**Conflict of Interest**

**From the desk of the editor**

When I travel around speaking at governance conferences or working with individual boards, I am increasingly asked about conflicts of interest: what they are, how to identify and handle them, and what their risks and implications are.

So we’ve dedicated this issue of *Governance Matters* to helping you answer these questions and avoid the tensions, embarrassments, losses, and even reputational damage that a poorly handled conflict of interest can lead to. In this newsletter, we will focus on the board member, but the same principles apply to managers, employees and perhaps even volunteers and suppliers.

One cautionary note: this is not intended as legal advice, and if you are facing a specific situation with risk of loss, I would definitely advise you to consult your counsel or a professional legal advisor.

As always, we hope you find this of value to you and your board and we welcome your feedback!

Debra L. Brown
Editor

**What is a conflict of interest?**

“A conflict of interest arises when the interests of a board member have the potential to be at odds with the best interests of the organization.”

When a board considers how narrowly or broadly to define a conflict of interest, it is instructive to keep in mind two key words in the definition above: “potential” and “best” …

- **Potential:** A conflict of interest does not exist only when interests are at odds. A conflict of interest may exist when there is the potential for interests to be at odds. It may be wiser to include these aspects within the definition of conflict of interest rather than excluding perceived or potential conflicts of interest from consideration and risking ignoring them.

- **Best:** A conflict of interest exists in the context of the best interests of the organization. This means that it is not sufficient for the organization to benefit, but how the decision is made is also of importance. It is important that the decision is made by the right individual or group, in an objective and informed manner, and according to all policies of the organization.

**Are there different kinds of conflict of interest?**

Yes. The board member’s conflict of interest may be:

- **Direct:** a narrow legal conflict of interest exists when a board member or immediate family member stands to gain or lose money personally because of a decision before the board or corporation;

- **Indirect:** when the financial gain is one step removed from the board member; or

- **Perceived:** when someone looking in from the outside perceives that a board member used his or her influence to get the board to make a decision that favoured someone or a group with whom the board member has affinity.

---

1 This is the definition we use at Brown Governance Inc. (BGI), originally referenced from Association Xpertise Inc., [www.axi.ca](http://www.axi.ca)

2 These points are emphasized by Association Xpertise Inc., [www.axi.ca](http://www.axi.ca)
HOW CAN I IDENTIFY A CONFLICT OF INTEREST IN A CO-OPERATIVE?

It can be more difficult to clearly discern a conflict of interest in a co-operative than in many other forms of organization. This is because co-ops are, by design, owned by either their customers (e.g. retail, housing, health or day care co-ops) or suppliers (e.g. dairy, grain, most agri-co-ops), and in some cases both (e.g. credit unions.) And because the board of directors of co-operatives is typically comprised of those member-owners.

Fortunately, there are explicit exemptions or exclusions in co-operative law that exempt normal membership transactions with the co-operative from being considered a conflict of interest. Otherwise, members of the co-op could not function practically as board members.

We have drawn up the following table to help you recognize whether a situation is a conflict of interest or not for a board member of a co-operative:

<table>
<thead>
<tr>
<th>Type of conflict</th>
<th>Examples: exempt from being a conflict</th>
<th>Examples: of a conflict</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct</td>
<td>In a credit union, approving interest rates on loans and deposits even if the board member has loans or deposits affected by these.</td>
<td>Board member or immediate family member being considered for contract for services or goods, or employment (bidding on an RFP, or leasing a property.)</td>
</tr>
<tr>
<td>Indirect</td>
<td>In an agri-coop, approving the building of a new plant that will add more value to the products even though the board members sell this product to the co-op.</td>
<td>Board member is an officer or executive of a potential supplier to the organization, or of a charity where the corporation is a major donor (both these examples actually occurred at Enron)</td>
</tr>
<tr>
<td>Perceived</td>
<td>In any co-op, approving a community investment program in a board member’s community or city (as long as the board member is not influencing the choice of community.)</td>
<td>A contract being awarded to a neighbour, someone the board member went to school with, or their local community.</td>
</tr>
</tbody>
</table>

The way you can usually tell if the decision is exempt from being a conflict in a co-operative is to test whether one board member’s interests are the same as, or substantially differ from, the interests of most of the members and the other board members in this decision:

- In the credit union example from the table above, most board members are likely to have loans or mortgages, so it would not be a conflict for them to vote on loan and mortgage interest rates. But if only one board member had a very large commercial loan, and no other board members did, it might be wiser to exclude that board member from voting on commercial loan interest rates and credit terms to avoid a conflict.
- The same rationale applies to an agri-coop—if most board members are suppliers of product, they can all vote to approve policies, pricing, etc., but if one board member has an inordinate or unique supplier situation, then he or she would usually be excluded from that decision.
- The same rationale applies to immediate family members of staff members, and this is why they are generally counselled not to serve on the board, since they could be in a conflict of interest situation almost continually.

A pretty good “gut test” for a conflict of interest is to ask: “How would this look as front page news?” Would readers understand what happened and why? How would the organization’s reputation be affected?
Conflict of Interest

When does a conflict of interest start and end?

