

**INTERIM REPORT OF THE SPECIAL INVESTIGATIVE COMMITTEE  
OF THE JOINT BOARDS OF  
SHRINERS HOSPITALS FOR CHILDREN**

**April 10, 2008**

**CONFIDENTIAL**

**I. Introduction**

**A. Overview and Charge of the Special Investigative Committee.** This Interim Report is made to Dr. Bernard Lemieux, Imperial Potentate of the Ancient Arabic Order of Nobles of the Mystic Shrine for North America ("AAONMS"), an Iowa Corporation, and Chairman of the Board of Directors of the Shriners Hospitals for Children ("SHC"), a Colorado nonprofit corporation, in accordance with his directive to the Special Investigative Committee (the "Special Committee") of the Board of Directors and Board of Trustees (the "Joint Boards") of SHC in September, 2007. This Interim Report will detail the course of the work of the Special Committee to date, some preliminary findings by the Special Committee, and certain issues that warrant additional investigation and reporting to Dr. Lemieux for consideration of possible remedial actions by the Joint Boards or the Members of AAONMS.

The Special Committee was appointed by Dr. Lemieux, under the authority of Section 510.3 of the Bylaws of SHC, on September 20, 2007,<sup>1</sup> to inquire into whether Mr. Ralph Semb, Chairman of the Board of Trustees and President of SHC, and Mr. Gene Bracewell, Treasurer and Trustee of SHC, engaged in unethical conduct by intervening in the executive evaluation process (the so-called 360° review)<sup>2</sup> for Mr. Edgar McGonigal, Director of Development of SHC, during the year 2007. The Special Committee retained as counsel Mr. Andrew J. Demetriou of the law firm of Fulbright & Jaworski L.L.P. The Special Committee initially understood its charge from Dr. Lemieux to include consideration of whether the conduct of Messrs. Semb and Bracewell violated ethical codes of SHC (and by implication, AAONMS)<sup>3</sup> and whether such conduct, even if not strictly proscribed by ethical codes or codes of conduct, nonetheless damaged, or could cause damage, to the interests of SHC. In the course of its investigation, the Special Committee became aware of potential conflict of interest concerns related to the actions of Messrs. Semb and Bracewell, which will also be addressed in this Interim Report.

Prior to its making any findings or report, the Special Committee's investigation was suspended by an unrecorded action of the Joint Boards in Executive Session on November 8,

<sup>1</sup> The initial members of the Special Committee were Robert Turnipseed, Mahlon Hessey, Robert Bailey, Al Madsen and Robert Smith. At an initial meeting of the Special Committee on October 5, 2007, Messrs. Madsen and Smith indicated that they were uncomfortable with service on the Special Committee. Mr. Bailey indicated orally to members of the Special Committee that he was unable to serve due personal considerations. On October 9, 2007, Dr. Lemieux reconstituted the Special Committee to include Messrs. Turnipseed, Hessey and John Nobles. All references to the Special Committee shall mean the Special Committee as reconstituted by Dr. Lemieux. Messrs. Madsen, Bailey and Smith did not participate in the investigation and have had no role in producing this Interim Report.

<sup>2</sup> Under the leadership of Mr. James Full, Executive Vice President of SHC, each member of the senior executive staff of SHC is reviewed on job performance by subordinates, other senior executives and members of the Joint Boards. This type of evaluation process is referred to as a 360° review, and its application to Mr. McGonigal will be discussed later in this report.

<sup>3</sup> The Special Committee has considered, as discussed below, the applicability of certain ethical principles that are binding on members of AAONMS, its officers and individuals elected or appointed to positions of authority by the members of AAONMS. Since SHC is the principal charitable activity of AAONMS, we believe that both of those codes of conduct should apply to the conduct of the Messrs. Semb and Bracewell, as Nobles and as Officers and Trustees of SHC.

2007. The Special Committee was reinstated by action of the Joint Boards on January 26, 2008 and was asked to continue its investigation.<sup>4</sup> In addition, the Special Committee was asked to expand its investigation to include matters related to the resignation of Mr. Willard Fawcett, the Controller of SHC in January, 2008 and allegations of potential irregularities in expenses and in the annual report of SHC to the Internal Revenue Service on Form 990 for the year 2006.<sup>5</sup>

This Interim Report will present the Special Committee's findings with respect to the evaluation of Mr. McGonigal and certain potential conflict of interest issues, as well as some observations and recommendations for consideration by the Joint Boards to prevent a recurrence of the events detailed in this Interim Report. The Special Committee has not had adequate opportunity to investigate the Fawcett matter, beyond some very preliminary inquiries and interviews, and is not in a position to reach any conclusions on this matter. The Special Committee does regard issues flowing from the Fawcett resignation and Mr. Fawcett's allegations as potentially very serious and require a mandatory and comprehensive continuing investigation.

**B. Review of Records and Interviews.** The Special Committee and its counsel have reviewed SHC employment records concerning Mr. McGonigal, policies concerning evaluation of senior executive staff of SHC, records of corporate proceedings of SHC during the relevant periods, memoranda by senior staff of SHC concerning Mr. McGonigal's performance and the 360° evaluation process during the year 2007, memoranda by senior staff concerning the discovery of the conduct that is the subject of this investigation and the internal investigation prior to the appointment of the Special Committee and various documents and memoranda received from members of the Joint Boards that are relevant to the matters under investigation.

In addition, the Special Committee interviewed members of senior management of SHC<sup>6</sup> and members of the Joint Boards, including Messrs. Semb and Bracewell.<sup>7</sup> The Special

<sup>4</sup> In the interim period, SHC retained the firm of McDermott Will & Emery to consider the appropriateness of termination of the Special Committee's investigation under charitable trust laws and applicable Internal Revenue Service rules. McDermott Will & Emery produced a rather extensive report of 36 pages, concluding that termination of the investigation posed significant risks to SHC and the Joint Boards in the event that the matter became known to state Attorney General or the Internal Revenue Service, and on this basis the Special Committee was rechartered. The McDermott Will & Emery report highlighted conduct related to the termination of the investigation that could have significant legal implications for SHC, which will not be repeated here.

<sup>5</sup> Mr. Fawcett announced his resignation on January 17, 2008. In an exit interview with Ms. Kathy Dean, Corporate Director of Human Resources, he made a number of allegations concerning potential financial, expense and tax irregularities which bear investigation. He also indicated that he had retained counsel to pursue a claim for constructive termination. SHC internal counsel is presently in discussions with Mr. Fawcett's lawyers concerning his allegations and employment claims. To date neither SHC management nor the Special Committee has received any documents Mr. Fawcett claims to possess that support his allegations.

<sup>6</sup> For purposes of confidentiality and protection of confidences, this report will not attribute certain comments to individual members of senior management, except by reference to identifying letters, e.g., Senior Executive A. In the same vein, individual members of the Joint Boards will be referred to, for example, as Board Member A. Identities of these individuals can be provided if essential.

<sup>7</sup> Messrs. Semb and Bracewell were initially made aware of the investigation by Dr. Lemieux in late September, 2007. Mr. Demetrious described the scope of the investigation to them in October, 2007 prior to initial interviews with each. As a consequence they are aware of the matters under investigation and the nature of facts adduced by

Committee has deemed the interviews conducted to date as sufficient for the purposes of the conclusions expressed in this Interim Report, but believes that further interviews are necessary with respect to the matters raised by the Fawcett resignation.

In anticipation of issues likely to be addressed in pursuing the Fawcett aspects of the investigation, counsel to the Special Committee has retained Deloitte & Touche Forensic Advisory Services to provide forensic accounting expertise and support in reviewing financial and accounting records relevant to the investigation.

## II. Applicable Ethical Principles

There are several ethical precepts that potentially apply to the conduct of this investigation. Article 10 of the Bylaws of the AAONMS specifies ethical principles that are binding on the members of the Shrine and in particular on those in authority. Section 210.2 embodies a Creed of the Shrine and states, in part: "As individuals we pledge ourselves to integrity, virtue and nobility of character. Our intentions will be honorable, our relationships trustworthy and our spirits forgiving of each other." Section 210.7 sets forth a Code of Ethics to which all officers and directors of the Imperial Council and all who may be elected or appointed to positions of authority shall abide. Section 210.7(b) provides that such individuals must: "Demonstrate the highest standards of personal integrity, truthfulness and honesty in all their fraternal activities; administer the Order's affairs with impartiality, efficiency and effectiveness and in a manner that enhances its good name and mission." Section 210.7(e) provides that officers and appointees should: "Exercise their independent judgment in the best interest of the Order, and free of compromising influences and loyalties, and act responsibly and in good faith, and in a manner not designed or intended to bring them personal gain from the discharge of their fraternal duties."

