Conflicts of Interest and the Non-Profit Board:

Guidelines for Effective Practice, 2nd Edition

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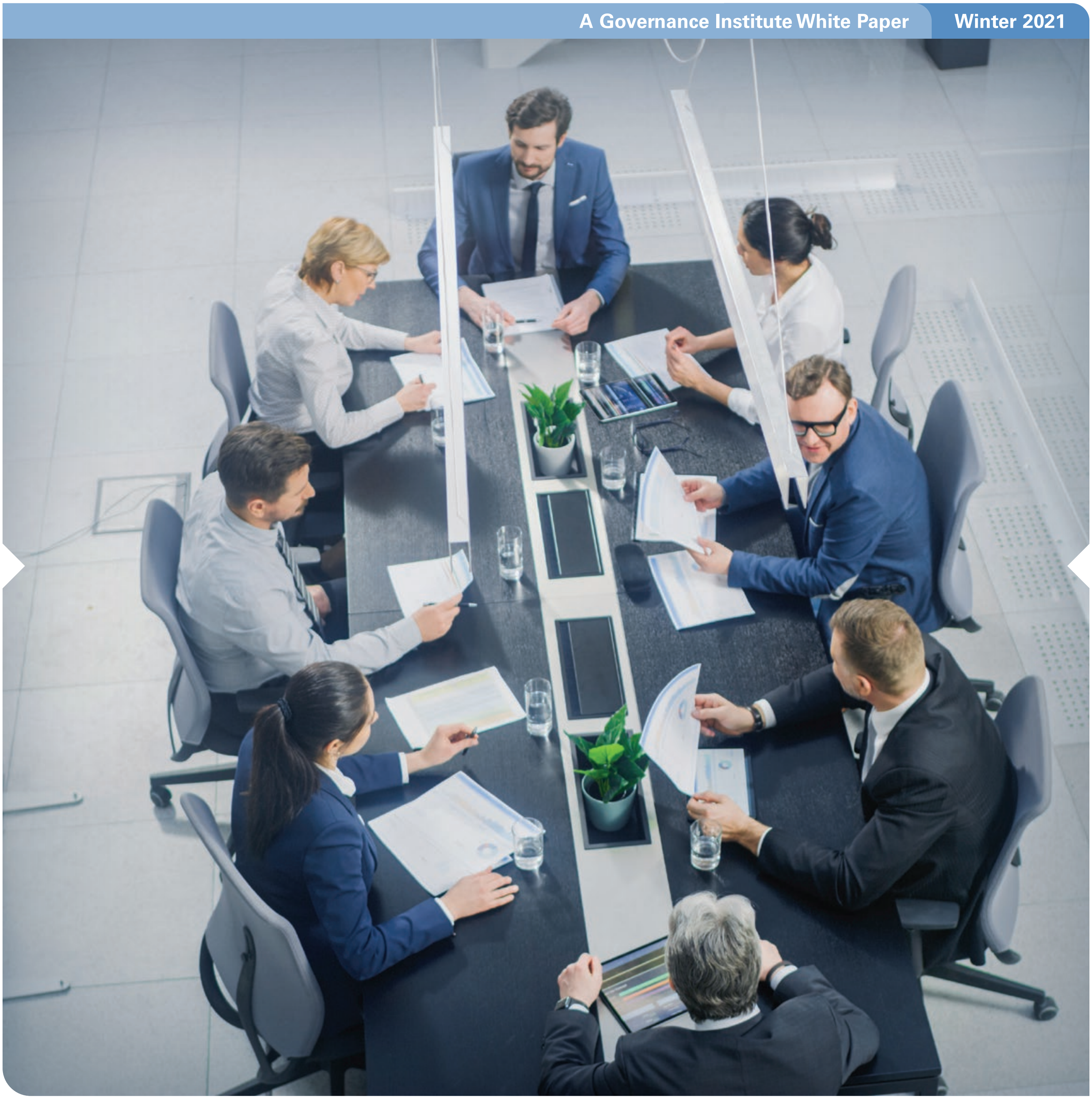

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Foreword

Why do individuals join non-profit boards? Because of a connection with the organization's mission and civic duty, to be sure. And also for more personal reasons—prestige, building social and business networks, and developing skills not available in one's day job, among others. When those motivations align, both the organization and the individual benefit.

But what about those inevitable times when there is friction, or even when a director allows personal gain to take precedence over mission? What happens next hinges on the organization's culture. It is this culture that will determine whether there will be opaque deals, exchanges of favors and blind eyes, or whether disclosure, discussion, and open decision making will ensure that the organization stays aligned with its mission.

The growing body of statutory requirements, regulations, and best practices provide organizations with the framework for systems of compliance. Whether those systems gel into a culture depends on committed and knowledgeable individuals constantly reviewing and reinforcing those systems. Thank you to Michael Peregrine and The Governance Institute for providing this important guidance to help healthcare organizations craft, and more importantly, implement sound conflict-of-interest policies, and for your commitment to fostering a culture of compliance that benefits us all.

Yael Fuchs
President, 2019–2020
National Association of State Charity Officials

Executive Summary

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

Evolution of the Law. In order to best understand where things stand now in terms of the law of conflict of interest, it is necessary to understand "where things used to be." In other words, effective conflict-of-interest oversight is enhanced by an appreciation of the law's evolution as it applies to the general concept of conflict of interest. As this white paper discusses in significant detail, current public policy generally allows conflict-of-interest transactions when certain specific statutory safeguards are satisfied. This reflects a corporate-law approach, which presumes that conflicts of interest are best addressed by scrutiny and management, not by attempts at elimination. This "permissive" approach is in strict contrast to the harsh treatment under the prior common law, which treated non-profit directors as "trustees, akin to fiduciaries of a charitable trust" and generally prohibited all business arrangements between the director and the organization.

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

Identifying Conflicts of Interest. The typical non-profit board reflects a diverse constituency with multiple civic, business, and community interests, activities, and affiliations. Given that, it is to be expected that individual directors will, from time to time, encounter situations where such interests, activities, and affiliations potentially conflict with those of the non-profit corporation. The potential for such conflicting interests to arise may increase with health industry diversification and provider consolidation. However, the mere fact that a director may periodically encounter a conflict does not place the director at immediate legal risk nor should it constitute a negative reflection on his/her integrity and ability to contribute to the board. Simply put, "conflicts happen."

Duty to Avoid Conflicts. Fiduciary principles regarding conflict of interest are grounded in the fundamental expectations that directors (a) should be sensitive to the issue of conflict of interest and (b) shall exercise good faith in attempting to avoid relationships and arrangements that may create conflicts, or the appearance thereof, during the director's term in office. In other words, directors are expected not just to disclose conflicts with which they are confronted; they're also expected to try to avoid circumstances that create them.

Disclosing Conflicts of Interest. The related 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 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. Transparency is supported by fulsome, timely disclosure by the implicated board members. 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.

Reviewing Conflicts Disclosures. The manner in which the board or relevant board committee reviews a conflicts-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 transactions related to conflicts of interest. 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), exemplary damages may be awarded.

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. This relationship should be carried forward in the context of governance policy development, and also in the formation and operation of key committees. The Internal Revenue Service (IRS) has traditionally been explicit in its confirmation of how conflict-of-interest policies and procedures contribute to preservation of federal tax exemption.

Conflicts vs. Independence. It is important to distinguish conflicts of interest from independence concerns.

"Positional independence"—e.g., separation between oversight and management—is well-established 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." 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 long 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.

Corporate Opportunity. Both well-established case law, as well as non-profit statutes in some states, recognize the doctrine of corporate opportunity as an element of the duty of loyalty. This doctrine is applied to preclude a board member (or other person in a fiduciary relationship to a company) from appropriating a business opportunity, prospect, or expectation that the director or other fiduciary identified, or developed with the support of corporate assets. Before taking advantage of that opportunity, the board member must first obtain board approval to do so.

Remedies for Breach. Most state laws do not specifically address remedies for breach of fiduciary duties. Typically, the remedy is left to the discretion of the court. However, it is worthwhile to note that a breach of the duty of loyalty carries with it a greater risk of prosecution and, ultimately, harsh sanctions. This is principally because the concept of self-dealing or similar improper conduct is perceived as antithetical to the expectation that a director will apply "absolute obedience" to the corporation's charitable purposes. Courts are more likely to impose financial sanctions (e.g., restoration of the corporate opportunity, reimbursement of self-dealing benefit) for duty of loyalty violations than for duty of care violations. State and federal charity officials will be very sensitive to credible, material allegations of conflict of interest.

The Role of the Law. The board must recognize that the interpretation of the duty of loyalty in general, and of conflicts of interest in particular, is substantially grounded in corporate law. Therefore, the general counsel and compliance officer should be consulted in any material discussion of conflicts related issues.

Introduction

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

The obligation to address conflict-of-interest matters appropriately is a critical 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. Business decisions requiring board authorization may be voidable if subject to conflict or bias in the deliberative process.

Courts have historically dealt severely with duty of loyalty violations. Furthermore, the mere *appearance* of a conflict can often lead to significant reputational harm for each of the implicated directors, the board as a whole, and the non-profit organization itself. Thus, the premise of this white paper is that 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. Such sensitivity also requires a recognition that conflicts issues invariably implicate legal concerns and often cannot be effectively addressed absent advice of its general counsel and compliance officer.

The Concept "in a Nutshell"

THE GOAL: To assure that directors don't use their position—including voting rights—for personal advantage.

THE ANALYSIS: Does the director have an interest in an arrangement of such personal significance that it could reasonably be expected to exert an influence on the director's judgment when called upon to vote on the arrangement?

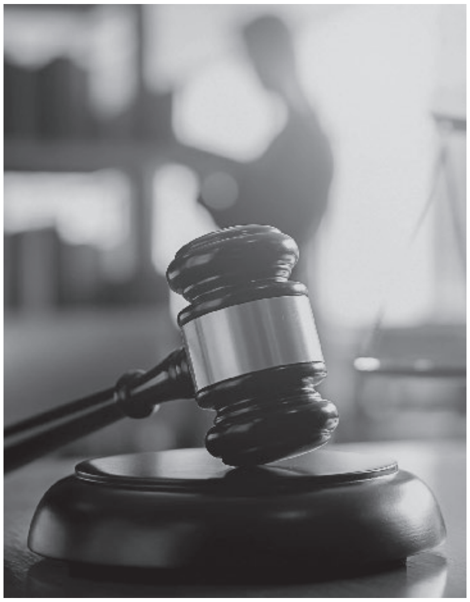
The following discussion is intended to provide board members, senior executives, compliance officers, internal auditors, and the general counsel with a greater appreciation of applicable public policy considerations, legal principles, and practical applications of conflict-of-interest oversight and management.

