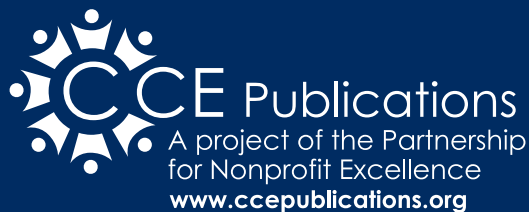


CCE DIALOGUES

Issues and Insights

Identifying and Managing Conflicts of Interest in the Nonprofit Sector

Winter 2009/2010



Managing and identifying conflicts of interest is one of the more important functions of a Board of Directors. It seems that there is a newspaper headline every week that illustrates examples of corporate and board conflicts of interest and self-dealing.

CEOs and Board members—especially the Chair—must recognize the organization's increasing statutory and regulatory obligations. There is oversight at both the Federal Level—the IRS has new disclosure requirements in the Form 990—and many state Attorneys General are taking a hard look at 501(c)(3) entities.

Federal and state laws may not be identical. For example, while section 715 of New York's Nonprofit law only requires directors and officers not participate in any vote in which they are an interested party, Internal Revenue Code section 2941 prohibits any charitable organization from having any part of its net earnings inuring to the benefit of any individual. Perhaps more importantly, even if no laws have been broken, an organization may be faced with an embarrassing public relations event if a conflict becomes known.

These issues may be particularly challenging for a small nonprofit board with few resources and less rigid governance policies. To be sure there may be occasions when a conflict is unavoidable, but even then there are a few core principles that a Board must adhere to.

Directors and Officers must adhere to their duties of loyalty and care. They must be able to deal with potential interested party transactions. All Boards should have procedures in place for identifying and managing conflicts of interest, and the Boards should remember that depending on the facts and circumstances, it may not be prudent to simply comply with minimum legal standards.

The following Legal Dialogue is a project of the Partnership for Nonprofit Excellence. It took place in the Fall of 2009. The panelists for the Dialogue were:

KARYL MAMMANO, Ph.D., Assistant Professor, accounting, finance and MIS at St. John Fisher College. Ms. Mammano is also a Director, Nonprofit Management Education for the Center for Community Engagement.

ANN MARIE COOK, President/CEO, Lifespan of Greater Rochester, Inc.

WILLIAM L. DORR, Esq. Mr. Dorr is a former partner with Harris Beach, LLC and, more recently, the Senior Vice President and Corporate Counsel for The Lifetime Healthcare Companies, Inc.

The discussion was moderated by RALPH W. COX, Esq., the former General Counsel for Excellus Health Plan, Inc.

RALPH: Before we can address how a not-for-profit organization identifies and manages conflicts of interest, I think we need a benchmark of what a conflict of interest is. I'd like your thoughts.

KARYL: My thought is when an individual would benefit personally from the transaction that's being conducted by the organization.

RALPH: What do you mean by a personal benefit?

KARYL: If I am the owner of a company and on the board of an organization, and my company bids to do work for the organization, and I am just a small four person office, I'd want to push for the business, but then I'm going to get a profit because of that business and it's going to benefit me personally.

RALPH: That's an example of a direct, personal benefit. Correct?

KARYL: Correct.

RALPH: Are there other types of conflicts that aren't quite so blatant?

BILL: One came up on a board—interesting, things have a serendipity—I'm on several boards, and on a small board I discovered that a very substantial amount of money is in CD's in a small bank, well over the \$250K FDIC limit for insurance. The money is at a bank that a member of a board is on and he directed it to the bank that he works for. That is not to say that we're not receiving a proper rate of interest, but the thought that I had is, supposing the bank goes under and we have put our money in an uninsured account that is in a bank that employs a board member. While I didn't say out loud that this is a conflict of interest, but at my direction we passed a resolution immediately to move the uninsured money out of that bank and into a different bank—enough money out so that we would have an insured amount in that bank. I don't know that that's a direct conflict of interest that was clearly improper, but I use a more common sense test: it didn't pass the 'smell test.' In other words, this conduct would be difficult to defend to regulators, the general public, and those that have an interest in the board's activities.

