Tools for Top-Notch CAAs

Section 5: Dealing with Conflicts of Interest

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This material is supported by Grant Number 90ET0505-03 from the ACF Office of Community Services, Community Services Block Grant within the Administration for Children and Families, a division of the U.S. Department of Health and Human Services. Neither the Administration for Children and Families nor any of its components operate, control, are responsible for, or necessarily endorse this material (including, without limitation, its content and any services or tools provided). The opinions, findings, conclusions, and recommendations expressed are those of the author(s) and do not necessarily reflect the views of the Administration for Children and Families and the ACF Office of Community Services, Community Services Block Grant.

CAPLAW

A. Overview

A conflict exists whenever circumstances trigger an individual to elevate personal interests over organizational interests. In any conflict of interest scenario, an individual has authority to make or influence decisions affecting an organization, such as a Community Action Agency (CAA), and has a personal or financial incentive to cause the organization to take, or not take, a particular action. Individuals with influence are often referred to as “insiders” and typically include an organization’s officers, board members, key employees, and other persons or entities who have a relationship with the organization. Put simply, an insider is a decisionmaker at a CAA who has a personal interest or stake in and influence over an organization’s decision.

Conflicts are a fact of life. Not all conflicts are objectionable or even defined as a “conflict of interest” by relevant laws or policies.[1] Thus, the process for dealing with potential and actual conflicts is how a CAA will maintain compliance. A conflict of interest policy is the most common mechanism by which an organization addresses and manages conflicts. All CAAs are required to adopt or sign conflict of interest policies. These policies address conflicts of interest at the organization and are informed by different federal and state laws and regulations. For nonprofit CAAs, the Internal Revenue Service (IRS) requires most 501(c) tax-exempt organizations to disclose on the Form 990[2] whether they have a conflict of interest policy and how it is implemented. For CAAs with Head Start and Housing and Urban Development (HUD) programs, the federal funds come with specific conflicts prohibitions. State laws also inform a CAA’s treatment of conflicts, including state nonprofit corporation acts governing nonprofit CAAs and local laws governing public CAAs.

Poorly managed conflicts can lead to negative consequences. State and federal governments are often concerned that conflicts of interest will lead to an organization paying too much for goods or services provided by insiders or paying insiders for unnecessary or inappropriate goods or services, thus diverting funds intended for a public charitable or educational purpose to an insider for private benefit. Funders worry that organizations will hire unqualified relatives of insiders as employees or as contractors, therefore weakening the ability of the organization to carry out its mission and the intended purposes of the funding. Conflicts can also adversely affect employee morale, draw unwanted media attention, and create negative public perceptions that can damage a CAA’s reputation. For these reasons, conflicts can jeopardize both a nonprofit CAA’s tax-exempt status as well as government funding received by both nonprofit and public CAAs by resulting in disallowances of costs that arose from conflicted transactions and were charged to grants and contracts.

B. Examples of Common Conflicts

Common conflicts encountered by CAAs include:

- **Sales of Goods, Services or Property** by a CAA's insiders to the CAA 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 CAA and an insider or related entity. Some state nonprofit laws prohibit or severely restrict loans from a nonprofit to its board members and officers. Examples include a bank that lends money to a CAA when the president of the bank serves on the CAA's board or a CAA that lends money to a newly hired CEO to buy a house.
- **Joint Undertakings** between CAAs and businesses or individuals who have valuable skills and expertise in an effort 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 participate 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 consider the interests of their constituency, each board member must ultimately 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. Doing so helps candidates understand what relationships may rise to the level of a conflict and how a CAA will approach such conflicts. If the conflict is prohibited under the CAA's policy, then the community member has a choice to make—be a board member and lose the relationship (e.g., a business opportunity) or refrain from board service. The bylaws should reflect the CAA's policy that precludes an individual from being elected or seated as a board member if they have a prohibited conflict. This would require the board to have 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, or final board approval through the board seating process. The bylaws should contain a similar provision for board members who find themselves faced with prohibited 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. Each board member owes a duty of loyalty to the CAA which requires the real estate developer to keep the CAA's best interest in mind when acting as a CAA board member. The duty requires the CAA and the real estate developer to assess whether the board member can honor her duty of loyalty to the CAA while simultaneously competing with the CAA for the land.

