

SECTION 5: DEALING WITH CONFLICTS OF INTEREST

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Conflicts of interest pose difficult issues for CAAs and other organizations. A conflict exists whenever circumstances could cause an individual to elevate his personal interests over the CAA's interests, with the result that the CAA's efforts become a secondary rather than the primary consideration. In the broadest sense, a conflict is a situation where an individual who has authority to make or influence decisions affecting the CAA, such as a board member or the head of the purchasing department, has a personal incentive, often a financial incentive, to cause the CAA to take, or not take, a particular action.

Part I: Conflicts of Interest

Everyone should be concerned about conflicts because, when poorly managed, they often lead to negative consequences. Most notably, conflicts can jeopardize a CAA's nonprofit and tax-exempt statuses and government funding and result in disallowances of costs charged to grants and contracts. State and federal governments are often concerned that conflicts of interest will lead to a nonprofit paying too much for goods or services provided by insiders or paying insiders for unneeded or inappropriate goods or services, thus diverting funding or assets intended for a public charitable or educational purpose to an insider for private benefit. They are concerned that unqualified relatives of insiders will be hired as employees or as contractors, therefore weakening the ability of the nonprofit to carry out its mission and the intended purposes of the funding. Both federal and state laws and program funding requirements have therefore imposed numerous conflict of interest restrictions. The IRS also requires most 501(c) tax-exempt organizations to disclose on the Form 990 whether they have a conflicts of interest policy and how it is implemented.

Conflicts can also adversely affect employee morale, draw unwanted media attention, and create negative public perceptions that can damage a CAA's reputation. The media often portrays conflicts as a sign of corruption and wrongdoing. When a newspaper or television reporter decides to investigate a charity, the story often will describe any conflicts that the reporter discovered even if the conflicts do not relate directly to the story's primary subject matter. The reporting will always present the conflicts in a negative light, thereby damaging the CAA's reputation.

Conflicts of interest are a fact of life. Not all conflicts are objectionable or even defined as a “conflict of interest” by relevant laws or policies. A person who faces a conflict has not necessarily done anything wrong. His or her conduct, as well as that of the CAA, will be judged by how both address the conflict. A conflict of interest policy tries to address those issues by defining conflicts, establishing a mechanism to disclose potential conflicts, outlining a process and criteria for determining whether a transaction involving a conflict is acceptable, and setting forth the consequences where a conflict is deemed unacceptable.

Every CAA should, and in many cases is required to, have a written policy that addresses conflicts of interests. With a written policy, CAA boards and senior managers will be less likely to adopt an ad hoc approach to conflicts that could result in ethically questionable and potentially illegal transactions, or reasonable and defensible transactions that lack sufficient documentation to withstand external scrutiny.

Examples of Common Conflicts

Common conflicts encountered by nonprofit organizations are:

- **Sales of Goods, Services or Property** by a nonprofit's officers, board members, employees, and other interested persons—often referred to as “insiders” — to the nonprofit or vice-versa. Examples include a CAA board member who provides legal services to a CAA for a fee; a CAA that hires the executive director's nephew to do plumbing work; or a CAA that leases its headquarters from its board chair.
- **Loans** to or from the nonprofit to a board member, officer, key employee, or related entity. Some states prohibit or severely restrict loans from a nonprofit to its board members and officers. Examples include a bank that lends money to a nonprofit when the president of the bank serves on the nonprofit's board or a nonprofit that lends money to a newly hired CEO to buy a house.
- **Joint Undertakings** between nonprofits and businesses and individuals who have valuable skills and expertise in an effort by the nonprofit to find innovative ways to deliver goods and services. In structuring a joint undertaking or other ongoing relationship, a CAA should ensure that the arrangement is structured so that the CAA's interests do not become secondary to the interests of any CAA officers, board members, or employees who are participating in the joint undertaking either directly or through ownership interests in another entity.
- **Positional Conflicts** that arise because a CAA board member simultaneously holds two positions, one as a member of the tripartite board and the other unrelated to the CAA (e.g. a full-time job, an elected office or a board member of another entity). A CAA's tripartite board is comprised of three categories of individuals who represent their respective constituencies. While board members of each category should take into account the interests of their constituency, each board member must still act in the best interests of the CAA as a whole.

Tip

BOARD ELIGIBILITY AND BYLAW REVIEW

The CAA should summarize the relevant portions of its conflicts of interest policy in the board application materials provided to prospective board members. A member of the community may want to be considered for board membership, but if his/her firm does business with the CAA and has what would be an impermissible conflict, then the community member has a choice to make—be a board member and lose the business opportunity, or refrain from board service. It is best if the impediment to membership is known up front. The bylaws should provide a process that will preclude an individual from being elected or seated as a board member if s/he has an impermissible conflict. This would require the board to have some final say in who is seated on the board, rather than give other parties the right to fill seats on the board without initial vetting by the CAA board through the application process. The bylaws should contain a similar provision for board members who find themselves faced with impermissible conflicts during their terms.

- **Corporate Opportunities** offered to a board member or an employee that might also be of interest to the CAA. For example, a real estate developer who serves on the CAA’s board might be interested in acquiring a parcel of land that the CAA is also interested in acquiring. This board member owes a duty of loyalty to the CAA. That duty requires the CAA and the real estate developer to assess whether he can honor his duty of loyalty to the CAA while simultaneously competing with the CAA for the land.
- **Employment.** Hiring the relatives of board members and key employees raises questions of favoritism or nepotism. For example, a CAA that hires the board chair’s daughter to head its weatherization program over a more qualified candidate potentially harms employee morale and, if the CAA runs a Head Start program, jeopardizes its Head Start funding.
- **Gifts to Board Members or Staff** from vendors may improperly influence their decisions in connection with doing business with the vendors. For example, a representative for a vendor of a financial software package may offer the CAA finance director two tickets to a baseball playoff game.

