

Conflicts of Interests and Charter Schools

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I. INTRODUCTION

A. What is a conflict of interests?

1. *Definition: "A real or seeming incompatibility between one's private interests and one's public or fiduciary duties."*
 - a. *Black's Law Dictionary 341 (9th ed. 2009)*
2. Public servant uses her influence to direct tax dollars to benefit herself, her family, or her friends
3. A conflict (singular) of interests (plural)
 - a. One person wearing two hats

B. Common examples in charter schools

1. Board member who wants to sell real estate
2. School leader who owns a charter school consulting business
3. Teacher who gives private lessons

C. Not a New Problem

1. "Until the 18th century, no-one expected the [British] king or his courtiers not to take advantage of their position to enrich themselves."

- a. Tim Lankester, *Conflict of Interest: A Historical and Comparative Perspective*, at page 5, para. 19 (University of Oxford, July 2007)
 - 2. 1843 = earliest known use of the phrase in English, according to *Black's Law Dictionary*
 - 3. *Historical Examples*
 - a. Ulysses S. Grant administration after the Civil War
 - (i) "Whiskey Ring" – public officials conspired with whiskey merchants to defraud the federal government of millions in liquor tax revenue (1875).
 - b. Political patronage system ("spoils system")
 - (i) Politicians would give public jobs to their friends, who would then kick back part of their salaries to the political parties
 - (ii) Civil Service Reformer: Theodore Roosevelt -- most famous commissioner from the US Civil Service Commission (1889–95).
 - 4. *Modern Example*
 - a. Barbara Byrd-Bennett, CEO of Chicago Public Schools, pled guilty in 2015 to charges that she steered \$23 million in CPS money to SUPES Academy and Synesi Associates in exchange for bribes and kickbacks.
 - (i) According to the criminal indictment, Ms. Byrd-Bennett had previously worked for SUPES Academy and Synesi Associates.
- D. Outline of Remainder of Talk
 - 1. Components of Common Conflict of Interests Policies
 - 2. Penalties for Engaging in Conflicted Transactions
 - 3. Sample Conflict of Interests Policy

II. CONFLICT OF INTERESTS POLICY

A. Common locations of these policies

1. School's corporate documents
 - a. Articles of Incorporation
 - b. Bylaws
2. Stand-alone Policy
 - a. Conflict of interests policy
 - b. Financial controls policy
 - c. Board governance policy
3. Charter school contract with authorizer

B. Components of a Conflict of Interests Policy

1. Who are the "interested persons" subject to it
 - a. Board member
 - b. Senior administrator
 - c. Members of an important committee
 - (i) Executive Committee
 - (ii) Finance committee
 - (iii) Facility committee
 - d. Any position with substantial influence over important decisions
2. What are "conflicted transactions"
 - a. When an "interested person" stands to gain financially from a transaction
 - b. When family or friends of an "interested person" stands to gain financially from a transaction

3. Duty to Disclose
 - a. "Interested persons" have a duty to disclose any *actual or potential* conflict of interests
 - b. Disinterested persons may have to decide whether a conflict really exists
 - (i) *Example:* School leader owns 1 share of Apple Corporation
 - (ii) *Example 2:* School leader owns payroll processing company
4. Process for determining whether "conflicted transaction" is nonetheless permitted
 - a. Interested person presents information on conflict and transaction
 - b. Interested person leaves ("recuses")
 - c. Disinterested people investigate transaction
 - (i) Is this a fair and reasonable transaction?
 - (ii) Is a more advantageous transaction reasonably available?
5. Record process for working through conflict of interests
 - a. Document, document, document
 - b. Protection for both school and interested person
6. Annual certification by "interested persons" that:
 - a. They know and will abide by the conflict of interests policy
 - b. They are not aware of any conflicts of interests

