



Good Governance: Developing a Conflicts of Interest Policy


October 18, 2018

Laura Abel, Senior Policy Counsel
label@lawyersalliance.org

Grace Heusner, Legal Fellow
gheusner@lawyersalliance.org

Resource Call Hotline: (212) 219-1800 ext. 224





Overview

- What is a conflict of interest?
- Legal framework
- Handling conflicts of interest
- Penalties for non-compliance
- Drafting and implementing a Conflict of Interest Policy

2

www.lawyersalliance.org



What is a Conflict of Interest?





What Is a Conflict of Interest?

- A conflict of interest arises where a director, officer, or other insider has an outside interest or relationship that conflicts or may conflict with his/her ability to act strictly in the best interests of the organization
- Some common scenarios:
 - Setting executive compensation
 - Voting on a commercial transaction in which an “insider” has a financial interest
 - A business corporation forming a nonprofit branch
 - Members of a nonprofit Board with close ties to a government agency
- *Many possibilities -- consider the particular circumstances of your organization!*

4

www.lawyersalliance.org



Goal of Conflicts of Interest Rules

- Exempt organizations need to be operated in the public interest and not for the private benefit of an individual
- Rules governing conflicts of interest are intended to:
 - Increase fiscal transparency;
 - Prevent private benefit;
 - Provide an enforcement mechanism and remedy for regulators; and
 - Assist directors and officers in satisfying their duty of loyalty

5

www.lawyersalliance.org




General Procedure for Conflicts of Interest

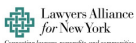
- Adopt a policy, use it, and ensure compliance
- Make initial and annual disclosures
- Disclose any conflict in a potential transaction
- Ensure the conflicted person is not present and does not participate in Board or committee deliberations (but can provide relevant information to the Board before deliberations start)
- Before approving, determine whether the proposed transaction is fair (use comparables if appropriate) and ensure that the process is documented

6


www.lawyersalliance.org



Legal Framework




Centering lawyers, nonprofits, and communities



Legal Framework

- New York State:
 - All NY nonprofits must have a conflict of interest policy, laying out how to identify and address related party transactions (may also cover other, non-financial conflicts)
- IRS:
 - Form 990 asks whether the filing organization has a written conflict of interest policy
 - IRS has rules against “excess benefit transactions”
- New York State and the IRS have similar, but not identical, definitions for conflicted persons
 - New York: “Related Party”
 - IRS: “Disqualified Person”
 - If any of these individuals are involved in a potential transaction, they are subject to special scrutiny

8 www.lawyersalliance.org



NY Related Party Transactions

A **related party transaction** is one in which

- A “related party” has a financial interest; and
- The corporation or its affiliate is a participant

A **related party** is:

- A director, officer, or key person of corporation or an affiliate;
- A relative of any of the above; or
- Any entity in which any of the individuals described above has at least 35% ownership interest, or in the case of partnership/professional corporation, a direct or indirect interest exceeding 5%

A **key person**:

- has responsibilities or exercises powers or influence over the corporation as a whole, similar to that of directors/officers; or
- manages the corporation or a substantial portion of the activities, assets, income, or expenses of the organization; or
- alone, or with others, controls or determines a substantial portion of the corporation’s capital expenditures or operating budget

9 www.lawyersalliance.org



Related Party Transactions: Exceptions

- The following are **not considered** related party transactions:
 1. Transactions where the transaction itself or the related party's financial interest in the transaction is ***de minimis***
 2. Transactions that would **not** usually be reviewed by the board in the **ordinary course of business** and are available to others on the same or similar terms
 3. Transactions that benefit a related party solely as a **member of a class of charitable beneficiaries**, where the benefit is available to all similarly situated members of that charitable class on the same terms
- A corporation can enter into a transaction under these circumstances without treating it like a "related party transaction"
- Even if a transaction falls into one of these exceptions, a corporation should still follow its Conflicts of Interest Policy and ensure that it is not an IRS excess benefit transaction

