



Conflicts of Interest at Foundations

AVOIDING THE BAD AND MANAGING THE GOOD



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The self-dealing rules absolutely prohibit most transactions between foundations and their board members and foundation managers (and certain family members and affiliated companies), without regard to whether the transactions are fair – or even advantageous – to the foundations.

Foundations seek active and engaged individuals to serve on their boards because they bring expertise, talents, and a commitment to the communities served by the foundation. Such individuals often face challenges in carrying out their board responsibilities; the number and breadth of associations they have make it likely that they will face situations that involve multiple loyalties. Making unbiased, independent decisions on behalf of a foundation can be difficult when a colleague, a friend, a family member, or a business relationship may be affected by, or benefit from, those decisions.

Multiple loyalties can create conflicts of interest. In private foundations, conflicts of interest occur when the financial or personal interests of board members or foundation managers are, or may appear to be, inconsistent with the interests of the foundation.

These situations arise, for example, when a foundation wants to hire a board member's company to provide investment advice, lease space in an office building owned by the family of a board member, or increase board compensation for the first time in many years.

In some cases, conflict-of-interest transactions violate the law; in other situations, they work to a foundation's advantage. Regardless of intention or result, however, foundations, their boards, and their managers must act very carefully when dealing with transactions that are, or may appear to be, inconsistent with a foundation's interest for the following reasons.

First, conflict-of-interest transactions can create substantial legal liability, especially if they violate the self-dealing prohibitions under the federal tax laws. In those situations, board members and foundation managers can be personally liable because they engaged in the transactions, approved them, or both.

Second, conflicts of interest carry very real risks of negative public perception. As charitable institutions provided with special tax status, foundations are expected to serve the public trust. When they engage in improper transactions – or those that give the appearance of impropriety – the damage can extend beyond their good name and reputation to the charitable sector as a whole.

Lastly, conflicts can compromise the decision-making process, preventing board members and foundation managers from having open and candid discussions and, in some cases, from acting in the best interests of the foundation.

The following discussion will guide board members and foundation managers in defining conflicts of interest, identifying which transactions are absolutely prohibited and which are permissible if properly handled, and developing a conflict-of-interest policy that protects foundations, board members, and foundation managers by taking self interest out of the decision-making process. Additionally, a sample conflict-of-interest policy and disclosure questionnaire for foundations is provided.

For foundations, the bottom line is this: Conflicts of interest should either be avoided or managed in such a way that the foundation and its board and managers are protected from liability or unwelcome publicity. By answering the following five questions and by following the processes recommended in this paper, foundations can minimize legal risks; protect themselves and their board members and foundation managers against bad publicity; and most of all, ensure the integrity of their decision-making process. The five questions are:

1. Is this transaction a conflict of interest or could it be perceived as such by others?
2. Is it prohibited by the self-dealing rules under the Internal Revenue Code?
3. Even if the transaction is not prohibited by the self-dealing rules, is it unfair to the foundation?
i.e., does it improperly benefit another person or organization?
4. Does the transaction create an appearance problem? How would it look on the front page of tomorrow's newspaper or to the foundation's founders?
5. Has the foundation followed its conflict-of-interest policy and documented that fact?

This paper outlines the law and the factors that should be considered when answering these questions. It also includes examples of situations that foundations regularly encounter to offer the reader an opportunity to "test" his or her understanding.

A conflict of interest arises whenever the “financial or personal interests” of a board member or foundation manager are, or appear to be, inconsistent or at odds with the interests of the foundation.

IS THIS A CONFLICT OF INTEREST?

The starting point for managing conflicts of interest is to know when they exist.

A conflict of interest arises whenever the “financial or personal interests” of a board member or foundation manager are, or appear to be, inconsistent or at odds with the interests of the foundation.

Most foundation conflicts of interest arise in the context of proposed transactions with parties that fall in the following general categories:

1. board members and foundation managers
2. family members of board members and foundation managers
3. organizations in which board members, foundation managers, and/or their family members have a significant financial relationship
4. organizations in which a board member, foundation manager, and/or family member is an officer, director, trustee, or employee.