There is always a moment when an action or intention of either the co-operative or a board member triggers a potential conflict. For example, the organization may consider or decide to undertake a project, expand, buy or lease equipment or facilities, or hire a staff member. Or a board member or employee may consider or decide to apply for a job posting, or bid on a contract.

A conflict does not end until the potential for gain or loss has been completely extinguished. This would mean that the opportunity (or risk; i.e. the uncertainty) is completely closed—the job has been filled, the contract completed, the transaction closed. There is usually a “cooling off period” after the end of a contract or transaction to ensure everything is working to the satisfaction of the corporation. For example, if a dispute arose over the work, or an employee or facility did not work out, the potential for conflict still exists—the board member could use his or her influence to stoke a conflict or dispute, for example.

Why does conflict of interest matter?

The primary governance purpose of boards is to act as the independent intermediary between the “principals” of an organization (those who supply or contribute resources to it; i.e. its members) and the “agents” of a corporation (those who apply or use those resources in productive activities; i.e. its management).

In order to accomplish this purpose effectively, the board must be able to think and act in the best interests of the co-operative or credit union, rather than in the interests of certain principals, agents, or themselves. Under co-operative law, board members are typically entitled to take into account the interests of the membership, but must still act in the co-op’s best interests.

This is called the “fiduciary” duty of directors, and it is the fundamental legal duty of directors required by statute (the Act under which you are incorporated.) It is also called a director’s “duty of loyalty,” and is the first test that a court or judge would apply in assessing the legality of an action.

What should we do if an individual is on the Board and has a conflict?

The legal standard in Canada is that a board member must declare a conflict of interest, and not take part in the decision taken by the board on that matter.

In practice, this means that a board member who has a conflict of interest leaves the board (or committee) meeting during the entire discussion and vote on that matter, and this is recorded in the minutes.

Strictly speaking under Canadian law, that director may stay in the room and simply refrain from voting. But almost always the director is asked to leave because of a concern that his or her presence during the discussion and/or vote could unduly influence other directors.

If enough directors declare a conflict, the board may lose quorum, and so lose its legal standing to make a decision—this actually happened in Canada in the case of the Royal Bank of Canada’s board of directors dealing with loans to borrowers associated with Bell Canada. That is why a minimum number of independent directors is often a good idea.

3 See Brown & Brown, Agency Governance Plus, Brown Governance Inc. which is based on Adam Smith’s original agency theory. www.browngovernance.com/resources/AgencyGovernanceExplained.htm
The point is that all board decisions must be made by independent or “disinterested” directors, by those directors who do not have a conflict of interest in that matter. By “independent,” we mean directors who are free of material interests or relationships (beyond their membership in the co-op itself). According to our national research into co-operative governance practices, fully eighty-four per cent of directors among respondent co-ops are considered independent.4

**WHAT ARE THE RISKS IF WE DON’T DEAL WITH CONFLICTS OF INTEREST THIS WAY?**

Simply put, the decision that the board made could be at risk, and could be undone or reversed.

The co-operative or credit union could be taken to court—by a competing supplier who lost a contract, for example, seeking an “oppression remedy”—and the contract could be cancelled. A court may do this if it found that the board made a decision and awarded a contract in violation of its fiduciary duty, because a director who had a conflict of interest took part in the decision.

Directors are normally protected by a legal standard in Canada (and the U.S.) called the “business judgment rule,” which states that courts will generally not substitute their judgment for the business judgment of the board. This gives directors a great deal of leeway, including making poor or even disastrous decisions. In order to apply this rule, though, courts will first check to ensure that board members did fulfil their duty of loyalty (fiduciary duty) and duty of care (due diligence.) If a board member was in a conflict of interest but this was not declared or was ignored, then the business judgment rule would probably be set aside, and this legal defence would then not be available to the corporation or board.

A court would then not hesitate to substitute its judgment for the board if it violated or ignored its fiduciary duty. It would seek to determine a reasonable or fair market value of the contract or transaction, what price the corporation could have obtained if the transaction had been at “arms-length.”

Damages could be awarded to the other supplier, or the co-operative could be forced to award the contract to that supplier. Both the co-operative and the conflicted director personally could face significant losses.

Beyond financial penalties and remedies, the lasting effect of ignoring conflict of interest is reputational. The entire board and executive could be tainted with the ethical aspects of the matter, could be set aside, and both personal and corporate reputations ruined for a lasting period of time. There is a long list of well-known examples where this sad situation actually happened. This is perhaps even more acute in a province or city where the business community is smaller and memories tend to last longer.

And, of course, the opposite is also true: co-operative boards that pay attention to conflicts of interest preserve and sustain the reputation and image of their co-op, and protect and build value for the membership and community.

Across Canada, four out of five (79%) boards of co-operatives ensure that a formal conflict of interest policy is in place at their co-operative.5 This is an issue taken seriously by co-operatives and their boards as collectively they seek to embrace the spirit, not just the letter, of the co-operative principles and values.

---

4 2008 national co-operative governance research to be published by CCA and BGI in June, 2008.
5 2008 national co-operative governance research to be published by CCA and BGI in June 2008.
Contact Us
We encourage you to submit articles, case studies, links or other resources for future newsletters. Please contact Quintin Fox (Quintin.Fox@CoopsCanada.coop), CCA’s Manager of Member Services, (613) 238-6711 ext 234.