Elements of GOVERNANCE®

Providing CEOs, board chairs, directors, and support staff with the fundamentals of healthcare governance

A SERIES BY THE GOVERNANCE INSTITUTE

CONFLICT OF INTEREST

THIRD EDITION

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Introduction

The manner in which individual directors and governing boards of non-profit corporations address conflicts of interest is of critical importance, for both legal/tax compliance and reputational reasons. This is particularly the case given the current "environment of skepticism" in which the non-profit sector finds itself.

The obligation to appropriately address conflict-of-interest matters is a main component of the bedrock fiduciary duty of loyalty. Individual directors can be exposed to legal risk by failing to make adequate disclosure of potential conflicts, while entire boards or committees can incur similar exposure for failing to diligently evaluate conflict-of-interest disclosures.

Courts have historically dealt severely with duty of loyalty-related violations. Furthermore, the mere *appearance* of a conflict can often lead to significant reputational harm for each implicated director, the board as a whole, and the non-profit organization itself. Boards must be perceived as acting in the best interests of the non-profit mission, and not in self-interest, if they are to faithfully protect assets dedicated to non-profit use. A principal means of achieving this goal is through the adoption and monitoring of sufficiently detailed conflict-of-interest policies and procedures. In addition, the board should be provided with continuing education not only on the application of these policies and procedures, but also on the public policy goals they seek to achieve.

In essence, the suggestion is that in the current environment, non-profit boards must exhibit a greater sensitivity to the presence and potential for conflicts of interest, and possess the focus and discipline to address such conflicts in the best interests of the organization. In certain circumstances, this could include advance approval and management of the conflict. Indeed, the risk of conflict has actually increased in recent years with substantial diversification of non-profit health systems into different types of business enterprises, product lines, ventures, and investments. Such diversification expands the universe of potentially conflicting financial and personal relationships of board members. As a result, it increases the importance of a broad based awareness of potential conflicts, and the implementation of an effective conflict-management plan throughout the health system.

A critical benefit of an effective conflict-of-interest program is to help assure the sustainability of board decisions which otherwise could be challenged on conflict-of-interest grounds. Effective conflict policies also support individuals in the performance of their duties, and indirectly enhance director recruitment and retention efforts. Directors and director candidates are likely to take comfort in well-functioning conflict policies that help them identify and disclose potential conflicts.

This *Elements of Governance*® is intended to provide board members, senior executives, and general counsel with a greater appreciation of applicable public policy considerations, legal principles, and practical applications of conflict-of-interest oversight and management.

Conflict-of-interest situations can constrain a board's effectiveness and credibility. The best defense is a policy tailored to the organization that spells out its position on conflicts—what they are and how to handle each occasion. In addition to a clear policy, board members must submit disclosure statements annually. Other key components of a comprehensive approach to conflicts of interest include:

1. Comprehensive director education on the duty of loyalty and on conflict-of-interest issues and obligations
2. A full appreciation by board members of the ongoing "duty to disclose" actual or potential conflicts
3. A written process for reviewing potential conflicts and disclosures
4. Criteria by which the board—or committee delegated to review conflict-of-interest issues—shall evaluate and resolve conflict-of-interest disclosures
5. Guidelines by which the board/committee may wish to "manage" conflict-of-interest relationships considered to be in the organization's best interests
6. A separate policy addressing the "independence" of board members
7. Clear direction on the appropriate level of scrutiny to be applied to the board when conflicts arise
8. A record to show the board's *reasonable good faith belief* in each transaction's fairness
9. The organization's definition of an independent director

The Duty of Loyalty

Director obligations with respect to conflicts of interest arise within the context of the bedrock fiduciary duty of loyalty. Responsibilities with respect to disclosure, evaluation, and management of potential and actual conflicts are best considered against the backdrop of this fundamental duty.

What It Provides

The fiduciary duty of loyalty obligates the non-profit director to exercise his/her corporate powers in good faith and in the best interests of the corporation, as opposed to their own interests or the interests of another entity (e.g., the constituency that may have selected the director or who the director may represent) or person.[1] The duty is subsumed within the general legal requirement that directors *act in good faith and in a manner the director reasonably believes to be in the best interests of the corporation.*[2] In its purest form, the duty of loyalty seeks to assure that the director will not use his/her position for individual personal advantage[3] (i.e., "an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest"[4]). The duty of loyalty typically subsumes issues with fraud, self-dealing, and improper diversion of corporate assets or opportunities of the corporation.[5]

The subjective requirement of "good faith" refers to a state of mind that evidences honesty of purpose, faithfulness to the director's duties and obligations, and freedom from an intent to defraud.[6] A court will conduct a "facts and circumstances" analysis to determine whether this good faith requirement is satisfied in individual circumstances.[7]

Traditionally, the duty of loyalty has been interpreted as obligating board members and other fiduciaries to use best efforts to avoid relationships and arrangements that could give rise to a conflict. The law seeks to discourage directors from entering into relationships knowing that they would likely create a conflict with his/her health system board service. More recent interpretations expand upon this concept to

1 American Bar Association Committee on Nonprofit Corporations, *Guidebook for Directors of Nonprofit Corporations*, Second Edition (Overton and Frey, editors) (henceforth, "Guidebook"), p. 29; Brodsky and Adamski, *Law of Corporate Officers and Directors*, Thompson/West (2005), § 21:8.

2 Revised Model Nonprofit Corporation Act, adopted by the Subcommittee on the Model Nonprofit Corporation Act, Corporation Law of the Business Law Section of the American Bar Association (Summer 1987) (henceforth, "Model Act") § 8.31; § 8.30, cmt. 4. *Author's note:* A highly regarded Third Edition of the Model Act was adopted in August 2008. However, the author is unaware of any state non-profit corporation law or judicial decision specifically based upon its provisions to date, and for that reason does not refer to the Third Edition herein.

3 Guidebook; Dennis J. Block, *The Business Judgment Rule: Fiduciary Duties of Corporate Directors*, Aspen Law & Business (1998), p. 263.

4 *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (1939); Block, 1988.

5 American Law Institute, *Restatement of the Law, Charitable Nonprofit Organizations*, Council Draft No. 2 (December 21, 2015) (henceforth, "Restatement Draft") at Sec. 2.01.

6 Model Act, § 8.30, cmt., Lex. Stat. Ballantine and Sterling California Corporation Laws § 103 Conflict-of-Interest Transactions, Matthew Bender & Co., 2008 (henceforth, "Ballantine and Sterling"), § 406.01.

7 Model Act, § 8.30, cmt. 6.

obligate fiduciaries to anticipate and deal with circumstances that involve the potential for conflict.[8] This speaks to the need to address conflict situations in a manner consistent with the duty of care; to deal with them formally and thoughtfully, as opposed to informally and haphazardly.

To Whom Does It Apply?

Like other fiduciary duties, the duty of loyalty is generally perceived as imposed on the persons or body having control over the affairs of the non-profit corporation (e.g., the "board of directors" or the "board of trustees," as the case may be).[9] This would include officers of the corporation serving in the capacity of a board member.[10] The duty is applicable to each individual member of the governing board (regardless of how that board member obtained his or her seat).[11] In the absence of any contrary statutory provision, it applies regardless of whether the board member is compensated or uncompensated.[12] A non-board member who exercises the powers of a governing board member (e.g., a "lay" member of a committee with board-delegated powers) is typically viewed as a fiduciary and thus subject to the duty of loyalty.[13] Generally speaking, a person who does not exercise the powers of an officer or director (e.g., an advisory board member) is not regarded as a fiduciary, although they may be subject to duty of loyalty principles dealing with confidentiality and appropriation of corporate opportunity. (It is often helpful to identify in board policy the extent to which an advisory board member owes a fiduciary duty to the corporation—if at all.)[14]

Depending upon specific state law, corporate officers who are not board members may nevertheless be subject to the fiduciary duties ascribed to board members (their duties are likely to vary widely depending upon the scope of the officer's duties, by law and policy provisions and the terms of an employment agreement).[15] This could include the corporation's CEO, the chief operating, financial, legal and accounting officers, and senior business unit/division heads.[16] Nevertheless, some non-profit organizations maintain separate conflict policies for board members, and for non-board member executives, respectively. Other non-profits require by employment contract such executives to adhere to a fiduciary-level standard.