Section 503.9 of the Bylaws of SHC contains a Code of Ethics, binding on officers, directors, trustees and employees and all who have been elected or appointed to positions of authority. Relevant provisions of the Code of Ethics require that these individuals:

- (h) Demonstrate the highest standards of personal integrity, truthfulness and honesty in all their corporate activities; administer the corporation's affairs with impartiality, efficiency and effectiveness and in a manner that enhances its good name and mission.
- (c) . . . [B]e scrupulous in the representation of their authority and avoid misleading those with whom they deal.

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the Special Committee. Prior to subsequent interviews on March 25 and April 2, 2008, each of Messrs. Semb and Bracewell were made aware of the Special Committee's further interest in determining facts relevant to this investigation. Both of them cooperated in interviews with the Special Committee.

- (e) Exercise their independent judgment in the best interests of the corporation, and free of compromising influences and loyalties; and act responsibly and in good faith, and in a manner not designed or intended to bring them personal gain from the discharge of their corporation duties.
- (f) Give notice, in a manner consistent with the corporation's bylaws, of any duality of interest or possible conflict of interest and make it a matter of record; give notice of any direct or indirect interest in an individual or organization which is proposing or is involved in a transaction with the corporation and thereafter, refraining from voting on the matter or transaction or otherwise attempting to exert influence over the matter or transaction.
- (g) Refrain from:
- ...
- (2) Soliciting or receiving, directly or indirectly, anything of value from (i) any purveyors or vendors of goods or services to the corporation, or (ii) any person or entity for influencing their actions[.]

In addition, the Joint Boards and the members of SHC adopted a conflict of interest policy on July 18, 1997, which was amended on April 18, 2007 (the "Conflict of Interest Policy"). The Conflict of Interest Policy provides, in pertinent part:

2. [...] A conflict of interest shall also be deemed to exist whenever any director, trustee, officer or employee accepts gifts, gratuities or other favors from any individual, or entity that does, or is seeking to do, business with SHC, under circumstances where it might be inferred that such action was intended to influence or would possibly influence the director, trustee, officer or employee in the performance of his duties. This does not preclude the acceptance of items of nominal or insignificant value, as defined in Internal Revenue Service regulations, which are not related to any particular transaction or activity of SHC.

8. In the event that a matter comes before the boards of directors or trustees, or a committee thereof, where a board member has a duality of interest or possible conflict of interest, he shall promptly make it a matter of record, and refrain from either voting or directly or indirectly influencing, or attempting to influence, the vote of the directors or trustees.

The Conflict of Interest Policy provides that the Joint Boards may reprimand a Member of the Joint Boards for violation of the Policy on a two-thirds vote and that notice of the reprimand may be brought to the attention of the Members of SHC at its Annual Meeting. In furtherance of the Policy, each member of the Joint Boards is required to execute an annual disclosure statement concerning any potential conflicts of interest. Messrs. Semh and Brucewell

each executed a disclosure statement on April 22, 2007, in which they indicated that that they were aware of no conflicts of interest within the meaning of the policy.

### III. Edgar McGonigal

A. Background on Mr. McGonigal. Mr. McGonigal was hired by SHC as its Corporate Director of Development in September, 2004, having served previously as Chairman of the Board of Governors of the Shriners Hospital in Chicago. He applied as a candidate for the position of Executive Vice President of SHC, to succeed Mr. Lewis Molnar, but that job was given to Mr. James Full. Senior Executives of SHC have indicated that the relationship between Messrs. Full and McGonigal is not close, which they attribute in part to the competition for the position of Executive Vice President. Mr. McGonigal has operated relatively independently of direction from Mr. Full, and Mr. Full has indicated that he has limited knowledge of the internal workings of Mr. McGonigal's department.

A number of individuals interviewed by the Special Committee have indicated that Mr. McGonigal has weak interpersonal skills, which are offset by strong technical competence in his position. Given that an important component of his job is interaction with local fundraising efforts and local development officers as well as donors, interviewees have expressed the view that personality is important to his performance. Based on the review of personnel records and evaluation materials on Mr. McGonigal, there is considerable disagreement among those who interact with him as to his suitability for his current position, and the Special Committee has no views on this matter. What we have concluded is that his record reflects both strong commendations and weaknesses.

On October 31, 2006, Mr. Semb came to SHC headquarters and attempted to terminate Mr. McGonigal for poor performance and insubordination.<sup>8</sup> Mr. Semb reported to the Special Committee that he was acting at the request of Mr. Full in meeting with Mr. McGonigal to terminate his employment. Apparently the meeting with Mr. McGonigal, at which Ms. Kathy Dean, Director of Human Resources for SHC, was present, was handled poorly. Mr. Semb stated that Mr. Full directed Mr. Fleisher to interrupt the meeting and escort Mr. McGonigal from the building, which Mr. Semb regarded as highly embarrassing and improper.

Interviews with Senior Executives of SHC suggest that Mr. Semb's action in demanding the meeting with Mr. McGonigal may have been unilateral (not at the request of Mr. Full) and that he was not familiar with the full range of performance appraisals on Mr. McGonigal or the basis on which a termination decision could be founded.<sup>9</sup> The accounts of Senior Executives familiar with these events disagree with Mr. Semb's recollection on a number of key points, including the instigation of the meeting with Mr. McGonigal, and the role of Mr. Fleisher in the meeting. In addition, the Special Committee has learned that two members of the Joint Boards

<sup>8</sup> Mr. Semb has indicated that Mr. Full was afraid to confront Mr. McGonigal based on concerns about Mr. McGonigal's potential reaction. Mr. Full has denied this.

<sup>9</sup> At the subsequent meeting of the Joint Boards, Mr. Frank Roth, a Trustee of SHC, confronted Mr. Semb with evaluation materials from Mr. McGonigal's personnel files, indicating that his performance was not unsatisfactory. Mr. Semb failed to respond to this information by providing his reasons for seeking termination.

were aware the Mr. Semb intended to terminate Mr. McGonigal in advance of the Joint Boards meetings in November, 2006, and they believe his purpose was to accomplish the termination without seeking authority from the Joint Boards. The Special Committee has also reviewed memoranda from Senior Executives that indicate that Mr. Bracewell was making comments about the unsuitability of Mr. McGonigal and suggesting that he needed to be removed from his position at a time prior to the termination meeting. Mr. McGonigal believes that the actions of Mr. Semb were based on his unwillingness to support initiatives of Messrs. Semb and Bracewell with respect to direct mail marketing, among other things, and therefore had retaliatory aspects.

It is certain that the termination of Mr. McGonigal was not authorized by the Salary and Personnel Committee or the Joint Boards, but was undertaken on Mr. Semb's authority as President of SHC. At the subsequent meeting of the Joint Boards in November 2006, a motion to terminate Mr. McGonigal was defeated in Executive Session and Mr. McGonigal was reinstated,<sup>10</sup> but Mr. Full was directed to prepare a performance plan for Mr. McGonigal and monitor his compliance. The Joint Boards declined to award Mr. McGonigal a performance raise granted to other Senior Executives.

Messrs. Semb and Bracewell met with Mr. McGonigal on November 27, 2006, to discuss the 2006 review of his performance. Part of the discussion involved a proposal by Convergence Direct Marketing ("Convergence") for SHC direct mail solicitation business and an incident at an August, 2006 Imperial Divan retreat, in which concerns about Convergence and improper relationships with a former vendor were raised.

At the Joint Boards meeting in April, 2007, a decision was made, following a motion by Mr. Bracewell, to award Mr. McGonigal the raise had been denied to him in November, 2006 and to increase his salary retroactive to January 1, 2007. This was based in part on perceived improvement in his performance in response to the performance plan. At this date Mr. McGonigal continues in his job, but there remain concerns about his management style and about his overall performance.

**B. The 2007 360° Review Process.** In June, 2007, Mr. Full commenced the 360° review process for senior executives of SHC, including Mr. McGonigal. As Mr. Full has described the process to the Special Committee, its objective is to provide a picture that can be used to direct executives in the improvement of their job performance. He does not consider the appraisals in the 360° review process to be the basis for a decision on either promotion or termination of an executive, but rather as a tool to assist in executive development. The

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<sup>10</sup> As we understand the chronology of events, Mr. Semb had, under his apparent authority as President of SHC, terminated Mr. McGonigal and thus the motion made would have been seeking ratification of this action. Since transcripts of the Executive Session are not available, we are unable to be precise in describing the action of the Joint Boards, other than to say that Mr. McGonigal was restored to his position.