Applying those categories, foundations can find themselves facing conflicts of interest when they propose to take actions such as engaging a board member’s law firm for professional services, hiring the president’s spouse as a program officer, selling foundation property to a board member’s grandchild, or making grants to a charity run by a board member’s child.

Some transactions that involve conflicts of interest are *absolutely prohibited by law*. Those transactions are described in the tax code and are known as the self-dealing prohibitions. Others do not involve activities that are prohibited by the self-dealing rules, but they are conflicts nevertheless and therefore require careful consideration in a process designed to show the fairness and integrity of the decision.

IS THE TRANSACTION PROHIBITED BY THE SELF-DEALING RULES?

The most dangerous conflicts of interest for foundations involve transactions that violate the self-dealing rules of the Internal Revenue Code.¹ These rules prohibit private foundations from engaging in certain transactions (called “acts of self dealing”) with board members, foundation managers, and certain of their family members and affiliated organizations (called “disqualified persons”).

Disqualified persons who engage in acts of self dealing are subject to excise tax penalties and are also required to correct the improper transactions by making payments back to the foundation. Board members and foundation managers who knowingly approve acts of self dealing are also subject to an excise tax. Repeated and willful violations of the self-dealing rules may cause a foundation to lose its tax exemption.

The self-dealing rules absolutely prohibit most transactions between foundations and their board members and foundation managers (and certain family members and affiliated companies), without regard to whether the transactions are fair – or even advantageous – to the foundations.

Some, but not all, of the activities that are prohibited by the self-dealing rules are:

- buying and selling property from or to disqualified persons, even on terms that are favorable to the foundation;
- renting property to disqualified persons, or leasing property from disqualified persons except on a rent-free basis;
- lending money to disqualified persons, or borrowing money from disqualified persons except on an interest-free basis; and
- allowing disqualified persons to use a foundation’s income or assets, except for goods or services that are furnished to them on the same terms as other members of the public.

¹ Section 4941 of the Internal Revenue Code.

² “Disqualified persons” are defined under Section 4946 to include board members, foundation managers, and persons who have made substantial contributions to the foundation (more than the greater of \$5,000 or 2 percent of total contributions); owners of more than 20 percent of a corporation, partnership, or trust that has made substantial contributions; corporations, partnerships, trusts, or estates in which the persons named above own more than a 35 percent interest; and senior government officials. The term also includes family members of the persons named above, but only their spouse, ancestors, and children, grandchildren, great-grandchildren, and their spouses; it does not include siblings, nieces and nephews, aunts and uncles, cousins, or other more distant relatives. The term does not include other Section 501(c)(3) organizations.

It is critical for foundations to take the right steps to ensure that any compensation paid to disqualified persons, including board members and foundation managers, is reasonable.

The self-dealing rules carve out an important exception that allows foundations to pay disqualified persons reasonable compensation for personal services.³ This is by far the most common conflict-of-interest situation for foundations, and it was a hot button for Congressional committees, the IRS, and state attorneys general in 2004 and 2005. It is critical for foundations to take the right steps to ensure that any compensation paid to disqualified persons, including board members and foundation managers, is reasonable.

The Internal Revenue Service has outlined the proper process for determining nonprofit compensation as part of the relatively new intermediate sanctions rules governing public charities. These rules establish three criteria for determining compensation that, if followed, will avoid any conflict of interest and create a presumption that the compensation paid is reasonable.⁴ While these rules do not apply to private foundations, they do provide guidance as to the appropriate compensation approval process.

They are as follows:

1. Compensation decisions should be made by an independent board or an independent committee of the board.
2. The board or board committee should obtain and rely on market data regarding compensation paid by similar organizations for similar services.
3. The board or board committee should contemporaneously document the basis for the compensation decision, including the decision made and the market data relied on to establish reasonableness, in its minutes.

