

CONFLICT *of* INTEREST: *Recusal Is Not Enough*

by Vernetta L. Walker

ACCORDING TO A RECENT GALLUP AND Wellcome Trust study, more than a third of people worldwide don't trust charities and NGOs.¹ In the United States, charities fare slightly better, with only 27 percent of respondents saying they do not trust them. For a sector that depends on and is accountable to the public, this is disturbing.

Fueling this negative perception is the steady stream of headlines about nonprofit organizations either failing to recognize conflicts of interest or making poor decisions in light of the facts and circumstances.

Just in the past few months, Baltimore's mayor Catherine Pugh resigned following a scandal that revealed she had profited in the hundreds of thousands of dollars from selling her self-published children's book to the University of Maryland

Medical System, where she served as a board member;² the *Washington Post* exposed eighteen board members of the National Rifle Association who were paid commissions and fees ranging from thousands to over \$3 million;³ and ProPublica's searing investigation into Memorial Sloan Kettering Cancer Center revealed a nest of self-serving behavior, including top executives who received personal annual compensation in the hundreds of thousands of dollars and in one instance over a million dollars in equity stakes and stock options from the drug and healthcare companies.⁴ Meanwhile, dozens of stories have appeared that raise questions in the minds of the public about pharmaceuticals' funding of patients' rights groups. These are just the tip of the iceberg of recent examples eroding the public trust.

Let's face it—conflicts of interest arise routinely in the ordinary course of doing business. Nonprofits cannot possibly avoid conflicts, but that is why it is important to have clear rules, policies, and guidelines to follow. Whether serving a small community-based nonprofit or a multibillion-dollar enterprise, boards need to recognize what is at stake: reputation, image, credibility, and the public trust. This begs the question: Is recusal enough to protect the organization?

This article examines how conflict of interest functions in the nonprofit sector, and explores crucial considerations and decision points for promoting ethical decision making.

VERNETTA L. WALKER, JD, is president and CEO of Walker & Associates Consulting and an adjunct lecturer for Columbia University. Prior to founding Walker and Associates, she served as chief governance officer for BoardSource. She also served as associate general counsel for the Maryland Association of Nonprofit Organizations, foundation advocacy counsel for the Alliance for Justice, and director of Administration of Justice Grants for the Florida Bar Foundation. With over two decades of experience as a nonprofit executive and consultant, Walker is passionate about helping organizations maximize their impact through exceptional leadership, intellectual engagement, and cultural competence.



Effective governance requires more than compliance. To be clear, doing what the law requires is a great starting point, but ethical leadership (doing what is right under the circumstances) has to be part of the equation.

What Is Conflict of Interest?

According to the IRS, a “conflict of interest occurs where individuals’ obligation to further the organization’s charitable purposes is at odds with their own financial interests,” and conflict-of-interest policies are “intended to establish procedures under which individuals who have a conflict of interest will be excused from voting on such matters.”⁵ These individuals, referred to as insiders,⁶ include officers, directors, managers, key employees, and any other person in a position of authority over an organization who might stand to benefit financially—directly or indirectly—from decisions he or she could make in such capacity.⁷ Frequently, cited examples of conflicts of interest include contracting with an insider; accepting gifts, gratuities, or favors from third parties that do business with the organization; gratuitous use of property of the organization; and seeking preferential treatment.⁸

Surprisingly, when the IRS revised Form 990 in 2008 and created a governance checklist (Part VI), it did not require that nonprofit organizations have a conflict-of-interest policy; rather, nonprofits simply have to report whether they have one.⁹ If the policy exists, they must indicate whether officers, directors, trustees, and key employees are required to disclose interests that could give rise to conflicts, and whether the organization monitors and enforces the policy. Organizations are then directed to Schedule O to describe how compliance is monitored.