To Whom Is the Duty Owed?

Like other fiduciary duties, governing board members owe their duty of loyalty to the charitable mission of the non-profit corporation, as typically manifested in the "purposes" clause of the articles of incorporation.[17] This is true for every member of

8 See, e.g., Guidebook, p. 30. Note that the conflict-of-interest policies of some non-profits specifically obligate directors to avoid arrangements that could give rise to a conflict. See, e.g., www.gatesfoundation.org/Jobs/Conflict-of-Interest.
9 The American Law Institute, *Principles of the Law of Nonprofit Organizations*, Tentative Draft No. 1 (2007, 2008) (henceforth, "ALI Principles"), § 300, pp. 27–30.
10 *Ibid.*
11 *Ibid.*
12 *Ibid.*
13 *Ibid.*
14 See also, Restatement Draft, Sec. 2.02.
15 Ballatine and Sterling, § 406.01[8].
16 ALI Principles, Section 350.
17 Guidebook, p. 30; Restatement Draft, § 2.02.

the governing board regardless of whether an individual member either was formally appointed by a separate constituency (e.g., medical staff, faculty, affiliated corporation) or informally appointed (e.g., through the efforts of a fellow board member, public official, donor, or community group).[18] In the absence of regular education on this point, this principle can become a significant source of controversy and even friction on non-profit boards with significant "constituent" representation. Board members are obligated to govern for charitable purposes, and not to serve the interests (or act for the benefit of) their fellow board members, nor individuals such as executives, donors or other private parties.[19]

Many health systems have a separate non-profit corporation that serves as the sole member of a group of affiliated corporations, exercising reserved powers over their operations. Where the charitable purposes clause of those affiliate corporations includes some form of reference to serving the charitable purposes of the member (or the "system" as a whole), those affiliate boards take such purposes into account when discharging their fiduciary duties.[20]

Who Enforces the Duty?

Like other fiduciary duties, the duty of loyalty is enforced by the attorney general or similar state official, typically working with the assistance of professional state charity officials. However, the governing board has a fundamental obligation to monitor the performance of fiduciary duties by individual board members. Furthermore, an individual board member who knows that another board member has intentionally breached the duty of loyalty may have a duty to act (e.g., to make disclosure).[21] While there is typically no private right of action recognized for violations of the duty of loyalty, some state non-profit laws provide for derivative action to be instituted by board members under certain specific circumstances.[22] As noted elsewhere in this publication, the Internal Revenue Service (IRS) also exercises a "stake" in the duty of loyalty enforcement topic through its "implied jurisdiction" over corporate governance.

Note that adherence to fiduciary duties may also be of consequence in regulatory dealings with other governmental agencies that have jurisdiction over the affairs of the corporation (e.g., the Securities and Exchange Commission, the Department of Justice, the Office of Inspector General, and the Department of Health & Human Services). This is particularly the case with respect to questions dealing with a board member's good faith (i.e., whether there exists evidence of a subjective belief that the board member was acting in the best interests of the charity given its purposes).

The July 29, 2016 settlement between the Pennsylvania Attorney General, the Hershey Trust Company, and the Milton Hershey School, concerning certain governance practices of the two entities, is one of the more recent and significant demonstrations of a state attorney general's interest in non-profit governance.

18 *Ibid.*
19 ALI Principles, Section 310, cmt. (a)(1).
20 *Ibid;* Sec. 310, cmt. (a)(3).
21 ALI Principles, § 350, pp. 333–335.
22 See, e.g., Model Act, § 6.30.

The settlement resolved an investigation that had been prompted by Attorney General concerns with Hershey compliance with a previous 2013 settlement between the parties on certain governance related issues. The key terms of the 2016 settlement reflect the particular focus of the Attorney General's scrutiny. Those terms included 10-year term limits for board members; mandatory performance evaluations; the resignations of five individual directors; required notice to the Attorney General on board nominations and a "best-efforts" commitment to nominate candidates with appropriate education, training, and experience; limits on director compensation; limits on cross-directorships with other Hershey-related entities; and clarifications to the existing Hershey conflict-of-interest policy.

One of the particular conflict-related concerns cited by the Attorney General in the settlement and prior communication was the summer employment of a trustee's son with one of the trust's investment management firms. The Attorney General also expressed concern with the "extraordinary expenses" incurred by the trust and the outside counsel engaged by the trust to advise its board on this issue.

Practice Tips

- Ask general counsel for briefing on duty of loyalty cases in your state of jurisdiction
- Confirm fiduciary duty owed by non-board members serving on board committees
- Discuss concepts of "good faith" and "best interests"
- Consider separate conflict policies for officers/directors and for non-officer members of executive staff
- Provide education on specific constituency challenges
- Address obligations of board members to disclose intentional breaches of other board members

Specific Application

The duty of loyalty relates to, and may be breached, whenever a governing board member:

- Fails to adequately disclose a conflict of interest
- Usurps a corporate opportunity
- Violates the obligation to preserve the confidentiality of corporate information

Satisfaction of the duty of loyalty is typically manifested by compliance with specific governance policies addressing conflicts, corporate opportunity, and confidentiality. It is also manifested in other actions by board members that reflect good faith (i.e., that the board member acted with an intent to support the charity's purpose in exercising other duties). Virtually all "best practices" compilations for the non-profit sector, as well as IRS exempt organization tax guidance, strongly encourage the adoption of policies and procedures intended to assure that conflicts of interest (or the appearance thereof) arising within the organization and the board are properly addressed by disclosure, recusal, or other means.[23]

Effective governance includes the obligation to periodically review the conflict-of-interest policy to assure that it remains sufficient to address the needs of the organization. For example, a policy that was prepared for the organization when it was essentially a community hospital organization may well be insufficient in the event that, over time, the community hospital organization has evolved into a multi-corporation diversified health system.

23 See, e.g., Panel on the Nonprofit Sector, *Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations* (2015), Principle #3.

Conflict of Interest: Core Concepts

A conflict of interest can be defined as arising when a person in position of organizational authority (e.g., an officer, director, or senior non-officer executive) may benefit financially from a transaction he or she could authorize in such capacity, including indirect benefits such as to family members or businesses with which the person is closely associated.[24]

The goal is to prevent individual officers and directors from using their fiduciary position (including but not limited to voting rights) for personal advantage.

Whenever an officer or director stands to gain materially, either directly or indirectly, from a specific transaction involving the organization, there is a potential conflict, and it should be treated as such by the director/officer and the board itself. Indeed, officers and directors should *avoid* the active pursuit of transactions and relationships they have reason to know will create a potential conflict of interest. However, the presence of a conflict of interest does not, in and of itself, violate the duty of loyalty. It also should not be regarded as a reflection on the integrity of the board or the individual director. Rather, it is the manner in which the director/officer and the board address the disclosed conflict that speaks to the fiduciary obligation and governs the enforceability of the implicated transaction.[25] The duty of loyalty requires that the director be aware of the potential for such conflicts to arise and respond with care and candor.[26]

Most effective conflict policies extend beyond the interests of a particular fiduciary, to include the interests of persons who are close to the fiduciary (e.g., family members and certain types of business or legal advisors thereof).

While conflicts often arise unexpectedly, they are not entirely unpredictable. When a board has a broad cross-section of individuals with diverse professional and financial interests, the likelihood that directors will have interests that will conflict with those of the organization is moderately high.

State Law Treatment

Most state non-profit corporation laws address the sustainability of conflict-of-interest transactions (e.g., a transaction with the corporation in which an officer or director has a direct or indirect interest). These laws typically provide that such transactions are not "voidable" if the transaction was fair to the organization at the time, and the transaction was approved in advance by the board where (a) the material facts of the transaction and the director's decision therein are known to the board or a committee thereof; and (b) the directors approving the transaction in good faith thought it was

24 See, e.g., Glossary to IRS Form 990.

25 Note that effective due diligence by the board on new director candidates can often identify potential conflicts of interest before they are manifested at the board level.