<sup>11</sup> These issues will be discussed in greater detail in Section III.C.

<sup>12</sup> The 2007 performance appraisal of Mr. McGonigal, issued by Mr. Full on November 27, 2007, indicates that Mr. McGonigal achieved good success in fundraising results, but needs to overcome perceptions that his communication and interpersonal skills are not commensurate with his executive position and that he has demonstrated a rigidity in management style that may limit strategic initiatives.

procedure followed by Mr. Full is to solicit from each Senior Executive the names of a several individuals at different levels within SHC and the local hospital system from whom reviews are to be requested. In the case of Mr. McGonigal, this would have included members of the Joint Boards as well as Development Directors at local hospitals. Mr. Full then chooses from the list submitted by the executive on a confidential basis and sends a standard questionnaire to the individuals selected. The identities of the reviewers is supposed to be confidential, so as to ensure candor in the evaluations.

On September 7, 2007, during the pendency of the 360° process for 2007, Mr. Semb contacted Mr. Full and requested that Mr. Robert Cotner, Director of Development at the Chicago SHC hospital and Mr. William Austin, Director of Development at the SHC Tampa hospital, be included as reviewers of the performance of Mr. McGonigal. Mr. Full regarded this as unusual, in that the identities of individuals providing reviews are intended to be confidential and Mr. Semb could not have known who would be designated for this purpose. Mr. Semb did not explain the reason for his request, and advised the Special Committee that his only motivation was to seek reviews from individuals who were in the best position to evaluate Mr. McGonigal.<sup>14</sup> Mr. Full acknowledged the request and did submit an evaluation form to Mr. Austin, in part to avoid a confrontation with Mr. Semb.

At or about the same time, Mr. Bracewell contacted both Messrs. Austin and Cotner to advise them that they might be reviewing Mr. McGonigal. Mr. Cotner was disturbed by the call, and felt that he was being pressured to provide a negative review of Mr. McGonigal. Mr. Cotner had, prior to this contact, already submitted a favorable report on Mr. McGonigal. Mr. Bracewell stated that he encouraged Messrs. Austin and Cotner to provide candid assessments of Mr. McGonigal's work and was not attempting to influence their submissions. However, in an interview with Ms. Dean and Mr. Fleisher, Mr. Austin indicated he believed that Mr. Bracewell was seeking to have him submit a negative evaluation on Mr. McGonigal, which would have been consistent with past criticism Mr. Austin had expressed. Mr. Austin submitted a report that was negative.<sup>15</sup>

Based on the 360° review process, Mr. McGonigal's performance was rated satisfactory and he was awarded a salary raise commensurate with other senior executives who had similar ratings.

**C. Direct Mail Marketing Program.** In May, 2006, Mr. Bracewell arranged a meeting among himself, Mr. Semb and Mr. McGonigal in Boston, to hear a proposal from a vendor seeking to manage direct mail charitable solicitations on behalf of SHC. The meeting

<sup>13</sup> Indeed, Mr. Cotner had already been selected for this purpose by Mr. Full, clearly unbeknownst to Mr. Semb.

<sup>14</sup> Mr. Semb offered no explanation as to why he would think that Mr. Full would not choose appropriate individuals for this purpose or why he had special expertise in making these particular requests. Mr. Bracewell advised the Special Committee that he recommended Messrs. Austin and Cotner to Mr. Semb since they were very senior development officers and would be in the best position to evaluate Mr. McGonigal.

<sup>15</sup> Mr. Full indicated that he gave no weight to Mr. Austin's report since it was solicited outside of the process. In addition, Mr. Austin's evaluation was the only one received that indicated less than satisfactory performance by Mr. McGonigal.



was arranged in Boston ostensibly since Mr. McGonigal was there on SHC hospital development matters, working with Mr. Bracewell, who was the Chair of the Development Committee. The meeting was held in the headquarters of Vantage Deluxe World Travel ("Vantage Travel"), a firm that provides travel and tour packages that are often offered to Shriner members. An affiliate of Vantage Travel, Vantage Direct Marketing Services ("Vantage DMS")<sup>16</sup> formerly provided direct mail marketing services to SHC and was known to Messrs. Semb and Bracewell.

At the meeting, a joint proposal was made by Vantage DMS and Convergence, a firm based in Bethesda, Maryland. Materials provided at the meeting, as well as slides used in the presentation, featured the names of both Vantage DMS and Convergence. The meeting was suggested to Mr. Bracewell by Mr. Henry Lewis, the Chief Executive Officer of Vantage Travel. Mr. Bracewell has had a long relationship with the Lewis family, in particular Edward Lewis, Mr. Henry Lewis' father. At the meeting, Mr. McGonigal apparently said little as he was unprepared for this presentation and did not understand why a proposal for SHC direct mail services was being entertained at this time.<sup>17</sup> He did, however, have the impression that Vantage DMS was leading the proposal and that there was a relationship between Vantage DMS and Convergence. Mr. Bracewell advised the presenters that SHC would be unable to do business with any entity in which Vantage related companies had an interest, due to past problems under the direct mail program operated by Vantage DMS, which terminated in 2003.<sup>18</sup> The materials at the meeting in Boston were returned to the Vantage DMS and Convergence representatives and not retained by Messrs. Semb, Bracewell or McGonigal.

On June 21, 2006, Convergence submitted a proposal for direct mail marketing services to SHC. This proposal was very similar to the proposal made the previous month at the Vantage Travel offices.<sup>19</sup> Mr. McGonigal did not believe that the Convergence proposal was superior to the existing contract between SHC and its incumbent vendor, Barton Cotton Sales Corporation ("Barton Cotton"). His view was that the Convergence proposal contemplated premium offerings to prospective donors which are costly to the charity involved and generate high profit margins for the solicitor firm, without ensuring increased donations. He believed that the strategy of sending out such premium items would not be beneficial for SHC. He also noted that the charges in the Convergence proposal for "low end" premiums, such as return address labels, were 50% higher than the charges by Barton Cotton.

<sup>16</sup> The Special Committee believes that Vantage Direct Marketing Services is the same or a successor entity to Vantage Financial Services, Inc., which formerly provided direct mail marketing services to SHC, as discussed in Section V.C. below. From a review of SHC records it appears that various Vantage entities have provided mail related services to SHC and AAONMS, including Vantage Group Services, Inc. and Vantage Financial Services, Inc. For convenience, we have referred to Vantage DMS without regard to actual corporate name of the entity involved.

<sup>17</sup> Mr. McGonigal had been told that the presentation would concern the Shriners Note Pad program for AAONMS. In fact, Convergence did submit a bid for direct mail services to AAONMS in June, 2006, in addition to a proposal to SHC.

<sup>18</sup> Further discussion of the history of the Vantage Travel and Vantage DMS relationships and the conflict of interest implications will be provided in Section V.C.

<sup>19</sup> The Special Committee has reviewed files concerning a contemporaneous Convergence proposed contract with AAONMS for Shriners Note Pads, on which Mr. Fleisher noted that its terms were identical to the terms of a prior contract with Vantage Group Services, Inc.

In an August, 2006 Imperial Divan retreat, Mr. Bracewell urged approval of the Convergence proposal. One of the participants at the retreat raised the question of whether Convergence was in any way related to Vantage Travel or Vantage DMS. Mr. Bracewell reacted very angrily to this suggestion of such a relationship, due to the taint associated with Vantage DMS.<sup>20</sup> Mr. Bracewell later criticized Mr. McGonigal privately for leaking details of the May, 2006 meeting in Boston. Mr. McGonigal has denied that he made any member of the Imperial Divan or Board of Trustees aware of the details of that meeting. The Convergence proposal was never submitted to Joint Boards for approval.

The Special Committee has received information from Senior Executive C and from Board Member A that indicates that contact between Mr. Bracewell and representatives of both Vantage DMS and Convergence continued into December, 2006, and that these contacts were communicated by Mr. Bracewell to those individuals. It is not clear why any contacts with Vantage DMS were continuing following Mr. Bracewell's statements at the meeting in Boston, and in fact he reported in the December conversations with Senior Executive C that it was not the right time to approach the Joint Boards about doing business with Vantage DMS. Mr. Bracewell was concerned because several members of the Joint Boards were taking what he characterized as "free trips" with Vantage Travel and that they should not be taking free trips from people they would not do business with.