Two Categories of Conflicts

The legal system divides conflicts into two categories, those that are legally prohibited and those that are legally permissible. A conflict of interest policy creates a board and senior management mindset that allows them to recognize potential conflicts, know the difference, take appropriate actions to avoid illegal conflicts or—if the CAA wishes to—proceed with a legally permissible conflict in an objective and transparent manner.

- **Legally Prohibited Conflicts.** Federal and state laws prohibit certain categories of transactions between a CAA and specified persons. For example, the Head Start Act prohibits financial transactions between a Head Start grantee and its board members and Policy Council members. In certain states, a nonprofit corporation cannot lend money to or borrow money from certain “insiders,” usually officers, board members, and employees, or may only do so on a limited basis.
- **Legally Permissible Conflicts.** When there is not a specific prohibition, the CAA and the conflicted person may be able to enter into the arrangement notwithstanding the conflict, but certain procedures should be followed before going forward with the transaction to ensure that it is both transparent and in the CAA’s best interest. State nonprofit corporate law often outlines a procedure that an entity can use to “validate” transactions with conflicts. Depending on the wording of the particular statute, following these provisions can provide some protection from liability to board members or the person with the conflict or preclude the transaction from being void or voidable. Because of the different statutory formulations and interactions with the case law defining the duty of loyalty, a CAA and its board and officers should consult with a lawyer familiar with applicable state law to better understand the procedures and their significance. Generally, the procedure to validate a conflict must include three elements: (1) notification of conflict; (2) disclosure of material facts related to conflict; and (3) an objective, good faith review prior to moving forward with the otherwise legally permissible transaction. This procedure of board validation would be followed for board members with conflicts, and, if attempting to gain protection from potential liability from federal tax law liability, for conflicts of high-level management staff as well. The CAA should develop procedures to ensure that transactions involving conflicts of other employees are either approved through appropriate procedures or avoided.

CASE SCENARIO:

THE NEED FOR A CONFLICT OF INTEREST POLICY

BCA’s board of directors has yet to adopt a conflicts of interest policy. It has never had to deal with a conflict, which explains why the board saw no need for a policy. (For purposes of this example, assume BCA does not operate a Head Start program.)

Two months ago, the board directed BCA’s CEO, Gloria Watson, to find larger facilities for BCA. During a subsequent lunch with Noelle Burke, a member of BCA’s board, Watson learned that Burke owns a building that might meet BCA’s needs for additional space. Burke and Watson negotiate a proposal under which BCA would enter into a triple net lease that requires BCA to pay a \$100,000 annual rent as well as all taxes, insurance, and maintenance expenses for the building. The initial lease term will be five years, with an option to renew for an additional five years.

Burke and Watson present the proposal to BCA’s board for approval at the next board meeting. Because everyone knows and likes Burke, everyone assumes she will propose a “fair” deal. The board votes unanimously in favor the proposal.

An investigative reporter for the local newspaper learns of the deal. He contacts a local real estate broker, who reports that BCA could have obtained comparable space for a mere \$80,000 per year, with the landlord responsible for all other building costs. The newspaper story results in several investigations and criticism from the community.

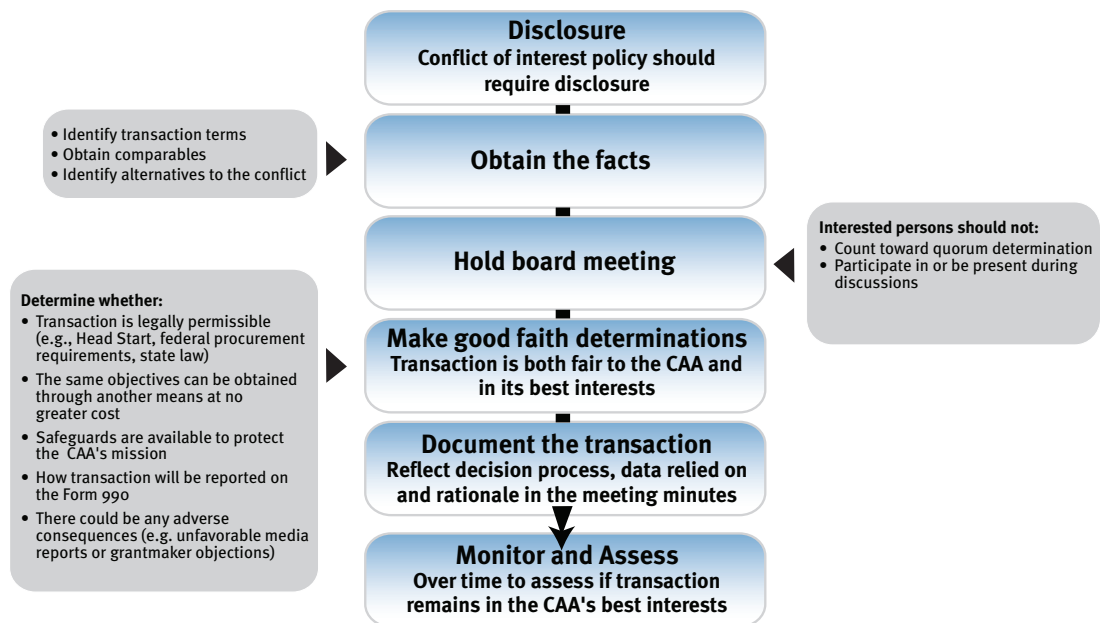
LESSON: Just because a CAA has never encountered a conflict does not obviate the need for a conflict of interest policy. By defining BCA’s values in advance and encapsulating them in a policy, BCA’s board can avoid the sort of ad hoc decisionmaking that often spells trouble. Had BCA adopted a policy in advance, the board would have had a blueprint to follow in evaluating the Burke-Watson proposal. Instead, the resulting decision was based largely on goodwill and emotion, which doesn’t always lead to a defensible decision when the decision is viewed in hindsight.

