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Conflicts of Interest for Nonprofits: Counseling Nonprofit Boards on Avoiding Conflicts

October 5, 2017

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Overview

- What are the key fiduciary duties of Board members?
- What is a conflict of interest?
- Why is it important to be able to identify a conflict of interest?
- How should a conflict of interest be addressed?

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Duty of Obedience

- The duty of obedience requires a director of a nonprofit corporation to understand and carry out the mission of the nonprofit corporation in a lawful manner.
- The duty of obedience encompasses the duty of care and the duty of loyalty.

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Duty of Care

- The duty of care requires a director of a nonprofit corporation to act with such care, including reasonable inquiry, as an ordinarily prudent person would act in similar circumstances. RCW 24.03.127
- To act with the proper care, a director should attend meetings, gather and review relevant information and use reasonable judgment in making decisions.

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Duty of Care (cont'd)

- Key components of the duty of care are good faith, prudent person and attentiveness.

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Duty of Loyalty

- The duty of loyalty requires a director of a nonprofit corporation to serve in good faith and act in the best interests of the nonprofit corporation. RCW 24.03.127
- A director of a nonprofit corporation should put the best interests of the nonprofit corporation above the director's own personal interests when making decisions for the nonprofit corporation.

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Duty of Loyalty (cont'd)

- A director of a nonprofit corporation should be aware of potential conflicts and act openly and honestly in dealing with such conflicts.
- Disclosure and reasonableness are key factors.

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What is a conflict of interest?

- A conflict of interest exists when a director has a material personal interest in a proposed transaction to which the nonprofit corporation may be a party.
- A conflict of interest is not inherently illegal or unethical.
- *"No Conflict/No Interest"* John Doerr
- A conflict of interest does not automatically mean the conflict is detrimental to the nonprofit corporation.

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Examples of Conflicts of Interest

- A business owned by a director sells computer equipment to the nonprofit corporation.
- An insurance agent who is also a director sells insurance to the nonprofit corporation.
- The nonprofit corporation pays the president compensation for the president's services to the nonprofit corporation.

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Examples (cont'd)

- Information obtained from the nonprofit corporation allows a director to make decisions on the sale or retention of personal assets.
- The nonprofit corporation loans funds to an officer, director or other key player.

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Why is it important to be able to identify and properly address a conflict of interest?

- *"History shows that where ethics and economics come in conflict, victory is always with economics. Vested interests have never been known to have willingly divested themselves unless there was sufficient force to compel them."*
B. R. Ambedkar
- State law obligations
- Duty of loyalty – RCW 24.03.127

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Why is it important . . . ? (cont'd)

- Exception on limiting personal liability of directors – Cannot limit liability of a director for any transaction from which the director will personally receive a benefit in money, property or services to which the director is not legally entitled.
RCW 24.03.025(c)

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Why is it important . . . ? (cont'd)

- Prohibition on private inurement
- Representations on tax-exempt application (Form 1023)
- Representations on annual information return (Form 990 or Form 990-PF)
- Intermediate Sanction/Excess Benefit rules for public charities (IRC Section 4958)

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Why is it important . . . ? (cont'd)

- Self-Dealing rules for private foundations (IRC Section 4941)
- Sarbanes-Oxley
- Increased actions by Attorneys General around the country
- Compliance with various good governance guidelines

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Why is it important . . . ? (cont'd)

- Desire to avoid negative publicity
- Desire to be transparent and open to various constituencies

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How should a conflict of interest be addressed?

- Overall goal should be to clearly document that the potential conflict of interest was disclosed and the board made its decision based on the fairness of the transaction and the best interests of the nonprofit corporation.

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How should a conflict of interest be addressed? (cont'd)

Preemptive Steps:

- Adopt a conflict of interest policy
- Review the policy annually with relevant parties
- Require periodic certifications from relevant parties indicating they have read and understood the policy and that will comply with the policy

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Anatomy of a Conflict of Interest Policy

- Overall objective of the policy: To protect the interests of the nonprofit corporation when it is contemplating entering into a transaction that might benefit the private interests of a key player.
- Who should be covered by the policy? Directors, officers and key players.