In some cases, it is not possible to follow the first step in this process because there are no independent members of the board. Board members cannot, for example, follow the first step when they set their own compensation. Similarly, family foundations may not have any outside board members who are independent of the family members whose compensation is under consideration. Where the first step cannot be met because there is no disinterested decision-maker, it is even more important for the board to follow the second step – to

obtain and rely on market data showing the reasonableness of the compensation. In some cases, boards may want to consider obtaining an opinion as to reasonableness from an independent compensation consultant. This can be helpful if the foundation is later audited by the Internal Revenue Service. It will also help protect board members from any liability for knowingly paying excessive compensation.

As mentioned above, even if the activity does not violate the prohibition against self dealing, it may be a conflict of interest that carries other risks to the foundation and its board members and foundation managers. As such, it should be flagged and handled properly to prevent liability or adverse publicity.

IS THE TRANSACTION FAIR TO THE FOUNDATION?

Foundations must also be careful not to engage in conflict-of-interest transactions on terms that are unfair to the foundation. This is a separate legal violation – a breach of the fiduciary duties owed to foundations by their board members and foundation managers. As fiduciaries, board members and foundation managers are required to act in the best interest of the foundation and not to engage in transactions that further their own interests at the foundation's expense.

Board members and foundation managers can be personally liable for any damage or loss to the foundation resulting from a breach of their fiduciary duties. Most states have officials in the office of the state attorney general who are charged with taking enforcement action – in some cases including lawsuits seeking money damages – against persons who breach their fiduciary duties to charitable organizations. These state officials have investigative powers similar to the Internal Revenue Service and will actively pursue allegations that board members and/or foundation managers have engaged in conflict-of-interest transactions that take unfair advantage of the foundations to which they owe fiduciary duties.

³ For purposes of the self-dealing rules, the “personal services” exception applies to services of employees who work for a foundation, services of board members, and professional services such as for legal, accounting, investment management, and trustee services.

⁴ Treas. Reg. 53.4958-6(a).

For foundations, the bottom line is this: Conflicts of interest should either be avoided or managed in such a way that the foundation and its board and managers are protected from liability or unwelcome publicity.

DOES THE TRANSACTION CREATE AN APPEARANCE PROBLEM?

Some transactions create an *appearance of a conflict of interest*, risking public perception that can damage the reputation of a foundation or its board and management. To understand the kind of negative impact they can cause, imagine headlines like these:

- Corporate foundation pays for employees to attend charity gala
- Foundation trustees steer contracts to family members
- Local foundation grant funds jobs for children of trustees
- Foundation pays millions in executive retirement.

Even where nothing untoward has occurred, foundations are exposed to headlines like these when they engage in transactions that create an appearance of a conflict of interest. To reduce the risk of negative perception and publicity, foundations should be sensitive to the issue of public perception, factor that into the decision-making process, and follow a conflict-management process such as that described below. For family foundations, issues of public perception may be particularly acute since there may be no independent board members to help counterbalance the perception of family self interest. In some cases, foundations may find it helpful to factor the philosophies of their original founders into their decision-making process, given that a marked deviation from the founders' wishes may itself raise issues of public perception.

Some appearances of conflict may occur because the foundation is involved with a transaction in which a foundation board member or manager is also associated with another organization but is able to act in a manner consistent with the best interests of both organizations. These are transactions that are more properly characterized as *dualities of interest*. Examples include situations in which foundation board members are also trustees of charitable organizations that receive foundation grants or transactions between a foundation and a company that employs a board member or his/her spouse. While the financial or personal interest of the board member in these cases may be negligible, these are the

kinds of transactions that raise questions about whether decisions have been unduly and inappropriately influenced by close relationships. For this reason, foundations should protect themselves by including these transactions within the scope of their conflict-of-interest policies.

HAS THE FOUNDATION FOLLOWED ITS CONFLICT-OF-INTEREST POLICIES AND PROCESSES?