Contents of the Conflict of Interest Policy

At a minimum, the policy should address the following:

- **Purpose.** An introductory statement identifying the policy's purposes and objectives, reflecting a philosophy that guides the board and others subject to it when the policy does not explicitly address a particular situation.
- **Covered Individuals.** Identify by category the persons who are covered by the policy. Due to different conflict of interest rules and procedures that apply, respectively, to board members, officers and employees, and Head Start Policy Council members, it is often clearer to have separate policies for each of those categories. At a minimum, persons covered by a conflict of interest policy should include board members, officers, key employees and others involved in the procurement process, and Head Start Policy Council members.
 - **Family Members.** Board members, officers, and employees sometimes face conflicts because of their relationship to someone else who does business with or receives funds, goods, or services from, the CAA. For this reason, the policy should define how transactions between the CAA and family members are treated. Policies typically define a family member as a covered person's spouse, children (including adopted and step-children), parents, in-laws, and brothers and sisters. Typically, if a transaction would be problematic or require approval if an officer, board member, or employee engaged in it, then the transaction will be viewed similarly if one of their family members engages in it. Including domestic partners in the definition of family member is recommended.
 - **Related Entities.** Define the related entities included in the policy. These typically include corporations and other entities owned by the CAA's officers, board members, or employees or controlled by or affiliated with the CAA itself, through authority to appoint at least a majority of the board members, for example. The trick is to define the ownership thresholds that bring an entity within the policy's scope. If a CAA has a particularly strong aversion to conflicts, its policy might cover any transaction between the CAA and an entity in which one or more covered persons own more than a 5 percent interest in the entity. Less risk adverse CAAs might set the threshold at more than 35 percent ownership interest. Some broadly-worded policies also include entities for which CAA insiders work or serve as officers, even if they do not have an ownership interest.
- **Conflicts Covered by the Policy.** This is best done with a general statement, accompanied by examples. At a minimum, the policy should address purchases and sales of goods, services, and property; loans; leases and use of property and resources; investments and joint ventures; and employment of family members.
 - **Enumerated Conflicts.** Some policies enumerate specific types of transactions, which often include: selling goods to the CAA; providing services to the CAA; leasing property to the CAA; and receiving gifts or loans from third parties dealing with the CAA. A more general statement, as described below, should also be used to catch situations not covered by specifically enumerated conflicts.
 - **General Statement.** Other policies use more generalized language, often providing that no officer, board member, or employee may vote or oversee any matter in which that person has a material or direct financial interest. Although a standards-based policy is often preferable, it should nevertheless specifically identify certain common transactions and circumstances.
 - **Exclusions of Certain Benefits.** The CAA may want to consider excluding from the conflicts of interest definition certain benefits provided to insiders who are eligible for CAA services. Typically, services or benefits provided by the CAA to an insider solely because the person is a member of a charitable class that the CAA intends to benefit as part of the accomplishment of its charitable purposes would not be considered a conflict of interest, provided that: (1) the insider meets all applicable eligibility criteria for the services/benefits, including funder rules on the provision of services/benefits to insiders; (2) the insider does not receive preferential treatment in receiving the services/benefits due to his or her status as an insider; (3) the services/benefits are provided on terms similar to services/benefits provided to individuals who are not insiders; and (4) neither the insider nor any of his family members are involved in the decision about whether to provide services/benefits to the insider. This exclusion is consistent with the IRS instructions for completing the related party disclosures on the Form 990.
- **Notification.** The policy should require those who are covered by it to notify the appropriate persons when they become aware of a potential conflict involving themselves, with whom they have family or business relationships and entities in which they have an ownership interest. Receiving a timely notification of potential conflicts is particularly important because early knowledge allows the CAA to prevent a potential conflict from ripening into an actual one. The policy should specifically instruct all covered persons to err on the side of disclosing more than may be necessary so that the CAA has the opportunity to review transactions and determine whether there is in fact a conflict.
- **Validation Process.** A CAA may choose to prohibit some or all conflicts outright or to allow certain legally permissible conflicts, subject to a review by the board or a board committee (for a board member, CEO or other staff as determined by the board) or by a designated staff member (for a staff member such as a purchasing manager). If the CAA allows certain legally-permissible conflicts, the policy should outline the procedures that must be followed before the CAA will enter into a transaction involving a conflict. Organizations should review applicable state laws to ensure that efforts to validate the conflict comply with statutory provisions, but six basic principles should guide the process:

