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“Nonprofit Conflicts of Interest – Six Degrees of Separation”

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“It’s not what you know – it’s who you know.” The responsibilities, privileges, advantages, and obligations that we have as family members, workers, friends, citizens, volunteers, neighbors, and human beings do not come to us by accident. Everything that we experience happens because we know someone, or someone knows us. At its core then, a “conflict of interest” is simply a condition of our existence – it is the dual admission that we are related to others and that we are who we are because of those relationships.

In recent years, the words “conflict of interest” immediately evoke images of unfairness, favoritism, and wrongdoing – stock and loan manipulations at Enron and WorldCom, luxury travel by fundraising and museum executives and their relatives, the “fox watching the henhouse” of ecclesiastical abuses in religious institutions. But we cannot separate ourselves from the people we know or the different roles that we play. In fact, it is more often than not because of those people and roles that we are given newer and better opportunities in life.

This paper attempts to bring sharper focus to the concept of “conflict of interest” in the context of service to nonprofit organizations. We examine legal restrictions on certain types of conflicts, processes that organizations and individuals can employ to avoid violating those restrictions, and thoughts about a culture of “constructive conflicts” that might move the topic from front-page headlines about criminal indictments to the human interest column in the second section (below the fold).

I. Introduction – Laws, Images, and Reality

In the nonprofit arena, a “conflict of interest” may be defined broadly as any situation in which a decision-maker for a nonprofit organization has a financial or other interest in, or relationship with, an entity or person that does business with the organization. Conflicts are unavoidable. The question is, “What do we do about them?”

The people who direct nonprofit organizations look first to the duties and restrictions imposed by law for guidance in dealing with conflicts of interest. These legal rules derive from a number of sources, including the common law handed down through court decisions, state statutes, the Internal Revenue Code (the “Code”) and Treasury Regulations (“Treas. Reg.”), and Internal Revenue Service (“IRS”) guidelines, returns, forms, notices, rulings, and publications.

In addition, media attention to the dealings of nonprofit organizations often leads directors and trustees to steer a wider berth around potentially questionable actions than the law requires. Public image is especially important for nonprofit organizations that rely on governmental grants, private gifts, and public memberships or event attendance for financial survival.

Beyond the important legal rules and public perceptions that require nonprofit leaders to avoid certain conflicts of interest, however, there is a very real aspect of this inquiry that should not be
lost. Recognizing and embracing the relationships and experiences that people bring to their roles with nonprofit organizations will improve the governance, efficiency, and effectiveness of those organizations in ways often ignored, overlooked, and unexpected.

II. Common Law

A. The Three Duties

As fiduciaries responsible for oversight, policy direction, and governance, directors or trustees of nonprofit organizations traditionally are bound by the common law duties of care, loyalty, and obedience. See Goldschmid, Harvey J., The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms, 23 Journal of Corporation Law 631, 641 (1998); see also Jurtz, Daniel L., Board Liability: Guide for Nonprofit Directors 21 (1988). (The many distinctions and similarities between directors [sometimes called “trustees”] of nonprofit corporations and trustees of charitable trusts are matters beyond the scope and page limitations of this paper, but much of what is said applies to both. As a general point of analysis, we address the fiduciary responsibilities of directors of nonprofit corporations with the understanding that charitable trustees often are subject to additional and more stringent obligations and rules.)

1. Care

The duty of care concerns the director’s attention to governance functions and typically requires her or him to use the care that an ordinarily prudent person would exercise in a like position and under similar circumstances. Among other things, this involves reading budgets, program reports, and important organizational documents; attending and participating in meetings; and supervising and evaluating top executives.

2. Loyalty

The duty of loyalty requires the director’s faithful pursuit of the interests of the organization served, rather than striving to protect or enhance the individual’s own financial or other interests or those of another person or organization. This is the starting point for most “conflict of interest” discussions.

3. Obedience

Lastly, the duty of obedience requires a director to act in concert with the organization’s mission, as expressed in its charter, constitution, articles of incorporation, bylaws, or other governing documents. It is not enough to do things well and for the public good – obedience to the mission of a particular organization means that there is a subcategory of good that defines the use of the assets, income, and resources of that organization. It generally is not obedient to the mission of a fine arts museum in Idaho to spend dollars to feed the hungry in the Ukraine.
B. **Loyalty in the Common Law – “Sibley” Rivalry**

Borrowing from legal and equitable concepts developed to regulate directors of for-profit corporations over many centuries, it is the common law duty of loyalty that requires a director of a nonprofit organization to place the interests of the organization before her or his own interests. “Generally, directors of a corporation stand in a fiduciary relationship toward the corporation. Out of this relationship arises a duty of reasonably protecting the interests of the corporation.” *Tower Recreation v. Beard*, 231 N.E.2d 154, 155 (Ind. Ct. App. 1967). Accordingly, directors should act in the best interests of the corporation that they serve, foregoing their own interests and the interests of other individuals and organizations. Further, a director may not use her or his corporate position for individual personal advantage nor take an opportunity available to the corporation and use it for other purposes. *Id.* at 155-156.

The fiduciary duty of loyalty is not limited to activities where financial advantage is realized by a director, however. The decision in *Stern v. Lucy Webb Hayes National Training School for Deaconesses and Missionaries*, 381 F. Supp. 1003 (D.D.C. 1974), commonly referred to as the *Sibley Hospital* case, illustrates different ways that a director of a nonprofit corporation may fail in the duty of loyalty.

To carry out one of its charitable purposes (i.e., providing health care services to the poor of the Washington DC area), the Lucy Webb Hayes National Training School built and operated the Sibley Memorial Hospital. Patients sued the hospital and its trustees (whom the court noted were actually nonprofit corporate directors not subject to the higher standards of conduct applied to trustees of private or public trusts) alleging, among other misconduct, that the trustees breached their fiduciary duties through mismanagement of hospital funds and various acts of self-dealing.

A substantial part of the hospital’s liquid assets was invested in savings and checking accounts that drew little or no interest at banks with which trustees of the hospital were affiliated. Some of the hospital’s trustees were directors, employees, and shareholders of the banks. *Sibley Hospital*, at 1009-1010. The trustees did not disclose their relationships with these institutions to the other trustees or to the hospital’s investment and finance committee. *Id.* at 1011, 1016. Further, the investment and finance committee did not meet for years and the hospital’s administrator and treasurer were left to handle its finances with “only cursory supervision from the Executive Committee and the full Board.” *Id.* at 1008.

The *Sibley Hospital* court explained that a director of a charitable organization like the hospital fails in her or his fiduciary duty to supervise the management of the organization’s investments if he or she (among other facts and circumstances):

- knowingly permitted the [organization] to enter into a business transaction with himself or with any corporation, partnership or association in which he then had a substantial interest or held a position as trustee, director, general manager or principal officer without having previously informed the persons charged with approving that transaction of his interest or position and of any significant reasons, unknown to or not fully appreciated by such persons, why the transaction might not be in the best interests of the [organization].
Id. at 1015. Notwithstanding the holding that the trustees breached their fiduciary duty to the hospital, the court found “no indication that any of the named trustees were involved in fraudulent practices or profited personally by lapses in proper fiscal supervision.” Id. at 1018.

Among other remedies for breach of fiduciary obligations, though, the court required the hospital’s board to adopt a policy governing the hospital’s future investments and directed that “[n]o existing financial relationships should be continued unless consistent with established policy and found by disinterested members of the Board to be in the Hospital’s best interests. In addition, each trustee should fully disclose his affiliation with banks, savings and loan associations and investment firms now doing business with the Hospital.” Id. at 1018-1019.

As in the Sibley Hospital case, if a director of a nonprofit corporation has a conflict of interest, does not disclose the conflict, and participates in a decision that could benefit the director, directly or indirectly, the director may have breached the duty of loyalty even without receiving financial gain from the resulting transaction or causing any actual loss to the corporation itself.

To guard against violating this duty under common law, a nonprofit corporation should consider adopting a conflict of interest policy and implementing procedures that will identify and address situations in which a director may have conflicting interests. More about that later.

III. State Statutes – Revised Model Nonprofit Corporation Act

Often as a codification of principles developed in court decisions like Sibley Hospital, state legislatures have enacted statutes establishing standards of conduct for directors of nonprofit corporations. In recent years, most of these statutes are fashioned after the Revised Model Nonprofit Corporation Act (“RMNCA”), published in 1987 by a subcommittee of the Business Law Section of the American Bar Association.

A. Fiduciary Standard of Conduct

The basic requirements of fiduciary responsibility for nonprofit directors are described in the model statute as follow:

(a) A director shall discharge his or her duties as a director, including his or her duties as a member of a committee:

(1) in good faith;

(2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and

(3) in a manner the director reasonably believes to be in the best interests of the corporation.

RMNCA section 8.30 (1987). Compliance with this standard provides one line of defense against civil liability for actions as a nonprofit director: “A director is not liable to the
corporation, any member, or any other person for any action taken or not taken as a director, if the director acted in compliance with this section.” RMNCA section 8.30(d).

On the other hand, acting for personal interest in a manner that hurts a nonprofit corporation, the classic “bad” conflict of interest, could violate this standard in any one (or more) of several different ways – establishing bad faith, the absence of care that an ordinarily prudent person would exercise, and conduct that the director believes (or reasonably should believe) is in the director’s best interest, rather than the best interests of the corporation.

B. Corporate Action in the Face of Conflict

The model law goes on to discuss what directors should do when a corporate action may be viewed as a conflict of interest transaction:

(a) A conflict of interest transaction is a transaction with the corporation in which a director of the corporation has a direct or indirect interest. A conflict of interest transaction is not voidable or the basis for imposing liability on the director if the transaction was fair at the time it was entered into or is approved as provided in subsections (b) or (c).

(b) A transaction in which a director of a public benefit or religious corporation has a conflict of interest may be approved:

(1) in advance by the vote of the board of directors or a committee of the board if:

   (i) the material facts of the transaction and the director’s interest are disclosed or known to the board or committee of the board; and

   (ii) the directors approving the transaction in good faith reasonably believe that the transaction is fair to the corporation; or

(2) before or after it is consummated by obtaining approval of the:

   (i) attorney general; or

   (ii) [describe or name] court in an action in which the attorney general is joined as a party; or

(c) A transaction in which a director of a mutual benefit corporation [i.e., a nonprofit corporation organized and operated to benefit a defined class of members, like a social club] has a conflict of interest may be approved if[.]
(1) the material facts of the transaction and the director’s interest were disclosed or known to the board of directors or a committee of the board and the board or committee of the board authorized, approved, or ratified the transaction; or

(2) the material facts of the transaction and the director’s interest were disclosed or known to the members and they authorized, approved, or ratified the transaction.

(d) For purposes of this section, a director of the corporation has an indirect interest in a transaction if (1) another entity in which the director has a material interest or in which the director is a general partner is a party to the transaction or (2) another entity of which the director is a director, officer, or trustee is a party to the transaction.