10

www.lawyersalliance.org



Exception to Related Party Transactions: *De Minimis* Transactions

- There is no bright-line test for measuring a *de minimis* transaction or financial interest
- Evaluated under a facts-and-circumstances determination that considers the size of the nonprofit's budget and assets, **and** the transaction or interest

11

www.lawyersalliance.org



Exception to Related Party Transactions: "Ordinary Course of Business" Exception

- A transaction or activity is in the ordinary course of business if it is consistent either with the corporation's past practices in similar transactions, or with common practices in the sector in which the corporation operates

12

www.lawyersalliance.org



Exception to Related Party Transactions: Benefitting a Member of a Charitable Class

- A transaction would fall into the this category if benefits are being provided to the related party solely because that person is a member of a class that the corporation intends to benefit as part of the accomplishment of its mission

13

www.lawyersalliance.org



Related Party Transactions – Procedures

- All RPTs:
 - disclose
 - recuse
 - is it fair, reasonable and in the corporation's best interests?
- If the related party's interest is *substantial*, and the corporation is *charitable*, must also:
 - consider alternative transactions to the extent available;
 - approve the transaction by at least a majority of the directors present; and
 - contemporaneously document basis for determination.

14

www.lawyersalliance.org



IRS Excess Benefit Transaction Regulations

- **An excess benefit transaction occurs** when the economic benefit given to a disqualified person exceeds the value of what the disqualified person provides the organization
 - Not just cash: may also include transfers of property, services, or any other benefit with economic value
- **Potential consequences:** a penalty upon
 - any “disqualified person” who receives an “excess benefit” from a covered tax-exempt organization, and
 - each “organization manager” who knowingly participates in the excess benefit transaction

15

www.lawyersalliance.org



IRS “Disqualified Person”

- A person is disqualified with respect to a transaction if he/she exercises **substantial influence** over affairs of the organization
 - Five-year look-back period
- Per se disqualified persons:
 - Voting members of the Board
 - President, CEO, COO, Treasurer, CFO
 - Family members of the above
 - spouse
 - siblings (full or half)
 - spouses of siblings (full or half)
 - ancestors
 - children
 - grandchildren & great-grandchildren

16

www.lawyersalliance.org



IRS “Disqualified Person” – Entities

- An entity is a disqualified person if it is 35% controlled because:
 - disqualified persons own more than 35% of the combined voting power
 - it is a partnership and disqualified persons own more than 35% of the profits interest
 - it is a trust or estate and disqualified persons own more than 35% of the beneficial interest

17

www.lawyersalliance.org



IRS “Disqualified Person” (cont’d)

- Facts and circumstances indicating “substantial influence:”
 - founder
 - substantial contributor
 - person’s income is derived from organization’s activities
 - authority to make financial decisions for organization
 - manages a substantial segment of organization’s activities
 - owns a controlling interest in a disqualified corporation
 - non-stock corporation owned or controlled by a disqualified person
- Exemptions:
 - Section 501(c)(3) nonprofits that do business with the organization;
 - Section 501(c)(4) advocacy organizations that work with the organization; and
 - Certain employees of the organization who:
 - Receive less than \$80,000 in annual compensation and benefits;
 - Are not substantial contributors to the organization; and
 - Are not otherwise disqualified persons

18

www.lawyersalliance.org



IRS Safe Harbor

- Designed to help tax-exempt organizations minimize the risk that the IRS will decide at a later time that their organization has engaged in excess benefit transactions
- Payments made to a disqualified person are presumed reasonable if the board (or other authorized body):
 - 1) approves the payment in advance
 - **interested parties may not participate;**
 - 2) finds that the payment was reasonable, based on relevant outside comparability data *before making its determination*; **and**
 - 3) adequately documents the basis for its decision.
- If organizations fall into the safe harbor provisions, the burden shifts to IRS to prove that the transaction is not fair and reasonable.

19

www.lawyersalliance.org



What Would You Do?


