driven entity. Unlike corporations that must continually strive to improve their processes in order to maximize their profitability and prevent erosion of their market share, KSBE's goal is to maintain the corpus of the Ke Alii Pauahi's Estate and prevent its erosion. As such, KSBE has an inherently different tolerance for risk and can operate on much longer time frames. For example, KSBE can afford to make investments with a low short-term return, but whose return in the long-term will exceed those that are more attractive in the short-term. The Hamakua Land acquisition is a prime example of such an investment. The land became available at a substantial bargain to KSBE

Although financial returns on the agricultural land were not expected to come to fruition for several years, the returns were expected to be great. As a perpetual trust, KSBE has time to wait for those returns.

In addition, there are inherent cultural factors reflected in the way that KSBE conducts business that have also been entirely overlooked by Arthur Andersen. Like many Asian cultures, Hawaiians place great emphasis on personal relationships, honesty and integrity when conducting business rather than on paper contracts. Although these practices may prove unnerving to those indoctrinated in western corporate cultural values, they are no less legitimate. This is demonstrated by the fact that many of the transactions criticized by Arthur Andersen for their lack of "due diligence" have proven to be very profitable. Ironically, had the Trustees blindly and strictly adhered to the ratios suggested by Cambridge Associates, Inc. and invested in liquid publicly traded securities in 1987, they would likely have lost a significant amount of those assets in the stock market crash that occurred in October, 1987. Similarly, had the Trustees blindly invested in core global securities in 1996, they would again likely have lost a significant amount of those assets in the Asian and Latin American financial crises that continue to this day.

In addition to its failure to consider the role of culture, certain recommendations contained in the Andersen Report raise the question of what Arthur Andersen considered in its analysis. Arthur Andersen appears to chastise the Trustees for failing to develop "next-step" action plans for development and for making opportunistic investments rather than "targeted" ones that "fit" within some corporate template. KSBE is <u>not</u> in the business of manufacturing widgets competing for market share and this mind-set is more than illustrative of the flaws in the Andersen Report.

iv. *The Andersen Report's Reliance On A Snapshot Of KSBE And Its Failure To Conduct A Detailed Analysis Of KSBE's History Results In A Flawed Analysis*

The Andersen Report also suffers from the fact that it is extremely limited in scope, covering only a three year window in KSBE's 115 year history There is no evidence in the report to suggest that Arthur Andersen considered this history as it relates to the evolution of KSBE's organizational processes or the decisions made. Nor does it appear that Arthur Andersen ever bothered to ask why KSBE's processes exist in their present form. Instead, relying on only three years worth of data, Arthur Andersen presumes to prescribe a remedy for KSBE's perceived ills. This is the equivalent of a doctor prescribing decapitation to cure a simple headache. Ironically, had Arthur Andersen examined the evolution of KSBE's processes, it would have become obvious to it that much of the confusion lies in the various, and often contradictory, recommendations contained in the various Master's Reports.

Regardless of the fundamental flaws contained in the Andersen Report, the Master's conclusions regarding the Trustees' performance of their fiduciary duties are a significant logical leap from the report's suggestions for improving KSBE's performance. Needless to say, the Attorney General's extrapolation from the Master's conclusions are light-years from the conclusions reached in the Andersen Report and thus completely unsupportable. The Attorney General can point to no place in the Andersen Report where the Report comes to a definitive conclusion that a breach of trust has occurred.

Based on the framework presented above within which the Attorney General and Master should have confined their actions, and based on the flaws contained in the Andersen Report, the Attorney General will be unable to meet her burden of proof.

3. The Attorney General Cannot Meet Her Burden Of Proving A Likelihood Of Prevailing On The Merits And She Cannot Make The Requisite Showing Of Irreparable Harm

In order to prevail on the merits of her request for interim removal, the Attorney General must first meet the high standard of proof for injunctive relief. The Attorney General must demonstrate that 1) she is likely to prevail on the merits of the underlying case for permanent removal; 2) that there is likely irreparable harm; and 3) to the extent public interest is affected, that an injunction is in the public interest. Life of the Land, 59 Haw. 156.

In her Response to the Master's Consolidated Report, the Attorney General originally outlined seven broad and separate areas supporting removal of the Trustees. In her dissimilarly organized Pre-Hearing Statement, she limited her basis for removal of Trustee Peters to the three following areas:

Governance (the lead trustee system)

- Duty of Care (investments and the Hamakua Land purchase)

  Duty of Loyalty (the reclassification of income to corpus, FDOC expenditures, conflict of interest policies, and the use of trust assets for trustee litigation and lobbying).[40]

Although it appears that the Attorney General has now limited her basis of removal against Trustee Peters, in an abundance of caution and as further argument against removal, Trustee Peters shall respond to all charges set forth by the Attorney General in her Response to the Master's Consolidated Report.

[40] Pre-Hearing Statement, p. 13-21

a. Governance: Utilization Of The Lead Trustee System and Skepticism Of Tthe CEO-Based Management System Is Not A Proper Basis For Removal

The Attorney General argues that the mere fact that the Master has requested Court intervention and Court-ordered implementation of a CEO-based system of management is sufficient grounds for removal. By so arguing, the Attorney General ignores the wide degree of latitude the law affords to Trustees in the determination of their means of carrying out their jobs.

Disingenuously, the Attorney General argues that assigning a chief executive to be responsible for particular functions (the Lead Trustee system) constitutes a breach of trust, and at the same time, argues that Peters' disagreement with the Andersen recommendation of a CEO system also represents a breach. The Attorney General cannot have it both ways.