According to the IRS, the revisions were added to improve tax compliance generally, especially as it relates to preventing nonprofits from serving private interests in a manner that is inconsistent with the organization’s charitable purposes.¹⁰ More precisely, federal tax law prohibits private inurement, whether through excessive compensation or paying more than fair market value to an insider.¹¹ Similarly, the private benefit doctrine prohibits charitable organizations from providing benefits—financial or otherwise—to a narrowly defined group rather than the public, unless said benefit is insubstantial or incidental.¹²

In an effort to strengthen compliance, some states have mandated conflict-of-interest policies through legislation. For example, the New

York Non-Profit Revitalization Act of 2013 requires that not-for-profit corporations adopt a conflict-of-interest policy that includes a definition of circumstances that constitute a conflict of interest; procedures for disclosing a conflict of interest to the audit committee or the board; a prohibition of the conflicted person from participating in, attempting to influence, or voting on the matter; and a requirement that the resolution of the conflict be documented in the minutes.¹³

But the fact is that many stop there in terms of understanding the requirements for avoiding conflicts of interest. That leaves the organization at high risk, because, additionally and ultimately, board members and officers owe a duty of loyalty to make decisions and act in the best interest of the nonprofit organization, not their own interest.¹⁴ There is no doubt that there are instances where transactions involving an insider may actually inure to the benefit of the organization and its constituents; but these instances deserve careful scrutiny, not only for whether or not they are well-considered and undeniably good decisions but also for whether they will be perceived that way by skeptics. How the organization manages each instance of conflict of interest can mean the difference between maintaining the public trust or being embroiled in a public scandal.

Technically, It’s Not Illegal...

Even with guidance from the IRS, statutes, and clearly articulated leading practices from organizations like BoardSource, BBB Wise Giving Alliance, and Independent Sector, nonprofits struggle.¹⁵ A closer look at real-life examples reveals three separate but related issues that surface repeatedly: (1) failure to navigate the gray areas of conflicts of interest, including group dynamics within the boardroom; (2) failure to navigate the gray areas of recusal and disclosure; and (3) failure to fully appreciate unintentional reputational damage because, technically, the transaction being considered is not illegal.

Navigating Gray Areas of Conflicts of Interest

Effective governance requires more than compliance. To be clear, doing what the law requires is a great starting point, but ethical leadership (doing

what is right under the circumstances) has to be part of the equation. In *Managing Conflicts of Interest*, authors Sarah Paul and Daniel Kurtz propose that we think about conflict of interest along a continuum from totally unacceptable at one end (illegal or widely regarded as unethical), to inconsequential at the other end.¹⁶ The problem is that not avoiding conflicts at the inconsequential end can lead to a well-populated swamp of the totally unacceptable, and that is a hard place from which to recover.

CASE STUDY #1

The case of Goodwill Omaha, in Nebraska, illustrates the above point exhaustively.

That case involved, among other issues, three specific major instances of conflict of interest associated with board members.¹⁷ The first was a contract for the architectural design of Goodwill Omaha's retail stores. The second was a contract for the construction of the stores. The third was a contract for insurance. The principal architect at the architectural firm served on the Goodwill board, as did the president of the construction company, who also had previously served as board chair—and the executive vice president of the insurance company was the current board chair.

Goodwill Omaha had a policy requiring that all board members sign a conflict-of-interest document, and they also had a process in place requiring at least three bids for certain jobs. The attorney general found that the bid process was routinely ignored: outside bids were not obtained for the contracts for design and construction of the stores. Upon further investigation, the attorney general concluded that the rates charged were fair to Goodwill Omaha but that the “fact that Goodwill Omaha's Board dispensed with the three-bid process, especially for its *most expensive transactions*, was troubling.”¹⁸ (Emphasis added.)

The report also details how Goodwill Omaha's routine business dealings with board members occurred in an environment of rubber-stamping and deference to the chief executive. There were multiple instances where the board failed to fulfill its fiduciary duties, and the report even references

the social relationship between the chief executive and the board member whose company received the construction contract, stating that bids had not been solicited since 1995. Such an environment can create loyalties, impair independent judgment, and erode checks and balances.

