



Key Concept

“Apart from any appearance of impropriety, organizations will lose their tax-exempt status unless they operate in a manner consistent with their charitable purposes. Serving private interests more than insubstantially is inconsistent with accomplishing charitable purposes.”

*~ IRS Purpose of
Conflict of Interest Policy*

About the Firm

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Thinking Beyond the Financial Aspect of a Conflict of Interest

By William M. Courson
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Congratulations, you have just been asked to serve on the board of a local nonprofit corporation. At your first meeting, the board is set to make a decision on engaging a new financial advisor. You are excited to see that a former mentor who helped propel your career is one of the finalists. You have always felt in debt to this individual for helping you launch your career. The organization's conflict of interest policy suggests you must announce to the other board members a conflict only when you will receive a financial benefit. Since you will receive no financial benefit in advocating and voting for your former mentor, you stay silent when the chair inquires as to whether there are any conflicts of interest with the finalists. You ignore the presentation and arguably superior experience of the other finalist, and vote for your former mentor.

Welcome to the world of non-financial conflicts of interest.

The law requires that the management and board members of nonprofit organizations exercise the duties of care and loyalty. These legal requirements provide a guidepost to ensure that a fiduciary's only consideration in each decision is the organization itself. Acting in the best interest of the organization, however, goes beyond the most commonly and easily avoided conflict of interest – that of extracting financial gain from the relationship.

When discussing conflicts of interest, most boards immediately

assume there must be an issue with a financial benefit to a board member or staff to the detriment of the organization. While that might be the most common conflict of interest boards face, there are others. These include when directors serve on another board for a similar organization or industry, and when directors serve on another board – regardless of the nature of the organization – and the two organizations solicit funds from the same sources. These non-financial conflicts of interests, as well as the tangential issues associated with classic financial conflict, are often overlooked.

The sample IRS conflict of interest policy, which most organizations follow for compliance with Form 990 purposes, requires:

- (1) A duty to disclose, whereby the interested person discloses the existence of the financial interest and is given the opportunity to disclose all material facts to the other directors or committee of directors considering the proposed transaction;
- (2) A determination of whether a conflict exists by the disinterested board members or disinterested committee members considering the transaction; and
- (3) A determination of other potential alternatives to the transaction at issue and whether a more advantageous alternative is available that would not give rise to a conflict.

These policies typically do not address the tangential issues associated with a financial conflict,

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and since they are not described in the organization's conflicts of interest policy, some boards may be overlooking these critical issues.

Boards need to view conflicts more broadly and look beyond the initial financial conflict that may be present when evaluating any board action. This includes looking beyond the legal requirements that simply protect an approved action from being voided or voidable.

Boards must consider how the interested director's personal or professional interest will affect his or her ability to put the best interests of the organization before personal or professional interest, and whether or not these conflicting loyalties will affect the director in such a way that the conflict cannot be overcome. These considerations go beyond whether or not a transaction with an interested director is fair in price and fair in dealing.

Boards must consider all tangential issues associated with a potential conflict beyond simply ensuring that an interested director discloses the conflict, refrains from discussion and refrains from voting on the matter. Boards must consider questions like:

- Will the interested director remember which hat he or she is wearing when making decisions on behalf of the organization after an interested transaction is approved?
- Will the interested director be able to make decisions solely in, or not opposed to, the best interests of the organization after an interested transaction is approved (and not make decisions to protect what will then be an interested position)?
- Will the other directors begin to question the motivation behind the decisions or questions that are raised by the interested director after an interested transaction is approved?
- Will the board have to closely consider such motivation as part of future board discussions?
- What is the impact on the board composition and director relations if the organization needs to terminate the engagement or end the transaction early?
- And finally, what happens if the transaction or engagement with the interested director turns sour?

Boards need to fully consider and evaluate questions like these when addressing a transaction involving a potential conflict of interest. Still, since most conflict of interest policies fail to address, and thus most boards fail to consider, these tangential issues, most boards are not prepared to address such issues when they arise.

Failure to consider these tangential issues associated with transactions with a director, or with engaging a director for professional services, could find a board going down a path that might prevent it from effectively providing the necessary oversight and direction to the organization. It can cause internal dissension among the directors and an environment that leads to more finger-pointing than focusing on the strategic objectives of the organization.

Indeed, if a board fails to evaluate all of the potential tangential issues, a board may find itself seeking not only a new service provider, but also a new director (or several new directors).

Fiduciaries should develop policies to avoid conflicts of interest and help define the potential conflicts. As with all policies, the conflict of interest policy should be regularly reviewed, especially as new board members are added. The review provides a topical reminder of the primary objective of a fiduciary: the advancement of the mission.

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