For many foundations, particularly family foundations, conflicts of interest can be unavoidable. To ensure that the foundation, its board, and its managers do not engage in illegal or risky decisions, the board should:

1. Adopt a written conflict-of-interest policy, which includes, at a minimum, the following provisions:
 - a statement of who the policy applies to (typically board members and foundation managers);
 - a definition of what constitutes a conflict of interest (including which family members⁵ and affiliated entities are encompassed within the policy);
 - a requirement that parties covered by the policy disclose any conflict to the board (or a designated board committee) in advance and leave the room during the board's discussion and decision;
 - a prohibition against any attempt by a board member or foundation manager with a conflict to influence the decision (i.e., a board member with a conflict may not lobby other board members);
 - a requirement that the existence and resolution of the conflict be documented in the foundation's records (typically the minutes of the meeting when the transaction was considered); and
 - a requirement that the foundation consult with its tax advisor as appropriate to ensure that the proposed transaction does not constitute an act of self dealing.
2. Require board members and foundation managers to fill out annual disclosure forms that list their affiliations and the names of businesses in which they have a significant

⁵ There is no precise definition as to which family members should be covered in a conflict-of-interest policy. The self-dealing rules are generally considered to be too narrow since they exclude siblings. However, some extended family relationships may be too remote to raise conflict issues. For example, while a proposed transaction between a foundation and a board member's child would constitute a conflict of interest, a transaction involving a distant cousin might not. This is a matter of individual foundation judgment.

ownership interest and, to the extent known, those of family members that are covered by the conflict-of-interest policy.

3. Before approving a proposed conflict-of-interest transaction, make sure that all the requirements of the conflict policy have been followed, including the requirement to obtain market data showing that the proposed transaction is reasonable, and then document the basis for the board's action (including reliance on market data) in the minutes.

Even the most comprehensive conflict-of-interest policy cannot cover every conceivable situation where there might be the appearance of a conflict. Accordingly, conflict-of-interest policies should encourage board members and foundation managers to follow the process outlined above any time there might be the appearance or perception of conflict, even if it is not directly covered by the policy.

CONCLUSION

Conflicts of interest must be handled carefully to ensure good, objective decisions; to preserve the reputation of the foundation, its board, and its managers; and to protect against liability. To do this, 1) answer the questions posed at the start of this paper, 2) enact and follow a conflict-of-interest policy, and 3) make sure the foundation's board and managers understand how to recognize and handle a conflict when one occurs.

There are a number of resources available on this issue. BoardSource, the premier resource for nonprofit governance programs and services, provides information, publications, training, and consulting on nonprofit governance. Additional expertise and resources can be found at the Council of Michigan Foundations, the Forum of Regional Associations of Grantmakers, and the Council on Foundations.

TEST YOUR UNDERSTANDING OF CONFLICTS OF INTEREST

Now it is time to put the principles into practice. The following are several situations that foundations commonly encounter. Read each situation and think about whether the situation a) involves an act of self dealing; b) is a breach of fiduciary duty; c) results in an actual or appearance of conflict that, unless handled properly, could damage a foundation's reputation; d) is all of the above; or e) is none of the above.

Situation 1: Foundation A owns its office building. It has extra space that it leases to a public charity grantee for a below-market rent. One of A's board members is on the board of the charity.

Answer: c) Because the grantee is a charitable organization, the transaction would not be an act of self dealing or a breach of fiduciary duty. It would be treated like an in-kind grant from the foundation to the charity. However, because one of A's board members is on the charity's board, there is a conflict of interest and the transaction should be approved by board members who do not have a conflict.

Situation 2: Foundation B hires a board member's law firm to provide legal services at the firm's normal hourly rates, which are consistent with the rates charged by other law firms in town.

Answer: c) Because the transaction involves the provision of personal services at reasonable rates, it would not be an act of self dealing or a breach of fiduciary duty. However, there is a conflict of interest and the transaction should be approved by board members who do not have a conflict.

Situation 3: Foundation C compensates its board members. One of the board members works for C's law firm, and he bills C at his normal hourly rates for attending board meetings.