26 Guidebook, p. 30

fair to the organization.[27] In such circumstances, the burden is upon a challenger to demonstrate the unfairness of the transaction to the non-profit.

Complex and often misunderstood issues arise with respect to the role of an interested director in attending and participating in any board or committee meeting held to take action on the transaction that gave rise to the conflict. State law should be consulted on these issues; in many situations the conflicted director may be counted for purposes of determining whether a quorum is present for the meeting, but may not be present at, participate in, nor vote in that meeting.

State law should be consulted on how to address conflicts of interest that are identified subsequent to the board's approval of the underlying transaction. It is not inconceivable that in some circumstances attorney general or judicial approval may be required. The reasons why the underlying conflict of interest was not disclosed in advance by the conflicted board member (or, if it was so disclosed, why the board did not address the conflict in a timely manner) would be important considerations for the reviewing body.

Duty of Loyalty

The board must:

- Discharge duties unselfishly, to benefit only the corporate mission and not the directors personally
- Avoid actively pursuing relationships that would create a conflict of interest
- Disclose situations with potential for conflict
- Avoid appropriation of opportunities of the organization
- Refrain from discussing confidential board business with others

It should be noted that the law has evolved substantially with respect to the treatment of conflict-of-interest transactions. Current public policy, as manifested by state non-profit corporation law, presumes that conflicts of interest are best addressed by scrutiny and management, *not* by attempts at elimination. This "permissive" approach is a far cry from the harsh treatment under prior common law, which treated non-profit directors as if they were trustees of a charitable trust, and generally prohibited all business arrangements between the director and the non-profit. Interestingly enough, some non-profits are reverting to their severe "no conflicts" standard out of abundance of caution and in reaction to particular concerns with the public "optics" associated with board member conflicts of interest.[28]

27 See, e.g., 805 ILCS 105/108.60.
28 Restatement Draft, Sec. 202, cmt. (b).

Conflict of Interest: Identification

The potential for a conflict of interest normally arises when a director (or committee member) has, directly or through a family member, a "material personal interest" in a proposed contract, transaction, arrangement, or affiliation to which the corporation may be a party.[29] The potential is made more acute where the contract, transaction, arrangement, or affiliation calls for board action. In the absence of specific law, "material" should be considered in its generally accepted legal context. For example, an interest may be regarded as material if there exists a substantial likelihood that a reasonable person would consider it important in deciding what action to take.[30] Such conflicts may arise from service on both the board and on a committee with board-delegated powers.

Typically, conflicts of interest arise in connection with a financial arrangement involving a director; where the director could experience personal gain or benefit if the transaction, arrangement or relationship were approved. In addition, it is increasingly recognized that potential conflicts may arise from certain non-financial interests, intra-board relationships, and interlocking board arrangements. Indeed, the law recognizes that the duty of loyalty may also be violated when a non-financial conflict prevents a director from acting in the best interests of the organization.[31] Directors and conflicts committees should be sensitive to the potential for conflict arising from all such relationships, identifying for directors this potential, and the resulting need for disclosure. This sensitivity goes directly to the issue of good faith.

Typical Financial Interests

Common examples of financial interests that could potentially create a conflict of interest involving a director (i.e., where the matter is brought before the board) include the following:

- An ownership or investment interest in a business involved in a contract, transaction, or arrangement with the non-profit organization. *(Example: Director "A" is a minority owner of a privately held refuse disposal company with which the non-profit organization purposes to contract for services.)*
- A compensation arrangement with an individual or entity involved in a contract, transaction, or arrangement with the non-profit organization. *(Example: Director "B" is a salaried Senior Vice President of a national banking corporation, from a subsidiary of which the non-profit organization is soliciting a proposal to provide banking services.)*
- A potential ownership or investment in, or compensation arrangement with, an individual or entity with which the non-profit organization is negotiating a contract, transaction, or arrangement for services. *(Example: Director "C" is negotiating to become a partner in Accounting Firm, which is simultaneously bidding to provide external auditor services to the non-profit organization.)*

29 Guidebook, p. 30.
30 Guidebook, p. 30; Model Act, § 8.31 cmt. 4, citing *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976).
31 ALI Principles, Sec. 310, cmt. d(1).

- An actual or potential ownership or investment in, or compensation arrangement with, a business, entity, or person who is competing or seeks to compete with the not-for-profit corporation.

Typical Non-Financial Interests

Non-profit directors sometimes must confront situations that are material, yet non-financial in nature. Often referred to as "dualities of interest," they typically (but not always) arise from the director's simultaneous, uncompensated service on one or more other corporate boards (whether for-profit or non-profit). The law generally recognizes that such non-financial interests or arrangements, and other types of "dualities" can also limit the ability of the board member to act in the best interests of the not-for-profit corporation. Common examples of such non-financial interests include, but are not limited to, the following:

- Director "A" serves on the board of Hospital Corporation, which is considering an expansion of its community ambulatory surgery centers; while simultaneously serving on the board of directors of a local community college, which plans on establishing medical clinics to serve the needs of students, faculty, employees, and those living in the area.
- Foundation Director "B" simultaneously serving as a board member of Museum, both of which are considering the commencement of a capital campaign that will target the same community of potential donors. (This goes to the broader issue of board service on other legal entities that may reasonably be expected to compete with the hospital corporation.)
- An individual serves as a board member of Health System "A"; while simultaneously serving as a board member of not-for-profit corporation "B" and for-profit corporation "C", both of which are in a position to contract for business with "A".
- The brother of Hospital Corporation Director "A" serves as the uncompensated chairman of the board of Physician Group, which is considering an affiliation with Hospital Corporation.[32]

Some sophisticated non-profit organizations seek to reduce duality-of-interest related rules by limiting the number (and types) of outside boards on which a director may be allowed to serve. It is conceivable that continued board service may be impractical if the charitable or corporate purposes of another corporation for which the board member serves as a fiduciary are in fundamental conflict.

Intra-Board Relationships

Other indirect interests potentially worthy of conflict disclosure, or at least sensitivity, are business and family relationships amongst board members of the same non-profit organization. The conflicts-related concern is that such a relationship could compromise the judgment of a director (i.e., causing the director to vote in a manner consistent

32 ALI Principles, Sec. 310, cmt. d(1).

with the views of another board member who is his/her business partner and thus not necessarily in a manner he/she feels is in the best interests of the corporation).

Thus, regulators are likely to be sensitive to the possibility that certain types of personal and business relationships between board members to have created material conflicts and independence concerns.

The IRS specifically asks about the presence of these "intra-board relationships" in Part VI of its Form 990, "Return of Organization Exempt from Income Tax."[33] Part VI-A, Question 2 asks, "Did any officer, director, trustee, or key employee have a family relationship or business relationship with any other officer, director, trustee, or key employee?"[34] The potential for conflicts to arise out of such "horizontal" relationships is real, and many organizations fail to make note of the issue, at least until the question arises within the context of the completion of the Form 990.

Interlocking Board Relationships

Many non-profit corporate systems (especially in healthcare) feature interlocking boards between parent and affiliate organizations. Such arrangements are perceived as supporting control arrangements, enhancing intra-system communication, increasing efficiency, and addressing challenges posed by a limited director pool. Individuals serving in such interlocking positions owe fiduciary duties to both corporations. A minority, yet vocal, perspective is that the parent corporation owes a fiduciary duty to the supported charity.

Potential conflict issues can arise in at least two different ways in "interlocking board" scenarios. The first area of potential conflict concern is where a parent corporation board is called upon to address an issue that is perceived as having advantages to the corporate system as a whole, but is disadvantageous to a particular affiliate.

The second area of potential conflict is when an individual is simultaneously serving as a common director between two separate non-profit organizations that are contemplating entering into a contract, transaction, or arrangement with each other. In such a situation, disclosure by the common director(s) is appropriate, without regard to whether the common director has a material financial interest in the transaction. (Note: whether such a financial interest exists may indeed be relevant for purposes of the review standard.)

These are situations where "unity of charitable purposes" clauses (i.e., where the affiliate's purposes include an express commitment to support the purposes of the health system parent organization) may provide clarity (see above).

