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August 12, 1999

Ret. Admiral Robert K.U. Kihune  
Mr. David Paul Coon  
Mr. Francis Keala  
Ms. Constance Lau  
Mr. Ronald Libkuman  
Interim Trustees  
Kamehameha Schools Bernice Pauahi Bishop Estate  
Kawaiahao Plaza  
567 South King Street  
Honolulu, Hawaii 96813

**Re:    Assessment of Risks of Litigating Revocation Issues**

Dear Ret. Admiral Kihune, Mr. Coon, Mr. Keala, Ms. Lau, and Mr. Libkuman:

This letter is in response to your request that we provide you with our opinion as to: (1) the risks of litigating the proposed revocation of the tax-exempt status of the Kamehameha Schools Bernice Pauahi Bishop Estate ("KSBE" or the "Estate") by the Internal Revenue Service (the "Service"); and (2) whether the settlement of the governance issues raised by the Service, on terms satisfactory to the Interim Trustees, is in the best interest of the Estate. For the reasons set forth below, it is our opinion that, if litigated, there is significant risk that the Service's proposed revocation would be sustained in a judicial proceeding. When this risk is considered in conjunction with the considerable costs of litigation, we are of the further opinion that settling the governance issues raised by the Service, on terms that would preserve KSBE's tax-exempt status and that are otherwise satisfactory to the Interim Trustees, would be in the best interest of the Estate.

## **I. Introduction**

In the draft Forms 5701 (Notices of Proposed Adjustment or "NOPAs") issued to KSBE in December of 1998, the Service proposed that KSBE's tax-exempt status be revoked. As described in the draft Forms 5701, the Service's core arguments supporting a revocation of KSBE's tax-exempt status are based on certain actions of the Incumbent Trustees (Henry H. Peters, Richard S. H. Wong, Marion Mae Lokelani Lindsey, Gerald A. Jervis, and Oswald K. Stender) that, in the Service's view, have: (1) caused the Estate to cease to be operated exclusively for educational purposes; and (2) resulted in prohibited private inurement to the Incumbent Trustees. With respect to the first of these arguments, the Service has asserted that revocation is appropriate because the Incumbent Trustees have neglected the educational mission of the Estate and have instead devoted their attention and Estate resources to the Estate's commercial and investment activities, as well as to their own private interests. The Service has asserted that the Incumbent Trustees have furthered these non-educational purposes at the expense of fulfilling the Estate's educational mission. The Service has further argued that those actions by the Incumbent Trustees that have served to further their own private interests have also resulted in private inurement, which, in the Service's view, provides a second justification for revoking the Estate's tax-exempt status.

In evaluating the risks of defending the Estate's tax-exempt status against these arguments, we have interviewed KSBE employees, reviewed and analyzed relevant documents, and reviewed and considered the findings and conclusions of independent third parties with respect to actions of the Incumbent Trustees. Our review shows that there is a strong similarity between the actions of the Incumbent Trustees that underlie the Service's bases for revoking the Estate's exempt status and the factual findings and conclusions of these independent third parties. Because we believe that these findings and conclusions provide guidance as to how a trier of fact would evaluate the Service's proposed revocation of KSBE's tax-exempt status, we have given them significant consideration. While some of the actions of the Incumbent Trustees as found by these independent third parties may not, in themselves, be discrete bases for the revocation of KSBE's tax-exempt status, collectively they are probative evidence of substantial nonexempt activities and purposes. Accordingly, we discuss below both the Service's allegations and the findings and conclusions of these independent third parties.

## **II. The Service's Arguments for Revocation**

We understand that the Service has informed the Estate that it intends to revoke KSBE's tax-exempt status for the Estate's taxable years ending June 30, 1992 through June 30, 1996, and on a going-forward basis, unless the Estate and the Service can reach agreement on certain governance issues, including the permanent removal of the Incumbent Trustees. Since the issuance of the draft Forms 5701, we have had several meetings with various representatives of the Service during which we have discussed the content of, and the basis for, the Service's

arguments supporting the revocation of KSBE's tax-exempt status. During the course of these meetings, we have confirmed that, if the issue is litigated, the Service is likely to raise the same arguments for revoking KSBE's tax-exempt status that are set forth in the draft Forms 5701 and would rely upon events occurring since the issuance of the draft Forms 5701 as providing additional support for these arguments. As discussed in more detail below, we have confirmed that the Service would focus on the actions of the Incumbent Trustees that the Service believes constitute neglect of the Estate's educational purpose and result in prohibited private inurement to the Incumbent Trustees.

**A. The Service's Reliance on the Incumbent Trustees' Neglect of the Estate's Educational Purpose**

We have confirmed that the Service's litigating position will be based, in significant part, on those actions of the Incumbent Trustees which, in the Service's view, have caused the Estate to cease to be operated exclusively for tax-exempt purposes. In order to be a tax-exempt educational institution under section 501(c)(3) of the Internal Revenue Code (the "Code"), KSBE must show that it has been "operated exclusively" for an "educational purpose." I.R.C. §§ 501(a) and (c)(3). The "operated exclusively" language has been interpreted by the United States Supreme Court to mean that "the presence of a single non-educational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes." *Better Business Bureau of Washington, D.C., Inc. v. United States*, 326 U.S. 279, 283 (1945); accord *Western Catholic Church v. Commissioner*, 73 T.C. 196, 209 (1979). In applying this standard, the relevant regulations state that "[a]n organization will be regarded as 'operated exclusively' for one or more exempt purposes only if it engages primarily in activities which accomplish one or more exempt purposes." Treas. Reg. § 1.501(c)(3)-1(c)(1). If "more than an insubstantial part of its activities is not in furtherance of an exempt purpose," the organization will not be so regarded. *Id.*; *Western Catholic Church*, 73 T.C. at 209.