(e) For purposes of subsections (b) and (c) a conflict of interest transaction is authorized, approved, or ratified, if it receives the affirmative vote of a majority of the directors on the board or on the committee, who have no direct or indirect interest in the transaction, but a transaction may not be authorized, approved, or ratified under this section by a single director. If a majority of the directors on the board who have no direct or indirect interest in the transaction vote to authorize, approve, or ratify the transaction, a quorum is present for the purpose of taking action under this section. The presence of, or a vote cast by, a director with a direct or indirect interest in the transaction does not affect the validity of any action taken under subsections (b)(1) or (c)(1) if the transaction is otherwise approved as provided in subsection (b) or (c).

(f) For purposes of subsection (c)(2), a conflict of interest transaction is authorized, approved, or ratified by the members if it receives a majority of the votes entitled to be counted under this subsection. Votes cast by or voted under the control of a director who has a direct or indirect interest in the transaction, and votes cast by or voted under the control of an entity described in subsection (d)(1), may not be counted in a vote of members to determine whether to authorize, approve, or ratify a conflict of interest transaction under subsection (c)(2). The vote of these members, however, is counted in determining whether the transaction is approved under other sections of this Act. A majority of the voting power, whether or not present, that are entitled to be counted in a vote on the transaction under this subsection constitutes a quorum for the purpose of taking action under this section.

(g) The articles, bylaws, or a resolution of the board may impose additional requirements on conflict of interest transactions.
RMNCA section 8.31 (1987). These state law provisions draw the fundamental roadmap for identifying and resolving conflicts of interest with respect to nonprofit corporations. The map is incomplete, however, and does not show special detours, highways under construction, and congested areas. Congress and the IRS are responsible for many of these added obstacles.

IV. The Code, the Regulations, and the IRS – A Quagmire of Conflicts

Federal tax law includes a variety of penalties for actions that constitute conflicts of interest in the nonprofit organization context. The thickest web of these special rules is cast over organizations exempt from the payment of federal income taxes under Code section 501(c)(3). If you can work through conflicts of interest in the 501(c)(3) environment, you should be able to handle anything.

A. Private Inurement, Private Benefit, and Section 501(c)(3)

Code section 501(c)(3) grants federal income tax exemption to religious, charitable, educational, scientific, and similar nonprofits. Code section 501(c)(3) organizations also are eligible to receive gifts and grants that are deductible as charitable contributions for federal income, gift, and estate tax purposes under Code sections 170(a)(1), 170(c)(2)(B), 2522(a), and 2055(a)(2).

The tax exemption and contribution benefits afforded to Code section 501(c)(3) organizations are not free, however. They come with obligations to serve the public good and a hefty measure of regulation and oversight. A nonprofit entity seeking recognition as a Code section 501(c)(3) organization must first pass several fundamental tests. Code sections 501(a) and 501(c)(3) provide exemption from the payment of federal income taxes to:

1. Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

Thus, a Code section 501(c)(3) organization must (i) operate exclusively for one or more of the listed exempt purposes, (ii) avoid private inurement of net earnings (and, as explained in the corresponding regulations, avoid “private benefit” generally), (iii) limit lobbying to an insubstantial part of its activities, and (iv) eschew entirely any involvement in politics.

With respect to conflicts of interest, Code section 501(c)(3) focuses on whether an organization allows its earnings to inure to the benefit of any private shareholder or individual. Effectively, this private inurement restriction extends the fiduciary duty of loyalty imposed on directors by
state law to the federal tax requirements for exemption under Code section 501(c)(3). Moreover, this federal rule of law applies not only to directors, but to any individual who has a special, close relationship or other private interest in the nonprofit organization – an “insider.”

Inurement includes an “advantage; profit; fruit; privilege; gain; [or] interest,” but does not include merely incidental benefits. **American Campaign Academy v. Commissioner**, 92 T.C. 1053, 1065-1066 (1989). Also, inurement generally occurs only with respect to private shareholders and individuals – persons who have a personal and private interest in an organization’s activities. **See** Treas. Reg. sections 1.501(a)-1(c), 1.501(c)(3)-1(c)(2). These individuals include an organization’s founders and directors, as well as family members of these insiders. **Id.**

In addition to avoiding private inurement, Code section 501(c)(3) organizations must serve public over private interests. Even if no private shareholder or individual receives a benefit constituting private inurement, an organization may be ineligible for tax exempt status because a substantial part of its activities further a nonexempt purpose, including benefiting a disinterested party. **American Campaign Academy**, 92 T.C. at 1055, 1065-1069 (organization that trained individuals for careers as campaign professionals was denied exempt status because it operated with the unstated purpose of assisting political parties and candidates).

**B. Self-Dealing and Section 4941**

As a result of the Tax Reform Act of 1969, most organizations that are described in Code section 501(c)(3) are presumed to be “private foundations” until they notify and convince the IRS otherwise (churches and very small charitable organizations are excepted from the notice requirement). **See** Code section 508(b). Private foundations generally are subject to more stringent rules than other Code section 501(c)(3) organizations, including the self-dealing rules of Code section 4941 and corresponding Treasury Regulations.

Code section 4941 imposes severe excise taxes on an insider (or “disqualified person”) who participates in an act of self-dealing involving a private foundation, and on the foundation managers who knowingly approved such act. A disqualified person includes a substantial contributor to the foundation, a director, an officer, employees with powers or responsibilities similar to those of directors or officers, and the family members of any of these individuals. Code section 4946(a)(1) and (b)(1).

An act of self-dealing includes “any direct or indirect . . . furnishing of goods, services, or facilities between a private foundation and a disqualified person; . . . payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person [in certain cases; . . . or] transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.” Code section 4941(d)(1)(C), (D), and (E). However, the following transactions (among others) typically will not constitute acts of self-dealing: (i) the provision of goods, services, or facilities by a disqualified person to a private foundation at no charge (if such goods, services, or facilities are used to further the foundation’s exempt purposes); (ii) the payment of compensation by a private foundation to a disqualified person for services that are reasonable and necessary to carry out the exempt purposes of the foundation (if
such payment is not excessive); and (iii) the provision of goods, services, or facilities by a private foundation to a disqualified person where such goods, services, or facilities are available to the general public on at least as favorable a basis as they are made available to the disqualified person. Code sections 4941(d)(2)(C) – (E); Treas. Reg. sections 53.4941(d)-3(a) – (c).

C. Controlled Grantees and Section 4942

Another special private foundation rule requires the annual minimum payout for charitable and other exempt purposes of a certain percentage (roughly 5%) of the value of a foundation’s investment assets. Contributions to “an organization controlled (directly or indirectly) by the foundation or one or more disqualified persons” generally cannot be counted as a “qualifying distribution” toward the required payout. Code section 4942(g)(1)(A).

The Pension Protection Act of 2006 (the “Pension Act”) amended Code section 4942 by, among many other things, tightening the definition of “qualifying distribution” with respect to private foundation grants to certain types of “supporting organizations.” Specifically, Section 1244(a) of the Pension Act replaced previous Code section 4942(g)(4) with the following new paragraph:

(4) LIMITATION ON DISTRIBUTIONS BY NONOPERATING PRIVATE FOUNDATIONS TO SUPPORTING ORGANIZATIONS. —

(A) IN GENERAL. — For purposes of this section, the term “qualifying distribution” shall not include any amount paid by a private foundation which is not an operating foundation to —

(i) any type III supporting organization (as defined in section 4943(f)(5)(A)) which is not a functionally integrated type III supporting organization (as defined in section 4943(f)(5)(B)), and

(ii) any organization which is described in subparagraph (B) or (C) if —

(I) a disqualified person of the private foundation directly or indirectly controls such organization or a supported organization (as defined in section 509(f)(3)) of such organization, or

(II) the Secretary determines by regulations that a distribution to such organization otherwise is inappropriate.

(B) TYPE I AND TYPE II SUPPORTING ORGANIZATIONS. — An organization is described in this subparagraph if the organization meets the requirements of subparagraphs (A) and (C) of section 509(a)(3) and is —

(i) operated, supervised, or controlled by one or more organizations described in paragraph (1) or (2) of section 509(a), or
(ii) supervised or controlled in connection with one or more such organizations.

(C) FUNCTIONALLY INTEGRATED TYPE III SUPPORTING ORGANIZATIONS. — An organization is described in this subparagraph if the organization is a functionally integrated type III supporting organization (as defined under section 4943(f)(5)(B)).

Thus, under new Code section 4942(g)(4), distributions from a private nonoperating (i.e., grantmaking) foundation to most “Type III” supporting organizations and to any type of supporting organization that is directly or indirectly controlled, or whose supported organization(s) are directly or indirectly controlled, by one or more of the private foundation’s disqualified persons, no longer constitute qualifying distributions.

For conflict of interest purposes, both the old payout requirement and the new Pension Act rules make it important for a private nonoperating foundation to determine the relationships of its directors and other disqualified persons. Even perfectly arms-length grants to charities that are directly or indirectly controlled by these individuals can trigger violations of the Code section 4942 payout requirements.

D. Controlled Grantees and Section 4945

In addition to payout concerns under Code section 4942, the Pension Act turned up the heat on payments to certain controlled grantees by amending the “taxable expenditure” rules of Code section 4945. The taxable expenditure restrictions, like the payout requirements, include the imposition of severe excise taxes on certain private foundation distributions to non-charities.

Code section 4945(d)(4), as amended by the Pension Act, now provides:

[T]he term “taxable expenditure“ means any amount paid or incurred by a private foundation . . . as a grant to an organization unless . . .

(A) such organization –

(i) is described in paragraph (1) or (2) of section 509(a),

(ii) is an organization described in section 509(a)(3) (other than an organization described in clause (i) or (ii) of section 4942(g)(4)(A)), or

(iii) is an exempt operating foundation (as defined in section 4940(d)(2)), or

(B) the private foundation exercises expenditure responsibility with respect to such grant in accordance with subsection (h) . . . . [emphasis added].
The taxable expenditure issue here, then, is whether a supporting organization that receives distributions from a private foundation is an organization described in clause (i) or (ii) of Code section 4942(g)(4)(A) – that is, whether the grantee is a “Type III” supporting organization that is not functionally integrated (as described elsewhere in the Pension Act), or any type of supporting organization that is directly or indirectly controlled, or whose supported organization(s) are directly or indirectly controlled, by one or more of the foundation’s disqualified persons. If the answer to any of these questions is “yes,” the foundation would be required to exercise expenditure responsibility with respect to distributions to such an organization in order to avoid making taxable expenditures under revised Code section 4945.

(It should be noted that although a private foundation safely may make grants to any type of supporting organization and avoid the imposition of taxable expenditure liabilities by exercising expenditure responsibility with respect to such grants under Code section 4945(d)(4)(B), expenditure responsibility does not resolve the qualifying distribution problems discussed previously.)

E. Excess Benefit Transactions and Section 4958

In 1996, Congress promulgated rules for public charities (i.e., Code section 501(c)(3) organizations that are not private foundations) and social welfare organizations that in many ways parallel the self-dealing rules governing private foundations. Code section 4958 permits the IRS to impose excise taxes on individuals or entities that receive excessive compensation or other excess benefits from an arrangement or transaction with a public charity. Sanctions may be imposed under Code section 4958 when a public charity has provided an “economic benefit,” directly or indirectly, to or for the use of any disqualified person where the “value of the economic benefit provided exceeds the value of the consideration received for providing such benefit.” Code section 4958(c)(1)(A).