While Trustee Peters does not agree with the criticism of the lead trustee system and does not agree with the rationale underlying the CEO-based structure, the Attorney General misses the key point: the lead trustee system has already been discontinued and the Trustees have agreed to implement a CEO-based system. Simply put, the Attorney General is beating a dead horse.

The Attorney General cannot prevail on her request for interim removal based on the lead trustee system *because it has been discontinued*, and she can show no imminent, continuing, or irreparable harm. The Attorney General has pointed only to past, speculative concerns to support her case.[41]

Likewise, the Attorney General will be unable to prevail on the merits of removing Trustee Peters for utilizing the lead trustee system. The administration and governance of a trust are the province of the trustee and a court will not interfere with the exercise of the trustee's

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[41] Id. at p. 34.

discretion except to prevent an abuse of discretion. Miller, 61 Haw. 351; IVA Scott at § 382. Moreover, certain duties of a trustee may be delegated to professionals, agents, or co-trustees, as long as the delegating trustee exercises general supervision over the delegatee's conduct. Restatement (Third) of Trusts § 171 In fact, the lead trustee system was embarked upon in good faith for the purpose of capitalizing upon each individual Trustee's interests and specialized experiences, while maintaining a collective decision making process within the Board of Trustees.[42] Furthermore, Trustees are not only entitled to determine the management structure of KSBE, they are also allowed to delegate to each other.[43] Given such authority, the utilization of the lead trustee system cannot possibly constitute a serious breach of trust[44] or gross negligence[45] which would warrant removal, much less immediate interim removal.

Trustee Peters has legitimate concerns and opposition to the CEO-based structure endorsed by the Master. Organization of KSBE is a matter within the discretion of the Trustees and the Will did not envision the delegation of Trustee's discretionary authority to persons other than her Trustees.

> I direct that a majority of my said trustees may act in all cases and may convey real estate and perform all of the duties and powers hereby conferred; but three of them at least must join in all acts. I further direct that the number of my said trustees shall be kept at five.

Will, Art. 14.

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[42] Trustee's Response to Master's Report on the 109th Annual Account, filed 12/3/97, p. 66.

[43] *"I also give unto my said trustees full power to make all such rules and regulations as they may deem necessary for the government of said schools and to regulate the admission of pupils, and the same to alter, amend and publish upon a vote of a majority of said trustees." Will, Art. 13*; 76 Am Jur 2d, Trusts § 378. See also, Bogert, §555, p. 110 (rev. 2d ed. 1980) ("[I]f the performance of an act may properly be delegated by the trustee, he may give such power to a co-trustee as well as to any other qualified person."); Restatement (Second) of Trusts, §194, comment b (1959) ("[T]o the extent and only to the extent that a trustee can properly delegate the performance of acts (see § 171), such acts can be properly performed by less than all of the trustees with the consent of the others.").

[44] Schildberg, 461 N.W.2d at 191.

[45] Smith, 54 F. Supp. at 238.

Trustee Peters continues to believe it is not appropriate to appoint a CEO with responsibility for the major affairs of KSBE. A CEO, a corporate model position, is directly in charge of the entire corporation and answers to the board of directors. A corporate model is not applicable to a trust estate. Trustees are not merely directors to whom some employee with control of the affairs of the estate reports periodically. Unlike a corporate director, a trustee is the legal owner of the estate entrusted to him and he is expected to administer that estate to the best of his ability. A trustee does not merely fix policies and leave the business to another to run such as would a CEO.

Given the legitimate concern Trustee Peters has with the CEO-based structure in KSBE, it was within Trustee Peters' discretion to resist implementation of the recommended management position. The fact that the Master would have exercised its discretionary power differently is not a sufficient reason for judicial interference in trust administration.[46] The utilization of the lead trustee system and resistance to the CEO-based system, in light of questions of validity under the Trust, cannot amount to a basis for removal of Trustee Peters, much less for his immediate interim removal.

b. Duty of Care and Investments: Trustee Peters' Actions Were Within The Proper Exercise Of A Trustee's Discretion

The Attorney General's allegation that Trustee Peters' breached his duty of care for investment decisions made by the Trustees amounts to no more than improper second guessing by the Attorney General based on the improper second guessing of the Master and Arthur Andersen. As such, the Attorney General cannot prevail on the merits of her claim of a breach of

[46] Takabuki, 67 Haw. at 530.

duty, much less show irreparable injury given that the decisions she attempts to second guess were all made in the past and that the Trustees have agreed to modify their practices in the future.

A trustee's duty of care in administration of a trust requires only that he exercise the care and skill that a man of ordinary prudence would exercise in dealing with his own property. Restatement (Second) of Trusts at § 174. Whether the trustee is prudent in dealing with trust property depends upon the circumstances as they reasonably appear to him at the time when he engages in a transaction and not at some subsequent time when his conduct is called into question. Id. Neither prophecy nor prescience is expected of the trustees and their performance must be judged not by hindsight, but by facts which existed at the time of the occurrence. Stark, 445 F.Supp. at 687-89. A court cannot interpose its judgment for that of the trustee if there is no standard by which to judge the reasonableness of the trustee's conduct and the trustee acts honestly and from proper motives. See, Richards, 48 Haw. at 61; Restatement (Second) of Trusts at § 187 cmt. i.

The investment decisions at issue were proper and prudent, and the Court should not countenance improper second-guessing by the Attorney General, Master, nor Arthur Andersen.

Investment Practices

There is no greater room for disagreement between the Attorney General/Master/Arthur Andersen and the Trustees than on the subject of investment. Indeed there is broad disagreement even among investment experts themselves. By its very nature, investment is inherently risky. Even the most careful and well-documented strategy can be foiled by unforeseen market shifts or conditions that are initially believed to be remote. Investment results are always celebrated or criticized in hindsight. In this case, however, hindsight shows that Trustee Peters' investment instincts and leadership have not only been prudent, but extremely astute.