We expect the Service to assert that the Incumbent Trustees have subordinated the educational purposes of the Estate to commercial or other non-educational purposes, thereby "fail[ing] the primary purpose of the Trust to educate children." (Primary Purpose NOPA at 167.) In support of this contention, the Service will assert that the Incumbent Trustees neglected the educational mission of the Estate by "delegat[ing] . . . the management of the Kamehameha Schools" to Trustee Lindsey, while the other four trustees devoted their time to overseeing non-education functions, such as Investments, Legal Affairs, and Governmental Affairs. (Primary Purpose NOPA at 168.) The Service will argue that, as lead trustee for education, Trustee Lindsey's mismanagement of the schools "engendered ongoing controversy, confusion, fear, low morale, and hostility within the Kamehameha Schools community," which seriously compromised the ability of the Estate to carry out its educational mission. (Primary Purpose NOPA at 168.) We expect the Service to assert that by failing to monitor or correct Trustee

Lindsey's actions, the Incumbent Trustees thereby undermined the well-being of the schools, through both their actions or inactions, as observed by the Visiting Committee of the Western Association of Schools and Colleges ("WASC"). (Primary Purpose NOPA at 8 and 169.) We have confirmed that it is the Service's view that the failure of the Incumbent Trustees to take any action "to restrain Lindsey until December, 1997, when they reacted to intense public criticism by removing Lindsey as lead trustee for education, and when Stender and Jervis petitioned the court to remove Lindsey as a Trustee," is evidence of the Incumbent Trustees' neglect of the educational purpose of the Estate. (Primary Purpose NOPA at 168.)

We have confirmed that the Service will also assert that the Incumbent Trustees' failure to conduct appropriate educational and investment planning is further evidence that the educational purpose of the Estate was "relegated to a position of relative unimportance in the overall operation of the Estate and to a position of relative unimportance to the Trustees." (Primary Purpose NOPA at 7 and 169.) With respect to educational strategic planning, we expect the Service to assert that the Incumbent Trustees' planning efforts were insufficient and the strategic planning that was undertaken was "fundamentally flawed," because it "failed to take into account the financial resources available and ... failed to utilize appropriate professional expertise." (Primary Purpose NOPA at 7 and 12.) In the Service's view, the lack of appropriate educational strategic planning is further evidence that the Incumbent Trustees' "time, efforts, energy, and financial resources" were "disproportionately devoted to" investments and commercial activities, *i.e.*, the "investment function" of the Estate, "rather than maintaining and benefiting the schools." (Primary Purpose NOPA at 161 and 169.) In this regard, we have confirmed that the Service will further assert that the Incumbent Trustees failed to spend enough on education programs: although asset values and revenues increased substantially over the audit period, expenses for "school operating costs" did not grow "proportionately," and the school operated on a "zero growth budget." (Primary Purpose NOPA at 11 and 15.)

With respect to the investment practices of the Incumbent Trustees, we expect the Service to argue that the Incumbent Trustees failed to develop a "coherent overall investment plan ... based upon sound investment principles." (Primary Purpose NOPA at 8.) Rather, we expect the Service to assert that the Incumbent Trustees made investment decisions on an *ad hoc* basis, "based on opportunities presented from various sources," rather than on the basis of whether they "fit within an approved portfolio strategy." (Primary Purpose NOPA at 165-66; Unreasonable Compensation NOPA at 73.) In the Service's view, the Incumbent Trustees failed to adequately coordinate investment decisions with educational planning, which "result[ed] in a disconnect between the two key components of an overall plan." (Primary Purpose NOPA at 11-12.) According to the Service, the Incumbent Trustees "systematically ignored sound investment management techniques as well as ... the advice of paid consultants, experts, court Masters, and their own staff" by investing primarily in illiquid investments. The Incumbent Trustees' decision to acquire illiquid investments, in the Service's view, "prevent[ed] KSBE

from being able to finance school activities at will.” (Unreasonable Compensation NOPA at 76; Primary Purpose NOPA at 165.) The Service will further assert that “poor investment decisions” by the Incumbent Trustees have “actually harmed the Estate by depleting [the] financial resources” available for exempt-function expenditures. (Primary Purpose NOPA at 6 and 97.)

**B. The Service’s Reliance on Actions of the Incumbent Trustees Resulting in Private Inurement**

We have confirmed that the Service’s litigating position will also be based on actions taken by the Incumbent Trustees with respect to their own compensation, which resulted in benefits to the Incumbent Trustees that the Service will assert constituted prohibited private inurement. An exemption from taxation based on section 501(c)(3) of the Code is conditioned on “no part of the net earnings of [the organization] inur[ing] to the benefit of any private shareholder or individual.” I.R.C. § 501(c)(3). The applicable regulations state that the words “private shareholder or individual” refer to “persons having a personal and private interest in the affairs of an organization.” Treas. Reg. § 1.501(a)-1(c). A private shareholder or individual includes a person, such as a trustee, who as an “insider” is in a position to control the disposition of an organization’s income or assets for personal gain. *United Cancer Council, Inc. v. Commissioner*, 165 F.3d 1173, 1176 (7<sup>th</sup> Cir. 1999), *rev’g* 109 T.C. 326 (1997). While *reasonable* compensation (either in the form of salaries or other benefits) does not constitute prohibited inurement (*e.g.*, *B.H.W. Anesthesia Found., Inc. v. Commissioner*, 72 T.C. 681, 685-86 (1979)), *any* benefit received by an insider that is not reasonable in relation to the services provided to an organization in return—*regardless of the “amount or extent” of this unreasonableness*—provides a sufficient ground for revoking an organization’s section 501(c)(3) status. *Founding Church of Scientology v. United States*, 412 F.2d 1197, 1202 (Ct. Cl. 1969), *cert. denied*, 397 U.S. 1009 (1970). Moreover, “[a]n organization’s property may be impermissibly devoted to a private use where private interests have control, directly or indirectly, over its assets, and thereby secure nonincidental private benefits.” *Redlands Surgical Servs. v. Commissioner*, No. 11025-97x, 1999 USTC LEXIS 29, at \*66 (July 19, 1999). If more than an insubstantial part of an organization’s activities further such private interests, or any other nonexempt purpose, the organization will not be operated exclusively for exempt purposes. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii); *American Campaign Academy v. Commissioner*, 92 T.C. 1053, 1066 (1989).

We expect that the Service will assert that, *inter alia*, the following actions of the Incumbent Trustees constitute prohibited private inurement: (1) taking unreasonable compensation; and (2) causing the Estate to incur expenses initially to oppose, and later (when it was clear that the legislation would pass) to modify, the proposed intermediate sanctions

legislation that was ultimately enacted as section 4958 of the Code.<sup>1</sup> (Primary Purpose NOPA at 156; Inurement NOPA at II.B.2.-4.) We also expect the Service to assert that those actions of the Incumbent Trustees that further their private interests also serve to further a nonexempt purpose, which indicates that the Estate is not being operated exclusively for exempt purposes and is therefore not entitled to tax-exempt status.