Disqualified Persons. Pursuant to Code section 4958, a disqualified person includes (i) an individual who was “in a position to exercise substantial influence over the affairs” of the public charity at any time during the five-year period ending on the date of the transaction, (ii) family members of such persons, and (iii) certain entities controlled by other disqualified persons. Code section 4958(f)(1)(A)-(C). The Pension Act added to this list the disqualified persons of “supporting organizations” to the “applicable tax-exempt organization,” donors and certain others related to a “donor advised fund,” and even investment advisors (and related persons) with respect to a charity that sponsors donor advised funds. Code section 4958(f)(1)(D)-(F).

Automatic Excess Benefits. The Pension Act also created a new level of concern for supporting organizations (that is, public charities described in Code section 509(a)(3)) that pay compensation or other amounts to certain large contributors and related persons. Code sections 4958(c)(3)(A)(i) and (ii) specifically provide that the term “excess benefit transaction” includes “(I) any grant, loan, compensation, or other similar payment provided by [a Code section 509(a)(3) supporting organization] . . . to a [substantial contributor, or to a family member of a substantial contributor, or to a 35-percent controlled entity], and (II) any loan provided by [a Code section 509(a)(3) supporting organization] . . . to a disqualified person [including persons in a position to exercise substantial influence at any time in the preceding 5 years, their family
members, and 35-percent controlled entities].” The “excess benefit” in each of these cases is the entire amount of the grant, loan, compensation, or other similar payment.

Safe Harbor. While these excess benefit rules in many respects parallel the self-dealing provisions applicable to private foundations, the corresponding regulations of Code section 4958 provide a safe harbor “rebuttable presumption” for public charities and their directors that is not available to private foundations and their directors. See, e.g., Treas. Reg. section 53.4958-6(a). For example, by following certain procedures outlined in the regulations, the amount of compensation paid by a public charity to a disqualified person is presumed to be reasonable, or the transfer of property between a public charity and a disqualified person is presumed to be made at fair market value. The procedures include: (1) the compensation arrangement or terms of the transfer must be approved by the public charity’s board of directors, a committee of the board of directors, or a properly authorized body independent of the disqualified person; (2) the authorized body must obtain and rely on appropriate comparable data before making its determination; and (3) the authorized body must adequately document the basis for its determination by the later of the next meeting of the body, or sixty days after final approval of the transaction. Id.

This safe harbor may be construed as a standard of due diligence that a board of directors should employ when it identifies a conflict of interest between a public charity and a disqualified person. In addition, because these excess benefit regulations mirror the self-dealing rules governing private foundations, it is likely that the IRS or a court would refer to these provisions as analogous authority with respect to a private foundation’s efforts, and more specifically the efforts of the foundation’s directors, to guard against acts of self-dealing.

Nonetheless, the pitfalls that await charities and private foundations in maneuvering the excess benefit and self-dealing rules are, to put it mildly, numerous and daunting. A Code section 501(c)(3) organization is now charged with learning details about the personal and business relationships of its directors at a level unprecedented even by the strict self-dealing rules first enacted in the Tax Reform Act of 1969.

F. Other Pension Act Provisions – Conflicts Multiplied

In addition to layering complexities on top of the minimum payout, taxable expenditure, and excess benefit transaction rules, the Pension Act imposed totally new restrictions on conflict transactions by certain types of charities. Donor advised funds, controlled supporting organizations, and substantial contributors to supporting organizations – beware.

1. Taxable Distributions by Donor Advised Funds

New Code section 4966(c) imposes prohibitive excise taxes on distributions by donor advised funds (first defined in the Pension Act at Code section 4966(d)(2)) to any “Type III” supporting organization that is not “functionally integrated” with its supported organization(s), unless the sponsoring organization exercises expenditure responsibility over the distribution. More to the point with respect to conflicts of interest, the statute also taxes distributions made without expenditure responsibility to a Type I or Type II supporting organization, or to a functionally
integrated Type III supporting organization, if a donor or the donor’s appointee or designee controls (directly or indirectly) an organization supported by the supporting organization.

2. Controlled Supporting Organizations

The new taxable distribution provision in the Pension Act (governing donor advised funds) highlights the similar language in Code section 509(a)(3)(C) that has received little attention since first enacted as part of the Tax Reform Act of 1969. Specifically, a supporting organization cannot be “controlled directly or indirectly by one or more disqualified persons [such as substantial contributors and their relatives] . . . .” Code section 509(a)(3)(C). An organization claiming this public charity status, and private foundations making grants to such organizations, should pay closer attention to the relationships of the persons governing the charity to make sure that the control restrictions are met.

3. Gifts from Substantial Contributors

The Pension Act also includes a complicated provision regarding gifts to certain types of supporting organizations from persons who control those entities’ supported organizations. Code section 509(f)(2)(A) provides, “For purposes of [Code section 509(a)(3)], an organization shall not be considered to be [a Type I or Type III supporting organization] . . . if such organization accepts any gift or contribution from any person described in subparagraph (B).” Subparagraph (B) describes “(i) a person [other than a public charity] who directly or indirectly controls, either alone or together with [other described persons], . . . the governing body of [a] supported organization [of the supporting organization grantee], (ii) a member of the family . . . of [a person described in subparagraph (i)], or (iii) a 35-percent controlled entity [of such persons].”

This provision is impossibly intricate and requires determinations regarding the governance structure and donation records of each of the supported organizations for Type I and Type III supporting organizations. As a practical matter, Type I and Type III supporting organizations should make sure that their supported organizations are nonprofit entities that receive broad public support and oversight and are not controlled by any individuals, families, or entities, meaning that such supported organizations could not be found to be controlled directly or indirectly by the donors to a supporting organization.

G. IRS Notice 2006-109 – Defining Control

Recognizing the number and complexity of questions raised by the Pension Act, on December 4, 2006, the IRS issued Notice 2006-109 to serve as interim guidance regarding several of the most pressing issues. Notice 2006-109 (i) sets forth interim definitions of “control” and “functionally integrated” and (ii) describes information upon which a private foundation may rely in confirming that a supporting organization is a Type I, Type II, or functionally integrated Type III supporting organization that is not controlled, and whose supported organization(s) are not controlled, by one or more disqualified persons.

For purposes of determining that a supporting organization is not “directly or indirectly control[led]” by one or more of the private foundation’s disqualified persons, the IRS will apply...
the definition of “control” contained in existing Treasury Regulations that interpret Code section 4942(g)(1)(A)(i):

In determining whether a disqualified person with respect to a private foundation controls a supporting organization or one of its supported organizations, the control standards established in Treas. Reg. section 53.4942(a)-3(a)(3) will apply. Under these standards, an organization is controlled by one or more disqualified persons with respect to a foundation if such persons may, by aggregating their votes or positions of authority, require the supporting or supported organization to make an expenditure, or prevent the supporting organization or the supported organization from making an expenditure, regardless of the method by which the control is exercised or exercisable.

Notice 2006-109. (As noted above, Code section 4942(g)(1)(A)(i), which was not amended by the Pension Act, provides that a distribution from a private foundation to any organization that is controlled directly or indirectly by the private foundation or one or more of its disqualified persons will not constitute a qualifying distribution.)

Similarly, the IRS will apply existing regulations for purposes of determining whether a Type III supporting organization is “functionally integrated” with one or more of its supported organizations: “[A]n organization will be considered a functionally integrated Type III supporting organization if it would meet the test set forth in Treas. Reg. section 1.509(a)-4(i)(3)(ii).” Notice 2006-109. The cited regulations set forth a portion of what is known as the “integral part” test for Type III supporting organizations. See Treas. Reg. section 1.509(a)-4(i).

Also, with respect to the Pension Act’s effective prohibition on private foundation grants to any supporting organization that is controlled, or whose supported organization(s) are controlled, by one or more of the private foundation’s disqualified persons, Notice 2006-109 suggests that “[a] private foundation considering a grant to a Type I, Type II, or functionally integrated Type III supporting organization may need to obtain a list of the grantee’s supported organizations from the grantee to determine whether any of the supported organizations is controlled by disqualified persons of the private foundation.” Using this list and its knowledge of the nonprofit positions of its own disqualified persons, the private foundation then may assess whether one or more of such disqualified persons may be in a position of control with the supporting organization or one of its supported organizations.

V. IRS Requirements and Treasury Proposals

The federal tax rules enacted in the Code and developed in the Treasury Regulations eventually and invariably are translated into IRS guidelines, tax and information returns, forms, notices, rulings, publications, and similar materials. Here is a summary of how the IRS weaves the conflict of interest laws and regulations into the fabric of exempt organization compliance measures, and of new proposals for regulatory guidance.
A. **Form 1023**

Form 1023, “Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code” (Rev. June 2006), includes questions designed to detect conflicts of interest and to expose the private benefits, private inurement, self-dealing, and excess benefit transactions they can create. These matters are scattered throughout the application.

**Purpose.** Part III of Form 1023 requires an applicant for exemption to identify the particular article or section of its organizing document that states the exempt purpose of the organization. Part IV then requires a narrative description of the organization’s past, present, and planned activities. Answers to these questions could suggest that the organization is actually serving the private interests of its founders or others – this is a good opportunity for the organization, instead, to describe in detail how public interests are served. The strength of this presentation will be helpful in explaining why policies or transactions that might appear to create prohibited conflicts of interest in fact further the exempt mission of the organization.

**Compensation.** Other questions seek information about compensation. A conflict of interest may appear when a person receiving compensation, or a relative or associate of that person, participates in setting the compensation amount. Part V of Form 1023 requires an organization to provide detailed compensation information for all officers, directors, and trustees; the five highest compensated employees receiving more than $50,000 annually; and the five highest compensated independent contractors receiving more than $50,000 annually.

**Relationships.** Part V also asks about family and business relationships among officers, directors, trustees, and highly compensated employees. See Form 1023, Part V, Lines 2a – 2c. Questions also require disclosure of work descriptions for officers, directors, and trustees, including qualifications, average hours worked, and duties. See id., Lines 3a and 3b. Lines 4a through 4g ask whether the organization uses certain compensation-setting practices, such as following a conflict of interest policy, documenting the details underlying compensation decisions, and researching compensation paid by similarly situated entities providing similar services. Lines 7, 8, and 9 inquire into the organization’s purchases of goods, services, or assets and its leases, contracts, loans, or other agreements from or with any of its officers, directors, trustees, or highest compensated employees.

**Conflicts of Interest.** The most direct discussion of conflicts of interest appears in Part V, Lines 5a, 5b, and 5c. If the organization seeking exemption has adopted a conflict of interest policy, a copy of the policy should be attached to Form 1023 upon submission to the IRS. If there is no such policy, the organization must describe the procedures that it will use to assure that individuals who have a conflict of interest with the organization will not have influence over the organization with respect to setting their own compensation and “regarding business deals with themselves.” See Form 1023, Part V, Lines 5b and 5c.