On top of all this, relatives of board members and executives were employed at the agency, which paid extraordinarily high salaries to executives while paying less than the minimum wage to employees with disabilities. Other family members were also the recipients of no-bid contracts. In answer to a question about the hiring of close relatives of senior staff and a board member, CEO Frank McGree said that Goodwill Omaha was lucky in that it gets referrals “from friends and family that already bleed Goodwill blue.”¹⁹

But, as was reported at the time, Goodwill was not hiding this information. In fact, it disclosed any number of business relationships on its 990 form—including with Kiewit, RDG Planning and Design, the insurance company Arthur J. Gallagher & Co., First National Bank of Omaha, and the Omaha law firm Baird Holm—and also confirmed relationships with Investors Realty, the Omaha law firm Fraser Stryker, and American National Bank. In all, seven of Goodwill's twenty-one board members were employed at one of those firms (with an eighth having just resigned). As reported by *NPQ* back in 2016, a number of experts commented on the situation in one of the many articles on the topic published by the *Omaha World-Herald*.²⁰

“My first reaction is just sadness,” said Dave Renz, a nationally renowned expert on nonprofit governance. “What you are describing here is a process that seems to undermine the trust that is essential for a nonprofit's donors, its constituents, its community. It's not all that unusual. But it is unacceptable.”

Omaha-based Angela Eikenberry, another national governance expert, says that beyond the legal requirements, “There's an ethical duty here—a duty to avoid the appearance of anything strange or anything that seems like a conflict. So, yeah, this kind of raises the eyebrows, doesn't it?”[. . .]

[N]ot avoiding conflicts at the inconsequential end can lead to a well-populated swamp of the totally unacceptable, and that is a hard place from which to recover.

So, how should nonprofits navigate the gray areas where relationships are involved, the actions are not illegal, and the organization has complied with the conflict policy?

“It’s a board’s job to ensure that the brand of the organization isn’t sullied by the practices of that organization,” said Renz. “Quite frankly, the cleanest way for an organization that’s taking great care is to just not engage in these kind of relationships. [...] Boards (around the country) are recognizing that there needs to be more care taken . . . to keep these processes clean.”²¹

Indeed, the organization saw its donors drop away precipitously, its property tax exemption come into question, and an investigation launched by the state attorney general. It required a sweep of executives and board members to even begin to right the ship.²²

Do Recusal and Disclosure Matter?

In the case of Goodwill Omaha, disclosure was a vastly inadequate response, and reinforced the message that the organization did not recognize or care about the degree to which it had strayed from arm’s-length decision making and into areas where habits of self- and mutual emolument were the standard. In such a situation—where a number of influential decision makers are benefiting financially from the organization—recusal can be a mere formality, accomplished with a wink and a nod; and 990 disclosure, at least at this point, is only useful if some enterprising reporter takes up the case, as happened with Goodwill Omaha and Sloan Kettering.

So, how should nonprofits navigate the gray areas where relationships are involved, the actions are not illegal, and the organization has complied with the conflict policy (i.e., disclosure and recusal)? Some organizations decide, as a matter of policy, never to enter into paid contractual relationships with any board member, so as to avoid speculation about abuse of position and influence for personal gain. Such organizations, of course, steer well clear of inviting vendors or potential vendors onto their boards. They also tend to be very careful about contracting with other organizations where staff members have an interest in the vendor or hire family members or personal friends, because they are consciously holding an ethical standard that argues against it.

Where using a board member as a vendor is

concerned, there may be some cases in which such situations emerge and the connection is limited enough, or thought to benefit the organization enough, that it may decide to leave some room in its policy while recognizing the risks it incurs in doing so. In all such cases, the board should make comparisons of alternative options; and it should take a vote on whether the proposal is fair and reasonable and in the financial best interest of the organization, but only if no other acceptable option is available.