Answer: d) Board compensation must be reasonable; the rate of pay should be comparable to what foundations pay board members for board service, not legal service.

Situation 4: Foundation D plans to lease office space from the father of a board member at a below-market rent.

As fiduciaries, board members and foundation managers are required to act in the best interest of the foundation and not to engage in transactions that further their own interests at the foundation's expense.

Answer: a) The parents of board members are disqualified persons, and the lease is an act of self dealing even though the terms are favorable to D.

Situation 5: Foundation E is a family foundation. It makes grants only to public charities that provide social services to low-income persons in the community. Some of E's board members and staff choose to provide volunteer services to its grantees.

Answer: e) The provision of volunteer services does not constitute the type of "financial or personal" interest that raises conflict-of-interest concerns.

Situation 6: Foundation F wants to sell an extra parcel of land. It obtains an appraisal of the value of the land and lists it with a broker. The sibling of a board member is the high bidder.

Answer: c) There is no act of self dealing because siblings of board members are not disqualified persons, and no breach of fiduciary duty because the process ensures a fair purchase price. However, there is a conflict of interest and the decision to sell should be made by board members who do not have a conflict.

RESOURCES

BoardSource

1828 L Street NW, Suite 900
Washington, DC 20016
202.452.6262
www.boardsource.org

Council of Michigan Foundations

P.O. Box 599, One South Harbor Avenue, Suite 3
Grand Haven, MI 49417
616.842.7080
www.cmif.org

Forum of Regional Associations of Grantmakers

1111 19th Street NW, Suite 650
Washington, DC 20036
202.467.1120
www.GivingForum.org

Council on Foundations

1828 L Street, NW
Washington, DC 20036
202.466.6512
www.cof.org

SAMPLE CONFLICT-OF-INTEREST POLICY AND QUESTIONNAIRE

Set forth below is a sample conflict-of-interest policy that may be used by foundations to develop their own policy, or to update an existing policy. The key elements include: 1) a definition of who is subject to the policy (in this case, board members and foundation managers, defined as “Covered Persons”); 2) a list of the transactions subject to the policy (“Covered Transactions”); and 3) the requirements applicable to Covered Persons in the case of proposed Covered Transactions. The latter include disclosing the conflict to the board, refraining from any effort to influence the decision about the Covered Transaction, and leaving the room during the board’s discussion and decision.

Note that the scope of the sample policy is fairly broad. The definition of “family member” includes, for example, stepchildren and in-laws. The definition of entities in which a Covered Person has a “material financial interest” is also quite broad, and includes entities in which a board member, foundation manager, and/or family member has a 10 percent interest. Foundations may choose to vary these definitions to reflect their particular circumstances.

Also attached is a sample disclosure questionnaire to be used in connection with this conflict-of-interest policy.

ABC FOUNDATION CONFLICT-OF-INTEREST POLICY FOR BOARD MEMBERS AND FOUNDATION MANAGERS

The ABC Foundation is a charitable organization whose board members and foundation managers are chosen to serve the public purposes to which it is dedicated. These persons have a duty to conduct the affairs of the Foundation in a manner consistent with such purposes and not to advance their personal interests. This conflict-of-interest policy is intended to permit the Foundation and its board members and foundation managers to identify, evaluate, and address any real, potential, or apparent conflicts of interest that might, in fact or in appearance, call into question their duty of undivided loyalty to the Foundation.

1. Covered Persons

This policy applies to the Foundation’s board members and foundation managers. Each Covered Person shall be required to acknowledge, not less than annually, that he or she has read and is in compliance with this policy.

2. Covered Transactions

This policy applies to transactions between the Foundation and a Covered Person, or between the Foundation and another party with which a Covered Person has a significant relationship. A Covered Person is considered to have a significant relationship with another party if

- a) the other party is a family member, including a spouse, parent, sibling, child, stepchild, grandparent, grandchild, great-grandchild, in-law, or domestic partner;

- b) the other party is an entity in which the Covered Person has a material financial interest. This includes entities in which the Covered Person and all individuals or entities having significant relationships with the Covered Person own, in the aggregate, more than 10 percent; or
- c) the Covered Person is an officer, director, trustee, partner, or employee of the other party.

