

PBPA Podcast Transcript
Recognizing and Navigating Conflicts of Interest
(26:42 minutes)



[00:00:00] **Sireesha:** Many nonprofit leaders are familiar with the idea of a conflict of interest, but recognizing one in the moment is another matter. A board member's family business, a vendor relationship, a shared client. These situations don't always come with a warning label, and even if the transaction is well-intentioned, a conflict that is not adequately reviewed by a board can expose your organization to legal risk, including IRS penalties. In this episode of the PBPA Podcast, Ben Barkley will answer our questions about conflicts of interest, how to recognize them, what to do once one arises, and he'll share real world examples that show how these situations actually play out.

Hello and welcome to the PBPA Podcast. In each episode of the PBPA Podcast, we explore legal questions relevant to Georgia nonprofits. I'm your host Sireesha Ghanta, Counsel and Education Director at the Pro Bono Partnership of Atlanta. PBPA strengthens our community by engaging volunteer attorneys to provide nonprofits with free business legal services. We provide numerous free resources via our website, including articles and webcasts specific to Georgia nonprofits and their business legal concerns. We also provide direct legal services to our clients. For more information on client eligibility requirements, to apply to be a client or to access our vast learning center, visit our website at pbpatl.org. Before we jump into this episode's topic, keep in mind that this podcast is general information, not legal counsel, contact your attorney for guidance on your nonprofits' specific situation.

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Ben, thanks so much for being here to answer my questions.

[00:02:56] **Ben:** My pleasure. Happy to be here.

[00:02:58] **Sireesha:** So Ben, let's start with the basics. Can you help us understand what exactly is a conflict of interest for a nonprofit?

[00:03:08] **Ben:** Sure. So a, a conflict of interest arises when a board member or an officer or a key employee has a personal or financial interest, can be direct or indirect, in a transaction or a decision involving the organization, such that the person's loyalty to the organization could reasonably be questioned.

The interest doesn't have to be the person's own. It can run through a family member or a business partner or an entity that the person is affiliated with. Uh, but I want to emphasize at the outset that a conflict is not an accusation of wrongdoing. It's a situation to be recognized and managed. The law anticipates that conflicts will arise, and so it's just a matter of having a process to deal with them.

[00:03:50] **Sireesha:** Okay. So that's good to know that just because a conflict of interest exists, it doesn't mean that it is a transaction that cannot be pursued. And we'll be talking about that a little more. Ben, are there different types of conflicts, or is a conflict always a conflict?

[00:04:09] **Ben:** That's a good question.

There, there are really three different categories that I would describe of conflicts. I think it helps to distinguish them because it frames how we address them at the board level. First is an actual conflict, and that's when a specific transaction is on the table in front of the board today, and there's a board member that has some sort of a financial interest in the transaction. So for example, the nonprofit is about to lease office space from a building that's owned by a board member.

The second is a, what we call a potential conflict. It's like a board member has a relationship or an interest that doesn't intersect with any pending decision, but it foreseeably could. So the board member, maybe the board member's accounting firm doesn't currently work for the nonprofit, but the organization may go through an RFP or something for a new auditor in the next year, and so it's a potential conflict. Could come up. There's a board member who does things that the nonprofit might actually need someday.

And then the other one, the final one, is what we call an appearance of conflict and that's when a reasonable outside director, that could be a donor or a grant maker, could be a journalist, could be, I don't know, some blog post or something, but could conclude that a board member's judgment might have been compromised even though everybody involved knows that there wasn't actually a disqualifying interest.

Either there wasn't a relationship, or it was handled. For example, if the if the nonprofit were to hire a consulting firm to help them through a strategic planning process, for instance, and you find out that the board chair's college roommate is a partner there, even though the board chair and the partner had no interest, no involvement in that particular transaction, you say it just looks bad or could look bad.

But the unifying principle across all three of those is disclosure. So actual conflicts, we'll talk about the conflict of interest policy and the formal legal procedures before the board. Potential conflicts, you capture those through the annual disclosure questionnaire, that we'll talk about in a little bit, so the board is prepared for them if it comes up.

And then appearances of conflict are also important- so they can be flagged and discussed at the board. So the board can manage the perception, uh, because for pros- for nonprofits, a lot of times trust is everything, the trust of your nonprofits, the trust of the public, et cetera. So all three are present and a good policy will deal with all three.