Chapter One: Evolution of the Law

An important prerequisite to any board-level discussion of conflicts of interest is a recognition that—while it certainly takes into consideration a variety of subjective factors—the concept is grounded in objective legal considerations. Principles addressing the key elements of conflicts of interest identification, disclosure, evaluation and resolution/mitigation are based on case law, state statutes, and government regulations. They are, in turn, interpreted and enforced by courts and regulators.

For those and other reasons, it is difficult for a governing board to effectively address conflicts of interest (and independence) issues without the assistance of its general counsel and chief compliance officer.

In order to best understand where things stand now in terms of the law of conflict of interest, it is necessary to understand "where things used to be." In other words, effective conflict-of-interest oversight is enhanced by an appreciation of the law's evolution as it applies to the general concept of conflict of interest.



As this white paper will discuss in significant detail, current public policy generally allows conflict-of-interest transactions when certain specific statutory safeguards are satisfied. This reflects a corporate-law approach, which presumes that conflicts of interest are best addressed by scrutiny and management, not by attempts at elimination.[1] This "permissive" approach is in strict contrast to the harsh treatment under the prior common law, which treated non-profit directors as "trustees, akin to fiduciaries of a charitable trust."[2]

Subjecting the non-profit director to the standards required of a trustee of a charitable trust has several notable implications. The most significant of these are that (a) the director is held to a liability standard of "simple negligence" as opposed to the more lenient standard of "gross negligence;" (b) delegation rights are limited; and (c) all business transactions and arrangements between the director and the non-profit organization are strictly prohibited, without regard to matters of board approval or fairness.[3]

Support for this harsh common law treatment eroded over time, with the recognition that such an absolute approach had the undesirable effect of denying the organization the assistance of individuals (e.g., directors) who were materially interested in the advancement of its mission.[4] In many instances, transactions involving directors have the potential for offering unique benefits associated with advice, quality, service, and cost as long as safeguards are in place to assure protection of the non-profit organization's interest.

For example, the American Bar Association's Model Nonprofit Corporation Act specifically rejects application of trust law to dealings between directors and the corporation as "overly restrictive for non-profit corporations.[5] It further rejects the notion that a director be prohibited from obtaining any profit from a transaction involving the director's corporation.[6] Thus, the more relaxed corporate law standard "attempts to provide a tolerable accommodation between the needs of non-profit corporations and the potential abuses by directors or officers."[7]

Accordingly, public policy has evolved to a far more lenient position (typically manifested by statute) creating a "rebuttable presumption" for conflict-of-interest transactions that are approved by a disinterested majority

[1] The American Law Institute, *Restatement of the Law of Charitable Nonprofit Corporations* (2020 draft), § 2.02. (Henceforth, "ALI Draft Restatement.")

[2] Lex. Stat. 1–6 Ballantine and Sterling California Corporation Laws, § 103 Conflict of Interest Transactions, Matthew Bender & Co., 2008. (Henceforth, "Ballantine and Sterling.")

[3] Peregrine and Schwartz, *The Application of Nonprofit Corporation Law to Healthcare Organizations*, American Health Lawyers Association (2002), pp. 50–52.

[4] Ballantine and Sterling, *supra*.

[5] *Model Nonprofit Corporation Act,* Third Edition, adopted by the Committee of Nonprofit Corporations of the Business Law Section of the American Bar Association, August 2008. (Henceforth, "Model Act.")

[6] *Ibid.*

[7] *Ibid.*

of the board, based on full disclosure, and supported by sufficient evidence of fairness to the corporation. This is, of course, a principle that the media and some non-profit sector observers often fail to appreciate.

This evolution in legal principles is noteworthy for two main reasons:

- First, governance—conscientious boards—need not prohibit all dealings between directors and the corporation in their zeal to achieve "best practice" (e.g., absolute prohibitions may be unnecessarily broad).
- Second, some such dealings can actually benefit the corporation and its mission, where certain safeguards are in place.

Practice Tips

In this regard, it would be helpful for the board "conflicts committee" (or other board committee responsible for handling conflicts of interest) to be briefed by general counsel on the evolution of conflict-of-interest law in its particular state and the extent to which vestiges of "trustee" treatment may remain. Indeed, there may be situations in which state law treats directors as trustees for certain reasons other than with respect to dealings between directors and the corporation.[8]

[8] American Bar Association, *Guidebook for Directors of Nonprofit Corporations*, Third Edition (Boyd and Frey, editors), Committee on Nonprofit Corporations (2012), pp. 53–55. (Henceforth, "Guidebook.")

Chapter Two: The Duty of Loyalty

Director obligations with respect to conflict 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 duty of loyalty obligates the non-profit director to exercise his/her corporate powers in good faith and in the best interests of the non-profit 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.[9] The duty is subsumed within the Model Act's requirement that directors act *in good faith and in a manner the director reasonably believes to be in the best interests of the corporation*"[10] [emphasis added]. In its purest form, the duty of loyalty seeks to assure that the director will not use his/her position for individual personal advantage;[11] for example, "an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest."[12]

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.[13] A court will conduct a facts and circumstances analysis to determine whether this good faith requirement is satisfied in individual circumstances.[14]

The requirement that the director act in the best interests of the corporation is both subjective and objective in nature. The "subjective" analysis seeks to confirm that the director actually believed that the action was, indeed, in the best interests of the corporation.[15] The "objective" analysis seeks to confirm the reasonableness of that actual state of mind (e.g., "...could [not would] a reasonable person in a like position and acting in similar circumstances have arrived at that belief").[16] Again, the court will apply facts and circumstances analysis in evaluating compliance with this requirement.[17] Unlike a business or even a mutual corporation, "best interests" of the non-profit corporation refers to satisfaction of the charitable or public mission expressed in its corporate purposes clause, and not to personal advantage or pecuniary return.[18]

To Whom Does It Apply?

Like other fiduciary duties, the duty of loyalty is generally perceived as imposed on the persons or body who hold a title that suggests the right to oversee the operations of, and set policy, for the non-profit corporation, as well as someone who performs similar significant duties for the corporation. These are the persons that the law generally refers to as fiduciaries to the non-profit corporation. From a nomenclature/title perspective, this would normally include trustees, directors, or other titles that serve to designate the person as a key officer (e.g., a president or chief executive officer-although their employment contract may specifically designate them as a fiduciary). Those titles do not, however, constitute the universe of persons the law may consider to be in a fiduciary relationship to the corporation (e.g., a person who has no formal role but nevertheless directs the affairs of a non-profit may be a fiduciary). In the absence of any contrary statutory provision, this concept of fiduciary status should apply regardless of whether the board member is compensated or uncompensated.[19]

A non-board member who exercises the powers of a governing board member (such as a "lay" member of a committee with board-delegated powers) is typically viewed as a fiduciary and thus subject to the duty of loyalty.[20] Depending on specific state law, corporate officers who are not board members may not 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, bylaw and policy provisions, and the terms of an employment agreement).[21] Accordingly, some non-profit organizations maintain separate conflicts policies for board members and for non-board member executives, respectively. Other non-profits require such

[9] Guidebook, *supra*, p. 43.
[10] Model Act, *supra* at § 8.30(a).
[11] Guidebook, *supra.*
[12] *Guth v. Loft, Inc.,* 5 A.2d 503, 510 (1939).
[13] Model Act, *supra* at Official Comment § 8.30(a)(1).
[14] *Ibid.*
[15] *Ibid.*
[16] *Ibid.*
[17] *Ibid.*
[18] Model Act, supra at Official Comment § 8.30(a)(2); Ballatine and Sterling, *supra.*
[19] ALI Draft Restatement at § 2.01.
[20] *Ibid.*
[21] ALI Draft Restatement at § 2.02; Ballatine and Sterling, § 406.01[8].

executives, by employment contract, 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.[22] This fundamental concept applies to every member of 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 (for example, through the efforts of a fellow board member, donor, or community group).[23] 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. It is important to recognize that fiduciary duties are owed to the purposes of the non-profit entity and not to the entity itself, "and that duty is owed to the purposes regardless of the legal form in which the entity was established."[24] As a result, it is conceivable that in certain circumstances "advancing the charitable purpose may be to the detriment of the charitable entity and result in the discontinuation of that entity."[25]

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, violations of the duty of loyalty may also implicate the jurisdiction of other regulatory agencies with an interest in the governance of charities and other non-profit corporations (e.g. the IRS, the Department of Justice, the Federal Trade Commission, and the Secretary of State and certain state licensure agencies). The presence or appearance of conflict may also affect the manner in which creditors and other third parties approach the performance of fiduciary duties in adversarial circumstances.

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., disclosure).[26] While there is typically no private right of action recognized for violations of the duty of loyalty, the Model Act contemplates, and many state non-profit laws provide for, derivative action to be instituted by board members under certain specific circumstances.[27]

Specific Application

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

- Has a conflict of interest;
- Usurps a corporate opportunity; or
- 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. Indeed, 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.[28]

The balance of this white paper will focus principally on the duty of loyalty as it relates to conflicts of interest, and tangentially to corporate opportunity to the extent that it involves similar concepts and issues.

Practice Tips

- **Ask general counsel for briefing on duty of loyalty cases in the 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 conflicts 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 (the "rat-out" rule).**

[22] Guidebook, *supra*, p. 43.
[23] *Ibid.*
[24] ALI Draft § 2.02, *supra*.
[25] *Ibid.*
[26] Guidebook, *supra,* p. 52; Model Act, at § 8.30(c).
[27] Model Act, *supra* at § 13.
[28] See, e.g., Panel on the Nonprofit Sector, *Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations* (October, 2007), Principle #3. (Henceforth, "Panel Report.")

Chapter Three: Conflicts of Interest Identification

Core Fiduciary Concepts

The typical non-profit board reflects a diverse constituency with multiple civic, business, and community interests, activities, and affiliations. Given that, it is to be expected that individual directors will, from time to time, encounter situations where such interests, activities, and affiliations potentially conflict with those of the non-profit organization.