33 The IRS Form 990 is available at www.irs.gov/pub/irs-pdf/f990.pdf.
34 *Ibid.*

Conflicts and Committee Service

It is important to note that the potential for conflict arises not only from director service at the board level, but also from service at the committee level. This is particularly the case with service on committees with board-delegated powers. Examples of situations where disclosure would be appropriate include:

- Director "A", whose adult child is a salaried employee of the non-profit, serving on the executive compensation committee, which has jurisdiction over the compensation of the senior executive ultimately responsible for the department in which the adult child works.
- Director "B", a partner in a local accounting firm, serving on the audit committee, which has announced its intention to send out a "request for proposal" for audit services to all local accounting firms.
- Director "C", whose minor child is applying for admission to a prestigious college preparatory school, serving on the board's nominating committee, which is considering the appointment of the executive director of that school to fill a vacancy on the board.

In each of these and similar situations, a threshold issue is whether the underlying contract, transaction, arrangement, or affiliation will be presented to the board or committee for action. However, the resolution may turn on materiality: is the relationship such that there is a substantial likelihood that a reasonable person would consider it important in deciding what action to take? The ultimate point is that the nature of non-profit board/volunteer service and philanthropic support is such that potential conflicts may arise from a wide variety of sources, and individual directors should be attentive to how their personal interests can give rise to a potential conflict.

No Exhaustive List

The conflict-of-interest oversight process is enhanced by efforts to educate board members with examples of the types of contracts, transactions, arrangements, and affiliations that may prompt disclosure. However, directors should be constantly reminded that there is no all-inclusive list of the types of interests for which disclosure would be appropriate. The burden is on the individual director to be sensitive to the potential for a particular interest to reasonably be considered by others as capable of affecting the director's objectivity or independence. In that situation, disclosure is appropriate.

It can be a useful process for evolving and growing non-profit health systems for the committee responsible for conflict of interest to provide periodic education to board and committee members on the types of potential conflicts that can arise as the system grows and diversifies.

Conflict of Interest: Disclosure

The principal affirmative conflicts-related obligation owed by non-profit directors is the so-called "duty to disclose." The board has a right to be made aware of reasons why individual directors could be acting under divided loyalty.

The duty of good faith incorporated within core fiduciary duty principles is often interpreted as incorporating an obligation to disclose to other board members non-confidential information of which they may be unaware yet may be relevant to the exercise of their duties.[35] This includes the obligation to disclose the implications of a proposed transaction or arrangement, when the "interested director" is aware of those implications but other directors and officers also called upon to review the transaction or arrangement are not so aware.

The goal is the establishment of a transparent process positioning the board to evaluate the nature of the interest, for purposes of (a) determining whether a conflict exists; and (b) if so, whether it can be managed. Failure to make adequate disclosure of a potential conflict of interest will be regarded as a breach of the "acting in good faith" component of the duty of loyalty.[36] That is one reason why board members are well advised to be inclined as a matter of basic orientation to make disclosure, even when there is some doubt as to its necessity.

Adequate disclosure serves two primary purposes. First, as noted, it addresses the director's fiduciary obligation. Second, it positions the board to evaluate the fairness of the proposed transaction in a fully informed manner. Full disclosure is a fundamental prerequisite for rebuttable presumption treatment for conflict-of-interest transactions under most state not-for-profit corporation laws. In the absence of such disclosure, a conflict-of-interest transaction is voidable, and upon challenge the non-disclosing director will have the burden to prove the fairness of the proposed transaction to the non-profit corporation.[37]

What Constitutes Full Disclosure

The desired standard of disclosure is considered to be that amount of information necessary to provide the full board/committee with the material facts of the transaction and the disclosing director's interest therein, such that the board/committee may determine the transaction's fairness to the non-profit organization.[38] A fact is generally considered material if there is a substantial likelihood that a reasonable person would

35 Report of the American Bar Association Task Force on Corporate Responsibility, March 31, 2003.

36 *Boston Children's Heart Foundation, Inc. v. Nadal-Ginard*, 73 F.2d 429, 433; 1996 U.S. App. Lexis 414 (1st Cir. 1996); Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems and Proposed Reforms*, 23 Iowa J. Corp. L. 631 (Summer 1998).

37 ALI Principles, § 330, p. 230; Model Act, § 8.31.

38 Model Act, § 8.31(c), cmt. 4, citing *TSC Industries v. Northway, supra.*

consider it important in deciding how to vote.[39] The conflicts decision makers must be positioned to evaluate the significance of the interest to the disclosing director, and whether it could reasonably be expected to exert an influence on the director's judgment if called upon to vote on the matter.

There may be situations in which the director may be limited, by fiduciary obligations owed to another organization, from including within the disclosure the full range of information that would otherwise be expected. In such situations, the director is obligated to disclose that amount of information with which he/she is comfortable (e.g., at least that the interest exists), leaving the meeting or at least abstaining from participating in the discussion, and of course not voting on the matter.[40] Consultation with the general counsel may be one approach to resolving such a disclosure dilemma. However, if the circumstances are significant to both the individual and the not-for-profit corporation, the director may wish to seek the advice of his/her own counsel. It is conceivable that resignation may be necessary if the director feels incapable of disclosing even that *de minimus* level of information.[41]

Adequate disclosure serves two primary purposes. First, it addresses the director's fiduciary obligation. Second, it positions the board to evaluate the fairness of the proposed transaction in a fully informed manner.

The Role of the Questionnaire

Standard practice in the non-profit sector is for directors and other interested parties to satisfy (in part) their duty to make disclosure through the completion and submission of an annual questionnaire or disclosure statement.[42] Such questionnaire normally requests information concerning all principal business and professional arrangements, and affiliations with business organizations conducting business with the non-profit. The expectation is that questionnaire answers will better position the board and individuals to identify potential conflicts as they exist or may arise. In that regard, it is important that the responsibility to review the completed questionnaires be delegated to a corporate officer qualified to review and analyze (e.g., the general counsel or chief governance officer).

However, it is extremely important to remember that the duty to make disclosure is an ongoing obligation; it is not fully discharged upon completion and submission of the annual questionnaire. The director or other interested person is obligated to provide the board/conflicts committee with updates to the information contained in

39 *Ibid.*

40 *Ibid.*; see also ALI Principles, § 330, p. 244.

41 *Ibid.*

42 Panel Report, available at https://www.independentsector.org/nonprofit_panel_reports_recommendations; Janet E. Gitterman and Marvin Friedlander, *Health Care Provider Reference Guide*, Internal Revenue Service EO Continuing Professional Education Text FY 2004 (Appendix A), available at http://garnerhealth.com/wp-content/uploads/2011/09/Health-Care-Provider-Reference-Guide.pdf.

the submitted questionnaire, when he/she subsequently becomes aware of an interest that requires disclosure. Furthermore, the typical questionnaire is general in nature and cannot be expected to prompt information about specific contracts, transactions, or arrangements with which the non-profit is, or may ultimately, be involved. Therefore, organizational reliance on the questionnaire as the principal disclosure vehicle is quite risky unless it is accompanied by regular reference by the conflicts committee and staff to the disclosures. Unfortunately, some large not-for-profit corporations still only require annual disclosures by its fiduciaries.

The board (or its governance committee) should provide board members with examples of the expected standard of written responses to the questionnaire.

Recordkeeping

Corporate records (including minutes) should assiduously document each level of the disclosure process:

- Conflict-related inquiry in the board/committee member nomination/reelection process
- Adequate completeness of annual questionnaire
- Periodic review of questionnaire disclosures against board agenda to identify potential conflicts subsequent to questionnaire submission disclosures
- Board/committee meeting to consider disclosures
- Conflict-related abstentions in meetings

A related issue of importance is the quality and timing of questionnaire responses and subsequent disclosures. Timely and informative disclosures position the board to initiate the conflicts review and determination process well in advance of the meeting at which the particular transaction would be submitted for approval. Questionnaire responses and subsequent disclosures should be clear, complete, and legible. Incomplete or illegible answers should serve to disqualify the entire submission.