ANN MARIE: Taking both definitions we have—I'm reading that a board member can't derive any personal profit, gain *directly* or *indirectly* because of their business affiliation or personal life, and if such, it would be considered a conflict of interest.

BILL: That issue comes up in the BlueCross BlueShield arena, but the law allows both hospital administrators, physicians and other providers to serve on the board. The boards set the rates for physician reimbursement and also have a great deal to do with hospital reimbursement. The law allows those people who have a direct financial interest in the

board's decisions to sit on the boards. So that's a conflict of interest that is allowed by law.

ANN MARIE: Well, I should have said that. Just because we consider it a conflict of interest, doesn't negate them from sitting on the board; but they have to declare that conflict if such a conflict is not known by the board.

BILL: In the BlueCross BlueShield example, they are allowed, not only allowed to sit on the board, but to vote their interests. Before the law was changed, the BlueCross BlueShield boards could be comprised of 50 percent physicians who were voting on their actual reimbursement schedules and they were allowed by law to do that, and they are still allowed by law. Now up to 20 percent can be physicians or providers on the BCBS boards under New York Insurance law.

KARYL: And that was going to be my question. I'm glad they dropped it from 50-20 percent, but you wouldn't want them, anybody who has a conflict that could predominate and gain control over something that's not necessarily good for the organization.

RALPH: We talked about personal interests and financial interests, and direct and indirect benefit. What about an instance where a nonprofit board is really looking for an angel—a large donor—and yet a board member serves on two separate boards and both of the boards he or she is serving on are looking for the same angel. Is there a conflict for the board member to know about what the first board is doing—who they're pursuing—when that information

would be of value to his other board?

ANN MARIE: Clearly, this is an instance where the board member must declare the conflict. The member has a duty of loyalty to this first board.

RALPH: This raises the question of how a board knows of the other affiliations of its members.

ANN MARIE: We ask for each member's résumé and it has to include boards and affiliations.

KARYL: And that's where I look at it too, the same as Ann Marie, and saying, "well, the person should be open about it and then just eliminate themselves from the discussion." But your board meetings aren't open—the nonprofit organizations don't have open laws, where their meetings have to be open, so how much does anybody know what's going on in a board meeting of any other organization unless somebody says something?

RALPH: Are conflicts of interest inherently improper? Can they and should they be avoided?

ANN MARIE: I don't think they're inherently improper. I think that sometimes it becomes an interesting dilemma when you

want individuals on your board who are as knowledgeable as possible in your particular area—for example, for Lifespan, it's aging. But if I get those individuals on the board, they may have a conflict of interest with us. While such members should not be in the majority, I don't think they're inherently improper as long as the potential conflict is disclosed and everyone else on the board understands.

BILL: I think from time to time, I conceive of

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and have seen situations where you actually want the person knowing there's a conflict of interest, but because of that expertise you want that person on your board.

Ralph: So what does a board member do in a situation that involves a conflict of interest? Is the board member a part of the discussion?

BILL: Well first off, full disclosure—the buzzword is *transparency*—so first off you have full disclosure, and then analyze the nature of the conflict. Sometimes it's full disclosure and the board member does not participate in the discussion. Sometimes they remove themselves from the room, and in extreme cases, resign from the board. And all three of those can occur where the conflict of interest filings have to mandate is full disclosure before you even start.

Ralph: Let's discuss hypotheticals. What if the board member is a senior partner in a large law firm in the city where the board is organized. Should that partner's law firm be used for board business?

BILL: My view has always been when I was in practice, I did not think that I personally could do as a good a job if I sat on the board and also gave legal advice. That view, however, is not universal within the legal profession. You can see that lawyers sit on these boards and send the work to their firms.

Ralph: When this issue comes up, what would the Chair do? What types of questions should the Chair be asking about this issue?

