

Navigating the rapids

How to Handle Conflicts of Interest on the Association Board?

Conflicts of interest may be an inevitable part of service on the board of an association. Unfortunately, how the board handles such conflicts is not. In this, perhaps more than other areas of association management, an ounce of prevention is worth a pound of cure. There are three key areas association directors must master to adequately discharge their legal duties in dealing with conflicts:

- Having an appropriate conflicts disclosure regime;
- Having a clear policy regarding conflicts of interest; and
- Following procedural guidelines when approving matters that involve a conflict.

Directors and executives of associations that follow these simple guidelines will sleep better at night and avoid the embarrassing publicity and potential liability associated with corporate meltdowns. Association boards should spend a reasonable amount of time now establishing or revisiting their own policies before a conflict rears its ugly head or the press calls.

How do you know a conflict when you see one? From a legal standpoint, “[a] conflict of interest is present whenever a director has a material personal interest in a proposed contract or transaction to which the corporation may be a party.”¹ From a practical standpoint, apply the “Times test:” How would you feel if the story was published in the Monday morning edition of the newspaper? If the transaction or agreement involving one of your directors or executives would be embarrassing or hard to explain, then apply the guidelines contained in this article.

A conflict may be financial or non-financial in nature. A conflict may arise directly or indirectly through some other individual or entity with whom the director or executive is associated or affiliated. With the appropriate disclosure regime in place, financial conflicts should be fairly easy to identify. Typically, a director or executive, one of their family members or a business in which they have an interest would benefit monetarily from the proposed transaction. For example:

- One of the directors of your association is also a partner in a public accounting firm that audits the association; or
- An executive’s spouse owns a printing firm that is bidding on the association’s annual report.

Non-financial conflicts can be a little trickier to identify, but it helps if you look for reputational or indirect benefits to a director, executive or family member. For example:

- The association or a related foundation makes a large charitable contribution to a director’s favorite charitable foundation, where she is an active member and director; or
- A full-ride scholarship is granted to a niece or nephew of a director.

These examples are more indirect and intangible than financial conflicts, but probably fail the “Times test.”

How do you install an early conflict warning system? In order to resolve potential conflicts, it’s imperative that the not-for-profit corporation maintain a culture of full disclosure. Disclosure is important for two reasons. First, if the board is unaware of the conflict, it cannot apply the procedural safeguards necessary to ensure the transaction is fair to the corporation. Second, each director has a duty of care to the association which includes a duty to become informed about the material terms of the conflict or potential conflict.

Disclosure should begin when a director or executive agrees to join an association and end when all ties with the association have been severed. In between, the board should require formal disclosure on an annual basis and informal disclosure of any material conflicts or potential conflicts whenever they arise. This is the same type of disclosure regime public companies employ to comply with Securities and Exchange Commission requirements. Typically, the annual disclosure comes in the form of a questionnaire each director and executive must complete and submit to the association’s secretary or counsel. It’s important to make this an annual event since your directors and executives, and their personal and business relationships, will change. It also serves as a reminder of each director’s and executive’s duties with respect to conflicts, a continuing education program if you will.

A sample conflict of interest questionnaire of The Art Institute of Chicago² includes the following basic elements:

- Name and address
- Association with the Institute
- Business and professional activities of the director and his immediate family members
- An affirmation that the director has read the Institute’s conflicts policy
- Disclosure of any conflicts or potential conflicts, including financial interests, collecting, use of Institute services, property or facilities, and privileged information

This is a good basic outline. I also recommend a section requiring disclosure of the compensation, perquisites and benefits received by each director or executive and their immediate family members. Executive compensation is a real hot button these days and should be periodically reviewed to ensure that compensation levels are reasonable and there are no “sweetheart” deals that would fail the “Times test.”

In this area of association management, your #1 goal is to avoid surprises. Therefore, it’s important that the association also require each director and executive to disclose any new conflicts or potential conflicts that may arise during the year before the annual disclosure document is completed – in other words a continuous disclosure system.

Otherwise, conflicts might fall through the cracks. Early disclosure of any conflict or potential conflict allows the board, management and counsel to properly address any emerging issues and control their own destiny.

What type of policy statement should the board adopt to address conflicts? The board should review existing policies to determine if they adequately address conflicts. Your policy statement may stand alone or form a part of an overall ethics policy. Every not-for-profit corporation should adopt and periodically review its policy statements, including one governing conflicts. In the wake of Enron and other corporate debacles, conflict policies have become an integral part of an emerging focus on business ethics in America.