III. SANCTIONS FOR ENGAGING IN CONFLICT OF INTERESTS TRANSACTIONS

A. Federal Law

1. Internal Revenue Code

- a. Private Benefit (Inurement) Doctrine under 26 U.S.C. 501(c)(3)
 - (i) IRC 501(c)(3) provides exemption from federal income tax for organizations that are "organized and operated exclusively" for religious, educational, or charitable purposes.
 - That is, not for the benefit of a private party
 - (ii) 501(c)(3) tax exemption is further conditioned on the organization being one "no part of the net income of which inures to the benefit of any private shareholder or individual."
 - (iii) Non-profit entities must establish that they are "not . . . operated for the benefit of private interests such as designated individuals, the creator or his family, or persons controlled, directly or indirectly, by such private interests." See 26 C.F.R. § 1.501(c)(3)-1(d)(1)(ii) (U.S. Treasury regulation related to § 501(c)(3) entities)
 - (iv) *Penalty:* Charter school could lose its 501(c)(3) status
- b. Excess Benefit Transaction under 26 U.S.C. 4958
 - (i) IRC § 4958 establishes excise taxes as an intermediate sanction where applicable tax-exempt organizations (like 501(c)(3)'s) engage in "excess benefit transactions" with "disqualified persons."
 - (ii) "Disqualified Persons" – Any person who was in a position to exercise "substantial influence" over the affairs of the charter school. IRC § 4958(f)(1)(A); Regs. § 53.4958-3(a)(1).
 - (1) Includes "family members" of disqualified persons
 - (2) That is, spouse, siblings, spouses of siblings, ancestors, children, grandchildren, great grandchildren, and spouses of children, grandchildren, and great grandchildren. IRC §§ 4958(f)(1)(B), (f)(4); Regs. § 53.4958-3(b)(1).

- (iii) “Substantial Influence” – The following positions qualify: see Regs. § 53.4958-3(c).
 - (1) Voting member of governing body;
 - (2) Chief administrators – those who have “ultimate responsibility for implementing decisions of governing body”
 - (3) Chief financial managers – CFO or treasurer
- (iv) “Excess benefit transaction” -- A transaction in which an economic benefit is provided by an applicable tax-exempt organization, directly or indirectly, to or for the use of any disqualified person, and the value of the economic benefit provided by the organization exceeds the value of the consideration (including the performance of services) received from the disqualified person for providing such benefit. IRC § 4958(c)(1)(A); Regs. § 53.4958-4(a)(1).
 - Charter school overpays for the product or service sold to it by the “disqualified person”
- (v) “Fair market value” -- Price at which property, or the right to use property, would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy, sell or transfer property or the right to use property, and both having reasonable knowledge of relevant facts. Regs. § 53.4958-4(b)(1)(i).
- (vi) *Penalties*: Excise taxes are imposed on (1) disqualified persons who benefit from excess benefit transactions and (2) organization managers who participate in these transactions knowing that they are excess benefit transactions.
 - (1) NB: *Both* the “disqualified persons” who benefit *and* those at the charter school who approved the transactions – even if they didn’t benefit – could be required to pay excise taxes, *i.e.*, penalties.

- (2) *25% penalty* – 25% of the excess benefit must be paid by “disqualified person” who benefited. See IRC § 4958(a)(1); Regs. § 53.4958-1(a).
- (3) *200% penalty* – If transaction is not corrected within the taxable period, an additional excise tax equal to 200% of the excess benefit is imposed on the “disqualified person” who benefited. See IRC § 4958(b); Regs. § 53.4958-1(c)(2)(i).
- (4) *10% penalty for charter school managers* – The 10% tax is payable by any “organization manager” who knowingly participated in the excess benefit transaction. IRC § 4958(a); Regs. § 53.4958-1(d)(1).
- (5) “Organization manager” is any officer, director, or trustee of the charter school. See IRC § 4958(f)(2); Regs. § 53.4958-1(d)(2)(i).

(vii) *Penalty*: Charter school could lose its 501(c)(3) status

- c. Conflicting Interest Transactions should be reported on Schedule L of Form 5500

B. Colorado Law

1. Code of Ethics

- a. *Legislative declaration*: “[W]hen citizens of this state obtain public office, conflicts may arise between the public duty of such a citizen and his or her private interest.” C.R.S. 24-18-101.
- b. *Breach of Public Trust*: “A public officer, . . . local government official, or employee whose conduct departs from his fiduciary duty [to benefit the people of the state] is liable to the people of the state as a trustee of property and shall suffer such other liabilities as a private fiduciary would suffer for abuse of his trust.” C.R.S. 24-18-103(2).
 - (i) *No Kick-Backs*: Public officer shall not “[a]ssist any person for a fee . . . in obtaining any contract . . . or other economic benefit from his agency.” C.R.S. 24-18-108(2)(b)

(ii) *No Paying Yourself*: Public officer shall not “[p]erform an official act directly and substantially affecting to its economic benefit a business or other undertaking in which he . . . has a substantial financial interest.” C.R.S. 24-18-108(2)(d)

■ Same rule for board members, C.R.S. 24-18-108.5(2)

■ Same rule for “local government official” and “local government employee,” C.R.S. 24-18-109(2)(b)

(iii) *Must Recuse on Board Votes*: “A member of the governing body of a local government who has a personal or private interest in any matter proposed or pending before the governing body *shall disclose such interest to the governing body and shall not vote thereon and shall refrain from attempting to influence the decisions of the other members of the governing body* in voting on the matter.” C.R.S. 24-18-109(3)(a)

c. *Safe Harbor for Full Disclosure*, C.R.S. 24-18-110

(i) Prior to transaction which would breach public trust, you may disclose in writing to Colorado Secretary of State

(1) Amount of financial interest

(2) Purpose and duration of services rendered

(3) Compensation received for services

(4) All other information necessary to describe person’s interest in transaction

(ii) After transaction, you must “state for the record the fact and summary nature of the interest disclosed at the time of performing the act.”