The potential for such conflicting interests to arise is likely to increase with (a) the continued diversification and consolidation in the healthcare industry; and (b) the focus on recruitment of directors with specific skill sets or background/experiences (who are thus in high demand for board service). Many healthcare companies have substantially expanded their strategic direction and their ownership portfolio. In particular, the focus on technology and innovation (as well as other themes of business disruption) is impacting the competitive horizon. These and similar factors require healthcare directors and governance support personnel to think more expansively about interests, relationships, and arrangements that could give rise to a potential conflict.

The reality of this basic board construct is recognized by the law. The mere fact that a director may periodically encounter a conflict of interest does not place the director at immediate legal risk (breach of duty or otherwise), nor should it constitute a negative reflection on his/her integrity and ability to contribute to the board.[29] Simply put, "conflicts happen."

In such a situation, the duty of loyalty obligates the board member to respond "with care and candor."[30] The board—and its individual members—should recognize that breach of fiduciary duty arises not with the presence of the conflict but rather with (a) the failure of the individual director to adequately disclose the presence of the conflict, and/or (b) the failure of the board/committee to adequately and timely resolve individual conflicts disclosures. It is in this context that the ability of both individual directors and the board to identify potential conflicts is critical to the conflicts compliance process.

Indeed, some non-profit commentary suggests that board members may also have a duty to *avoid* likely impermissible conflicts (those conflicts which no board could reasonably waive in the best interests of the corporation, given the facts and circumstances of the conflict-of-interest transaction).[31] Especially under this more aggressive suggestion, identification of the potential conflict is fundamental to compliance.

A common misperception of the conflict-of-interest oversight process is that in its desire to protect the non-profit mission, it is punitive to individual directors. Indeed, an effective process protects the interests of the individual director (from breach of duty exposure) while simultaneously serving the corporation's interest (from board decisions improperly motivated by self-interest). For the conflicts process to function as intended, it is important that individual board members recognize that the process protects both the organization and the director.

Reflective of their duty of loyalty roots, conflict-of-interest policies and procedures are intended to prevent individual directors and others with organizational decision-making authority from taking action that may benefit themselves, their immediate family members, their business affiliates, and other civic or community interests.[32] Simply put, the goal is to protect against situations that could prevent the director from acting in the best interests of the organization. In order to effectively do so, however, such policies and procedures should provide guidance on conflict identification (e.g., the types of potential contracts, transactions, arrangements, and affiliations that may give rise to a conflict of interest).

Basic Concept

The term "conflict of interest" has no universally accepted definition and its use often varies according to particular circumstances. Generally speaking, a conflict of interest can be considered to arise when the personal interests of an individual (or an organization) has the potential to affect an obligation owed to make decisions for the benefit of a third party.[33]

Corporate director conflicts of interest are considered to arise when directors' personal, financial, or similar interests conflict with their fiduciary responsibilities to the purposes of the corporation (in the context of a non-profit

[29] Panel Report, Principle #3, *supra;* Guidebook, *supra,* pp. 43–44.

[30] *Ibid.*

[31] *Ibid.*

[32] David B. Rigney, "Conflicts of Interest Policies and Procedures for Nonprofit Organizations," *Nonprofit Governance: The Executive's Guide* (Victor Futter & Geroge W. Overton, eds.) 1997, p. 111.

[33] Dennis F. Thompson, "Understanding financial conflicts of interest," *The New England Journal of Medicine,* Vol. 329 (August 19, 1993), pp. 573–576; Guidebook *supra,* p. 44.

corporation); or to the corporation and its shareholders (in the context of a for-profit corporation).[34]

In other words, a conflict of interest arises when, within the circumstances of a particular decision-making context, an individual is compressed by two co-existing interests that are in direct conflict with each other. For example, primary interests of a corporate director (e.g., his/her fiduciary obligations) may become inappropriately influenced by secondary interests such as personal benefit (e.g., financial gain, personal or professional reputation, familial needs) or similar obligations to another organization. The presence of such a conflict does not in and of itself establish a breach of any specific duty. Nevertheless, the failure to adequately address the conflict can have a direct impact on organizational and personal reputation, and the integrity and reliability of the underlying decision-making process or other duties (e.g., exercise of oversight) which the director owes.[35]

Identifying Potential Conflicts

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.[36] The potential is made more acute where the contract, transaction, arrangement, or affiliation calls for board action. "Material" should be considered in its generally accepted legal context; for example, an interest will be regarded as material if there exists a substantial likelihood that a reasonable person would consider it important in deciding what action to take.[37] Such conflicts may arise from service on both the board, and on a committee with board-delegated powers.

Typically, conflicts of interests arise in connection with a financial arrangement involving a director. 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.[38] Directors and committees responsible for conflicts should be sensitive to the potential for conflict arising from *all* such relationships, identifying for directors this potential, and the resulting need for disclosure.

There is no uniform definition of "family member" for purposes of the conflict-of-interest process. Many non-profits define the term to include the director's spouse, children, grandchildren, great grandchildren, siblings (by the whole or half-blood), and the spouses of such different classes of family members. Some organizations apply the definition used by the IRS in the Form 990 for these purposes.

Typical Financial Interests

Common examples of financial interests that could potentially create a conflict of interest involving a director (e.g., 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 an accounting firm, which is simultaneously bidding to provide external auditor services to the non-profit organization.]*

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). 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.

[34] Peter E. Kay, "Director Conflicts of Interest under the Model Business Corporation Act: A Model for All States," *The George Washington Law Review*, Vol. 207, No. 69 (1994).

[35] See, e.g., P. A. Komesaroff, I. Kerridge, and W. Lipworth, "Conflicts of interest: new thinking, new processes," *Internal Medicine Journal*, Vol. 49, No. 5 (2019), pp. 574–577.

[36] Guidebook, *supra,* pp. 43–45.

[37] *Ibid.*

[38] ALI Draft Restatement at § 2.02.

- Foundation Director B simultaneously serves 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.
- 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.

A more difficult analysis is presented when the non-financial interest is based on associational or other non-fiduciary relationships; for example:

- The spouse of Museum Director A is an uncompensated officer of a community organization that publicly opposes by litigation a proposed expansion of the Museum campus (e.g., would the family relationship affect Director A's objectivity in connection with decisions concerning the expansion?).
- Foundation Director B is a publicly recognized major donor to Social Service Agency, which has applied to Foundation for a major benevolence grant (e.g., would the donor relationship—neither financial nor fiduciary in nature to Foundation—affect Director B's objectivity in connection with decisions concerning the grant request?).
- Medical Research Organization Director C is a prominent, life-long uncompensated volunteer supporter of Disease Prevention Organization, which has published in its quarterly journal the results of clinical research that challenges previous findings of Medical Research Organization (e.g., would the volunteer position affect Director C's objectivity in connection with decisions regarding a possible response to the publications?).

Intra-Board Relationships

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

For example, Hospital Directors A and B are principal investors in the same partnership, in which Director B holds authority regarding the timing and amount of certain annual discretionary financial awards. An important vote at the Hospital board is coming up, on a matter which Director A supports but knows that Director B strongly opposes. Director A questions whether he should oppose the matter in order to avoid alienating Director B and jeopardizing the likelihood of receiving a discretionary partnership distribution before year end.

The IRS specifically inquires about the presence of these "intra-board relationships" in Part VI of its Form 990, "Return of Organization Exempt from Income Tax." 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?"[39] 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.

It is important to recognize for conflicts identification purposes that a conflict can arise even in situations in which a director receives no monetary or tangible benefit from a transaction; it is not a prerequisite for a determination that a director may be biased (or appear to be biased) for conflict identification purposes.[40]

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.

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 perceived as having advantages to the corporate system as a whole, but which is disadvantageous to a particular affiliate.

For example, consider a proposal before the parent company board to reallocate the provision of women's healthcare services from one hospital in the system (Affiliate "A") to another hospital in the system (Affiliate "B") in order to materially expand the level and quality of care that can be provided.

While such a proposal may be in the best interests of the system, Affiliate B, and the parent corporation, it may not be in the best interests of Affiliate A, which would be losing its obstetrics service. The common directors between the parent board and Affiliate A may be faced with conflicting duties of loyalty given the nature of the proposal. The common directors between the parent board and Affiliate B may not be faced with conflicting duties of loyalty assuming that the proposal is in the best interests of both the parent corporation and Affiliate B. Nevertheless, disclosure of the interlocking board relationship by all involved directors may well be prudent, particularly when

[39] See the IRS Form 990, available at www.irs.gov/pub/irs-pdf/f990.pdf.

[40] Guidebook *supra,* p. 44.

the issue involves controversy/significant community interest. Concerns with respect to the potential for a disabling conflict may arise when common directors constitute a majority of an organization's board.

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. (Whether such a financial interest exists may indeed be relevant for purposes of the review standard; see Chapter 5.)

In both of these situations, the corporation/board should involve its general counsel in the resolution of the disclosure/potential conflict. This is particularly important for conflicts arising from interlocking directorships within health systems. It is also important to the extent that the issue of interlocking directors implicates antitrust concerns.

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 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.
- Director A, whose adult child is a salaried employee of the non-profit organization, 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.

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 ultimate 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. Their "heads should be on a swivel" when it comes to conflict vigilance. Staff (e.g., governance support personnel and the general counsel) should be vigilant as well.

Practice Tips

- **Conduct a "pre-clear" of potential conflicts of interest as part of the new director nomination due diligence process.**
- **Periodically provide directors with media articles on conflict-of-interest issues.**
- **Reduce the potential for conflicts arising from intra-system interlocking boards by adopting a common charitable mission amongst parent and affiliates.**
- **Periodically identify potential conflict risks and corporate opportunities for board.**
- **Identify a "go-to" person within the organization (e.g., general counsel, compliance officer, or chief governance officer) who may answer questions on conflict identification and disclosure.**
- **Directors should be clear: "When in doubt, disclose!"**

Chapter Four: Conflicts of Interest Disclosure

In General

The principal affirmative conflict-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 individual directors could be acting under divided loyalty. 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. The knowing failure to make adequate disclosure of a potential conflict of interest risks being regarded as a breach of the "acting in good faith" component of the duty of loyalty.[41]

A strong argument can be made that the duty of loyalty requires directors to identify for the rest of the board actual or potential conflicts of a fellow director or officer that such director or officer has not himself or herself affirmatively disclosed. This requirement would arise from the basic obligation of a director to disclose to the board of directors information and analysis known to them that is relevant to the board's decision making and oversight responsibilities.[42]

A circumstance in which a director would sit idly by, and not identify an undisclosed conflict of another director while the board proceeded to consider a transaction or relationship implicating the undisclosed conflict could give rise to a breach of the duty of care.