In addition, the board should not tolerate delinquent submission of completed questionnaires. Some form of punitive response should be provided for in board policy for failure to submit an adequately completed questionnaire within a set period of time. Use of a proxy (e.g., secretary, attorney, or accountant) to complete and file the questionnaire (as opposed to advising on its completion) should be prohibited.

Conflict of Interest: Review

The manner in which the board or relevant committee reviews a conflict-related disclosure is of critical duty-of-loyalty-related significance.

The reviewing body must conduct its activity consistent with a particular standard of care. Furthermore, assuming proper disclosure and adequate board review, state law may specifically allow entering into certain conflict-of-interest transactions. Failure to adequately consider disclosed potential conflicts places the directors involved in the review process at risk of breach of duty-of-care exposure. Furthermore, conflict-of-interest transactions approved absent appropriate board review or outside rebuttable presumption guidelines may be subject to judicial rescission. In such situations, the interested director has the burden of demonstrating the transaction's fairness. In egregious situations (e.g., fraud or malicious conduct), damages may be awarded.[43]

Standard of Care

The general expectation is that a potential conflict disclosure will be referred to a committee consisting of disinterested board members, for a determination as to whether the contract, arrangement, transaction, or relationship constitutes a conflict of interest. In its review process, the disinterested board/committee members will be required to adhere to a standard of care that is proportional to the nature and extent of the disclosed arrangement and the related financial implications.[44] This standard of care extends to the associated activities of gathering information related to the disclosure, and determining whether the disclosed arrangement is both fair to, and in the best interests of, the non-profit organization. Broadly speaking, the more significant the potential conflict of interest, the more due diligence will be necessary to address the board's obligation to closely scrutinize the relevant facts, make an informed decision, and document in writing the investigation process and the ultimate decision.[45]

The great weakness of many not-for-profit board conflicts processes is that they involve "real-time" disclosure and review (i.e., the disclosure is made at the board meeting at which action on the subject relationship is to be taken). A disclosure of a possible conflict at that meeting often doesn't allow the board or its committee of disinterested members to make a thoughtful decision. Rather, the decision is made "under the gun" and is subject to the glare and tensions of an actual board meeting—and the decision of whether a disclosure constitutes a conflict is made by the board chair, following an "on the spot" review.

Some commentaries suggest that for potential conflicts that do not involve financial arrangements, a less invasive review of the disclosure may be appropriate.

43 Model Act, § 8.31 cmt.
44 ALI Principles, § 330(a)(4).
45 *Ibid.*

"Rebuttable Presumption"

Fundamental to the board's duty-of-loyalty oversight is the recognition that, as a matter of public policy and under certain proscribed circumstances, many conflict-of-interest transactions may be approved as in the non-profit's best interests. Indeed, the laws of many states[46] provide a specific "rebuttable presumption" for conflict-of-interest transactions approved in advance by the board, or a committee with board delegated powers under the following types of circumstances:

1. The material facts of the transaction and the director's interest are known or disclosed to the board or committee (including all facts not previously known to the board). Prudent practice favors a written record of the facts disclosed or known to the board.[47]
2. Exercise of good faith and reasonable business judgment by the deliberative body that the conflict-of-interest transaction is both fair and in the best interests of the non-profit organization. *Note:* this does not require an absolute determination of fairness, but rather that the directors believed it was fair and had a reasonable basis on which to reach their conclusion.[48] By this standard, the directors are shielded from liability even if it were subsequently determined that the directors' fairness conclusion was wrong.[49] (Business judgment rule protection is generally not available to directors whose exercise of care was not in good faith.[50])
3. Abstention by the conflicted director (e.g., (i) the disclosing director may not in any way seek to influence the deliberative process, other than to make disclosure as requested of relevant information; and (ii) the disclosing director may attend the meeting at which the conflict-of-interest transaction is considered, but solely for the purposes of answering questions, and must leave the meeting prior to the commencement of substantive discussion relating to approval or disapproval of the conflict-of-interest transaction).[51]

In some states, it may be possible to obtain judicial or attorney general ratification for conflict-of-interest transaction if obtained in advance of, or immediately following consummation of, the transaction. However, such a post-transaction process is not guaranteed and therefore advisable to seek the safe harbor treatment in advance.[52]

These types of "rebuttable presumption" statutes do not act like a traditional "safe harbor." Rather, if their requirements are met, they serve to place the burden of challenging the particular action on the individual or entity that seeks to mount a challenge.

Note that the board's governance committee should work closely with its general counsel to assure that its process satisfies all of the specific statutory requirements for "rebuttable presumption" treatment are met as they may vary on a state by state basis.

46 See, e.g., 805 ILCS 105/108.60; Cal. Corp. Code § 5233.
47 ALI Principles, § 330(a)(2), p. 229; Guidebook, p. 32; Model Act, § 8.31.
48 Model Act, § 8.31 cmt. 2(a).
49 *Ibid.*
50 ALI Principles, § 365(c).
51 ALI Principles, § 330(a)(2); Guidebook, p. 32; Model Act, § 8.31.
52 *Ibid.*

Quorum and Voting Requirements

Issues related to quorum and voting requirements in conflict-of-interest matters are usually specific to state law. The general approach seems to be that the presence of the disclosing/"interested" director may be counted in determining whether a quorum is present but may not be counted (i.e., the interested director may not vote) when the board or committee takes action on the potential conflict or the actual transaction.[53] There is less statutory uniformity on whether the disclosing/"interested" director may remain in the meeting room for the discussion of the potential conflict or actual transaction, regardless of whether he/she may be counted towards a quorum and be allowed to vote on the matter. The better practice is that the disclosing/"interested" director not be allowed to remain in the room following discussion relating to the nature of the conflict.[54] Experience suggests that the potential "chilling effect" of such presence on the decision making of the other board members can be significant, and inconsistent with the goal of an informed, unbiased resolution of the matter. This is particularly the case if the disclosing/"interested" director is an influential presence on the board or committee.

Interlocking Directors

Depending on particular state law, transactions involving interlocking directorates, where no material financial interest exists, may be subject to a more relaxed approval process. In such situations, a contract or other transaction is not void or voidable by the non-profit corporation simply because a common director(s) was present at the board/committee meeting at which the contract or transaction was approved, if:

- The material facts as to the transaction and the common directorship(s) were fully disclosed or known to the approval body and such body approved the transaction by a sufficient vote, where the common directors abstained from voting; or
- The contract or transaction was just and reasonable to the corporation at the time it was authorized.[55]

However, interlocking directorships can create conflicts concerns when the interests/purposes of one corporation for which a director may serve are not consistent with another corporation for which that same director may also serve as a board member. This may even be the case in with parent/affiliate relationships, depending upon the particular circumstances. In such circumstances, conflict concerns arising from interlocking board memberships can be mitigated where there is commonality of purpose or a recognition that the affiliate operates to be loyal to and further the strategic objectives, interests, and charitable mission of the (system), and to contribute to the growth, development, and financial strength of the (system).

Of course, in extreme situations, involving the boards of corporations that are competitors, interlocking boards can present antitrust issues under Section 8 of the Clayton Act.

53 See, e.g., 805 ILCS 105/108.60(c).
54 Guidebook, p. 33.
55 See, e.g., Cal. Corp. Code Secs. 5234(a), 7233(b); Ballantine and Sterling, § 406.03.

Conflict Management

The premise of the rebuttable presumption is, as noted above, that certain types of conflict-of-interest transactions may be appropriate for the non-profit organization to pursue, where specific criteria have been satisfied in advance. However, in many such circumstances it may be important that additional "conflict management" safeguards are applied prospectively to provide additional protection from self-dealing risks that may otherwise arise from the transaction.

The specific types of safeguards will vary depending upon the facts and circumstances of the particular conflict-of-interest transaction. However, they typically reflect the following basic themes:

- Confirmation that no more advantageous transaction or arrangement is reasonably attainable under circumstances that would not give rise to a conflict of interest[56]
- Periodic status reports to the conflicts committee
- Monitoring the benefits of the transaction or arrangement to the non-profit organization
- Assuring that the conflicted director will not have excessive ongoing involvement in the transaction or arrangement
- Excess utilization/benefit safeguards (e.g., protections against unanticipated or excessive personal benefit to the conflicted director)

The risk of conflict-management plans is at least two-fold: first, that for various reasons the application of the specific conflicts management controls may be applied less vigorously than may otherwise be desirable; and second, that a decision to terminate the transaction or otherwise resolve the underlying conflict may be too difficult (either for legal or practical considerations) to implement.