The conduct of the trustee in making an investment is to be judged as of the time when the investment was made, not in hindsight. During the years in controversy, trustee investment decisions were governed by H.R.S. § 560:7-302 which provides that a trustee must observe the same standards in dealing with trust assets that would be observed by a prudent person dealing with the property of another. If the trustee has special skills or is named a trustee on the basis of representations of special skills or expertise, the trustee is under a duty to use those skills. If the trust instrument grants the trustees discretion over investments, a court is confined to the single inquiry of whether the trustees have acted in good faith and have exercised such discretion as would be reasonably exercised by ordinarily prudent persons.[47]

The prudent investor standard is applied to the entire investment portfolio, not to each individual investment.[48] The trustee is not precluded from investing a portion of the trust income or principal in risky investments, including venture capital companies and other corporations.[49] In making investment decisions, a trustee may rely upon recommendations, reports, and presentations made by staff or professionals, but he is not bound to follow their recommendations.[50] The trustee must still exercise his own independent judgment in light of the information and advice that he receives.[51]

> A trustee is not liable for breach of fiduciary duties if he has exercised reasonable due diligence in either making an investment or retaining trust assets. Stark, 445 F. Supp. at 679; Restatement (Second) of Trusts at § 227. Furthermore, a trustee is not inherently negligent for retaining trust property during a period of declining market values. Stark, 445 F. Supp. at 679. Similarly, the fact that certain trust property may not be desirable for a long term investment does not mean that a trustee is under a duty to sell it at the first possible opportunity. Id.

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[47] Fox v. Harris, 119 A. 256, 260 (Md. 1922).
[48] Restatement (Third) of Trusts § 227 (emphasis added).
[49] Id. at § 227 cmt. p.
[50] III Scott § 227.1.
[51] Id.

Although the State of Hawai'i adopted the Hawai'i Uniform Prudent Investor Act, H.R.S. Ch. 554C ("HUPIA"), on April 14, 1997, the statute is prospective only and does not apply to the years in controversy. Therefore, the nonexclusive factors listed in H.R.S. Ch. 554C do not apply in determining whether the trustees acted as prudent investors in making their investments.

As set forth above, blind adherence to ratios and corporate templates would have led to severe losses during the crash of the stock market on Black Tuesday 1987, the continuing Russian and Asian economic crises beginning in 1996, and Latin-American economic crisis of the present. From 1980 to 1994, during Trustee Peters' tenure, the total rate of return for all of KSBE's asset classes including Hawai'i real estate, North American real estate and marketable securities and financial assets was a compounded 17.3%, outperforming virtually all other portfolios in Honolulu. Trustee's Response to 109th Annual Account filed 12/3/97, p. 32. This return is higher than that of Yale University and puts KSBE among the best performing of the major endowments, nationwide. Id. More recently under Trustee Peters' leadership, KSBE achieved immediate diversification in its holdings with a brilliant investment in Goldman Sachs, one of the premier investment banking firms in the world. When Goldman Sachs becomes a publicly traded entity, KSBE's investment is expected to further increase in value and become a larger percentage of KSBE's holdings.

Arthur Andersen and the Master may not be comfortable with the fact that the Trustees do not always defer to the opinion of accountants, investment advisors, lawyers and other professionals in making decisions. However, it is well within a trustee's discretion to accept or reject such opinions, [52] and a trustee is under the obligation to exercise his own independent

[52] III Scott § 227.1

judgment in light of the information and advice that he receives.[53] The Attorney General has shown no abuse of discretion in the ultimately astute investment decisions made by the Trustees and Trustee Peters and thus removal is unwarranted.

ii. *The Hamakua Land Transaction*

The Attorney General identifies the Hamakua Land transaction as a basis for Trustee Peters' removal, criticizing the transaction despite its value to KSBE and the Hawaiian people. The Attorney General's attack on this transaction is perhaps the most glaring example of how the Attorney General (as well as the Master and Arthur Andersen) has missed the forest for the trees in her wild pursuit of removal.

The Attorney General seeks removal because the Hamakua Lands increased KSBE's agricultural land holdings and because of certain preliminary staff advice.[54] In addition to being improper second guessing, the Attorney General ignores the opinion of her own office which approves of investment decisions that take into consideration more than a profit-making motive. Hawai'i Attorney General Op. No. 87-2 (April 20, 1987), 1987 Haw. AG Lexis 5 (investment decisions may be "premised upon social and moral facets as long as the resulting transaction [does] not sacrifice the safety of the trust corpus and production of an adequate return on investments).

The purchase of the Hamakua Lands gave KSBE control over some of the best forestry

[53] Id.