In April, 2007, Mr. Bracewell, Mr. John Cinotto,<sup>21</sup> and four other members of the Joint Boards took a cruise arranged by Vantage Travel. During the cruise, Mr. Bracewell and Mr. Cinotto attended a presentation by the direct mail solicitation firm MCS Direct (aka Mail Computer Services, Inc.), on strategies for direct mail fundraising by charities. Following its seminar presentation, MCS Direct expressed interest in pursuing a vendor relationship with SHC.

On May 14, 2007, representatives of MCS Direct and PEP Direct<sup>22</sup> made marketing presentations to Mr. Semb, Mr. Bracewell, Mr. Cinotto and Mr. McGonigal. The MCS Direct presentation was apparently very poor and did not impress the SHC group. Mr. McGonigal reported to the group that he had discovered an apparent joint venture relationship between MCS

<sup>20</sup> This meeting apparently failed to comply with the provisions of §207.9 of the Bylaws of AAONMS, requiring that minutes of meetings of the Board of Directors and Imperial Divan to be kept and "Where matters related to [SHC] ... have been mentioned or discussed, copies of complete and accurate minutes reflecting such subject matter and discussions shall be promptly forwarded to all directors and trustees of [SHC]." See also SHC Bylaws §§ 506.9 and 507.4(c) for corresponding provisions. These provisions were added to the Bylaws of the respective organizations in 1999 to make decisions of the Joint Boards more transparent and to keep all persons involved in SHC operations aware of matters under discussion by those individuals who serve on either of the Joint Boards, thus prohibiting secretive action, and inhibiting block voting by Directors or Trustees based on agreements or decisions made outside of a meeting of the Joint Boards.

<sup>21</sup> Mr. Cinotto currently serves as the Chairman of the Development Committee.

<sup>22</sup> Mr. Bracewell proposed the inclusion of PEP Direct in these meetings. He did not recollect exactly how he heard about PEP Direct, and the Special Committee does not believe that this contact originated with Vantage Travel or Vantage DMS. The Special Committee is aware of the results of an internal investigation by SHC to explore the existence of any relationships between PEP Direct and Vantage DMS. This investigation disclosed that PEP Direct formerly worked closely with Vantage DMS, but that this relationship largely terminated in late 2004, when PEP Direct was acquired by Quadriga Arts, Inc. and there was no significant relationship at the time of the May, 2007 presentation by PEP Direct.

Direct and Vantage DMS, that was featured on the Vantage DMS website.<sup>23</sup> Mr. Bracewell was upset by mention of this issue and terminated the conversation. The PEP Direct proposal was generally well received by the participants, although Mr. McGonigal noted in an e-mail to Mr. Bracewell, dated May 15, 2007, that it was not in fact comparable to the current arrangement with Barton Cotton and contemplated a higher level of spending for the same or lower returns to SHC. Mr. Bracewell did not receive this message well, and accused Mr. McGonigal of undue loyalty to Barton Cotton. Mr. McGonigal subsequently used information from the proposal by PEP Direct to secure an increased guaranty from Barton Cotton to SHC.

Both Messrs. Bracewell and Semb have indicated to the Special Committee that their only interest in seeking proposals from vendors such as Convergence, MCS Direct and PEP Direct was to assure that SHC considered competitive alternatives in direct mail vendors. Mr. McGonigal has expressed sympathy with this view, and has affirmed his willingness to evaluate alternative proposals. He noted that there were, in his mind strong efforts by these individuals to cause SHC to do more than just consider options, but rather to push the business to these alternate firms, without due regard for the performance of Barton Cotton or its rights under existing contracts with SHC.

Within a month after May presentations, Mr. Bracewell began limiting his contact with Mr. McGonigal and to raise a number of performance related issues, involving problems at the hospitals in St. Louis and Hawaii. Mr. McGonigal believes that this change in attitude was in some way related to his assessment of the direct mail proposals and rebuff of efforts to replace Barton Cotton.

It appears that efforts by Vantage DMS to secure SHC business continued into late 2007. Mr. Cinotto reports a meeting in November, 2007 with Mr. Semb, in Mr. Semb's office at SHC Headquarters, in which Mr. Semb related that he and Mr. Bracewell had communicated with Mr. Lewis of Vantage DMS and that Vantage DMS was prepared to offer whatever was necessary to buy out SHC's obligations to Barton Cotton. Mr. Cinotto rejected this idea, as he had come to believe the Messrs. Semb and Bracewell were not simply motivated by an interest in improving

<sup>23</sup> The Special Committee has seen screenshots from the Vantage DMS website describing the joint venture, which reflects a copyright date of 2006. At the present time, there is no such content on either firm's website, but a Google search (as of the date of this Interim Report) of the words "MCS Direct Vantage" readily brings up a cached page from the Vantage DMS website describing the venture. The Special Committee was informed by Mr. Bracewell in his interview of November 2, 2007, that he had a lawyer investigate the relationship between Vantage DMS and MCS Direct and his lawyer concluded that there was no joint venture or other relationship between the firms. He stated that this report had been provided to Mr. Fleisher. Mr. Fleisher denies ever having received such a report. In an interview with the Special Committee on April 2, 2008, Mr. Bracewell produced a very short and after the fact letter from Henry Melikian of Vantage Financial Services, dated November 8, 2007 (following the date of his first interview with the Special Committee at which he mentioned an investigation by his own lawyer), denying any "affiliation" between Vantage and MCS Direct. Since the word affiliation was not defined in Mr. Melikian's letter, and is susceptible to a variety of different interpretations and because the letter is not clear as to which Vantage related entity the denial pertains, the Special Committee places little weight on this letter as establishing the lack of ties between Vantage DMS and MCS Direct. Mr. Bracewell was unable to explain the presence of contrary information on the Internet, although it is possible that whatever relationship existed between Vantage DMS and MCS Direct had been terminated by November 2007.

the SHC direct mail solicitation program, but had a particular interest in Vantage DMS regarding the business. Messrs. Semb and Braccwell have denied that they had any such communications with Mr. Lewis or Mr. Cinotto. They reported that their only recent communications with Mr. Lewis concerned the possibility that Mr. Lewis would make a major gift to SHC out of the proceeds of the sale of one his businesses. This gift has never materialized.

**IV. Willard Fawcett**

Mr. Fawcett resigned as Controller of SHC in January, 2008 after a career with SHC stretching back over 25 years. In his exit interview with Ms. Deary, he stated that he felt as though he had been forced out, and passed over for promotion to the position of Chief Financial Officer. He also stated that senior SHC individuals, including Mr. Full and Mr. Semb, were disrespectful of him and that his most recent performance evaluation had been "manipulated" by Mr. Full to be more negative than they should have been. More ominously, he claimed that members of the Joint Boards had committed various violations of policy and that Mr. Semb had signed the Internal Revenue Service Form 990 for the year 2006 notwithstanding a letter from Mr. Fawcett attached to the Return that stated concerns about the correctness of information included in the return. He also suggested that Mr. Semb had directed him to "make up whatever information he needed to complete the 990s [sic]". He indicated that he had hired an attorney to pursue claims against SHC that may involve constructive discharge.

The situation with Mr. Fawcett is complicated and the Special Committee is not certain as to the weight that should be given his claims. It appears that he had a very difficult relationship with Mr. Full, as compared to his close relationship with Mr. Full's predecessor, Mr. Molnar. He objected to management reforms that enhance accountability as well as the introduction of the 360° review process. He also disagreed with significant changes in accounting systems and policy implemented by Mr. Full. In 2006, he resigned over a dispute about the level of his compensation and this caused highly charged discussions among the Salary and Personnel Committee and the Joint Boards, which ultimately required adjustment of several salaries to ultimately accommodate Mr. Fawcett. Mr. Fawcett did not enjoy good relations with other Senior Executives and was viewed as a loner on many issues. Nonetheless, given his long tenure with the organization and his sensitive role in handling matters such as expense reports for senior executives and members of the Joint Boards and tax filings, if there are significant problems in financial reporting it is very likely that he is aware of them. The Special Committee has heard from more than one individual their suspicions that Mr. Fawcett has been secreting copies of documents related to potential malfeasance, to use as leverage in the event of his termination, and his statements in the exit interview are consistent with these suspicions.

