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Conflict of Interest

FOURTH EDITION

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Elements of Governance® is designed to provide CEOs, board chairs, directors, and support staff with the fundamentals of not-for-profit governance. These comprehensive and concise governance guides offer quick answers, guidelines, and templates that can be adapted to meet your board's individual needs. Whether you are a new or experienced leader, the *Elements of Governance*® series will help supply you and your board with a solid foundation for quality board work.

This *Elements of Governance*® is adapted from the The Governance Institute white paper, *Conflicts of Interest and the Non-Profit Board: Guidelines for Effective Practice,* 2nd Edition, Winter 2021 by Michael Peregrine. Readers seeking more in-depth information on this topic should refer to this white paper.

About the Author

Michael W. Peregrine is a Partner in the law firm of McDermott Will & Emery LLP, resident in the Firm's Chicago office. He concentrates his practice in the representation of corporations (and their officers and directors) in connection with governance, corporate structure, fiduciary duties, and officer-director liability issues. Michael is recognized as one of the leading national practitioners in corporate governance law and is a senior contributor to Forbes.com, where his articles focus on governance concerns.

Michael is outside governance counsel to many prominent corporations, including hospitals and health systems, voluntary health organizations, social service agencies, colleges and universities, and health insurance companies. Clients seek Michael's counsel on matters relating to board conduct, structure, effectiveness, composition and controversy, as well as on internal and external/regulatory challenges to governance. He serves frequently as special counsel in connection with confidential internal board reviews and investigations. He regularly advises boards on complex business transactions, including more than 125 change-of-control transactions in his 40-year career.

Michael has particular expertise in advising boards on complex officer and director conflicts of interest and code of conduct issues.

Recently, Michael has served as lead transaction counsel in connection with a series of nationally prominent combinations of religious-sponsored health systems and large regional health systems/academic medical centers.

Michael is well known as a thought leader in corporate governance. He authors monthly columns on corporate governance for Corporate Counsel magazine and for publications of The Governance Institute. He is a regular contributor on corporate governance topics to *The New York Times*' "Deal Book" feature; Corporate Board Member, *The Chronicle of Philanthropy*; The Harvard Law School Forum on Corporate Governance and Financial Regulation; The Columbia Law School's Blog on Corporations and the Capital Markets, the New York University School of Law Compliance and Enforcement Forum, and Law360.

Michael is noted for his extensive experience advising non-profit corporations on matters of corporate law and governance. He authors a monthly publication, "Corporate Law and Governance Newsletter," and moderates a monthly director education podcast, "Governing Health."

Michael is a co-author of the three corporate governance compliance white papers published jointly by the Office of Inspector General (Department of Health and Human Services) and the American Health Lawyers Association.

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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.

> Conflicts issues invariably implicate legal concerns and often cannot be effectively addressed absent advice of the general counsel and compliance officer.

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 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.

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?

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

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

1. Comprehensive director education on the duty of loyalty and on conflict-of-interest issues and obligations
2. A full appreciation by board members of the ongoing "duty to disclose" actual or potential conflicts
3. A written process for reviewing potential conflicts and disclosures
4. Criteria by which the board—or committee delegated to review conflict-of-interest issues—shall evaluate and resolve conflict-of-interest disclosures
5. Guidelines by which the board/committee may wish to "manage" conflict-of-interest relationships considered to be in the organization's best interests
6. A separate policy addressing the "independence" of board members
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The Duty of Loyalty

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

What It Provides

The 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.[1] The duty is subsumed within the *Model Nonprofit Corporation 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*"[2][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;[3] for example, "an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest."[4]

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.[5]

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.[6] 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").[7]

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

1 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.")
2 *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.")
3 Guidebook, *supra*.
4 *Guth v. Loft, Inc.,* 5 A.2d 503, 510 (1939).
5 Model Act, *supra* at Official Comment § 8.30(a)(1).
6 *Ibid.*
7 *Ibid.*

absence of any contrary statutory provision, this concept of fiduciary status should apply regardless of whether the board member is compensated or uncompensated.[8]