[54] The Attorney General's criticism of the method employed by the Trustees for facilitating this transaction is yet another example of the inappropriate second guessing engaged in by the Attorney General, Master and Arthur Andersen. Debt financing allows for a greater return on equity than if the purchase price were paid in cash, especially given the low interest rate available to KSBE and the low transaction costs. Debt financing preserves KSBE's liquidity, allowing the cash that would otherwise be spent on the acquisition to be available for the schools and other investments. Debt financing allowed KSBE to participate in a diversified high quality investment opportunities such as the Goldman Sachs investment all at the same time.

lands in the world, consolidated its preexisting holdings and positioned KSBE to benefit from the predicted worldwide shortage of pulp and timber. Over 99% of the lands acquired are being leased, and, in 2002, the Hamakua Lands will yield percentage rents due from the first timber harvests. More importantly, the land purchase was of deep cultural importance, keeping a critical mass of Hawai'i land in the hands of Hawaiians - a highly sensitive issue for many Hawaiians today --- for the benefit of future Hawaiians. The Trustees have provided more than ample documentary evidence of the prudence of this transaction.[55]

Ultimately, the purchase of the Hamakua land was prudent because it was consistent with the age old maxim "buy low, sell high." The Asian financial crisis and the sharp drop in Hawai real estate values, coupled with the fact that the land was sold in connection with a foreclosure. resulted in an artificially depressed price. It is telling that the land was independently and separately appraised by five parties at over $51 million and that outside investors were willing to pay approximately $20 million for only 3,000 acres of the property. Ultimately, KSBE was able to purchase 30,000 acres for $21 million, just $1 million above what outsiders were willing to pay for a small percentage of the property The Trustee's realized gain of an over 150% return on their investment in the Hamakua lands can hardly be called an imprudent investment justifying removal. Moreover, the Attorney General again cannot show irreparable harm given that the transaction occurred in the past.

iii. *Diversification*

The Master acknowledges that the bulk of KSBE's assets is Hawai'i real estate which comprised the original trust corpus. Because the Will restrains the Trustees from freely selling

[55] Objection and Response of Trustee Peters to Master's First Supplemental Report filed 9/29/98, p. 15-50 with attachments.

those lands, the ability of the Trustees to fully maximize the return on the overall portfolio is limited. Yet, despite knowledge of these limitations, the Master seems to push for sale of real estate solely for the sake of reducing land holdings to reach an arbitrary target diversification ratio. The Attorney General blindly follows.

The Trustees have agreed that greater diversification is desirable. But what the Master and the Attorney General ignore is that the years under review are only a snapshot of the process whereby KSBE has evolved from being almost entirely invested in Hawai'i real estate to holding hundreds of millions or billions of dollars in equity investments. The surge in Hawai'i land values in and after 1989 distorts the Trustees' diversification efforts. In the period after the Master's review (after 1997), certain private equity investments soared in value and went public while the Hawai'i real estate market remains in a slump. It is a pity that this shift in market conditions did not occur during the period which the Master reviewed, but it is a greater pity that neither the Master, Arthur Andersen, nor the Attorney General have the skill, wisdom or objectivity to recognize the effect of market conditions on the Trustees' efforts at diversification.

Investment ratios are constantly in flux, even with no purchase or sale activity, as the value of holdings go up and down. As such, they are goals and cannot be treated as absolutes. The years under review were years of resolution in which prior troubled investments were turned around or losses recognized and many successful investments were positioned for public offerings. The anticipated growth of KSBE's private equity investments will now enable KSBE to become more diversified. More importantly, however, is the fact that investment decisions are left to the sound discretion of the Trustees absent abuse of discretion. The Attorney General has failed to demonstrate any abuse of that discretion that would warrant removal

iv. *Documentation*

The Trustees have acknowledged the deficiencies found in their documentary practices. They have now been upgraded and the Trustees have agreed to implement the Arthur Andersen recommendations in this regard.[56] The appropriate remedy has already been implemented, and there is no evidence of irreparable harm.

The reported lapses in administrative procedures, though regrettable, are hardly a basis for the drastic relief of removal. It is important to note that the Master and Arthur Andersen have undertaken a more comprehensive and detailed analysis of KSBE's operations than has anyone in recent memory, if ever. Yet despite the criticism of documentation practices, the Master's Consolidated Report does not challenge the substance of any particular real property transaction. Deficiencies in the minutes and other formal reports do not mean that discussions were not held or that the Trustees acted without adequate information. There have been contemporaneous records such as staff reports which memorialize the substance of staff and Trustee actions. Any weakness of these administrative procedures do not constitute serious breaches or gross negligence that would warrant removal.

v. *Performance Measures*

Performance measures are a matter of discretion and choice. Disagreement with the Master's choice of measures is well within the Trustees' discretion and their duty to exercise their own judgment and skill, and it is simply insufficient grounds for removal. Even more illustrative of the Attorney General's failure to comprehend the parties' roles is that Stipulation No. 9 Concerning Master's Recommendations filed herein on October 2, 1998, does not provide

[56] Stipulations and Order Concerning Master's Recommendations. Stip. Nos. and 12.

specific measures leaving the same to the discretion of the Trustees.[57]

c. Duty of Loyalty: Trustee Peters Has Acted With The Utmost Fidelity To The Trust

i. *Conflict of Interest*

The Trustees stipulated to adoption of stricter guidelines and procedures to ensure appropriate compliance with fiduciary standards.[58] Thus, the Attorney General cannot credibly argue that there is continuing, imminent, irreparable harm.

ii. *Lobbying*

The evidence will show that all lobbying efforts were proper and sound utilization of the Trust assets.

iii. *IRS Audit*

Trustee Peters objects to the recusal of the Trustees from the IRS audit of KSBE.

iv. *FDOC*

The Attorney General is correct in her statement that "Trustees are allowed by law to receive commissions based on revenue and income earned, and on capital transactions," and that the Trustees serving in 1961 voted to waive commissions with respect to capital expenditures.[59] She is also correct in noting that the 1966 Trustees agreed to waive commissions on certain of such expenditures from and after 1966.[60] However, the Attorney General is mistaken in her assertion that the waiver voted upon by the 1961 Trustees and referenced by the 1966 Trustees

[57] Id., Stip. No. 9.
[58] See Trustee's Response to Master's Consolidated Report, p. 92
[59] Pre-Hearing Statement, p.19.
[60] Id., p.20.

was intended to constitute an obligation binding all future Trustees without regard to possible changes in circumstances.[61]

First, the 1961 waiver explicitly reserved the continuation of the waiver to "future action of the Trustees."[62] In other words, the Trustees who themselves voted[63] to waive commissions reserved the right to change their minds if circumstances should warrant. Second, the 1966 waiver did not even appear in the actual minutes; instead, the Trustees voted[64] to attach (not to incorporate) a statement regarding the commissions.