Appendix A of the Instructions to Form 1023 contains a “Sample Conflict of Interest Policy” (“Sample Policy”) designed in its own words.
to protect [the tax-exempt Organization’s] . . . interest when it is contemplating entering into a transaction or arrangement that might benefit the private interest of an officer or director of the Organization or might result in a possible excess benefit transaction.


The Sample Policy provides procedures to address an actual or possible conflict of interest, rules for determining compensation, administrative procedures, and special rules for hospitals. The Sample Policy includes a three-step conflict of interest procedure.

First, an interested person must disclose any potentially conflicting financial interest and be given the opportunity to present all material facts with respect to that interest. An interested person is any director, principal officer, or member of a committee with delegated powers who has a direct or indirect financial interest in an entity or individual entering, or seeking to enter, a transaction with the exempt organization. A financial interest includes an actual or potential ownership, investment, or compensation interest, directly or indirectly, through business, investment, or family relationships.

Second, after a financial interest has been identified, the organization’s governing board must decide whether the interested person’s financial interest rises to the level of a conflict of interest. While the interested person may present information and discuss the financial interest, the interested person must leave the meeting before the governing board discusses and votes on whether a conflict of interest exists.

Third, if the governing board determines that a conflict of interest exists, it must follow procedures for addressing that conflict. These procedures include excluding the interested person from discussion and vote on the transaction; appointing a disinterested committee, when appropriate, to investigate alternative transactions; exercising due diligence to determine whether a more advantageous, conflict-free transaction could be reasonably obtained; and, if no better transaction is available, voting on whether the transaction is in the organization’s best interest and is fair and reasonable. Throughout this process, the governing board must maintain good records of its meetings and actions.

In addition to a procedure for handling conflicts, the Sample Policy provides special rules for determining compensation. No voting member of the governing board may vote on her or his own compensation, even if that person is a member of a compensation-related committee. The member, however, may provide information to the committee regarding compensation.

Finally, the Sample Policy provides administrative procedures for annually distributing the conflict of interest policy and periodically reviewing the organization’s compensation arrangements and other transactions for reasonableness, private inurement, impermissible private benefit, or excess benefit.
The Sample Policy provides two special provisions for use by hospitals: (1) if a party is an interested person as to one part of the health care system, he or she is interested as to all parts of the system, and (2) physicians receiving compensation from the organization cannot vote on compensation, serve on compensation committees, or provide information to any committee regarding physician compensation.

B. Form 990

Form 990, “Return of Organization Exempt From Income Tax,” is filed annually by several categories of tax exempt organizations, including most public charities described in Code section 501(c)(3). Like Form 1023, it includes questions aimed at detecting private benefit, private inurement, self-dealing, and excess benefit transactions.

Loans. Part IV, Lines 50 and 63, of Form 990 requires reporting organizations to disclose receivables and loans from current and former officers, directors, trustees, and key employees, and to provide a schedule detailing the terms of each such transaction. Line 51 also requires disclosure of any family or business relationships between other borrowers and any officer, director, trustee, key employee, or substantial contributor to the organization.

Compensation. Similar to Form 1023, Form 990 also focuses closely on compensation, asking questions to detect whether individuals setting compensation had conflicting interests in those decisions. Parts V-A and V-B of Form 990 require disclosure of the names and addresses of the organization’s current and former officers, directors, trustees, and key employees, along with titles and average hours worked per week (for current positions), compensation paid, contributions to employee benefit plans and deferred compensation plans, and expense accounts and other allowances. Organizations also must disclose whether individuals holding current positions are related to each other through family or business relationships, and whether such persons receive compensation from related organizations.

Conflicts of Interest. Form 990 also now asks the direct question, “Does the organization have a written conflict of interest policy?” Part V-A, Line 75d. No instructions – no attachment required – just the question. This is a hint.

Schedule A Information. Public charities filing Form 990 must also submit Schedule A, which requires disclosure of compensation details for the five highest paid employees other than officers, directors, and trustees; the five highest paid independent contractors for professional services; and the five highest paid independent contractors for other services. Schedule A also contains a series of questions aimed at transactions (e.g., sales, exchanges, leases, or loans) between the organization and substantial contributors, trustees, directors, officers, creators, key employees, or members of their families, and other related taxable organizations.
C. **Form 990-PF**

For many years, much of the information now being requested in Form 990 and Schedule A has been required of Code section 501(c)(3) private foundations on Form 990-PF, “Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation.” The private foundation return requires identification of persons who became substantial contributors during the tax year (Part VII-A, Line 10). It asks a series of questions patterned after the self-dealing restrictions of Code section 4941 (Part VII-B, Line 1). The return also requires detailed disclosures regarding compensation to officers, directors, trustees, foundation managers, the five next highest-paid employees, and the five highest-paid contractors. Form 990-PF, Part VIII.

Although all of the details of inquiries made on Forms 990 and 990-PF are not identical, the focus is the same and exempt organizations of all types should continue to expect more, rather than less, scrutiny with respect to potential conflicts of interest, especially in the area of compensation.

D. **Proposed Treasury Regulations**

On September 9, 2005, the U.S. Department of the Treasury published proposed new regulations to clarify (i) the substantive requirements for tax exemption under Code section 501(c)(3), specifically with respect to the prohibition on private inurement, and (ii) the relationship between those substantive requirements and the excess benefit transaction regulations under Code section 4958. 70 Federal Register (“Fed. Reg.”) 53599 (September 9, 2005). The proposed regulations will become effective after publication of a Treasury Decision adopting the rules as final. Prop. Treas. Reg. section 1.501(c)(3)-(1)(g)(3). The proposed regulations add to Treas. Reg. section 1.501(c)(3)-1(d)(1) a new subdivision (iii), with three examples illustrating the requirement that an organization serve public rather than private interests. Each example contains facts that lead to a finding of improper private benefit.

The second portion of the proposed regulations adds a new paragraph (g) to Treas. Reg. section 1.501(c)(3)-1. The new paragraph explains the relationship between the excess benefit transaction rules of Code section 4958 and tax exemption requirements of Code section 501(c)(3). The new text affirms the current rule that “[s]ection 4958 does not affect the substantive standards for tax exemption under section 501(c)(3) or (4), including the requirement that . . . no part of [an organization’s] net earnings inure to the benefit of any private shareholder or individual.” Treas. Reg. section 53.4958-8(a). Thus, a set of facts that supports imposition of excise taxes under Code section 4958 may also trigger the private benefit prohibition of Code section 501(c)(3), thus jeopardizing an organization’s tax-exempt status.

The proposed regulations also describe five factors that the IRS will consider in determining whether revocation of tax-exempt status is appropriate when Code section 4958 excise taxes are imposed, including (1) the size and scope of the organization’s regular and ongoing activities that further exempt purposes, (2) the size and scope of the excess benefit transaction or transactions, (3) whether the organization has been involved in repeated excess benefit transactions, (4) whether the organization has implemented safeguards that are reasonably
calculated to prevent future violations, and (5) whether the excess benefit transaction has been corrected. Prop. Treas. Reg. section 1.501(c)(3)-1(g)(2)(ii).

The proposal provides that the five factors “will be considered in combination with each other” and that “[d]epending on the particular situation, the Commissioner may assign greater or lesser weight to some of the factors than to others.” Prop. Treas. Reg. section 1.501(c)(3)-1(g)(2)(iii). Finally, the proposed regulations contain five examples applying the factors under circumstances in which an excess benefit transaction was found. Notably, adoption of a conflict of interest policy was identified in two of the five examples as a safeguard to prevent future violations that helped the hypothetical organization preserve its exempt status despite the occurrence of one or more excess benefit transactions. See Prop. Treas. Reg. section 1.501(c)(3)-1(g)(2)(iv).

VI. Congressional Scrutiny, IRS Enforcement, and Private Sector Oversight

A. Studies in Congress

Senate Hearings. Oversight of the nonprofit sector has been a priority on Capitol Hill for a number of years. Congressional hearings before the United States Senate Finance Committee on June 22, 2004, clearly signaled imminent legislative reform proposals for charitable organizations. In conjunction with these hearings, the Committee’s legislative staff issued a bipartisan Staff Discussion Draft (the “Discussion Draft”) criticizing current nonprofit practices in three key areas: tax evasion (through abusive tax shelter practices), governance, and operations.

During his testimony before the Finance Committee, IRS Commissioner Mark Everson focused initially on “the need for enhanced governance” in the nonprofit arena. Written Statement of Mark W. Everson, Commissioner of Internal Revenue Before the Committee on Finance, United States Senate, “Hearing on Charitable Giving Problems and Best Practices” (June 22, 2004). Importantly, Mr. Everson cited reforms to the oversight and governance of corporations in the for-profit sector, established under the Sarbanes-Oxley Act of 2002, and compared the activities that triggered those reforms to the abusive transactions that the IRS has encountered in the nonprofit sector:

In recent years there have been a number of very prominent and damaging scandals involving corporate governance of publicly traded organizations. The Sarbanes-Oxley Act has addressed major concerns about the interrelationships between a corporation, its executives, its accountants and auditors, and its legal counsel. Although Sarbanes-Oxley was not enacted to address issues in tax-exempt organizations, these entities have not been immune from leadership failures. We need go no further than our daily newspapers to learn that some charities and private foundations have their own governance problems. Specifically, we have seen business contracts with related parties, unreasonably high executive compensation, and loans to executives. . . . All these reflect potential issues of ethics, internal oversight, and conflicts of interest.

In addition to proposing regulatory reform with respect to conflict of interest transactions, the Discussion Draft proposed a number of regulatory changes with respect to nonprofit corporate
governance. Many of these proposals would extend the regulatory authority of the IRS into areas traditionally reserved for state control. For example, the Discussion Draft proposed the imposition of federal fiduciary duties on directors of nonprofit organizations: “[A board] member has to perform his or her duties in good faith; with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and in a manner the director reasonably believes to be in the best interests of the mission, goals, and purposes of the corporation.” Discussion Draft, at 12. The Discussion Draft suggested federal penalties for breach of these duties.

Moreover, the Discussion Draft proposed that nonprofit boards should be required to adopt conflict of interest policies and to report annually all “conflict of interest opinions” involving agreements with insiders. Id. at 9-10. The Discussion Draft also recommended that the IRS have the authority to require removal of any board member, officer, or employee who is found to have violated self-dealing rules, conflict of interest policies, excess benefit transactions, or private inurement rules. Id. at 13-14.

One month after the initial Senate Finance Committee hearing, on July 22, 2004, the Committee hosted a private roundtable discussion to give individuals in the tax-exempt sector an opportunity to comment on the Discussion Draft and on the topic of charitable reform generally. The Committee conducted a follow-up hearing on April 5, 2005, “Charities and Charitable Giving: Proposals for Reform,” and held another hearing on June 8, 2005, entitled “The Tax Code and Land Conservation: Report on Investigations and Proposals for Reform.” The Committee also convened a hearing on “Hurricane Katrina: Community Rebuilding Needs and Effectiveness of Past Proposals” (September 28, 2005) and, on March 3, 2006, another entitled “A Private Roundtable to Explore Issues of Nonprofit Governance and Accountability.”

