Ethics and Nonprofits

By Deborah L. Rhode & Amanda K. Packel
Unethical behavior remains a persistent problem in nonprofits and for-profits alike. To help organizations solve that problem, the authors examine the factors that influence moral conduct, the ethical issues that arise specifically in charitable organizations, and the best ways to promote ethical behavior within organizations.

Hose who work on issues of ethics are among the few professionals not suffering from the current economic downturn. The last decade has brought an escalating supply of moral meltdowns in both the for-profit and the nonprofit sectors. Corporate misconduct has received the greatest attention, in part because the abuses are so egregious and the costs so enormous. Chief
Addressing these ethical concerns requires a deeper understanding of the forces that compromise ethical judgment and the most effective institutional responses. To that end, this article draws on the growing body of research on organizational culture in general, and in nonprofit institutions in particular. We begin by reviewing the principal forces that distort judgment in all types of organizations. Next, we analyze the ethical issues that arise specifically in the nonprofit sector. We conclude by suggesting ways that nonprofits can prevent and correct misconduct and can institutionalize ethical values in all aspects of the organization’s culture.

**Causes of Misconduct**

Ethical challenges arise at all levels in all types of organizations— for-profit, nonprofit, and government—and involve a complex relationship between individual character and cultural influences. Some of these challenges can result in criminal violations or civil liability: fraud, misrepresentation, and misappropriation of assets fall into this category. More common ethical problems involve gray areas—activities that are on the fringes of fraud, or that involve conflicts of interest, misallocation of resources, or inadequate accountability and transparency.

Research identifies four crucial factors that influence ethical conduct:

- **Moral awareness:** recognition that a situation raises ethical issues
- **Moral decision making:** determining what course of action is ethically sound
- **Moral intent:** identifying which values should take priority in the decision
- **Moral action:** following through on ethical decisions.

People vary in their capacity for moral judgment—in their ability to recognize and analyze moral issues, and in the priority that they place on moral values. They also differ in their capacity for moral behavior—in their ability to cope with frustration and make good on their commitments.

Cognitive biases can compromise these ethical capacities. Those in leadership positions often have a high degree of confidence in their own judgment. That can readily lead to arrogance, overoptimism, and an escalation of commitment to choices that turn out to be wrong either factually or morally. As a result, people may ignore or suppress dissent, overestimate their ability to rectify adverse consequences, and cover up mistakes by denying, withholding, or even destroying information.

A related bias involves cognitive dissonance: People tend to suppress or reconstrue information that casts doubt on a prior belief or action. Such dynamics may lead people to discount or devalue evidence of the harms of their conduct or the extent of their own responsibility. In-group biases can also result in unconscious discrimination that leads to ostracism of unwelcome or inconvenient views. That, in turn, can generate perceptions of unfairness and encourage team loyalty at the expense of candid and socially responsible decision making.

A person’s ethical reasoning and conduct is also affected by organizational structures and norms. Skewed reward systems can lead to a preoccupation with short-term profits, growth, or donations at


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the expense of long-term values. Mismanaged bonus systems and compensation structures are part of the explanation for the morally irresponsible behavior reflected in Enron Corp. and in the recent financial crisis. In charitable organizations, employees who feel excessive pressure to generate revenue or minimize administrative expenses may engage in misleading conduct. Employees’ perceptions of unfairness in reward systems, as well as leaders’ apparent lack of commitment to ethical standards, increase the likelihood of unethical behavior.

A variety of situational pressures can also undermine moral conduct. Psychologist Stanley Milgram’s classic obedience to authority experiment at Yale University offers a chilling example of how readily the good go bad under situational pressures. When asked to administer electric shocks to another participant in the experiment, about two-thirds of subjects fully complied, up to levels marked “dangerous,” despite the victim’s screams of pain. Yet when the experiment was described to subjects, none believed that they would comply, and the estimate of how many others would do so was no more than one in 100. In real-world settings, when instructions come from supervisors and jobs are on the line, many moral compasses go missing.

Variations of Milgram’s study also documented the influence of peers on individual decision making. Ninety percent of subjects paired with someone who refused to comply also refused to administer the shocks. By the same token, 90 percent of subjects paired with an uncomplaining and obedient subject were equally obedient. Research on organizational behavior similarly finds that people are more likely to engage in unethical conduct when acting with others. Under circumstances where bending the rules provides payoffs for the group, members may feel substantial pressure to put their moral convictions on hold. That is especially likely when organizations place heavy emphasis on loyalty and offer significant rewards to team players. For example, if it is common practice for charity employees to inflate expense reports or occasionally liberate office supplies and in-kind charitable donations, other employees may suspend judgment or follow suit. Once people yield to situational pressures when the moral cost seems small, they can gradually slide into more serious misconduct. Psychologists label this “the boiled frog” phenomenon. A frog thrown into boiling water will jump out of the pot. A frog placed in tepid water that gradually becomes hotter will calmly boil to death.

