Managing Conflicts of Interest for Private Foundations

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Managing Conflicts of Interest for Private Foundations

In our personal lives, conflicts exist everyday and in some cases cannot be avoided. Everything from your morning commute to a missed cup of coffee, when combined with a less-than-sympathetic coworker, can set the stage for conflict. Similar conflicts can arise within private foundations. When such conflicts pertain to our service or employment with a foundation or its mission, they can create complex challenges known as conflicts of interest. Generally a conflict of interest exists when an individual has a personal bias or “interest” that conflicts with the interest of the private foundation.

Conflicts of interest are natural and should not always be regarded as negative as long as they are anticipated and managed appropriately. If you have the right staff and/or board members, whether paid or working on a volunteer basis, they will be involved and passionate about the work and mission of your foundation. Chances are that their passion may spill over to other organizations, and that they may be directly supporting the organizations and people to whom your foundation makes grants or serves. That support can include one or more of the following; volunteer work, board service, and employment within those other organizations.

Board members and employees have a fiduciary duty of loyalty to the private foundations they serve, meaning that they should never put their own interests ahead of the work of the foundation. Individuals can become easily conflicted as they navigate between their loyalties to the different charitable organizations with which they are involved. Some examples of when individuals may find themselves facing a dilemma are:

- They favor personal causes or organizations outside of the funding interest of the foundation to the detriment of other worthy groups vying for a foundation’s grant money who squarely fit within the foundation’s mission.
- They favor paying a grant to an organization where their spouse is employed to support the spouse’s efforts.
- Their preference is to fund project “A” above project “B” because they are getting a personal benefit by paying A.
- They approve a grant that fulfills a personal pledge.

Can any of these biases or preferences create a problem for the individual or the foundation with which they are most associated? The answer is: “it depends.” Resolution of the matter will depend on the nature of the conflict. In some cases a conflict can be appropriately managed through disclosures and resolution in compliance with the foundation’s procedures. Other conflicts, such as excess compensation, may be prohibited by the Internal Revenue Code and give rise to excise taxes if not resolved.

Importance of having a conflicts of interest policy

How can a private foundation help avoid such conflicts? At a minimum, all private foundations should have a conflicts of interest policy, which addresses in writing the types of conflicts your foundation could encounter. The policy should clearly identify who, within the foundation, is expected to abide by the rules of the policy. Does it apply to board members, staff, volunteers, vendors, or grantees? Or all these individuals?

The policy also should include clear procedures that supplement the policy itself. These would be rules that define what is meant by a conflict of interest for the private foundation, what the process is to identify/recording potential conflicts and state a process as to what happens in the event of a conflict, and what to do if it is later discovered that an action was taken without the procedure being followed. The combination of a written policy and procedures could protect the foundation and manage the individuals involved.

Another important action that a foundation needs to take with its conflicts of interest policy is to educate all parties. It isn’t enough to just have the policy written down; the appropriate parties must be aware of the policy and abide by its terms. Foundations shouldn’t assume that the people involved in the organization will remember that they need to disclose a potential conflict of interest. A well-drafted conflicts of interest policy should also require updates and acknowledgement by the applicable parties on a regular basis (at least on an annual basis); this exercise can serve as a prudent reminder of the rules which need to be followed. The policy and procedure should be intertwined into the process of the foundation so when a conflict happens...
everyone knows what to do. This exercise also serves as a prudent reminder of the rules by which everyone involved needs to abide. Boards should discuss this in their regular meetings but especially when grants are considered.

Another key way foundations can be prepared to deal with potential conflicts of interest is when new people come on board. Foundations should consider, as a best practice, requiring disclosures of volunteer activity and board service, as well as requiring periodic updates about such activities. Perhaps asking for updates annually or semi-annually so records are kept up to date may be appropriate. Do not let a conflict lead you away from recruiting a new board member if he or she is the best person for the role. Instead, ensure that the candidate and the foundation are made aware of the potential conflict and that it is documented and disclosed as it is being evaluated.

**Potential consequences of conflicts of interest**

So what happens if there is a conflict of interest that someone within the foundation chooses to ignore or willfully neglect? Some situations may lead to words we do not want to hear in the charitable arena, such as excess benefits, self-dealing, personal inurement and the like. The words mean similar things and all hold negative connotations. All conflicts of interest do not give rise to these excessive situations, however, they should all be carefully considered. The IRS has rules that are clearly outlined related to conflicts of interest and the worse case scenarios that may result in excise taxes to a private foundation that may lead to a loss of the tax-exempt status.