(iii) Such disclosure shall constitute an affirmative defense to any civil or criminal action or any other sanction.

- d. *No Interest on Contracts*: Public officers, local government officials, and local government employees “shall not be interested in any contract made by them in their official capacity” or by the public entity for which they are members or employees. C.R.S. 24-18-201
 - (i) Not a “Contract” if:
 - (1) Contract is awarded to lowest responsible bidder
 - (2) Due to geographical restrictions, the charter school could not otherwise reasonably afford itself of the subject of the contract.
 - (3) Interested person has disclosed his interest and not voted or exercised influence over decision-making process
- e. *Voidable Contracts*: Public entity that enters into an “interested contract” may void it. C.R.S. 24-18-203
- f. *Penalty*: Court may impose a fine for a violation of Code of Ethics of up to twice as much as interested person was trying to gain. C.R.S. 24-18-206

2. Colorado Criminal Code

- a. “A ‘potential conflicting interest’ exists when the public servant is a director, president, general manager, or similar executive officer or owns or controls directly or indirectly a substantial interest in any nongovernmental entity participating in the transaction.” C.R.S. 18-3-308(2).
- b. “A public servant commits *failing to disclose a conflict of interest* if he exercises any substantial discretionary function in connection with a government contract, purchase, payment, or other pecuniary transaction without having given seventy-two hours’ actual advance written notice to the secretary of state and to the governing body of the government which employs the public servant of the existence of a known potential conflicting interest of the public servant in the transaction with reference to which he is about to act in his official capacity.” C.R.S. 18-3-308(1)

- c. "Public servant" means "any officer or employee of government, whether elected or appointed . . ." C.R.S. 18-1-901(3)(o)
 - 3. Charter Schools Act
 - a. Violations of law are grounds for revocation of the charter contract. C.R.S. 22-30.5-110(3)
- C. Charter Contract
 - 1. Most charter contracts prohibit conflicted transactions
 - 2. Most charter contracts also expressly incorporate some or all of the above statutes
- D. District Policies
- E. Common Penalties for Violations of a School's Conflict of Interests Policy
 - 1. Removal from board
 - 2. Termination of employment
 - 3. Claim of breach of fiduciary duty

CONFLICT OF INTEREST POLICY

ARTICLE 1. PURPOSE

The purpose of the conflict of interest policy is to protect the School's tax-exempt interest when it is contemplating entering into a transaction or arrangement that might benefit the private interest of an officer or director of the School or might result in a possible excess benefit transaction. This policy is intended to supplement but not replace any applicable state and federal law that governs conflict of interest applicable to nonprofit and tax-exempt charitable organizations.

ARTICLE 2. DEFINITIONS

2.1 **Interested Person.** Any director, principal officer, or member of a committee with governing board delegated powers, who has a direct or indirect financial interest, as defined below, is an interested person.

2.2 **Financial Interest.** A person has a financial interest if the person has, directly or indirectly, through business, investment, or family:

- (a) an ownership or investment interest in any entity with which the School has a transaction or arrangement,
- (b) a compensation arrangement with the School or with any entity or individual with which the School has a transaction or arrangement, or
- (c) a potential ownership or investment interest in, or compensation arrangement with, any entity or individual with which the School is negotiating a transaction or arrangement.

Compensation includes direct and indirect remuneration as well as gifts or favors that are not insubstantial.

A financial interest is not necessarily a conflict of interest. Under Article 3, Section 3.2, a person who has a financial interest may have a conflict of interest only if the appropriate governing board or committee decides that a conflict of interest exists.

ARTICLE 3. PROCEDURES

3.1 **Duty to Disclose.** In connection with any actual or possible conflict of interest an interested person must disclose the existence of the financial interest and be given the opportunity to disclose all material facts to the directors and members of the committees with governing board delegated powers considering the proposed transaction or arrangement.

3.2 **Determining Whether a Conflict of Interest Exists.** After disclosure of the financial interest and all material facts, and after any discussion with the interested person, he or

she shall leave the governing board or committee meeting while the determination of a conflict of interest is discussed and voted upon. The remaining board or committee members shall decide if a conflict of interest exists.

3.3 **Procedures for Addressing the Conflict of Interest.**

3.3.1 An interested person may make a presentation at the governing board or committee meeting, but after the presentation, he or she shall leave the meeting during the discussion of, and the vote on, the transaction or arrangement involving the possible conflict of interest.

