

DIRECTOR'S *Monthly*

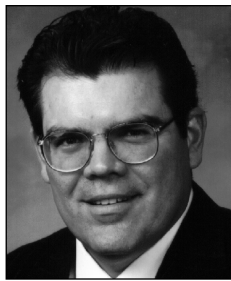


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Handling Conflicts of Interest at the Board Level

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How can your board address conflicts of interest? Here are some practical approaches.

Conflicts of interest at the board level. Do they matter? Should you address them at the board level? How should they be addressed? Should your position or view differ depending on the role you are playing or serving in the organization—such as officer, director, or advisor?

First, the easy answers. Yes, conflicts of interest at the board level do matter. And, yes, you should address them at the board level. So much for the easy answers. Now let us consider the difficult ones. But first, some background.

Conflicts Defined

Corporations and organizations of all types, whether for-profit, nonprofit, associations, partnerships, or trusts, are all faced with handling conflicts of interest at the governance level. Simply put, a

conflict of interest at the board level may be defined as “any transaction in which a director of the corporation has material interest.”

This material interest can be direct or indirect, and conflicts can even exist for directors who receive no money or tangible benefits from a transaction. For example, access to information about a corporate opportunity misused, or dis-

closure of important confidential information, can create very real conflicts.

In the for-profit world, most state corporation statutes follow the Model Corporation Act in requiring disclosure of material facts as to any relationship or financial interest of corporate officers and directors in contracts or transactions with the organization. Other guidelines also address conflicts. For example, the

DIRECTOR SUMMARY

At the board level, a conflict of interest may be defined as “any transaction in which a director has a material interest.” How can directors of for-profit and nonprofit boards spot and resolve conflicts? Real-life examples and practical “armchair” advice shed light on this difficult subject. ▀

The role of the National Association of Corporate Directors is to enhance the governance and performance of business entities. Since its founding in 1977, the NACD has pursued this goal by offering a broad spectrum of educational and membership benefits, including publications, seminars, and consultative services. The NACD lists all interested members on The Director's Registry, which is used by member companies and others that seek qualified directors. To educate the corporate community and to provide networking links among NACD chapter members, the NACD holds an annual Corporate Governance Conference, where it presents a Director of the Year Award.

Conflicts of interest involving a director or executive are not inherently illegal; nor are they to be regarded as a reflection on the integrity of the board, the executive, the particular director, or other parties.

Report of the NACD Blue Ribbon Commission Report on Director Professionalism found it very important "To seek disclosure of any relationships that would appear to compromise director independence."

In the nonprofit world, the basic duty of loyalty to put the organization's interests first has always been a general principle required for directors to apply openness and fairness in dealing with potential conflicts.

The potential for conflicts of interest at the board level is broad indeed. It includes such related issues as fraud, abuse, kickbacks, embezzlement, and undue influence, to name just a few. And, no small amount of litigation has resulted from these cases in various forms, including shareholder actions, derivative lawsuits, and government investigations.

Information

Interestingly, much good information is surfacing regarding conflicts of interest. In the for-profit world, a recent study by three professors at the University of Pennsylvania's Wharton School of Business, found six different board characteristics linked to both higher CEO pay and weaker performance. One of the key characteristics was "outside directors who have business dealings with the company." That sure sounds like a classic conflict of interest to me!

In the non-profit world a number of fine publications currently address conflicts of interest, such as *The Guidebook for Directors of Non Profit Corporations* published by the American Bar Associ-

ation and *The Legal Obligations of Non-profit Boards*, a guidebook for board members, published by National Center for Nonprofit Boards.

Three Cases

Just in the recent past, three of my real-world board experiences coalesced to highlight this hot topic of conflicts of interest in the boardroom, and I share these here:

► Early in the week, I conducted a dozen one-on-one confidential interviews with trustees of a large charity as part of my work on an operations review consulting engagement. During the interviews, several trustees voluntarily raised a number of concerns regarding perceived conflicts of interest at the board level. Specific concerns included the following examples:

– *Example 1.* Some of the directors—namely a stockbroker, insurance agent, construction manager, and a real estate broker—were providing services to the organization.

– *Example 2.* A retiring president of the charity was pushing to create a related-party foundation to focus on fundraising, with herself as the new foundation's first president.

– *Example 3.* Several trustees who worked for or served on the board of this fine charity also served on the board of other local charities. All these other local charities could (possibly) be considered competitors for services and fundraising dollars, and some could be perceived as direct competitors of the charity in question.

– *Example 4.* Several of the officers of this large charity also served as officers of an unrelated organization that managed investment funds for this charity.

– *Example 5.* Attorneys representing this charity also represented some of the trustees. Beyond that, one attorney also represented the corporate trustee of a foundation and trust fund that was a major source of revenue for this charity.

► Midweek, I received a call from a "new" board member of a thriving local business. This was an astute professional who was having "some concerns and questions" about her service on the local board she had been so eager to join. She knew we shared a common interest in the topic of good corporate governance and she wanted to discuss her concerns on possible conflicts of interest within this organization's board and its structure. The questions she posed were very precise and pointed:

– *Example 6.* "Does anyone have a say on this board besides Mr. Jones?"