> *In the non-profit sector,* appearances count. *Charity regulators responsible for safeguarding charitable assets sometimes justify "judging a book by its cover." That is particularly the case with the increase in financial abuse in recent years. Fairly or unfairly, non-profit boards must consider more seriously the risks associated with the* appearance *of a conflict.*

56 IRS Healthcare Provider Reference Guide, Appendix A, p. 31.

Appearance of Conflict

General best practices provide that conflict-of-interest policies should distinguish between situations that give the *appearance* of a conflict, and those that suggest a material conflict involving a financial or other interest in a transaction involving the organization.[57] By this, the suggestion is made (at least indirectly) that appearance issues should be treated with less scrutiny than interests that suggest a probable conflict.

Yet, in the non-profit sector at least, *appearances count.* The experience of charity regulators responsible for safeguarding charitable assets is such as to justify sometimes "judging a book by its cover." That is particularly the case with the increase in financial abuse in the non-profit sector in recent years. It is for these and other similar reasons that—fairly or unfairly—non-profit boards must consider more seriously the risks associated with the *appearance* of a conflict.

Arrangements that only create the appearance of a conflict of interest may nevertheless create two significant risks for a non-profit organization: (a) the risk of reputational harm associated with media reports of the matter; and (b) the risk of charity regulator inquiry based on the media reports—and the significant legal costs likely incurred in responding to the inquiry. Accordingly, the responsible non-profit board will exercise vigilance in evaluating the potential implications of director interests that only create the appearance of a conflict, to the same degree that it does with those that create a material risk of a conflict.

57 Panel Report.

Tax-Exemption Considerations

There is a highly significant federal tax-exemption component to the conflict-of-interest process. Non-profit boards should recognize the crucial relationship between effective conflict-of-interest oversight and federal tax-exempt status.

The IRS has traditionally been explicit in its confirmation of how conflict-of-interest policies and procedures contribute to preservation of federal tax exemption.

IRS focus on exempt organization conflicts of interest is manifested broadly: in general, through Internal Revenue Code ("IRC") and Treasury Regulations prohibitions against private inurement and excessive private benefit; and more specifically in the Intermediate Sanctions excise tax provisions of IRC 4958, the Form 990, publication of a sample conflict-of-interest policy, IRS exempt organization informational publications, and in published comments by senior IRS officials. This collective focus reflects a fundamental IRS concern that the assets of a charitable organization, recognized as income tax-exempt, not be subjected to improper diversion by "insiders" (i.e., persons in a position to exercise substantial control over the organization, such as officers, directors, or trustees). The adoption of a "substantial" conflict-of-interest policy helps demonstrate that a tax-exempt organization promotes charitable purposes, rather than benefiting private interests.[58]

Effective conflict-of-interest oversight is based not only on compliance with non-profit corporate law, but also with the terms of federal tax-exempt status.

General Perspective

The primary conflict-related emphasis of the IRS is on the adoption of a written conflict-of-interest policy. It is the IRS' general perspective that the presence and enforcement of a conflict-of-interest policy serves to protect the exempt organization's interest in transactions or arrangements that may also benefit the private interest of an officer or a director.[59] The IRS perceives the presence of a conflict policy as assisting the board in making decisions in an objective manner, protecting against inappropriate influence by "insiders" and others with a private interest.[60] An additional perceived benefit

58 Internal Revenue Service, "Governance and Related Topics—501(c) Organizations," available at www.irs.gov/pub/irs-tege/governance_practices.pdf.

59 Lawrence M. Brauer and Charles F. Kaiser III, "Tax-Exempt Health Care Organization Community Board and Conflicts of Interest Policy," in IRS Exempt Organizations Continuing Professional Education Professional Education Technical Instruction Program for FY 1997, pp. 18–19, available at https://www.irs.gov/pub/irs-tege/eotopicc97.pdf.

60 *Ibid.*

of such a policy is that it helps to assure that the tax-exempt organization (i) satisfies its charitable purposes, and (ii) pays no more than reasonable compensation to its highest compensated employees. (In this regard, the IRS believes there is a direct relationship between maintenance of adequate books and records, and an effective conflict-of-interest policy.)[61]

The IRS does not view adoption of a conflict-of-interest policy as a prerequisite for income tax-exempt status. However, its adoption is "almost universal," because it serves as an important vehicle for non-profit organizations to avoid sanctions by violations of the IRC/Treasury Regulations provisions addressing private inurement, private benefit, and intermediate sanctions.[62]

Healthcare-Specific Application

The IRS has historically taken the position that the adoption of a conflict-of-interest policy is one of the factors taken into consideration in determining whether hospitals and other healthcare organizations satisfy the community benefit standard for tax-exemption as set forth in Rev. Rul. 69-545, 1969-2 C.B. 117.[63]

The presence of conflict of interest does not, in and of itself, violate the duty of loyalty. Rather, it is the manner in which the director and the board address the disclosed conflict that speaks to the fiduciary obligation.

Form 990

Corporate governance of tax-exempt organizations is a key factor addressed in the Form 990 (Return of Organization Exempt from Income Tax). The governance-related provisions incorporated within the redesigned Form 990 include (but are not limited to) those relating to conflict-of-interest oversight and policies.

For example, the *governance structure and management-related questions* in Part VI, Section A, explore the presence of family or business relationships between board members, officers, and/or key employees, among other topics. This is the matter of potential intra-system conflicts and bias, discussed above.

Part VI, Section B requests information regarding the use of *governance-related policies and procedures*, including (but not limited to) a written conflict-of-interest policy that requires regular disclosure by officers and directors and which is subject to regular and consistent monitoring and enforcement. The Form 990 also asks whether the organization "regularly and consistently" monitors and enforces compliance with the policy.

61 *Ibid.*

62 IRS Health Care Provider Reference Guide, p. 11.

63 Lawrence M. Brauer and Charles F. Kaiser III, "Tax-Exempt Health Care Organizations Revised Conflicts of Interest Policy," in IRS Continuing Professional Education Technical Instruction Program for FY 2000, p. 45, available at https://www.irs.gov/pub/irs-tege/eotopice00.pdf.

Corporate Opportunity

Another generally recognized component of the nonprofit director's duty of loyalty, closely associated with conflicts of interest, is the doctrine of corporate opportunity.

Generally speaking, this doctrine proscribes a director's usurpation of a business opportunity which the director reasonably should know may be of interest to the corporation, without prior board approval.

It is based on the principle that the corporation has a "prior right" to accept or disclaim certain business opportunities that present themselves to a director.[64]

When presented with a business opportunity, the director is obligated to make a detailed, timely disclosure to the board so that it may decide what action to take (i.e., providing to the board a "first option" to participate in the opportunity on the same terms, in lieu of the director's participation).[65] A director who "usurps" a corporate opportunity may breach the duty of loyalty and be exposed to damages or equitable remedies.[66]

The principle supporting the doctrine of corporate opportunity has been described by the courts as follows: *[I]f there is presented to a corporate officer or director a business opportunity, the corporation is financially able to undertake that is, from its nature, in the line of the corporation's business and is of practical advantage to it, is one in which the corporation has an interest or a reasonable expectancy, and, by embracing the opportunity, the self-interest of the officer or director will be brought into conflict with that of this corporation, the law will not permit him to seize the opportunity for himself.*[67]

The need for disclosure arises when the director/officer is presented with a business opportunity that:

- Is a matter the corporation has the financial means to undertake
- Is "in the line of the corporation's business" and may be of particular advantage to it
- Falls within the present or (reasonably expected) future plans of the corporation
- Has a character such, that by appropriating the opportunity, the personal interest of the director will be brought into conflict with the interest of the corporation[68]

In order for the director to avoid any appearance of impropriety, he/she should make disclosure of the opportunity before becoming legally obligated with respect to it. Any request that the board abstain from exercising it should be clearly set forth by the

64 ALI Principles, § 330, p. 240.
65 Guidebook, p. 34: See also, William E. Knepper and Dan A. Bailey, *Liability of Corporate Officers and Directors*, Seventh Edition (2007), § 4.12.
66 ALI Principles, Sec. 330, p. 240.
67 *Guth v Loft Inc,* 5 A2d 503 (Del Ch 1939).
68 Knepper and Bailey, 2007, § 4.12.

interested director in writing and set forth in the corporate records.[69] Upon this disclosure, the board must make a separate evaluation of whether it wishes to pursue the opportunity on the terms provided to (and in lieu of) its director. Any rejection of the opportunity must be fair to the corporation.[70]

Relevant judicial decisions indicate that courts will often use one of the following tests to evaluate a "corporate opportunity"-based challenge:

- Test one: Is the corporate opportunity an activity closely associated with the current or anticipated business of the corporation?
- Test two: Was the corporation denied an opportunity in which it had a tangible interest or expectancy?
- Test three: Was the director's action with respect to the opportunity "fair" under all relevant facts and circumstances?
- Test four: Involves a combination of tests one and three.