- **Obtain All Facts.** Before the decision is made, obtain all material facts pertaining to the transaction and the conflict.
- **Act in Good Faith.** Act in good faith and base the decision solely on what is in the best interests of the CAA.
- **Demonstrate Fairness.** Before approving the transaction, demonstrate that it is fair to and in the best interests of the CAA.
- **Exclude Interested Parties from the Deliberations.** The individual with the conflict should not be present while the board or other party making the determination discusses the transaction, except for making an initial presentation or responding to questions. If a board member, the individual should not be present for the board vote, or counted for purposes of determining whether there is a quorum.
- **Review and Approval by Independent Board Members.** Any conflict transaction requiring board approval should be approved by independent board members who constitute a majority of all board members (unless the CAA’s articles of incorporation or bylaws require a higher percentage). An independent board member is usually defined as one who is neither an employee nor is involved in any conflict of interest transactions himself or herself.
- **Satisfy Tax Law Requirements.** The board should conduct the process so as to permit reliance on the rebuttable presumption in Section 4958 of the Internal Revenue Code—this provision is referred to as the “intermediate sanctions.” The decision should be made by an independent board, be supported by appraisals or other evidence demonstrating that the transaction’s pricing reflects fair market value (or a bargain to the CAA), and there should be a contemporaneous written record that lists the comparables or bidding process that the board relied on and describes the basis for the decision. (See Part II for a more detailed discussion of the intermediate sanctions).



■ **Sanctions.** The policy should define the consequences if someone violates it; people are more likely to take the policy seriously if violations carry consequences.

• **Sanctions and Employees.** Any sanctions should be integrated with employee policy handbook. Terminating an employee is risky business, even when the person is an at-will employee. By providing notice of any sanctions, the CAA will support the termination and may head off litigation.

• **Sanctions and Board Members.** When a board member violates the policy, involuntary removal can be difficult, particularly if the board member has been elected or appointed by an outside group, elected official, or constituency, as is often the case with CAAs. Some state laws do not allow a board to remove such members; the entity that designated the individual must do so. Any sanctions provided for in the policy should be integrated with the relevant portions of the CAA’s bylaws, articles of incorporation, and other organizational documents. This is one example of why it may be preferable to include a provision in the bylaws for removal for cause and to make all appointments to the board advisory only; subject to election by the board as a whole.

■ **Disclosure.** The policy should require each covered person to disclose actual and potential conflicts in a timely manner. An annual conflicts of interest disclosure questionnaire, which serves as a reminder to covered persons that the CAA has a conflict of interest policy and that compliance with it is both important and expected, is recommended. A questionnaire also can serve as a tax-compliance tool. Organizations (most if not all CAAs) required to file a Form 990 must disclose extensive information to the IRS, and sometimes to state regulators, pertaining to certain related-party transactions and relationships among board members. The disclosure requirements are complex, but the instructions to the Form 990 permit the organization to rely on an annual questionnaire in fulfilling the disclosure requirements. Auditors also typically require disclosure of related party transactions.

Implementing a Conflict of Interests Policy

Each CAA should integrate its conflict of interest policy into its operations. Although there is no “right” way to do this, here are a few suggestions:

- **The Form.** People often speak of a conflict of interest policy without giving much thought to its physical form. Some organizations have one written document. This is simple and convenient, but it may not be the best way to communicate the policy to different audiences.
 - **Board Members.** The CAA should distribute the master policy to all board members.
 - **Employees and Officers.** In the case of employees, the CAA should consider two versions of the policy. The first should be distributed to officers (including board members who are officers) and key employees and look similar to the one distributed to board members, but will contain the appropriate requirements and references for key employees and officers. The second should be one or two paragraphs notifying all employees of the overall policy. It should be included in the employee handbook.
 - **Head Start Policy Councils.** CAAs operating Head Start programs should distribute an appropriately modified version of the policy to members of the Policy Council.
- **Notification.** Individuals who are subject to the policy and faced with a potential conflict should be required to notify someone who is in a position to address the issue.
 - **Board Members and Officers.** Board members might be asked to notify the board chair of any potential conflicts. Or the policy might require board members to notify the board’s audit committee.
 - **Key Employees.** Key employees might be asked to notify the executive director because s/he is the intermediary between them and the board. In large CAAs, key employees who don’t have regular contact with the executive director might be asked to contact someone in the HR department.
 - **Head Start Policy Councils.** Notification could go to the chairperson of the Policy Council and the Head Start director.

Conflicts are the acid test of a board’s determination to act ethically. People on boards know and often trust each other, which means their natural inclination is to do each other favors and think the best of each other. Those tendencies often blind boards to the problems associated with conflicts, particularly problems of perception.

CASE SCENARIO: TONE AT THE TOP

Over the years, BCA has regularly done business with members of its board of directors. It has borrowed money from a board member’s bank, purchased property from a board member, and used a board member’s printing company to meet its printing needs. The board has always rationalized approving transactions with insiders on the grounds that the insiders are either volunteers or work for “nonprofit” wages even though they could earn more in the for-profit sector. Assume for purposes of this example that BCA does not operate a Head Start program.

For years, Sam Melvin, BCA’s chief bookkeeper, has taken note of these deals with insiders. He finally decides that it is time for him to “get his.” As a result, he puts in place an elaborate scheme involving phantom vendors, permitting him to steal money from BCA. When Melvin is caught, he tells the FBI:

Despite all the conflicts I noticed and how others were getting rich at the expense of BCA there still remains the question of myself. As I allude to in the last paragraph I did convert BCA

funds, goods and service to my own use. I am not sure when this began, but probably around late 2010. Like all schemes it started out discreetly and grew. I am ashamed and remorseful for these actions and offer no credible excuse for what I did. At some point I guess I began to feel that I should be getting my fair share, at least this is how I rationalized my use of BCA resources.¹

LESSON: In his letter, Sam Melvin contended that seeing everyone benefitting from their positions with the nonprofit served as the catalyst for his wrongdoing. In other words, the tone at the top, or at least perceptions regarding that tone, influenced behavior. Employee perceptions are one reason to avoid conflicts, or at least to have a policy that ensures that any conflicts don’t disadvantage the CAA and are out in the open.

