

# Conflicts of Interest

## *Bridging the Gap between Theory and Practice*

### Notes

- What makes something a conflict of interest can also be a benefit, or a good arrangement for the club.
- It is imperative for a board to have a clear, consistent route for resolving conflicts.
- Stay in tune with the requirements of the IRS and the local statutes governing your club's formation.
- Professional ethics codes offer four conflict of interest tests: the peer standards test; the public disclosure test; the reasonable person test; and, the best interest test.

*"If I, taking care of everyone's interests, also take care of my own, you can't talk about a conflict of interest" – Silvio Berlusconi.*

While it might seem somewhat counterintuitive to open a discussion on conflicts of interest with a quotation from the famous, or perhaps infamous, former Italian Prime Minister, the thoughts embodied in his statement get at the heart of the very real ethical dilemmas that many private club board members face, and the often gray area of what really constitutes a conflict. This article will review textbook views on conflict of interest; provide real life examples from private clubs across the country; and suggest litmus tests that board members individually and club boards collectively can apply to determine if a conflict exists, and how it should be addressed.

Conflict of interest discussions in the private club world tend to focus on the tax-exempt private club—the "990 filer," thanks in no small part to the various Internal Revenue Service (IRS) musings on the topic over the last few years. However, all nonprofit private clubs, whether tax-exempt or taxable, should ask, "Are we just trying to keep the IRS happy, or are we serious in identifying and resolving conflicts of interest to

improve our club and ensure the best in club governance?" Obviously, the latter represents the approach private clubs should adopt.

### **Defining a Conflict of Interest**

The IRS Form 1023 provides a governmental view on what constitutes a conflict of interest:

*"A conflict of interest occurs where individuals' obligation to further the organization's charitable purposes is at odds with their own financial interests. For example, a conflict of interest would occur where an officer, director or trustee votes on a contract between the organization and a business that is owned by the officer, director or trustee."*

While this definition focuses primarily on financial conflicts, private club conflicts of interest are often more subtle, multi-faceted or more unusual than the classic examples listed above. For instance, what about the club board member who also sits on the board of another club, or indeed owns a competing business such as a golf facility, fitness center, spa or even a fine dining restaurant? Is this board member perfectly placed to make unbiased business decisions in the boardroom, or is this board member pulled in competing directions?

Since so many private club interactions are non-financial in nature, we need to examine differently those possible con-

BY PHILIP NEWMAN

Truth is like the sun.

You can shut it out for a time, but it ain't goin' away.

ELVIS PRESLEY

flicts of interest to understand the gray areas beyond straightforward financial benefit. In practice, what makes something a conflict of interest can also be a benefit, or a good arrangement for the club. For example, the board member who owns an insurance brokerage firm might go the extra mile to get the club a deal that it otherwise could not obtain; or the club may benefit from working with the law firm of a board member since that board member will ensure that the firm will do excellent work at low cost to the club. To run our clubs like businesses, should we take advantage of these relationships, or avoid them entirely? Perhaps taking another view on conflict of interest will help us deal with these situations.

### Testing Your Boundaries: Four Approaches

Most literature on how to avoid conflicts of interest suggests that board members need to be independent on all voting matters in the club boardroom. Governance best practices also tell us that board members should be independent *in appearance*, not just in fact. While this thought process is somewhat helpful in determining conflicts of interest, there are four other “tests” found in the ethics codes of various professions that we can consider: the peer standards test; the public disclosure test; the reasonable person test; and, the best interest test.

The *peer standards test* asks private club board members to consider what is acceptable industry behavior in any given situation. Essentially, would a board member feel comfortable sharing his or her decision on a potential conflict of interest at a major industry conference and expect it to be met with approval? If not, the board member may have ignored the indications that a conflict might exist. This test has its limitations. Look to recent stories of impropr-

ety from the financial institutions industry to see that just because your industry accepts a certain behavior, doesn't, in itself, make it acceptable.

The *public disclosure test* asks board members to imagine announcing a decision to the media or general public. How would key stakeholders in the community react to the decision made by the board member or indeed the full board? Keeping this test in mind can illuminate instances where conflict may be perceived to exist, even if they technically do not meet the black and white definitions of conflict from the IRS or state nonprofit statutes.

To apply the *reasonable person test*, board members facing a conflict of interest dilemma ask, “What would a reasonably prudent person do under the circumstances?” Defining reasonably prudent can be a challenge in itself; therefore, it might be better to apply this test by asking if trusted business professionals, such as attorneys or accountants, would agree with the board member's position on whether a conflict exists in a given situation. Provided that many conflict of interest decisions end up being referred to a club's accountant or legal advisor for guidance, this test could arguably be the best place to start when evaluating a potential conflict.

Last, but far from least, the *best interests test* engages the core of a director's typical responsibility to act honestly, in good faith and in the best interests of the club. It deals with the director's implicit and explicit duties of loyalty to the club as a whole. This can be particularly troublesome to board members in private clubs who may be associated with certain “factions” in the club—think golfers versus tennis players versus social members. Indeed, one or more of these constituent groups may have been responsible for the board member having been elected in the first place. Will

the board member who uses the club exclusively for golf vote affirmatively in the boardroom for a much-needed capital expenditure in another area of the club, even if he or she will never use that amenity? When the votes are cast, that board member has a responsibility to cast their vote by determining the best interest of the club overall.

If board members find themselves frequently conflicted between the best interest of the club and those of particular member groups, then arguably a more holistic view is required and the board should undertake a strategic review of the club's direction, purpose and needs.

