Conflicts of Interest Laws Governing Public Servants Should Be Applied to Employees of Not-for-Profits Receiving Municipal Funding

By Asaf Naymark

I. Introduction

Many not-for-profits receive funding from local governments for performing what are often, in effect, government functions. While these organizations are beholden to federal and state laws governing not-for-profits, those laws often provide few ethics restrictions. By contrast, the municipal employees who dole out public funds to such groups are accountable to state and municipal laws governing the actions of public servants, often including stringent ethics restrictions. This article will address that disparity.

Public servants may be prohibited from, among other things, taking part in their organization's business dealings with the municipality or in any business dealings where they have conflicting interests.[1] This may preclude even attending a meeting about municipal funding for a not-for-profit organization in which the public servant is an employee.[2] Additionally, a municipality's code of ethics may forbid using one's municipal position for private or personal gain or advantage for oneself, one's close relatives, or one's business associates.[3] For example, a council member may thus be permitted to sponsor funding for an organization where a relative or business associate is a paid employee only if there is no reasonable likelihood that the employee will benefit from the transaction.[4]

In the absence of such rules for not-for-profit organizations, the violation of such precepts has resulted in the leaders and other employees of not-for-profits receiving excessive compensation, among other forms of self-dealing and corruption, that codes of ethics are meant to prevent. A few months ago, for example, the *New York Post* reported egregious instances of self-dealing in not-for-profits receiving New York City funds.

> Some of the ugliest abuse [of New York City funding by not-for-profits], of course, comes courtesy of lawmakers who steer public bucks, through a member item or pork-barrel system, to nonprofits that hire friends, relatives or even themselves…. Topping the list: Pols like Assemblyman/Brooklyn Democratic boss Vito Lopez, Ridgewood Bushwick Senior Citizens Council's founder. The council, which relies heavily on public cash, pays big bucks to Lopez's girlfriend and campaign treasurer, who run the place. Also: The Metropolitan Council on Jewish Poverty, whose boss, Willie Rapfogel, is married to Assembly Speaker Sheldon Silver's chief of staff. Silver makes sure the council gets ample public funding: Tax forms for its 2008-09 fiscal year list some $14 million in government grants about half its total revenue. Rapfogel's share? A whopping $409,916 in salary, deferred pay and nontaxable benefits.[5]

The amount of similar bad press that not-for-profits have been receiving for shady business practices makes it seem clear that federal and state laws, as well as market forces, have been unable to help these organizations meet their duty of undivided loyalty to their public funders and to the public. Professor Melanie Leslie has attributed this failure to the lack of clear rules that focus on procedure instead of outcomes and that, according to her, would help enforce positive governance norms in not-for-profit organizations.[6] Specifically, Professor Leslie explains, requiring disclosure of conflicts of interest can increase boardroom awareness of the conflict, and requiring advance approval of a transaction can increase awareness that such transactions are often problematic.[7] Additionally, there should be clear rules guiding board approval of transactions, requiring recusal of interested directors from meetings where approval of the interested transaction is being voted on, and providing no defense for violations.[8]

Municipalities should apply their local ethics laws governing municipal employees, if they have them, and adopt them if they do not, to not-for-profits that receive municipal funding because those who run them and work for them often function largely as public servants when expending municipal funds. They should be held accountable to the government and to the public for using resources and positions meant to provide a public benefit. Applying these local ethics laws to not-for-profits can help prevent governance issues and breaches of fiduciary duty by authorizing local governmental agencies to advise, discipline, train, and vet not-for-profits by using the clear guidelines of the local ethics law and an understanding of the idiosyncrasies of the conflicts of interest that local not-for-profits may be guilty of allowing.

II. Shortcomings of Current Not-for-Profit Law

The growing not-for-profit sector has undoubtedly for many years raised governance issues that do not exist, or that exist but to a lesser degree, in the for-profit sector. These issues include self-dealing, such as excessive executive compensation and other irresponsible or dishonest use of the organization's assets, and of positions of influence. The disparity between the enforcement of ethical precepts in the two sectors largely results from the control that market forces impose on for-profits that is mostly absent among not-for-profits.

Market forces such as the influence of institutional investors, share prices that telegraph the financial health of the business, shareholders, and the threat of takeovers that will oust inefficient managers, combine to help check some of the wasteful or abusive practices of for-profit directors and managers.[9] Accordingly, a court's application of the business judgment rule, designed to implicate only the most reckless corporate behavior, sets a legal standard that is usually high enough to hold a company's managers and directors responsible for their actions.[10]

By contrast, not-for-profits, whose bottom line is eleemosynary rather than financial, are legally accountable only to the Attorney General for all but the most abusive or dishonest practices, because the market does not eliminate the lesser abuses. Even when the Attorney General does have a viable cause of action against a not-for-profit, the dearth of resources and lack of institutional interest may keep an "Aspiring Governor" from pursuing most such cases. Additionally, the standard of the business judgment rule is too low, leaving many negligent and irresponsible board members unscathed. As tax-free dollars pour in, boards charged with promoting the public welfare may squander the government's tax dollars. Furthermore, any attempt to examine a not-for-profit board's practices may be met with a concern that the investigation could tarnish its reputation and curb whatever benefit it was conferring on the public.

