Board Conflicts Of Interest In An Age Of Behavioral Ethics

by Jeffrey M. Kaplan and Rebecca Walker

On conflict of interest issues, most board members are certain they know where the guard rails are—until they find themselves accused of unethical conduct. While the rules for what constitutes a conflict of interest are fairly straightforward, identifying conflicts in ourselves and others is often more challenging than we realize. Setting conflict rules for your board is critical, but it is less important than being able to identify the *behaviors* such rules seek to prevent.

Among the numerous types of ethics-related risks facing business organizations, business people and boards of directors, conflicts of interest (COI) are especially important.

Conflicts of interest are certainly common in businesses. This is evident from the fact that corporate compliance and ethics officers in many companies devote a great deal of their work time to dealing with COI issues. COI-related concerns often arise in other settings as well, such as non-profit organizations, politics, science, journalism and sports. The very pervasiveness of COIs in the world at large can enhance the sensitivity to—and expectations of—relevant stakeholders in business organizations.

Conflicts of interest are at the root of many other types of ethical issues, such as all cases of corruption and many instances of fraud and insider trading. In some areas of business (such as government contracting, healthcare and financial services), COI-related regulation is extensive, because of the extensiveness of COI-based challenges. However, in virtually every organization of any size there are at least some COI-related risks.

More than most other risk areas, conflicts of interest tend to be personal, which can create great challenges to addressing them appropriately. Think, for example, of the CEO who wants her company to hire a nephew who the CEO insists is "without question the best person for the job." COIs can be "personal" not only to winners but also losers, such as the employee who did not get that position.

Board members have a particular need to understand conflict issues because their job is to resolve conflicts between management and shareholders.

How a company responds to conflicts of interest may impact the sense of "organizational justice" that employees have regarding the company. Conflicts often create the perception of a double standard, which can have a corrosive effect on a company's ethical culture and overall compliance risk profile.

While every business person should know the basics about conflicts, for corporate board members, the need is particularly pronounced. That is because the very position of corporate directors exists, in part, to ameliorate the COI-like tension (sometimes referred to as a type of "agency problem") between corporate managers and shareholders.

Given this role, a board member's remit should include knowing the types of risks to the organization that arise from COIs; the company's COI disclosure procedures; directors' own COIs (actual or apparent); and the COIs of the executives who the board is charged with overseeing. Failure on any of these fronts can raise doubts about a board's ability to discharge its duties to its shareholders. For instance, in one case involving apparent conflicts by a company's CEO, noted corporate governance expert Ben Heinemann (former general counsel of General Electric) observed that the board had put itself in a situation where its only options were to

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look, either “ill-informed and negligent” or, on the other hand, complicit in the CEO’s dealings.

☐ ***Duty of loyalty.*** Courts have long required directors and officers to serve their corporations faithfully, maintaining a “duty of loyalty” to the corporation. This is typically described as both a negative and positive duty—a duty not to use one’s position for personal gain, and a duty to act in the best interests of the company. The duty of loyalty is typically described broadly and inflexibly in the case law, though, in practice, a significant amount of flexibility is typically afforded directors’ conduct.

A primary question in assessing a conflict of interest is whether the relevant “interest” is of the type and significant enough to create a conflict.

Transactions to which the corporation is a party that benefit a director personally in some manner are classic examples of corporate conduct involving a conflict of interest. These are typically referred to as “interested director transactions.” In the past, these transactions were either void or voidable at the election of the corporation. However, the law has evolved to allow more flexibility.

Under the laws of most states (as found in statutes and judicial holdings), if an interested director either fully discloses the conflict to the disinterested members of the board and receives majority approval, or if the transaction is fair to the corporation, then it will typically not be set aside.

A primary question to be considered in assessing a conflict of interest is whether the relevant “interest” is of the type and significant enough to be capable of creating a conflict. As a general matter, an interest must be “material” to be considered conflicts-creating. Other factors are also relevant, as discussed below.

☐ ***Personal interests in company transactions.*** Issues typically considered sufficient to create a conflict where a director’s duty of loyalty is concerned are financial interests. Courts typically find that a director has no conflict if he or she has no financial interest in a transaction. The financial interest can be direct or it can be indirect, through family or a corporate or business relationships.

For example, the Model Business Corporation Act defines conflicting interests in purely financial terms. Under the Act, a conflict exists where a director or a “related person” is a party to a corporate transaction “or has a beneficial financial interest in or so closely linked to the transaction and of such financial significance to the director or a related person that it would reasonably be expected to exert an influence on the director’s judgment if he were called upon to vote on the transaction.”

