

# Introduction

Individuals who volunteer to serve on nonprofit boards tend to be actively engaged in their communities and have a myriad of professional, personal, and community relationships. Many serve on more than one nonprofit board at a time. The nonprofit sector depends on the spirit of volunteerism displayed by these engaged and capable individuals. However, these board members can also face challenges in carrying out their board responsibilities precisely because of the number and breadth of the associations and connections they have. Making unbiased, independent decisions on behalf of the organization can be difficult when a colleague, a friend, a family member, another organization, or a business relationship may be affected by or benefit from those decisions. The more connected a board member is, the more likely it is that such intertwining circumstances will arise, creating potential and sometimes problematic conflicts of interest.

The following chapters seek to demystify many of the legal rules relating to conflicts of interest that are applicable to nonprofit board members and executive staff, giving current and prospective board members the knowledge they need to serve with confidence. Because there are many legal definitions and nuances involved, the text seeks to create both a common understanding of conflicts of interest and a common vocabulary with which to discuss conflict issues.

## WHAT IS A CONFLICT OF INTEREST?

A *conflict of interest* exists when a board member, officer, or management employee has a personal interest that is in conflict with the interests of the organization, such that he or she may be influenced by this personal interest when making a decision for the organization. Conflicting interests may include both financial and nonfinancial concerns, although the law is most often concerned with and focused on financial interests. While the term *conflict of interest* has taken on a negative connotation, only some of the many different types of conflicts of interest may actually be harmful to an organization. How an organization manages conflicts of interest and ensures open and honest deliberation affects all aspects of its operations and is critical to avoiding legal problems and public scandals, making good decisions, and remaining focused on the organization's mission.

The key for nonprofit boards is *not* to try to avoid all possible conflict-of-interest situations, which would be impossible; rather, boards need to identify and follow a process for handling them effectively. There is no single solution to addressing conflicts that will best suit every nonprofit organization. It is essential to keep in mind the importance of disinterested decision making so that all board members can aid their organizations in determining how best to address conflict concerns, helping to protect themselves and the organizations they serve. As board members and chief executives gain a greater understanding of the legal and organizational concerns surrounding conflicting interests, they will be able to help their organizations distinguish between situations in which conflicting interests can be beneficial to the organization and situations where a board member may be using his or her role to

gain a personal advantage; and, they will be able to concentrate more on the challenges and psychic rewards that accompany nonprofit service.

The issue of conflicts of interest also relates to the more general subject of ethical conduct. Many organizations seek not simply to comply with legal regulations — which is required — but also to encourage the highest standards of behavior by its board and staff. This is not purely a concern for high-mindedness; donors and volunteers of nonprofit organizations trust organizations to be good stewards of their resources and to uphold rigorous standards of conduct and personal integrity.

## **HEIGHTENED SCRUTINY OF NONPROFIT ORGANIZATIONS**

The need for board members to understand the legal landscape surrounding conflicts of interest, as well as public perceptions in this regard, is particularly important given the increased scrutiny of nonprofit organizations by government regulators and by the public.

The Internal Revenue Service (IRS), state attorneys general, Congress, and the media have sharpened their focus on the nonprofit sector and the extent to which boards fulfill their oversight responsibilities. The Taxpayer Bill of Rights 2 introduced intermediate sanctions for excess benefit transactions (see Chapter 2 for further discussion), and regulations were finalized in 2002. In 2004, the IRS announced a new enforcement program seeking to identify and halt abuses by tax-exempt organizations that pay excessive compensation and benefits to their officers and other insiders.