[00:06:20] **Sireesha:** And do conflicts always have to involve money?

[00:06:25] **Ben:** Uh, no, and that's a common misconception. Georgia has a safe harbor procedure that we'll talk about in a minute. It's built, and the safe harbor is built primarily around financial interest because that's the one that gets the most attention and the most opportunities. Um, and that's where money or property or some economic value flows to a director or a relative of the director.

But the universe of conflicts a board will actually deal with are much broader than that, like I talked about a minute ago. Personal relationships can create conflicts. So if you had a board member who's close friends with the executive director he or she may struggle to, uh, objectively evaluate how the board member's, how the executive director's performing.

Or you could have a board member who's on another board also, and maybe they're, competing for the same grant or something. It's not personal benefit to that director, but it is a conflict in loyalties, you might say. And again, a well-designed conflict of interest policy, will deal with all those pretty broadly.

And, and the, kind of the best thing is to make it broad and give the board chair, or if you have a governance committee, give the governance committee chair the authority to deal with those as they come up.

[00:07:31] **Sireesha:** Okay. Those examples are very helpful to understand what a non-financial conflict might look like.

But my next question is regarding financial conflicts. Does, what does Georgia law actually require? That a nonprofit do when a financial conflict arises.

[00:07:52] **Ben:** All this is governed by the Georgia Nonprofit Corporation Code, and it has what lawyers call a safe harbor provision, and basically a step-by-step process that if you follow the steps, the transaction is protected from being challenged in court or by some other government entity. Um, you think of it as a checklist that when you walk through the safe harbor checklist, it gives the board and the director legal cover.

And the process has several steps. The first one is is a unifying theme throughout our talk this morning, is on full disclosure. Um, and the first step always is that it's more than just saying, "I have a conflict," "What do you guys wanna do?" It requires full disclosure, and so the law, requires that the director lay out everything they know about it, about the situation, all the relevant facts. If it's leasing a building, how much space, and probably what, what does rent cost in the building. This a good deal or not? Um, anything that the rest of the board would need to know in order to make a, an informed decision.

And then second is recusal, um, meaning that the director who's got the conflict of interest, after they've made the full disclosure, needs to bow out. They need to recuse themselves from the meeting and from the vote. A lot of times, I think it's fine for the board member to stick around long enough to answer questions from the other board members to make sure that they have full disclosure.

But then that board member should leave. It's not enough just to sit there and not vote. The board member should leave the meeting uh, so that it's effective, so they're not, staring people down or people are afraid to vote against it because they don't wanna offend them or something like that.

And then third, uh, the transaction must be approved by a majority vote of the directors who are independent of the situation. And the codes also says there has to be at least two, so you have to have at least two independent directors who vote in favor of it, and it's a majority of those voting.

The statute calls these "qualified directors". That basically means that they don't have any interest in the transaction, and they're not related don't have a family or a business, uh, or professional relationship. Uh, they're not, it's not their brother or sister or mother or father or partner, something like that.

So you can have some small boards, particularly some small nonprofits. So, if you have one director who's conflicted because they're in the transaction, another director, it's, they're, you know, they're related or they're business partners or something, you can run out of people real quickly. And, I've seen situations, not very often, where you've had to, actually had to appoint a new director who was independent, so you'd have two to give it the blessing.

Um, and then finally, the fourth, the statute doesn't expressly require this but the whole process should be documented in the minutes.

The minutes don't need to be a transcript of what happened, but you should say, "Jane Smith disclosed a conflict. They had a discussion for her to describe everything she knew about it, uh, give a little bit about it," and then say that, "Jane left the meeting and recused herself from the deliberations, and then the board met and, you know, and the board voted to approve it on a, six to one vote or something."

So you want to make sure you have good process so you can show that the process was followed after the fact.

[00:10:47] **Sireesha:** Yeah, a good process and good documentation. Thanks for making that so clear. But maybe an example would help make it even more clear. Can you give us some real world examples of the kinds of transactions where these issues come up?

[00:11:04] **Ben:** Sure, sure. Um, the most common scenarios that I see maybe first would be a board member's company wants to provide services to the nonprofit. You know, these days it'll be IT support, web design, accounting, construction, catering, leasing, some property from a board member, maybe leasing some office space from a board member.