At present the SHC legal department is engaged in discussions with Mr. Fawcett's lawyer to settle any dispute concerning his resignation. SHC has requested that Mr. Fawcett provide a proffer of documentation that supports his claims of financial irregularities. On March 27, 2008 Mr. Fawcett's lawyer stated that his client had information concerning the following matters: failure to report benefits as income (presumably reimbursement of personal, non-business expenses that should have been reported on either Form W-2 or Form 1099-MISC and Form 990) and business transactions not in the best interests of SHC (presumably involving conflict of interest or private benefit or inurement). The lawyer did not mention the 2006 Form 990 or

related correspondence referred to in Mr. Fawcett's exit interview with Ms. Dean. He also has not provided any actual documentation to substantiate the claims.

It is difficult to evaluate the seriousness of these issues without significant additional investigation. Mr. Fawcett's allegations may be animated by a desire to obtain a significant cash settlement from SHC, and could be embellished by him toward this end. It is entirely sensible to obtain a proffer reflecting serious and substantive matters of concern as a condition to any such settlement. The Special Committee proposes that the investigation continue, hopefully with Mr. Fawcett's cooperation in the identification of specific transactions for study.

Without necessarily crediting any of Mr. Fawcett's allegations, the Special Committee nonetheless has made inquiries of Messrs. Semb and Bracewell, as well as Senior Executive A and Board Members A and B. In its interview with Mr. Semb on March 25, 2008, the Special Committee asked him to address the circumstances concerning the 2006 Form 990. He stated that he did not recollect signing the form, although he attributed this to the fact that he signs a great many documents on behalf of SHC. He did not seem to appreciate that he had not been asked to sign prior Form 990s on behalf of SHC. He denied receiving a letter from Mr. Fawcett detailing any concerns about the form; in fact he noted that he typically looks for an approval by SHC counsel or other Senior Executives of any documents that he executes on behalf of SHC.<sup>24</sup> He also denied ever having a conversation with Mr. Fawcett in which he suggested falsifying any information on the Form 990. The Special Committee also made preliminary inquiries about expense items for Mr. Semb that have been identified to it as questionable,<sup>25</sup> but he has denied any improper reporting or expense reimbursement. In his interview with the Special Committee on April 2, 2008, Mr. Bracewell indicated that he was unaware of any issues concerning his expenses and that he believes he has adequately documented all expenses reimbursed by SHC.

## V. Findings

A. General Observations: In the course of its investigation the Special Committee has taken note of attitudes and behaviors of various individuals within SHC that have contributed to the matters subject to investigation. The historical governance structure of SHC, with volunteer Directors and Trustees exercising senior management authority, creates tension with the Senior Executives and limits the ability of Mr. Full to exercise the type of oversight of management customary for an individual in his position. Without diminishing the dedication and commitment of leaders such as Messrs. Semb and Bracewell to the mission of SHC, the Special Committee has found that these individuals do not approach management of the organization in the same fashion as the professional executives.

The Special Committee has seen evidence of actions taken by members of the Joint Boards on the basis of incomplete information and without regard for views of Senior Executives that differ from the conclusions of the members of the Joint Boards. For example, it was

<sup>24</sup> The Special Committee's counsel has reviewed several agreements executed by Mr. Semb that bear initials of SHC counsel or other Senior Executives indicating approval of the document.

<sup>25</sup> Certain information concerning these expenses has been furnished to the Special Committee by Joint Board Members and a Senior Executive. This information may or may not correlate to the assertions of Mr. Fawcett.

apparent that Messrs. Semb and Bracewell ignored important elements of the 360° review process, including the necessity for confidentiality of identities of the reviewers. When interviewed, both them professed to understand the process, but their actions were inconsistent with those statements.

The abortive attempt to terminate Mr. McGonigal on October 31, 2006 also speaks to these attitudinal issues. Mr. Semb's explanation that he was acting at the direction of Mr. Full is inconsistent with other information received by the Special Committee and appears self-serving. We believe that this was an instance in which, due to his position as President of SHC, Mr. Semb felt it was within his prerogative to terminate a Senior Executive, and he took this action without sufficient regard for any support for the decision in the personnel records of Mr. McGonigal. The Special Committee views such exercise of authority as potentially very dangerous for the organization in an era in which employment termination decisions are frequently litigated at considerable expense and loss to employers. The McGonigal termination meeting does not appear to be an isolated incident. Senior Executive B described a "culture of fear" among senior management at SHC as a consequence of the actions of individuals such as Messrs. Semb and Bracewell, often accompanied by the implicit threat of termination of employment if headquarters personnel do not bend to their will.<sup>26</sup> Comments of other Senior Executive are consistent with this perception.

The Special Committee has also noted evidence of an attitude of entitlement among members of the Joint Boards. These individuals actively campaign for their seats on the Joint Boards (at considerable personal expense) and are very concerned about protecting their positions once elected. This concern was highlighted by Messrs. Smith and Madsen in the initial meeting of the Special Committee. One of these individuals stated that he was willing to serve on the Special Committee, but that his service would effectively mean the termination of his tenure on the Joint Boards. The remaining members of the Special Committee understood this to mean that if the results of the investigation were critical of Messrs. Semb and/or Bracewell there could be retaliation directed at the members of the Special Committee, presumably in the form of denial of key Committee assignments.

There is also competition for appointment to the Chairmanship of key Committees of the Joint Boards and the appointments process represents a means of rewarding allies of the Imperial Potentate and Chairman of the Board of Trustees. Consequently, dissent from the views of these senior leaders is rare, particularly among the members of the Board of Directors. In addition, Committee Chairmanships appear to be coveted because these offices carry with them access to significant financial resources, authority over important contractual and transactional affairs of the corporation and the ability to travel first class extensively at the expense of SHC. Due to the disparity in resources between AAONMS and SHC, it is thought that Members of the Board of Directors in particular seek access to perquisites associated with participation on key

<sup>26</sup> Mr. Semb expressed surprise that such a statement would have been made to the Special Committee, as he regards his relationships with senior management, particularly Mr. Full, to be constructive and good. He maintains that he has "never overruled" a decision by management. This appears to be inconsistent with the weight of information received by the Special Committee from other individuals interviewed.

Committees. The Special Committee does not mean to imply that this authority is exercised improperly in most circumstances. To the contrary, the proper performance of the duties delegated to the Trustee Officers and Committee Chairs under the existing SHC Bylaws unquestionably requires significant time, and the management of over 20 far flung facilities will inevitably involve travel by key Officers and Committee members. In view of recent Internal Revenue Service guidance and investigations of leading charities by State Attorneys General and the United States Senate Finance Committee,<sup>27</sup> it is important that SHC be circumspect about expenditures by Officers, Directors and Trustees. In the absence of a robust and accountable system of internal financial accounting and expenditure controls, there is the prospect of abuse of perquisites in violation of federal and state tax and charitable trust laws.<sup>28</sup> The issues identified by Mr. Fawcett are exactly the sort of potential problems that could arise in the existing management culture.

The Special Committee is also concerned about the certain aspects of its interviews with Messrs. Semb and Bracewell. In the case of Mr. Semb, we note that matters on which his accounts did not square with the other (sometimes multiple) sources of information or he had no clear recollection of situations for which other individuals recounted a very definite role on his part. The inconsistencies and lapses in memory are generally self-serving. It is particularly significant that he has limited recollection concerning the 2006 Form 990, although he acknowledged that he did in fact execute it. The Special Committee can readily empathize with the demands on him to sign large numbers of papers on behalf of SHC and the general principle that he looks for an approval of documents that he signs on behalf of the organization. His failure to have a specific recollection about a document as important as the Form 990, especially since he had never been asked to sign it in prior years, raises serious concerns about his actions and the credibility of his denial of the statements made by Mr. Fawcett.

Mr. Bracewell admitted to fellow members of the Joint Boards at the meeting in November, 2007, that he secretly tape recorded the Special Committee's interview with him on November 2, 2007. Apparently he consulted legal counsel on this point prior to the interview and was advised, correctly, that Georgia law permits the taping of a phone conversation so long as at least one person consents. Unfortunately, he apparently did not seek advice on whether this rule would apply when the participants on the call are in different states, some of which require consent of all parties to be tape recording of a telephone conversation. In this instance, two of the participants are in states that require mutual consent, and Mr. Bracewell's actions were

<sup>27</sup> Examples of organizations that have been the target of recent state and federal investigations are The J. Paul Getty Trust (excessive compensation to CEO, abuse of perquisites and benefits and lack of Board oversight), American University (improper expenses by University President), Allegheny Health and Education Foundation (excessive compensation and improper expenditures on perquisites, including stadium boxes and corporate aircraft), The Bishop Trust (excessive compensation and perquisites as well as conflicts of interest and lack of Board oversight) and the United Way of America (abuse of perquisites, insider transactions designed to disguise abusive transactions, lack of Board oversight and fraudulent tax filings), Smithsonian Institute (excessive compensation and benefits derived from third parties as a result of position held at Institute), Internal Revenue Service "soft" audits of exempt organizational executive compensation and several Congressional committee investigations and oversight initiatives, particularly by Senator Grassley.