¹ Quote is based on a pre-sentencing letter written by a nonprofit executive to a district court judge in a federal criminal case. The executive was subsequently sentenced to 15 years in prison for stealing somewhere around \$1.5 million from his employer, a well-known nonprofit.

A CAA's board may believe there are circumstances that justify a transaction with an insider (i.e., board member, officer, key employee, or another person or entity with a relationship with the CAA), assuming that type of insider transaction is not prohibited by a funder, such as Head Start. For example, particularly in a small town, the insider transaction may truly offer the best deal or the only provider of the service. If possible, however, the CAA's board should consider an alternative to these transactions, because conflicts can result in both foreseen and unforeseen problems. Possible alternatives include procuring goods or services from a business in another town, asking the board member to step down, or validating the transaction by the board member removing himself or herself from the discussion and vote and the board or committee making an independent determination as to whether the transaction with the board member is in the best interest of the CAA, or, conversely, if there is another business that would supply equivalent goods or services for a better price.

Conflicts are tracers. When organizations run into serious trouble due to poor governance and internal controls, the organizations are often riddled with conflicts of interest. Leaders of CAAs with existing conflicts should consider those conflicts more closely. Chances are the problems run deeper than the conflicts and warrant a fuller examination of governance and staff policies and practices.

Part II: Additional Legal and Regulatory Considerations

Federal Tax Law

Intermediate Sanctions

The intermediate sanctions are a comprehensive set of federal tax rules designed to ensure that transactions between Internal Revenue Code Section 501(c)(3) charities¹ and insiders reflect market values. The goal is to prevent “sweetheart deals.” The sanctions apply to transactions between an organization and certain related parties. They also apply to compensation agreements.

The sanctions under Code Section 4958² are referred to as “intermediate” because they permit the parties to a transaction that is determined to be abusive, i.e. to reward an insider in excess of the fair market value, to reverse the abusive aspects of the transaction. Before the enactment of the intermediate sanctions, the only statutory remedy available to the IRS was to revoke the organization's tax-exempt status. That remedy is still available to the IRS, but it is generally limited to cases of clear and extensive diversion of charitable assets to private interests.

- **The Remedy.** The sanctions require the beneficiary of a transaction that is too favorable to the beneficiary to return amounts received in excess of market value to the exempt organization and to pay an excise tax potentially equal to 25 percent of the excess, if the beneficiary falls into one of the categories of designated insiders.
- **The Rebuttable Presumption.** The centerpiece of this regime is a rebuttable presumption that a transaction is reasonable if the charity adheres to certain procedures before entering into the transaction.³ Specifically, the organization must demonstrate that: (1) the transaction or arrangement was approved in advance by the board of directors (or a committee thereof); (2) such board (or committee) was comprised entirely of individuals who did not have conflicts as defined by the regulations; (3) such board (or committee) obtained in advance and relied on appropriate data as to comparability of the transaction's price with market values; and (4) such board (or committee) adequately documented the basis for its determination concurrently with the decision. The rules contemplate otherwise conflicted individuals recusing themselves from the process. The rebuttable presumption does not provide the organization or the insider with ironclad protection. The IRS can rebut the presumption; in other words the IRS

CASE SCENARIO:

DUALITIES OF INTEREST—PUBLIC SECTOR MEMBER OF THE BOARD

Director of City Grants Warren Yatzke serves as a public sector member of BCA's board; as the mayor's designee. Yatzke has never been excited about being a member of BCA's board. He finds the organization to be poorly run and inefficient. He repeatedly has tried to correct the deficiencies, but has met with continued resistance from entrenched management.

BCA recently applied for a city grant to fund one of its programs. Even though he is a member of the board, Yatzke doesn't believe he can recommend to the mayor that the city award the money to BCA. Yatzke believes that the funds would be better utilized if awarded to Yellow Community Works (YCW), an organization that offers many of the same types of programs that BCA offers.

LESSON: Yatzke faces a conflict rooted in his dual positions. As a member of BCA's board, Yatzke owes BCA a duty of loyalty. He should be doing everything possible to further BCA's mission, which arguably means that Yatzke should advise the mayor to award the grant to BCA. However, Yatzke, as a city employee, also has a duty to the city to recommend that the grant be awarded to the most worthy organization, which clearly is not BCA. It is unlikely that BCA or the state attorney general would successfully win a lawsuit against Yatzke were he to recommend that the grant be awarded to YCW, but BCA's board and management are likely to be less than pleased with Yatzke, reducing his effectiveness. In situations like the one in this example, everyone should agree in advance about the protocol for dealing with this sort of conflict and adjust their expectations accordingly.

can challenge the transaction and attempt to prove that it was not fair to the organization by proving, for example, that the comparables relied on by the organization were not reasonable or appropriate in the circumstances that existed at the time of the board's decision.

If the organization does not follow these steps, the transaction is not automatically unreasonable or considered an "excess benefit transaction," but the nonprofit will have the burden of proving the reasonableness of it if the IRS challenges it.