Adequate disclosure serves three 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. Third, it may alert the board to more significant or systemic concerns arising from the nature of the director's disclosure. Full disclosure is a fundamental prerequisite for rebuttable presumption treatment for conflict-of-interest transactions under most state non-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.[43]

Potential vs. Actual

Effective disclosure practice should draw a distinction between *potential* and *actual* conflicts of interest. The policy goal should be to prompt the individual director to disclose those interests (whether contracts, transactions, agreements, or affiliations) *that have the potential for* being in conflict with the interests of the corporation. The job of actually determining whether a particular disclosed interest constitutes an actual conflict of interest is the responsibility of the board or the responsible committee. Interests (disclosed or not disclosed) constitute a conflict of interest only if the board or appropriate committee determines that they create conflict of interest. Is this too fine of a distinction? Not really. Effective disclosure practice is best served when an individual director does not feel burdened by the obligation to actually determine whether a particular interest is indeed a conflict of interest. Rather, the director's responsibility is to make disclosure merely on the potential that the interest could reasonably constitute a conflict (e.g., affecting the director's ability to act in the best interests of the corporation).[44] In sum, the basic rule should be, "when in doubt, disclose!"

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, arrangement or relationship, and the disclosing director's interest therein, such that the board/committee may determine the transaction's fairness to the non-profit organization.[45] A fact is generally considered material if there is a substantial likelihood that a reasonable person would consider it important in deciding how

[41] *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," *Iowa Journal of Corporate Law,* Vol. 631, No. 23 (Summer 1998).

[42] American Bar Association, *Report of the American Bar Association Task Force on Corporate Responsibility*, 2003.

[43] ALI Draft Restatement, supra at § 2.02; Model Act at § 8.31.

[44] Guidebook, *supra,* pp. 45–49.

[45] Model Act at § 8.31.

to vote.[46] 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.

In this regard, it is particularly important that the disclosure should include its nature—whether arising from direct or indirect financial, personal, or other arrangements.[47] For example, disclosure of a financial interest would ideally include such details as:

- The nature of the arrangement (e.g., a compensation arrangement for employment)
- The parties (e.g., the director and the corporation from which the non-profit intends to purchase goods and services)
- The dollar amount (e.g., total annual compensation and how it is determined)
- The time period involved (e.g., the term of the employment agreement)
- The scope of the arrangement (e.g., to serve in a particular position with the corporation with certain stated responsibilities)

Ideal disclosure of a non-financial interest likely would include, among other information, the nature of the interest (the board's position with an organization with which the non-profit wishes to contract, for example); the parties involved (such as the name of the other corporation the director serves), and the extent to which the director participates in the decision-making process (normally, by vote, and by participation in meeting).

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.[48] Where particularly sensitive confidentiality concerns exist, the director may wish to consult first with the organization's general counsel. The director may seek to make a discrete disclosure through a corporate officer, such as the general counsel or compliance officer. It is conceivable, though, that resignation may be necessary if the director feels incapable of disclosing even that *de minimus* level of information.[49]

Case Example

A leading conflict-of-interest case in the non-profit sector provides a good example of where non-disclosure, or limited disclosure, can constitute a breach of the duty of loyalty. The case involved a physician who served as both the president and as a director of a non-profit healthcare organization. Concerns arose with respect to the physician/executive's role in establishing his salary, establishing a severance plan, and using corporate funds for personal expenses. The organization sued the physician for breach of fiduciary duty on the basis of self-dealing. The court held for the non-profit organization (awarding damages), determining that the physician/executive breached his duties by failing to disclose to the organization the salary and benefits he earned from an outside source; information that would have been relevant to any discussion by the board of reasonable compensation, the court concluded.[50]

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.[51] Such a questionnaire normally requests information concerning all principal business and professional arrangements and affiliations with business organizations conducting business with the non-profit organization. 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, chief compliance officer 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 (or the board committee responsible for handling conflicts) with updates to the information contained in the submitted questionnaire when he/she subsequently becomes aware of an interest that requires disclosure. This is particularly the case in connection with important transactions (e.g.,

[46] Model Act at § 8.31.

[47] Guidebook, *supra,* pp. 45–49.

[48] *Ibid.;* see also ALI Draft Restatement, *supra* at § 2.02.

[49] *Ibid.*

[50] *Boston Heart Foundation, Inc. v. Nadal-Ginard, supra,* n. 37.

[51] Panel Report, *supra*; Janet E. Gitterman and Marvin Friedlander, "Health Care Provider Reference Guide," *Internal Revenue Service EO Continuing Professional Education Text FY 2004* (Appendix A). (Henceforth, "Gitterman and Friedlander.")

mergers or affiliations) for which a supplemental or other form of updated disclosure may prove useful.

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. Such a practice, while potentially time consuming, can aid considerably to efforts designed to identify conflicts in advance. Support in this regard can come from advance distribution of detailed board and committee agendas, thus allowing members the opportunity to evaluate the potential that particular agenda items might prompt the need to make disclosure. In addition, supplemental/targeted disclosures for particular transactions may be advisable. Comprehensive questionnaires often seek to elicit from the specific information necessary to complete the organization's Form 990 from the IRS.

Recordkeeping

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

- Conflict-related inquiry in the board/committee member nomination/re-election 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

Submitted questionnaires should be kept in corporate records that, like minutes, are readily accessible. Advice on disclosure questions provided to directors by the general counsel should similarly be documented for the file, in writing. As discussed in more detail in Chapter Five, meticulous minutes should be taken at all meetings called to resolve potential conflict disclosures.

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 conflict 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. Illegible or incomplete 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 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.

Practice Tips

- **Ensure directors submit subsequent (to questionnaire submission) disclosures as needed throughout the year.**
- **Hold a board/committee meeting to consider disclosures.**
- **Determine and communicate to directors how to address conflict-related abstentions in meetings.**
- **Emphasize the personal liability protection associated with disclosure.**
- **Review the individual questions set forth in the questionnaire to confirm that they seek to elicit useful conflict-related information.**
- **Adopt specific requirements for timeliness and quality of questionnaire responsibilities, with penalties for non-compliance.**
- **Assign to the general counsel the responsibility to review submitted questionnaires.**
- **Consider a summary of conflict disclosures, reviews, and abstentions that is reported to the board as part of the annual report of the conflicts committee.**

Chapter Five: Conflicts of Interest Review Process

In General

The manner in which the board or relevant committee reviews a conflict-related disclosure is of critical fiduciary significance. The reviewing body must conduct its activity consistent with the duty of care or similar standard. Furthermore, assuming proper disclosure and adequate board review, state law may specifically allow entering into certain transactions related to conflict of interest. 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 (such as fraud or malicious conduct), exemplary damages may be awarded.[52]

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.[53] 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.[54] The non-profit organization's general counsel, and/or outside corporate counsel (and perhaps the chief compliance officer), should be involved in the conflict-of-interest evaluation process to advise the designated review body.[55]

The Role of Fairness

In the most general sense, an interested director may defend himself/herself against any effort to avoid a conflict-of-interest transaction on the grounds of its fundamental fairness to the corporation at the time it was authorized or entered into. (This is even if the rebuttable presumption criteria, described below, have not been satisfied.) The standard generally referred to in evaluating the fairness of conflict-of-interest transactions was established by the Supreme Court:

> "Their dealings with the corporation are subjected to a rigorous scrutiny.... The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's-length bargain."[56]

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[57] 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 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.[58]
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.
3. It is important to note that this does not require an absolute determination of fairness, but rather that the directors believed that it was fair and had a reasonable basis on which to reach their conclusion.[59] By this standard, the directors are shielded from liability even if it were subsequently determined that the directors' fairness conclusion was wrong.[60] (Business judgment

[52] Model Act at § 8.31, 8.60.
[53] ALI Draft Restatement, *supra* at § 2.02.
[54] *Ibid.*
[55] *Ibid.*
[56] Model Act at § 8.31, Comment H.
[57] See, e.g., 805 ILCS 105/108.60(c).
[58] Model Act at § 8.60; ALI Draft Restatement at § 2.02.
[59] Model Act at § 8.31, 8.60.
[60] *Ibid.*

rule protection is generally not available to directors whose exercise of care was not in good faith.)[61]

4. 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.[62]
5. Rebuttable presumption or safe harbor treatment can also be obtained by court or attorney general approval for the transaction if obtained following consummation of the transaction, however, it is not guaranteed and therefore advisable to seek the safe harbor treatment in advance.[63]

This type of statutory safe harbor is similar to the "Rebuttable Presumption of Reasonableness" under the Intermediate Sanctions excise tax penalty rules of the IRS, in that they both seek to place the burden on those challenging the fairness of the transaction. If the rebuttable presumption requirements are not met, the burden shifts to the conflicted director to prove that the transaction is both fair and in the best interests of the non-profit.[64]

Consistent with the evolution from "trust" to "corporate" law standards discussed in Chapter One, this safe harbor approach rejects the harsh view that a director may not profit from a transaction involving his or her corporation.[65] The rebuttable presumption concept acknowledges that some individuals are elected to non-profit boards because of their particular professional or other skills, which potentially may be made available to the non-profit under favorable treatment.[66] In this way, the law seeks to "provide a tolerable accommodation" between organizational needs and potential abuse by officers and directors.[67]

Quorum and Voting Requirements

Issues related to quorum and voting requirements in conflict-of-interest matters are usually state-law specific. 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 (the interested director may not vote) when the board or committee takes action on the potential conflict or the actual transaction.[68] There is less statutory uniformity 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 for the discussion relating to the nature of the conflict.[69] 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.

Representative State Statute

A useful example of how states, and their charity officials, address conflict of interest issues for non-profit corporations is contained in guidance from the New York Attorney General's office. The guidance summarizes the scope of the statute and provides additional explanation of, and rationale for, key portions of the underlying statute.