With respect to unreasonable trustee compensation, we have confirmed that the Service will argue that the compensation paid to the Incumbent Trustees during the Estate's 1990 through 1998 tax years was "outside the upper range of reasonable compensation" and therefore constituted prohibited private inurement of Estate assets to the Incumbent Trustees. (Unreasonable Compensation NOPA at 103.) The Service will assert that when the factors considered by the courts in determining what constitutes reasonable compensation are applied to the compensation received by the Incumbent Trustees during these years, it is clear that such compensation is "excessive." (Unreasonable Compensation NOPA at 27-28 and 103.)

We have confirmed that the Service will challenge the underlying assumptions of the Strategic Compensation Associates ("SCA") and Towers Perrin compensation studies—studies that the Incumbent Trustees have attempted to use to justify the high levels of compensation they received during the years under consideration. (Unreasonable Compensation NOPA at 18-19.) In particular, the Service will argue that both of these studies are "seriously flawed and failed to provide appropriate rationalization for the high pay [of the Incumbent Trustees]," because their determinations of what constitutes reasonable compensation are premised on the Incumbent Trustees performing the roles of a full-time CEO, CFO, COO and Treasurer in addition to the governance role typically performed by a member of a corporate Board of Directors or by a trustee of a charitable trust. (Unreasonable Compensation NOPA at 66 and 95.) Although we expect the Service to accept that the Incumbent Trustees performed "a broader management role [than] is the case with the trustees of most large trusts and foundations," and therefore their compensation "may be related partially to corporate executive compensation," we expect the Service to assert that it is inappropriate to aggregate the compensation paid to "senior operating executives" of large investment banks or like enterprises and assume that it is reasonable to divide this total amount among the five trustees. (Unreasonable Compensation NOPA at 18, 55 and 66.)

In support of this position, the Service will assert that, given the "overlapping" of the traditional trustee functions with the atypical management functions performed by each of Incumbent Trustees, each had to spend a portion of his or her time on traditional governance functions, which necessarily reduced the time that each Incumbent Trustee could spend

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<sup>1</sup> In the draft Forms 5701 on Inurement and Primary Purpose, the Service alleged a number of other examples of private inurement, which are set out in the attached Appendix B.

performing management functions. (Unreasonable Compensation NOPA at 55.) As such, the Service will argue, it was inappropriate for the SCA and Towers Perrin compensation studies to compare "total compensation paid to the Trustees as a group" with the total compensation paid to the "combined senior management staff and board of directors ... in other comparison organizations." (Unreasonable Compensation NOPA at 19.) The Service will assert that according to the Incumbent Trustees' own description of their combined governance and management role, the Incumbent Trustees could not be performing the role of a "full-time executive." (Unreasonable Compensation NOPA at 68.) The Service will further support its position that the Incumbent Trustees have overstated the extent of the additional management responsibilities and duties they actually performed for KSBE by pointing to: (1) the seeming "overlap" of the day-to-day management responsibilities of the Incumbent Trustees with those of KSBE executives and other KSBE staff members (Unreasonable Compensation NOPA at 30, 46, and 68); (2) the Incumbent Trustees' extensive use of outside professional consultants "in running the business affairs of the Estate" (Unreasonable Compensation NOPA at 30, 51 and 55); and (3) the reduction in time available for KSBE activities resulting from each Incumbent Trustee's service on one or more boards of KSBE's for-profit subsidiaries, especially with respect to Trustee Peters, who held as many as fourteen directorships or "similar positions" in one year. (Unreasonable Compensation NOPA at 33 and 45; Primary Purpose NOPA at 52.)

With respect to what are appropriate "comparison organizations" for determining reasonable compensation, we expect the Service to assert that the SCA and Towers Perrin compensation studies are flawed in their respective assumptions that "the most reasonable comparables for KSBE are not large educational trusts or other charitable trusts but rather large public investment banks or real estate development organizations," in the case of the SCA study, or "manufacturing and service companies," in the case of the Towers Perrin study. (Unreasonable Compensation NOPA at 63 and 66.) Because some portion of the Incumbent Trustees' time had to be spent on performing traditional governance functions, according to the Service, the SCA and Towers Perrin studies should have included "foundations or other large exempt organizations" in the mix of comparable entities for purposes of determining what constituted reasonable compensation. (Unreasonable Compensation NOPA at 63.) We expect the Service to assert that the failure of the SCA and Towers Perrin studies to consider all appropriate comparables, coupled with their "double counting" of the actual functions performed by the Incumbent Trustees, served to "dramatically inflate" the overall level of compensation determined to be reasonable by these studies. (Unreasonable Compensation NOPA at 67.)

In this regard, we have confirmed that the Service will attempt to use arguments and facts, previously advanced by the Estate to justify the compensation of the Incumbent Trustees, to bolster the Service's argument that the Estate was not operated exclusively for tax-exempt purposes. For example, we expect the Service to argue that if "other types of exempt organizations or educational trusts are not [appropriate] comparisons" on which to base the

compensation of the Incumbent Trustees, this calls into question whether KSBE continues to operate "as such." (Unreasonable Compensation NOPA at 64.) We have confirmed that an attempt to justify the Incumbent Trustees' compensation based exclusively on the scope and sophistication of their investment management activities will be cited by the Service to demonstrate that the actions of the Incumbent Trustees were primarily directed toward achieving commercial or other non-educational purposes. (See Primary Purpose NOPA at 166.)