■ **Disqualified Persons.** The intermediate sanctions only apply to transactions between the organization and individuals who are referred to as "disqualified persons." A disqualified person is anyone who was in a position to exercise substantial influence over the organization during the five-year period before the transaction in question. Examples of disqualified persons include voting members of the board, the president, chief executive officer, chief operating officer, the treasurer, the chief financial officer, and other persons who have substantial influence over the affairs of the organization. An employee who receives less than \$110,000 in total compensation during the 2011 tax year (this number is indexed for inflation and adjusted annually) generally will not be considered a disqualified person if the employee is not a voting member of the board or one of the officers named earlier. There are related-party rules which can cause someone otherwise not considered to be a disqualified person to be treated as one because of family membership or beneficial ownership interests.

This is only a brief summary of the intermediate sanctions. These rules are quite complex. For a more detailed discussion, the IRS has published a guide available on its website.⁴ Consultation with an attorney and/or accountant is also advised.

Form 990 Required Disclosures

The IRS requires tax-exempt organizations to make numerous disclosures on Form 990 concerning transactions with insiders and related organizations.⁵ The definitions, contained in the instructions to Form 990, are often quite complicated and therefore require careful reading. Even if an accountant prepares the Form 990, the persons reviewing and signing the form should speak to the accountant to ensure an understanding of the required disclosures.

Form 990 also requires responses to questions concerning whether the tax-exempt organization has a written conflict of interest policy, whether it requires annual disclosures of conflicts, and whether it monitors and enforces compliance with the policy.⁶

Federal Grant Requirements

Procurement Regulations

The rules governing the use of federal grant funds to buy goods and services look unfavorably upon conflicts of interest. The existence of a conflict could result in the denial of a reimbursement request or a claim for repayment of funds already advanced. It could also result in termination or non-renewal of the grant and audit or monitoring findings. OMB Circular A-110, the grant administration standards for nonprofit recipients of federal grant funds, requires grantees to "maintain written standards of conduct governing the performance of its employees engaged in the award and administration of contracts."⁷

Since all CAAs are subject to this regulation as recipients of federal Community Services Block Grant funds, they should ensure that these standards are followed. In essence, OMB Circular A-110:

- Prohibits employees and officers from participating in the selection, award, or administration of a procurement contract funded by federal grant funds if they have a real or apparent conflict of interest; and
- Defines "conflict of interest" to mean whenever:
 - an employee or officer;
 - a member of his or her immediate family;
 - his or her partner; or
 - An organization that employs or is about to employ any of the parties described above has a financial or other interest in the firm selected for an award.

In addition, OMB Circular A-110 prohibits gifts from vendors other than those of insignificant value. Grantees are permitted to set standards for situations in which the financial interest is not substantial or the gift is an unsolicited item of nominal value.

To ensure that these standards are followed, they should be included in a personnel policy handbook and employees, particularly those who have a role in selecting vendors and administering vendor contracts, should receive training on them. The Circular also requires the standards of conduct to provide for disciplinary actions to be applied for violations of such standards.

The standards of conduct shall provide for disciplinary actions to be applied for violations of such standards by officers, employees, or agents of the recipient.

One recommended step, in addition to having such employees complete and sign annual conflict of interest disclosure forms, is to include a question or certification on vendor bidding or selection documents and/or contracts to the effect that they do not have a prohibited conflict of interest, as defined by the definition above, and have not and will not in the future offer gifts to employees or officers.

Professional Service Providers

No federal grant funds may be used by grantees to pay for professional services provided by officers or employees of the grantee.⁸ For example, a grantee may not use federal grant funds to pay attorneys fees to its Head Start director, who happens to be a lawyer, for advice in connection with a real estate transaction. Nor may the grantee use federal grant funds to pay the volunteer president of the board of directors, also an attorney, for such advice.

The Head Start Act

The 2007 amendments to the Head Start Act imposed very stringent conflict of interest restrictions on members of the governing board and the policy council. The Act now both generally prohibits board members from having financial conflicts of interest with the grantee and bans certain specific conflicts related to employment and compensation.⁹ Unlike other laws' conflict of interest provisions, it does not permit a prohibited conflict situation with a board member to be validated through a process of disclosure and approval by other board members.¹⁰ Some people might draw the wrong conclusion: that the organization needs a one sentence conflict of interest policy prohibiting all conflicts of interest. This is an overly simplistic approach. Like other CAAs, a CAA with a Head Start program requires a comprehensive conflict of interest policy.

The Act contains the following conflict of interest provisions:

- **Financial Conflicts.** Board members may not have “financial conflicts of interest” with the grantee or a delegate agency. There is no provision for a process to approve the transaction if it is in fact in the best interest of the grantee to engage in the transaction; it is just outright prohibited. In other words, if a grantee finds itself wanting to do business with a board member, it has only two choices: ask the board member to resign, or don't do business with him/her. The Act does not define the term “financial conflict of interest,” and the Office of Head Start has not adopted any regulations on this issue. Although the Office of Head Start has posted a Policy Clarification on the conflicts of interest provision generally, it really does not provide any clarification on the definition of financial conflicts.¹¹ Thus, the grantee needs to define the term for itself. This is not a difficult determination when the grantee is doing business directly with a board member. The phrase clearly contemplates sales and exchanges of goods, services, and property; loans and other extensions of credit, and leases.

The provision does not explicitly address, however, whether the ban applies to just direct conflicts with the board member, or also includes indirect conflicts, such as a transaction with the board member's spouse, an entity owned by a board member, or an entity that employs the board member. CAPLAW recommends that the grantee's written conflict of interest policy define the term and that the coverage and the scope of the coverage be determined by the extent of the potential influence of the financial interest on the board member.