The Attorney General would have the Court interpret these voluntary acts of Trustees in 1961 and 1966 as binding legal obligations of those Trustees and all of their successors. If such a binding legal obligation were intended by either the Attorney General in 1966 or the Trustees at that time, or by KSBE at that time, surely an unambiguous document setting forth such an agreement would be available. Instead, the only documentation offered by the Attorney General are:

> extracts from the 1961 and 1966 minutes, which clearly describe the voluntary nature of the waiver;

2. the Attorney General's 1966 statement that "the Trustees have agreed that there will not be commissions paid on money borrowed or paid for construction ... of Kamehameha Schools facilities."

3. an Amended Order making no specific reference to the waiver whatsoever.[65]

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[61] See generally Trustees' Objection to Attorney General's Response to the Master's Consolidated Report on the 109th, 110th, and 111th Accounts, pp. 22-26 (hereinafter "Trustees' Objection to AG's Response").
[62] Pre-Hearing Statement, Exhibit 1.
[63] The emphasis is in the original minutes of the Trustees, indicating the voluntary, nonbinding, nature of the waiver.
[64] Again, the emphasis is in the original minutes of the May 12, 1966 meeting.
[65] Pre-Hearing Statement, Exhibit 5.

The documentation attending the 1961 and 1966 waivers demonstrates clearly the voluntary nature of those waivers. The Attorney General produces no clear documentation of a binding agreement with respect to commission waivers, because no such binding agreement exists.

Subsequent to 1966, differing constituent Boards of Trustees made and rescinded their own commission waivers as they saw fit in light of the circumstances of the times, which can only emphasize the voluntary nature of the historical commission waivers.

The Attorney General would have the Court adopt the view that the Trustees' decision to accept compensation to which they are legally entitled to constitutes a breach of fiduciary duty. Moreover, attempting to manufacture a breach of fiduciary obligation in the treatment of commissions on FDOC, the Attorney General ignores the glaring reality that the total compensation received by the Trustees during the period in question, even including the commissions with respect to FDOC, remained well within the amount specified by the relevant Hawai'i statutes. Consequently, even if the Court were somehow able to find that the recission of the commission waiver constituted a breach of duty, the fact that the Trustees' total compensation remained less than their statutory entitlement would indicate that the recission caused no harm to the estate, much less irreparable harm.

In any event, in this situation removal would not be the appropriate remedy since surcharge is measurable, and less drastic.

d. Accumulated Income: The Trustees' Accumulation Of Income And Reclassification Of Income As Corpus Does Not Warrant Removal

The Attorney General concludes that the accounting for principal and income and the accumulation of income violates both the Will and earlier court orders. Not only does the

Attorney General fail to supply any credible foundation for these assertions, she cannot point to any precedent where the accounting judgments made by trustees, based upon due diligence and with the advice of counsel and independent accountants, has been held to constitute a breach of any duty owed by a trustee. Finally, none of the evidence put forth by the Attorney General demonstrates any harm to the estate as a consequence of these accounting judgments. Accordingly, the Attorney General makes no case whatsoever for the removal of the Trustees based on these accounting judgments, much less a case for immediate interim removal.

Interim removal is not justified because the Will does not forbid the accumulation of income, it merely requires the income to be expended for specific purposes.[66] Indeed, the Court has previously recognized that:

> *...the prudent administration of the Schools would not lend itself to the careless expenditure of funds merely to comply with the Will's stated direction to expend all of the annual income for the maintenance of the schools.*

Master's Consolidated Report citing to Report of Master Hong on Petition of the Trustee's of the 99th Annual Account filed 8/2/85, p. 18-19.

The Will's direction regarding income of KSBE must be considered in the context of the time when it was made, and the composition of KSBE at that time. In 1884, KSBE consisted almost entirely of real estate that produced comparatively little in the way of annual cash income. Thus, Ke Alii Pauahi wanted to ensure that enough funds would be made available for her intended purpose. Over the last 115 years, the composition of KSBE has been altered dramatically, by both the land reform movement and the wide variety of income-producing investments that are now available. At the same time, accounting standards have been developed

[66] See Trustees' Response to Master's Consolidated Response, pp. 16-35 for an additional discussion of accumulation of income.

that could never have been conceived in 1884. Yet the Attorney General would have the Court apply a "strict construction" to the Will, to prevent the Trustees from making reasonable interpretations of the Will in order to adapt to contemporary financial and cultural circumstances.

Like the United States Constitution, whose text remains fixed yet adaptable to changing times, the Will must be susceptible to changing interpretations based on the prevailing circumstances of the times.

If the Trustees were to conclude that all the income of the trust must be spent as soon as it is earned, as the Attorney General argues, they would be unable to prepare for the support of the Schools during times when income might be diminished. Indeed, the retention of a portion of current income to fund future needs is a necessary element of assuring the stability of KSBE, and preserving its ability to continue providing educational services to students during hard times as well as good times.

To balance the Will's direction that the annual income be expended on school operations with a safeguard against imprudent spending for the sake of spending, the Court ordered the Trustees to continue to engage in long-range planning for the expenditure of accumulated income.[67] In compliance with that order, and consistent with sound management practice, the Trustees have continued to engage in long-range planning for the expenditure of accumulated income.