- **Employment** of the relatives of board members and key employees can raise 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 which prohibits such family favoritism.

- **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 which could improperly influence the finance director to select the vendor's software, even if it is not the best value for the CAA.

CASE SCENARIO #1

Dualities of Interest - Public Sector Member of the Board

Director of City Grants Warren Yatzke serves as a public sector member of Blue Community Action (BCA's) tripartite board as the mayor's designee. Yatzke is not excited about serving on BCA's board. He finds the organization to be poorly run and inefficient. He repeatedly tries to correct the inefficiencies but meets 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 feel that 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 he believes is YCW. In situations like this, everyone should agree in advance about the protocol for dealing with this sort of conflict and adjust their expectations accordingly.

C. 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 prohibited 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 recipient 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. A CAA's conflict of interest policy should describe legally prohibited conflicts and how the board will address them.

- **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. To do so, the parties should follow certain procedures before moving forward with the transaction to ensure transparency and that the transaction is in the CAA's best interest. Certain conflicts, such as some low-income sector board members receiving CAA services, are not only permissible but part of a CAA's mission to serve low-income families.

  State nonprofit corporate law often outlines a procedure that an entity can use to "validate" transactions with conflicts. Following the state-specific provisions may 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 their interactions with the case law, 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 includes three elements:

  1. Notification of conflict
  2. Disclosure of material facts related to conflict
  3. An objective, good faith review prior to moving forward with the otherwise legally permissible transaction

  A CAA should develop similar procedures or prohibitions for transactions involving conflicts of other employees.

CASE SCENARIO #2

The Need for a Robust Policy

BCA has never encountered a conflict of interest. Thus, its conflict of interest policy simply states that the organization should only engage in transactions where a conflict of interest exists if the board votes to approve the transaction. 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 BCA board member, 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 of the proposal.

An investigative reporter for the local news 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 news 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 robust conflict of interest policy. If BCA's policy defined a process for assessing conflicts that included a thorough, objective review by the board, BCA could have avoided the sort of ad hoc decision making that often spells trouble. A robust policy would provide the board with a blueprint to follow in evaluating proposals like the Burke-Watson one. 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.

D. Content of Policies

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. If a transaction is problematic or requires approval if an officer, board member, or employee engages in it, then the transaction is viewed similarly if one of their family members engages in it.

    - *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 averse 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.

- **Responsibility for Implementing the Policy.** Typically, the CAA's board of directors is responsible for adopting the policy. The policy should indicate that it will be disseminated to board members to sign upon joining the board and then at a minimum every two years thereafter. The policy and any disclosure statements should also be reviewed regularly.

- **Conflicts Covered by the Policy.** 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 such as those listed above. 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. This general statement should nevertheless specifically identify certain common transactions and circumstances.

    - *Exclusions of Certain Benefits.* The CAA may want to exclude from the conflicts of interest definition certain services or benefits provided to insiders who are eligible for CAA services. Typically, these services or benefits are not considered a conflict of interest under a CAA's policy, 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 their family members are involved in the decision about whether to provide services/benefits to the insider. The CAA may also exclude from the conflicts of interest definition certain expense reimbursements. Typically, such reimbursements are not considered a conflict of interest under a CAA's policy, provided that (1) the reimbursement is for reasonable, necessary, and documented expenses; (2) the cost was incurred in the course of performing authorized services for the CAA; and (3) the reimbursement is made pursuant to a board-approved expense reimbursement plan.[3]