In each of those, the board member has a, direct financial interest in the transaction. But it could also be, you know, a board member is applying for a staff position at the nonprofit. Um, and that's a, the related person definition in the statute covers spouses, children, siblings, parents, and individuals sharing the director's home.

So if a child is applying for a position and you're on the board, it's considered an actual conflict. Even if the child is living on their own and independent, it's considered an actual conflict and so needs to run through the process.

The other big one is executive comp. Executive director comp pretty much comes up every year for every organization that's got staff. Um, and there the board is setting the executive director's salary. Board members may have personal relationships with the executive director. A lot of smaller nonprofits, the executive director may act- may also be a board member sometimes.

Um, and that's a transaction that implicates the Georgia financial interest rules. We'll also talk a little bit later about, of that, about the IRS rules that can also apply, particularly in comp And then maybe

one more example you have a major donor sits on the board and wants the organization to fund a program that directly or indirectly benefits, um, the donor's family or their business.

So those are probably the situations I've seen come up the most

[00:12:38] **Sireesha:** And you mentioned, um, board members. Do employees also have to share if there is a potential conflict of interest? For example, if it's the executive director's spouse who owns a company that the organization might consider hiring.

[00:12:57] **Ben:** Yeah, and there's a complimentary set up. We have been talking mostly about director conflicts of interest, but most policies also apply to officers of the organization. Senior staff. It might not apply directly to, your receptionist or a non-executive employee. But anyone considered an officer, the, the executive director, the vice president or something, if they have, staff officer positions.

There, there's also a, um... it's different because, if they're not voting on it, if they're not on the board and they're not voting on it but there are direct officers do have fiduciary duties to the organization as well. There's a similar regime under the nonprofit code that talks, it's primarily around disclosure because you don't have to, unless there's an actual conflict on the board, it just has to be approved by the board, and that would be fine.

[00:13:42] **Sireesha:** That makes sense.

[00:13:43] **Ben:** Yeah.

[00:13:43] **Sireesha:** And we talked about the IRS in a couple of your answers. And if the board of a nonprofit follows the Georgia Safe Harbor procedures, like you just mentioned and shared with us, does that take care of the IRS and potential federal tax issues, too?

[00:14:02] **Ben:** No and that's probably one of the most important points that I can make today. Um, the Georgia Safe Harbor and the federal tax rules are really two completely separate systems. There's overlap, but they're really separate. And following one does not take care of the other.

The Georgia statute, asks basically, "Did the board follow the right process, disclosure, recusal, independent vote?" Uh, you do all that, then you're fine from a, you know, corporate law, nonprofit corporate code standpoint.

But the IRS ask a completely different question, which is, "Did the organization pay a fair price or fair value for what they paid for?" Um, so if a nonprofit pays a board member's company \$100,000 for services that are really only worth 60,000, either 'cause the board didn't know or whatever the IRS considers that \$40,000 difference to be what they call excess benefit.

The whole scheme of shared nonprofit 501[c] 3 charities, is that you can't give a, a personal benefit to directors that's, other than what the board, the nonprofit is normally doing. So it's considered an excess benefit. And if the IRS determines it to be an excess benefit, then they can impose- for the person who received it, it could be, I think it's currently 25% of that amount, that excess amount.

And if they, IRS determines that it was, flagrant, uh, and it wasn't corrected, then they could impose a penalty of up to 2X what the, the amount was. Um, and board members can also have IRS penalties. Uh, I think the current penalty is about \$20,000 per transaction.

So the board can follow the Georgia disclosure and vote procedures just fine and still approve a deal at above market terms. They looked at it, they approved it they were okay with it. Um, but if it was if it was not fair to the organization from a fair market value standpoint, IRS could still have problems with it

[00:15:47] **Sireesha:** And this ties into the board's duties. They have duty of care, duty of loyalty, and duty of obedience, so-

[00:15:55] **Ben:** Yeah, exactly ...

[00:15:55] **Sireesha:** even while they're reviewing the potential conflict, they need to keep the best interest of the organization in mind.

[00:16:02] **Ben:** Exactly.

[00:16:04] **Sireesha:** Is there any way to get protection on the IRS side? You mentioned the Georgia Safe Harbor provisions, and if an organization follows that, then they should be protected from any potential questioning of that transaction.

Is there something similar on the IRS side?