### Putting It Into Practice: Private Club Case Studies

#### Applying the peer standards test:

##### Hiring a family member

While board members are frequently warned of the perceptions—and realities—associated with allowing their family members to be employed at their club, one case in particular highlights the need for caution in this situation. A club in the Midwest hired a relative of the club president as its controller. The individual appeared well qualified and suited for the position, having previously worked in other clubs as well as small businesses. Due to the controller's relationship to the president, the general manager was instructed not to perform a background check, a standard operating procedure at this club for all department heads. Needless to say, it was a great embarrassment to the club, and the president, when the controller was caught stealing from the club. Of even greater embarrassment, however, was the fact that a background check would likely have identified the controller's history of fraud in her previous places of employment. In this case, even if the president and board had passed the conflict of >>>



# Model Form

## Conflict of Interest Disclosure

NAME

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POSITION / TITLE

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Each Responsible Party (as defined in the Conflict of Interest Policy) will disclose each issue, subject, person or entity in which he/she has a financial interest (as defined in the Conflict of Interest Policy) where there is the potential that the [insert the name of the Club] (the "Club") Board of Directors may make decisions that affect that issue, subject, person or entity. Responsible Parties are expected to review their disclosure statements and update them as conflicts arise or on an annual basis, whichever occurs first.

*Please list any organization or group in which you have a financial interest or in which you hold a position of management or governance authority and with which the club does business.*

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*Please describe the nature of any business transacted with the companies or organizations noted.*

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I have nothing to disclose at this time.

I have read [insert the name of the Club]'s Conflict of Interest policy and understand its provisions. I hereby affirm that during the period indicated above, I have not, to the best of my knowledge and belief, been in a position of possible conflict of interest, except as noted above.

SIGNATURE

DATE

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PRINT NAME

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Source: Club Governance Guidelines, National Club Association, [www.nationalclub.org](http://www.nationalclub.org)

For a model Conflict of Interest Policy please visit [www.nationalclub.org](http://www.nationalclub.org). The form can be found on the Member Home Page.

interest tests related to the hiring decision in the first place, there is no excuse for allowing the conflict to cause a deviation from a standard hiring practice—namely the background check. Conflict of interest? Yes.

### **Applying the best interest test: Financial management**

Consider the retirement community club in the mid-Atlantic that provides an active lifestyle and amenities to its homeowners. Like many bundled community clubs, the club's budget was historically built on the premise that all homeowners benefitted from, and consequently should in some degree contribute to, the amenities of the club, regardless of whether, or how often, the homeowner used the amenities. This budget methodology had served the community well for many years, even through the darkest days of the recession.

However, a new treasurer took it upon herself to challenge this traditional budget construct and proposed realigning the revenue sources of the club. Maintenance fees (dues) paid by all homeowners would be relied on less in favor of user fees from the amenities. Such a shift, over time, would have a dramatic effect on the economic stability of the club, essentially unbundling a bundled community. Through various channels, it became apparent to the board and the membership that the treasurer was not utilizing any of the club amenities. Rumors also persisted that she was personally suffering financial difficulties and the perception steadily grew that she was re-engineering the club's revenue streams for her own benefit by minimizing the mandatory charges she would have to pay. When the board undertook a strategic planning process to understand what the community wanted as a whole, her positioning and lobbying left her in an untenable position. Conflict of interest? Based on the best interest test: yes.

### **Applying the public interest test: Your club or your livelihood**

A mandatory membership club in the Pacific Northwest was hoping for a good slate of candidates for the board. One member who tendered his name to the nominating committee happened to be the primary realtor in the club community, enjoying the business of a majority of home listings. The nominating committee felt uneasy about this member's application to run for the board. Working through the club's conflict of interest framework, the committee came to the conclusion that the member should be allowed to run for the board.

In the aftermath of losing the election, the member made numerous inquiries about why he lost. The resounding message from the grassroots membership was that they weren't sure the member would always vote club first, real estate second. They couldn't imagine how the realtor would vote for necessary dues increases or capital assessments because those higher fees, while competitive with other communities in the area, might make it harder for the realtor to close an individual sale. Conflict of interest? It certainly appears that had the nominating committee applied the conflict of interest test, it could have had reason to decline the member's application to run for the board.

### **Next Steps To Tackling Conflicts Of Interest**

Regardless of a club's conflict of interest policy or decision-making framework, it is imperative for a board to have a clear, consistent route for resolving conflicts. The board or governance committee should understand how it would investigate issues and document their resolution. Legal review of the club's process is imperative to ensure compliance with statutes as well as compatibility with the club's governing documents and rules.

When designing a conflict of interest policy and framework, consider who it applies to—who is considered a “covered” person? How often is the policy reviewed and how often are board members reminded it exists?

While most clubs will have board members provide an annual conflict of interest statement, others remind their board and committee members prior to every meeting that they're responsible for doing the right thing. Ultimately, clubs must do what is in the best interest of the membership as a whole.

Clubs in small communities can certainly struggle to comply with a mandate not to do business with members, as there may be little alternative in terms of banking, legal or other professional services. These situations require even greater attention. Regardless of location, clubs must stay abreast of the requirements of the IRS and the local statutes governing their formation.

Perhaps private club board members, when facing ethical decisions or conflict of interest situations would do well to consider the thoughts of former Chief Justice Earl Warren who spoke of “... *a law beyond the law, as binding on those of us who love our institutions as the law itself, although there is no human power to enforce it. In the law beyond the law, which calls upon each of us to be fair, each of us necessarily is his own Chief Justice. In fact, he is the whole Supreme Court from which there lies no appeal.*” ■

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