<sup>28</sup> We note the areas highlighted in the KPMG Letter, referred to in Section V.D. as suggestive that the present controls on expense reimbursement may be deficient.

therefore legally questionable. The concern raised is that his behavior, in not seeking consent from the Special Committee in advance, reflected distrust of the Special Committee and is inconsistent with his responsibilities of honesty and candor in his dealings with a body properly constituted by the Imperial Potentate to investigate matters of seriousness to the corporation.

**B. Intervention in the 360° Review Process.** There is no dispute concerning the fact of intervention by Messrs. Semb and Bracewell in the 360° review process for Mr. McGonigal. At best, there is the mitigating factor that they may sincerely believe that Mr. McGonigal is unqualified to continue in his position, and that the best interests of SHC would be served by his dismissal. If that is the case, then there are available processes, working in conjunction with SHC Human Resources and other senior management, to address his status.<sup>29</sup> The Special Committee is mindful that attributes such as a positive personal image and chemistry with other Senior Executives, Officers, Directors, Trustees and local management at the SHC hospitals are critical to effective performance of Mr. McGonigal's job. Judgments on these job criteria are highly subjective as reasonable individuals can differ. As noted at the outset of this Interim Report, the Special Committee has no independent views on Mr. McGonigal's job performance or qualifications.

Senior Executives A and B have indicated that the actions of Messrs. Semb and Bracewell compromised the 360° review process in an unprecedented way. In their view, this breach, which became known to members of the Joint Boards<sup>30</sup> and to Mr. McGonigal, could create serious problems in connection with future decisions concerning his employment status with SHC. The fact that the outcome of the process did not affect Mr. McGonigal's continued employment, and indeed the fact that the 360° review process is not intended to provide a basis for employment termination decisions on Senior Executives, do not excuse the intervention by Messrs. Semb and Bracewell, which can only reasonably be explained by an interest on their part in seeking a basis for his dismissal. The choice of an oblique approach to the replacement of Mr. McGonigal, through intervention in the 360° review process, suggests that Messrs. Semb and Bracewell were attempting to accomplish their purpose through subterfuge rather than by directly making their views known to Senior Executives and the Joint Boards, especially in light of the prior aborted termination of Mr. McGonigal. Even if there were no inference of a motive for their actions in potential conflicts of interest, discussed below, the behavior of Messrs. Semb and Bracewell is inconsistent with the ethical principles cited in Section II above, particularly Sections 503.9(b) and (c) of the SHC Bylaws.

In contravention of Section 503.9(b), their actions have impaired the efficiency and effectiveness in management of the corporation's affairs. Their actions have likely created a situation in which future evaluation of Mr. McGonigal's performance, and any decision on his termination, must be weighted the likely prospect of litigation about whether his termination was

<sup>29</sup> In the Special Committee's interview with Mr. Semb on October 30, 2007, he indicated that he had no current intention to seek Mr. McGonigal's termination, and that any determination as to his status would be made by Mr. Full. We are not certain whether this statement is a response to the investigation or represents a true change in attitude toward management processes.

<sup>30</sup> Mr. Comer reported his concerns over the contact by Mr. Bracewell to at one least one member of the Joint Boards. As a consequence, we believe it became known to other members.



in retaliation for his opposition to initiatives by Messrs. Semb and Bracewell. In addition, especially in light of the circumstances surrounding Mr. Fawcett's resignation,<sup>11</sup> the Special Committee is concerned that Mr. McGonigal may be privately maintaining information concerning the actions of members of the Joint Boards that he believes may be damaging to SHC. It would not be surprising to discover that he believes that if Messrs. Semb and Bracewell retain their present authority and are supported by the Joint Boards and future officers of SHC, he will be terminated from his position, and he is preparing for that eventuality.<sup>12</sup>

In addition, the demand for inclusion of Messrs. Cotner and Austin in the review process and Mr. Bracewell's communications with them are inconsistent with Section 503.9(c), in that they represented their authority to act when in fact they were not authorized to intercede in the process. Mr. Semb has indicated that he viewed his actions as inherently within his authority to oversee management of SHC by virtue of his office. The Special Committee disagrees on the basis that if Messrs. Semb and Bracewell could take these actions under their general authority as corporate officers, that would completely erode the effect of the Code of Ethics.

C. Conflicts of Interest and Direct Mail: The saga of the direct mail vendor proposals raises potentially serious issues of conflicts of interest and lack of good faith in conducting the affairs of SHC. In order to appreciate this conclusion, it is necessary to recount certain background concerning a relationship between Vantage Financial Services, Inc. ("Vantage FS") and SHC during the period between June, 1999 and December, 2003. SHC had contracted with Vantage FS to provide direct mail solicitation services, including development of a rather extensive mailing list of prospective donors. The business relationship ultimately proved unsatisfactory to SHC, as the return from the direct mail campaign was very low as against other solicitation efforts on behalf of charities like SHC. The final accounting for the VFS/SHC direct mail program indicated that SHC received net donations of \$2,514,694 out of gross donations of \$46,155,104, or 5.4%.<sup>13</sup> In contrast, fees paid to VFS (which included costs incurred by VFS in providing direct mail services, which costs reduce profits realized by VFS) amounted to \$43,344,899, or 93.9% of the amounts received. By way of contrast, for the years 2005-2007 returns to SHC from the Barton Cotton direct mail program amounted to \$10,971,761 out of gross donations of \$23,903,781 or 45.9%.

During the term of the SHC contract, VFS was investigated by the United States Postal Service and charged with misuse of charitable organization mailing privileges involving 78 million pieces of mail. The Postal Service complaint indicated that VFS had engaged in a practice of entering into secret side letters with charities under which VFS had a financial stake

<sup>11</sup> It may not be confidential that Mr. Fawcett has alleged irregularities in his 360° evaluation. While the Special Committee has no information as to whether Mr. Fawcett is aware of the issues under investigation, including the problems with Mr. McGonigal's 360° evaluation, we have found that there are few secrets within SHC and information imparted to Senior Executives or members of the Joint Boards becomes known to others.

<sup>12</sup> The Special Committee has had this view related to it in interviews with Board Member A and Senior Executives A and B.

<sup>13</sup> The amounts shown were compiled by Mr. Fawcett. Mr. Chip Jones, the Imperial Auditor, referred to similar numbers as the results of the Vantage Program at the Joint Boards Meeting in April, 2006.

in the proceeds of the mailings.<sup>34</sup> Mr. Lewis was directly implicated in the Postal Service proceedings and he, other senior executives of VFS and the corporation faced criminal charges, which were ultimately settled in October, 2003, with a payment by VFS of a fine of \$4.5 million without admission of guilt by VFS or its executives.

As a consequence of the tortuous history of the VFS relationship, the Joint Boards determined not to renew the contract with VFS, and the contract was terminated by mutual agreement of the parties in December, 2003. Under the terms of the letter of termination, SHC paid VFS all amounts due under the contract and was entitled to all of its donor lists and related information.<sup>35</sup>

Vantage Travel has a long history with AAONMS, in arranging group travel and cruises for members of the Shrine. There is a tradition that each incoming Imperial Potentate arranges a cruise or similar trip for members of the Imperial Divan and other key Shriners. It is a normal business practice of Vantage Travel (and for that matter other cruise operators) to provide complimentary passage to the leaders of organizations that sponsor large tour groups.<sup>36</sup> In addition, it appears that Vantage Travel uses its tour business to promote the services of its affiliated companies, and apparently has made use of free passage on cruises to drive business to its direct mail marketing enterprise.<sup>37</sup>

The Special Committee is aware of participation by Mr. Bracewell on cruises arranged by Vantage Travel, and at least some of these have been provided to him at no charge, or on the basis of his payment of transport to dockside, on a nominal fee. Mr. Semb has indicated that he has not participated in a Vantage Travel arranged cruise, at least since 1999. Nonetheless he is very familiar with Mr. Lewis and the Vantage organizations and we believe that he is aware that Mr. Bracewell has taken advantage of cruise opportunities through Vantage Travel.

The May, 2006 meeting in the Vantage Travel offices in Boston was at best inappropriate, given the conflict of interest policy of SHC. Mr. Bracewell advised the Special Committee that the meeting was arranged in Boston as a convenience, because Messrs. McGonigal, Bracewell and Semb were scheduled to be there, and yet he professes that he did not

<sup>34</sup> The Special Committee is not aware of any evidence indicating that VFS had any such arrangement with SHC.