BILL: Well, the first thing is: Do you have the necessary skill set to do the work?

Ralph: Do lawyers routinely turn down the work?

BILL: Yes, I think there are times, but you put your finger on it: Large, multi-disciplined law firms want to keep the business.

ANN MARIE: We have had the attorney's lawyer sit on a board. He doesn't sit on the board right now, but any legal work that that firm received, we documented each year's giving to the auditors in the finance committee so people can see it.

Ralph: Would you pay the standard rate or a discount?

ANN MARIE: We got a discounted hourly rate.

Ralph: But still, you have no way of controlling the number of hours, would you?

ANN MARIE: No, but I have to say the bill ... given the fact that's not the only law firm we use ... it's really based on what we need, and the board chair had it, it never looked out of whack. We always got a 30 percent discount off the hourly rate.

KARYL: I know that in many of the professional firms, like the attorneys, and accountants always will give a discount to the nonprofits, anyway, if they want their business, because they look at this as being kind of their help too, to provide services to the community.

Ralph: So, as a Chair or a member of the board, recognizing the fiduciary duty of care and loyalty that you have—what types of questions would you want to ask your board member before permitting the law firm to get the company's business—the entity's business?

BILL: Well, you want to know the level of expertise of the question that's being asked. Some law firms might not be able to handle it. That's the big thing—you want to get the best legal advice you can from whatever source, whatever pool of resources that you have.

ANN MARIE: That's how we measure it. With the agency's law firm—we use them for any real estate dealings, and HR issues, because they're well versed in that, but if we're doing a guardianship work, for instance, for an

older adult, we use a different law firm in turn because they specialize in that. So it's really the specialization of the law firm and, of course, the hourly rate.

RALPH: There are other examples that could present a conflict of interest. One would be if the board member runs a public relations firm and wants to do the advertising campaign for the entity. Is there a problem there?

BILL: There's an inherent problem there. The thing is if it's a garden-variety service that you're purchasing and it's not any particular great expertise, what is the harm to *not* give it to the board member but to give it to somebody else. And then it's as clean and you don't have anybody looking and asking why you're doing certain things. I always believed that if you could find the service or the goods from a non-board member, you're better off. If in fact you can't, or you get a good discount, the board member wants to really help out, as long as it's transparent and someone looks at it to make sure that you're getting value for the dollar, and it's documented. I would say that it's all right.

ANN MARIE: I completely agree about the transparency. That becomes the key thing. For instance, there have been times we have used an advertising firm in which a board member has sat on the board. It has saved us a tremendous amount of time because they know the marketing message—what we're trying to achieve. We've talked about this in board meetings. We don't have to repeat all this information to a new agency. And other times we've felt that another agency was appropriate, but it's the transparency of it that becomes important.

KARYL: And sometimes you look at the small nonprofit boards, and they're really working boards, so you're looking at people with the expertise to help you use some of the things, and this would be especially true with start-up organizations where you want the sweat equity

of the board member, but then going back very transparent. This is what's going on, so that everybody knows that this is going on. Cause there's independence by fact, and independence in appearance, too.

BILL: I agree. I have been asked for legal expertise by boards on which I serve. Start up boards are clearly looking for board members who can in fact bring their outside interests to give things of value, rather than just expertise—the things of value to the organization.

RALPH: Bill, you've talked about transparency and we've touched on the duty of care and duty of loyalty. When you said that the board shopped around for the best rate, is there a paper trail that the board could demonstrate what they actually did to show that they were meeting their fiduciary responsibilities?

BILL: In the minutes we put in that we would shop for the best rate and then come back and say this is the best rate that we could find. So that the next board minutes would say, we looked for the best rate. As to saying, for putting in the minutes or any documents, that this rate, this rate, this rate from these five banks; no, I don't think that that was done. It was done by the minutes. We looked for the best rate—come back—we found it. In my opinion, given my view, that was acceptable in this case.