In October 2004, the IRS issued a revised version of its Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code (the Form 1023), which, for the first time, includes extensive questions on conflicts of interest. It also asks whether the organization has adopted a conflicts-of-interest policy consistent with the sample policy provided with the Form. If the organization has adopted a similar policy, it is asked to include a copy with its application and to explain how it was adopted (such as by resolution of the board). If no such policy is in place, the organization must describe what procedures will be followed to ensure that conflicts of interest will be managed wisely. The Form states that, although a conflict-of-interest policy is recommended, it is not required in order to obtain exemption. The instructions do state, however, that “by adopting the sample policy or similar policy, you will be choosing to put in place procedures that will help you avoid the possibility that those in positions of authority over you may receive an inappropriate benefit.” Although the IRS had previously issued a model conflict-of-interest policy, it was directed mainly at health care organizations and was not included in the IRS Form 1023. This new IRS Form, which has been required since May 2005, underscores the need to manage conflicts of interest properly and the centrality of that concern to good governance. (A copy of the IRS policy that accompanies the new Form is included in Appendix 2.)

Funders and credit rating agencies nationwide also are looking with increasing attention at organizations' management, including the way they deal with conflicts and similar governance issues. In addition, although the Sarbanes-Oxley Act of 2002 does not generally apply to nonprofit organizations, as of the writing of this book,

New York, Massachusetts, California, Hawaii, Iowa, Texas, and other states have considered measures for nonprofit governance reform. California's adoption of the California Nonprofit Integrity Act of 2004, which took effect for 2005, is the first example of state legislation aimed at regulating the internal governance practices of nonprofit organizations. Although the main focus of the California Act is to increase the attorney general's oversight of charitable entities and commercial fundraisers in the state through increased disclosure and reporting requirements, the legislation contains a few Sarbanes-Oxley-type provisions and also may be applied to nonprofits qualified to do business in California even if they are not incorporated in the state.

One of the two requirements of the Sarbanes-Oxley Act that does apply to nonprofit organizations is the requirement that all organizations provide protection for whistleblowers and penalties for actions against them. In response to this requirement, organizations are strongly encouraged to adopt a whistleblower policy to ensure compliance and to provide a means for employees, officers, and directors to raise good-faith concerns about behavior that appears to be illegal, dishonest, or unethical. A key component of the policy is the prohibition against retaliation against anyone who makes a good-faith allegation under the policy. This requirement also highlights the need for openness and transparency.

Also at this time Congress is actively reviewing perceived abuses in the nonprofit sector, with several reforms already proposed in tax reconciliation legislation recommended in November of 2005.

## **OVERVIEW**

The purpose of this book is to help nonprofit board members and chief executives develop a better understanding of conflicts of interest and how to manage them. The first chapter describes how conflicts of interest may arise. To help board members think through potential conflicts of interest, it acknowledges the difficulty of defining conflicts by illustrating them in terms of a continuum, with unacceptable (illegal) conflicts at one end and inconsequential conflicts at the other, and a range of situations in between.

The second chapter addresses legal considerations in detail, aiming to clarify the legal concepts and terms, and give nonprofit board members the knowledge they need to act in accordance with state and federal law. This chapter includes a discussion of the IRS intermediate sanctions rules applicable to public charities as well as the stricter self-dealing rules that private foundations must follow. The material is intended as a basic guide and will also help board members recognize when they may need the advice of a legal professional.

Chapters 3 and 4 outline the steps a nonprofit board can take to ensure that it is prepared to handle conflicts of interest proactively and constructively. Chapter 3 discusses the conflict-of-interest policy and board member disclosure statement in detail. Chapter 4 provides guidelines for responding to conflicts of interest that have already become problematic.

Chapter 5 looks at the broader ethical context, seeking to provide guidance for board members as they consider the ramifications of their actions in terms of public

perception and personal integrity, and discusses the increasing interest in having an organizational code of ethics. The appendices that follow include a Q&A section, sample policies and forms, and a glossary of key terms.

The best approach to managing conflicts of interest may vary from one nonprofit organization to another, but all nonprofits share the fundamental need for disinterested decision making. When making decisions, board members must set aside personal agendas and put the interests of the organization above all else. Conflicting interests will always be a key issue for nonprofit organizations, which requires the care and attention of board members who are active and engaged.