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Conflict of Interest Policies

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As good corporate governance practices become increasingly important, many public companies, private companies, and tax-exempt entities have taken a closer look at their polices and practices relating to conflicts of interest. Public companies and tax-exempt entities may have to adopt a conflict of interest policy (a "COI policy") to comply with regulatory or accreditation requirements; other entities may choose to do so to advance their business objectives. While business entities have long recognized the potential value in conducting business with their officers, directors and other employees, they are also realizing that these relationships can create problems, especially if they are unaware of the relationships. The fear of the "front page" report alleging improper relationships and dealings is real. Just last week, the *Wall Street Journal* reported in a front page article that the California Public Employees' Retirement System had begun a "special review" of business dealings between itself and a business entity headed up by one of its board members (October 13, 2009). According to the WSJ, "The disclosure deepens concerns that alleged conflicts of interest are undermining state retirement funds."

Why have a conflict of interest policy?

In some cases, the regulators who oversee certain businesses strongly encourage the implementation of COI policies. Public companies, for instance, implement COI policies to comply with (i) the disclosure requirements mandated by the Securities and Exchange Commission (such as those provided in Regulation S-K) and (ii) the listing requirements of the major securities exchanges such as NYSE and NASDAQ. Public companies have to identify and provide information on conflicts of interest to satisfy disclosure requirements, and the implementation of the COI policy is the means to gather that information.

Similarly, tax-exempt entities are encouraged to have a COI policy and to provide copies of their COI policies as part of the exemption application process. Once the ruling is issued, they are required to provide information about their COI policy on an on-going basis in their annual 990 tax reports.

Entities also adopt COI policies voluntarily to ensure that they give proper approval to transactions that raise conflicts of interest. Corporate and other state business statutes have specific provisions outlining the approval process for conflict of interest transactions. Many of these statutes require, for instance, that directors who have a conflict of interest recuse themselves from voting on those matters to ensure that approval comes from the disinterested directors or shareholders. Compliance is often mandatory and corporate action taken in a manner inconsistent with these statutes may not be valid and may result in violations of fiduciary duties by an entity's directors or managers. A well-drafted COI policy will ensure that the legally required steps are always taken.

Finally, while some organizations implement COI policies solely to ensure compliance with legal requirements, many other organizations implement such policies for business purposes. Businesses are realizing that they need to know if their employees are engaged in activities that may impair their loyalty or judgment as employees; even if those activities are permitted, it is important to know about them.

What types of transactions should be covered?

A conflict of interest typically arises when an officer, director, employee or other representative with the power to exert control or act on behalf of a business entity has a personal interest that is in conflict with the best interests of that business entity. Conflicts of interest arise in a variety of contexts such as when a business entity makes a loan to an officer or director, when a controlling person owns a business that provides goods or services to the business entity or when a controlling person competes in some capacity with the business entity.

The COI policy should be tailored for each business entity. Clearly, the textbook conflict of interest transaction, in which in which the business entity is on one side of the transaction and an officer or director of the business entity is on the other side, should be addressed. Consider, also, whether the scope of the COI policy should include service on for-profit and nonprofit boards, outside employment (including self employment), the appropriate use of business assets and expenses, and employment of relatives. In some instances, other related ethics matters such as insider trading and the giving and receiving of gifts, bribes, kickbacks or other improper payments may be covered in COI policies. The COI policy should also address the extent to which a key person can compete with the business entity and pursue business opportunities that might otherwise belong to the business entity.

While a COI policy should specifically include common conflict transactions and situations within its scope, the policy should also be clear that the list is not exhaustive and that, when in doubt, individuals within the business entity should identify possible conflicts so that they may be addressed appropriately.

Who should be covered?

In addition to defining the scope of transactions and relationships covered, the COI policy should address the individuals who must report under the policy. This scope, too, is tailored for each business entity depending on the entity's reason for implementing the policy and the nature of the entity's business or other activities. If, for example, a business entity chooses to implement a COI policy with the primary goal of ensuring proper disclosure mandated by SEC regulations or stock exchange rules, then it may be reasonable to limit coverage to directors and certain officers of the business entity. However, if a business entity is implementing a policy for other business reasons, it may make sense for the policy to cover a broader range of individuals. For example, a school may want its teachers to disclose the extent to which they propose to tutor students outside the school environment.

Larger business entities may maintain two or more COI policies, one for directors and/or senior officers and one or more separate policies for other employees.

How should conflicts be resolved?

When a conflict of interest is identified, there are two primary approaches to addressing the conflict. First, for the most serious conflicts— those that are illegal or would materially impair a person's ability to perform his or her duties to the organization loyally and effectively —it would be appropriate for the organization to prohibit such transactions.

The second approach is to require disclosure of the conflict but to provide a mechanism for the conflict to be approved or waived by the business entity. With the second approach, the decisionmakers who approve or disapprove the conflict transaction will vary depending on the type of conflict and the role of the conflicted person in the organization. For example, if a director owns a significant supplier to the business entity, the other disinterested directors may be vested with authority to waive the conflict arising from that relationship. In contrast, if the conflict arises with a junior employee, that individual's supervisor or another executive may have the authority to waive or approve the conflict.

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