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.[9] 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).[10] Accordingly, some non-profit organizations maintain separate conflicts policies for board members and for non-board member executives, respectively. Other non-profits require such 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.[11] 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).[12] 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."[13]

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).[14]

8 The American Law Institute, *Restatement of the Law of Charitable Nonprofit Corporations* (2020 draft), § 2.02. (Henceforth, "ALI Draft Restatement.")
9 *Ibid.*
10 ALI Draft Restatement at § 2.02; Lex. Stat. 1–6 Ballantine and Sterling California Corporation Laws, § 103 Conflict of Interest Transactions, Matthew Bender & Co., 2008. (Henceforth, "Ballantine and Sterling.")
11 Guidebook, *supra,* p. 43.
12 *Ibid.*
13 ALI Draft § 2.02, *supra.*
14 Guidebook, *supra,* p. 52; Model Act, at § 8.30(c).

Specific Application

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

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

Satisfaction of the duty of loyalty is typically manifested by compliance with specific governance policies addressing conflicts, corporate opportunity, and confidentiality. It is also manifested in other actions by board members that reflect good faith (i.e., that the board member acted with an intent to support the charity's purpose in exercising other duties). Virtually all "best practices" compilations for the non-profit sector, as well as IRS exempt organization tax guidance, strongly encourage the adoption of policies and procedures intended to assure that conflicts of interest (or the appearance thereof) arising within the organization and the board are properly addressed by disclosure, recusal, or other means.[15]

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

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 conflict policies for officers/directors and for non-officer members of executive staff.
- Provide education on specific constituency challenges.
- Address obligations of board members to disclose intentional breaches of other board members (the "rat-out" rule).

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

Conflict of Interest: Core Concepts

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 service). Many healthcare companies have substantially e their strategic direction and their ownership portfolio. Ir 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 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.[16] Simply put, "conflicts happen."

In such a situation, the duty of loyalty obligates the board member to respond "with care and candor."[17] The board—and its individual members—should recognize that breach of fiduciary duty arises not with the presence of the conflict but rather with:

- The failure of the individual director to adequately disclose the presence of the conflict, and/or
- 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.

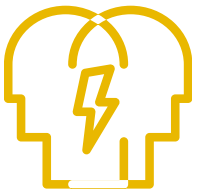
Indeed, some non-profit commentary suggests that board members may also have a duty to *avoid* likely impermissible conflicts (those conflicts which no board could reasonably waive in the best interests of the corporation, given the facts and circumstances of the conflict-of-interest transaction).[18] Especially under this more aggressive suggestion, identification of the potential conflict is fundamental to compliance.

16 Panel Report, Principle #3, *supra;* Guidebook, *supra,* pp. 43–44.
17 *Ibid.*
18 *Ibid.*

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.

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, 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



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.[19]

Duty of Loyalty

The board must:

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

19 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.

Conflict of Interest: Identification

The potential for a conflict of interest normally arises when a director (or committee member) has, directly or through a family member, a "material personal interest" in a proposed contract, transaction, arrangement, or affiliation to which the corporation may be a party.[20] 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.[21] Such conflicts may arise from service on both the board, and on a committee with board-delegated powers.

Typically, conflicts of interest arise in connection with a financial arrangement involving a director. In addition, it is increasingl nized that potential conflicts may arise from certain non-financ interests, intra-board relationships, and interlocking board arrangements. 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.

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 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

20 Guidebook, *supra,* pp. 43–45.
21 *Ibid.*

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.
- 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.[22]

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.

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

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

a family relationship or business relationship with any other officer, director, trustee, or key employee?"[23]

It is important to recognize for 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).[24]

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 that is 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 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.

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.