- For example, one could reasonably assume a board member who is the sole owner of a corporation that operates a small plumbing business from whom the grantee wants to purchase services is likely to have a material financial interest in the grantee engaging in that transaction. Therefore, that type of conflict (100 percent ownership) would likely be considered a prohibited financial conflict of interest under the Head Start Act, even though the transaction is with the corporation and not the board member directly.
- But is a grantee prohibited from acquiring office supplies from a company that is one percent, five percent, or twenty percent owned by a board member? The IRS's intermediate sanctions set the threshold at 35 percent. Other standards, such as those of the Financial Accounting Standards Board, would look to the extent of control by the board member over the decision of the grantee, rather than a set percentage of ownership.¹² Other factors may be the dollar amount of the transaction or the portion it represents of the total revenue of the business. The sample conflict of interest policy for board members of CAAs with Head Start programs included in Appendix C in the online version of this toolkit (available at www.capl原因.org) sets the materiality threshold at 5 percent of ownership of the business, but also includes a catch-all statement that covers any situation where the board member has a material financial incentive to engage in the transaction, such as receiving a commission based on the sale or a bonus tied to the business with the grantee.
- Clearly, defining a “financial conflict of interest” is more of an art than a science, but a good faith effort to define the term in the policy, using reasonable criteria and common sense, should go a long way toward staying out of trouble on that issue. The Office of Head Start has said this about addressing conflicts:

OHS suggests that Head Start agencies faced with a conflict of interest situation should examine the facts, analyze the issues, and make a determination about how the situation will be handled. The agency is advised to make a record of the conflict of interest situation, how it was resolved, and why it was resolved in a particular way.¹³

- When in doubt, consult legal counsel and/or run the transaction past the Office of Head Start.

CASE SCENARIO:

DUALITIES OF INTEREST— LOW-INCOME MEMBER OF THE BOARD

Larry Hartford is a member of the BCA's board of directors. He holds one of the board positions allocated to low-income community members. Due to cutbacks in federal funding, BCA's board is considering whether to eliminate a program with high overhead costs that are ineligible for reimbursement under a federal grant. Hartford is troubled by this idea, but he recognizes the problem that BCA faces. He has heard from many members of the low-income community who have urged him to fight for the program. He has lost much sleep over this decision. As a representative of the community, he would like his vote to reflect the community's concerns and desires, but he also doesn't want to place BCA in financial jeopardy.

LESSON: The law provides little guidance to people facing Hartford's predicament. As a board member representing an important constituency, Hartford certainly should give voice to the interests of the low-income community. However, as a board member, Hartford has a duty to act in BCA's best interests. Hartford must try to reconcile what are conflicting interests or perspectives. State law probably provides him with some degree to latitude, but many corporate law experts would likely agree that Hartford should not focus just on the desires of his low-income constituency when casting his vote.

- **Receipt of Compensation.** Board members cannot receive compensation for service as members of the board or for providing services to the grantee.

Although a member of the governing board cannot receive compensation for service as a board member, OHS does permit the grantee to establish policies and procedures to reimburse board members for reasonable costs actually incurred by members, such as transportation and child care expenses, if associated with participation in board and committee meetings. Reimbursement may be limited to low-income board members.¹⁴

- **Employment-Related Conflicts.** Neither board members nor members of their immediate family may be employees of the grantee, whether in Head Start or elsewhere in the organization. A person's immediate family includes the person's "spouse, parents and grandparents, children and grandchildren, brothers and sisters, mother-in-law and father-in-law, brothers-in-law and sisters-in-law, daughters-in-law and sons-in-law, and adopted and step family members."¹⁵

- **Operating As an Independent Entity.** The board must operate as an entity independent of grantee staff.¹⁶

- **Head Start Policy Councils.** Policy Council members may not have a conflict of interest with the Head Start grantee or any delegate agency. This prohibition is broader than the one that applies to board members as it applies to all conflicts, not just financial conflicts.¹⁷ In addition, Policy Council members cannot receive compensation for serving on the Policy Council or for providing services to the grantee.

HUD Programs

Some U.S. Department of Housing and Urban Development grant programs from which CAAs may receive funding also face significant additional conflict of interest restrictions. These rules limit the ability of individuals who have a role in an entity receiving direct grant funding from HUD to also serve a role at the entity serving as a subgrantee of the HUD funding. For example, a member of the city council of the locality receiving Community Development Block Grant (CDBG) funds may not also serve on the board of a CAA receiving CDBG funds from the city, assuming she exercises any functions or responsibilities regarding CSBG activities or votes, or could vote, or could gain inside information on who receives CDBG funds from the city. The reason is that would violate the HUD rule that:

No person who is an employee, agent, consultant, officer, or elected official or appointed official of the grantee, or of any designated public agencies, or of subgrantees, who exercises or has exercised any functions or responsibilities with respect to CDBG activities, or who is in a position to participate in a decisionmaking process or gain inside information with regard to such activities, may obtain a financial interest or benefit from a CDBG-assisted activity, or have a financial interest in any ... agreement with respect to a CDBG-assisted activity, or with respect to the proceeds of the CDBG-assisted activity, either for themselves or those with whom they have business or immediate family ties, during their tenure or for one year thereafter.¹⁸

Although not every HUD office or program necessarily interprets this rule in the same way, and the extent of a local official's involvement in the HUD programs may vary, the conflict issues raised by these HUD regulations should be considered when selecting CAA board members and/or applying for certain HUD funds, such as CDBG, the HOME program and the Emergency Shelter Grant program. One possible solution for CAA public sector board members is for the public official to appoint a representative (preferably someone who is not a public employee) who serves as the CAA board member, rather than the public official himself. Another possible resolution is to seek a waiver of the provision from HUD, which the rules permit under certain circumstances.