– *Example 7.* "I have heard the management team is highly compensated. It is hard to find out how much pay they are getting. Should I be concerned?"

– *Example 8.* "The organization's attorney is a voting director himself and the personal attorney of several directors, including the key player, Mr. Jones. Doesn't that present conflicts and cause some problems?"

► My third recent encounter on the topic of good corporate governance surfaced while attending a fun social event for one of the nonprofit boards where I serve as a trustee. Some time back during a management transition, a very talented new president chose for expedience and other good reasons to handle an important real estate transaction for the charity through a top local real estate agent. This agent would be serving in the dual capacity as both a trustee for the charity and serving as their real estate agent. This was an obvious conflict of interest for the real estate agent, but because it was acknowledged and disclosed as such, many trustees were ready to go along.

I objected vigorously to this plan. My position was simple. This distinguished trustee and top real estate agent could serve well in either capacity, as trustee or real estate agent, but he should not do both. He creates a troubling conflict and sets the stage for other trustees to expect the benefit of business relationships with the charity, a slippery slope I personally opposed.

– Example 9. “It is probably my imagination, but ever since being vocal in my opposition to this transaction, my active involvement with the good people of this board and organization has never been quite the same.”

If the experiences and examples recited here are typical, and I believe they are, then conflicts of interest occurring at the board level are a fairly typical and regular occurrence. Some conflicts are easy

to spot and address, others are not. And, the level of concern about conflicts existing ranges widely among various persons, organizations, industries, and authorities.

These nine examples of perceived conflicts of interest at the board level deserve attention. I could provide comprehensive disclaimers and thorough detailed analysis. Instead, at Box 1 below, you will find my on the spot armchair advice and practical responses, along with other comments.

In addition, my work with conflicts of interest has surfaced several key thoughts and findings:

► **Organizations are always subject to conflicts.** Conflicts will regularly surface. Sooner or later, most every trustee, director and executive will face a potential conflict of interest, whether apparent, real, or merely perceived.

► **The nature of the conflict must be carefully weighed by boards and individuals.** Knowing that conflicts of inter-

Box 1. ARMCHAIR RESPONSE TO EXAMPLES 1 THROUGH 9

Ex. 1. Professional on the board providing services. Absolute conflicts of interest on the board must be disclosed and should be avoided. Once the first such conflict occurs, it can move to the point where you have the potential for every party or director around the table having a deal.

Ex. 2. Retiring president of charity pushing to head related party foundation. No apparent technical conflicts of interest if handled as an arm’s length transaction, but likely big potential for management and organizational problems, especially if new president of charity is not in the loop on this event.

Other comments: If the relationship between retiring president and new president is good and healthy, this could work out nicely. A new president unfamiliar with the situation or circumstances could be seriously threatened by this, and the reporting relationship of the retiring president serving the new foundation, or the issue of overlapping directors are just a few of the many issues to sort through with this.

Ex. 3. Trustees serving on “competing” charity board. It is common practice and a fact of life in most communities with the non-profit world, and especially in smaller communities. Seek to avoid dual service on major competing or contending agencies.

Other comments: This was studied by E. Fram and J. Withers in *Nonprofit World*, 17 (2) pp. 19-21, “Conflict of Interest in the Boardroom?” (1999 March-April).

Ex. 4. Officers of charity also serving as officers of investment fund manager for charity. Absolute conflict of interest; requires full disclosure; parties involved should remove and recuse themselves from decision making for the client charity on matters related to investment fund management and services.

Other comments: This represents the classic conflict of interest and should seriously be avoided.

Ex. 5. Attorneys on the board represent charity and trustees. It is common practice, and raises very real conflicts of interest. It is seldom addressed and only poses serious problems in the most unusual circumstances, but those circumstances can be compelling and create real problems, such as a loss of attorney client privilege for the charity.

Other comments: Leave this to the lawyers and their malpractice carriers. For fun, you might read “Danger, Lawyer on Board,” *ABA Journal*, July 1993, p. 102.

Attorney trustee represents both foundation and trust that is major source of revenue for charity. Let’s be real here . . . you treat this person very special, and let the attorney worry about the obvious multiple conflicts of interest this presents.

Other comments: Alternately, you can carefully seek to surface the issue of conflicts in an appropriate fashion and with the greatest of skill, seeking to assure fairness in all transactions with the foundation and trust.

Ex. 6. Does anyone have a say besides Mr. Jones? Probably not. Mr. Jones built the company and you, along with the other directors, serve at his pleasure. Be clear about why you are there, review the D& O policy, if there is one, and if the company does not have a policy be sure there is substantial equity or net worth in the company to cover potential liabilities.

Other comments: Alternately, check the bylaws for good indemnification language on the directors, do bulletproof estate planning, live “at risk,” or resign from the board.

Ex. 7. Key information not shared with directors. No real issues of conflict here, but the standard of conduct applicable to the individual corporate director includes the duty of care, which requires that a director be informed and exercise independent judgment.

Other comments: Why isn’t information being shared and what do you think is really going on here? Read the comments in Example 6 above, and if you have any concerns at all, either politely obtain the information, live at risk, or resign.