RALPH: The next question is whom should this conflict of interest policy apply to? Clearly board members and officers, but what about others?

BILL: Certainly, board members, officers, how far down on the management do you go, particularly from a large corporation?

ANN MARIE: We go down as far as senior management.

KARYL: I was going to say that with the nonprofits you can—I had to sign conflicts of interest and it was the senior management—

the next line down—in the chain.

RALPH: Is that enough? Let me give you an example. The purchasing director may not be a senior manager, but the purchasing director may have a brother or brother-in-law that runs a supply company that he may be purchasing from. Do you think you need to go beyond just senior officers and management?

ANN MARIE: The answer is yes, but that person is senior management for us.

KARYL: I would take it from a policy of approval of vendors and looking from that aspect, from the accounting aspect to see that there could be a potential conflict and the volume of work we would be doing with that supplier. I'd like to think these conflicts are in the past, but even in 2005, there was a major scandal involving the Roslyn School District. Among other problems, Superintendent Frank Tassone was convicted of embezzlement, but conflicts of interest escaped the board. For example, it turned out that a desktop publisher was paid \$800,000 by the district, but it was never disclosed that the publisher's owner shared an Upper East Side apartment with Tassone. Now, that was an example of outright fraud. You may be tempted to say the board may not be able to prevent outright fraud. However, even in this case, it appears that the board did not perform its duty regarding a conflict of interest.

RALPH: Do you have any specific criteria that a small board should follow in identifying and managing conflicts of interest, or is it fact-specific?

BILL: In a small nonprofit—and in a small

town, you're going to have the purchasing agent's brother be the supplier because there's no way around it. And that goes back to the transparency. There may be a sole source eventually and you have to rely to some extent on the integrity and honesty of the people that you're involved with. If they're not honest, you

don't want them on your board anyway. But, I'm concerned to have a hard and fast rule. It is a case-by-case analysis. I can think of a number of instances now, in a couple of small boards that I sit on, that we actually are looking for such a circumstance—Can your brother-in-law help us out?—so to speak.

KARYL: I look at that and think, can your brother-in-law help? You're looking at this possibly a one time deal, or commitment of a vendor, that I don't see that being as much as a problem as when you're using state contracts, where you can only go to one vendor. You can't shop around. But this is going back to volume, too, and nature of what it is. Are these office supplies? Are these other types of material goods that do constitute a large amount of your budget or physical presence? I think those are some of the things that you have to take into consideration also.

ANN MARIE: We have a lot of state contracts and county contracts—we're required to have three bids for most vendor work. If there are not three people in the area then you submit what you have and then have to justify why you don't have those three bids. But we have that across the agency, regardless, for one policy, and as a result then you can look at costs, what you're receiving, and then have that documentation.

BILL: Well overarching from the whole

The Board must mandate full disclosure of any potential conflict of interest, and document in the minutes not only the disclosure, but also the actions taken (e.g., that the board member left the room during the discussion of the issue) as a result of that disclosure.

discussion, I think there has been an improvement in the nonprofit area recently. I say that because I have a reaction that it seems to me that particularly in the larger nonprofits, board members are now more transparent than they are required to be, more so than maybe 30 years ago, more conscious of possible conflicts. That said, there will be recurring examples where breaches occur.

KARYL: In New York state, we've discussed the Roslyn School District, but there was also the Urban League of Albany, which essentially was forced to dissolve. Aaron Dare, CEO and president of the Urban League, was disciplined by the Attorney General for financial misconduct related to his conflicts of interest and forbidden from running any nonprofit organization in New York state for ten years. The agency was driven to financial ruin, and the Attorney General stated that he would be unable to recover all the damages caused by the breach of duty by the Urban League's officers and director to identify and manage these conflicts of interest.

RALPH: This really comes down to the entity may very well have a conflict of interest form, and they may send it out to its board members and officers and senior management on an annual basis, but isn't the real issue: what do they do with the conflict of interest form; who reviews it, and who reviews the reviewer?