Finally, the Attorney General's allegations that Trustee Peters was improperly compensated for the $350 million in income that was later reclassified as corpus is specious.

[67] Findings of Fact, Conclusions of Law and Order Approving 99th Annual Report, October 8, 1985, at p. 6.

Trustee Peters was legally entitled to all commissions on the income and as demonstrated below the beneficiaries have not been deprived of the benefit of the funds in question.

Alleged Concealment in the Classification of Income as Corpus

Contrary to the unfounded allegation of the Attorney General, the Trust has not suffered any harm, let alone irreparable harm, as a result of the reclassification of income as corpus. The Master did not find or allege that the reclassification of income to corpus harmed the trust, but simply recommended segregation of the accounts and future reporting in conformity with the trust accounting format as prescribed by the Andersen Report, beginning with the 112th Annual Report[68] (emphasis added). Far from finding any harm to the Trust from the failure to segregate these accounts from 1988 through 1997, the Master's recommendation is merely prospective. In fact, the reclassification enabled the Trust to present its financial condition to potential lenders and co-investors on a basis familiar to them, and thus comparable to the financial statements of other borrowers and investors, and thereby likely *benefited* the Trust.

The Attorney General has not established that the reclassification of income to corpus actually harmed the trust and, more importantly, is a continuing harm to the trust. The reclassification issue is moot. The Trustees, although disagreeing with the Master's criticism, recommendations and reasoning pertaining to the accumulation of income issue, have agreed to support adoption of the Master's recommendation.[69] The Trustees will restore to the income account all accumulated income reclassified as corpus, the Trustees will forego further reclassifications, and the Trustees will provide the Master with the requested accounting and compliance report for review and verification. If the 1998 reclassification represents a mistake,

[68] Master's Consolidated Report, p. 31 (Recommendation No. 2).
[69] Stipulations and Order Concerning Master's Recommendations, Stip. Nos. 2-6.

the measures described above represent the remedy. The remedy does not require the removal of the Trustees, much less their immediate interim removal.

The Attorney General cannot possibly prove that there is any continuing, imminent or irreparable injury that would result if Trustee Peters is not immediately removed. The Attorney General cannot possibly prevail on the merits because she has not offered any proof that the reclassification of income as corpus constitutes a breach of trust. The reclassification was researched by General Counsel who gathered copies of prior court orders, masters' reports, relevant provisions of the Will, Collins v. Hodgson 36 Haw. 334 (1943) and other pertinent information. General Counsel advised that accumulated revenue could be transferred to corpus based on (i) a 1977 order of this Court authorizing commingled investment and reinvestment of accumulated income and corpus in income-producing property; (ii) the recommendation of the Master of the 99th Account that long range planning for the expenditure of accumulated income be reflected in the 10-year plan; and (iii) the fact that the Will contemplates the use of both income and corpus to cover maintenance expenses at the Kamehameha Schools. As the Supreme Court of Hawai'i made amply clear in Richards and contrary to the Attorney General's mistaken belief, "a trustee can safely rely on counsel upon legal questions which arise in the management of the estate when the ordinarily diligent and careful man would do the like in respect to his own property." 48 Haw. at 55. "To seek and follow the advice of competent counsel is certainly indicatory of prudence in the exercise of discretion." Id. Since income and corpus may be commingled for investment and used for the same purpose of maintenance, it was not important that a separate income account be reflected on KSBE's financial reports. There was no duplicity in the action as evidenced by the continued segregation of the revenue and corpus accounts in regular internal reports. Non-disclosure may have been a mistake, but evidence will show clearly

the diligence that supported the decision.

The action was reasoned and supported by legal counsel. Such action was within the discretion of the Trustees. Under such circumstances, there cannot be a credible argument that the mere act of an accounting entry, with no consequent harm to the trust, constitutes a breach the seriousness of which warrants removal.

The Trustees did not conceal trust income from the Master.[70] The Attorney General incorrectly makes the bold assertion that Trustee Peters breached his fiduciary duties by concealing trust income from the Master with the intent of deceiving the Master. That is simply not the case. There is no requirement contained in the Will to report separately the Corpus and Accumulated Income accounts. Contrary to the Attorney General's allegation, no such Agreement was made between the Trustees and the Attorney General, nor was such an agreement adopted by the Court.

The amount of accumulated income of the Trust is readily determinable at this time and at any particular point in time.[72] The total amount of accumulated income, together with the corpus, remains dedicated exclusively to the charitable purposes of the Trust, consistent with the requirements of the Will.

Moreover, the combination of Corpus and Accumulated Income accounts in KSBE's financial statements for FY 1988 was motivated by sound business reasons.[73] Subsequent to 988, the accounts have been the subject of review on six occasions by four Masters, none of

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[70] See generally Trustees' Objection to AG's Response, pp. 8-9 (citing Phillips v. Moeller, 170 A.2d 897, 902 (Conn. 1961) for the proposition that the failure of the trustees' annual accounts to disclose certain matters as distinct items is not grounds for removal).

[71] Pre-Hearing Statement, p. 13.

[72] "In order to comply with the provision of the Will, KSBE accounts separately on its books and records for income and corpus activity." Andersen Report, p. 79.

[73] These reasons are described in detail on pp. 17 to 26 of the Trustees' Response to Master's Consolidated Report.

whom objected to the Accounting. Despite the Attorney General's contention that the stipulated agreement between the Trustees and the Attorney General required segregation, no such "stipulated agreement" was ordered by the Court. Therefore, the 1970 court order did not impose a limit on the Trustees' discretionary powers with respect to the classification of income and corpus. The Trustees' decision not to segregate income and corpus was within their discretionary powers, and may not be changed by the court, absent an abuse of discretion.