Moral blinders are especially likely in contexts where people lack accountability for collective decision making. That is often true of boards of directors—members’ individual reputations rarely suffer, and insurance typically insulates them from personal liability. A well-known study by Scott Armstrong, a professor at the Wharton School of the University of Pennsylvania, illustrates the pathologies that too often play out in real life. The experiment asked 57 groups of executives and business students to assume the role of an imaginary pharmaceutical company’s board of directors. Each group received a fact pattern indicating that one of their company’s most profitable drugs was causing an estimated 14 to 22 “unnecessary” deaths a year. The drug would likely be banned by regulators because a competitor offered a safe medication with the same benefits at the same price. More than four-fifths of the boards decided to continue marketing the product and to take legal and political actions to prevent a ban. By contrast, when a different group of people with similar business backgrounds were asked for their personal views on the same hypothetical, 97 percent believed that continuing to market the drug was socially irresponsible.

These dynamics are readily apparent in real-world settings. Enron’s board twice suspended conflict of interest rules to allow CFO Andrew Fastow to line his pockets at the corporation’s expense. Some members of the United Way of the National Capital Area’s board were aware of suspicious withdrawals by CEO Oral Suer over the course of 15 years, but failed to alert the full board or take corrective action. Experts view the large size of some governing bodies,
Compensation. Salaries that are modest by business standards can cause outrage in the nonprofit sector, particularly when the organization is struggling to address unmet societal needs. In a March 23, 2009, Nation column, Katha Pollitt announced that she “stopped donating to the New York Public Library when it gave its president and CEO Paul LeClerc a several hundred thousand-dollar raise so his salary would be $800,000 a year.” That, she pointed out, was “twenty times the median household income.” Asking him to give back half a million “would buy an awful lot of books—or help pay for raises for the severely underpaid librarians who actually keep the system going.”

The problem is not just salaries. It is also the perks that officers and unpaid board members may feel entitled to take because their services would be worth so much more in the private sector. A widely publicized example involves William Aramony, the former CEO of United Way of America, who served six years in prison after an investigation uncovered misuse of the charity’s funds to finance a lavish lifestyle, including luxury condominiums, personal trips, and payments to his mistress. Examples like Aramony ultimately prompted the IRS to demand greater transparency concerning nonprofit CEO compensation packages exceeding certain thresholds.

Nonprofits also face issues concerning benefits for staff and volunteers. How should an organization handle low-income volunteers who select a few items for themselves while sorting through noncash contributions? Should employees ever accept gifts or meals from beneficiaries or clients? Even trivial expenditures can pose significant issues of principle or public perception.

Travel expenses also raise questions. Can employees keep frequent flyer miles from business travel? How does it look for cash-strapped federal courts to hold a judicial conference at a Ritz-Carlton hotel, even though the hotel offered a significantly discounted rate? The Panel on the Nonprofit Sector recommends in its Principles for Good Governance and Ethical Practice that organizations establish clear written policies about what can be reimbursed and require that travel expenses be cost-effective. But what counts as reasonable or cost-pay for raises for the severely underpaid librarians who actually keep the system going.”

Conflicts of Interest. Conflicts of interest arise frequently in the nonprofit sector. The Nature Conservancy encountered one such problem in a “buyer conservation deal.” The organization bought land for $2.1 million and added restrictions that prohibited development such as mining, drilling, or dams, but authorized construction of a single-family house of unrestricted size, including a pool, a tennis court, and a writer’s cabin. Seven weeks later, the Nature Conservancy sold the land for $500,000 to the former chairman of its regional chapter and his wife, a Nature Conservancy trustee. The buyers then donated $1.6 million to the Nature Conservancy and took a federal tax write-off for the “charitable contribution.”

Related conflicts of interest arise when an organization offers preferential treatment to board members or their affiliated companies. In another Nature Conservancy transaction, the organization received $100,000 from SC Johnson Wax to allow the company to use the Conservancy’s logo in national promotion of products, including toilet cleaner. The company’s chairman sat on the charity’s board, although he reportedly recused himself from participating in or voting on the transaction.