23 See the IRS Form 990, available at www.irs.gov/pub/irs-pdf/f990.pdf.
24 Guidebook *supra,* p. 44.

Conflicts and Committee Service

There is particular potential for conflict when serving on a committee with board-delegated powers. Examples of situations where disclosure would be appropriate include:

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

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

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!"

Conflict of Interest: Disclosure

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. 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.[25]

Adequate disclosure serves three primary purposes:

1. First, as noted, it addresses the director's fiduciary obligation.
2. Second, it positions the board to evaluate the fairness of the proposed transaction in a fully informed manner.
3. 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.[26]

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.

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.[27] A fact is generally considered material if there is a substantial

25 *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).

26 ALI Draft Restatement, *supra* at § 2.02; Model Act at § 8.31.

27 Model Act at § 8.31.

likelihood that a reasonable person would consider it important in deciding how to vote.[28] 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.[29] 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)

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

The Role of the Questionnaire

Standard practice in the non-profit sector is for directors and other interested parties to satisfy (in part) their duty to make disclosure through the completion and submission of an annual questionnaire or disclosure statement.[30] 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., mergers or affiliations) for which a supplemental or other form of updated disclosure may prove useful.

28 *Ibid.*
29 Guidebook, *supra,* pp. 45–49.
30 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.")

Advance distribution of detailed board and committee agendas allows members the opportunity to evaluate the potential that particular agenda items might prompt the need to make disclosure.

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.

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.

Conflict of Interest: Review

The reviewing body must conduct its activity consistent with the duty of care or similar standard. Failure to adequately consider disclosed potential conflicts places the directors involved in the review process at risk of breach of duty-of-care exposure. Furthermore, conflict-of-interest transactions approved absent appropriate board review or outside "rebuttable presumption" guidelines may be subject to judicial rescission. In such situations, the interested director has the burden of demonstrating the transaction's fairness. In egregious situations (e.g., fraud or malicious conduct), damages may be awarded.[31]

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.[32] 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.[33]

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.[34]

"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[35] provide a specific "rebuttable presumption" for conflict-of-interest transactions approved in advance by the board, or a committee with board delegated powers under the following types of circumstances:

1. The material facts of the transaction and the director's interest are known or disclosed to the board or committee (including all facts not previously known to the board). Prudent practice favors a written record of the facts disclosed or known to the board.[36]
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.

31 Model Act at § 8.31, 8.60.
32 ALI Draft Restatement, *supra* at § 2.02.
33 *Ibid.*
34 *Ibid.*
35 See, e.g., 805 ILCS 105/108.60(c).
36 Model Act at § 8.60; ALI Draft Restatement at § 2.02.

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.[37] By this standard, the directors are shielded from liability even if it were subsequently determined that the directors' fairness conclusion was wrong.[38] (Business judgment rule protection is generally not available to directors whose exercise of care was not in good faith.)[39]
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).[40]
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.[41]

Quorum and Voting Requirements

Issues related to quorum and voting requirements in conflict-of-interest matters are usually specific to state law. The general approach seems to be that the presence of the disclosing/"interested" director *may* be counted in determining whether a quorum is present but *may not* be counted (the interested director may not vote) when the board or committee takes action on the potential conflict or the actual transaction.[42] There is less statutory uniformity on whether the disclosing/"interested" director may remain in the meeting room for the discussion of the potential conflict or actual transaction, regardless of whether he/she may be counted towards a quorum and be allowed to vote on the matter. The better practice is that the disclosing/interested director *not* be allowed to remain in the room for the discussion relating to the nature of the conflict.[43] Experience suggests that the potential "chilling effect" of such presence on the decision making of the other board members can be significant, and inconsistent with the goal of an informed, unbiased resolution of the matter. This is particularly the case if the disclosing/"interested" director is an influential presence on the board or committee.

Interlocking Directors

Depending on particular state law, transactions involving interlocking dictatorships—where no material financial interest exists—may be subject to a more relaxed approval process.