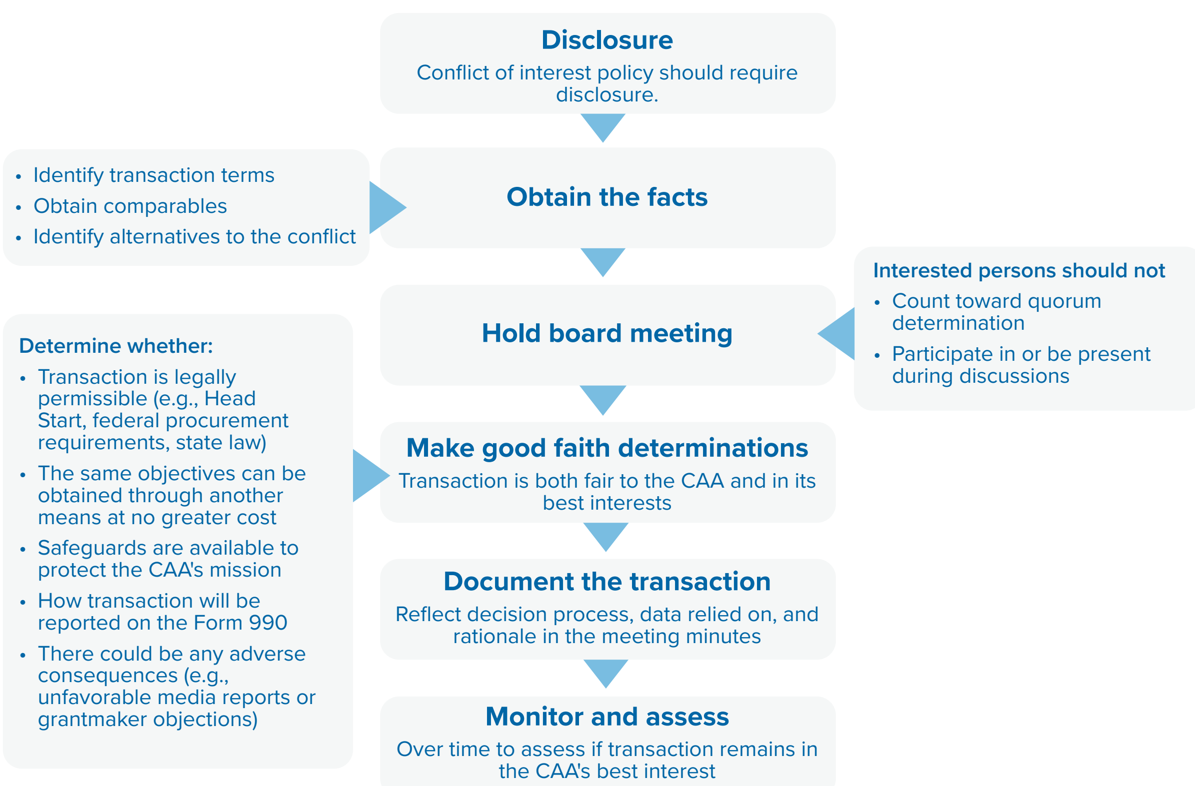
- **Notification.** The policy should require each covered person to disclose any potential or actual conflict involving themselves or others in a timely manner. Receiving a timely notification of potential conflicts is particularly important because early knowledge allows the CAA to prevent a potential 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. The policy may include a form conflict of interest disclosure statement that covered persons can use to disclose the material facts about potential or actual conflicts. The policy should require notification to specified individuals at the CAA who are in a position to address the issue.
    - *Board Members and Officers.* Board members might be asked to notify the board chair or the board's audit committee of any potential conflicts.
    - *Key Employees.* Key employees might be asked to notify the executive director. 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.* Members of the Policy Council might be asked to notify the chairperson of the Policy Council and the Head Start director.
- **Validation Process.** When a CAA is not required by a funder or funding source to strictly prohibit certain conflicts, the CAA is free to choose which conflicts to permit or prohibit. Conflicts that a CAA allows are often referred to as legally permissible conflicts that have undergone a validation process, i.e., a level of review by the organization that protects the organization from improper influences. The review is typically conducted by the board, a board committee, and/or a designated staff member. They must follow the procedures outlined. The Decisionmaker must follow the procedures outlined in the policy before the CAA may enter a transaction that involves such a conflict. While state laws may apply to such procedures, these 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 the conflicted party is a board member, they should not be present for the board vote or counted towards 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 transaction themselves.