In view of the complexity of this particular Estate, and the absence of clear-cut guidance in the Will or in the statutes as to the financial reporting of corpus and income, and the precedent established in 1966 for the handling of disagreements over classifications of income and corpus, the remedy sought by the Attorney General – removal of the Trustees – is patently disproportionate to the materiality of the issue.

Generally Accepted Accounting Principles for a statement of financial position of a not-for-profit organization are no more stringent than those applicable to a commercial enterprise, and *do not require the presentation separately of Corpus and Accumulated Income accounts* (emphasis added).[74] Indeed, the trust accounting format described in the Andersen Report and recommended by the Master cannot be found in Accounting Standards.[75]

Accordingly, the classification of Corpus and Accumulated Income accounts in reports filed with the Court does not represent a breach of duty which caused harm to KSBE.

ii. *Expenditure for Education*

The accumulated income exists unimpaired and is being held solely for the benefit of the Kamehameha Schools. There has been no misappropriation, misapplication or misuse of these

[74] Accounting Standards, Financial Accounting Standards Board, June 1997, §No.5.104.
[75] Compare id., §§No.5.131 with Andersen Report, p.85.

funds. The funds have been and still are available for deployment for education issues. There has been no past or future harm of any kind that would warrant removal of a Trustee based on the non-expenditure of these funds.

The fact that an accumulation occurred over a seven year period is not evidence of a breach. The language of Will does not necessarily mandate the annual expenditure of all income received. Always mindful of the perpetual nature of the trust, the maintenance of liquid resources was and always has been an important issue for the long term especially in light of plummeting land values in Hawai'i over recent years.

It would not be prudent for the Trustees to expend all revenues received every year. Previous Masters advised against such spending for spending's sake. The Master's report does not call on the Trustees to make unplanned expenditures, rather he emphasizes strategic planning for such expenditures. Master's Consolidated Report, p. 40 (Recommendation 5). The Trustees have diligently engaged in exactly this process.

e. The Strategic Planning, The Beneficiaries, And The Educational Mission: The Trustees' Actions Were Within The Authority Granted By The Will, Were Exercised Within The Discretion Afforded The Trustee, And Cannot Form The Basis For An Action For Removal

i. *Strategic Plan*

In his report, the Master expressed dissatisfaction with the strategic planning undertaken by the Trustees. In an extraordinary leap of reasoning, the Master concludes that because he is personally dissatisfied, the Court should intervene to compel, monitor, review and approve a new strategic plan. Such personal disagreement is not within the purview of the Master's review and should not have been expressed. Hustace Report at p. 9. But, the Master did express it, the Attorney General wrongly adopted it, and it now serves as another flawed basis for the Attorney

General's call for the Trustee's discretion to be substituted by that of the Court.

The Attorney General cannot succeed on the merits of her removal action by attempting to substitute her discretion for that of Trustee Peters. The Trustees are entrusted with the discretion and authority to set the direction of the educational programs of the KSBE. As such, a court will not interfere with the exercise of the trustee's discretion except to prevent an abuse of discretion. Miller, 61 Haw. at 351; Richards, 48 Haw. at 61; IVA Scott at § 382. The Attorney General cannot demonstrate an abuse of discretion as the Trustees have created and begun implementation of a strategic plan.

The Master, and apparently the Attorney General, expected a strategic plan to develop overnight. Immediately after the Master's 105th report in 1992 which recommended the development of an educational strategic plan, the Trustees began engaging in retreats and work sessions. By March 1994 the strategic plan had a mission and values, vision, goals and strategic objectives. The Master's own narrative concedes the fact that the strategic planning process has been ongoing. The incumbent Board of Trustees has undertaken more planning activity than any Board in memory. What the Master dismisses as flawed process is an evolving work in progress. What the Master summarily rejects as a disparate assortment of forty studies, surveys and reports is the product of many months of systematic work by the Trustees and by professional staff among all divisions of KSBE. The process employed by the Trustees was textbook strategic planning. Although it did not yield the results the Master and Attorney General apparently expected, there is no evidence that Trustee Peters failed to engage in the strategic planning process in fulfillment of his duties to the Trust.

Again, it was in the Trustees' discretion to select the format for their strategic plan. Although the Master would have preferred that the Trustees used the Booz Allen Hamilton

model, Hawai'i's population, economy and society and KSBE's financial position were very different today than it was when the Booz Allen Hamilton report was written in 1966. The Booz Allen Hamilton model of 1966 is seriously outdated and inapplicable to the Kamehameha Schools as it enters the new millennium. More importantly, the Master is not allowed to substitute his discretion for that of the Trustees. The fact that the Master had a different opinion is not a legitimate ground for removal.

In addition, given the fact that there is a strategic planning process agreed to by stipulation which is expected to yield a final result within a certain time, the Attorney General cannot argue that there is an irreparable harm that would result if the Trustees continue to serve.

ii. *Educational Mission*

Like strategic planning, the educational mission of KSBE goes to the very heart of governance and is the province of the Trustees. The Attorney General and the courts may not substitute their judgment for that of the Trustees absent an abuse of discretion. Miller, 61 Haw. at 351; Richards, 48 Haw. At 61; IVA Scott at § 382. The Attorney General simply has not shown such an abuse.

During the first school year of Kamehameha Schools in 1887-88, the campus enrollment was comprised of only 37 students. By 1995-96, campus enrollment at the Kapalama campus of Kamehameha Schools from K through 12 reached a peak of 3,092.[76] In addition, KSBE provided Center-Based Preschool services throughout the state to 780 four-year old children in 1995-96. Moreover, over 1,800 college-enrolled students benefited from over $12 million in scholarships funded by KSBE.