Somewhat similar to the conflict-of-interest rebuttable presumption, a party alleging that a "business opportunity" pursued by a director constitutes a "corporate opportunity" has the initial burden of proof. Once satisfied, the burden moves to the implicated director, who must demonstrate the equity of the transaction process.

69 Guidebook.
70 ALI Principles.

Director Independence

It is important to distinguish conflicts of interest from independence concerns. "Positional independence" (e.g., separation between oversight and management) is receiving increasing attention in the non-profit sector as a governance best practice.

The basic principle associated with positional independence is the need for "processes conducive to the exercise of independent, informed oversight by a group of individuals, a majority of whom are separate from management."[71] The underlying policy expectation (based on core Sarbanes-Oxley principles) is that governance oversight will be enhanced by positioning the majority of directors to be free of relationships with the corporation or its management, whether business, employment, charitable, or personal—that may impair, or appear to impair, the director's ability to exercise independent judgment. Indeed, the Panel on the Nonprofit Sector has recommended that a "substantial majority" (i.e., two-thirds) of the members of the non-profit board should be independent. Independence issues also apply to key board committees (e.g., audit, compliance, and executive compensation) for both corporate responsibility and tax-exemption-related reasons.[72]

Positional independence as a governance concept is distinct from the question of whether a director has a conflict of interest with respect to a particular transaction.[73] Nevertheless, in practicality the distinction between "independence" and "conflict of interest" is often blurred in a manner that is confusing for the board. Both concepts focus on the ability of the board to render decisions in an objective manner without undue influence by individual directors who may possess a bias or other private interest. "Independence" is a structural consideration that focuses on the overall relationship between the director and the non-profit organization and its affiliates. In other words, the "independence inquiry" examines the potential for financial and other relationships that could reasonably be expected to influence a director's ability to meet fiduciary duty obligations to the non-profit on a consistent, "global" basis. Directors possessing such relationships should be limited in number. The conflict-of-interest inquiry examines the potential for interests and relationships to affect a director's ability to meet fiduciary duty obligations as it relates to a discrete issue.

71 ALI Principles, Sec. 310 (c)(3).
72 Panel Report, Principle 12.
73 ALI Principles.

IRS Definition of an "Interested Person"

There is no one-size-fits-all definition of an "interested person" of a non-profit corporation, for the purposes of determining director independence. Some state non-profit codes (e.g., California) have adopted a specific definition. The IRS adopts a unique and multi-step definition of an "interested person" for Form 990 reporting purposes. Healthcare corporations should consult their tax counsel as to the application of this definition (contained in the Index to the Form 990) for purposes of applying it to specific relationships.

The following sample definition of an "interested person" is from the IRS's sample conflict-of-interest policy:

1. Interested Person

Any director, principal officer, or member of a committee with governing board delegated powers, who has a direct or indirect financial interest, as defined below, is an interested person.

If a person is an interested person with respect to any entity in the healthcare system of which the organization is a part, he or she is an interested person with respect to all entities in the healthcare system.

2. Financial Interest

A person has a financial interest if the person has, directly or indirectly, through business, investment, or family:

a. An ownership or investment interest in any entity with which the Organization has a transaction or arrangement,

b. A compensation arrangement with the Organization or with any entity or individual with which the Organization has a transaction or arrangement, or

c. A potential ownership or investment interest in, or compensation arrangement with, any entity or individual with which the Organization is negotiating a transaction or arrangement.

Compensation includes direct and indirect remuneration as well as gifts or favors that are not insubstantial.

Determining Whether a Conflict of Interest Exists

A financial interest is not necessarily a conflict of interest. A person who has a financial interest may have a conflict of interest only if the appropriate governing board or committee decides that a conflict of interest exists.

After disclosure of the financial interest and all material facts, and after any discussion with the interested person, he/she shall leave the governing board or committee meeting while the determination of a conflict of interest is discussed and voted upon. The remaining board or committee members shall decide if a conflict of interest exists.

Appendix: Sample Conflict-of-Interest Policy

NOTE: This sample policy is expanded from the basic sample policy provided by the IRS. Great care should be taken to review the provisions of applicable state non-profit corporation law before finalizing the provisions of any conflict-of-interest policy. This language is intended to provide an example of a concise corporate policy regarding conflicts of interest, as opposed to simply a policy that addresses the procedure by which potential conflicts are identified, disclosed, and resolved. Healthcare corporations should consult their general counsel with respect to the development of a conflict-of-interest policy that addresses the specific need of the corporation and which complies with applicable law.

Board Policy No.: _____ **Subject:** Conflicts of Interest

Effective Date: _____, 20XX **Category:** Resolution

PURPOSES:

1. To protect the interests of **[name of organization]** (and its subsidiaries and affiliates) when it is contemplating entering into a contract, transaction, or arrangement that has the potential for benefiting the private interests of a "covered person," as defined below.
2. To assure that all individuals who, by virtue of their position, can influence decisions affecting the business, operations, ethical and/or competitive position of the corporation, perform their duties in an impartial manner, free from any bias created by personal interests of any kind.
3. To clarify the duties and obligations of covered persons in the context of potential conflicts of interest and, further, to provide such covered persons with a method for disclosing and resolving potential conflicts of interest.
4. To supplement (not replace) any applicable state laws governing conflicts of interest applicable to charitable, non-profit corporations. To the extent that other federal or state laws may impose more restrictive conflict-of-interest standards (including more extensive disclosures of actual or potential conflicts of interest), the board of directors of the corporation shall modify the substantive and procedural terms of this policy to assure compliance with such additional standards.

POLICY:

1. The policy of the corporation is: (a) to require that each covered person promptly, fully, and on a timely basis comply with the disclosure requirements set forth in this policy or in such other policies or procedures as may be developed by the board or its delegates in accordance with this policy; and (b) not to engage in any contract, transaction, or arrangement involving a conflict of interest unless the disinterested members of the board of directors (acting at a duly constituted meeting thereof; with the advice of legal counsel) determine by a majority vote that appropriate safeguards to protect the charitable mission of the corporation can be established and implemented.

As such, this policy applies to: (a) covered persons; and (b) any contract, transaction or arrangement involving the corporation.

Note: This language is intended to provide a concise corporate policy regarding conflicts of interest, as opposed to simply a policy that addresses the procedure by which potential conflicts are identified, disclosed, and resolved.

2. **Definitions**
   a. **Covered person**: Any director, officer, or non-director member of a committee with governing board-delegated powers or other person in a similar position of authority over the corporation is a covered person.

      Note: This reflects an intentional shift in focus (from "interested person") to the broader class of individuals who are subsumed within the scope of the policy and not just those who have an interest—the scope should be broader because it is intended to apply to all decision makers.
   b. **Conflict of interest**: A "conflict of interest" exists when a covered person has an interest in a proposed contract, transaction, or arrangement to which the corporation may be a party and with respect to which the covered person would otherwise be called upon to render a decision in that capacity.