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

37 Model Act at § 8.31, 8.60.
38 *Ibid.*
39 ALI Draft Restatement at § 2.02; Guidebook *supra,* pp. 44–48.
40 Model Act at § 8.31, 8.60.
41 *Ibid.*
42 See, e.g., 805 ILCS 105/108.60(c).
43 Guidebook, *supra,* pp. 44–48.

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

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.

Such safeguards 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[44]
- Periodic status reports to the committee responsible for reviewing conflicts
- Monitoring the benefits of the transaction or arrangement to the non-profit organization
- Assuring that the conflicted director will not have excessive ongoing involvement in the transaction or arrangement
- Excess utilization/benefit safeguards (e.g., protections against unanticipated or excessive personal benefit to the conflicted director)

> In the non-profit sector, appearances count. Fairly or unfairly, non-profit boards must consider more seriously the risks associated with the appearance of a conflict.

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.[45]

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. 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.

Reputational issues are a significant corporate asset, so how "appearance" issues are presented in the public can be a major consideration. 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.

44 Gitterman and Friedlander, *supra,* Appendix A, p. 31.
45 Panel Report, *supra*.

Thus, arrangements that only create the *appearance* of a conflict of interest may nevertheless create significant risks for a non-profit organization. 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 decision tree for 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.

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.[46] 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.[47]

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.[48] 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.

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

General Perspective

The primary conflict-related emphasis of the IRS is on the adoption of a written conflict-of-interest policy. It is the IRS' general perspective that the presence and enforcement of 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.[49] While not required as a condition for tax-exempt status, the IRS views conflicts policies as serving at least four main goals:

1. Defining conflict of interest
2. Identifying the classes of individuals associated with the organization to whom the policy is subject

46 Remarks of Steven T. Miller, Commissioner, Tax Exempt and Government Entities Division, Internal Revenue Service, October 22, 2007.
47 *Ibid.*
48 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.
49 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.

3. Facilitating the disclosure of information that may help identify conflicts of interest

4. Specifying procedures to be followed in managing conflicts of interest.[50]

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.[51] 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.[52] (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.)

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.[53]

The IRS has historically taken the position that the adoption of a conflict-of-interest policy is one of the factors in determining whether hospitals and other healthcare organizations satisfy the community benefit standard for tax exemption.

Form 990

Corporate governance of tax-exempt organizations is a key factor addressed in the Form 990 (Return of Organization Exempt from Income Tax).[54] 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

50 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."

51 *Ibid.*

52 *Ibid.*

53 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.

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

intra-system conflicts and bias, discussed in the "Conflicts of Interest: Identification" chapter.

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."[55]

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).

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).[56] 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.

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 as well as in Appendix A of this publication.)
- Consider specific conflict-related implications of the questions in the Form 990.

55 *Ibid.*
56 Gitterman and Friedlander, *supra.*

Director Independence

"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."[57] 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."[58] 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.[59] 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
- 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.[60] Nevertheless, in practicality the distinction between "independence" and "conflict of interest" is often blurred in a manner that is confusing for the board. "Independence" is a structural consideration that focuses on the overall relationship between the director and the non-profit organization and its affiliates. 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.

57 The American Law Institute, *Principles of the Law of Nonprofit Organizations Tentative Draft No. 1* ("ALI Principles Draft") at § 310(c)(3).
58 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.
59 Panel Report, *supra,* Principle #12.
60 ALI Principles Draft, *supra.*

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.

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 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.

Practice Tip

- 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.

IRS Definition of an "Independent Person"

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

A member of the governing body is considered **"independent"** only if all four of the following circumstances applied at all times during the organization's tax year.

1. The member wasn't compensated as an officer or other employee of the organization or of a related organization (see the Instructions for Schedule R (Form 990)) except as provided in the religious exception discussed below. Nor was the member compensated by an unrelated organization or individual for services provided to the filing organization or to a related organization, if such compensation is required to be reported in Part VII, Section A.