We also expect the IRS to assert that neither the Towers Perrin nor the SCA study "examined qualifications, experience, or performance as a criterion for compensation," all of which would be considered by a court. (Unreasonable Compensation NOPA at 62.) With respect to the experience and qualifications of the Incumbent Trustees, we expect the Service to argue that, "with the possible exception of Trustee Stender," none of the Incumbent Trustees had "experience in operating a trust," much less a tax-exempt trust with a defined educational mission. (Unreasonable Compensation NOPA at 4 and 54.) Furthermore, in the Service's view, the Incumbent Trustees lacked the "experience [in] running and managing large investment portfolios" that was necessary to carry out their purported combined governance and management functions (again with the possible exception of Trustee Stender), which is "further evidenced by the fact that the [Incumbent] Trustees spent millions of dollars on outside consultants, attorneys, and accountants ... in running the business affairs of the Estate." (Unreasonable Compensation NOPA at 54-55.) With respect to the "success [of the Incumbent Trustees] in using the organization's resources to further [its educational] goals," we expect the Service to argue that the bulk of the Estate's financial wealth is due to "a general price rise of real estate in Hawaii," and that "the performance of the investment assets actively managed by the [Incumbent] Trustees has not been encouraging." (Unreasonable Compensation NOPA at 100-101.) We expect that the Service will assert that when the qualifications, performance, and experience of the Incumbent Trustees are evaluated, they result in a further reduction in the amount of compensation that a court would deem to be reasonable. (Unreasonable Compensation NOPA at 103.)

The Service will further argue that the Incumbent Trustees' desire to preserve the level of their compensation led them to focus most of their attention on investments, and not on KSBE's educational mission, because their compensation is commission based. (Primary Purpose NOPA at 167.) In the Service's view, the Incumbent Trustees "manipulated" the amount of the commissions to which they were entitled by taking the following actions: retroactively revoking previous waivers of commissions; transferring investments to subsidiaries before writing them down to reflect losses; including interest payments in the computation of commissions on loans made by KSBE to its subsidiaries; failing to reduce the commission base by losses incurred at the subsidiary level; including in the commission base income that was subsequently transferred to corpus; and including returns on capital as well as partnership distributions in the commission base. (Unreasonable Compensation NOPA at 11-12 and 77.) The Service will assert that these actions demonstrate the significant focus of the Incumbent

Trustees on their own compensation and return on investments. (Primary Purpose NOPA at 169; Unreasonable Compensation NOPA at 11.) The Service will argue that, coupled with the failure to monitor Trustee Lindsey's mismanagement of the schools, these actions evidence a neglect of the Estate's educational mission and indicate that the Estate is not being operated exclusively for tax-exempt purposes. (Primary Purpose NOPA at 169.)

We have confirmed that the Service will focus in particular on the Incumbent Trustees' lobbying activities with respect to the intermediate sanctions provision. The Service believes that, in addition to constituting a nonexempt expenditure, the incumbent Trustees' lobbying activities are an example of the Incumbent Trustees' efforts to preserve their personal interests to the detriment of the Estate. In the Service's view, these expenses were incurred by the Estate solely because the Incumbent Trustees wanted to protect their ability to continue to receive unreasonable compensation. (Inurement NOPA at II.B.2.-7.) The Service will point to this action, as well as the Incumbent Trustees' overall course of conduct, as support for its contention that the Incumbent Trustees "view[ed] themselves as the Estate and the Estate's corpus as theirs to do with as they pleased." (Primary Purpose NOPA at 6.)

### **III. Existing Findings Regarding the Incumbent Trustees' Conduct**

Much of the Incumbent Trustees' conduct that is relevant to the issues raised by the Service has already been examined by independent third parties, including a trier of fact, two court-appointed fact finders, and a nationally recognized school accreditation organization. More specifically, we are referring to the following: Judge Bambi Weil's Findings of Fact and Conclusions of Law with Respect to Judge Weil's Order Reaffirming the May 6, 1999 Order Granting the Petition for the Removal of Trustee Marion Mae Lokelani Lindsey (June 10, 1999); Judge Patrick Yim's Final Report of Fact Finder (December 4, 1997); Colbert Matsumoto's Master's Consolidated Report on the 109<sup>th</sup>, 110<sup>th</sup>, and 111<sup>th</sup> Annual Accounts of the Trustees (August 7, 1998) and Master's First Supplemental Report on the 109<sup>th</sup>, 110<sup>th</sup>, and 111<sup>th</sup> Annual Accounts of the Trustees (September 29, 1998); and the Report of the Visiting Committee of the Western Association of Schools and Colleges, March 9-12, 1998 (the "WASC Accreditation Report"). To the extent that these sources contain findings of fact or conclusions of law that address the same or similar issues raised by the Service's proposed revocation, we believe that they provide guidance as to the types of inferences and conclusions that a trier of fact could draw or reach in determining whether the Service's proposed revocation of KSBE's tax-exempt status should be sustained.

We note at the outset with respect to all of these reports and opinions that the Incumbent Trustees were offered the opportunity to provide their views to the examining individuals and, in most instances, took advantage of that opportunity. For example, Judge Yim was specifically authorized by the Incumbent Trustees to serve as a fact finder to investigate problems at the Kamehameha Schools pursuant to the Incumbent Trustees' petition to the Probate Court; as part

of the fact-finding process, Judge Yim interviewed the Incumbent Trustees. Similarly, the Incumbent Trustees had an opportunity to influence the outcome of the WASC Accreditation Report during the year-long school self-study as well as during the WASC Visiting Committee's campus visit. Master Matsumoto's reports were issued to the Probate Court only after the Incumbent Trustees had been given the opportunity to supply the Master with relevant information and to submit written responses to the Master's findings in his earlier reports. Judge Weil's decision was based on a petition for removal filed by Trustees Stender and Jervis and was opposed by the other Incumbent Trustees, who formally opposed the petition in court. All of the Incumbent Trustees entered appearances in this proceeding, were represented by counsel, and, with the exception of Trustee Peters, testified at length during the hearings on the petition.

**A. Judge Weil's Decision Removing Trustee Lindsey**

On May 6, 1999, after a lengthy trial, Judge Weil issued an Order permanently removing Trustee Lindsey as a KSBE Trustee. On June 10, 1999, Judge Weil issued Findings of Fact and Conclusions of Law supporting her Order removing Trustee Lindsey on the grounds that Trustee Lindsey's actions constituted breaches of the duty of loyalty, the duty to comply with the trust instrument, the duty of care, and the duty to exercise sound discretion in the management of the Estate's affairs. The following Findings of Fact and Conclusions of Law are particularly relevant to the issues raised by the Service.