- *Satisfy Tax Law Requirements*. The board should conduct the validation process in a way that allows the CAA to rely on a rebuttable presumption, which is a legal assumption that the court will believe is true until evidence is presented to the contrary. The rebuttable presumption establishes the assumption that the transaction is reasonable pursuant to Section 4958 of the Internal Revenue Code—this provision is referred to as "intermediate sanctions." More information about intermediate sanctions see discussion below in **G. Federal Tax Law**.

  To establish a rebuttable presumption, an independent board must make a decision about the conflict transaction that is supported by (i) appraisals or other evidence demonstrating that the transaction's pricing reflects fair market value (or a bargain to the CAA) and (ii) a contemporaneous written record that lists the comparables or bidding process that the board relied on and describes the basis for the decision.



- **Sanctions.** The policy should define the consequences if someone violates it; board members and employees are more likely to take the policy seriously if violations carry consequences.
    - *Employees.* A CAA's employee handbook should include the sanctions an employee will face for conflict of interest violations. The CAA should follow its established procedures for adverse employment actions, including termination.
    - *Board Members.* The bylaws or a board approved policy should include the sanctions a board member will face for conflict of interest violations. Such sanctions typically consist of removal for cause or without cause and an option to resign from the board. State nonprofit corporation laws may make removing board members who are appointed to the board by third parties difficult because the appointor (i.e., the third party) retains the authority to remove the appointed member. However, if the board votes to seat all members, then the board is likely to maintain its authority to remove all board members, including those appointed by third parties.

E. Form of Policies

People often speak of a conflict of interest policy without giving much thought to its physical form. Some organizations have one written document, which while simple and convenient, may not be the best way to communicate the policy to different audiences. While the concepts and procedures in separate policies are often largely the same regardless of the covered person, the roles that each audience plays within the organization varies such that a combined policy may cause unnecessary confusion. For example, board members are usually only involved in procurement decisions that either meet a specified dollar threshold or create certain liabilities for the organization. Conversely, the dollar thresholds that apply to procurement decisions by senior staff are lower and occur more regularly as part of the daily operations of an organization. CAAs may thus consider having different conflict of interest policies for different groups of covered persons, which may include:

- **Board Members.** The CAA should distribute the conflict of interest 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 a conflict of interest policy distributed to officers (including board members who are officers) and key employees. This policy looks 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.

F. Conflicts Questionnaires and Disclosures

A questionnaire that asks the board to disclose potential and actual conflicts of interest serves as a helpful reminder to covered persons that the CAA has a conflict of interest policy and that compliance with it is both important and expected. A questionnaire can also help a CAA meet specific conflict of interest obligations. For example, nonprofit, tax-exempt CAAs must disclose to the IRS in the Form 990 certain related party transactions and relationships among board members. The disclosure requirements are complex, but the instructions to the Form 990 permit an organization to rely on an annual questionnaire in fulfilling the disclosure requirements. Auditors also typically require disclosure of related party transactions.

CASE SCENARIO #3

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 in a letter:

> *Despite all the conflicts I noticed and how others were getting rich at the expense of BCA there still remains the question of myself. 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.*[4]

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.

G. Federal Tax Law

Intermediate Sanctions

Intermediate sanctions are a comprehensive set of federal tax rules designed to prevent "sweetheart deals." The sanctions apply to transactions between Internal Revenue Code Section 501(c)(3) charities[5] and insiders, including compensation agreements, and ensure these transactions reflect market values. Intermediate sanctions permit the parties to a transaction to remedy any excess of the fair market value that an insider receives.[6] Before the enactment of 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 intermediate sanctions require the beneficiary of an excess transaction 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 is an insider.

- **The Rebuttable Presumption.** The centerpiece of the intermediate sanctions is a rebuttable presumption that a transaction is reasonable if the charity adheres to certain procedures before entering into the transaction.[7] 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 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 the required 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.** 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 $160,000 in total compensation during the 2026 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.[8] 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.