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Anatomy of a Conflict of Interest Policy (cont'd)

What are the procedures when there is a potential conflict?

- Duty to disclose all actual or possible material direct or indirect conflicts and relevant facts.
- Duty to respond to allegations of wrongdoing or conflicts after the fact.

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Anatomy of a Conflict of Interest Policy (cont'd)

What are the procedures when there is a potential conflict?

- The interested party should fully disclose such information and then leave the meeting.
- The disinterested directors should fully discuss the information.

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Anatomy of a Conflict of Interest Policy (cont'd)

What are the procedures when there is a potential conflict?

- A decision should not be made until the directors know the full scope of the potential conflict and have made a reasonable investigation to determine whether the nonprofit corporation can enter into a better or more advantageous transaction with a different party.

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Anatomy of a Conflict of Interest Policy (cont'd)

Minutes should contain:

- a reasonably detailed description of the potential conflict;
- the additional facts considered;
- documentation of the absence of the interested party from the discussion and vote; and
- a list of all directors who voted for and against the proposed transaction.

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Tales From the Dark Side

- *United Way of America/Aramony:* CEO was fired in 1992. Helped usher in the intermediate sanction rules applicable to public charities.

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Tales From the Dark Side (cont'd)

- *Adelphi*: New York State Board of Regents removed 18 of the 19 board members for failure to protect the university's interests. The board overpaid the president. One board member's insurance company earned \$1.2M in commissions from the university. The New York Attorney General filed suit against the former board members and they settled for \$800K.

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Tales From the Dark Side (cont'd)

- *Allegheny Health, Education and Research Foundation*: Executive was paid an annual salary of \$1M. Nonprofit declared bankruptcy. Executive was sentenced to 23 months in prison for using nonprofit assets to pay for profit expenses.

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Tales From the Dark Side (cont'd)

- *Smithsonian*: CEO resigned after allegations of a variety of improprieties. An independent panel determined the CEO was paid excessive compensation and noted positional conflicts from the CEO's service on other boards. The panel determined the board failed to exercise their fiduciary duties. The panel has recommended significant changes to the Smithsonian's governance structure.

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Tales From the Dark Side (cont'd)

- *ABC Foundation:* Foundation had \$3M in assets and paid various family members an aggregate of \$150K in salaries plus a variety of expense reimbursements. Wrongdoing caught during IRS compensation inquiry. Self-dealing penalties imposed.

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Tales From the Dark Side (cont'd)

- *Bishop Estate:* Charitable trust formed to operate private schools. Five trustees paid an annual salary in excess of \$900K. State Attorney General investigated fraud, mismanagement, personal benefit. Four of the five trustees were removed by the probate judge and the fifth trustee resigned.

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Tales From the Dark Side (cont'd)

- *Caracci/Sta-Home Health Agencies:* The nonprofit sold its assets to a related for-profit entity for a discounted price. Amount had to be repaid and penalties in excess of \$1M were imposed.

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Attachments

- Form of IRS Conflict of Interest Policy
- Certification
- Rebuttable presumption checklist
- RCW 24.03.025
- RCW 24.03.127

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Q & A

- If you have additional questions, please let me know.
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Q & A

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Lorri Dunsmore has over 30 years of experience representing individuals, businesses and tax-exempt organizations in a variety of charitable, wealth transfer, business succession and federal tax matters. Lorri regularly works with individuals and tax-exempt organizations to address a wide range of tax and state law issues impacting charitable giving, formation of nonprofits and addressing the specialized needs of tax-exempt organizations including private foundation excise taxes, excess benefit transactions, lobbying restrictions, fundraising law compliance, commercial co-ventures and joint ventures. Lorri has spoken and written about numerous issues related to nonprofit governance and compliance matters and has worked with a variety of tax-exempt organizations to provide training for board members and officers. Lorri's practice also includes advising clients on the formation, operation, management and transfer of family business entities. She works closely with families to implement business succession and wealth transfer strategies. Lorri has experience advising privately held corporations, limited liability companies and professional corporations on issues ranging from formation to dissolution.

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