      Note: The purpose of this addition is to include, as a frame of reference, a specific definition.
   c. **Covered interest**: A covered person has an interest with respect to a contract, transaction, or arrangement in which the corporation is (or would be, if approved) a party if the person has, directly or indirectly, through a business, investment or family member:
      i. An ownership or investment interest in any entity involved in such contract, transaction, or arrangement;
      ii. A compensation arrangement with an individual or entity involved in such a contract, transaction, or arrangement;
      iii. A potential ownership or investment interest in, or compensation arrangement with, an individual or entity with which the corporation is negotiating such contract, transaction, or arrangement; or
      iv. A fiduciary position (e.g., member, officer, director, committee member) with respect to an entity involved in such contract, transaction, or arrangement, but only to the extent that such position involves a material financial interest of, or benefit to, such person.

      For purposes of this section, compensation includes direct and indirect remuneration, consulting fees, board or advisory committee fees, honoraria, as well as gifts or favors that are substantial in nature.

      A covered interest does not necessarily constitute a conflict of interest. Under Section 3(d) below, a covered person who has an interest may have a conflict of interest only if the disinterested members of the executive committee decide that a conflict of interest exists.

d. **Family member**: With respect to a covered person, "family member" means, as applicable, a spouse, brothers or sisters (by whole or half-blood), spouses of brothers or sisters, ancestors, children, grandchildren, great-grandchildren, and spouses of children, grandchildren, and great-grandchildren.

Note: Attention should also be given to the organizational costs associated with having even the "appearance" of impropriety.

3. **Procedures**
   a. **Duty to disclose**: A covered person must disclose the existence of any interest and be given the opportunity to disclose all material facts to the directors and members of committees with governing board delegated powers considering the proposed contract, transaction, or arrangement.
   b. **Annual questionnaire**: Each covered person shall completely, accurately, and within the required timeframe established by the board [or the executive committee] submit the annual conflict-of-interest questionnaire (the "annual questionnaire") as prepared and distributed by the board [or executive committee].

   Note: It is important for the board to closely monitor the responsiveness associated with completion of the questionnaires.
   c. **Continuing disclosures**: If, subsequent to completion of the annual questionnaire, any covered person becomes aware of an interest that could give rise to a conflict of interest with respect to a proposed contract, transaction, or arrangement involving the organization, the covered person shall promptly make disclosure of the interest to the board [or the executive committee].
   d. **Determining whether a conflict exists**: The board [or the executive committee] shall determine by a majority vote of disinterested directors whether the disclosed interest may result in a conflict of interest. The executive committee shall: (i) review responses to the annual questionnaire and any continuing disclosures that are made during the year; (ii) take such steps as are necessary to identify interests and review any so identified; (iii) make such further investigation as it deems appropriate with regard to interests disclosed or identified; and (iv) determine whether any such interest gives rise to a conflict of interest. The subject covered person shall not be present during any meeting in which the executive committee conducts its evaluation, except to answer questions of the executive committee as may be necessary. The executive committee may request additional information from all reasonable sources and shall involve the general counsel in its deliberations. Once all necessary information has been obtained, the executive committee shall make a finding as to whether a conflict of interest indeed exists. Only disinterested committee members may vote to determine whether a conflict of interest exists. The subject covered person may not be present when this vote is taken.

   Note: This anticipates that the board may delegate the conflicts review process to the executive, or similar, committee.

e. **Addressing the conflict of interest**: Once the disinterested members of the board of directors have determined that an actual conflict of interest exists with respect to a particular contract, transaction, or arrangement:
   i. The disinterested members of the board of directors shall exercise due diligence to determine whether the corporation could obtain a more advantageous contract, transaction, or arrangement with reasonable efforts under the circumstances and, if appropriate, shall appoint a non-interested person or committee to investigate alternatives to the proposed contract, transaction, or arrangement.
   ii. In considering whether to enter into the proposed contract, transaction or arrangement, the board of directors or executive committee may approve such a contract, transaction, or arrangement only if the disinterested directors determine by a majority vote that:
      1. The proposed contract, transaction, or arrangement is in the corporation's best interests and for the corporation's own benefit; and
      2. The proposed transaction is fair and reasonable to the corporation, taking into account, among other relevant factors, whether the corporation could obtain a more advantageous contract, transaction, or arrangement with reasonable efforts under the circumstances.
   iii. The disinterested members of the board of directors or executive committee may, in their discretion, require the interested person to leave the room while the proposed contract, transaction, or arrangement is discussed. The covered person shall leave the room while the matter is voted on and only disinterested directors may vote to determine whether to approve the transaction or arrangement.

      In determining whether and when to require the covered person to leave the room during discussion of the proposed contract, transaction, or arrangement, the disinterested directors shall balance the need to facilitate the discussion by having such person on hand to provide additional information with the need to preserve the independence of the determination process.

      Note: Special care should be applied to assure that policy provisions establishing a conflict-of-interest review process are consistent with applicable state law.

f. **Violations of the conflict-of-interest policy**: If the board of directors or a committee has reasonable cause to believe that a covered person has failed to comply with the disclosure obligations of this policy, it shall inform the covered person of the basis for its belief and afford the covered person an opportunity to address the alleged failure to disclose. After hearing the response of such person and conducting such further investigation as may be warranted under the circumstances, the board of directors shall determine whether such person has, in fact, violated the disclosure requirements of this conflict-of-interest policy. If the board determines that there has been a violation, the board shall take appropriate disciplinary and corrective action, which may include removal (if the covered person is a board or committee member) or termination (if the covered person is an employee).

4. **Records of proceedings**: The minutes of meetings of the board of directors and any committee with board-delegated powers shall include:
   a. The names of persons who disclosed or were otherwise found to have an interest relevant to any matter under discussion at the meeting, a general statement as to the nature of such interest (e.g., employment arrangement, equity interest, or board membership or officer position in another corporation), any action taken to determine whether a conflict of interest exists, and the board or committee's conclusion as to whether a conflict exists; and
   b. The names of the persons present for the discussions and votes relating to the contract, transaction, or arrangement, a summary of the content of these discussions that contains the type of information regularly reported in board or committee minutes and identifies whether any alternatives were considered, and a record of any vote taken in connection therewith.
   c. If appraisals (for tangible property) or third party comparable data (for compensation) were considered by the [board or committee], the nature and source of the data.

5. **Compensation**
   a. A voting member of the board who receives compensation, directly or indirectly, from the corporation for services is precluded from voting on matters pertaining to that member's compensation.
   b. A voting member of any committee whose jurisdiction includes compensation matters and who receives compensation, directly or indirectly, from the corporation for services is precluded from voting on matters pertaining to that member's compensation.
   c. No voting member of the board or any committee whose jurisdiction includes compensation matters and who receives compensation, directly or indirectly, from the corporation, either individually or collectively, is prohibited from providing information to any committee regarding compensation.

6. **Annual statements**: Each interested person shall sign an annual statement that the interested person: (a) has received a copy of this policy; (b) has read and understands the policy; (c) agrees to comply with the policy; (d) understands that the policy applies to committees and subcommittees; (e) understands that the corporation is a charitable organization that must engage primarily in exempt activities; (f) agrees to report to executive committee any change to matters previously disclosed on the conflict-of-interest questionnaire; and (g) states that the information provided in the conflict-of-interest questionnaire is true and accurate to the best of his or her knowledge and belief.

7. **Periodic reviews**: To ensure that the corporation operates in a manner consistent with charitable purposes and does not engage in activities that could jeopardize its tax-exempt status, periodic reviews shall be conducted. The periodic reviews shall, at a minimum, include the following subjects:
   a. Whether compensation arrangements and benefits are reasonable, based on competent survey information, and the result of arm's-length bargaining.
   b. Whether partnerships, joint ventures, and arrangements with management organizations conform to the corporation's written policies, are properly recorded, reflect reasonable investment or payments for goods and services, further charitable purposes, and do not result in inurement, impermissible private benefit, or in an excess benefit transaction.

8. **Use of outside experts**: When conducting the periodic reviews as provided for in Section 7, the corporation may, but need not, use outside advisors. If outside experts are used, their use shall not relieve the governing board of its responsibility for ensuring periodic reviews are conducted.

Note: Sections 5, 7, and 8 are from the IRS's template conflict-of-interest policy.