It should be noted that, in some states, the lack of resources to prosecute is not the only impediment to effective imposition of ethics rules on not-for-profits expending taxpayer dollars. Rather, the actual legislation governing not-for-profits does not even place a sufficient burden on these organizations to hold their officers and employees to high ethical standards. New York Not-for-Profit Corporation Law is one of those less-than-helpful examples. Under that law, an interested transaction is not void if its material facts were disclosed in good faith to the members voting on it.[11] Furthermore, the interested person can be counted in the quorum of a meeting to authorize the transaction.[12] This completely disregards deleterious effects of groupthink on not-for-profit governance.[13] Moreover, even in the absence of good-faith disclosure, if the transaction was "fair" to the corporation, it is not void.[14]

Federal tax law also comes up short in addressing growing governance issues, especially excessive executive compensation. The Internal Revenue Code prohibits 501(c)(3) organizations from engaging in transactions in which the net earnings inure to the benefit of private shareholders,[15] including excess benefit transactions such as excessive executive compensation.[16] However, the intermediate sanctions regime meant to prevent such transactions[17] allows organizations to invoke a "rebuttable presumption,"[18] which in practice, once invoked, will not be rebutted by the IRS.[19] Furthermore, one questions the extent to which smaller organizations have the budgets necessary to regularly consult with legal counsel about such matters and to obtain advice about paying competitive salaries to skilled employees while staying within the IRC's safe harbor. Therefore, while this safe harbor should incentivize organizations to implement more procedures against self-dealing, many not-for-profits have been unaffected by the provision.

III. Proposed Solution—Applying Ethics Laws Regulating Municipal Officers and Employees to the Officers and Employees of Not-for-Profits Receiving Municipal Funding

There are strong policy reasons justifying the extension of laws governing the behavior of public servants to their counterparts who receive government funding to meet public needs. Furthermore, this extension would appear to offer a promising way to ensure that those who spend public money do not breach their duty of loyalty to the public and destroy its trust in the municipal funder.

A. Why Should Municipal Ethics Laws Be Applied to Not-for-Profits Receiving Municipal Funding, and How Would It Prevent Conflicts of Interest in the "Independent" Sector?

Privatization and public-private partnerships have caused additional governance issues to emerge in the intersection of the government and not-for-profit sectors. Certain provisions of ethics laws that were traditionally applicable only to local government and its civil servants are becoming applicable to the private, not-for-profit sector as the government continues to contract out governmental functions. Municipal contractors who are essentially employed by the municipality to perform municipal functions are in a position

similar to that of public servants, because both are compensated by public funds and are charged with performing a public service.

Thus, local ethics laws—which, as noted above, may prohibit a municipal employee, or one of his or her immediate family members, from being involved in an organization that deals with the municipality—should apply not only to the municipal employee but also to the associated party on the other side of the transaction. By applying such ethics provisions to employees of not-for-profits receiving municipal funding, the municipality can increase oversight of nonprofits through the municipal ethics board, which should have the authority to investigate, give advice on, and enforce compliance with ethics laws.[20]

Additionally, through its policies regarding procurement of human services, a municipality can further regulate not-for-profits in the area of conflicts of interest. For example, New York City's procurement policy already requires that provisions prohibiting conflicts of interest be included in City contracts; the Mayor's Office of Contract Services (MOCS), which works with each City agency's chief contracting officer to ensure compliance with Procurement Policy Board rules and other laws, including the City's ethics law, has authority to help regulate employees of not-for-profits contracting with the City.[21] Furthermore, the Capacity Building and Oversight unit of MOCS, which carries out its charge of regulating not-for-profits contracting with the City by training and vetting not-for-profits,[22] is able to inspect not-for-profits based on their compliance or ability to comply with the City's ethics law, and raise awareness of the importance of such compliance through MOCS' training and assistance programs.

B. An Example of Broadening the Scope of a Municipal Ethics Law as It Would Apply to the Officers and Employees of Not-for-Profits

In order to illustrate how one might broaden the scope of municipal ethics laws to apply to not-for-profits expending municipal funds for essentially municipal functions, one might examine how New York City has done so in the context of discretionary funds granted by the New York City Council to not-for-profit organizations. As news articles suggest, not-for-profits receiving discretionary funding from New York City Council Members are an especially ripe area for cracking down on self-dealing by broadening the scope of the City's ethics law beyond City employees. Council Members have been caught funneling City money to friends and relatives who have lined their pockets with the funds. News articles from recent months seem to suggest that, despite tougher regulations set in place since some big scandals were brought to light a few years ago, there is still too much room for those ignorant or scornful of the law to maneuver.