House Hearings. The House Ways and Means Committee also held several similar hearings with respect to important nonprofit sector issues: “Hearing on an Overview of the Tax-Exempt Sector” (April 20, 2005); Subcommittee on Oversight, “Hearing to Review the Tax Deduction for Façade Easements” (June 23, 2005); Subcommittee on Oversight, “Hearing to Review the Response by Charities to Hurricane Katrina” (December 13, 2005); and Subcommittee on Oversight, “Hearing on Charities and Employment Taxes” (May 25, 2006).

Joint Committee on Taxation. In addition to formal hearings in both houses of Congress, on January 27, 2005, the staff of the Joint Committee on Taxation released a report entitled “Options to Improve Tax Compliance and Reform Tax Expenditures” (the “JCT Report”). The Joint Committee prepared the report at the request of then Senate Finance Committee Chairman Charles Grassley and then Ranking Member Max Baucus (the Senators made this request by letter dated February 26, 2004). The report “describes a number of proposals that would reduce the size of the tax gap by curtailing tax shelters, closing unintended loopholes, and addressing other areas of noncompliance in present law, . . . [and] contains proposals that would reform certain tax expenditures.” JCT Report, at 1.

Government Accountability Office. Moreover, on July 27, 2006, the U.S. Government Accountability Office (“GAO”), an independent and nonpartisan agency that advises Congress and executive agencies about ways to make government more effective and responsive, issued a
report to the House Ways and Means Committee entitled “Tax-Exempt Organizations: Collecting More Data on Donor-Advised Funds and Supporting Organizations Could Help Address Compliance Challenges.” The GAO report, provided at the request of then Ways and Means Committee Chairman Bill Thomas, identifies perceived abuses involving supporting organizations and donor advised funds (including improper donor control and benefit and other misuses of charitable assets) and suggests that the IRS should begin collecting additional information on Forms 990 to assist with enforcement activities against these abuses and to prepare for potential future reforms.

B. Reports from the Sector

On September 22, 2004, Senate Finance Committee leaders encouraged Independent Sector, a nonpartisan coalition of more than 500 nonprofit organizations throughout the United States, to convene an independent panel on the nonprofit sector to consider and recommend actions that would strengthen good governance, ethical conduct, and effective practice by public charities and private foundations. On October 22, 2004, Independent Sector responded to the Finance Committee’s request by forming the Panel on the Nonprofit Sector (the “Nonprofit Panel”), a group of representatives, advisors, and academics interested in nonprofit issues. After many months of meetings and research, the Nonprofit Panel issued a series of reports.

On June 22, 2005, the group released a document entitled Strengthening Transparency, Governance, Accountability of Charitable Organizations (the “Final Report”), recommending more than 120 actions to be taken by charitable organizations, by Congress, and by the IRS to reform the nonprofit sector. (This followed a preliminary Interim Report published on March 1, 2005.)

The Nonprofit Panel’s reports suggest a number of best practices for nonprofit governance, including adopting conflict of interest policies and whistle-blower protections for board and staff who report illegal practices or violations of policy, and establishing independent audit committees to oversee and direct annual audits (the Final Report cites a California statute enacted in 2004 that prohibits staff or persons with material financial interests from serving on audit committees). See Final Report, at 79-82.

Not resting with just a Final Report, in April of 2006 the Nonprofit Panel released nine supplemental recommendations (the “Supplement”). These supplemental recommendations address a variety of topics, including the adoption of a “prudent investor standard” for charitable organizations, whether organized in corporate or trust form, and a section on “Compensation of Trustees of Charitable Trusts.” This section suggests that directions in a trust instrument or state law approval with respect to trustee compensation should not be considered in determining reasonable compensation for trustees of private foundations:

As noted above, the intermediate sanction regulations already make it clear that the federal requirement that such compensation be reasonable also applies to trustee compensation set in accordance with state statutes or approved by a state court. In audits of estate tax liability, the IRS does not permit deductions for trustee fees that are found to be unreasonable, even if those fees have been approved by a court.
There is no reason why the standard for compensation of trustees of private foundations should be any different. However, some have relied upon the current ambiguity and state statutory fee schedules to justify over-compensation of trustees who provide little or no service to a foundation. In order to eliminate this practice, the private foundation self-dealing regulations should be amended to include a statement, similar to that in the intermediate sanction regulations, clarifying that compensation of trustees of a tax-exempt private foundation must meet the federal standard of reasonableness, even where a state fee schedule or court order may allow payment of higher fees.

Supplement, at 15 (footnote omitted). This recommendation is directed at trust form private foundations, but if adopted it might include language informing the process for making compensation determinations for all foundation managers. The lesson – state law authorization, even by a court, may not be determinative of all legal concerns triggered by conflict of interest transactions (such as compensation setting).

C. A Law is Born

Then, on August 17, 2006, President Bush signed into law the Pension Act, discussed in some detail above in explaining current federal law regarding private foundation minimum payout requirements, taxable expenditures, excess benefit transactions, donor advised funds, and supporting organizations. The story does not stop there, however.

D. Next Steps

Congress, the IRS, and the private nonprofit sector show no signs of resting on the charitable reforms enacted in the Pension Act.

Congress. Section 1226 of the Pension Act requires the Secretary of the Treasury to submit to Congress, not later than August 17, 2007, a report on Treasury’s study of donor advised funds and supporting organizations, specifically considering several matters:

• Whether continued charitable income, gift, and estate tax deductions are appropriate with respect to donations to supporting organizations and sponsoring organizations of donor advised funds, in light of the manner donated assets are used (for example, failure to expend such assets for charitable purposes within a reasonable time) or the use of donated assets to benefit a donor (or one of the donor’s relatives);

• Whether a minimum payout requirement should apply to donor advised funds;

• Whether the retention of advisory rights or privileges by donors to supporting organizations or to sponsoring organizations of donor advised funds is consistent with the allowance of charitable deductions for completed gifts; and
• Whether these issues also should be considered in the context of other types of charities or charitable donations.

This provision of the Pension Act indicates that Congress intends to take further action with respect to supporting organizations, donor advised funds, and other charitable organizations, and to involve the IRS in that process.

The IRS. The IRS is moving forward with some initiatives of its own. In early February of 2007, the IRS released a preliminary staff discussion draft on “Good Governance Practices” (available at http://www.irs.gov/charities/charitable/article/0,,id=167626,00.html). The draft articulates several practices to assist nonprofit organizations in pursuing “exempt purposes and earning public support.” The suggested practices include adoption of a code of ethics (describing “behavior that [the board] wants to encourage and behavior it wants to discourage”) and a conflict of interest policy that:

• Requires directors and staff to act solely in the interests of the charity without regard for personal interests;

• Includes written procedures for determining whether a relationship, financial interest, or business affiliation results in a conflict of interest; and

• Prescribes a certain course of action in the event a conflict of interest is identified.

The Sector. And the private nonprofit sector is not to be outdone. The Nonprofit Panel recently announced the work of a special Advisory Committee on Self-Regulation of the Charitable Sector (the “Advisory Committee”). The committee examined self-regulation and accreditation systems for a large number of charitable organizations and developed a set of 29 principles of effective practice for charitable organizations. The committee published its draft recommendations, inviting public comment through January 24, 2007, and suggesting that all public charities with at least $1 million in annual revenues and all private foundations with at least $25 million in assets should implement the practices. The committee released its second draft in late February, adding two new principles and soliciting additional public comment through March 30, 2007.

The practices recommended by the Advisory Committee are grouped into five themes: facilitating legal compliance and public disclosure (which includes implementation of conflict of interest and whistleblower policies); effective governance; strong financial oversight; responsible fundraising; and additional principles (risk management and adoption of a code of ethics). The principles may be found at http://www.nonprofitpanel.org/selfreg/index_html.

VII. Headlines

Stepping back from the detail of existing and potential legal rules governing conflicts of interest, it is important to focus on the broader consequences of transactions that are perceived or publicized as conflicts. Consider a few headlines:
These examples, and so many other reports from across the nation, reflect a growing concern with conflicts of interest on nonprofit boards. Conflicts of interest that result in unearned personal benefits to nonprofit and civic leaders, or their families or friends, are scandalous because nonprofit organizations exist to serve public rather than private interests. We simply expect more from people who are entrusted with charitable resources and responsibilities.

The results of negative press often are immediate, wide-ranging, and substantial. In 2002, the United Way of the National Capital Area (“UWNCA”) faced severe criticism regarding imprudent spending by top officials and mismanagement, harkening back to the 1995 conviction of William Aramony for stealing more than $1.2 million from the United Way of America. On top of its legal problems, UWNCA had to deal with the lost “trust and confidence of its donors,” possible curtailing of payments to social service programs, and the risk that the national organization would revoke its local membership. See Williams, Grant, United Way of America Chief Worries That Problems at D.C. United Way Will Cause Loss in Donations to the Needy, The Chronicle of Philanthropy (Update) (August 24, 2002) (quoting Brian A. Gallagher, Chief Executive of the United Way of America).

When the headlines turn this sour for a nonprofit organization, changes in staff and board leadership or structure often follow. In the UWNCA case, the first reported steps toward correction included a call for the departure of Norman O. Taylor, the chief executive of the local agency, and the appointment of a special committee of community leaders to formulate a code of ethics and other guidelines for the charity. Id. Thus, even if the law does not require a governance structure and policies designed to prevent “bad” conflict of interest transactions, those practices make sense from a public relations perspective and as prophylactic measures to have “on the ready” should criticisms arise.
VIII. Real Conflicts and Practical Solutions

Thus far we have analyzed many and sundry ways that conflicts of interest can cause problems for directors of nonprofit organizations and the organizations themselves:

- Court injunction or other judicial remedies for breach of the state law duty of loyalty.

- Revocation of tax exemption for prohibited –
  - private inurement, or
  - private benefit.

- Private foundation excise tax liabilities for –
  - self-dealing,
  - failure to make required minimum payouts, or
  - using the foundation’s income or assets to pay taxable expenditures.

- Public charity excise taxes on excess benefit transactions.

- Penalties on taxable distributions from donor advised funds.

- Loss of public charity status as a supporting organization because of –
  - improper donor control, or
  - acceptance of gifts from substantial contributors who control supported organizations.

- Threats of new rules imposed by –
  - statute,
  - regulation, or
  - nonprofit sector guidelines or accreditation requirements.

- Negative media reporting and the accompanying loss of –
  - funds,
  - public trust,
  - ability to accomplish mission, or
  - governance control.

For a part-time nonprofit director who (in most cases) is serving without pay, this is simply too much to remember, much less to consider, in trying to understand how to handle conflicts of interest. A few real life examples, and a couple of suggestions about procedures that might cover most situations, could help.

A. Conflicts That Really Happen

The number of combinations of relatives, friends, acquaintances, business associates, co-workers, employers, employees, neighbors, schoolmates, fraternity brothers, sorority sisters, golf
buddies, bowling league companions, and other individuals that may be involved with the same nonprofit organization is endless. The right (or wrong) combinations can spell trouble for the peaceful, effective, and efficient accomplishment of nonprofit goals.