“Related person” is defined quite broadly to include “the spouse (or a parent or sibling thereof) of the director or a child, grandchild, sibling, parent (or spouse of any thereof), of the director or an individual having the same home as the director…”

However, there are some examples of a court finding that a non-financial interest has created a conflict. In *In re Oracle Corp. Derivative Litigation,* a special litigation committee (SLC) of the company asked the Delaware Chancery Court to dismiss a shareholder derivative action alleging that certain Oracle directors engaged in insider trading. Oracle’s board had formed the SLC, which rejected the plaintiffs’ demand to bring suit, and the SLC then sought dismissal of the suit based on this rejection.

Where a special litigation committee rejects a demand to sue and seeks dismissal of a suit, the committee has the burden to show that there is no material issue of fact that calls its independence into doubt. A committee’s independence depends on “whether a director is, for any substantial reason, incapable of making a decision with only the best interests of the corporation in mind.”

In *Oracle,* two members of the SLC were professors at Stanford University. The directors whose conduct was at issue included:

☐ Another Stanford professor, who taught one of the members of the SLC and served with that SLC member at the Stanford Institute for Economic Policy Research (SIEPR).

☐ A Stanford alumnus who had directed millions of dollars of contributions to Stanford during recent years, served as chair of SIEPR's Advisory Board, had a conference center named for him at SIEPR's facility, and had contributed nearly $600,000 to SIEPR and the Stanford Law School.

☐ Oracle's CEO, who made millions of dollars in donations to Stanford through a personal foundation and large donations indirectly through Oracle. He was also considering making donations of his $100 million house and $170 million for a scholarship program at around the same time period the SLC members were added to the Oracle board.

Independence may be compromised any time a director is "beholden to an interested person," which includes personal or other relationships.

None of the above-described relationships constitutes a "financial interest" of a member of the committee. However, the court nonetheless found that the relationships create a reasonable doubt about the impartiality of the SLC and denied the SLC's motion to dismiss.

The court noted that independence may be compromised any time a director is "beholden to an interested person. Beholden in this sense does not mean just owing in the financial sense; it can also flow out of 'personal or other relationships' to the interested party."

☐ ***Competing against the company.*** A director or officer in competition with the corporation is a fairly blatant example of a breach of the fiduciary duty of loyalty. One cannot both compete against the company and act in the company's best interests. A director can, however, operate a business that is distinct from or even related or complementary to the corporation's business without breaching the duty of loyalty.

☐ ***Related party transactions.*** When a director of Company A is involved somehow (as owner, director, officer or employee) in an organization that does or seeks to do business with Company B, whether the situation is considered permissible or not depends largely on the procedures employed by the board in reviewing and approving the transaction.

Employing an appropriate process is critical to dealing with director conflicts of interests. The process should include precautionary measures to ensure that full disclosure is made concerning directors'

Writing Your Conflicts Policy

Add These To Your List

The following are important considerations in drafting director conflict of interest policies:

☐ A discussion of the fiduciary duty of loyalty owed by directors to the corporation and the importance of compliance with the policy.

☐ An explanation of what conflicts of interest are (e.g., an interest or relationship that creates a conflict between the best interests of the organization and the personal interests of the director).

☐ Specific examples of the types of conflicts most likely to arise.

☐ A discussion of apparent and potential, as well as actual, conflicts.

☐ A requirement that directors disclose to a designated member of the board (such as the chair of the governance committee) any interest that may create a conflict with the best interests of the organization, and that the disclosure be prompt and in writing.

☐ A procedure for approval of board conflicts as appropriate (for example, requiring a majority vote by disinterested members of the governance committee, and only upon a clear showing that approval is in the best interest of the company).

☐ Prohibition against a director participating in any discussions or other decision making on a transaction in which she or he has an interest, and the requirement that interested directors recuse themselves from voting on a matter in which they have an interest, unless receiving written permission to be involved in such matter.

☐ Discussion of how approved conflicts should be monitored by the board.

☐ Directors' duties with respect to oversight of officers' actual, apparent or potential conflicts of interest.

☐ A discussion of any requirements related to annual conflict of interest questionnaires or any other required certifications of compliance with the conflicts policy.

personal interests, such as the periodic circulation of a conflicts of interest questionnaire. With respect to significant new transactions, it may be appropriate to specifically inquire of directors as to the existence of any personal interest in the transaction.

If a conflict of interest exists, the interested director, after making full disclosure and answering any questions, should refrain from voting on the transaction in question. Where the presence of the interested director is not required for a quorum, or where the director cannot be counted in determining a quorum, it is generally appropriate for the director to recuse herself from the meeting while the transaction is discussed.

☐ ***Executive compensation.*** Executive compensation decisions raise noteworthy (and perennial) questions about board oversight of conflicts. Indeed, in every officer's or director's negotiations for compensation, there is an inherent conflict between his and the company's interests, as every dollar in pay is a dollar taken from the corporation.

Boards typically approve the salary of the CEO, and may also approve the salaries of other senior officers. However, the ability of the board to exercise truly independent oversight in this area is frequently questioned, since corporate officers, especially CEOs, exercise substantial influence over the corporate boards that oversee them. The New York Stock Exchange seeks to mitigate this concern by requiring its listed companies to have a compensation committee composed of independent directors.