Generally speaking, the guidance and the statute require: (i) directors to make disclosures about potential conflicts at the beginning of their board service, and annually thereafter; (ii) directors, officers, and "key persons" to disclose potential conflicts of interest in issues coming before the board and to refrain from participating in both board deliberations and decisions on those issues; and (iii) the non-profit corporation to set forth its procedures for disclosing and resolving conflicts in a specific conflicts-of-interest policy that is adopted by the board.[70]

Aspects of the statute emphasized by the guidelines include the need to make a written record of the manner in which the disclosed conflict was resolved; the broad

[61] ALI Draft Restatement at § 2.02; Guidebook *supra,* pp. 44–48.
[62] Model Act at § 8.31, 8.60.
[63] *Ibid.*
[64] ALI Draft Restatement at § 2.02; Guidebook, *supra,* pp. 44–48.
[65] Model Act at § 8.31, 8.60.
[66] *Ibid.*
[67] *Ibid.*
[68] See, e.g., 805 ILCS 105/108.60(c).
[69] Guidebook, *supra,* pp. 44–48.
[70] State of New York Attorney General, *Conflicts of Interest Policies Under the Non-profit Corporation Law*, Charities Bureau Guidance Document, September 2018.

definition of "key person" (that could include the organization's founder, and a substantial donor) and the need to prevent any attempt by the person with the conflict to influence the conflict resolution process.

Additional Requirements

In certain states, it may also be acceptable for a non-profit organization to impose additional requirements for the approval of conflict-of-interest transactions.[71] These might include, for example, requiring supermajority (as opposed to simple majority) vote for approving conflict-of-interest transactions, and requiring that approval for such transactions may only be provided by the full board and not by a committee with board-delegated powers.[72] It is also conceivable that a board could vote to prohibit all transactions between interested directors and officers.[73] Such an action would require close deliberation by the board as to whether reversion to a harsher trust-law approach would truly be in the best interests of the organization. In addition (and depending on state law), the board could also approve a "streamlined approach" to resolving certain types of conflicts; for example, advance waiver of routine conflict-of-interest transactions, or of potential business opportunities in which the charity might otherwise be interested.[74]

Interlocking Directors

Depending on particular state law, transactions involving interlocking dictatorships—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) was 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.[75]

However, conflicts issues relating to interlocking dictatorships between related corporations under common control or ownership are increasingly complex and contentious. Where issues are presented to a healthcare board and the impact of the resolution of those issues may affect "sister" or affiliated corporations in a different manner, the interlocking director may be in a difficult conflict situation where recusal may be necessary. Advice of the general counsel may be necessary to resolve the issue.

Conflicts 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 "conflicts 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, of course, 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[76]
- Periodic status reports to the committee responsible for reviewing conflicts
- Monitoring benefits of 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 to protect against unanticipated or excessive personal benefit to conflicted director)

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.[77] 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 is that it may often be appropriate to review those situations where there is merely an appearance of a conflict, even if the organization itself has determined that a conflict does not exist or otherwise did not act in response to the arrangement.

[71] Model Act, *supra* at § 8.31.
[72] *Ibid.*
[73] *Ibid.*
[74] ALI Draft Restatement, *supra* at § 8.31.
[75] Ballantine and Sterling, *supra* at § 406.03.
[76] Gitterman and Friedlander, *supra,* Appendix A, p. 31.
[77] Panel Report, *supra.*

Factors that prompt appearance issues can be reflective of a host of corporate governance issues, and may invite inquiry by regulators who are responsible for safeguarding charitable assets—as a valid extension of the "where there's smoke, there may well be fire" adage. 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.

Reputational issues are a significant corporate asset, so how "appearance" issues are presented in the public can be a major consideration. The media rarely appreciates the nuances of a complex corporate transaction, but is particularly sensitive to situations suggestive of conflict of interest—particularly those involving non-profits. Many state charity officials will say that they do take media stories about charity abuse seriously and may, in certain situations, make initial inquiries with a charity based on allegations in the media.

Thus, 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.

You Make the Call: Actual Conflict, Troublesome Appearance, or Acceptable Process?

The building committee of a non-profit museum selects as its architect for a major expansion project the daughter-in-law of its board chair/major donor. The selection process did not involve competitive bids, but did include presentations submitted by the individual candidates, and the selection was based on the candidate with the superior presentation. The selection reflected the committee's interest and acknowledgement of the architect's experience (which included a similar project for another charitable organization for which the architect's father-in-law served as board chair). The nature of the family relationship was fully disclosed to the board of trustees before the selection was ratified, as well as to the state agency that was to provide a portion of project funding. The board chair recused herself from the vote and played no role in the selection process.

Practice Tips

Refer to Appendix B for a list of sample review criteria which could be applied by the board or conflicts committee in evaluating whether a potential conflict disclosure constitutes an actual conflict of interest.

Consider adopting a conflict management plan to provide prospective protection of the organization's interests in conflict transactions that have satisfied the safe harbor criteria.

Chapter Six: 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.

This focus on conflict-of-interest oversight is part of a much larger IRS emphasis on the corporate governance of tax-exempt organizations. IRS officials have repeatedly expressed their belief that the existence of an independent governing board, combined with well-designed governance and management policies and procedures, increases the likelihood that an organization will comply with the tax laws.[78] To that end, the promotion of good governance, management, and accountability has become a new "pillar" of the IRS' compliance program for the tax-exempt sector.[79]

The IRS' view is that efforts to maintain a compliant, healthy charitable sector are supported by efforts to encourage the tax-exempt community to adhere to commonly accepted standards of good governance. The IRS has expressed concern with increasing evidence of abuse within the tax-exempt sector and about the failure of the sector to fully appreciate the extent to which abuse has emerged in recent years.[80] Organizational efforts to maintain effective oversight of conflict-of-interest transactions is thus perceived from an exemption perspective as a means of supporting meaningful governance and accountability.

IRS focus on conflict-of-interest in tax-exempt organizations 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 exempt from federal income tax as an organization described in IRC 501(c)(3), not be subjected to improper diversion by "insiders" (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.[81]

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, and assure appropriate coordination between governance and tax-compliance activities.

General Perspective

Unlike the broader corporate law interpretation discussed above, the IRS sees conflicts of interest arising principally out of financial relationships, and not out of material non-financial relationships such as board service on a competing organization.[82] 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 such a 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.[83] While not

[78] Remarks of Steven T. Miller, Commissioner, Tax Exempt and Government Entities Division, Internal Revenue Service, October 22, 2007.

[79] *Ibid.*

[80] *Ibid.*

[81] Internal Revenue Service, "Governance and Related Topics—501(c)(3) Organizations," contained in *Life Cycle of a Public Charity,* February 14, 2008 (henceforth, "Position Paper"), available at www.irs.gov/pub/irs-tege/governance_practices.pdf.

[82] Internal Revenue Service, Form 990 Instructions: "For this purpose, a conflict of interest does not include questions involving a person's competing or respective duties to the organization and to another organization, such as by serving on the boards of both organizations, that do not involve a material financial interest of, or benefit to, such person."

[83] Lawrence M. Brauer and Charles F. Kaiser, "Tax-Exempt Health Care Organizations Community Board and Conflicts of Interest Policy," in *IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 1997* (1996), pp. 18–19.

required as a condition for tax-exempt status, the IRS views conflicts policies as serving at least four main goals: (i) defining conflict of interest; (ii) identifying the classes of individuals associated with the organization to whom the policy is subject; (iii) facilitating the disclosure of information that may help identify conflicts of interest; and (iv) specifying procedures to be followed in managing conflicts of interest.[84] The IRS perceives the presence of a conflict-of-interest policy as assisting the board in making decisions in an objective manner, protecting against inappropriate influence by "insiders" and others with a private interest.[85] An additional perceived benefit 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.[86] (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.)

The IRS does not view adoption of a conflict-of-interest policy as a prerequisite for tax-exempt status. However, its adoption is "almost universal," because it serves as an important vehicle for tax-exempt organizations to identify potential violations of IRC/Treasury Regulations provisions addressing private inurement, private benefit, and Intermediate Sanctions and avoiding sanctions for the same.[87]

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 Revenue Ruling 69-545, 1969-2 C.B. 117.[88]

Private Inurement/Private Benefit

The concerns with self-dealing that are at the core of the duty of loyalty's focus on conflicts of interest are reflected in the bedrock provisions of the IRC prohibiting *private inurement* and *more than incidental* (or "*excess") private benefit*. In general terms, the prohibition against private inurement provides that no part of an organization's net earnings shall inure in whole or in part to the benefit of private shareholders or individuals. Private shareholders or individuals are defined as persons having a personal and private interest in the activities of the organization.[89]

The prohibition against excess private benefit derives from the "operational test" for exemption as an organization described in IRC Sec. 501(c)(3), which test requires that Section 501(c)(3) organization be "operated exclusively" for charitable purposes. Treasury Regulations provide that: (a) an organization will be regarded as operated exclusively for exempt purposes only if it engages primarily in activities which accomplish one or more exempt purposes; and (b) that an organization exempt under IRC 501(c)(3) must serve:

> "…a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish it is not organized or operated for the benefit of private interests such as designated individuals…."

Unlike private inurement, private benefit involves benefits flowing to anyone, not just insiders.[90] Private benefit will create a tax-exemption concern only if it is more than incidental to the charitable purposes served by the exempt organization, as measured from both qualitative and quantitative perspectives.[91]

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.

Intermediate Sanctions

Also closely related to conflict-of-interest issues are the provisions of IRC 4958, which apply penalty excise taxes to *disqualified persons* ("insiders") who receive excessive economic benefits from the tax-exempt organization. An excess benefit can arise through an exchange of compensation and other compensatory benefits in return for the services of an "insider," or by means of an exchange of property between an insider and the exempt organization.[92] The actual excess benefit will occur when the

[84] Brauer and Kaiser, 1996; Form 990 instructions define conflict of interest as arising "when a person in a position of authority over an organization, such as an officer, director or manager, may benefit financially from a decision he or she could make in such a capacity, including indirect benefits such as to family members or businesses with which the person is closely associated."