- By implementing a lead trustee system of governance, the Incumbent Trustees placed the duty and responsibility for the oversight of the Schools solely in the hands of an individual who lacked appropriate educational expertise for, or failed to properly apply such expertise to, that task. (Page 181, ¶ 25.)
- As lead trustee for education, Trustee Lindsey micromanaged the Schools and unilaterally (without oversight or input from the Incumbent Trustees) made major educational decisions. (Page 83, ¶ 267.) As a consequence:

Trustee Lindsey's actions undermined the authority of the school president and the established structure of the educational program, thereby creating hostility and confusion among the trustees and the trust beneficiaries, including teachers, students, support staff, and alumni (page 186, ¶ 36);

Trustee Lindsey's actions caused the dysfunctional governance of the Schools and the resulting public controversy and hostility in the community (pages 83, ¶ 267; 148, ¶ 453); and

Trustee Lindsey's actions produced tragic consequences for the ability of the Kamehameha Schools to carry out the Estate's educational mission (page 63, ¶ 201).

- Despite the deteriorating situation at the Schools, Trustees Peters and Wong joined with Trustee Lindsey and

(as a voting majority) supported an investigation of a student petition and other activities in order to suppress critics of the Trustees, actions which were wholly Trustee self-interested and detrimental to the Trust beneficiaries (pages 156, ¶ 478; 183, ¶ 28); and

opposed the petition of Trustees Stender and Jervis for the permanent removal of Trustee Lindsey (page 1).

- The deteriorating situation at the Schools was further exacerbated by the following actions and inactions of the Incumbent Trustees:

the failure to adopt appropriate educational strategic plans, such that, with the exception of the *Go Forward* expansion program (approved by the Board in April of 1995), planning for the existing schools was left *de facto* to the school staff and administration (pages 138, ¶ 426; 141 ¶ 434); and

the decision to cut the community outreach programs (over the opposition of Trustee Stender), which reduced the number of Hawaiians served by KSBE from approximately 30,000 in 1992 to 3,200 in 1996 and caused a substantial layoff in the KSBE workforce, resulting in community anger and anxiety on the part of the remaining workforce (pages 82, ¶ 262; 138, ¶ 426 n.34); and

the failure, as of the end of the trial for Trustee Lindsey's removal, to actively address the substantive issues regarding education and presidential leadership at the Schools (page 156, ¶ 478).

Because Judge Weil's decision occurred after the Service issued the draft Forms 5701, there is no mention of the decision in the Forms 5701. We would, however, expect the Service to argue that the decision supports the Service's position that the Incumbent Trustees neglected the primary reason for KSBE's tax-exempt status—the education of Hawaiian children. A more detailed description of Judge Weil's Findings of Fact and Conclusions of Law is contained in the attached Appendix A.

## **B. The Yim Report**

On May 14, 1997, the Incumbent Trustees petitioned the Probate Court to appoint a “neutral and impartial third-party fact finder ... charged with the obligation to ascertain the material and relevant facts concerning the allegations, rumors and innuendo now affecting the management and administration of the Kamehameha Schools and the consequent internal situation arising therefrom.” In their petition, the Incumbent Trustees suggested that Mr. Patrick Yim, a retired judge of the Probate Court, would be an appropriate fact finder because the Incumbent Trustees concluded that he was “a person of unquestioned probity whose fairness and integrity will be recognized by all [of the Incumbent] Trustees and their administrators, staff and employees.” On July 10, 1997, the Probate Court granted the Incumbent Trustees’ petition and appointed Judge Yim to investigate problems relating to the management and administration of the Kamehameha Schools. During the course of his fact finding, Judge Yim interviewed the Incumbent Trustees, former Trustees, administrators, teachers, students, alumni and parents. Before filing his Final Report, Judge Yim met with the Incumbent Trustees on November 10, 1997, and made several recommendations to the Incumbent Trustees concerning the management of the school and their oversight of the Education Group.

Most of Judge Yim’s Final Report recounts how Trustee Lindsey’s conduct had a negative impact on the administration of the Kamehameha Schools. Because many of these findings are similar to those of Judge Weil, they are not repeated here, but rather are summarized in Appendix A. Judge Yim also commented on the conduct of the other Incumbent Trustees noting the following.

- The Incumbent Trustees acquiesced in Trustee Lindsey’s actions with respect to the Schools and, inexplicably, were either oblivious to or ignored those specific actions which impacted negatively on the administration of the Schools. (Sections VI.F. and VII.A.)
- Given the problems on campus, the other Incumbent Trustees knew or should have known that Trustee Lindsey was engaged in actions that were detrimental to the Schools and reflected poorly on the Board. “Though the alarms were being sounded by the actions of one of the Trustees [*i.e.*, Trustee Stender], the others either ignored it, or failed to grasp the consequences of it.” (Section VII.T.)

## **C. The WASC Report**

In 1998, a WASC Visiting Committee visited the Kamehameha Secondary School (“KSS”) as part of its reaccreditation review. Owing to the nature of the secondary school and the governance role of the Incumbent Trustees, WASC deemed the participation of the Incumbent Trustees in the school’s self-study process to be essential. Accordingly, WASC

asked Trustee Lindsey to serve on the focus group addressing organization for student learning. Trustee Lindsey, however, declined to serve. After completing its review of the secondary school, WASC issued a report that was critical of certain aspects of the school administration (principally resulting from the actions of the Incumbent Trustees). As a consequence of this review, WASC curtailed KSBE's accreditation period to three years from the customary six-year period that KSS had received since 1975. The WASC Accreditation Report findings are set out in more detail in Appendix A.

With respect to the conduct of the Incumbent Trustees, the report commented as follows.

- The Incumbent Trustees' form of governance was "a perverse application of top-down decision-making which has openly undervalued, if not scorned, the professional expertise, talent, and commitment of the non-administrative staff." (Page 16.)
- The Incumbent Trustees' "dysfunctional" approach to the governance of KSS produced "an oppressive, intimidating, and fearful professional climate" at the School. (Pages 16-17.)
- The following seven decisions had a negative effect on the management, operation, and administration of the School:

Trustee Lindsey's mandate to use only those Hawaiian words in the Pukui-Elbert Dictionary, to the exclusion of modern Hawaiian language words;

the Board's non-recognition of planning efforts by the KSS administration and staff in the early 1990s;

Trustee Lindsey's suddenly mandated curriculum project while the faculty was in the middle of self-study work required for WASC's review of KSS;

a suddenly mandated change in the KSS's standardized testing program without consultation with faculty;

appointment of an extra administrator as an additional management layer between the president and school administrators;

purchase of an expensive collection of Hawaiiana (the Baker-Van Dyke Collection) for the library, without consulting the staff or considering other financial priorities, after Trustee Stender had judged the collection to be duplicative and not worth the investment; and

Trustee Lindsey's involvement in such minutia as T-shirt designs and communications between KSS and constituents. (Page 17.)