3.3.2 The chairperson of the governing board or committee shall, if appropriate, appoint a disinterested person or committee to investigate alternatives to the proposed transaction or arrangement.

3.3.3 After exercising due diligence, the governing board or committee shall determine whether the School can obtain with reasonable efforts a more advantageous transaction or arrangement from a person or entity that would not give rise to a conflict of interest.

3.3.4 If a more advantageous transaction or arrangement is not reasonably possible under circumstances not producing a conflict of interest, the governing board or committee shall determine by a majority vote of the disinterested directors whether the transaction or arrangement is in the School's best interest, for its own benefit, and whether it is fair and reasonable. In conformity with the above determination it shall make its decision as to whether to enter into the transaction or arrangement.

3.4 **Violations of the Conflicts of Interest Policy.** If the governing board or committee has reasonable cause to believe a member has failed to disclose actual or possible conflicts of interest, it shall inform the member of the basis for such belief and afford the member an opportunity to explain the alleged failure to disclose.

If, after hearing the member's response and after making further investigation as warranted by the circumstances, the governing board or committee determines the member has failed to disclose an actual or possible conflict of interest, it shall take appropriate disciplinary and corrective action.

ARTICLE 4. RECORDS OF PROCEEDINGS

The minutes of the governing board and all committees with board delegated powers shall contain:

(a) The names of the persons who disclosed or otherwise were found to have a financial interest in connection with an actual or possible conflict of interest, the nature of the financial interest, any action taken to determine whether a conflict of interest was present, and the governing board's or committee's decision as to whether a conflict of interest in fact existed.

(b) The names of the persons who were present for discussions and votes relating to the transaction or arrangement, the content of the discussion, including any alternatives to the proposed transaction or arrangement, and a record of any votes taken in connection with the proceedings.

ARTICLE 5. COMPENSATION

A voting member of the governing board who receives compensation, directly or indirectly, from the School for services rendered other than his services to the School as a member of the governing board, is precluded from voting on matters pertaining to that member's compensation.

A voting member of any committee whose jurisdiction includes compensation matters and who receives compensation, directly or indirectly, from the School for services rendered other than his services to the School as a member of the governing board, is precluded from voting on matters pertaining to that member's compensation.

No voting member of the governing board or any committee whose jurisdiction includes compensation matters and who receives compensation, directly or indirectly, from the School, either individually or collectively, is prohibited from providing information to any committee regarding compensation.

Voting members of the governing board may receive reasonable compensation for their services to the School as members of the governing board, provided that such compensation is reasonable compensation for the services so rendered and that such compensation has been approved by the board of the School.

ARTICLE 6. ANNUAL STATEMENTS

Each director, principal officer and member of a committee with governing board delegated powers shall annually sign a statement which affirms such person:

- (a) has received a copy of the conflicts of interest policy,
- (b) has read and understands the policy,
- (c) has agreed to comply with the policy, and
- (d) understands the School is charitable and in order to maintain its federal tax exemption it must engage primarily in activities which accomplish one or more of its tax-exempt purposes.

ARTICLE 7. PERIODIC REVIEWS

To ensure the School operates in a manner consistent with charitable purposes and does not engage in activities that could jeopardize its tax-exempt status, periodic reviews shall be conducted. The periodic reviews shall, at a minimum, include the following subject:

(a) whether compensation arrangements and benefits are reasonable, based on competent survey information, and the result of arm's length bargaining, and

(b) whether partnerships, joint ventures, and arrangements with any taxable organizations conform to the School's written policies, are properly recorded, reflect reasonable investment or payments for goods and services, further charitable purposes and do not result in inurement, impermissible private benefit or in an excess benefit transaction.

ARTICLE 8. USE OF OUTSIDE EXPERTS

When conducting the periodic reviews as provided for in Article 7, the School may, but need not, use outside advisors. If outside experts are used, their use shall not relieve the governing board of its responsibility for ensuring periodic reviews are conducted.

ARTICLE 9. COMPETITION IN CONTRACTING

In the event that the School determines the need to procure outside suppliers or contractors (other than tax-exempt organizations, governments or government chartered subdivisions or instrumentalities with similar purposes or for related projects) for an amount in excess of \$25,000.00, the School shall select such contractors on a competitive basis.

ARTICLE 10. LOANS

The School shall not make loans to officers or directors.

ARTICLE 11. PRIVATE FOUNDATION

The School shall not participate in any transaction not allowed for a private foundation as provided in the Articles of Incorporation.

ARTICLE 12. SPECIAL RULE FOR GRANTS

No member of the Board shall participate in any grant selection process for any period during which any child, grandchild, niece, grandniece, nephew, or grandnephew of such person or his/her spouse has applied for and is under consideration for any grant.