[76] Master's Consolidated Report, p. 10 citing One Hundred and Ninth Annual Report from the President, Kamehameha Schools to the Board of Trustees, School Year 1995-96 at 7-10.

In the summer of 1996, the post high-school scholarship program increased by $3.1 million. In August 1996, pilot Neighbor Island satellite schools opened on Maui and East Hawai'i. The Hoaliku Drake Preschool, designed as a model for other permanent preschools, opened in Waianae in September 1996. In August 1997, the Education Strategic Plan for 1997-2005 was approved and the Maui School Master plan was completed. The Trustees continue to maintain a large portfolio of liquid assets that are poised to be strategically redeployed in order to meet the operational and capital requirements of the expanding Kamehameha Schools in the next millennium. It is ironic that the Attorney General is seeking removal of the Trustees for failure to further the education mission of the trust in the face of such rapid and progressive growth in the education programs of the Kamehameha Schools. The Attorney General simply has not demonstrated an abuse of discretion warranting the substitution of her discretion or that of the court. Moreover, in addition to her failure to demonstrate that she can prevail on the merits, the Attorney General fails to state how there could be possibly any irreparable harm to the educational mission if the Trustees continue to serve.

f. Trustees May Not Be Removed On The Grounds Of Hostility Among Themselves Or Between the Beneficiaries and Themselves, Unless Such Hostility Materially Interferes With The Administration Of The Trust

Hostility, animosity, or friction among the trustees or between the trustees and the beneficiaries is insufficient grounds to justify removal, unless such hostility, animosity, or friction materially or substantially interferes with the administration of the trust. Wolosoff, 500 A.2d at 1082 (the general rule is that mere friction or hostility between a beneficiary and a trustee is not necessarily a sufficient ground for removal. otherwise a beneficiary or co-trustee who otherwise lacks sufficient grounds for removal of a trustee could nevertheless compel that removal by instigating a fight). In determining whether to remove a trustee on grounds of

hostility, the court must determine not only the existence of such feelings, but whether such a relationship has either resulted in actual acts of misconduct or has created a conflict of interest which appears likely to endanger the trust or the welfare of the beneficiary. Id.

Factors a court should consider in determining whether a trustee should be removed on the grounds of hostility include: (1) the nature and objectives of the trust; (2) the powers of the trustee; (3) the necessity or desirability of collaboration between the parties; (4) the origin of responsibility for the hostility; and (5) the extent to which discretion has been entrusted to the trustee which might adversely affect the rights or benefits of the beneficiary seeking removal. Id.

As a matter of law, however, if the trustee establishes that he has in all respects conducted himself properly as a trustee and is competent to continue as such, the mere fact of friction between the him and the beneficiaries or co-trustees is not sufficient cause for his removal. In re Graves Estate, 110 N.Y.S.2d 763, 766 (NY 1952).

Furthermore, hostility which is not justified by any act or conduct of the trustee, or which results from the acts or conduct of the beneficiary is not sufficient ground for removal. IFS Industries, Inc., 159 Cal.App.3d at 754, ("[i]t would be a poor rule indeed that would permit a beneficiary to remove a trustee for hostility it itself engendered. ."); Schildberg, 461 N.W.2d at 192 - 193. In dictum, the court stated:

> Disagreement and unpleasant personal relations between the trustee and beneficiaries are not usually enough to warrant removal. The beneficiary often conceives that he could manage the trust better than the trustee, resents failure to follow his advice, is dissatisfied with rate of returns on trust assets, thinks that the trustee is too conservative in investment policies, and otherwise finds fault with the trustee. Thus friction develops. But the settlor has entrusted management to the trustee, not the beneficiary. The very fact that he created a trust showed that he did not want the beneficiary to be the controlling factor in the management of

> the property. However, in some instances the hostile relations between the trustee and beneficiary have gone so far that the court feels a new trustee should be appointed. Where the malicious or vindictive conduct of the trustee is the cause of disagreement and bitterness, removal is apt to be decreed. Id. at 192-93.

In order for the trustee to be removed there must actually be hostility between the trustees and the beneficiaries. The beneficiaries under the Will of Ke Alii Pauahi are the students of the Kamehameha Schools and other indigent children of native Hawaiian ancestry. It is wholly irrelevant that friction or hostility may exist between the Kamehameha faculty, staff, alumni, and parents, and trustees because these groups are not beneficiaries under the Will. Miller v. Alderhold, 184 S.E.2d 172 (Ga. 1971); Montclair National Bank & Trust Company v. Seton Hall College of Medicine and Dentistry, 217 A.2d 897, 905 (N.J.Ch.Div. 1966), rev'd on other grounds, 233 A.2d 195 (App.Div. 1967) (the true beneficiaries of a gift to a medical school will be the students).

IV. CONCLUSION

In light of the foregoing, it is respectfully submitted that the Attorney General's Request for Interim Removal of Trustee Peters should be denied.

DATED: Honolulu, Hawaii, March 2, 1999.

RENEE M. L. YUEN
Attorney for HENRY HAALILIO PETERS

IN THE CIRCUIT COURT OF THE FIRST CIRCUIT

STATE OF HAWAII

In the Matter of the Estate	)	EQUITY NO. 2048
of	)	CERTIFICATE OF SERVICE
BERNICE P. BISHOP,	)	
Deceased.	)	

CERTIFICATE OF SERVICE

I hereby certify that on the date below a true and correct copy of the foregoing document was served on the following parties, at their last known addresses, in the manner indicated below:

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