

# An Affair to Remember: When Conflicts Get Personal

By Ralph E. DeJong and Michael W. Peregrine

The Madoff scandal continues to provide very useful governance lessons for nonprofit groups.

Hadassah, the Jewish volunteer organization, learned this summer that a woman who had served as the charity's chief financial officer had a long-term affair with Bernard Madoff, who is now serving a jail term for running a Ponzi scheme. During that time, the charity put \$40-million into Mr. Madoff's accounts. While Hadassah reportedly earned an average 11-percent return on its Madoff investments, and had removed substantial sums from its Madoff accounts over time, it still suffered a serious investment loss when the scandal was revealed last winter.

We've become somewhat immune over time to reports of large Madoff investment losses incurred by charities. Yet this one is a bit different. It's more personal.

And it raises serious questions about the effectiveness of charity conflict-of-interest policies. This latest Madoff twist shines a spotlight on a very sensitive issue — the extent to which the personal and family relationships, not just financial relationships, of nonprofit directors, officers, and other key employees should be disclosed. Hadassah learned the news when reporters started asking the group about revelations in a new memoir by a woman who says she had an affair with Mr. Madoff for two decades.

Typically, questions about personal and family interests are not included in charity disclosure forms. In a "seller's market" for volunteer board service, charities are justifiably reluctant to push too deep for information concerning the private lives of prospective donors and board members. "It's none of our business" is the usual refrain. Thus, the standard disclosure questionnaire usually focuses only on financial interests. Indeed, the definition of "conflict of interest" from the Form 990 speaks principally to financial ties.

Yet one would be hard pressed to deny that an intimate personal relationship between a charity's chief financial officer and its outside investment manager was relevant to the charity's investment committee. Depending on the facts and circumstances, a state attorney general might rule that the failure to disclose such a relationship constituted a breach of the officer's duty of loyalty.

The Hadassah incident is obvious but hardly unique. Nonprofit groups face many situations in which personal and family relationships — which have nothing to do with money but plenty to do with blood and emotion — can inject bias in the decision-making process. It doesn't have to be a salacious affair — there are going to be times when the most basic of family or personal relationships will be relevant to board decision making. What if the charity were negotiating a business deal with someone who is the best friend of one of its board members? Or is an ex-spouse? Talk about emotion in the decision-making process.

Depending on the circumstances, personal relationships can influence how a board member approaches a particular decision. In such a situation, the relationship should be disclosed and the board should rule on the extent to which the conflict will limit a board member's involvement in certain issues.

The Internal Revenue Service has recently revised the Form 990, the informational tax return most charities must file annually, to encourage greater disclosure of potential conflicts of interest — and that will force charities to focus more carefully on disclosure. The new form requires disclosure of family relationships, personal contracts, and business deals but not other personal relationships. However, the new form also requires a charity to determine how many of its board members are independent, and it notes that business and personal relationships are an important part of that determination.

All the signs suggest that regulators are taking a tougher stand to crack down on improper ties among nonprofit board members and employees.

If nothing else, the latest Madoff news should prompt nonprofit boards to consider how personal relationships involving officers and directors may affect the decision-making process, and to consider whether and how to ask about such relationships. Of course, board members are loath to disclose personal matters, and nobody with a sound mind is going to disclose an illicit affair or other notorious personal matter through the regular system for determining improper conflicts.

However, one possible response might be to discreetly educate top officials and board members about their legal obligations to put loyalty to the organization above everything else and to explain how certain personal and family relationships could be problematic. It's not just sordid assignments that are a matter of concern but also many other kinds of family and personal ties. The key is whether board members should be told about possible conflicts.

At the very least, making an effort to educate top leaders would put key players on notice that they need to think hard about the potential fiduciary consequences of such relationships. At best, a confidential process could be created to facilitate sensitive disclosures.

Not every nonprofit board is going to face the kind of mess Hadassah did. But such problems happen more often than most charities realize, and smart boards will make the effort to remind everyone about what's at risk.

*Ralph E. DeJong and Michael W. Peregrine are lawyers at McDermott, Will, & Emery, in Chicago. They both specialize in legal issues related to nonprofit groups.*