

Conflicting Interests

Practical tips on what to do and how to do it

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Charities are facing heightened scrutiny today from both regulators and the general public in situations where their directors, officers, and other insiders derive (or appear to derive) personal benefits from the organization. Although conflicts of interest have traditionally fallen within the purview of state regulators, conflicts are more important than ever before due to the Internal Revenue Service's (IRS) recent introduction of the revised Form 990.

The new Form 990, which emphasizes transparency, requires filers to complete a separate schedule devoted entirely to the public disclosure of transactions involving interested individuals. Not every transaction involving a conflict is illegal or impermissible. But, they can lead to significant legal compliance issues and can also pose serious reputation risks for charities in the eyes of the public if they are not properly addressed. In this environment, it is essential for charities to maintain safeguards to avoid even the appearance of impropriety.

The adoption of a comprehensive conflict of interest policy is critical to protect a charity and to prevent its directors from violating fiduciary obligations and self-dealing rules. Charities are encouraged to go beyond just the policy by implementing detailed conflict procedure guidelines to ensure legal compliance and to protect against potential damage to the organization's reputation.

THE PURPOSE OF THE POLICY

Board members and management owe a fiduciary duty of loyalty to the charity they serve, which requires that directors and officers exercise their powers with undivided allegiance. The duty of loyalty prohibits directors and other insiders from engaging in impermissible self-dealing. At the same time, board members are often chosen because of their experience and ability to make valuable resources available on favorable terms.

The purpose of a conflict of interest policy is to protect the best interests of a charitable organization when it contemplates

entering into a contract or other transaction that could benefit the private interest of an organization's officers, directors, key employees or certain other individuals (such as close family members or business interests).

Although a contract or transaction that involves a conflict of interest does not alone require that the organization avoid the arrangement altogether, it does require special attention by the board in deciding whether to authorize the arrangement. Conflict policies help ensure that when an actual or potential conflict arises, proper procedures are in place to address the situation. At a minimum, the policy should specify who is covered by the policy (commonly referred to as "interested persons"), how individuals should disclose to the organization potential or actual conflicts, and what the procedures are for considering and resolving conflicts.

THE POLICY

There are several important elements that should be included in every effective conflict of interest policy. First and foremost, the policy should begin with a purpose clause that clearly states the policy is intended to protect the charity's best interests when it is contemplating entering into a transaction that could confer excess benefits on an interested person.

The policy should also establish the meaning of important terms. Here, at least three definitions should always be included. The policy should clearly define the "interested persons" covered by the policy and when such persons have a "financial interest" that would give rise to a conflict of interest. The IRS's sample conflict policy considers "interested persons" to be directors, officers, or committee members who have a financial interest in transactions with the charity. However, many charities might prefer to expand the definition to include senior executives and staff.

Examples of situations where an insider has a "financial interest" include one in which an insider has a significant ownership interest in a company that provides goods or services to the charity or where an insider sits on the board of another organi-

zation that is the potential recipient of a grant from the charity.

"Compensation" should also be clearly defined to include direct and indirect remuneration as well as substantial gifts and favors. A gift or favor may be defined in such a way that it is only considered "substantial" if it is valued above a certain capped amount. This amount may vary depending on the activities of the charity.

THE PROCEDURES

The policy should establish procedures for the board to follow with respect to conflicts of interest. In general, the following steps should be required. First, the material facts relating to the potential conflict of interest should be disclosed to the board.

Next, although it might be permissible under state law for interested directors to be counted when determining the presence of a quorum at the board meeting which authorizes the transaction, it is advisable that the policy specify that interested direc-

tion to determine if the organization can, using reasonable efforts, obtain a more advantageous transaction that will not lead to a conflict of interest. If an alternative is not possible or readily obtainable, disinterested members of the board may determine whether the transaction is in the organization's best interest and whether it is fair and reasonable.

In the event that there are no remaining disinterested directors to vote on the matter, the board could appoint a committee composed of independent outsiders to examine and vote to authorize the transaction on behalf of the board. Large boards in particular might also consider establishing a special committee to initially vet situations involving conflicts and to make threshold determinations before bringing the matter to the full board.

As with other important board decisions, any time a transaction involving an actual or potential conflict is addressed at a board or committee meeting, the minutes of that meeting should reflect who participated in the discussions, the basis for the board or committee's decision on the transaction, and the basis for determining whether the transaction was or was not in the organization's best interest.