1. **Family Conflicts**

Family relationships can compromise the board’s duty of loyalty in matters affecting different members. *Mid-List Press v. Nora*, 374 F.2d 690 (8th Cir. 2004), is discussed later as an example of a conflict arising out of a beneficiary relationship; it also provides an example of board members remaining loyal to the nonprofit corporation despite pressure to benefit a family member. When a father wanted to circumvent established publishing procedures, the daughter and son-in-law upheld those procedures and ultimately, with their fellow board members, brought suit against the father for his inappropriate behavior. As the following case illustrates, however, board members are not always able to loose the family ties.

In *Summer v. Cherokee Children & Family Services*, 112 S.W.3d 486 (Tenn. Ct. App. 2002), improper family conflicts of interest contributed to the court’s decision to approve a petition by the attorney general to dissolve two nonprofit corporations. The two nonprofits were founded by WillieAnn Madison, who, along with her husband and father, served as board members for both corporations. The board of one corporation approved numerous transactions benefiting Madison and her family, including unreasonable compensation for Madison, loans to a Madison-owned company, Christmas bonuses to employees (which included Madison’s children, stepson, and nephews), no-interest loans to Madison’s stepson, a lease for a Madison-owned building, and investments in a Madison-owned bank. Additionally, the accountant for the nonprofit corporations, Madison’s husband, issued checks for Madison’s personal transactions. The presence of so many family connections may have blinded the board to the fairness of these transactions. Madison’s father testified that he “thought that the financial affairs of the corporation and the financial affairs of [his] daughter were the same.”

It simply is very difficult to put family concerns aside. Every nonprofit organization should consider placing some non-family members on the board, even when the organization is a family-funded private foundation or similar entity, and using independent service providers to prevent conflict transactions arising from family loyalties. If the board decides to contract with a related party (and the transaction would otherwise be permitted), it should carefully investigate its alternatives and document the reasons why contracting with the related party is in the nonprofit organization’s best interests. Interested board members, if possible, should recuse themselves from deliberations and voting and should not be counted as part of the quorum.

2. **Vendor Conflicts**

Nonprofit board members, because they typically have day jobs, are often well-situated to know about the best providers of goods or services for a nonprofit organization, or be in positions to provide the goods or services themselves. However, board members – or their firms – acting as paid providers of goods or services to a nonprofit organization that they serve presents the classic situation of a conflict of interest that can go bad. Take the case of *Committee to Save Adelphi v.*
The Board of Regents removed members of the Adelphi University Board of Trustees for breaching their duty of loyalty in part because of conflict of interest transactions between the University and board members’ businesses. Board members actively solicited work from Adelphi for their insurance and advertising companies without disclosing their interests in the transactions or recusing themselves from voting. Another board member was “of counsel” to a law firm that provided services to Adelphi. Even though he did not disclose his relationship with the law firm, the Board of Regents noted that he did not solicit business from Adelphi (his firm was hired for its reputation in the area) and did not receive any of his firm’s income from Adelphi. Therefore, he was not removed because of his direct benefit from conflict of interest transactions; nonetheless he lost his position for neglect of duty in connection with the other breaches approved by the trustees.

And the poster child for vendor conflicts is the Sibley Hospital case, discussed at length earlier. Several of the board members in that case had relationships with financial institutions holding hospital investments in low or no interest deposit accounts. The board members failed to disclose those interests or to recuse themselves from voting on the account transactions. In one instance, a board member advised the investment committee to approve a contract with his institution. Another negotiated the interest rate for the hospital’s account with his institution. Although the court did not require removal of the trustees in Sibley Hospital (because the board was already in transition, the board members were nearing the end of their service, and removal would “unduly disrupt the affairs of the hospital”), it ordered that each new trustee read the decision and that the board review, prior to each meeting for the following five years, a summary of all transactions in which hospital affiliates, including board members, had an interest.

The results in these cases point to several protective measures – board members with potential vendor relationships should disclose their material business relationships, recuse themselves from any deliberations, votes, or quorums regarding conflicting matters, and avoid soliciting business from nonprofit organizations that they serve. In appropriate situations, the board might collect information from each interested board member and then conduct an independent investigation of alternatives. In any case, it is important to document support for any arguably conflicting decision so that responses to later questions may be presented as more than after-the-fact justifications.

3. Serving on Multiple Boards

Civic-minded individuals often serve on multiple nonprofit boards. Overlapping board memberships create conflicts of interest because the best interests of different organizations do not always align. The question then becomes, “How can you be loyal to one organization, without being disloyal to the other?” The answer, “Sometimes, you just can.”

For example, in Opinion of the Attorney General, Commonwealth of Kentucky, No. 78-337 (May 18, 1978), 1978 WL 26381, the city and a nonprofit volunteer fire department planned to
enter into an agreement where the city could use the fire department’s training room in exchange for the city blacktopping the fire department’s driveway. A member of the city’s board of trustees also served on the board of the fire department. The state attorney general advised that even though the overlapping member had an interest in both projects, there was no impermissible conflict of interest because the board member had no pecuniary interest in the projects. However, the attorney general advised the board member to recuse himself from the discussion and vote on the agreement.

Similarly, in Opinion No. 693 (N.J. Supreme Court Advisory Committee on Professional Ethics, 2002), 2002 WL 31624569, a board member of a nonprofit legal assistance organization also served as the executive of a nonprofit housing corporation that was landlord for some of the legal assistance organization’s tenant clients. The state’s rules of professional conduct generally prohibited board members of nonprofit legal assistance groups from direct involvement in cases handled by staff attorneys. Because of this rule, the state advisory committee advised that even though the situation may have presented the appearance of impropriety, the legal assistance organization’s staff attorneys could represent tenants of the housing corporation if, in their “sound professional discretion,” their representation was not materially limited and if they obtained client consent.

In these situations, best practice may depend on the disparity of interests between and among different nonprofit organizations served by the same board member. Dual membership is helpful when the organizations in question are similar and their transactions are mutually beneficial. Where there is divergence, however, the overlapping member might take the position of sharing non-confidential information and then recusing herself or himself from deliberations, votes, and any quorums on matters related to the other organization. When the interests of different nonprofit organizations frequently conflict, dual board membership should be avoided because frequent recusals could make the board member ineffective for either organization.

4. **Board Members as Employees**

Employees of a nonprofit corporation may serve as board members; however, employees will always have a direct conflict with respect to setting their own compensation and other terms of employment. For private foundations and public charities, the specific rules of Code sections 4941 and 4958 will provide some clear guidelines and restrictions with respect to these situations.

In addition, just as a matter of good practice, employee board members should always disclose all material information with respect to, and available by virtue of, their employment and non-employee board members should reasonably investigate each issue involving such employee directors, act in the best interests of the organization, and document the reasons supporting every decision impacting employment relationships. An affected employee board member should recuse herself or himself from deliberations and voting on employment issues, and should not be counted in establishing a quorum for such votes.

The case of **Boston Children’s Heart Foundation v. Nadal-Ginard**, 73 F.3d 429 (1st Cir. 1996), illustrates the danger and difficulty in permitting employees to serve as directors. A nonprofit
corporation conducting cardiology research employed a physician who also served as a board member. The physician was associated with the organization in many ways: he was the president and a member of the three-person board of directors; he chaired an affiliated hospital’s department of cardiology; and he was on the faculty of an affiliated medical school. He also served as an investigator with the Howard Hughes Medical Institute (HHMI), directing HHMI’s Laboratory of Cellular and Molecular Cardiology at the affiliated hospital. Even though the physician did not perform the same research for the principal nonprofit organization and for HHMI, his contract with HHMI prohibited him from accepting a salary from the former. The physician ignored this contract provision, and in addition to other wrongdoing, he accepted compensation from the nonprofit organization without disclosing his salary and fringe benefits from HHMI.

The nonprofit organization successfully sued the physician for breach of fiduciary duty. Even though the physician was not being paid twice for the same work, the board, if presented with the HHMI compensation information, could have decided to allocate all or part of the physician’s salary to other purposes. The court ordered the physician to pay the nonprofit organization over six million dollars in damages and costs. Without the relationships and trust that the physician developed as a board member, the problems that led to this lawsuit might have been detected and corrected much sooner.

5. Board Members as Beneficiaries

A nonprofit organization’s beneficiaries may also sit as members of the board. However, a beneficiary board member will have a conflict of interest in matters regarding the services that the board member may receive. As with employee directors, beneficiary board members should disclose all material facts regarding their status as a beneficiary. Unlike the employment situation, though, beneficiary board members generally should be permitted to participate in decisions on most matters – that is, where their benefits are more indirect and result only from being a part of a charitable class served by the organization. It indeed would be a strange thing to say that directors of a nonprofit hospital could not be admitted as patients.

For example, a resident of a nonprofit continuing care facility served as a paid, voting member of the board of directors in Opinion of the Virginia Attorney General (September 25, 2000), 2000 WL 1545003. The attorney general approved the arrangement in an advisory opinion, noting that residency at the facility did not necessarily mean the board member had a personal interest in every transaction. Even if the resident had a personal interest in certain transactions, those transactions would not be voidable under Virginia law as long as “the material facts of the transaction and the director’s interest were disclosed or known and the transaction was approved, authorized, or ratified by the board, and the transaction was fair to the corporation.”

Special benefits, not available to a charitable class generally, make for a different result however. In Mid-List Press v. Nora, 374 F.2d 690 (8th Cir. 2004), Dr. James Nora served as a director and president of a nonprofit publisher. Nora’s daughter and son-in-law also served on the board and managed the company’s daily operations. Nora submitted a book to the company for publication and was told that he would need to go through the same process as other submitting authors. Without the board’s approval, Nora proceeded to have his book published. When the board
discovered his activities, it removed him and sued him for falsely designating the origin of his book, engaging in deceptive trade practices, and breaching his fiduciary duties to the organization. The court enjoined Nora from using the publisher’s trade name to market his book, commenting that “publication of the corporate president’s own book without following normal procedures could seriously tarnish [the corporation’s] reputation as a nonprofit publisher, and thus run counter to the corporation’s interests.”

6. Government Officials Serving as Directors

Government officials often sit on nonprofit boards. In these situations, the most critical questions often involve the officials’ capacity to serve the government in such dual roles, rather than their ability to fulfill duties to nonprofit organizations. Many jurisdictions have strict conflict of interest rules for government officials, prohibiting them from discussing or voting on legislative (or in some cases, executive or judicial) matters in which the officials have a direct or indirect interest. As the cases below demonstrate, some courts interpret the phrase “direct or indirect” narrowly to cover only financial interests, allowing a government official to vote for government programs or policies that would benefit a nonprofit organization on whose board the official sits. Other courts, however, interpret the rules broadly to include non-pecuniary interests, such as a board member’s personal interest in the success of the nonprofit organization.

In most jurisdictions, a government official may not exercise her or his position to benefit a nonprofit organization which pays compensation to the official. Whether an official can act on governmental matters benefiting a nonprofit organization with which the official holds an unpaid position depends on the jurisdiction.