2. The member didn't receive total compensation exceeding $10,000 during the organization's tax year (including a short year, regardless of whether such compensation is reported in Part VII) from the organization and related organizations as an independent contractor, other than reasonable compensation for services provided in the capacity as a member of the governing body. For example, a person who receives reasonable expense reimbursements and reasonable compensation as a director of the organization doesn't cease to be independent merely because he or she also receives payments of $7,500 from the organization for other arrangements.

3. Neither the member, nor any family member of the member, was involved in a transaction with the organization (whether directly or indirectly through affiliation with another organization) that is required to be reported on Schedule L (Form 990 or 990-EZ) for the organization's tax year.

4. Neither the member, nor any family member of the member, was involved in a transaction with a taxable or tax-exempt related organization (whether directly or indirectly through affiliation with another organization) of a type and amount that would be reportable on Schedule L (Form 990 or 990-EZ) if required to be filed by the related organization.

Determining Whether a Conflict of Interest Exists

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

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

Corporate Opportunity

Another recognized component of the non-profit director's duty of loyalty, closely associated with conflicts of interest, is the doctrine of corporate opportunity. Generally speaking, this doctrine proscribes a director's usurpation of a business opportunity which the director reasonably should know may be of interest to the corporation, without prior board approval. It is based on the principle that the corporation has a "prior right" to accept or disclaim certain business opportunities that present themselves to a director.[61]

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).[62] A director who "usurps" a corporate opportunity may breach the duty of loyalty and be exposed to damages or equitable remedies.[63]

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.*[64]

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[65]

In order for the director to avoid any appearance of impropriety, he/she should make disclosure of the opportunity before becoming legally obligated with respect to it. Any request that the board abstain from exercising it should be clearly set forth by the interested director in writing and set forth in the corporate records.[66] 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.[67]

61 ALI Draft Restatement at § 2.02 cmt. (g); Model Act at § 8.70.
62 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.
63 ALI Draft Restatement at § 2.02 cmt. (g); Model Act at § 8.70.
64 *Guth v. Loft,* 5 A.2d 503 (Del., 1939), cited in *Fiduciary Duty of Corporate Directors, supra.*
65 Knepper and Bailey, *supra,* at § 4.12.
66 Guidebook, *supra.*
67 ALI Draft Restatement at § 2.02 cmt. (g); Model Act at § 8.70.

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

- **Test one:** Is the corporate opportunity an activity closely associated with the current or anticipated business of the corporation?
- **Test two:** Was the corporation denied an opportunity in which it had a tangible interest or expectancy?
- **Test three:** Was the director's action with respect to the opportunity "fair" under all relevant facts and circumstances?
- **Test four:** Involves a combination of tests one and three.[68]

"Corporate opportunity" challenges can arise 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 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.

68 Knepper and Bailey, *supra,* at § 4.12.

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Appendix A: Conflicts-of-Interest Policy

NOTE: The preparation and adoption of a conflicts-of-interest policy is a significant exercise of board responsibility. Such a policy should reflect applicable state corporate, federal tax, and other applicable law, and well as the unique circumstances of the organization's corporate structure and organizational hierarchy. It should be implemented together with a conflicts-of-interest questionnaire required to be completed no less than annually by each officer and director.

BOARD POLICY NO.:	**SUBJECT:** Conflicts-of-Interest Policy
EFFECTIVE DATE:	**CATEGORY:** Board Policy

Purposes:

1. To protect the interests of the Corporation ([Name of Organization] and its subsidiaries) when it is contemplating entering into a contract, transaction, or arrangement that has the potential for benefiting the private interests of a "Covered Person," as defined below.

2. To assure that all individuals who, by virtue of their position, can influence decisions affecting the business, operations, ethical, and/or competitive position of the Corporation, perform their duties in an impartial manner, free from any bias created by personal interests of any kind.

3. To clarify the duties and obligations of "Covered Persons" in the context of potential conflicts of interest and, further, to provide such "Covered Persons" with a method for disclosing and resolving potential conflicts of interest.