[00:16:24] **Ben:** There is. Um, the IRS has their own version of a safe harbor, and they call it, lawyers love it, but they call it a rebuttable presumption of reasonableness. That basically means, um, in plain English, that if the organization does three things, then the IRS has to prove that it was, if they want to challenge something, they have to prove that it was unfair.

Uh, and it's presumed to be fair, and the IRS has to come in and show it's a lot harder to show something was unfair than to show that you've looked at it and made a reasonable decision. So if the IRS thinks you made a reasonable decision, then they usually can't challenge, they have a hard time challenging it. Um, and it's a much better position to be in to force the IRS to prove it than making you prove that it was okay. Um, and three steps really.

The first is that, like the Georgia statutes approved by people with no conflict of interest, typically your independent board members, so that's overlap.

Uh, and then two, before approving it, that the board members actually looked at comparable market data. So if it's that leasing the building, leasing office space, they look to have talked to agents, get some idea of what that space should cost and maybe what other space like it would cost. So it's not a favor to the director. They're paying fair market value for it. But they've got to demonstrate that they actually looked at something.

I know on boards that I serve on, when I've been on the compensation committee for the executive director, for instance, we always have to go out and find out what other executive directors of

comparable size organizations are paid. Uh, that way you can look at that and then document that you did that so that you can show that you've met the duty of looking at what comparable market data would be.

And then that last part I mentioned is writing it down so the documentation. Uh, again, not part of the Georgia Safe Harbor, but in good practice, IRS requires that you, and they, and it has to be done contemporaneously.

So you, this is one of those ones where you make the decision, and then you write the minutes up months later. It's a good idea to go ahead and get the minutes for that meeting done, same day or right, right away, and get them before the rest of the board so that you can show that it was documented. And again, like the, with the Georgia statute, you wanna talk about who approved it uh, what data you looked at, things like that so that it's documented right.

So the key difference really is Georgia cares more about process. Did you disclose and recuse? And then the IRS cares about the substance. Did you check the market and pay a fair price? Um, and a smart board would handle both at the same time, and your policy would typically, include both elements so that you get it all done at the same time.

[00:18:53] **Sireesha:** And A lot of organizations have a form that they share with their board members and key, maybe key employees, asking them to provide annual disclosures about potential conflicts. Can you help me understand what role does that annual disclosure questionnaire play?

[00:19:10] **Ben:** Yeah, I would look at those as an early warning system for conflicts. The primary value is that they capture the universe of relationships, and can help identify potential conflicts before they come up.

Um, and that way you can, uh, deal with them before it's a problem. So if something's coming up and you say, "Hey, I think, John is a partner at that accounting firm. Maybe before we hire them, we better, check with John and make sure there's anything we need to know, and run it through the process."

So that's a way to do that. And a, you know, well-drafted questionnaire is gonna ask each board member to disclose financial interests or family relationships or employer and client information that deal with the organization. They might typically, what other boards are you on?

Any other kind of affiliations that could intersect with the nonprofit's, operations. Typically, those aren't an actual conflict standing alone. Again, it's the potential conflict that we talked about. And once you have that map of relationships, you can, you can be prepared for it if it comes up.

And the IRS reinforces this. The Form 990, which is the annual financial return that a nonprofit files, and it's publicly available, I should point out, and it asks whether officers, directors, and key employees are required to make these kind of, fill out one of these questionnaires annually.

And it doesn't say you have to do that but you have to say yes or no, do you do that? And if you say no, then that's basically telling every donor and grant maker who looks at that return that you don't have a system in place for spotting potential conflicts, and so it just looks bad. So it's best to do that and go ahead. It's good policy and practice but it's also, people are watching. You know, there are

organizations, that grade I forget the name of them, they grade nonprofits on a governance, an issue of governance score. And uh, that's one of the things they look at. Do they have a policy? Do they have, do they require annual disclosures and that sort of thing.

[00:20:50] **Sireesha:** And if a funder sees that they do not have a conflict of interest policy or do not require annual disclosures, that can be a definite red flag.

[00:21:00] **Ben:** Yeah, that used to come up a lot 25 years ago, but doesn't come up that often, I think probably 'cause organizations like Pro Bono Partnership are getting the word out and accounting firms are doing a better job of reminding clients when they fill out the 990- it would really be a good idea for us to check yes here, so maybe you should go ahead and find out how to get one of these in place.

[00:21:18] **Sireesha:** And Ben, what are the most common mistakes that you see organizations make when they're dealing with and navigating conflicts of interest?