[85] *Ibid.*

[86] *Ibid.*

[87] Gitterman and Friedlander, *supra,* p. 11.

[88] Lawrence M. Brauer and Charles F. Kaiser, "Tax-Exempt Health Care Organizations Revised Conflicts of Interest Policy," in *IRS Continuing Professional Education Technical Instruction Program for FY 2000*, p. 45.

[89] Treas. Reg. Sec. 1.501(c)(3)-1(c)(1); 1.501(c)(3)-1(d)(1)(ii).

[90] Gitterman and Friedlander, *supra*, p. 7.

[91] *Ibid.*

[92] Gitterman and Friedlander, *supra*, p. 6.

value of the economic benefit provided by the non-profit exceeds the value of the consideration (including the performance of services) received for providing the benefit. Fair market value is the methodology applied to ascertain value.[93] Many types of excess benefit transactions that implicate the Intermediate Sanctions rules are transactions that also implicate the conflict-of-interest disclosure rules of an organization (and which might be prevented if subjected to a thorough conflicts review before consummation).

The "Rebuttable Presumption of Reasonableness" under the Intermediate Sanctions rules provides generally that if an organization meets the following three requirements, payments it makes to an "insider" under a compensation arrangement are presumed to be *reasonable,* and a transfer of property, or the right to use property, is presumed to be at *fair market value*.[94] Satisfaction of the Rebuttable Presumption of Reasonableness procedures requires a demonstration that the following steps have been followed:

- Approval in advance by an authorized body composed entirely of individuals who do not have a conflict of interest;
- The authorized body relied on appropriate comparability data before making its determination; and
- The authorized body adequately documented its decision concurrently with making that determination.[95]

If these three criteria are satisfied, the burden shifts to the IRS to demonstrate that an excess benefit indeed was provided. What is particularly unique about the Intermediate Sanctions provisions is the similarity between its criteria and the rebuttable presumption established under many state non-profit corporation laws for certain conflict-of-interest transactions. Both concepts focus on a determination of fundamental fairness to the organization of the underlying transaction, approval by a disinterested body, and contemporaneous recordkeeping.

Revocation Risks

It is vitally important that boards and both conflicts and compliance committees recognize the close relationship between potential violations of the duty of loyalty and the risk of jeopardizing the organization's IRC Section 501(c)(3) status. Inurement and excess private benefit remain grounds for revocation of tax-exempt status. While the legislative history for immediate sanctions and federal tax regulations indicate that Intermediate Sanctions should be used in lieu of revocation of tax-exempt status absent egregious facts, the facts and circumstances as to what constitutes egregious transgressions remains unclear.[96] As noted above, contracts, transactions, or arrangements that involve duty of loyalty issues (e.g., conflicts, self-dealing, and corporate opportunity) may also implicate the Intermediate Sanctions and private benefit tax rules. Thus, not only can certain types of conflict-of-interest transactions create Intermediate Sanctions exposure for the participants and private benefit risk for the organization, they may, in extreme circumstances, place the organization's tax-exempt status in jeopardy. For these reasons, boards and their conflicts committees must be highly sensitive to the federal tax-exemption implications of many conflict-of-interest transactions they are called on to review. Similarly, compliance and audit committees must be sensitive to the duty of loyalty implications of many excess benefit and private benefit transactions they must review.[97]

Public Positions/Publications

In numerous tax guidance publications and public comments, the IRS and its senior officials have stressed the important relationship between an effective conflict-of-interest policy and preservation of tax-exempt status. Notably, the IRS update and summary of its positions on the corporate governance of tax-exempt status ("Position Paper") encourages charities to adopt a conflict-of-interest policy "that requires directors and staff to act solely in the interests of the charity without regard for personal interests; includes written procedures for determining whether a relationship, financial interest,

[93] Gitterman and Friedlander, *supra,* p. 6.

[94] Treas. Reg. 53 4958-GT.

[95] *Ibid.;* see also, Lawrence M. Brauer, Toussaint T. Tyson, Leonard J. Henzke, and Debra J. Kawecki, "An Introduction to I.R.C. 4958 (Intermediate Sanctions)," in *IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 1997*, pp. 271–273.

[96] Treas. Reg. 1.501(c)(3)-1(f)(2)(ii).

[97] Standards for Recognition of Tax-Exempt Status if Private Benefit Exists, 73 Fed. Reg. 16519–16525, March 28, 2008.

or business affiliation results in a conflict of interest; and describes a course of action in the event a conflict of interest is identified."[98] The Position Paper also emphasizes the relationship of the conflict-of-interest policy to compliance with the duty of loyalty by the charity's governing board.[99] In the Position Paper, the IRS encourages charities to regularly review and evaluate the conflict-of-interest policy. The perspectives expressed in the Position Paper are consistent with public comments expressed by senior IRS officials and other charity regulators with respect to increasing instances of abuse in the non-profit sector.[100] This abuse is perceived as arising in some situations from a "sense of entitlement" by organizational insiders who are not accountable to their board of directors, the public, or to the regulatory agencies.[101] From this perspective, non-profit governance has been found to be wanting in many instances. Furthermore, there is a sense in the regulatory community that the non-profit sector lacks a full appreciation of the extent to which abuse has emerged.[102] Over the past few years, conflict of interest issues at well-known institutions continue to be the source of media attention and state charity officials' scrutiny.

The Form 990

Corporate governance of tax-exempt organizations is a key factor addressed in the Form 990 (Return of Organization Exempt from Income Tax).[103] For example, Form 990, Part IV, asks whether there were any transactions between the tax-exempt organization and directors, officers, key employees, family members related to such persons, and corporations owned by such persons. If there were transactions with such persons, then detailed disclosure of the transaction is required in Form 990, Schedule L, Transactions with Interested Persons.

Further, the governance-related provisions of Form 990 include (but are not limited to) questions relating to conflict-of-interest oversight and policies. For example, the *governance structure and management-related questions* in Part IV, 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 in Chapter Three.

In addition, 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, directors and key employees and which is subject to regular and consistent monitoring and enforcement."[104]

Section B also inquires (at Question 12b) whether the organization's officers, directors, trustees, and key employees are required to make an annual (or more frequent) disclosure of interests that could give rise to conflicts of interest (e.g., a list of family members, substantial business or investment holdings, and other transactions or affiliations with businesses or other organizations).

The extent to which the organization enforces its conflict-of-interest policy has long been an area of interest to the IRS. The Form 990, Part VI, Section B, question 12c, asks whether the filing organization regularly and consistently monitors and enforces compliance with its conflict-of-interest policy and expressly requires a description of how the policy is monitored and enforced by the organization in Form 990, Schedule O. Schedule O should also contain a description of any conflict management plan or other restriction imposed on persons determined to have a conflict (e.g., prohibiting them from participating in board deliberations and decisions concerning the conflicts transaction).

Additional Space

The final Form 990 allows organizations to use Schedule O to supplement their Part VI governance (and other) responses. This change was made in response to concerns that a narrative answer (as opposed to a mere yes or no) was needed to properly respond to several of the questions. According to IRS Exempt Organizations senior leadership, organizations should use Schedule O to respond to specific governance-related questions regarding the recording of governance body meetings and how the organization determines executive compensation amounts.[105] Schedule O also may profitably be used to address the manner in which the organization effects its conflict-of-interest policy, and by which the board reviews the entire Form 990 prior to filing. Thus, there is substantial governance and tax-compliance benefit to be gained from a thorough and thoughtful use of Schedule O as it may relate to answering the conflict-of-interest questions in Part VI.

[98] Position Paper.

[99] *Ibid.*

[100] Remarks of Steven T. Miller, "The IRS' Role in an Evolving Charitable Sector," before the Philanthropy Roundtable, November 10, 2007. (Henceforth, "Miller 11/10/2007 Remarks.")

[101] *Ibid.;* see also, U.S. Senate, "Senators Express Concern over Charitable Abuse, Cite Opportunity to Protect Charities," July 23, 2007.

[102] *Ibid.*

[103] Internal Revenue Service, "About Form 990, Return of Organization Exempt from Income Tax" (www.irs.gov/forms-pubs/about-form-990).

[104] *Ibid.*

[105] See "IRS Releases Redesigned Form 990," *The Exempt Organization Tax Review*, January 2008, p. 9.

As noted above, the board and its conflicts committee should be aware that conflict-of-interest issues may also be covered tangentially in several other sections of the new Form 990, most particularly Schedule L, which is to be used by organizations to report certain transactions with interested persons. Among these are (a) excess benefit transactions which, as noted above, may also implicate duty of loyalty issues, and (b) "horizontal" business and financial transactions involving interested persons (the so-called "horizontal conflicts" issue, as described above).

Sample Conflict-of-Interest Policy

For a number of years, the IRS has published (and periodically updated) a sample conflict-of-interest policy (designed for hospitals but generally applicable to all tax-exempt organizations).[106] This sample policy provides a useful description of the key provisions that should be incorporated in a conflict-of-interest policy. Its utility for more sophisticated non-profit organizations is limited because it is "bare-bones" in nature, does not reference material non-financial interests, and lacks extensive discussion of the conflicts review process. It is, however, a helpful platform from which to consider designing a conflict-of-interest policy.

In these and other ways, the IRS manifests its interest in non-profit corporate governance in general, and conflicts of interest in particular. Board members are thus to be reminded that effective oversight in this area is based not only on compliance with non-profit corporate law, but also with the terms of federal tax-exempt status as well.

Practice Tips

- **Educate the board on tax-exemption concerns pertaining to conflicts of interest.**
- **Review the conflict-of-interest policy for a possible "upgrade" if it is a "mirror image" of the IRS Sample Policy. (The Governance Institute provides a robust sample conflict-of-interest policy for members at www.GovernanceInstitute.com/templates.)**
- **Consider specific conflict-related implications of the questions in the new Form 990.**

[106] Gitterman and Friedlander, *supra.*

Chapter Seven: Distinguishing Conflicts of Interest from Independence Concerns

"Positional independence"—e.g., separation between oversight and management—relates primarily to the composition of the board and key committees. It has been a focus of corporate governance attention since the Sarbanes-Oxley era.

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."[107] The underlying policy expectation 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."[108] 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.[109] The focus on director independence extends to such key board functions as executive performance evaluation; CEO succession protocols; corporate financial planning; audit, internal controls, and financial planning; conflicts of interest disclosure review; and the composition of the governing board. For that reason, independence concerns also apply to key board committees (e.g., audit, compliance, and executive compensation) for both corporate responsibility and tax-exemption-related reasons.