1. Current Law Governing the Discretionary Funding Process

The New York City Policy Procurement Board promulgates rules that govern the City's procurement of goods and services,[23] including procurements funded by discretionary funds.[24] Under the discretionary funding process, Council Members may use their allotted funds to sponsor community-based not-for-profit organizations of their choice[25] and vote on the budget proposals that provide that funding.[26]

Although per the Policy Procurement Board Rules Council Members have the authority to spend public dollars on community-based not-for-profits, as public servants, they are beholden to the City's ethics law. For example, a Council Member may not sponsor funding where a person with whom he or she is "associated" within the meaning of the ethics law has a paid position with the recipient not-for-profit and may benefit as a result of the funding.[27] In close cases, the Council Member may solicit the advice of the Conflicts of Interest Board, the City's ethics board, and if that agency determines that no reasonable likelihood exists that the associated person will directly benefit from the funding, the sponsorship will be permissible.[28]

On the other hand, a Council Member may vote on a budget bill to provide discretionary funding to not-for-profits even if a person who is "associated" with that Council Member has a paid position at a particular organization that is set to receive funding,[29] provided that the Council Member discloses the interest to the Conflicts of Interest Board.[30]

As to requirements imposed on the recipients of discretionary funds, there are many, some of which are similar in substance to the requirements imposed on the Council Members who vote to provide the funding, such as disclosure requirements and restrictions on use of the funds. For example, information about organizations receiving discretionary funds, including descriptions of how the organization intends to use the funds, is publicly available.[31] Also, an organization must apply to receive discretionary funding, and in doing so, answer questions about, among other things, "qualifications, and integrity."[32] Additionally, organizations receiving more than $10,000 of discretionary funds must go through a pre-qualification process, with the City agencies overseeing each program determining whether the organization is "qualified,"[33] and requiring a "Conflicts of Interest Disclosure Certification."[34] Furthermore, organizations must use the funds for a "City purpose," and organizations that receive between $10,000 and $1 million must attend training on topics such as legal compliance and internal controls.[35]

2. Closing the Circuit: Enacting Procedural Requirements to Help the Council and the Not-for-Profits It Supports Achieve Better Governance and Avoid Conflicts of Interest

Despite the Council's disclosure, training, vetting, and spending requirements for not-for-profits receiving its funding, there are a number of areas where applying the City's ethics law to the officers and employees of these organizations would ensure for the Council, and assure the public, that Council Members and their funded organizations are acting ethically.

First, if the ethics law applied to the recipient organizations' officers and employees in the context of their involvement with City funds, they would be held to the same standards as Council Members when it comes to avoiding a conflict of interest. For example, as discussed, in close questions Council Members are expected to seek advice from the Conflicts of Interest Board about the legality of funding an organization where an associated party is a paid officer or employee; and only after the Board has determined that there is no reasonable likelihood that the officer or employee will benefit from the transaction may the Council Member proceed.[36] Applying the ethics law to the paid officers and employees on the other side of the transaction would impose on that officer or employee not only a higher ethical standard but would encourage the officer or employee to seek advice, on penalty of being held accountable for engaging in conflicts of interest. This would at least put such officers and employees on notice; and, at best, it would help the organization create more internal controls, thereby contributing to a more robust governance system within the not-for-profit.

Second, as previously noted, Council Members who wish to vote on a budget bill providing discretionary funds are allowed to do so, provided that they disclose any potential conflicts of interests. The reason for the different standards between voting on and sponsoring funds is that voting is considered part of the elected official's essential function, because not voting can disenfranchise one's constituents.[37] In other words, if not for the "essential function" quality of the voting power, a Council Member would be held to the same standard when voting on as when sponsoring funds. Holding the associated party of a voting Member accountable for violations of the City's ethics law and requiring that associated party to seek advice from the City's ethics board to determine whether to proceed with the transaction would help compensate, at least partially, for the voting Member's reduced responsibility in the voting process. The associated party, not being an elected official, would not have the benefit of relying on the "essential function" of the voting power.

Finally, if the municipal ethics law were applied to not-for-profit officers and employees, the ethics board would have the authority to impose fines and other sanctions on those who violate that law, as well as to provide training on the law, which currently only public servants must attend, and to give advice. This approach would, one hopes, reinforce governance norms and minimize destructive groupthink within not-for-profit organizations receiving municipal funding.