4. To supplement (not replace) any applicable laws governing conflicts of interest applicable to charitable, non-profit corporations. To the extent that other Federal or state laws may impose more restrictive conflict-of-interest standards (including more extensive disclosures of actual or potential conflicts of interest), the Board of Directors of the Corporation shall modify the substantive and procedural terms of this Policy to assure compliance with such additional standards.

Policy:

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

   As such, this Policy applies to: (a) Covered Persons; and (b) any contract, transaction, or arrangement involving the Corporation.

2. *Definitions.*

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

   b. *Conflict of Interest.* A "conflict of interest" exists when a Covered Person has a Covered Interest in a proposed contract, transaction, or arrangement to which the Corporation may be a party and with respect to which the Covered Person would otherwise be called upon to render a decision in that capacity.

   c. *Covered Interest.* A Covered Person has a Covered Interest with respect to a contract, transaction, or arrangement in which the Corporation is (or would be, if approved) a party if the person has, directly or indirectly, through a business, investment, or family member:

      i. An ownership or investment interest in any entity involved in such contract, transaction, or arrangement;

      ii. A compensation arrangement with an individual or entity involved in such a contract, transaction, or arrangement;

      iii. A potential ownership or investment interest in, or compensation arrangement with, an individual or entity with which the Corporation is negotiating such contract, transaction, or arrangement; or

      iv. A fiduciary position (e.g., member, officer, director, committee member) with respect to an entity involved in such contract, transaction, or arrangement, but only to the extent that such position involves a material financial interest of, or benefit to, such person.

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

      A Covered Interest does not necessarily constitute a conflict of interest. Under Section 3(d), below, a Covered Person who has a Covered Interest may have a conflict of interest only if the disinterested members of the Executive Committee decide that a conflict of interest exists.

   d. *Family Member.* With respect to a Covered Person, "Family Member" means, as applicable, a spouse, brothers or sisters (by whole- or half-blood), spouses of brothers or sisters, ancestors, children, grandchildren, great-grandchildren, and spouses of children, grandchildren, and great-grandchildren.

3. *Procedures.*

   a. *Duty to Disclose.* A Covered Person must disclose the existence of any Covered Interest and be given the opportunity to disclose all material facts to the directors and members of committees with governing board delegated powers considering the proposed contract, transaction, or arrangement.

   b. *Annual Questionnaire.* Each Covered Person shall completely, accurately, and within the required timeframe established by the Board [or the Executive Committee] submit the annual Conflicts-of-Interest Questionnaire as prepared and distributed by the Board [or Executive Committee].

   c. *Continuing Disclosures.* If, subsequent to completion of the Conflicts-of-Interest Questionnaire, any Covered Person becomes aware of a Covered Interest that could give rise to a conflict of interest with respect to a proposed contract, transaction, or arrangement involving the Organization, the Covered Person shall promptly make disclosure of the Covered Interest to the Board [or the Executive Committee].

   d. *Determining Whether a Conflict Exists.* The Executive Committee shall determine by a majority vote of disinterested directors whether the disclosed Covered Interest may result in a conflict of interest. The Executive Committee shall: (i) review responses to the Conflicts-of-Interest Questionnaire and any continuing disclosures that are made during the year; (ii) take such steps as are necessary to identify Covered Interests and review any so identified; (iii) make such further investigation as it deems appropriate with regard to Covered Interests disclosed or identified; and (iv) determine whether any such Covered Interest gives rise to a conflict of interest. The subject Covered Person shall not be present during any meeting in which the Executive Committee conducts its evaluation, except to answer questions of the Executive Committee as may be necessary. The Executive Committee may request additional information from all reasonable sources and shall involve the General Counsel in its deliberations. Once all necessary information has been obtained, the Executive Committee shall make a finding as to whether a conflict of interest indeed exists. Only disinterested committee members may vote to determine whether a conflict of interest exists. The subject Covered Person may not be present when this vote is taken.

