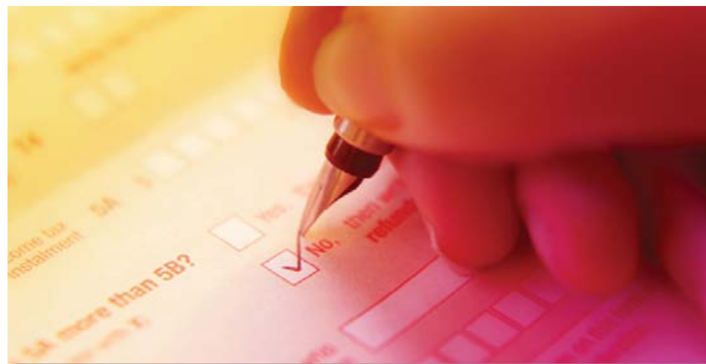
Business Relationships with Directors Require Increased Sensitivity

Non-profit boards should scrutinize more closely proposed business relationships between the organization and its directors, given increasing legal pressures and public scrutiny. It should be noted that these "director-as-vendor" relationships are not *per se* unlawful. Indeed, in many situations they offer substantial service advantages and financial benefits to the organization. However, when improperly structured, these relationships present the appearance of—if not the opportunity for—abuse. Further, they are the subject of substantial new public disclosure obligations in the Form 990. For these and other reasons, non-profit boards should be cautious in approving or continuing director-as-vendor relationships.

Prevalence

The practice of board members entering into business relationships with the corporations they serve as fiduciaries is not uncommon in the non-profit sector. In fact, many such business relationships predate the membership on the board (since often those business relationships are instrumental in indicating who would be an excellent new board member). Independence requirements, expertise needs, and principles of effective governance typically prompt non-profits to "tap" community business leaders for board service. Invariably, many of the companies represented by these leaders may conduct (or seek to conduct) business with the non-profit from time to time. This is particularly the case in communities where the most qualified business-based board candidates are executives or owners of principal vendors to the non-profit.

The recent (February 2009) IRS report on the non-profit hospitals sector includes data that confirms the prevalence of director-as-vendor relationships. Sixty-five percent (65%) of the responding hospitals (303 out of 468 respondents) reported having at least one such relationship. Somewhat surprisingly, the IRS data also show that director-as-vendor arrangements are more prevalent in urban and suburban hospitals than in rural hospitals. Indeed, the percentage of hospitals reporting director-as-vendor relationships to the IRS generally increased as revenue size increased.



Perceived Value

Many non-profits engage in director-as-vendor relationships because of the perception (and belief) that they bring specific value to the organization. This value might arise from any number of factors: a) the familiarity/comfort of contracting with a trusted individual; b) the expectation of much greater service and vendor communications; c) materially discounted contracting price and/or terms; and d) the opportunity to gain some other (appropriate) market or commercial advantage.

However "real" and attractive these benefits may be to the non-profit, they do not serve to eliminate or discount the principal legal and "optics" risks increasingly associated with director-as-vendor relationships (as discussed below).

Director-as-vendor relationships implicate an increasing number of significant legal and "optical" issues for the non-profit organization, its board, and the participating director. The overarching legal concern is that board members will seek to take advantage of their "insider" relationship to enrich themselves at the non-profit's expense.

Legal Implications

The principal challenge to director-as-vendor relationships is that they implicate an increasing number of significant legal and "optical" issues for the non-profit organization, its board, and the participating director. The overarching legal concern is that board members will seek to take advantage of their "insider" relationship to enrich themselves at the non-profit's expense. These legal issues include the following:

- **Independence.** Director-as-vendor relationships implicate important corporate and tax-exemption standards, which require board/committee control by a majority of "independent" (or "disinterested") directors. A director-as-vendor is unlikely to be regarded as an "independent" director under any traditional definition. The higher the number of directors serving as corporate vendors, the less likely it will be that the board and/or key committees will be able to satisfy relevant independence requirements.
- **Conflicts of interest.** Director-as-vendor relationships also implicate important "duty of loyalty" issues relating to conflicts of interest and appropriation of corporate opportunity. A director who has a (direct or indirect) business relationship with the non-profit is likely to have a conflict of interest that should be disclosed to, and addressed by, the board. Conflict-of-interest transactions (e.g., director-as-vendor relationships) that are entered into without specific board approval are subject to rescission under specific state law.
- **Tax penalties.** Director-as-vendor arrangements that provide excess-market level (or similar) benefits to the director create unique Internal

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Revenue Code tax risks to both the non-profit and the participating director. Given the director's status as a corporate "insider," any such excess benefit arrangement implicates the prohibition against private inurement, which places the non-profit's tax-exempt status at risk. Such an arrangement also subjects the director (and, potentially, approving board members) to individual tax liability under the Intermediate Sanctions penalty excise tax provisions.

- **Corporate law penalties.** Similarly, inappropriately structured director-as-vendor arrangements are also subject to challenge/rescission under general non-profit corporate law (both statutory and common law)—apart from conflict-of-interest principles. For example, the state attorney general typically has broad jurisdiction to challenge director-as-vendor arrangements that are perceived to involve unreasonable compensation to the director (or his/her business enterprise), and to remove or otherwise penalize participating directors.

"Optics"

Regardless of what the law might provide, director-as-vendor arrangements are increasingly viewed with suspicion and concern by both regulators *and* the media (i.e., with a presumption that the director has taken advantage of the position to benefit personally from the board position). Boards would be well advised to closely consider the organizational risks (e.g., reputational damage, regulatory scrutiny) associated with negative media exposure before proceeding with director-as-vendor arrangements.

What's New?

Director-as-vendor arrangements are receiving greater attention of late, principally because of the substantially increased focus in the Form 990 on business relationships between "insiders" and the non-profit. The new Form 990 (for fiscal years beginning in and after 2008), which is available to the public through certain Web sites, and in particular Schedule L of the new form, requires disclosure of material transactions (generally involving payment of more than $10,000) between the organization and a director. The listed transactions not only include business deals involving the director directly, but also those involving a member of the director's family, a business of which the director and family members own at least 35 percent, or any business that the director serves in a special capacity (such as an officer, director, trustee, key employee, or significant owner). These new disclosure rules shine a bright new spotlight on business transactions that directly or indirectly involve directors, and the new disclosures are likely be scrutinized by the media, the general public, and regulators and enforcement bodies such as the IRS. Furthermore, brand new examination guidelines just released by the IRS direct agents to consider the scope of director-as-vendor arrangements involving non-profit charities.

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What to Do About It?

Non-profit boards may consider responding to this increased scrutiny by adopting enhanced internal governance controls with respect to proposed and existing director-as-vendor arrangements. The purpose of such controls would be to position the board to more closely monitor the reasonableness, and implications of, any such arrangements. Suggested controls might include the following, among others:

- Increased board education on the risks associated with director-as-vendor arrangements
- Enhanced board disclosure process for proposed and existing relationships
- Satisfaction of state corporate law (conflict of interest) and tax-exemption safe harbors (such as the "rebuttable presumption of reasonableness" as to financial transactions with "disqualified persons," including directors and officers) with respect to all proposed relationships
- Application of specific "benchmarking" from which the board may consider the appropriateness of individual proposed relationships
- A policy prohibiting active solicitation of corporate business by board members
- Involvement of the general counsel in board evaluation of specific proposals
- Periodic review of implications of existing relationships to board/committee independence requirements
- Annual board review of Form 990 Schedule L ("Transactions with Interested Persons")

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