- The zero growth budget was cited as an area of concern because it prohibited staff from planning ahead and from responding to equipment and learning response needs, especially in view of increased enrollment and inflation. (Page 43.)

#### **D. The Court-Appointed Master's Report**

Pursuant to the Will of Princess Bernice Pauahi Bishop and applicable Hawaiian law, the Probate Court appointed Mr. Colbert Matsumoto as the Court's Master to "review the operations of the fiduciary in light of the terms of the controlling document, as well as the financial transactions of the trust or estate." Pursuant to this charge, Master Matsumoto reviewed the 109<sup>th</sup>, 110<sup>th</sup>, and 111<sup>th</sup> Annual Accounts of the Incumbent Trustees (covering the Estate's fiscal years 1994 through 1996) and reported his findings and recommendations to the Probate Court in a Consolidated Report covering all three annual accounts that was filed on August 7, 1998. After receiving the Response of the Incumbent Trustees to this Consolidated Report, as well as additional information from the Incumbent Trustees concerning the three annual accounts, Master Matsumoto issued his First Supplemental Report on the 109<sup>th</sup>, 110<sup>th</sup>, and 111<sup>th</sup> Annual Accounts on September 29, 1998.

Master Matsumoto found the following as part of his review of the 109<sup>th</sup>, 110<sup>th</sup> and 111<sup>th</sup> Annual Accounts of the Incumbent Trustees.<sup>2</sup>

- In implementing the lead trustee system, the Incumbent Trustees:

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

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<sup>2</sup> Page number references are to the Master's Consolidated Report on the 109<sup>th</sup>, 110<sup>th</sup>, and 111<sup>th</sup> Annual Accounts of the Trustees (August 7, 1998); section number references are to the Master's First Supplemental Report on the 109<sup>th</sup>, 110<sup>th</sup>, and 111<sup>th</sup> Annual Accounts of the Trustees (September 29, 1998). A more detailed description of these reports, with accompanying references, is contained in Appendix A. In his reports, Master Matsumoto relied extensively on the Arthur Andersen Management Audit Findings Report (July 1998). Accordingly, we have not discussed the Arthur Andersen Report separately in this opinion. Those aspects of the Arthur Andersen Report that are not merely duplicative of Master Matsumoto's reports, however, are set out in Appendix A.

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

instituted no procedure for monitoring or reviewing performance. (Pages 104-5.)

- The Incumbent Trustees failed to conduct adequate educational strategic planning with respect to the *Go Forward Initiative* by:

not seeking input and comment regarding the strategic-planning process with respect to the *Go Forward Initiative* from professional staff and key management employees at the Kamehameha Schools, which led to frustration and disappointment on the part of staff members and employees (page 98); and

failing to obtain the benefit of critical analysis by educational experts (page 93).

- Despite significant increases in net assets from fiscal years 1994 to 1996, the Incumbent Trustees did not increase direct and indirect education program expenditures. (Pages 17-18 and 18 n.6.) Moreover, the Incumbent Trustees conducted planning for the *Go Forward Initiative* on a “budget neutral” basis, and terminated the community outreach programs, at a time when the Estate had an accumulated income balance of more than \$316 million. (Page 85.)

- The Incumbent Trustees reduced the amount of unrestricted income available for spending on the Schools by:

making unauthorized annual transfers of income (out of which educational expenditures are to be made) to corpus totaling approximately \$350 million by fiscal year-end 1997 (pages 33-34); and

establishing “replacement cost reserves” within the annual revenue accounts and charging to such accounts expenses that were properly chargeable to corpus (page 34).

- The Incumbent Trustees lacked an appropriate investment plan containing a clear asset-allocation policy incorporating risk and return objectives. (Page 62.) Instead, the Incumbent Trustees made investment decisions that:

resulted in investments that were opportunistic and highly unusual for a perpetual endowment with a defined social mission (pages 61-62);

tied up the bulk of the Estate's assets in high-risk, long-term, illiquid investments with undependable cash-flow forecasts, thus making planning for educational spending difficult (pages 62 and 86);

resulted in almost \$400 million in losses and loss reserves during the five years from fiscal year 1991 through fiscal year 1996 (Section IX);

failed to take into account recommendations by the KSBE staff aimed at establishing overall strategic planning objectives for the Estate (page 61);

required extensive allocations of human resources (page 62); and

invested substantial additional amounts of Estate resources in real estate, despite the already disproportionately large real estate holdings in the Estate's investment portfolio, thereby further reducing the diversity and liquidity of the Estate's portfolio (pages 66-67).

- Neither of the two compensation reports commissioned by the Incumbent Trustees during fiscal year 1996 examined qualifications, experience, or performance as a criterion for compensation, although each is premised on the assumption that each of the Incumbent Trustees actually performs a role comparable to those of the CEO, COO, CFO, and Corporate Treasurer of large and complex business organizations. (Pages 118-19.)
- The Incumbent Trustees engaged the services of lobbyists and otherwise expended Estate funds initially to oppose the enactment of the intermediate sanctions provision of the Code (I.R.C. § 4958) and later to modify certain provisions contained in the legislative history. (Pages 136-37.) This attempt to influence the legislative process by the Incumbent Trustees was predominately directed at preserving the historical procedure for determining compensation of the Incumbent Trustees under state statutory law and minimizing the potentially adverse impact that the intermediate sanctions provision would have on their continued ability to receive compensation in accordance with, and at levels permitted under, state law. (Section XIV.)

#### **E. Other Factual Allegations**

In addition to the conduct of the Incumbent Trustees discussed above, we are aware that other factual allegations have been made by the Service, as well as by other persons, such as the Hawaii State Attorney General. Because the Service's core arguments with respect to its proposed revocation of KSBE's tax-exempt status can be based sufficiently on the findings discussed above, we have not discussed the Attorney General's additional allegations in this opinion. Regardless of their relevance to the Service's core arguments, however, these facts could have a negative impact on a court's willingness to sustain KSBE's tax-exempt status if the issue is litigated. It is possible, therefore, that the Service will choose to bring such facts to the attention of the trier of fact if the issue of KSBE's tax-exempt status is litigated. Accordingly, we have set out these allegations in Appendix B.