Questions a board should always take into account include: Is it a one-off situation or a regular occurrence? What due diligence is required to justify and document the decision to move forward? How will stakeholders, the press, or charity watchdogs view the transaction? Additionally, a written code of ethics can help codify expectations regarding delivery on the mission, standards for the organization as a whole, and guidelines to promote organizational integrity and public accountability.

There is no question that indulging in financial relationships with board members as a matter of course is negligent behavior. One need only look at the recent reports about the NRA’s contracts with board members to get a sense of how financially risky it is. As with Goodwill Omaha, the NRA’s stated justification was anything but reassuring. NRA spokesman Andrew Arulanandam, in defense of the practice, called the national gun rights movement “a close-knit community comprised of partners and vendors who understand the issue and are defenders of the Second Amendment [...] Therefore connections between employees or board members and partners are not unusual.”²³

Reputation and Unintended Consequences

The questions in the previous section can also help assess unintended consequences in situations where the board has complied with its conflict-of-interest policy but things still smell a little fishy. The following case study, which is based on a real encounter, illustrates the reputational risks and consequences of not fully appreciating the need to be accountable to stakeholders and the public.

CASE STUDY #2

A nonprofit organization focused on improving environmental conservation through policy advocacy, research, and building coalitions engaged a consultant to conduct a governance review of its practices, policies, and operations. The timing of the review was prompted by the organization's major funder, which had expressed a desire to substantially increase its financial investment in the nonprofit based on mission alignment and its belief that the organization was well-positioned for growth, barring any red flags.

The organization produced its conflict-of-interest policy, minutes, and disclosure forms, among other organizational documents. A comprehensive document review and interviews with board members and other stakeholders revealed that the nonprofit had active contracts with several board members for research. In a meeting with the consultant, board members and staff were sincere and earnest about following their conflict-of-interest policy to the letter, but also stated that it was easier to engage board members who possessed the expertise needed to conduct research projects. They offered additional justification, stating that the contracts were not illegal and did not exceed fair market value for the services. While this was true, board members did not grasp the bigger issue at play—public perception. In fact, their failure to adequately factor in this issue was about to cost them considerably more: significant financial support to accelerate and deepen their mission impact.

One more example punctuates what should be the first consideration—maintaining the public trust. Earlier this year, the University of Maryland Medical System put its CEO on temporary leave following reports that nine of the thirty-member board of directors had substantial business deals with the system.²⁴ Maryland lawmakers introduced legislation to bar UMMS board members from having financial interests in contracts with the system, and the board chairman, Stephen Burch, stated, “There is nothing more important than the trust of those that depend upon the board’s leadership”—adding that the board is “firmly committed to evolving our governance principles and operating with even more transparency.”²⁵

Analytical Framework for Ethical Leadership

Ethics aren't simply a list of behaviors, a set of restrictions on what we can and cannot do. Ethics aren't just something we do because we know people are watching us. Ethics are a reflection of ourselves. Ethical behavior expresses who we are, what values we hold dear and what principles we will always fight for. Our ethics go straight to the heart of who we are.

—Lilya Wagner, director of Philanthropic Service for Institutions at the North America Division of the Seventh-day Adventist Church

In *Ethics in Nonprofit Organizations: Theory and Practice*, author Gary Grobman writes that “board members are ethically obligated to avoid even the appearance of a conflict of interest,” and asserts, “As a basic principle, it is unethical for a board member to be personally enriched financially by service on the board.”²⁶ “In practice,” he continues, “disclosing and not participating has minimal practical value.”²⁷

The fact that nonprofits exist for the purpose of social impact has inherent implications for governance and leadership. Maintaining a culture of integrity goes a long way in earning and being worthy of the public trust. Conflict-of-interest policies are a start, but the real work involves thoughtful deliberations and decision making. The following ethical framework, based on the work of Frederic Reamer, PhD, provides structure for ethical deliberations:²⁸

1. Identify the ethical issues that are or could be controversial.
2. Identify those who will be affected by the decision. (What stakeholders are impacted by the dilemma, and how?)
3. Identify the potential courses of action and the possible benefits and risks for each.
4. Examine how proposed courses of action are or are not consistent with organizational values, personal values, and ethical principles and guidelines.
5. Consult others not directly involved with the dilemma for input and advice (attorneys, experts, colleagues, and the like).
6. Make the decision and document the decision-making process.