For a more detailed discussion of the complex law of intermediate sanctions, see the IRS guide available on its website.

Form 990 Required Disclosures

Tax-exempt nonprofit organizations are required to file the Form 990 annually to provide the IRS and the public with certain information about their programs, finances and operations. The Form 990 requires nonprofits to make numerous disclosures, including those concerning transactions with insiders and related organizations.[9] It also requires a nonprofit to answer whether it has a written conflict of interest policy, whether it requires annual disclosures of conflicts, and whether it monitors and enforces compliance with the policy. The definitions contained in the instructions to Form 990 are often quite complicated and require careful reading and possible consultation with an accountant or tax attorney.

H. Federal Grant Requirements

Procurement Regulations

Rules governing the use of federal grant funds to buy goods and services look unfavorably upon conflicts of interest. The Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards (Uniform Guidance) requires recipients or subrecipients of federal awards to maintain written standards of conduct covering conflicts of interest and governing the actions of its employees engaged in procurement. Individuals with real or apparent conflicts of interest are prohibited from participating in the selection, award, or administration of a contract supported by a federal award.[10] The Uniform Guidance also prohibits gifts from vendors other than those of insignificant value and requires disciplinary actions for violations of the standards. A conflict in violation of the Uniform Guidance could result in temporarily withheld payments, disallowed costs, or suspension or termination of a federal award.

A CAA may include the Uniform Guidance procurement standards in a conflict of interest policy specific to covered employees or a personnel policy handbook. Employees, particularly those who have a role in selecting vendors and administering vendor contracts, should receive training on the standards. A CAA may set thresholds for situations where the financial interest is not substantial or a gift is an unsolicited item of nominal value.[11] Often CAAs will have covered employees complete and sign annual conflict of interest disclosure forms. CAAs should include questions or certifications in the form that ask about vendor bidding or selection documents and/or contracts as well as gifts to employees or officers.

The Uniform Guidance also requires written standards of conduct covering organizational conflicts of interest if the recipient or subrecipient has a parent, affiliate, or subsidiary organization other than a unit of government or tribe. Organizational conflicts mean that because of relationships with a parent company, affiliate, or subsidiary organization, the CAA is unable to, or appears unable to be, impartial in conducting a procurement action.[12]

Professional Service Providers

No federal grant funds may be used to pay officers or employees of a CAA, outside of their approved salary and benefits, for any professional or consulting services provided to the CAA.[13] For example, a recipient 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 recipient use federal grant funds to pay the volunteer president of the board of directors, also an attorney, for such advice.

Community Services Block Grant (CSBG)

The federal CSBG Act does not include conflict of interest requirements. Rather, CSBG Organizational Standard 5.6 requires every governing board member of a nonprofit CAA to sign a conflict of interest policy within the past two years. Advisory board members of a public CAA must sign a conflict of interest policy or comparable government document within the past two years.[14]

CASE SCENARIO #4

Dualities of Interest – Low-Income Sector Member of the Board

Juliette Hartford is a member of BCA's board of directors. She holds one of the board positions allocated to representatives of the low-income community. 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 she recognizes the problem that BCA faces. She has heard from many members of the low-income community who have urged her to fight for the program. She has lost much sleep over this decision. While she would like her vote to reflect the community's concerns and desires, she 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 conflicting interests or perspectives. Many corporate law experts would likely agree that Hartford should not focus just on the desires of her low-income constituency when casting her vote.

Head Start

The Head Start Act imposes stringent conflict of interest restrictions on members of the governing board and the Policy Council. The Act generally prohibits board members from having financial conflicts of interest with the recipient and bans certain specific conflicts related to employment and compensation.[15] CAAs with a Head Start program require a comprehensive conflict of interest policy to address these specifics of the Act.

The Act contains the following conflict of interest provisions:

- **Financial Conflicts.** Board members may not have "financial conflicts of interest" with the recipient or a delegate agency.[16] The Act prohibits such conflicts outright, with no option for a process for other, independent board members to approve the transaction if it is in the best interest of the recipient. In other words, if a recipient wants to do business with a board member, it has only two choices: ask the board member to resign, or don't do business with them.