At a minimum, your conflict policy should include the following basic elements:

- A definition of a conflict of interest, including any specific concerns of your association;
- A statement that the association seeks to avoid conflicts of interest or even the appearance of impropriety;
- A requirement that all actual or potential conflicts be reported, including the material terms of such conflicts and the director's or executive's interest;
- A requirement that any conflict of interest transaction be approved by a disinterested majority of the board, a board committee or the members;
- A means for reporting violations of the policy to the board or a governance official; and
- A statement of the consequences of a violation of the policy, up to and including removal.

Just like the disclosure questionnaire, it's important that the policy is provided to directors and executives on arrival and periodically thereafter to reinforce the conflicts policy and procedures.

What procedural safeguards should be used to approve conflict of interest transactions? Each director of a not-for-profit corporation has a duty of loyalty to the corporation. This duty "requires directors to exercise their powers in the interest of the corporation[,] not in their own interest or the interest of another entity or person."³ Given this duty of loyalty, directors should seek to avoid self-dealing or conflicts and, where conflicts do arise, use the appropriate techniques for approval of agreements or transactions in which they have an interest. The goal is to ensure that the conflict of interest transaction is fair to the corporation and remove the interested director or executive from the approval process. The primary technique used to approve such transactions is to have a body of the board or members that have no interest in the transaction review and approve or disapprove it.

For example, Illinois law generally prohibits loans to not-for-profit directors and officers, except loans to employed directors or officers authorized by a majority of the non-employed directors and in furtherance of the purposes of the corporation and in the ordinary course of its affairs.⁴ The penalties for failure to comply are rather draconian,

imposing personal liability on the directors for the amount of any loan in violation of this law until repaid. Only loans with a legitimate business purpose approved by a disinterested majority are exempt from personal liability.

The American Bar Association's Revised Model Nonprofit Corporation Act (the "Model Act")⁵ provides that a conflict of interest transaction with a mutual benefit corporation (like a trade association) is not voidable or the basis for director liability if the transaction was fair at the time it was consummated or is approved by a disinterested majority of the board or of the members after disclosure of all material facts. It's important to note that the Model Act is really a general guide to best practices in not-for-profit law and the laws in each state may be different. Two important principles may be drawn from the Model Act relating to conflict of interest transactions in trade associations:

1. *The "no harm, no foul" principle.* Conflict transactions that are fair to the association, *i.e.*, no less favorable to the association than that which could be obtained in an arms' length transaction with an outsider, impose no harm on the association and are not the basis for liability under the Model Act. Of course, fairness of a conflict transaction does nothing to prevent unwanted or embarrassing publicity about the nature and extent of financial dealings between trade associations and their directors. Best practices suggest conflict transactions should be avoided if at all possible.
2. *Full and fair disclosure is critical.* Approval by a disinterested majority only works if there is disclosure of all material facts of the transaction and conflict of interest. This is consistent with the general duty of care all directors have to their corporation. Put simply, you have to make sure you understand what you are voting on in sufficient detail to adequately represent the association's best interests.

Conclusion. This area of the law may seem like form over substance, but the idea is to remove those with the conflict or self-interest from the approval process and ensure that the remaining directors are fully informed and can adequately represent the corporation's best interest. The key considerations are to have written policies and procedures in place before any conflict arises, to insist on full disclosure of any actual or potential conflicts and to require independent approval of all conflict transactions. When considering conflicts it's important to remember that even the appearance of impropriety can (and probably will) harm the corporation's best interests. If in doubt use the "Times test:" How would you feel if this story breaks in the Monday edition of the newspaper?

¹ GUIDEBOOK FOR DIRECTORS OF NONPROFIT CORPORATIONS, ABA Section of Business Law (G. W. Overton, Ed.), 1993 (the "ABA Guide"), p. 28.

² Reprinted with permission of The Institute in the ABA Guide, p. 112.

³ ABA Guide, p. 28.

⁴ Illinois General Not For Profit Corporation Act of 1986, Section 108.80 (805 ILCS 105/108.80).

⁵ Section 8.31. The Revised Model Nonprofit Corporation Act was published by the Business Law Section of the American Bar Association in 1987.