Maintaining a culture of integrity goes a long way in earning and being worthy of the public trust. Conflict-of-interest policies are a start, but the real work involves thoughtful deliberations and decision making.

7. Monitor and evaluate the outcome. (Are there unintended consequences or environmental shifts that require making changes?)

In using this framework, boards are forced to consider and clearly identify the ethical issues, determine who might be impacted, and gather information before making a decision. It requires practice to not react reflexively, but this is the deeper work organizations are called to do to move beyond compliance and ensure ethical leadership.

NOTES

1. Julian Wylie, "A Third of People Globally Lack Confidence in Charities, Gallup Study Says," *Chronicle of Philanthropy*, June 20, 2019, www.philanthropy.com/article/A-Third-of-People-Globally/246530.
2. Paul Schwartzman and Peter Hermann, "Baltimore Mayor Catherine Pugh resigns amid book scandal," *Washington Post*, May 2, 2019, www.washingtonpost.com/local/md-politics/baltimore-mayor-catherine-pugh-resigns-amid-book-scandal-health-problems/2019/05/02/fc91f2b0-67ad-11e9-8985-4cf30147bdca_story.
3. Ruth McCambridge, "NRA Board Members Collect Money from, Rather Than for, the Organization," *Nonprofit Quarterly*, June 9, 2019, nonprofitquarterly.org/nra-board-members-collect-money-from-ratherthan-for-the-organization/.
4. Katie Thomas and Charles Ornstein, "Memorial Sloan Kettering Curbs Executives' Ties to Industry After Conflict-of-Interest Scandals," Sloan Kettering Cancer Center's Crisis, *New York Times* and ProPublica, January 11, 2019, www.propublica.org/article/memorial-sloan-kettering-curbs-executives-ties-to-industry-after-conflict-of-interest-scandals; Katie Thomas and Charles Ornstein, "Facing Crisis, Sloan Kettering Tells Exec to Hand Over Profits From Biotech," Sloan Kettering Cancer Center's Crisis, *New York Times* and ProPublica, September 29, 2018, www.propublica.org/article/facing-crisis-sloan-kettering-tells-exec-to-hand-over-profits-from-biotech; and Alia Paavola, "Memorial Sloan Kettering bars top executives from pharma boards," *Becker's Hospital Review*, January 14, 2019, www.beckershospitalreview.com/pharmacy/memorial-sloan-kettering-bars-top-executives-from-pharma-boards.html.
5. "Form 1023: Purpose of Conflict of

Interest Policy," IRS website, November 27, 2018, www.irs.gov/charities-non-profits/form-1023-purpose-of-conflict-of-interest-policy.