  The Act does not define the term "financial conflict of interest," and the Office of Head Start (OHS) has not adopted any regulations or guidance that defines it. A recipient must define the term for itself in its conflict of interest policy. The definition should address the scope of the policy's coverage which will be informed by the extent of the potential influence of a financial interest on a board member. The definitions should address direct as well as indirect conflicts, such as a transaction with a board member's spouse, an entity owned by a board member, or an entity that employs the board member. Including examples of prohibited financial conflicts of interest can provide helpful clarification to any definition in the policy.

  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 recipient wants to purchase services is likely to have a material financial interest in the recipient 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.

A CAA may also look to other non-Head Start laws and guidance to inform the percentages of board member ownership – one percent, five percent, or twenty percent – that may rise to the level of a prohibited financial conflict of interest. The IRS's intermediate sanctions set the threshold at 35 percent. Other standards, such as those of the Financial Accounting Standards Board (FASB), look to the extent of control by the board member over the decision of the recipient, rather than a set percentage of ownership.[17] Other factors may include the dollar amount of the transaction or the portion it represents of the total revenue of the business. CAPLAW's *Sample Conflict of Interest Policy for Board Members of CAAs* with Head Start 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 recipient.

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 to helping Head Start agencies examine the facts, analyze the issues, and make a determination about how to handle conflict situations. Head Start agencies should make a record of conflict of interest situations, including how and why they were resolved. When in doubt, consult legal counsel and/or run the transaction past OHS.

- **Receipt of Compensation.** Board members cannot receive compensation for service as members of the board or for providing services to the recipient.[18] Although a member of the governing board cannot receive compensation for service as a board member, OHS permits the recipient 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 at the discretion of the CAA.[19]

- **Employment-Related Conflicts.** A recipient may not employ board members and members of their immediate family in the Head Start program or elsewhere in the organization.[20] A person's immediate family often 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.[21]

- **Operating as an Independent Entity.** The board must operate as an entity independent of recipient staff.[22]

- **Head Start Policy Councils.** Policy Council members may not have a conflict of interest with the Head Start recipient or any delegate agency.[23] This prohibition is broader than the one that applies to board members as it applies to all conflicts, not just financial conflicts. In addition, Policy Council members cannot receive compensation for serving on the Policy Council or for providing services to the recipient.[24]

HUD Programs

Some U.S. Department of Housing and Urban Development (HUD) grant programs from which CAAs may receive funding also face significant conflict of interest restrictions. These rules often limit the ability of individuals who have a role in an entity receiving direct funding from HUD from also serving in a role at a subrecipient of the HUD funding.

For example, a Community Development Block Grant (CDBG) rule prohibits covered persons who exercise or have exercised any functions or responsibilities with respect to CDBG activities, or who are in a position to participate in a decision-making process or gain inside information with regard to such activities, from obtaining a financial interest or benefit from a CDBG-assisted activity. A covered person, their immediate family members, and those with whom they conduct business may not have a financial interest in any contract, subcontract, or agreement with respect to CDBG-assisted activities during the covered person's tenure or for one year thereafter. Covered persons include any person who is an employee, agent, consultant, officer, or elected official or appointed official of either the recipient, any designated public agencies, or subrecipients receiving CDBG funds.[25]

A CAA board should consider the HUD conflict of interest rules when selecting board members if the CAA is a HUD recipient and/or when applying for certain HUD funds, such as CDBG, the HOME program, and the Emergency Shelter Grant program. For CAAs navigating HUD rules, like the one applicable to CDBG, a possible solution for public officials who serve in the public sector of the tripartite board is to appoint a representative (preferably someone who is not a public employee) to serve as the board member, rather than the public official themselves serving. Another possible resolution is to seek an exception, which the rules permit under certain circumstances.[26]

I. State, Local and Accounting Rules

State and Local Governments

Some states and localities have their own conflict of interest restrictions that impact 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 herself from taking part in discussions or votes on those matters, be it while acting on behalf of the CAA or on behalf of the government.