In *Barry v. Johns*, 920 P.2d 222 (Wash. Ct. App. 1996), the city council approved a provision in a city contract with a nonprofit organization that limited the personal liability of the board members of that organization. Some of the council members who voted on the provision also served as directors of the nonprofit organization. Another city council member challenged the provision, alleging that it had been approved contrary to conflict of interest rules. The state code of ethics prohibited council members from holding any “beneficial interest” in municipal contracts. The court held that the interested council members had not violated the code because a “beneficial interest” was a financial interest only and because state law already limited the liability of the nonprofit board members. The court commented that overlapping memberships must be allowed so that individuals can be involved in the community without having to resign other positions. Although there is some danger that personal agendas may override the public will, voters know that their representatives will have some personal influence and can control this through the democratic process.

The opposite result was reached in *Advisory Opinion 91-11* (Ohio Board of Commissioners on Grievances and Discipline, 1991), 1991 WL 717481. A municipal judge served as an unpaid board member for a nonprofit corporation that provided services to the municipal court under a contract with the city. The Ohio Board of Commissioners on Grievances and Discipline advised that the judge should avoid board membership for three reasons. First, under Ohio’s Code of Judicial Conduct, a judge was not permitted to serve on a nonprofit board if it is likely that the
organization’s matters will come before the court – the judge’s frequent disqualification would be inconvenient. Second, Ohio ethics law prohibited public officials from authorizing contracts in which they are interested, which the commission interpreted to include contracts with nonprofit organizations on whose boards the officials sat. Third, the judge’s membership on the board might cause “real, imagined, or even subconscious pressure to refer as many participants as possible to the program in order to ensure its success,” and the community and defendants might have less confidence in the judge’s decisions because of perceived impropriety.

7. **Attorneys Serving as Directors**

An attorney serving on the board of directors of a nonprofit organization may face special challenges under the professional responsibility standards governing the practice of law. Courts often resolve conflicts between an attorney’s service as a nonprofit board member and her or his obligation to a client with differing interests by requiring the attorney to choose between the two. Guess what – the paying client often wins (but not always).

For example, in *Equal Employment Opportunity Commission v. Luby’s*, 347 F. Supp. 2d 743 (D. Ariz. 2004), the Equal Employment Opportunity Commission filed an action against an employer for discriminating against its employee. The employee was represented by lawyers from a nonprofit public interest law firm. An attorney who belonged to the firm representing the employer also served as a board member with the public interest law firm.

The employee filed a motion to disqualify both the board member and her firm from representing the employer. The employee argued that the attorney’s representation presented a conflict of interest because of the attorney’s knowledge of the public interest law firm’s financial position and strategies.

The court denied the request to disqualify for several reasons. First, the court found that the attorney’s representation of the employer did not present a conflict of interest under Arizona’s ethical rules because the attorney never represented the employee herself and because the employer had consented to the representation. Second, the court noted that, pursuant to Arizona’s ethical rules, when the attorney received an email regarding possible litigation against the employer, she promptly deleted the email and contacted the nonprofit law firm’s executive director requesting to be screened from the matter. She also resigned from the nonprofit board upon request, ensuring that she would never receive confidential information and eliminating “even the appearance of impropriety.”

Regarding the attorney’s knowledge of the operations of the nonprofit organization, the court analogized to for-profit law firms:

> The fact that she might have substantial information about her former firm’s finances or litigation strategies would not prohibit her representation of a client adverse to the firm’s client. If such general information does not disqualify a lawyer leaving a law firm, neither does it disqualify a lawyer leaving a director’s position with a public service law firm.
An attorney may be precluded from choosing to represent a client directly adverse to the nonprofit organization that he or she has served as a director, however. In Berry v. Saline Memorial Hospital, 907 S.W.2d 736 (Ark. 1995), a member of a local law firm served on the board of a county-owned hospital from July 1, 1989, through June 30, 1992. While on the board, he learned confidential information about the hospital’s quality assurance programs and peer reviews. After the board member left the board, the senior partner of his firm was retained by the widower of a hospital patient in a negligence action against the hospital.

The hospital moved to disqualify the law firm because the previous board member had knowledge of the confidential quality assurance and peer review information that was at issue in the case. The court granted the hospital’s motion. “After the lawyer’s term on the board ends, the lawyer should not take any action to the detriment of the hospital when that action is based upon confidential information the attorney gained during the fiduciary relationship.”

B. Practical Solutions

Understanding what things can go wrong, and finding ways to keep them from happening – are two different things. The preceding pages present scores of problems. The next couple of pages offer some basic steps toward solution. First, we explain why the easy step – just adopting the conflict of interest policy proffered by the IRS with the instructions to Form 1023 – may not be the best. Then, we suggest a different course.

1. Why the IRS Approach Won’t Work

The IRS helped the nonprofit sector greatly by suggesting a Sample Conflict of Interest Policy (the “Sample Policy”) for exempt entities. (The policy is at pages 25-26 of the Instructions for Form 1023 and may be accessed at http://www.irs.gov/pub/irs-pdf/i1023.pdf.) The Sample Policy focuses on certain conflict transactions that the IRS views as problematic and recommends steps to avoid those problems. The IRS template may not be the best model to use as a final and complete policy, however, because it is both over and under inclusive. Here is what we mean.

Interested Person. Article II, Section 1, of the Sample Policy defines persons covered by the policy to include only “[a]ny director, principal officer, or member of a committee with governing board delegated powers, who has a direct or indirect financial interest [as defined later in the policy].” This definition is targeted to those positions most likely to trigger exemption, self-dealing, or other tax problems.

In practice, however, nonprofit organizations should take a broader view in identifying and resolving harmful conflicts of interest and may want to consider covering employees with decision-making authority, or even all employees (especially for smaller entities that do not have well-developed employee handbooks or employment policies), and all committee members (even those without delegated powers). When an organization relies on the expertise, knowledge, and recommendations of employees and volunteers (at all levels), it is helpful to know about significant biases or motivators for those individuals.
Financial Interest. The Sample Policy goes on to define a reportable conflict as a “financial interest” in which a person has, “directly or indirectly, through business, investment, or family:”

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

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

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

Article II, Section 2. This definition suffers from the absence of any sense of magnitude – is ownership of one share of stock in the bank used by a nonprofit organization a financial interest; what if the share is owned by a brother-in-law; how is a director to know about all of the nonprofit organization’s transactions, arrangements, and negotiations?

Conflict of Interest. The Sample Policy acknowledges that all financial interests do not constitute conflicts of interest triggering the procedural requirements of the policy. “A financial interest is not necessarily a conflict of interest. Under Article III, Section 2, 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.” Article II (final sentence). The problem here is that it takes a board or committee determination before an interested person can have any clue as to whether a financial interest should be disclosed. This approach requires a massive amount of volunteer time to even start the process of identifying conflicts, much less resolving them.

Disclosure. The Sample Policy then imposes a duty to disclose – “In connection with any actual or possible conflict of interest, an interested person must disclose the existence of any financial 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 transaction or arrangement.” Article III, Section 1. This provision may have been designed to limit disclosures to proposed transactions or arrangements that are brought to the interested person’s attention; that is, individuals apparently are not required to share information about their jobs, families, and investments unless and until they are asked to participate in a decision with respect to a matter.

The strategy may prove to be too little, too late, however – a director in a meeting is asked to vote on an emergency grant (one of fifty on the agenda) to a local charity whose building was struck by lightning and needs immediate repair; the director’s son volunteers at the charity and has done free-lance computer work for a modest fee. Is the director to know (much less remember) all of the details of the son’s involvement, decide if this constitutes a reportable “financial interest,” and seek a determination by the appropriate board that it does not rise to the level of a “conflict of interest,” all on the fly before voting? Moreover, what constitutes a proper “opportunity to disclose all material facts” – without having an idea about potential conflicts in advance, these conflict inquiries could seriously disrupt and extend meetings.
Conflict Determination Procedure. Once a financial interest is disclosed, the Sample Policy requires the members of “the governing board or committee” who are not interested in the proposed transaction or arrangement to discuss and vote on whether a conflict of interest exists. Article III, Section 2. The policy does not provide for an earlier “exit ramp” to make this decision without taking the time of the entire body. More importantly, it leaves total discretion in the governing board or committee to determine when a financial interest is a problem – that is, a “conflict of interest” is whatever the board or committee says it is (the old, “I will know it when I see it”). This gives no guidance or comfort to a board or committee member trying to make these determinations in a reasoned, consistent, and supportable way.

Procedures for Addressing Conflicts. Once a conflict has been determined, the Sample Policy provides a suggested process for resolving the matter. Article III, Section 3. We outlined the process earlier in examining the conflict of interest provisions of Form 1023. In particular, the interested person must be excluded from discussion and vote on the potential conflict of interest transaction; the chair of the deciding board or committee should appoint a disinterested committee, when appropriate, to investigate alternative transactions; exercising due diligence, the board or committee must determine whether a more advantageous, conflict-free transaction could be reasonably obtained; and, if no better transaction is available, the board or committee (with no interested person voting) must by majority vote determine that the transaction is in the organization’s best interest, “for its own benefit,” and is fair and reasonable. Throughout this process, the governing board must maintain good records of its meetings and actions. See Article IV.

These steps, although appropriate in extreme cases, may prove unnecessarily burdensome for nonprofit organizations in their day-to-day operations. The search for more advantageous, conflict-free transactions might reduce to an open bidding process for all purchases and contracts, which can delay and add huge expense to any activity. Even governmental entities that are subject to detailed statutory public bidding requirements are permitted to enter into certain transactions (such as professional service contracts) through private negotiation.

Other Provisions. The Sample Policy also provides special rules for determining compensation, administrative procedures for distribution of the conflict of interest policy, and periodic review of the organization’s compensation arrangements and other transactions for reasonableness, private inurement, impermissible private benefit, or excess benefit. See Articles V, VI, and VII. These provisions are directed to specific tax issues. Although these matters deserve close and constant attention, and involve serious consequences flowing from specific instances of conflict of interest, the details of these topics may better be addressed in an organization’s more specific legal, audit, and tax compliance policies and practices.

2. An Alternative – or Two

It is very easy to critique someone else’s work. Many of us make careers out of criticizing the IRS (and others do that just for fun). The IRS Sample Conflict of Interest Policy serves a very useful purpose, and it is up to lawyers and other advisors to nonprofit organizations to consider that document and to tailor it to the particular needs of the sector.
Template Policy. We have attempted to do that in the generic “Template Conflict of Interest Policy” attached as Appendix A to this paper. There is much that can be criticized about our attempt also, but we believe that it is a useful approach that provides standards (although broad) and processes that are more likely to be followed than some of the parts of the IRS Sample Policy. A policy adopted but not implemented, in our view, is worse than no policy at all.

Template Form. We also have attached a “Template Conflict of Interest Disclosure Form,” at Appendix B. It is a short form that directors and others may use to provide the information needed to uncover potentially harmful conflicts of interest, for resolution under the policy.