KARYL: Those are the practical considerations I face. I said, I've got a stack of conflict of interest forms sitting on the floor of my home office from a board that I'm sitting on. Do I need to know and need to remember everybody's conflict? And who else on my board needs to review these? I happen to be the president, so it's me and one other officer, but how am I going to remember what kind of conflict there is, and if you have a large board who's the gate keeper of that when it comes up? I think it falls back to the individual and their personal ... taking the

stand and saying I can't be involved.

BILL: Clearly if the board has a compliance or governance committee, that committee should review it. It may be a good idea to have outside counsel review them too.

Ralph: Well, mechanically, does this mean that an entity should have a spreadsheet or grid of its board members that's acceptable to the Chair and to others that outlines just for a refresher potential conflicts or membership in other organizations for each board member. Is there any reason that a board couldn't have that?

KARYL: A board should have such a spreadsheet for quick reference.

ANN MARIE: Yes. What I do now is review all the conflicts of interest and bring it to the board chair's attention ... of having a grid that's distributed and everybody knows.

BILL: That works for a larger board, but what do you do with a small organization with just a few board members? I think it depends on the size of the board and how much you've got invested in both time and effort. You don't want to make it too cumbersome, and I see in smaller boards and in these times, it's a challenge to get people to serve on boards. If you make it difficult for them, you have difficulty finding people who want to serve and give any of their time to these organizations that really need help and expertise. That's not a conflict of interest issue, I suppose, it's just something that I'm running into in a couple of the organizations with which I'm involved.

KARYL: I agree with both pieces. One is because I'm always constantly being asked to be on a board because of my financial background. One board is a startup board, so until the organization grows, I'm their accountant. Another organization, because their business manager is not an accountant, I'm considered the mitigating control for the audit and for their financial report. So in that case we went

out on an RFP, I needed to ... even though I was involved in the process, I didn't feel I could vote on it since I knew the accounting firm. You have that, but then you have the well-developed organization that has a lot going on that the grid would ... I don't think that that would be too much of a problem for them, and it's the internal staff who's figuring this out. I think this goes back, as my final point, is going back to, is it really, if you're looking at the person who is on the board helping you with hands on—is it really a conflict of interest, or are they just helping manage the organization until you really get going?

BILL: I agree with that. That's the idea, particularly of a startup. If you're looking for that sort of thing, and frankly you're looking for what could be considered a conflict. I don't consider it to be such, but somebody who's a purist might. Your law firm can help us out; get on the board.

ANN MARIE: I completely agree. I think size of the organization matters in terms of complexity, and some of these smaller nonprofits startups, as long as it's transparent—again using that word—and everybody knows about it, I think it's OK.

RALPH: So nonprofit boards have challenges in identifying and managing conflicts of interest, but here are some guides:

- **There are statutory and regulatory reasons for having a conflict of interest statement and policy.**
- **That conflicts of interest statements need to be done on an annual basis.**
- **The key is full disclosure transparency and self-monitoring.**
- **A good board has the ability to identify potential conflicts and recognize there is simply no 'one size fits all.'**
- **The common sense approach begins with 'Does what's happening pass the smell test?'**

BILL, ANN MARIE, KARYL: Yes, Yes, Yes.

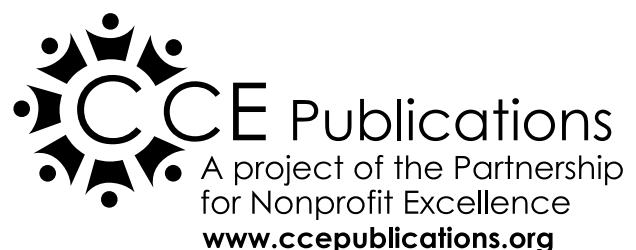
ADDITIONAL RESOURCES THAT MAY BE HELPFUL

www.BoardSource.org

www.GovernanceMatters.org

www.ManagementHelp.org

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