A Covered Transaction also includes any other transaction in which there may be an actual or perceived conflict of interest, including any transaction in which the interests of a Covered Person may be seen as competing or at odds with the interests of the Foundation.

3. Disclosure, Refrain from Influence, and Recusal

When a Covered Person becomes aware of a proposed Covered Transaction, he or she has a duty to take the following actions:

- a) immediately disclose the existence and circumstances of such Covered Transaction to the Foundation’s board in writing;
- b) refrain from using his or her personal influence to encourage the Foundation to enter into the Covered Transaction; and
- c) physically excuse himself or herself from any discussions regarding the Covered Transaction except to answer questions, including board discussions and decisions on the subject.

In order to assist the Foundation in identifying potential Covered Transactions, each Covered Person annually shall complete a Conflict-of-Interest Questionnaire provided by the Foundation, and shall update such Questionnaire as necessary to reflect changes during the course of the year. Completed Questionnaires shall be available for inspection by any board member, and may be reviewed by the Foundation's legal counsel.

4. Standard for Approval of Covered Transactions

The Foundation may enter into a Covered Transaction where

- a) such Transaction does not constitute an act of self dealing,
- and b) the board determines, acting without the participation or influence of the Covered Person and based on comparable market data, that such transaction is fair and reasonable to the Foundation. The board shall document the basis for this determination in the minutes of the meeting at which the Covered Transaction is considered, and shall consult with the Foundation's legal advisor as necessary to ensure that the Transaction does not constitute an act of self dealing.

5. Administration of Policy

This policy shall be administered by the board, which shall be responsible for the following:

- a) reviewing reports regarding the Conflict-of-Interest Questionnaires;
- b) receiving disclosures of proposed Covered Transactions;
- c) reviewing proposed Covered Transactions to determine whether they meet the above-described standard;
- d) maintaining minutes and such other documentation as may be necessary and appropriate to document its review of Covered Transactions; and
- e) reviewing the operation of this policy and making changes from time to time as it may deem appropriate.

ABC FOUNDATION CONFLICT-OF-INTEREST QUESTIONNAIRE

Name: _____ Date: _____
(please print)

ABC Foundation (“ABC”) requires each board member and foundation manager annually 1) to review the ABC’s Conflict-of-Interest Policy (the “Policy”); 2) to disclose any possible personal, familial, or business relationship that reasonably could give rise to a conflict of interest or the appearance of a conflict of interest; and 3) to acknowledge by his or her signature that he or she is acting in accordance with the letter and spirit of such Policy.

The information provided on this form shall be available for inspection by members of the Board and ABC’s legal counsel, but shall otherwise be held in confidence except when, after consultation with the applicable board member or foundation manager, the Board determines that ABC’s best interest would be served by disclosure.

Please respond to the following questions to the best of your knowledge.⁶

1. Please list all corporations, partnerships, associations or other organizations of which you are an officer, director, trustee, partner, or employee, and describe your affiliation with such entity.

2. Please list all corporations, partnerships, or other entities in which you have a material financial interest as defined in the Policy.

3. Please list all business dealings that you, your family members, and/or entities listed in paragraphs 1–2 above have had with ABC in the past year.

⁶ Use continuation sheets, if needed, to provide more detailed answers to any of the questions.

Name: _____ Date: _____
(please print)

4. Please list any proposed business dealings between ABC and you, your family members, and/or entities listed in paragraphs 1–2 above. Describe each such relationship listed and the actual and potential financial benefits as you can best estimate them.

5. Are you aware of any other relationships, arrangements, transactions, or matters which could create a conflict of interest or the appearance of conflict? If so, please describe.

I have received and read the ABC Foundation Conflict-of-Interest Policy.
I am currently, and agree to remain, in compliance with the Policy.

Signature



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