These examples raise a number of ethical questions. Should board members obtain contracts or donations for their own organizations? Is the board member’s disclosure and abstention from a vote enough? Should a major donor receive special privileges, such as a job or college admission for a child? In a recent survey, a fifth of nonprofits (and two-fifths of those with more than $10 million in annual expenses) reported buying or renting goods, services, or property from a board member or an affiliated company within the prior two years. In three-quarters of nonprofits that did not report any such transactions, board members were not required to disclose financial interests in entities doing business with the organization, so its leaders may not have been aware of such conflicts.

Despite the ethical minefield that these transactions create, many nonprofits oppose restrictions because they rely on insiders to provide donations or goods and services at below-market rates. Yet such quid pro quo relationships can jeopardize an organization’s reputation for fairness and integrity in its financial dealings. To maintain public trust and fiduciary obligations, nonprofits need detailed, unambiguous conflict of interest policies, including requirements that employees and board members disclose all financial interest in companies that may engage in transactions with the organization. At a minimum, these policies should also demand total transparency about the existence of potential conflicts and the process by which they are dealt with.

Publications and Solicitation. Similar concerns about public trust entail total candor and accuracy in nonprofit reports. The Red Cross learned that lesson the hard way after disclosures of how it used the record donations that came in the wake of the 9/11 terrorist attacks. Donors believed that their contributions would go to help victims and...
their families. The Red Cross, however, set aside more than half of the $564 million in funds raised for 9/11 for other operations and future reserves. Although this was a long-standing organizational practice, it was not well known. Donor outrage forced a public apology and redirection of funds, and the charity's image was tarnished.23

As the Red Cross example demonstrates, nonprofits need to pay particular attention to transparency. They should disclose in a clear and non-misleading way the percentage of funds spent on administrative costs—information that affects many watchdog rankings of nonprofit organizations. Transparency is also necessary in solicitation materials, grant proposals, and donor agreements. Organizations cannot afford to raise funds on the basis of misguided assumptions, or to violate public expectations in the use of resources.

Financial Integrity. Nonprofit organizations also face ethical dilemmas in deciding whether to accept donations that have any unpalatable associations or conditions. The Stanford Institute for Research on Women and Gender, for example, declined to consider a potential gift from the Playboy Foundation. By contrast, the ACLU’s Women’s Rights Project, in its early phase, accepted a Playboy Foundation gift, and for a brief period sent out project mailings with a Playboy bunny logo.24 When Stanford University launched an ethics center, the president quipped about what level of contribution would be necessary to name the center and whether the amount should depend on the donor’s reputation. If “the price was right,” would the university want a Ken Lay or a Leona Helmsley center on ethics?

Recently, many corporations have been attempting to “green” their image through affiliations with environmental organizations, and some of these groups have been entrepreneurial in capitalizing on such interests. The Nature Conservancy offered corporations such as the Pacific Gas and Electric Co. and the Dow Chemical Co. seats on its International Leadership Council for $25,000 and up. Members of the council had opportunities to “meet individually with Nature Conservancy staff to discuss environmental issues of specific importance to the member company.”25

There are no easy resolutions of these issues, but there are better and worse ways of addressing them. Appearances matter, and it sometimes makes sense to avoid affiliations where a donor is seeking to advance or pedigree ethnically problematic conduct, or to impose excessive restrictions on the use of funds.

Investment Policies. Advocates of socially responsible investing argue that nonprofit organizations should ensure that their financial portfolio is consistent with their values. In its strongest form, this strategy calls for investing in ventures that further an organization’s mission. In its weaker form, the strategy entails divestment from companies whose activities undermine that mission. The issue gained widespread attention after a Jan. 7, 2007, Los Angeles Times article criticized the Bill & Melinda Gates Foundation for investing in companies that contributed to the environmental and health problems that the foundation is attempting to reduce.