State or Local Conflict of Interest Rules

Some states and localities have their own conflict of interest restrictions on the ability of public officials to serve on boards of entities that receive funding from them if those public officials have a role in the selection of the funding recipients or the administration of the grants or contracts. Even if such board service is not prohibited, the public official may be required to recuse himself from taking part in discussions or votes on those matters, be it in the CAA and/or in the government. Speak to the elected official and a knowledgeable attorney to avoid problems in this area.

In addition, some states and localities have their own conflict of interest rules that apply to nonprofit organizations and other entities that receive government funding. These rules may be included in state laws and/or in funding contracts. Review your contracts carefully to ensure compliance with these rules in drafting the conflict of interest policy and engaging in any transactions with insiders.

Financial Accounting Systems Board (FASB)

Auditors follow FASB standards, which require that material "related party transactions" be disclosed in financial statements.¹⁹ States and other jurisdictions may also incorporate those standards into their rules. For example, Massachusetts generally limits the amounts paid in related party transactions (as defined by FASB) that are funded through contracts with the state to the lower of cost or fair market value.²⁰ FASB's definition of a "related party transaction" focuses on the control or influence that the organization insider or family member has over the other party with whom the organization is doing business. For example, a related party transaction includes transactions by a nonprofit with:

- Family members of the nonprofit's management who might control or influence a member of management; and
- Entities in which a person whose influence over the nonprofit is so significant that one or more of the transacting parties might be prevented from fully pursuing its own separate interests, has an ownership interest.

CASE SCENARIO: LOAN FROM A BANK

Muriel Litwin is the president of the Ten Spot Community Bank and she serves on BCA's board. BCA has been looking for a bank to provide a revolving line of credit to finance its working capital needs. Litwin proposes a loan at ½ percentage point below prevailing market rate for comparable organizations. BCA's board views this as a win-win situation because it reduces BCA's financing costs and helps Ten Spot satisfy certain community lending requirements imposed by state law. Assume BCA does not operate a Head Start program.

At the time Ten Spot and BCA put the credit facility into place, BCA was financially sound, but during the last two years, BCA's creditworthiness has significantly deteriorated. Its outside law firm and CFO have determined that bankruptcy may be the only hope of keeping BCA's doors open.

BCA's finance committee is scheduled to meet today to hear a presentation from the CFO and BCA's law firm about BCA's deteriorating financial condition and plan for bankruptcy. Litwin is a member of the finance committee and will be in attendance.

LESSON: When an organization borrows money, both the organization and the lender expect that the loan will be repaid. Given those expectations, a loan like the one from Ten Spot to BCA looks like a good deal for both sides. Circumstances sometimes change, with the result that what seemed to be a good idea ends up highlighting serious conflicts of interest for those involved.

Litwin owes both BCA and her employer duties of loyalty. What is Litwin supposed to do with what she learns during finance committee's meeting? On the one hand, she can keep her employer in the dark, respecting BCA's desire to position itself in the best position vis-à-vis Ten Spot. That means that Litwin is ignoring her duty to Ten Spot and its shareholders. Or, Litwin can inform Ten Spot of the problems and the likely bankruptcy, which could thwart BCA's efforts to place itself in the best position possible vis-à-vis its lender. That course may honor Litwin's duty to Ten Spot, but it clearly violates her duty to act in BCA's best interests.

Despite the obvious potential problems this sort of loan poses, there will be organizations and financial institutions that ignore them. In such cases, everyone should agree upfront about how the banker/board member will act should problems arise.

Endnotes

1. The intermediate sanctions also apply to Section(c)(4) organizations (social welfare).
2. 26 U.S.C. 4958.
3. 26 C.F.R. 53.4958.
4. <http://www.irs.gov/pub/irs-tege/eotopicho2.pdf>
5. Form 990, Part IV, and Schedules L and R.
6. Form 990, Part VI.
7. 2 C.F.R. 215.42
8. 2 C.F.R. Part 230, App. B __.37. (nonprofit grantees) and 2 C.F.R. Part 225, App. B __.32.
9. 42 U.S.C. 9837(c)(1)(C).
10. However, in Policy Clarification OHS-PC-E-029, which is only guidance and not binding authority, the Office of Head Start (OHS) said that in situations where there is a potential personal conflict of interest (as opposed to a financial conflict of interest of the board member) that is not otherwise expressly prohibited by the language in the Act, the conflict may be resolved through the exclusion of the board member from discussion and voting on the matter.
11. OHS PC-09-E-029. OHS Policy Clarifications are available on the Early Childhood Learning and Knowledge Center (ECLKC) website (<http://eclkc.ohs.acf.hhs.gov/hslc>).
12. FASB Accounting Standards Codification 850.
13. OHS-PC-E-029. Policy Clarifications are not binding law and are subject to change. They are useful for providing insight into OHS's thinking at the time the clarification is issued. As they are sometimes revised on or deleted from the website, CAPLAW recommends printing them out if a grantee intends to rely on them inc case a question is raised at a later point.
14. OHS-PC-E-030.
15. OHS-PC-E-029.
16. 42 U.S.C. 9837(c)(1)(C)(iv).
17. 42 U.S.C. 9837(c)(2)(C).
18. 24 C.F.R. 570.611.
19. FASB Accounting Standards Certification 850.
20. 808 C.M.R. 1.05.