A CAA should carefully review its contracts with state and local governments to maintain compliance with conflict of interest rules that are specific or unique to that government entity and incorporate those requirements in the CAA's conflict of interest policies. CAAs should also consult with an attorney knowledgeable about state and local government conflict of interest rules to maintain compliance in this area.

Accounting Standards

Auditors follow Financial Accounting Standards Board (FASB) accounting standards, which require that material "related party transactions" be disclosed in financial statements.[27] States and other jurisdictions may also incorporate those standards into their rules. For example, in Massachusetts, costs associated with related party transactions funded through contracts with the state are reimbursable only to the extent that the costs do not exceed the lower of the actual cost or the market price.[28]

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.

CASE SCENARIO #5

Loan from a Bank

Jenny Litwin is the president of the Ten Spot Community Bank and she serves on BCA's board. BCA is 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 significantly deteriorated. Its outside law firm and CFO 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 the 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. In such cases, everyone should agree upfront about how the banker/board member will act should problems arise. BCA could have required Litwin to recuse herself from all discussions and votes relating to the loan transaction – from the very beginning through now and beyond. Most state nonprofit corporation laws would likely have required this recusal for the transaction to be considered permissible.

End Notes

[1] CSBG Organizational Standard 5.6 requires each governing board member of a nonprofit CAA to sign a conflicts of interest policy within the past two years and each advisory board member of a public CAA to sign a conflict of interest policy or comparable government document within the past two years.

[2] The Form 990 is the annual informational return that the IRS requires most organizations exempt from federal taxes to file to report on the organization's activities, governance and finances.

[3] See 26 C.F.R. 53.4958-4(4)(v)

[4] 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.

[5] The intermediate sanctions also apply to Section (c)(4) organizations (social welfare).

[6] 26 U.S.C. § 4958

[7] 26 C.F.R. 53.4958

[8] 26 C.F.R .53.4958-3(d)(3); https://www.irs.gov/retirement-plans/cola-increases-for-dollar-limitations-on-benefits-and-contributions

[9] Form 990, Part VI, Question 12

[10] 2 C.F.R. 200.318(c)(1)

[11] 2 C.F.R. 200.318(c)(1)

[12] 2 C.F.R. 200.318(c)(2)

[13] 2 C.F.R. 200.459

[14] Federal Office of Community Services (OCS) Information Memorandum (IM) 138. The CSBG Organizational Standards set forth in IM 138 were subsequently adopted by state CSBG offices.

[15] 42 U.S.C. § 9837(c)(1)(C)

[16] 42 U.S.C. § 9837(c)(1)(C)(i)

[17] FASB Accounting Standards Codification 850

[18] 42 U.S.C. § 9837(c)(1)(C)(ii)

[19] 2 C.F.R. 200.476 of the Uniform Guidance applies to Head Start funding and absent OHS regulations and guidance serves as the rule that informs the allowability of board member expenses. Section 200.476 establishes that travel and subsistence costs of directors (i.e., board members) are allowable.

[20] 42 U.S.C. § 9837(c)(1)(C)(iii)

[21] This list of individuals originated from guidance issued by OHS in the form of a policy clarification, OHS-PC-E-029, which was removed as of September 2017. Other requirements such as the IRS intermediate sanction rules offer helpful guidance as to who may be considered an immediate family member for purposes of assessing potential and actual conflicts of interest, see 26 C.F.R. 53.4951-3(b). CAAs could define the term to be more inclusive of other family members (by, for example, including domestic partner or stepparents in the definition). CAPLAW does not recommend making the definition less inclusive by removing family members from the definition.

[22] 42 U.S.C. § 9837(c)(1)(C)(iv)

[23] 42 U.S.C. § 9837(c)(2)(C)(i)

[24] 42 U.S.C. § 9837(c)(2)(C)(ii)

[25] 24 C.F.R. 570.611(b)

[26] 24 C.F.R. 570.611(d)

[27] FASB Accounting Standards Codification 850

[28] 808 C.M.R. 1.05(8)