<sup>35</sup> At the April 2006 meeting of the Joint Boards, Mr. Semb made statements that could only be viewed as supportive of the work Vantage had done for SHC, and noted that despite the "hullabaloo" over Vantage, they had raised money for SHC. After he was contradicted by Mr. Jones as to the relatively small returns from the Vantage program and Mr. Frank Roth, as to the business reputation of Vantage, he relented. This exchange, in the context of the other events in this narrative, suggests that Mr. Semb may not have been sensitive at all to the seriousness of the Vantage problems and the risks of further entanglements with Vantage DMS. In his interview with the Special Committee on March 25, 2008, he expressed the view that all of the direct marketing firms behave in unethical manners to attract business. This statement is also at odds with his behavior relative to Vantage described in this Interim Report and reflects on his candor to the Special Committee.

<sup>36</sup> A recent Vantage Travel brochure indicates that free passage will be provided to the leader of any group with in excess of 10 fare paying individuals.

<sup>37</sup> The internal investigation into relationships between Vantage Travel, Vantage DMS and PEP Direct, referred to in note 21, also disclosed that Vantage Travel used complimentary cruise packages to drive business to its direct mail affiliates, and that his practice was unique among direct mail solicitation firms.

understand there to be any relationships between Convergence and Vantage DMS. This is difficult to credit, as the meeting was suggested by Mr. Lewis of Vantage DMS. Convergence is based in Bethesda, Maryland, and it is unlikely that its representatives would choose to schedule a meeting with SHC at Vantage Travel's offices, or that Vantage Travel would host the meeting, if Vantage DMS were not involved. This is borne out by the uncontroverted fact that the presentation materials indicated a joint venture between the two firms to provide the services.<sup>38</sup>

Viewing the circumstances in the light most favorable to Messrs. Bracewell and Semb, and assuming that Mr. Bracewell was genuinely surprised that Vantage DMS would have a role in the proposal, his subsequent actions are not consistent with his reported statements that SHC could not do business with Vantage DMS or other Vantage-related companies. Mr. McGonigal has indicated that the Convergence proposal was effectively identical to the presentation at the meeting in Boston. Mr. Bracewell spoke in favor of the Convergence proposal at a Imperial Divan retreat in August, 2006, notwithstanding Mr. McGonigal's conclusion that it was not favorable to SHC. If Mr. Bracewell was legitimately taken unawares that Vantage DMS would participate in such a proposal, he failed to demonstrate any skepticism concerning doing business with Convergence, which would have seemed warranted. Instead he strongly objected to the implication that Vantage DMS was behind the Convergence bid and criticized Mr. McGonigal for allegedly leaking the facts of the joint presentation in Boston.

Mr. Bracewell remained in contact with Convergence and Vantage DMS. While it may have made sense for him to discuss things with Convergence, if it were truly independent of Vantage DMS, we see no reason why he should have communications with Vantage DMS in view of his other statements. Further, his comments to Senior Executive C in December, 2006 reflect an awareness that there is a linkage between participation on Vantage Travel cruises by leaders of AAONMS who also happen to be on the Joint Boards and driving business to other Vantage-related businesses. This fits precisely with what the Special Committee has come to understand as Vantage's marketing strategy, of using cruise packages to win business for other units.

The April, 2007 Vantage cruise, on which Messrs. Bracewell and Cinotto attended the presentation by MCS Direct, also fits this pattern. It would seem inconsistent with what the Special Committee has come to understand are Vantage's business practices, for Vantage Travel to permit companies to market services to their cruise customers without some benefit to Vantage. At the very least this should have been cause for some suspicion concerning linkage between MCS Direct and Vantage DMS. Not surprisingly, the relationship between Vantage DMS and MCS Direct became evident and was apparently exposed by Mr. McGonigal at the time of the May, 2007 presentations.

The alleged proposal by Vantage DMS to buy out SHC's contractual obligations to Barton Cotton (which had just been renewed in November, 2007), so that Vantage DMS could

<sup>38</sup> It appears that Vantage DMS regularly contracts out large portions of the work associated with conducting charitable solicitation campaigns. We understand that PEP Direct provided considerable back office and production support for Vantage DMS at the time that SHC had previously contracted with Vantage DMS and it is likely that Convergence may have been involved to support Vantage DMS if the proposal had been accepted.

become the direct mail vendor to SHC, is further evidence that Messrs. Semb and Bracewell were entertaining the prospect of business relationships with Vantage DMS in spite of the Joint Boards contrary statements on this point. Aside from the prospective conflict of interest considerations, such a proposal would have created possible liability for SHC and Vantage DMS for interference with Barton Colton's contractual relationship.

The continuing contact with Vantage Travel and Vantage DMS cannot be reconciled with the explanations offered by Messrs. Semb and Bracewell, and creates a very strong inference that there is some motivation for them to have involvement in what was a series of proposals that appeared to emanate from Vantage, directly or indirectly. These facts also suggest that they are at best insensitive to the seriousness of the prior problems with VFS and indifferent to the risks of future relationships with Vantage DMS or affiliated companies.<sup>19</sup> A favorist suggests the type of behavior that is the reason for having the Conflict of Interest Policy.

While the Special Committee can appreciate that there are plausibly innocent explanations for individual events in this chain viewed in isolation, these explanations grow increasing tenuous in the context of what is clearly a pattern of actions by Vantage DMS to become a vendor to SHC. The SHC Conflict of Interest Policy specifically addresses gifts, gratuities or favors received by a covered person "under circumstances where it might be inferred that such action was intended to influence or would possibly influence the director, trustee, officer or employee in the performance of his duties." The policy also requires that any member who may have a conflict of interest is required to make a record of such and "refrain from voting or directly or indirectly influencing, or attempting to influence, the vote of the directors or trustees." The fact that SHC did not actually transact business with Vantage DMS or MCS Direct does not relieve the taint of potential conflict of interest.

Measured against this standard, Mr. Bracewell's conduct violates the Conflict of Interest Policy. While the Special Committee is unable to determine the extent of personal benefits he received from Vantage Travel, he has unquestionably received some value, at the very least for the April, 2007 cruise, for which he stated to Board Member A and confirmed to the Special

<sup>19</sup> Under Internal Revenue Code § 171(c)(3) and Treasury Regulations § 1.501(c)(3)-1, an organization exempt from federal income tax may not engage in any transaction that results in private inurement or impermissible private benefit. For this purpose, private inurement results if an insider (one who has substantial influence over the charitable organization such as trustees, directors, and key officers including the CEO, President and CFO) receives assets of the charitable organization without providing to the charitable organization fair value in return. The consequences of violation of the private inurement rules range from the imposition of excise taxes on the insider and the persons with the charitable organization that approve the "excess benefit" transaction to revocation of the exempt status of the charitable organization. Private benefits are permissible when the benefit conferred upon a private person is not merely incidental to the achievement of charitable purposes of the charitable organization. The private benefit must be incidental both qualitatively and quantitatively. Qualitatively incidental means that private benefit is merely a byproduct of achieving the charitable purpose or benefit. To be quantitatively incidental, the private benefit must be insubstantial in an amount compared to the charitable purpose or benefit. The great disparity in returns to SHC under the prior VFS arrangement as opposed to the Barton Colton arrangement, should have given individuals evaluating any proposals from any Vantage-related entity pause, at the very least, that such a relationship might involve private benefit. The fact that VFS was involved in activity that resulted in serious federal charges should also have been taken into account by these individuals, as it was by the Joint Boards in determining not to do further business with VFS in 2003.

Committee on April 2, 2008, that he received complimentary passage.<sup>40</sup> Under the terms of the Conflict of Interest Policy, this should have been disclosed and Mr. Bracewell should not have participated in any discussions involving potential dealings with Vantage DMS or companies affiliated with it in or 2007. Instead he participated in the discussion of the Convergence proposal and the presentations on May 14, 2007, apparently without consideration of any possible relationship between MCS Direct and Vantage DMS. This might have been understandable had the events surrounding the May, 2006 meeting with Vantage DMS and Convergence in Boston not transpired. Mr. McGonigal was sufficiently wary, based on his prior experience, to investigate the link between MCS Direct and Vantage DMS, and with apparently minimal effort discovered evidence of a relationship. At best Mr. Bracewell was inattentive to this issue, but given his professed long history with the Lewis family and knowledge of Vantage, his inattention is not excusable. Messrs. Cinotto and McGonigal have formed a view based on their work with Mr. Bracewell that he has been an advocate for business relationships with these companies affiliated with Vantage Travel and has attempted to influence the thinking of others.