Ex. 8. Attorney represents corporation and directors. Read response at Example 5.

Other comments: Example 5 refers to a charity situation. Example 8 refers to a for-profit corporation. Consequently, the standard of care and the potential for real risk and adverse consequence could be substantially higher. This calls for substantial due diligence on your part, a whole lot of trust, or very good protection as outlined above.

Ex. 9. My involvement never has been the same. It is not my imagination. Directors, particularly in charities, are polite and do not like personal conflict. Interestingly, while a number of the trustees privately tell me they support my position and are pleased that the issue surfaced, no other trustee has publicly objected to this continuing conflict, or voted to end it.

Other comments: Interestingly, the board voted to add an appropriate and comprehensive conflict of interest procedure to the bylaws. Despite this positive development, however, I am disappointed to report that no one has yet deemed it appropriate to use with the ongoing conflicts with our trustee serving in the dual capacity as our real estate agent.

est will regularly surface, it is good to anticipate key points. Are we dealing with minor issues or substantive matters? Are we handling a one-time issue or a recurring event? Are we intentionally setting policy or inadvertently establishing precedent with how we handle a particular conflict? Are we taking the moral high ground, reflecting integrity and the standard we want for the organization and board regarding conflicts, or are we starting down a slippery slope to future conflicts with serious potential problems attached?

► **Conflicts of interest generally are not inherently or per se illegal.** Conflicts of interest involving a director or executive are not inherently illegal; nor are they to be regarded as a reflection on the integrity of the board, the executive, the particular director, or other parties. The manner in which the director and board handle the conflict, assuming it is properly disclosed, determines the propriety of the transaction.

► **Threshold thoughts on conflicts.** While most conflicts of interest involv-

ing trustees, directors, or executives are not inherently illegal, many of the standards, rules, or guidelines on conflicts provide limited direction for effectively dealing with conflicts of interest.

Remembering that it is fair to say that everyone has the potential for a conflict sooner or later, three polarities or questions should be kept top of mind when thinking of conflicts:

- Is this an inherent conflict we are all subject to—or a self-inflicted conflict we choose to make?

Box 2. POSSIBLE STANDARDS TO APPLY WHEN CONSIDERING CONFLICTS OF INTEREST

	No Standards*	Standards Reflecting Minimum Legal Requirements	Standards Reflecting Principles of Good Governance	Highest Possible Ethical Standards
Board Focus	Directors avoid or ignore the issue of conflicts.	Directors follow the form and letter of the law related to conflicts.	Directors adhere to the substance and intent of the law related to conflicts.	Directors' actions reflect integrity beyond reproach.
Board Practice	Directors react to conflicts only when they surface as real "problems."	Directors attend to the basic legal formalities that are required to keep them safe.	Directors establish "Best Practices" to surface conflicts and provide independent review.	Directors assiduously seek to avoid conflicts, making this an organizational priority.
Criteria for Determining Conflicts	Conflicts are recognized only after the application of some internal or external influence or force.	Conflicts are defined according to all applicable legal standards, including local rules, state statutes, federal laws (IRS, etc.), corporate articles and bylaws, company policies and procedures, attorney opinions and advice, and insurance contracts and policies.	All minimum legal requirements are applied. Board of the organization defines conflicts and encourages the consistent compliance and disclosure: awareness is key applied through compliance work; disclosure is key and not discretionary; independent review is key to compliance.	Directors take the position that conflicts must be avoided and will not be permitted, except by rare exception.
Observed Frequency	Conflicts can occur without review.	Conflicts occasionally occur, usually with review.	Conflicts seldom occur, always with review.	Conflicts rarely occur, and only after independent review and by exception.
Routine Policy	Conflict policy does not exist or is not applied. * Including vague or no standards.	Conflicts policy exists, but policy may not be actively enforced.	Conflicts policy is regularly enforced, reviewed, and disclosed. The policy includes procedures for addressing conflicts.	The board builds on good governance by paying assiduous attention to conflicts, proactively developing ways to prevent or resolve them.

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- Is this an unavoidable conflict—or an avoidable or voidable conflict?
 - Is this best addressed by adhering to minimum legal standards—or best addressed by the highest principles of good corporate governance?

► **Possible standards to apply in considering conflict of interest policies.** As a result of my research on conflicts of interest, I have developed a simple frame of four possible standards to apply when boards or individuals are considering the topic of conflicts of interest, considering individual cases involving conflicts of interest, or developing conflicts of interest policies. (See Box 2, on p. 4.)

Some Final Thoughts

Effective boards pay serious attention to conflicts of interest. Many boards strive for and focus on collegiality and trust. That's good. But in the words of Tom Horton, NACD chairman and former president of the American Management Association, "every good board needs a curmudgeon."

Yes, building trust is very important in developing boards and good corporate governance. But trust can become debilitating, and as the record shows from many unfortunate incidents over the years, failing organizations specialize in hiding the truth. So trust must be tempered with responsibility and accountability.

Good governance demands a dynamic tension, and those unwilling to play the occasional role of watchdog at the necessary and appropriate times, may be destined to serve as lap dogs or worse. ►

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