#### **IV. Judicial Review of The Service's Proposed Revocation**

We have confirmed that the Service intends to revoke KSBE's tax-exempt status if certain governance issues, including the permanent removal of all five Incumbent Trustees, are not resolved to the Service's satisfaction. It is our opinion that, given the Service's insistence on certain governance changes (including the permanent removal of the Incumbent Trustees), the Estate is faced with the choice of reaching agreement with the Service on these issues or ultimately taking the issue of the revocation of KSBE's tax-exempt status to court. With respect to the latter alternative, we have focused on those judicial forums that are available in a declaratory judgment action under section 7428 of the Code: the United States Tax Court, the District Court for the District of Columbia, and the United States Court of Federal Claims. I.R.C. § 7428. In order to use other forums, such as the District Court for the District of Hawaii, the Estate would have to pay the entire amount of tax resulting from the revocation of its tax-exempt status and sue for a refund. We understand that the anticipated size of the tax payment could be in excess of \$500 million (excluding interest) for the Estate's 1992 to 1998 tax years;<sup>3</sup>

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<sup>3</sup> We understand that in the event that the Service were to revoke KSBE's tax-exempt status, the Service would seek revocation retroactive to the Estate's tax year ending June 30, 1990, solely on the basis that compensation paid to KSBE trustees during those years was unreasonable. For purposes of this opinion, however, we have limited our analysis of the risks of litigating the revocation of KSBE's tax-exempt status to KSBE's tax year ending June 30, 1992 and following years.

because of the magnitude of that payment, the Estate would want to file a declaratory judgment action in order to avoid paying the tax as a prerequisite to litigation.<sup>4</sup>

The Tax Court has promulgated rules that govern the procedures for declaratory judgment actions under section 7428 of the Code; these rules, or substantively similar ones, are applied in the other available forums. Under the applicable Tax Court Rules, a trial is required in revocation cases unless the parties agree that the administrative record contains all of the relevant facts and that such facts are not in dispute. Rules 217(a) and (c), Tax Court Rules of Practice and Procedure. Trials in revocation cases are conducted in accordance with the rules of practice and procedure generally applicable to trials. Rule 217(b)(3), Tax Court Rules of Practice and Procedure.

It is our view that the Service's proposed revocation would raise material issues of fact that would be disputed by the parties. Accordingly, a lengthy trial would be required, governed by the rules of practice and procedure generally applicable to trials in the Tax Court (or one of the other available forums). The burden of proof would be on KSBE to introduce credible factual evidence establishing that it is entitled to retain its section 501(c)(3) status. I.R.C. § 7491(a); Rules 142 and 217, Tax Court Rules of Practice and Procedure.

In light of the findings discussed above with respect to the conduct of the Incumbent Trustees, it is our opinion that the Estate would face a formidable task in carrying its burden of proof. While those findings would probably not be controlling in a declaratory judgment proceeding, they would likely be admissible, and therefore could, in themselves, influence the outcome of the litigation. In any event, they certainly provide guidance as to how a trier of fact would react to evidence similar to that produced in these earlier proceedings. In that regard, we have made inquiries of the KSBE staff and certain outside consultants in an effort to find rebuttal evidence. To date, we have not received information that would provide a clear defense to these allegations. Moreover, in our review of the transcripts of witness testimony offered during the hearing for Trustee Lindsey's removal, including the testimony of four of the five Incumbent Trustees, we found little credible evidence that would contradict the Service's assertions regarding the Incumbent Trustees' conduct. To the contrary, the testimony of the witnesses in that proceeding—which includes the testimony of Trustees Lindsey and Wong as

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<sup>4</sup> As an alternative to filing a declaratory judgment under section 7428 of the Code, the Estate could, within ninety days of its receipt of a statutory notice asserting a deficiency for the audit years (1992-1996), bring an action in the United States Tax Court to redetermine the deficiency resulting from the revocation of the Estate's tax-exempt status solely for those years. I.R.C. § 6213. This is an inefficient alternative to a declaratory judgment proceeding, however, because it would not resolve the issue of the Estate's future tax liability resulting from the Service's revocation of KSBE's section 501(c)(3) status on a going-forward basis. Section 7428 of the Code allows both the deficiency resulting from the revocation of the Estate's tax-exempt status during the audit years, and its continuing qualification for section 501(c)(3) status, to be resolved in one proceeding.

well as that of other current and former KSBE employees—appears to offer additional support for the Service's arguments based on the conduct of the Incumbent Trustees.<sup>5</sup>

Nevertheless, we believe that there are probably some defenses that could be presented to a court by means of testimony from some of the Incumbent Trustees and, if the case were tried, we would use our best efforts to develop that evidence. The probative value of such evidence would be problematic, however, because to date there has been disagreement among the Incumbent Trustees regarding the propriety of their conduct, as demonstrated by their previous actions and testimony.

We have also reviewed the earlier compensation studies commissioned by the Incumbent Trustees and have discussed these studies with an outside compensation consultant. Based on this review, and on our discussions with the outside compensation consultant, it is our opinion that there is a significant risk that a court would find that those studies were based on a number of incorrect or questionable assumptions regarding the scope of the Incumbent Trustees' actual management duties and responsibilities. Consequently, it is our opinion that there is significant risk that a court would conclude that the ranges of reasonable compensation for the Incumbent Trustees established by those studies are excessive.

More specifically, we are particularly concerned that the compensation studies failed to address the Incumbent Trustees' qualifications (or lack thereof) and their actual performance. A court, however, would consider these factors in reaching a decision. *See, e.g., Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9<sup>th</sup> Cir. 1983); *Pulsar Components Int'l, Inc. v. Commissioner*, 71 T.C.M. (CCH) 2436, 2441 (1996). Based on our review of the available facts regarding the Incumbent Trustees' qualifications, experience, and performance, we believe that there is significant risk that a court would conclude that these factors serve to reduce the range of what constitutes reasonable compensation to the Incumbent Trustees, thereby providing further support for the Service's argument that the compensation paid to the Incumbent Trustees was unreasonable and therefore constitutes prohibited private inurement.<sup>6</sup>

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<sup>5</sup> We have also reviewed the testimony of witnesses at the evidentiary hearing before Judge Hirai on the Attorney General's petition for the removal of the Incumbent Trustees, which began on March 29, 1999 and lasted several weeks. Again, we found little credible evidence that would contradict the Service's assertions regarding the Incumbent Trustees' conduct. In any event, we would expect that if the proposed revocation went to trial, the Service would put on witnesses who would contradict this type of testimony by the Incumbent Trustees.