Combined Template. Finally, Appendix C is a combined “Template Combined Conflict of Interest Policy and Disclosure Form.” This may be a worthwhile assistance to persons signing the disclosure – everyone knows exactly what they are to do without rummaging through bylaws or board manuals to remember which positions or interests need to be included. One caveat about this approach, however – a conflict of interest policy is important enough to include as part of a nonprofit organization’s governing documents or published corporate policies, and any change in the language of those separate records from time to time needs to be included in revisions to the combined form also.

IX. Closing Thoughts – Conflict is a Good Thing

If we are only six degrees of separation from every other human being on the planet (and even if not), conflicts of interest are simply a part of life. In serving nonprofit organizations, we should acknowledge and use our relationships to increase the good things that those organizations accomplish. It is not prudent to avoid electing a banker to a nonprofit board because the organization will need to open a savings account; it is counterproductive to eschew volunteer service by successful business leaders and investors because the organization needs to purchase goods and services in the marketplace; and it is shameful if we exclude the people served by a nonprofit organization from the boardroom where those services are developed and debated.

Throughout this paper, we have described and dissected the many bad consequences that may flow from ignoring conflicts of interest. We would prefer to end with the happy recognition of the many good consequences of identifying and using conflicts of interest in a positive manner. This could be termed a principle of “constructive conflicts.”

Gathering Information. Every nonprofit organization benefits greatly by learning more about the relationships, resources, interests, and abilities of its directors, officers, committee members, volunteers, employees, service providers, contractors, beneficiaries – in short, everybody who could help in fulfilling the organization’s mission. A simple, usable, and used conflict of interest policy is, first and foremost, a means to gather this kind of knowledge.

Building Relationships. More than that, however, the culture of “constructive conflicts” in a nonprofit organization will encourage deeper and content-filled interactions among people associated with the enterprise, greater sharing of concerns, responsibilities, and contacts, and increased awareness of how “little me” (connected to every other person in the world by six
degrees or less) can do more to achieve the goals of my favorite nonprofit organization. By bringing relationships to the forefront, we will bind directors, staff, and others more closely to each other and to our organizations.

**Raising the Bar.** In addition, serious attention to the disclosure of potentially harmful conflicts and honest deliberation of what to do when the situation arises cause nonprofit directors and others to focus on the work they do and to value their contributions of time, experience, and opinion even more. If we are asked and are willing to consider whether an organization’s funds could be spent in a better way, even at the expense of a colleague’s family or business interests, we realize the importance of our joint endeavors and respect our colleague even more (for opening herself or himself to scrutiny, discussion, and accountability).

* * * *

John Donne wrote, “No man is an island, entire of itself . . . .” *Devotions upon Emergent Occasions*, No. 17 (1624). He is still right.
APPENDIX A

Template Conflict of Interest Policy

(“Corporation”)

It is the policy of the Corporation and its Board of Directors that the Corporation’s directors, officers, committee members, and employees carry out their respective duties in a fashion that avoids actual, potential, or perceived conflicts of interest. Each of the Corporation’s directors, officers, committee members, and employees shall have the continuing, affirmative duty to report any personal ownership, interest, or other relationship that might affect her or his ability to exercise impartial, ethical, and business-based judgments in fulfilling responsibilities to the Corporation. In addition to any legal or other requirements that apply to the Corporation and its directors, officers, committee members, and employees, the following principles shall guide the conduct of the Corporation’s affairs:

1. **Impartial Dealings.** Directors, officers, committee members, and employees of the Corporation shall conduct their duties with respect to “Conflict Persons” (that is, grantees, contractors, suppliers, agencies, and other persons transacting or seeking to transact business with the Corporation) in a completely impartial manner, without favor or preference based upon any consideration other than the best interests of the Corporation.

2. **Acceptance of Gifts, Etc.** Directors, officers, committee members, and employees of the Corporation shall not seek or accept for themselves or anyone else any gift, entertainment, or other favor from a Conflict Person except (i) common courtesies consistent with ethical and accepted business practices or (ii) gifts, entertainment, or favors that have no relation to the Corporation or its affairs (for example, personal gifts between family members or friends).

3. **What is a Conflict of Interest – Directors and Committee Members?** If a director or committee member, or a Relative of such person (the term “Relative” means spouses, ancestors, and descendants, whether by whole or half blood), directly or indirectly owns a significant financial interest in, is a director, officer, or trustee of, or is employed by any Conflict Person, the director or committee member shall disclose that interest, position, or employment relationship and shall refrain from voting on any issue pertaining to the Conflict Person.

4. **What is a Conflict of Interest – Officers and Employees?** An officer or employee of the Corporation shall not conduct business on behalf of the Corporation with a Relative of such person or with a business entity in which the officer, employee, or her or his Relative owns a significant financial interest, or by which such officer, employee, or Relative is employed, except where such interest or employment has been disclosed.
to, and specifically approved and authorized by, the Board of Directors of the Corporation.

5. **Conflict of Interest Disclosures.** The Board of Directors may require the Corporation’s directors, officers, committee members, or employees to complete annually (or as otherwise scheduled by the Board) a disclosure form regarding any conflict of interest described in this policy. The disclosure statement shall be in such form as may be prescribed by the Board and may include information regarding a person’s participation as a director, officer, trustee, committee member, or employee of any other nonprofit organization (whether or not such organization is a Conflict Person). The Board of Directors shall be responsible for oversight of all disclosures or failures to disclose, and for taking appropriate action in the case of any conflict of interest transaction.

The failure of the Corporation, its Board of Directors, or any or all of its directors, officers, committee members, or employees to comply with this conflict of interest policy shall not invalidate, cancel, void, or make voidable any contract, relationship, grant, action, transaction, debt, commitment, or obligation of the Corporation that otherwise is valid and enforceable under applicable law.
APPENDIX B

Template Conflict of Interest Disclosure Form

Pursuant to the Corporation’s Conflict of Interest Policy (the “Policy”), I acknowledge, attest, and represent the following:

1. I have read and understand the Policy.

2. I am in compliance with the Policy.

3. Reported below, or by attached list, are (i) all conflicts of interest (i.e., specified relationships with Conflict Persons, as described in the Policy) that may arise as a result of my role with the Corporation (for example, “Board director – ABC Charity” or “Employee – XYZ Bank”) and (ii) my positions as director, office, trustee, committee member, or employee of any other nonprofit organization (whether or not such organization is a Conflict Person, such as “Board director – ABC Charity”):

   ____________________________________________________________________
   ____________________________________________________________________
   ____________________________________________________________________
   ____________________________________________________________________
   ____________________________________________________________________
   ____________________________________________________________________
   ____________________________________________________________________
   ____________________________________________________________________
   ____________________________________________________________________

4. I will report promptly any changes to the information provided above.

________________________________________________________________________  ________________________
Signature                  Date

Printed Name (Director, Officer, Committee Member, or Employee)
APPENDIX C

Template Combined Conflict of Interest Policy and Disclosure Form

(“Corporation”)

Printed Name: ______________________________________________________

(Director, Officer, Committee Member, or Employee)

The purpose of this policy and disclosure form is to assist each director, officer, committee member, and employee of the Corporation to identify and disclose any conflicts of interest that may arise in the course of service to the Corporation.

Conflict of Interest Policy

It is the policy of the Corporation and its Board of Directors that the Corporation’s directors, officers, committee members, and employees carry out their respective duties in a fashion that avoids actual, potential, or perceived conflicts of interest. Each of the Corporation’s directors, officers, committee members, and employees shall have the continuing, affirmative duty to report any personal ownership, interest, or other relationship that might affect her or his ability to exercise impartial, ethical, and business-based judgments in fulfilling responsibilities to the Corporation. In addition to any legal or other requirements that apply to the Corporation and its directors, officers, committee members, and employees, the following principles shall guide the conduct of the Corporation’s affairs:

1. Impartial Dealings. Directors, officers, committee members, and employees of the Corporation shall conduct their duties with respect to “Conflict Persons” (that is, grantees, contractors, suppliers, agencies, and other persons transacting or seeking to transact business with the Corporation) in a completely impartial manner, without favor or preference based upon any consideration other than the best interests of the Corporation.

2. Acceptance of Gifts, Etc. Directors, officers, committee members, and employees of the Corporation shall not seek or accept for themselves or anyone else any gift, entertainment, or other favor from a Conflict Person except (i) common courtesies consistent with ethical and accepted business practices or (ii) gifts, entertainment, or favors that have no relation to the Corporation or its affairs (for example, personal gifts between family members or friends).

3. What is a Conflict of Interest – Directors and Committee Members? If a director or committee member, or a Relative of such person (the term “Relative” means spouses, ancestors, and descendants, whether by whole or half blood), directly or indirectly owns a significant financial interest in, is a director, officer, or trustee of, or is employed by any Conflict Person,
the director or committee member shall disclose that interest, position, or 
employment relationship and shall refrain from voting on any issue 
pertaining to the Conflict Person.

4. What is a Conflict of Interest – Officers and Employees? An officer or 
employee of the Corporation shall not conduct business on behalf of the 
Corporation with a Relative of such person or with a business entity in 
in which the officer, employee, or her or his Relative owns a significant 
financial interest, or by which such officer, employee, or Relative is 
employed, except where such interest or employment has been disclosed 
to, and specifically approved and authorized by, the Board of Directors of 
the Corporation.

5. Conflict of Interest Disclosures. The Board of Directors may require the 
Corporation’s directors, officers, committee members, or employees to 
complete annually (or as otherwise scheduled by the Board) a disclosure 
form regarding any conflict of interest described in this policy. The 
disclosure statement shall be in such form as may be prescribed by the 
Board and may include information regarding a person’s participation as a 
director, officer, trustee, committee member, or employee of any other 
nonprofit organization (whether or not such organization is a Conflict 
Person). The Board of Directors shall be responsible for oversight of all 
disclosures or failures to disclose, and for taking appropriate action in the 
case of any conflict of interest transaction.

The failure of the Corporation, its Board of Directors, or any or all of its directors, officers, 
committee members, or employees to comply with this conflict of interest policy shall not 
invalidate, cancel, void, or make voidable any contract, relationship, grant, action, transaction, 
debt, commitment, or obligation of the Corporation that otherwise is valid and enforceable under 
applicable law.

Disclosure

Pursuant to the Corporation’s Conflict of Interest Policy (the “Policy”), I acknowledge, attest, 
and represent the following:

1. I have read and understand the Policy.

2. I am in compliance with the Policy.

3. Reported below, or by attached list, are (i) all conflicts of interest (i.e., specified relationships 
with Conflict Persons, as described in the Policy) that may arise as a result of my role with 
the Corporation (for example, “Board director – ABC Charity” or “Employee – XYZ Bank”) 
and (ii) my positions as director, office, trustee, committee member, or employee of any 
other nonprofit organization (whether or not such organization is a Conflict Person, such as 
“Board director – ABC Charity”):
4. I will report promptly any changes to the information provided above.

___________________________________________  ________________________
Signature             Date

___________________________________________
Printed Name (Director, Officer, Committee Member, or Employee)