While Mr. Semb has denied receiving any benefits directly or indirectly from Vantage Travel or Vantage DMS during the relevant period, and the Special Committee is not aware of any evidence to the contrary, there is little doubt that he has been involved with Mr. Bracewell's efforts to promote alternative direct mail vendors proposed by and through contacts with Vantage Travel, and has had independent contacts with Mr. Lewis. His support for Mr. Bracewell's initiatives can be considered to be enabling conduct that violates the Conflict of Interest Policy and constitutes a serious breach of duty in its own right.

The impact of the conflict of interest problems is magnified to the extent that it relates to the efforts to remove Mr. McGonigal. The timing of the November, 2006 termination meeting and the intervention in the 360° review process follow closely on the rejection of proposals that came as a result of contacts with Vantage Travel. As noted before, individual events in isolation may admit of alternative explanations, but given the repeated sequence of proposals originating from suspicious sources as well as the reactions by Messrs. Bracewell and Semb to both the rejection of these proposals and the implication that Vantage Travel or Vantage DMS was involved directly or behind the scenes, the Special Committee sees a pattern of conduct that is most readily explained by a motivation to drive the direct mail business toward particular vendors and to silence opposition to their plans.

**D. Fawcett Allegations.** As noted, the Special Committee has been unable to conduct a thorough investigation of the allegations made by Mr. Fawcett in his exit interview, and has no views as to whether his statements are credible. However, it would be extraordinarily irresponsible for the Joint Boards to ignore the statements that he made in his exit interview, as they relate to matters that are extremely serious and would require prompt corrective action by SHC.

<sup>40</sup> Mr. Cinotto has advised the Special Committee that he paid the requisite fare for the cruise and therefore his participation in the consideration of the MCS Direct proposal would not violate the Conflict of Interest Policy.

If Mr. Fawcett's claims can be substantiated, SHC could face liability for so-called "excess benefit transactions" under the Internal Revenue Service intermediate sanctions regime.<sup>41</sup> An excess benefit transaction occurs when an insider, e.g., a key officer (such as President, CEO or CFO) or director of a charitable organization, who has power to influence the charity, obtains an amount of money or other benefits from the organization in an amount that is not commensurate with the value provided to the organization. Thus far, what we know of Mr. Fawcett's allegations include improper reimbursement of expenses that did not further the exempt purposes of SHC and contracts that were not in the best interests of SHC and may have involved self-interest on the part of members of the Joint Boards. An insider who is involved in excess benefit transactions may face liability for excise taxes ranging from 25% of the excess benefits from the transaction (plus possible failure to report penalties and interest costs) to 200% of the excess benefits from the transaction, (plus possible failure to report penalties and interest costs), if the insider does not correct the excess benefit and restore all losses to the charitable organization.<sup>42</sup> In addition, the Internal Revenue Service can impose personal penalties up to \$20,000 per transaction, in the aggregate, on all individuals who approve an excess benefit transaction.<sup>43</sup> The Internal Revenue Service may also revoke the exempt status of the organization.<sup>44</sup>

Of greater concern is Mr. Fawcett's allegation (which, we emphasize is unsubstantiated at this time) that the 2006 Form 990 may include improper reporting of certain items, and that the form was executed by Mr. Semb notwithstanding the identification by Mr. Fawcett of irregularities in the return. If this allegation turns out to be correct, SHC and Mr. Semb would face very severe consequences.

Even if any financial irregularities discovered do not implicate criminal liability, their existence may reflect a breakdown in internal financial controls and lack of oversight by the Joint Boards. It is essential that matters that may be specifically identified by Mr. Fawcett be investigated and addressed with dispatch and that SHC undertake to determine on its own initiative whether there are potential issues involving expenditures by Officers, Directors, Trustees and Senior Executives that are inconsistent with the tax laws and the exempt status of

<sup>41</sup> Internal Revenue Code § 4958 et seq. and Treasury Regulations § 53.4958 et seq.

<sup>42</sup> Internal Revenue Code §§ 4941, 4958.

<sup>43</sup> Internal Revenue Code § 4958(d)(2).

<sup>44</sup> New Treasury Regulations concerning the revocation of exemption were issued on March 28, 2008, 73 Fed. Reg. 16519 (3/28/08). The factors that are considered in determining whether revocation is appropriate when there is an excess benefit transaction have been finalized without major revisions. These factors include: (1) The size and scope of the organization's regular and ongoing exempt activities; (2) The size and scope of the excess benefit transactions in relation to the size and scope of the organization's regular and ongoing exempt activities; (3) Whether the organization has been involved in multiple excess benefit transactions with one or more persons; (4) Whether the organization has implemented safeguards that are reasonably calculated to prevent excess benefit transactions; and (5) Whether the excess benefit transaction has been corrected, or the organization has made good faith efforts to seek correction from the disqualified persons who benefited from the excess benefit transaction. All factors are considered in combination with each other, and the IRS may assign greater or lesser weight to some factors than to others. The fourth and fifth factors will weigh more heavily in favor of continued tax-exempt status if the organization discovers and takes action with respect to the excess benefit transactions before the IRS discovers them.

SHC.<sup>45</sup> The management letter from SHC's outside auditors at KPMG, dated April 6, 2007 (the "KPMG Letter"), identified a number of significant issues concerning expense reimbursement policy that require prompt attention, and review of the expense items described in the KPMG Letter may yield evidence of transactions that require corrective action.<sup>46</sup>

## VI. Recommendations.

Based on its findings, the Special Committee makes the following recommendations to the Imperial Potentate, for his consideration and presentation to the Joint Boards:

1. The reprimand of Messrs. Semb and Bracewell for violation of the Conflict of Interest Policy and the reporting of any reprimand to the Members of SHC at its Annual Meeting. The reprimand should also make reference to violations of the Code of Ethics of SHC and of AADNMS.
2. Further investigation by the Special Committee into the allegations made by Mr. Fawcett, including investigatory work by both internal accounting personnel and Senior Executives at SHC as well as independent forensic accounting work to be performed by Deloitte & Touche Forensic Advisory Services.
3. Authorization of all necessary actions to address the matters identified in the KPMG Letter with respect to expense reimbursement policies and review of reimbursement records of the Members of the Joint Boards and Senior Executives to determine whether there is a need for corrective action with respect to reporting or recovery of reimbursement amounts.
4. Amendment of the Conflict of Interest Policy and the Bylaws to (a) vest authority in a designated full-time member of the Legal Department of SHC to determine in advance whether any conflict of interest exists with respect to any transaction, on the request of a Member of the Joint Boards, an Officer or a Senior Executive and (b) vest authority in a designated Committee of the Joint Boards, which may be a newly organized Corporate Compliance Committee, to investigate and report to the Joint Boards on any potential violation of the Conflict of Interest Policy.
5. Amendment of the SHC Bylaws to debar from business with SHC any entity that provides or offers any gifts, gratuities or favors to any member of the Joint Boards, any Officer or Senior Executive of SHC.

<sup>45</sup> The Special Committee is aware that an internal review of the extent of reimbursement for travel by spouses of the members of the Joint Boards, and whether such reimbursement was reported as income to those individuals is underway at this time. That is a mere starting point in determining whether there are significant compliance issues related to expense reimbursement that will require action by management of SHC and ultimately the Joint Boards.

<sup>46</sup> The Special Committee is concerned that these issues were raised only in the KPMG Letter, commenting on the financial statements for the year ended December 31, 2006, and not in any of the prior four years' management letters, as the practices noted in the KPMG Letter have likely existed for some time. A significant internal review will be required to determine whether there are material compliance issues to be addressed, and consideration should be given to external independent evaluation of any findings.

6. Implementation of program for corporate compliance, including a hotline or other similar confidential means for employees, Senior Executives, Trustees or Directors to report suspected incidents or corporate wrongdoing, conflict of interest, violations of corporate policy or violations of law, and which requires confidential investigation of any such reports and reporting to appropriate corporate authorities for resolution and corrective action.

Respectfully submitted,

**THE SPECIAL INVESTIGATIVE  
COMMITTEE OF THE JOINT BOARDS OF  
SHRINERS HOSPITALS FOR CHILDREN**

**Mahlon W. Hessey, P.P.**

**John C. Nobles, Past Imperial Potentate**

**Robert N. Turpinseed, Past Imperial Potentate**

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