IV. Conclusion

News reports on self-dealing among charities suggest that these scandals are rocking the not-for-profit world. Legislation and enforcement resources at the federal, state and municipal level seem inadequate to regulate these organizations or to help them create better internal controls. The law is changing quickly, while high-ranking government officials are promising to bring new order to charities by capping executives' salaries[38] and requiring fuller disclosure on executive compensation.[39] However, with increasing privatization and public-private partnerships, conflicts of interest among not-for-profits are a growing concern. At the same time, at the municipal level this trend can present more opportunities to help these organizations achieve better governance and preserve the public trust. Applying municipal ethics laws to the not-for-profits that do business with the government offers such an opportunity to provide these organizations with more oversight, clear advice, and training on good governance.

Endnotes

1. *See, e.g.*, N. Y. City Charter § 2604.
2. *See, e.g.*, New York City Conflicts of Interest Board, Ethics: A Plain Language Guide to Chapter 68, (Dec. 2010), *available at* http://www.nyc.gov/html/conflicts/downloads/pdf2/books/orange_bk.pdf (accessed Dec. 8, 2011).
3. § 2604.
4. *See, e.g.*, New York City Conflicts of Interest Board, COIB Advisory Opinion No. 2009-2, *available at* http://archive.citylaw.org/coib/AO/arch%202009/AO2009_2_Council_discretionary_funding.pdf (accessed Dec. 8, 2011).
5. Editorial, *The Nonprofit Crackdown*, New York Post, Aug. 15, 2011.
6. Melanie B. Leslie, *The Wisdom of the Crowds? Groupthink and Nonprofit Governance*, 62 Fla. Law Rev. 1179, 1180 (2010).
7. *Id.* at 1220–22.
8. *Id.* at 1223–24.
9. See Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. Sch. L. Rev. 457, 476–77 (1996).
10. See Susan N. Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 U. Haw. L. Rev. 593, 615 (1999).
11. N-PCL § 715(a).
12. N-PCL § 715(c).

13. Leslie, *supra* note 6, at 1183.
14. N-PCL § 715(b).
15. I.R.C. § 501(c)(3).
16. I.R.C.C.F.R. § 1.501(c)(3)-1(f)(2)(ii).
17. I.R.C. § 4958.
18. I.R.C.C.F.R. § 53.4958-6(b).
19. *See* Staff of the Joint Comm. on Taxation, 109th Cong., *Options to Improve Tax Compliance and Reform Tax Expenditures* 263 (2005) (JCS-02-05) ("If the procedures were followed, the agent knows success on the merits is unlikely because the IRS will have to overcome a presumption of reasonableness in favor of the taxpayer. Under such circumstances, agents often will abandon the issue.")
20. *See, e.g.*, N.Y. CITY CHARTER § 2603.
21. New York City Mayor's Office of Contract Services, About MOCS, http://www.nyc.gov/html/mocs/html/about/about.shtml (accessed Oct. 28, 2011).
22. New York City Mayor's Office of Contract Services, Agency Procurement Indicators (2011), http://www.nyc.gov/html/mocs/downloads/pdf/procurement_indicators_2011.pdf (accessed Dec. 8, 2011).
23. N.Y. CITY CHARTER § 311.
24. Rules of City of N.Y. Procurement Policy Board (9 RCNY) § 1-02(e).
25. *Supra* note 4, at 3.
26. *Id*. at 5.
27. *Supra* note 4, at 8, 14–15. "A person or firm 'associated' with a public servant includes a spouse, domestic partner, child, parent or sibling; a person with whom the public servant has a business or other financial relationship; and each firm in which the public servant has a present or potential interest." N.Y. CITY CHARTER § 2601(5).
28. *Supra* note 4, at 14–16.
29. *Id*. at 8.
30. *Id*. citing N.Y. CITY CHARTER §2604(b)(1)(a).
31. New York City Council, Discretionary Funding Policies and Procedures, *available at* http://council.nyc.gov/html/budget/PDFs/DiscretionaryFundingPoliciesFY12.pdf (accessed Dec. 8, 2011).
32. *Id*. at 3.
33. *Supra* note 22.
34. New York City Department of Youth & Community Development, Prequalification for City Council Discretionary Awards, *available at* http://home2.nyc.gov/html/dycd/downloads/pdf/PQL_Application4_1_2010.pdf (accessed Dec. 8, 2011).
35. *Supra* note 31.
36. In fact, the Council Member may proceed without consulting the Board, but does so at his or her peril. Misreading the applicable law and precedent may well result in an enforcement action.
37. *Supra* note 4, at 8.
38. *See, e.g.*, Susan K. Livio, *N.J. Gov. Christie Looks to Impose Salary Cap on Nonprofit CEOs*, NEWARK STAR-LEDGER, Apr. 26, 2010.
39. *See, e.g.*, Russ Buettner, *Panel Asks Nonprofits for Compensation Data*, N.Y. TIMES, Aug. 26, 2011, at A23.

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