 Lawyers Alliance
for New York
Connecting lawyers, nonprofits, and communities




What Would You Do?


- Wildflowers is a nonprofit corporation that works to remove invasive species from Central Park and plant native species instead.
- Wildflowers is fiscally sponsored by the Parks Foundation, and an Joe Green, an employee of the Parks Foundation, holds one Board seat on Wildflowers' six-seat Board of Directors.
- Wildflowers now wants to buy seeds from the Parks Foundation.
- Can the organization enter into this transaction? What are some issues to consider?

21


www.lawyersalliance.org



Penalties for Non-Compliance




Lawyers Alliance
for New York
Overseeing lawyers, nonprofits, and communities



New York State

- If the transaction is not reasonable and in the corporation's best interest, NYS Attorney General can bring action to:
 - enjoin, void or rescind transaction
 - remove directors
- Person who received unfair benefit can be required to:
 - account for any profits from transaction and pay them to corporation (if conduct was willful & intentional, pay up to double the profits)
 - pay the corporation the value of the property/assets used
 - return lost property/assets to the corporation
- No safe harbor, but may be able to receive retroactive approval in certain circumstances
- Depending on the facts, a failure of a director or officer to make proper disclosures may also lead the Attorney General to charge that there has been a breach of the duty of loyalty

23 www.lawyersalliance.org



IRS

- In some circumstances where there has been a private benefit, IRS may revoke tax-exempt status!
- In the case of an excess benefit transaction, a range of penalties:
 - Return of "excess benefit" plus interest
 - First tier: "tax" of
 - 25% of value of excess benefit on beneficiary,
 - 10% on managers & others who participated in the decision (including silence or abstention).
 - Second tier: If the correction payment is not made before IRS sends a notice of deficiency about, or imposes, the first tier tax, an additional tax of 200% of the excess benefit may be imposed on the beneficiary
 - Maximum penalty for organizational managers is \$20,000


24 www.lawyersalliance.org



Drafting and Implementing a Conflict of Interest Policy




Lawyers Alliance
for New York
Centering lawyers, nonprofits, and communities



Drafting a Conflicts Policy

- Under New York law, a conflict of interest policy must contain:
 - A definition of what constitutes a "conflict of interest"
 - The procedure for disclosing a potential conflict to the Board or designated committee and procedure for determining if a conflict exists
 - A requirement that a person with a conflict not be present at or participate in Board or committee deliberations or vote on the matter giving rise to the conflict
 - A prohibition against any attempt by the person with a conflict to improperly influence the deliberation or voting on the matter
 - A requirement that the existence and resolution of the conflict be documented, including in the minutes of any meeting at which the conflict was discussed or voted on
 - Procedures for disclosing, addressing or documenting related party transactions
- A Conflict of Interest Policy may also cover other, non-financial conflicts


26 www.lawyersalliance.org



Annual Disclosure Requirements

- Before a director is **initially elected**, and **annually thereafter**, the director must complete, sign and submit a written statement identifying:
 - any entity of which the director is an officer, director, trustee, member, owner, or employee that has a relationship with the organization; and
 - any transaction in which the organization is a participant and in which the director might have a conflicting interest

27 www.lawyersalliance.org



Implementing a Conflict of Interest Policy

- Once a policy has been implemented, your organization must use it!
- Decide who at your organization will handle these issues
- Any director, officer or key employee with an interest in a related party transaction must disclose the material facts
- Person with a conflict may not:
 - be present at or participate in board or committee deliberations
 - attempt to improperly influence the deliberation or voting on the matter

28

www.lawyersalliance.org



Related Party Transactions and Conflicts of Interest

October 18, 2018

Laura Abel, Senior Policy Counsel
label@lawyersalliance.org

Grace Heusner, Legal Fellow
gheusner@lawyersalliance.org

Resource Call Hotline: (212) 219-1800 ext. 224

 **Lawyers Alliance
for New York**
Connecting lawyers, nonprofits, and communities