**Self-dealing** is essentially associated with disqualified persons with respect to private foundations and is defined in the Internal Revenue Code § 4941. Disqualified persons are defined as individuals who currently are in a position to exercise substantial influence over the activities of the foundation. They include:

- Officers, directors, and trustees
- Committee members
- Employees
- Foundation decision makers (similar to officers, directors, trustees, committee members or employees)
- Substantial contributors (those that contribute an aggregate amount of more than $5,000 if such amount is more than two percent of the total contributions received by a foundation in given year of their contribution)
- Individuals who own more than 20 percent of a business enterprise that is a substantial contributor
- Family members of a person already described (spouse, ancestors and lineal descendants and their spouses)
- Corporations, partnerships, trusts or estates in which a person described owns more than 35 percent of the voting power, profits interest or beneficial interest
- Government officials

Self-dealing occurs when certain activities happen between the Foundation and a disqualified person. Some of these activities include:

- The sale, exchange or leasing of property
- Lending of money or other extensions of credit
- Furnishing of goods, services and facilities
- Payment of compensation
- Transfer to, or use by or for the benefit of a disqualified person of the assets of a foundation

We have included some illustrations in this paper to highlight how ignored conflicts of interest can turn into potential problems.

There are exceptions to some of the above examples of self-dealing but they must be reviewed carefully. For example, compensation is allowed for personal services by disqualified persons under certain circumstances. Boards, employees and other foundation managers should be familiar with the rules and regulations or they should consult their trusted philanthropic specialist.

**Illustrative examples of potential conflicts of interest**

Here are some examples of conflicts of interest that can occur:

**Illustration 1**

Elizabeth’s grandson has applied for a scholarship from a local private foundation where Elizabeth serves on their scholarship committee. Elizabeth really loves her grandson and he is a brilliant student who is very worthy of any scholarship. He has a different last name from Elizabeth, so the other committee members may not even be aware that he is related to her. Elizabeth is sure she can champion an approval for his award. Is this a conflict of interest? What if it were her nephew instead of her grandson applying for the scholarship?
It is self-dealing and a real conflict of interest—if Elizabeth follows through with her plan to champion approval for her grandson’s award, the foundation and Elizabeth have violated §4941 of the Internal Revenue Code and will be liable for penalties. If it were her nephew, it might not rise to a §4941 violation since he’s not a lineal descendant, but an argument could be made that it is still a conflict of interest.

Illustration 2
Jose is a sales officer for a local trust and investment firm. He also is an avid community volunteer and works to promote his employer whenever anyone has a need. Jose serves on the board of a local non-profit organization and they need a new investment manager for their private foundation. Jose recommends his firm be considered and mentions to his manager that he has a great lead on a potential piece of sizable new business. Jose plans to lead the sales team and knows that if he closes this business he will have aced his sales goals for the year. The commission check will help him pay a few bills off as well. Is this a conflict of interest? What if Jose does not participate on the sales team and in no way is compensated for the sale?

Neither the non-profit organization nor the foundation, in this example, may know about this conflict of interest but they should be aware of the risk. Most for-profit institutions also have codes of conduct or a similar conflicts of interest policy. If Jose’s firm gained the business, he would clearly benefit personally as well. The best course of action would be for Jose to totally remove himself from the sales and decision-making process so that he has no decision-making power, either on behalf of his employer or the non-profit board. He can in no way get compensation and if the foundation decides to vote on hiring his firm, he should abstain from that vote because of the conflict of interest.

Illustration 3
Chanel loves working in her dream career as a prominent attorney. She has been quite successful and has accumulated a great deal of knowledge in the non-profit arena. The firm for which she works is extremely supportive of her community involvement and she has been asked to join the board of the SRZ Foundation, a client of her firm. The SRZ Foundation compensates its board members. Chanel attends her first meeting and decides to bill SRZ at her normal hourly rate for attending the meeting and plans to continue that process for future meetings.

All compensation, at any level within a private foundation, must be reasonable. Chanel’s rate would have to be compared with what the SRZ Foundation is paying other board members. It is important to note here as well that, in this example, Chanel is being compensated for her board services not her legal work. Sure, she brings legal expertise to the board table, but the facts of our example do not indicate that she was hired for legal services. The board compensation for the SRZ Foundation should be compared to what other foundations of similar size pay their board members for equal services.

Unwelcome publicity
There is more to say about conflicts of interest than one white paper can hold. It is extremely important for private foundations to be alert even to the appearance of a potential conflict. Front page news about even minor conflicts can potentially decimate the ability of private foundations to adequately support their communities and causes. Even if the conflict proves false, in many cases the damage may have already been done as far as potential centers of influence are concerned. Moreover, the problems may only just be starting as the foundation also will have to factor in the cost of the defense required to save both its name and its mission. It is extremely important to guard the foundation’s reputation.

Conclusion
To help your foundation avoid the consequences of potential conflicts of interest, it is important to fully understand IRS rules and prohibitions. In the case of particularly complex issues, you may find it helpful to consult a trusted advisor such as a Wells Fargo Philanthropic Specialist. Drawing on the services of an advisor who specializes in the complexities of a private foundation, is dedicated to helping preserve and protect them, while educating others on their missions and goals, can help a foundation avoid the types of pitfalls outlined in our examples. The Specialists at Wells Fargo can help a private foundation recognize the issue, understand the rules, assist with policies and procedures, and provide advice on policy implementation and monitoring. If you have additional questions about conflicts of interest or other issues facing your nonprofit, please contact your Wells Fargo Relationship Manager or call a Wells Fargo Philanthropic Sales Strategist at 855-435-4108.