THE ANNUAL DISCLOSURE

Conflict disclosure questionnaires are a key element of good governance practices for charities when dealing with conflicts of interest. On an annual basis, a charity should distribute its conflict policy and require directors, officers, key employees, and committee members to complete a questionnaire in which all potential and actual conflicts are disclosed.

The questionnaire should prompt insiders to disclose various situations which could lead to conflicts, including any financial interests in or membership on the board of entities doing business or associated with the charity, any compensation received from the charity, any affiliation with an entity that might compete with the charity, and any relationships (whether by family or business) to any other officer, director, or key employee of the charity. The

5 Tips For Conflict Compliance

- Adopt a comprehensive conflict of interest policy.
- Annually distribute disclosure questionnaires to directors, officers and key employees.
- Create a conflict decision tree to address conflict scenarios before they arise.
- Educate the board and staff on the importance of conflict disclosure.
- Review the conflict policy periodically to make sure it continues to meet the organization's needs.

tors will not be present at the time the board discusses and votes on whether to authorize the transaction.

Finally, the remaining disinterested board members should make the final determination of whether a conflict exists and whether to authorize the transaction. To do so, they should review all material information related to the transaction and investigate alternatives to the proposed transac-

disclosure statement can be customized to address the specific needs and activities of a particular charity.

As a helpful way of reminding directors, officers, and other insiders of their special duties to the organization, the annual questionnaire should include a statement to be signed by the individuals affirming that they have read, understood, and agreed to comply with the organization's conflicts policy. This statement should also affirm their understanding that the charity must engage primarily in activities that further its charitable purposes.

The statement may also provide that each individual agrees to fulfill his or her fiduciary obligations to the charity, to protect confidential information, to notify the board of any conflicts involving his or her business interests (or those of his or her family members), and that they will recuse themselves from any board action when a conflict exists.

BEYOND THE POLICY – GUIDELINES AND BEST PRACTICES

Some charities have begun to take the concepts contained in their conflict of interest policies and procedures a step fur-

ther by developing separate comprehensive guidelines as a companion to the conflict policy to help their boards and staff members identify and resolve each conflict situation appropriately. The policy, procedures and guidelines work together to provide clear and consistent guidance to the organization's management and staff in addressing conflicts. Typically, conflict guidelines outline the disclosure, review and approval procedure for various types of conflicts that may arise.

For example, the guidelines might specify how a conflict involving a staff member should be disclosed, reviewed and ultimately resolved, which could differ substantially from the procedures applicable to disclosure by directors or related organizations.

Perhaps the most important tool in thorough conflict guidelines is a conflict of interest decision tree for various circumstances in which conflicts arise. This helpful resource allows the organization to consider different types of conflict scenarios ahead of time and determine what outcome is best for the organization. By answering a series of questions in a particular order, the board or the conflicts review committee is able to uniformly analyze the conflict situa-

tion and reach a recommended course of action, whether that is to authorize the transaction despite the conflict or avoid the arrangement all together.

CONSEQUENCES

Consequences of non-compliance involving conflicts of interest can be severe. State regulators can investigate the organization and its directors, officers, or other key management employees individually to seek various remedies, such as imposing financial sanctions, removing directors (and in extreme cases, replacing the entire board), or seeking criminal penalties for financial mismanagement, such as fraud or embezzlement.

In states that limit the personal liability of volunteer directors, this liability shield usually does not apply to conflict of interest transactions involving such directors. Furthermore, directors and officers insurance might not cover claims involving conflicts. In addition to compliance concerns on the state level, federal regulators also have a strong interest in ensuring that charities adhere to good governance with respect to conflicts of interest.

The IRS has developed extensive rules

against private inurement and private benefit transactions and is empowered to impose harsh financial penalties against individuals and management and, in situations involving egregious violations, to revoke the charity's tax exempt status entirely.

Good governance and compliance flow from the top down, so the burden falls on every nonprofit board to stress the importance of disclosures and to make a regular practice of analyzing and deciding whether to authorize transactions involving conflicts. The best way to ensure that the organization is effectively handling conflicts of interest is to educate the board on this important area of governance and to adhere to a comprehensive conflict of interest policy and procedures supplemented by a carefully considered set of guidelines that is regularly reviewed by the board, officers and top management. *NPT*

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