[00:21:29] **Ben:** I can think of a handful that come up, um, pretty regularly and repeatedly. I think the first is treating disclosure alone as sufficient without following through with the rest of the process, recusal, qualified director vote, et cetera. That sometimes.

Second, uh, I say failing to identify indirect conflicts. You know, the board member may not have a personal financial interest but maybe their spouse or sibling or business partner does. And so just making sure you're comprehensive about that. And again, the related person definition, it's pretty broad. Any kind of, again, siblings and grandparents and people that live in the house with you.

Third, uh, we talked a little bit earlier about allowing the conflicted director to stay in the room during the deliberations, maybe just to answer questions. The statute requires the director play no part in the deliberation or the vote. Again, if they wanna answer some questions before the deliberations start, that's fine. But once the deliberations start, you separate it and say in the minutes, "John left the meeting, and then the board, deliberated."

And then finally we talked at the very beginning about confusing a conflict of interest with wrongdoing. When boards treat conflicts as something shameful, or wrong some board members can be defensive. Maybe they stop disclosing. And it's really just the healthiest boards, uh, treat disclosure as routine. You routinely fill out the questionnaire. If you have good directors on your board who are active in the business community and in the other communities that you want, conflicts will come up. And you just have to have a policy that deals with them. It's not an admission of bad faith. It's just a question of, how do you deal with the inevitable conflict that will come up?

[00:23:01] **Sireesha:** And we've talked a lot about process and procedures, generally speaking. Now let's talk a little bit about why it's important to actually have this in writing and have a written conflict of interest policy

[00:23:16] **Ben:** Yeah, I'd go as far as to say it's essential. I think it's probably the most important governance document a nonprofit can have after their bylaws. You know, a good conflict of interest policy, um, it does several things at once.

It defines what a conflict is broadly enough to cover all the ones we talked about, financial, personal, professional. It establishes the disclosure and recusal procedures that will follow. It requires the annual disclosure questionnaires so potential conflicts are identified.

And then it creates accountability by assigning responsibility to somebody for tracking it, whether it's the board chair, governance committee, executive director somebody responsible for monitoring compliance.

If you don't have a policy, then you're just making it up and improvising every time. Improvisation can lead to inconsistency incomplete documentation, and then potential exposure. Again, all the nonprofits I've worked with for the last 35 years, they don't come up very often. But if it does come up- it can be a problem and for the organization, so you just have a procedure to deal with it, follow it and you'll be in good shape. And again, like we talked about the 990 also asks, "Do you have a conflict of interest policy?" And you want to be able to say yes again, from a governance standpoint.

Um, but the good news is these are not hard. They're, you don't have to start from scratch. The pro bono partnership staff and volunteer lawyers have forms and frequently help nonprofits put these together. The IRS maintains a quite good sample conflict of interest policy on their website for nonprofits to use. It's a real solid starting point, covers the core elements. You could use it as, it's good, it's a good foundation for that, but then you just need to make sure you tailor it for the organization's actual size.

The, uh, empty stocking fund that I work with here in Atlanta doesn't need the same policy that the American Cancer Society needs, dealing with millions and millions of dollars of conflicts and 25 or 40 board members. Both need a policy. They need to follow it because, but they just need to be tailored so you don't create some monster that you can't follow.

But my final point is that, as bad as it is not to have a policy, it's even worse to have one and then not follow it because then people say, "Well, you had a policy, but you didn't follow it. Why didn't you follow your policy?" So get a good policy. It can be simple, but get a good one in place, and then follow it and pay attention to it

[00:25:25] **Sireesha:** Ben, you have answered all of my questions, and I have learned a lot today. I thank you so much for sharing your time and expertise with us, and I am sure this is gonna be very helpful to nonprofits to understand how to recognize a conflict, how to navigate a conflict, and the importance of having a written policy. Thank you so much for being here.

[00:25:52] **Ben:** Look forward to helping more of your clients with their conflict of interest policies.

[00:25:58] **Sireesha:** We hope that you found this episode of the PBPA Podcast to be informative and helpful. We add new episodes every month with short conversations about general, yet important legal information for Georgia nonprofits. Remember that this is not legal counsel. Talk to your attorney about your organization's specific concerns. Thanks for tuning into the PBPA Podcast. And to all nonprofits listening out there, thank you for all the good work you continue to do in our community.