<sup>6</sup> We further note that the Estate's prior effort to justify the high levels of compensation paid to the Incumbent Trustees by comparing their duties and responsibilities to those of top executives in commercial entities (such as banks, real estate investment trusts, and like entities) may have significant drawbacks if advanced in a declaratory judgment action. Such an argument potentially supports the Service's position that the principal focus of the Incumbent Trustees was on non-educational purposes.

In reaching our conclusion, we have considered the implications of the Congressional enactment of section 4958 of the Code (*i.e.*, the “intermediate sanctions” provision). In lieu of revoking an organization’s section 501(c)(3) status in cases involving private inurement to insiders, such as the Incumbent Trustees, section 4958 of the Code permits the Service to impose a penalty tax directly on the insiders who benefit from that inurement. Section 4958 of the Code does not apply, however, to transactions occurring before September 14, 1995, and therefore has no impact on the Service’s proposed revocation of the Estate’s tax-exempt status for the tax years ending June 30, 1992 through June 30, 1995. Moreover, the enactment of section 4958 of the Code has no effect on the Service’s argument that the Estate failed to carry out its mission of operating exclusively for educational purposes and therefore should have its tax-exempt status revoked. Revocation is appropriate either as an alternative to, or in addition to, the imposition of intermediate sanctions penalty taxes when an organization “no longer operates as a charitable organization.” H.R. Rep. No. 104-506, n.15, at 59 (1996).

It should also be noted that any reliance upon the enactment of section 4958 of the Code would bring the efforts of the Incumbent Trustees with regard to that legislation into sharp focus. Before and after filing his Consolidated Report, Master Matsumoto sought information from the Incumbent Trustees that would allow him to evaluate whether the expenditures made by the Estate for lobbying against, or for modifications to, the intermediate sanctions legislation were necessary, or appropriate and reasonable, to carrying out the purposes of the Estate. In response, he received two letters from one of the Estate’s outside legal consultants “purporting to respond to his inquiry,” but he was “unsuccessful in obtaining the pertinent documents” related to the legislative efforts of the Incumbent Trustees with respect to the intermediate sanctions legislation. (Matsumoto at § XIV.) Based upon our review of the internal documents of the Estate and the files of one of its outside law firms, we believe that there is considerable additional support for the Master’s conclusion that the primary—if not the sole—focus of the Incumbent Trustees’ legislative efforts was initially to defeat, and later to modify, the legislative proposal in order to protect their ability to control the level of their compensation. If the trier of fact in a declaratory judgment action were to determine that the Incumbent Trustees’ lobbying effort had this purpose, the amounts expended for these efforts—approximately \$1 million in Estate assets—would constitute prohibited private inurement.

Moreover, the efforts of the Incumbent Trustees to defeat or modify the intermediate sanctions legislation would provide additional support for the Service’s argument that more than an insubstantial part of the organization’s activities served private interests, and therefore nonexempt purposes. We believe that there is a significant risk that a trier of fact in a declaratory judgment action would find, as Master Matsumoto did, that the intermediate sanctions legislation was in the best interest of the Estate because it serves to “better insulate the Estate’s tax-exempt status from the consequences of any improper actions by its Trustees.” (Matsumoto at 136.) As such, the Service may be able to argue successfully that the Incumbent Trustees’ efforts to defeat the proposed provision, or to seek self-serving modifications to the

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legislative history, furthered only their private interests, to the detriment of the Estate and its charitable mission. This would provide additional support for the Service's argument that revocation is appropriate because the Estate was not being operated exclusively for exempt purposes.

## **V. Conclusion**

The conduct of the Incumbent Trustees that has been identified by the judicial and independent fact finders discussed above offers considerable support for the Service's revocation arguments. Based on the facts that have already been found by several independent fact finders, we believe that KSBE would face significant challenges in an effort to maintain its tax-exempt status for the audit years, and on a going-forward basis, if the issue were litigated. While we would use our best efforts to develop responsive facts and legal arguments, we must caution that additional adverse facts could surface that are not set forth in this letter and the accompanying appendices. Thus, based on a careful consideration of these and other factors discussed above, should the matter proceed to litigation, we conclude that the Estate faces a significant risk that the Service's revocation of KSBE's section 501(c)(3) status would be sustained.

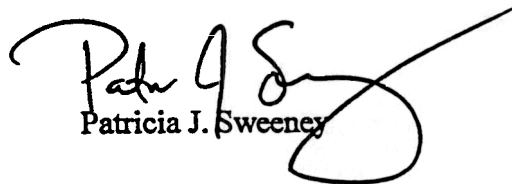
In weighing these risks, we are mindful that a case of this nature, involving complex facts, will require the review and production of numerous documents, as well as the interviews, depositions, and testimony of many witnesses—a process that is likely to be further complicated by contradicting testimony. Thus, in addition to disrupting the normal business operation of the Estate and consuming substantial amounts of personnel time and resources, such litigation would impose a significant financial burden on the Estate, involving at least several million dollars in legal fees and other expenses. Moreover, the time period between the Service's revocation of KSBE's tax-exempt status and the rendering of a judicial opinion concerning KSBE's continuing qualification as a 501(c)(3) organization would be lengthy, potentially more than three years. The threat of revocation would create financial uncertainty in the Estate's operations during these years, thereby possibly precluding the Estate from engaging in meaningful strategic planning for educational programs, or implementing expansion plans, until litigation is resolved and the amount of the liability resulting therefrom (including a substantial tax bill if revocation is sustained) is resolved.

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Weighing these costs and the significant risks involved with this litigation, as discussed above, it is our opinion that avoiding litigation of the revocation issues through a settlement with the Service that would preserve the Estate's tax-exempt status, on terms that are acceptable to the Interim Trustees, would be in the best interest of the Estate.

Sincerely yours,

  
Robert L. Moore, II

  
Patricia J. Sweeney