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.[110] 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 act, and 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.

Positional independence is similar to conflict of interest in that both are subject to parallel treatment under state non-profit corporate and federal tax laws. For example, the IRS has historically taken the position that, irrespective of size, a governing board should include independent members and should not be dominated by employees or others who are not, by their very nature, independent individuals because of family or business relationships. For that reason, the IRS reviews the board composition of charities to determine whether the board represents a broad public interest, and to identify the potential for insider transactions that could result in misuse of charitable assets.

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. Nevertheless, in practicality, the distinction between "independence" and "conflict of interest" is often blurred in a manner that is confusing for the board. Thus, it is important for governance compliance purposes that the existence and reasons for this distinction under the law is made clear to the board.**

The IRS also considers whether a charity has independent members, stockholders, or other persons with the authority to elect board members of the board or approve or reject board decisions, and whether the charity has delegated control or key management authority to a management company or other persons.

Further, a criterion under the "community benefit standard" of hospital tax-exempt status is board control maintained by a majority of individuals who are independent community/civic leaders. The Form 990 (Part VI, Question 1b) asks for the number of independent voting members of the governing body. In responding to the question, the organization must apply the four-part definition of "independent voting member of the Board of Directors" set forth in the instructions to this question to

[107] The American Law Institute, *Principles of the Law of Nonprofit Organizations Tentative Draft No. 1* ("ALI Principles Draft") at § 310(c)(3).

[108] Peregrine and Broccolo, "Independence and the Nonprofit Board: A General Counsel's Guide," *Journal of Health Law*, Vol. 39, No. 4 (Fall 2006), p. 499.

[109] Panel Report, *supra,* Principle #12.

[110] ALI Principles Draft, *supra.*

resolve whether a specific voting member of its board is "independent" for purposes of Form 990 reporting.

Note also that the independence standard for purposes of Part VI of the Form 990 is not the same as the "absence of conflict of interest" standard for purposes of the Rebuttable Presumption of Reasonableness under the Intermediate Sanctions Regulations.

Also, the non-profit corporation laws of some states (e.g., New York State, California) mandate certain requirements regarding the extent to which boards and committees of non-profit organizations be vested in "disinterested"/independent directors.

Particularly challenging for non-profit corporate directors is the fact that the IRS definition of *independent* director will likely vary from other meanings of the term independent that may apply to the corporation and its board; e.g., such as for state law, or internal conflict of interest policy purposes. Along the same lines, the IRS regulations regarding satisfaction of the "rebuttable presumption of reasonableness" requires that the compensation arrangement in question must be approved in advance by an authorized body of the applicable tax-exempt organization, which is *composed of individuals who do not have a conflict of interest concerning the transaction*. Accordingly, it is important that board leadership help individual members distinguish between "independence" and "conflict-of-interest" criteria and standards while assuring that governance policies addressing both are in place.[111]

Practice Tips

Through governance leadership and board education, clarify the differences between independence and conflict rules and policy considerations while making sure the organization has policies governing both.

[111] Internal Revenue Service, "Life Cycle of a Public Charity," *Governance and Related Topics—501(c)(3) Organizations,* February 14, 2008 (www.irs.gov/pub/irs-tege/governance_practices.pdf).

Chapter Eight: Corporate Opportunity

Another recognized component of the non-profit director's duty of loyalty, closely associated with conflict 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.[112]

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 (e.g., providing to the board a "first option" to participate in the opportunity on the same terms, in lieu of the director's participation).[113] A director who "usurps" a corporate opportunity may breach the duty of loyalty and be exposed to damages or equitable remedies.[114]

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 which the corporation is financially able to undertake 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."[115]

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; and
- 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.[116]

In order that the director may 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 interested director in writing and set forth in the corporate records.[117] 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.[118]

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.[119]

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.[120]

However, emerging public policy suggests a willingness to allow ratification of a defective disclosure, to avoid negative inferences if the safe harbor approach is not satisfied, and to provide special rules where a delay in making disclosure was based on good faith. This emerging policy reflects an interest in enlarging the ability of directors to obtain safe harbor protection in business opportunity situations.

"Corporate opportunity" challenges can rise in the non-profit sector in any number of ways. One example is where a non-profit hospital/director pursues the acquisition of undeveloped real estate in which the director knew or should have known that the hospital may wish to acquire for future expansion. Another example is a

[112] ALI Draft Restatement at § 2.02 cmt. (g); Model Act at § 8.70.

[113] Guidebook, *supra,* p. 49; *see also,* William E. Knepper and Dan A. Bailey, *Liability of Corporate Officers and Directors*, Seventh Edition (2007), at § 4.12.

[114] ALI Draft Restatement at § 2.02 cmt. (g); Model Act at § 8.70.

[115] *Guth v. Loft,* 5 A.2d 503 (Del., 1939), cited in *Fiduciary Duty of Corporate Directors*, *supra.*

[116] Knepper and Bailey, *supra,* at § 4.12.

[117] Guidebook, *supra.*

[118] ALI Draft Restatement at § 2.02 cmt. (g); Model Act at § 8.70.

[119] Knepper and Bailey, *supra,* at § 4.12.

[120] *Ibid.*

museum director purchasing a work of art for his/her personal collection, which the director knew or should have known would have been a valued addition to the museum's own collection. A more extreme example is the board of directors taking advantage of specific investment opportunities provided to them by the corporation's investment bankers, in appreciation for the corporation's business.

With the broadening of the business and investment diversification and innovation activities of many non-profit hospitals and health systems comes an increased risk of "corporate opportunity challenges." Boards and individual directors must be vigilant to both the definition of a corporate opportunity and to potential for such opportunities to arise in particular circumstances.

The general counsel can help focus the board's corporate opportunity discussion by determining whether state law applies the rule only to (i) opportunities that the director identifies from his/her board service; or (ii) opportunities that arise regardless of how the director first identified them.

Practice Tips

- **Educate the board on the doctrine of "corporate opportunity."**
- **Periodically provide directors with examples of potential corporate opportunities of organization.**
- **Encourage fulsome evaluation of "opportunity" disclosures.**
- **Consider the possibility of an advance waiver for certain *de minimus* forms of corporate opportunity.**

Chapter Nine: Risks of Non-Compliance

Most state non-profit corporation laws do not specifically address remedies for breach of fiduciary duties. Typically, the remedy is left to the discretion of the court. However, it is worthwhile to note that a breach of the duty of loyalty carries with it a greater risk of prosecution and, ultimately, harsh sanctions. This is principally because the concept of self-dealing or similar improper conduct is perceived as antithetical to the expectation that a director will apply "absolute obedience" to the corporation's charitable purposes. Courts are more likely to impose financial sanctions (e.g., restoration of the corporate opportunity, reimbursement of self-dealing benefit) for duty of loyalty violations than for duty of care violations.[121]

The state attorney general is typically the party with principal standing to pursue a remedy for breach of fiduciary duty. The attorney general may seek a variety of remedies, in civil or administrative action, to address an alleged breach of the duty of loyalty. These include an accounting, removal of the implicated director(s), or receivership. Removal is rarely sought absent egregious circumstances. Monetary damages could be applied in the order of disgorgement, surcharge, restitution, and the payment of costs of any associated proceeding. In the extreme case, where self-dealing concerns are rampant throughout the organization and the board itself shows no indication of willingness to address the situation, remedies such as liquidation of assets, placing the assets in a constructive trust, and removal of the entire board become legitimate options.[122] Of course, criminal penalties are available for breaches of the duty of loyalty that involve financial concerns (such as embezzlement or fraud).

Whether the non-profit organization itself has a cause of action (other than removal) against a director for violation of the duty of loyalty in general, and conflict-of-interest rules in particular depends largely on state law.[123] To the extent possible, it is expected to pursue such an action when necessary to protect the non-profit assets (on duty of care principles). Such action typically reflects favorably on the good faith of the organization and its board.

Most state non-profit corporation laws allow the board of directors to remove one or more of its members whether the right to do so requires evidence of "cause" is dependent on the provisions of state law and/or the organization's bylaws. An example would be removal of a director for repeated failure to comply with conflict disclosure requirements, including but not limited to failure to submit in a timely manner a completed conflict disclosure questionnaire.

Some state non-profit corporation statutes have "liability shield" language that seeks to limit the financial exposure of individual directors. These liability shields, whether enacted by statute or contained in the articles of incorporation of an organization, are typically not intended to apply with respect to conflicts of interest/self-dealing or other breaches of the duty of loyalty.

It should also be noted that duty of loyalty violations (e.g., conflict-of-interest transactions and usurpation of corporate opportunity) may create exempt organization income tax exposure, as well as potential tax exposure for the individual director (e.g., Intermediate Sanctions excise taxes). The nature of the conflict of interest may also trigger regulatory scrutiny and create reputational damage for the director and the corporation.

In addition, non-profit directors should be sensitive to the extent to which damages associated with duty of loyalty violations may be excluded from coverage under directors' and officers' insurance coverage.

It should also be noted that boards (and their committees) who fail to adequately enforce conflicts of interest policies and protocols may themselves be exposed to regulatory scrutiny under breach of fiduciary duty principles.

In addition (and as noted above) corporate transactions and other business arrangements that are the byproduct of a conflict of interest are, under most state laws, voidable and subject to challenge.

Accordingly, non-profit directors should be very attentive to the risks of non-compliance with the duty of loyalty in general, and conflict-of-interest provisions in particular.

Practice Tips

- **Educate the board regarding the liability risks associated with duty of loyalty violation; link this discussion to the review of benefits of conflict-related disclosure**.
- **Educate the board regarding obligations to pursue the material breach of duty of loyalty violations.**

[121] ALI Principles Draft, *supra,* § 360.
[122] ALI Principles Draft, *supra.*
[123] ALI Principles Draft, *supra, at* § 330, p. 226.

Conclusion

In the rapidly evolving, diversified, healthcare environment, issues with respect to actual or apparent conflicts of interest involving the non-profit governing board have become acute. As described in detail, concerns with the relationship of conflicts and the organization's charitable, tax-exempt purposes are regularly expressed by legislatures, regulators, public interest groups, and the media. Unresolved conflict-of-interest issues can pose significant legal and reputational harm to both the organization and to its individual board members.