Many nonprofit leaders have resisted pressure to adopt socially responsible investing principles on the grounds that maximizing the financial return on investment is the best way to further their organization’s mission, and that individual divestment decisions are unlikely to affect corporate policies. Our view, however, is that symbols matter, and that similar divestment decisions by large institutional investors can sometimes influence corporate conduct. Hypocrisy, as French writer François de La Rochefoucauld put it, may be the “homage vice pays to virtue,” but it is not a sound managerial strategy. To have one set of principles for financial management and another for programmatic objectives sends a mixed moral message. Jeff Skoll acknowledged as much following his foundation’s support of Fast Food Nation, a dramatic film highlighting the adverse social impacts of the fast-food industry. “How do I reconcile owning shares in [Coca-Cola and Burger King] with making the movie?” he asked.26

As a growing number of foundations recognize, to compartmentalize ethics inevitably marginalizes their significance. About a fifth of institutional investing is now in socially screened funds, and it is by no means clear that these investors have suffered financial losses as a consequence.27

Accountability and Strategic Management. By definition, nonprofit organizations are not subject to the checks of market forces or majoritarian control. This independence has come under increasing scrutiny in the wake of institutional growth. In 2006, after a $30 billion gift from Warren Buffet, the Gates Foundation endowment doubled, making it larger than the gross domestic product of more than 100 countries. In societies where nonprofits serve crucial public functions and enjoy substantial public subsidies (in the form of tax deductions and exemptions), this public role also entails significant public responsibilities. In effect, those responsibilities include fiduciary obligations to stakeholders—those who fund nonprofits and those who receive their services—to use resources in a principled way. As a growing body of work on philanthropy suggests, such accountability requires a well-informed plan for furthering organizational objectives and specific measures of progress. A surprising number of nonprofits lack such strategic focus. Many operate with a “spray and pray” approach, which spreads assistance across multiple programs in the hope that something good will come of it. Something usually does, but it is not necessarily the cost-effective use of resources that public accountability demands.

Money held in public trust should be well spent, not just well-intentioned. But in practice, ethical obligations bump up against significant obstacles. The most obvious involves evaluation. Many nonprofit initiatives have mixed or nonquantifiable outcomes. How do we price due process, wilderness preservation, or gay marriage?

Although in many contexts objective measures of progress are hard to come by, it is generally possible to identify some indicators or proxies. Examples include the number and satisfaction of people affected, the assessment of experts, and the impact on laws, policies, community empowerment, and social services. The effectiveness of evaluation is likely to increase if organizations become more willing to share information about what works and what doesn’t. To be sure, those who invest significant time and money in social impact work want to feel good about their efforts, and they are understandably reluctant to spend additional resources in revealing or publicizing poor outcomes. What nonprofit wants to rain on its parade when
that might jeopardize public support? But sometimes at least a light drizzle is essential to further progress. Only through pooling information and benchmarking performance can nonprofit organizations help each other to do better.

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<th>Promoting Ethical Decision Making</th>
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<td>Although no set of rules or organizational structures can guarantee ethical conduct, nonprofits can take three steps that will make it more likely.</td>
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Ensure Effective Codes of Conduct and Compliance Programs.

One of the most critical steps that nonprofits can take to promote ethical conduct is to ensure that they have adequate ethical codes and effective compliance programs. Codified rules can clarify expectations, establish consistent standards, and project a responsible public image. If widely accepted and enforced, codes can also reinforce core values, deter misconduct, promote trust, and reduce the organization’s risks of conflicting interests and legal liability.

Although the value of ethical codes and compliance structures should not be overlooked, neither should it be overstated. As empirical research makes clear, the existence of an ethical code does not of itself increase the likelihood of ethical conduct. Much depends on how standards are developed, perceived, and integrated into workplace functions. “Good optics” was how one manager described Enron’s ethical code, and shortly after the collapse, copies of the document were selling on eBay, advertised as “never been read.”

A recent survey of nonprofit organizations found that only about one third of employees believed that their workplace had a well-implemented ethics and compliance program. This figure is higher than the corresponding figure for the business (25 percent) and government (17 percent) sectors, but still suggests ample room for improvement. Part of the problem lies with codes that are too vague, inflexible, or narrow. Only about half of nonprofit organizations have conflict of interest policies, and fewer than one third require disclosure of potentially conflicting financial interests. A related difficulty is compliance programs that focus simply on punishing deviations from explicit rules, an approach found to be less effective in promoting ethical behavior than approaches that encourage self-governance and commitment to ethical aspirations.

To develop more effective codes and compliance structures, nonprofit organizations need systematic information about how they operate in practice. How often do employees perceive and report ethical concerns? How are their concerns addressed? Are they familiar with codified rules and confident that whistle-blowers will be protected from retaliation? Do they feel able to deliver bad news without reprisals?

Promote Effective Financial Management.