To mitigate the inherent conflicts in setting executive compensation, many corporations have attempted to establish a system for independent review of pay, and also use compensation consultants to assist them in devising pay packages for high-level executives. We note, however, that these consultants also create conflicts of interest concerns, even where they are retained by independent directors.

☐ ***Inappropriate use of company assets, including confidential information.*** Directors and officers have a duty to protect the company's resources, which includes using them for business and not personal purposes. Diverting a corporation's assets for personal use is an example of allowing one's personal interests to prevail over the best interests of the corporation.

Following several well-publicized examples of abuse of corporate assets in the late 1990s and early 2000s, the New York Stock Exchange required listed companies to adopt codes of business conduct and ethics for all directors, officer and employees.

The long history of insider trading cases provides helpful illustrations of the harm resulting from the usurpation of confidential information for the personal benefit of a director or third party. (The best known example of this in recent years concerned a director of Goldman Sachs who leaked word to a hedge fund about a planned investment in the firm by Warren Buffett.)

Directors and officers may not take business opportunities for their own benefit that should rightfully belong to the company.

☐ ***Corporate opportunities.*** Corporate opportunities are another area of potential conflicts of interest between directors and the corporation. The doctrine of corporate opportunities provides that directors and officers may not take business opportunities for their own benefit that should rightfully belong to the company.

While the law on conflicts of interest is well-developed and fairly straightforward, human behavior (including behavior related to COIs) often is not so obvious. History and case law abound with stories in which directors put themselves in untenable positions. To paraphrase Ben Heineman, directors in such situations seem either to be negligent or complicit in executive's conflicts, as well as negligent or complicit in their own.

Above all, behavioral ethics teaches that we are not as ethical as we think. Studies showing that people tend to overestimate the likelihood that they will act ethically in a given situation are a central part of the behavioral ethics canon. Behavioral ethics helps us to understand the COI-related gap between "is" and "ought." Understanding this field of knowledge can help directors keep their companies and themselves in the clear on COIs and other ethical issues.

The fact that board members are powerful people is not a source for comfort, as some may be tempted to think. Rather, several behavioral ethics studies have shown that people with power tend to act less ethically than do others. The phrase "power corrupts, and absolute power corrupts absolutely" is proved through social science research.

The fact that those who have conflicts are professionals (for instance, in finance or law) is not a source for comfort either. Various studies have shown that professionals often do not do a good job in mitigating the impact of conflicts on their own behavior. Among the many examples of this is research showing that auditors tend to be swayed by conflicts in making professional judgments.

The fact that a COI is disclosed does not necessarily reduce the risk of its having a corrupting effect. In fact, disclosure can make the COI worse, as some behavioral studies have shown that disclosure tends to "morally license" conflicted behavior. (though in some circumstances disclosure has been found by researchers to inhibit conflicted conduct.) Additionally, the act of disclosure may operate as a form of psychological pressure on the recipient to agree to a waiver.

"Motivated blindness" limits our ability to see unethical conduct of others where we have a reason to ignore such conduct. We expect that this could be a particularly insidious force in a boardroom, where directors rely on each other (and on executives) in many ways. The picture that emerges from these and other studies is one of ethical vulnerability of corporate directors, which, in turn, supports the need for heightened ethical awareness.

As a final thought, consider a case that shows there can be a level of complexity to COI cases that may not be picked up even in behavioral research. Years ago one of the authors was hired to conduct an investigation where the client had entered into a complex business arrangement with another entity with which one of the client's executives had a relationship. The relationship and proposed arrangement were fully disclosed and approved by the board of directors.

After some time, the arrangement ran into business difficulties. Although the client had lived up to its contractual obligations, the other entity suggested that it should have done more to make the arrangement work. This suggestion, in turn, made some employees of the client suspicious that that entity had in fact been promised more than was disclosed by the executive. This caused the employees to take defensive measures which put further strain on the arrangement. Ultimately, the arrangement collapsed, with dire consequences for both parties.

This "tangled web" can be considered a case of a "reverse conflict of interest," and one where disclosure leads to overreaction rather than an under reaction, which is what a behaviorist might expect. Presumably matters of this sort are rare, but the case is useful as reflecting how varied conflicts of interest can be. Moreover, it shows that while an in-depth knowledge of law, ethics and psychology are necessary for directors to deal with conflicts, having the wisdom to focus on what is unique and potentially dangerous about a situation may be the most important skill of all. ■

Cases and statutes discussed in this article can be found in Rebecca Walker's book, Conflicts of Interest in Business and the Professions: Law and Compliance *(Thomson). Behavioral ethics studies and news stories referenced can be found in Jeff Kaplan's blog [conflictofinterestblog.com].*

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