6. Sarah E. Paul and Daniel L. Kurtz, *Managing Conflicts of Interest: The Board's Guide to Unbiased Decision Making*, 3rd ed. (Washington, DC: BoardSource, 2012), 95.
7. "Instructions for Form 990 Return of Organization Exempt From Income Tax, 2016," Internal Revenue Service, December 2016, 22.
8. *Ibid.*, 23.
9. IRS Form 990, Part VI, Section B, line 12, 24.
10. "Background Paper: Forms 990, Moving from the Old to the New," Internal Revenue Service, August 19, 2008, www.irs.gov/pub/irs-tege/moving_from_old_to_new.pdf.
11. See "Overview of Inurement/Private Benefit Issues in IRC 501(c)(3)," 1990 EO CPE Text, accessed July 15, 2019, www.irs.gov/pub/irs-tege/eotopic90.pdf.
12. *Ibid.* See also "Private Benefit, Private Inurement, and Self-Dealing," BoardSource, June 8, 2016, boardsource.org/resources/private-benefit-private-inurement-self-dealing/.
13. New York Non-profit Revitalization Act of 2013, Section 715-a, assembly.state.ny.us/leg/?default_fld&bn=A08072&term=2013&Summary=Y&Text=Y.
14. BoardSource, *The Handbook of Nonprofit Governance* (San Francisco: Jossey-Bass, 2010).
15. *Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations*, 2nd ed. (Washington, DC: Independent Sector, 2015); *Recommended Governance Practices* (Washington, DC: BoardSource, 2016); and "How We Accredit Charities" web page, BBB Wise Giving Alliance, accessed July 16, 2019, www.give.org/for-charities/how-we-accredit-charities.
16. Paul and Kurtz, *Managing Conflicts of Interest*, 22.
17. *Report on Investigation of Goodwill Industries, Inc. and Goodwill Specialty Services, Inc.: Executive Summary*, Attorney General Douglas J. Peterson, Nebraska Department of Justice, issued June 26, 2018, protectthegoodlife.nebraska.gov/sites/protectthegoodlife.nebraska.gov/files/doc/2018.06.26%20Goodwill%20Exec%20Summary%20%26%20Report.pdf.
18. *Ibid.*, 34.
19. Henry Cordes, "Susie Buffett, now ex-donor, calls Goodwill CEO's defense of pay 'outrageous,'" *Omaha World-Herald*,

October 28, 2016, www.omaha.com/news/metro/susie-buffett-now-ex-donor-calls-goodwill-ceo-s-defense/article_8a3f3ac0-9bbc-11e6-9651-d35471a141c5.html.

20. Matthew Hansen, "Goodwill Omaha's no-bid contracts raise conflict-of-interest concerns," *Omaha World-Herald*, November 29, 2016, www.omaha.com/news/metro/goodwill-omaha-s-no-bid-contracts-raise-conflict-of-interest/article_e01183ad-616b-55a9-aed6-05714aa66831.html.

21. Ruth McCambridge, "Is a Conflict a Conflict, Disclosed or Not? Goodwill of Omaha's Tangled Ball of Relationships," *Nonprofit Quarterly*, November 28, 2016, nonprofitquarterly.org/conflict-conflict-disclosed-not-goodwill-omahas-tangled-ball-relationships/.

22. Mara Klecker, "Goodwill Omaha is 'on the right path' to improvement, new CEO says," *Omaha World-Herald*, April 9, 2018, www.omaha.com/news/metro/goodwill-omaha-is-on-the-right-path-to-improvement-new/article_90ff2cbf-ec67-505b-b61b-8e189f4fbe7c.html.

23. Beth Reinhard et al., "NRA money flowed to board members amid allegedly lavish spending by

top officials and vendors," *Washington Post*, June 9, 2019, www.washingtonpost.com/investigations/nra-money-flowed-to-board-members-amid-allegedly-lavish-spending-by-top-officials-and-vendors/2019/06/09/3eafe160-8186-11e9-9a67-a687ca99fb3d_story.html.

24. Harris Meyer, "U-Maryland Medical System CEO put on leave after board conflict scandal," *Modern Healthcare*, March 21, 2019, www.modernhealthcare.com/providers/u-maryland-medical-system-ceo-put-leave-after-board-conflict-scandal.

25. Ibid.

26. Gary M. Grobman, *Ethics in Nonprofit Organizations: Theory and Practice*, 2nd ed. (Harrisburg, PA: White Hat Communications, 2015), 50.

27. Ibid.

28. Frederic G. Reamer, "Making Difficult Decisions," Eye on Ethics, *Social Work Today*, October 14, 2002, www.socialworktoday.com/news/eoe_101402.shtml.

To comment on this article, write to us at feedback@npqmag.org. Order reprints from <http://store.nonprofitquarterly.com>.

THE Nonprofit QUARTERLY

The latest news and analysis about the nonprofit sector from the *Nonprofit Newswire*



Regular feature articles



Subscription information for the print magazine



For more information from the *Nonprofit Quarterly* go to www.nonprofitquarterly.org