Another step that nonprofits can take to foster ethical behavior and promote public trust is to use resources in a socially responsible way. In response to reports of bloated overhead, excessive compensation, and financial mismanagement, watchdog groups like Charity Navigator have begun rating nonprofits on the percentage of funds that go to administration rather than program expenditures. Although this rating structure responds to real concerns, it reinforces the wrong performance measure, distorts organizational priorities, and encourages disingenuous accounting practices. Groups with low administrative costs may not have the scale necessary for social impact. The crucial question that donors and funders should consider in directing their resources is the relative cost-effectiveness of the organization. Yet according to a 2001 study by Princeton Survey Research Associates, only 6 percent of Americans say that whether a program “makes a difference” is what they most want to know when making charitable decisions. Two-thirds expect the bulk of their donations to fund current programs and almost half expect all of their donations to do so. Such expectations encourage charities to provide short-term direct aid at the expense of building long-term institutional capacity.

Moreover, the line these donors draw between “overhead” and “cause” is fundamentally flawed. As Dan Pallotta notes in Uncharitable, “the distinction is a distortion.” All donations are going to the cause, and “the fact that [a dollar] is not going to the needy now obscures the value it will produce down the road” by investing in infrastructure or fundraising capacity. Penalizing charities for such investments warps organizational priorities. It also encourages “aggressive program accounting,” which allocates fundraising, management, and advertising expenses to program rather than administrative categories. Studies of more than 300,000 tax returns of charitable organizations find widespread violation of standard accounting practices and tax regulations, including classification of accounting fees and proposal writing expenses as program expenditures.

To address these issues, nonprofit organizations need better institutional oversight, greater public education, and more transparent and inclusive performance measures. Ensuring common standards for accounting and developing better rating systems for organizational effectiveness should be a priority.

Institutionalize an Ethical Culture. In its National Nonprofit Ethics Survey, the Ethics Resource Center categorizes an organization as having a strong ethical culture when top management leads with integrity, supervisors reinforce ethical conduct, peers display a commitment...
to ethics, and the organization integrates its values in day-to-day decision making. In organizations with strong ethical cultures, employees report far less misconduct, feel less pressure to compromise ethical commitments, and are less likely to experience retaliation for whistle-blowing.1 This survey is consistent with other research, which underscores the importance of factoring ethical concerns into all organizational activities, including resource allocation, strategic planning, personnel and compensation decisions, performance evaluations, auditing, communications, and public relations.

Often the most critical determinant of workplace culture is ethical leadership. Employees take cues about appropriate behavior from those at the top. Day-to-day decisions that mesh poorly with professed values send a powerful signal. No organizational mission statement or ceremonial platitudes can counter the impact of seeing leaders withhold crucial information, play favorites with promotion, stifle dissent, or pursue their own self-interest at the organization’s expense.

Leaders face a host of issues where the moral course of action is by no means self-evident. Values may be in conflict, facts may be contested or incomplete, and realistic options may be limited. Yet although there may be no unarguably right answers, some will be more right than others—that is, more informed by available evidence, more consistent with widely accepted principles, and more responsive to all the interests at issue. Where there is no consensus about ethically appropriate conduct, leaders should strive for a decision-making process that is transparent and responsive to competing stakeholder interests.

Nonprofit executives and board members also should be willing to ask uncomfortable questions: Not just “Is it legal?” but also “Is it fair?” “Is it honest?” “Does it advance societal interests or pose unreasonable risks?” and “How would it feel to defend the decision on the evening news?” Not only do leaders need to ask those questions of themselves, they also need to invite unwelcome answers from others. To counter self-serving biases and organizational pressures, people in positions of power should actively solicit diverse perspectives and dissenting views. Every leader’s internal moral compass needs to be checked against external reference points.

Some three decades ago, in commenting on the performance of Nixon administration officials during the Watergate investigation, then-Supreme Court Chief Justice Warren Burger concluded that “apart from the morality, I don’t see what they did wrong.”2 19 This comment has eerie echoes in the current financial crisis, as leaders of failed institutions repeatedly claim that none of their missteps were actually illegal. Our global economy is paying an enormous price for that moral myopia, and we cannot afford its replication in the nonprofit sphere.

Notes
12 See Panel on the Nonprofit Sector, Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations, October 2007: 27, which advises against compensating internal or external fundraisers on the basis of a percentage of the funds raised.
19 Internal Revenue Service, Form 990 Redesign for Tax Year 2008 Background Paper, December 20, 2007.
23 Birchard, “Nonprofits by the Numbers.”
33 Ethics Resource Center, National Nonprofit Ethics Survey 2007: 1, 4-5, 10, 16.