Thus, conflict-of-interest management should be an important priority of the non-profit healthcare board. This is for five principal reasons—regulatory compliance, consistency with governance best practices, and liability protection for individual directors, and individual and corporate reputation.

An effective conflict-of-interest management plan will consist of the following important components:

1. **Conflicts Policy:** confirmation that the board not only has adopted a conflict-of-interest policy, but also that the policy is appropriately detailed as to process and sufficient in scope to address the unique conflicts challenges of the organization.
2. **Disclosure Protocol:** establishment of a "climate" within the board that encourages disclosure of actual or apparent conflicts of interest, and a formal protocol by which such disclosure can be facilitated, both on an annual basis and a periodic basis (as issues may arise).
3. **Education:** a system of regular internal education to the board concerning conflict-of-interest issues, including application of the organization's own conflicts policies and procedures and the legal issues collaterally implicated by conflicts issues (e.g., tax-exempt and "appearance" concerns).
4. **Review and Management:** the process by which the board will review disclosures to determine whether they in fact constitute conflicts of interest, and if so, whether such conflicts can be waived subject to the application of a conflicts management plan to the particular circumstances.

Through such a four-part effort and other similar means, non-profit organizations and their governing boards will be more capable of responding to the important legal and reputational challenges posed by conflicts of interest.

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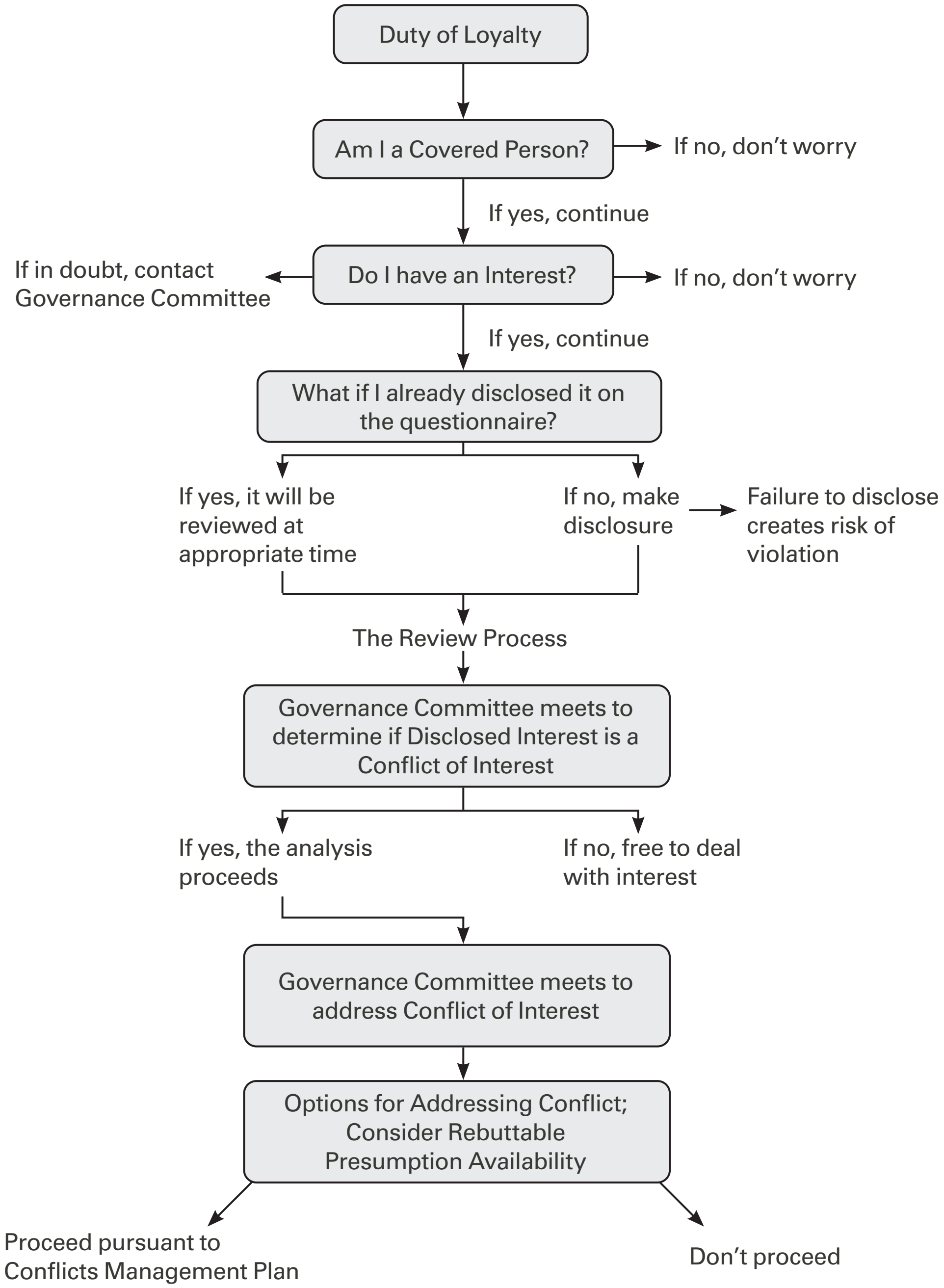
Appendix A: Director's Conflict-of-Interest Decision Tree


Duty of Loyalty
Am I a Covered Person?
If no, don't worry
If yes, continue
If in doubt, contact Governance Committee
Do I have an Interest?
If no, don't worry
If yes, continue
What if I already disclosed it on the questionnaire?
If yes, it will be reviewed at appropriate time
If no, make disclosure
Failure to disclose creates risk of violation
The Review Process
Governance Committee meets to determine if Disclosed Interest is a Conflict of Interest
If yes, the analysis proceeds
If no, free to deal with interest
Governance Committee meets to address Conflict of Interest
Options for Addressing Conflict; Consider Rebuttable Presumption Availability
Proceed pursuant to Conflicts Management Plan
Don't proceed

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Appendix B: Sample Evaluation Factors

Note: The following is a non-exclusive list of the types of questions conflicts committee members may choose to ask as part of their efforts to determine whether a director's interest in a contract, transaction, arrangement, or affiliation, to which the corporation is a party, constitutes a conflict of interest. In conducting the analysis, the committee members' focus should be whether the particular interest is of such personal significance to the director that it could reasonably be expected to exert an influence on the director's judgment when called upon to vote on the contract, etc. This template does not reflect specific state law.

Pursuant to Section of the [Name of Organization] Conflict-of-Interest Policy, the [board or designated committee] is responsible for determining whether disclosed interest constitutes a conflict of interest pursuant to the Policy. To facilitate the efforts of the [board or designated committee] in rendering decisions under Section of the Policy, the following (non-exclusive) evaluation factors may be considered with respect to the evaluation of individual interests:

1. **In General.** In conducting their duties under Section of the Policy, [board] [committee] members shall exercise a degree of care (including gathering information) that is proportional to the degree of the potential conflict and the amount of money involved.
2. **Specific Factors.** In evaluating whether a particular disclosed interest constitutes a conflict of interest, [board] [committee] members may consider the following factors, among others:
    a. With respect to an ownership or investment interest:
        i. The dollar value of the interest (in absolute terms);
        ii. The dollar value of the interest as a percentage of ownership interest in the entity;
        iii. The perceived importance of the transaction or arrangement to [Name of Organization] and to the entity, respectively;
        iv. Whether the transaction or arrangement can reasonably be expected to have a materially favorable impact on the value of the ownership or investment interest;
        v. The extent to which the ownership or investment interest might reasonably be expected to influence the entity in connection with its performance under the transaction or arrangement; and
        vi. Other similar factors.
    b. With respect to a compensation arrangement:
        i. The dollar value of the arrangement (in absolute terms);
        ii. The dollar value of the arrangement (in relative terms);[124]
        iii. The nature of the underlying compensation arrangement (e.g., rank-and-file employee, managerial authority, executive, partner, director, vendor);
        iv. With an entity where the [Name of Organization] director or committee member serves as an employee (including executive and management relationships), partner, or director, or in a comparable position, whether (a) the [Name of Organization] director or committee member is in a position to exercise significant influence over the affairs of the entity; and (b) the compensation of the [Name of

[124] This is intended to address the situation where the compensation arrangement is significant in relation to the total compensation paid to others for similar services, or whether the compensation paid by the organization is a significant expense of the organization.

Organization] director or committee member is based primarily on revenues derived from the activities of the entity.[125]

v. For vendors,

1. The dollar value of the services (in absolute terms);
2. The dollar value of the goods or services relative to the overall volume of goods or services: (i) purchased by [Name of Organization] in general; (ii) purchased by [Name of Organization] for this particular good or service (e.g., legal services budget); or (iii) provided by the director or the director's affiliated entity in general.
3. The director's position within the vendor entity (e.g., owner, partner, or employee);
4. The impact the business relationship with [Name of Organization] has on the director's compensation from or career advancement within this entity;
5. Whether the director provides the services directly, supervises the delivery of services, or has no connection to the delivery of services; and
6. Where in the [Name of Organization] organizational hierarchy lies the decision to authorize the goods or services to be purchased from the director/vendor (e.g., board, executive, or departmental level) and whether the director's position in [Name of Organization] is likely to involve the director in, or give the director influence over, the decision to engage the director or the director's affiliated entity.

c. With respect to non-financial interests:

i. The materiality of the interest;

ii. The nature of the interest;

iii. The presence of specific factors that may prevent the director from acting in the best interests of [Name of Organization] in connection with the transaction or arrangement;

iv. With respect to multiple board memberships, the presence of specific factors indicating a potential whereby the director may subordinate his/her duty to [Name of Organization] to his duty to the other entity for which he serves as a director; and

v. Other similar factors.

3. **Non-Financial Interests.** In general (and depending upon state law), due to the often-attenuated nature of non-financial interests, the [board] [committee] is warranted in applying less rigorous scrutiny, and in granting greater deference to good faith decisions made by directors with such non-financial interests.

[125] This is intended to address the situation where an officer/director/committee member has a compensation arrangement as an employee, partner, director, etc. with an entity with which the organization is conducting, or expects to conduct, business.

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