   e. *Addressing the Conflict of Interest.* Once the disinterested members of the Board of Directors have determined that an actual conflict of interest exists with respect to a particular contract, transaction, or arrangement:

      i. The disinterested members of the Board of Directors shall exercise due diligence to determine whether the Corporation could obtain a more advantageous contract, transaction, or arrangement with reasonable efforts under the circumstances and, if appropriate, shall appoint a noninterested person or committee to investigate alternatives to the proposed contract, transaction, or arrangement.

ii. In considering whether to enter into the proposed contract, transaction, or arrangement, the Board of Directors or Executive Committee may approve such a contract, transaction, or arrangement only if the disinterested Directors determine by a majority vote that:
    - The proposed contract, transaction, or arrangement is in the Corporation's best interests and for the Corporation's own benefit; and
    - The proposed transaction is fair and reasonable to the Corporation, taking into account, among other relevant factors, whether the Corporation could obtain a more advantageous contract, transaction, or arrangement with reasonable efforts under the circumstances.

iii. The disinterested members of the Board of Directors or Executive Committee may, in their discretion, require the Covered Person to leave the room while the proposed contract, transaction, or arrangement is discussed. The Covered Person shall leave the room while the matter is voted on and only disinterested Directors may vote to determine whether to approve the transaction or arrangement.

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

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

4. *Records of Proceedings.* The minutes of meetings of the Board of Directors and any committee with Board-delegated powers shall include:

   a. The names of persons who disclosed or were otherwise found to have a Covered Interest relevant to any matter under discussion at the meeting, a general statement as to the nature of such interest (e.g., employment arrangement, equity interest, or board membership or officer position in another corporation), any action taken to determine whether a conflict of interest exists, and the Board or committee's conclusion as to whether a conflict exists.

   b. The names of the persons present for the discussions and votes relating to the contract, transaction, or arrangement, a summary of the content of these discussions that contains the type of information regularly reported in Board or committee minutes and identifies whether any alternatives were considered, and a record of any vote taken in connection therewith.

c. If appraisals (for tangible property) or third-party comparable data (for compensation) were considered by the Board or Committee, the nature and source of the data.

5. *Compensation.*

   a. A voting member of the Board who receives compensation, directly or indirectly, from the Corporation for services is precluded from voting on matters pertaining to that member's compensation.

   b. A voting member of any committee whose jurisdiction includes compensation matters and who receives compensation, directly or indirectly, from the Corporation for services is precluded from voting on matters pertaining to that member's compensation.

   c. No voting member of the Board or any committee whose jurisdiction includes compensation matters and who receives compensation, directly or indirectly, from the Corporation, either individually or collectively, is prohibited from providing information to any committee regarding compensation.

6. *Annual Statements.* Each Covered Person shall sign an annual statement that the Covered Person: (a) has received a copy of this Policy; (b) has read and understands the Policy; (c) agrees to comply with the Policy; (d) understands that the Policy applies to committees and subcommittees; (e) understands that the Corporation is a charitable organization that must engage primarily in exempt activities; (f) agrees to report to the Executive Committee any change to matters previously disclosed on the Conflicts-of-Interest Questionnaire; and (g) states that the information provided in the Conflicts-of-Interest Questionnaire is true and accurate to the best of his or her knowledge and belief.

7. *Periodic Reviews.* To ensure that the Corporation operates in a manner consistent with its charitable purposes and does not engage in activities that could jeopardize its tax-exempt status, periodic reviews shall be conducted. The periodic reviews shall, at a minimum, include the following subjects:

   a. Whether compensation arrangements and benefits are reasonable, based on competent survey information, and the result of arm's length bargaining.

   b. Whether partnerships, joint ventures, and arrangements with management organizations conform to the Corporation's written policies, are properly recorded, reflect reasonable investment or payments for goods and services, further charitable purposes, and do not result in inurement, impermissible private benefit, or in an excess benefit transaction.

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

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