



Conflicts of Interest Policies Under the Not-for-Profit Corporation Law

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Conflicts of interest for board members are almost inevitable in not-for-profit corporations, and the existence of conflicts of interest should not disqualify board service. In fact, board members with significant community and business relationships are valuable because of the contacts and expertise they bring to the board, and more likely to have conflicts arising from those relations. An effective conflict of interest policy allows a not-for-profit entity to benefit from engaged and sophisticated board members, and to manage conflict of interest issues in ways that provide reassurance that the mission of the entity remains paramount.

This guidance has been drafted to assist not-for-profit corporations and trusts (hereafter collectively “nonprofits”) that are drafting, reviewing, or revising their Conflict of Interest Policies and adopting and implementing those policies. It has been up-dated to reflect amendments to the Not-for-Profit Corporation Law (“N-PCL” that were enacted in November of 2016 and, with one exception, became effective on May 27, 2017¹. The guidance is not intended to serve as a substitute for advice from a nonprofit’s attorney, nor should it be construed to have anticipated or addressed every issue that a nonprofit should consider or address when drafting or implementing its policy.

¹¹ An amendment to Not-for-Profit Corporation Law § 713(f) that permits an employee to be the board chair under certain circumstances became effective on January 1, 2017.

The N-PCL follows both common law and best practices literature in requiring directors to make disclosures about potential conflicts of interest at the beginning of their service, and on an annual basis thereafter. It also requires directors, officers and key persons (called “key employees” prior to the 2016 amendments)² to disclose potential conflicts of interest in issues that come before the board and to refrain from participating in board deliberations and decisions on those issues. The N-PCL requires that a nonprofit’s procedures for disclosing and resolving conflicts of interest be set forth in a Conflict of Interest Policy adopted by the board. The Conflict of Interest Policy adopted by the Board must reflect the minimum standards set forth in N-PCL Section 715-a.

Where a director, officer, or key person has a conflict of interest, as defined by a nonprofit’s Conflict of Interest Policy, in an issue coming before the board, that individual must disclose the circumstances giving rise to the conflict, and the nonprofit has an obligation to make a record of the existence of the conflict and how it was addressed, both with respect to that individual and with respect to the transaction.

Director, officer, key person, related party and relative are all terms that are defined in the N-PCL. *See* N-PCL §§ 102(a)(6), 102(a)(22), 102(a)(23), 102(a)(25), 713(f). A 2016 amendment to the N-PCL replaced the term “Key employee” with the term “key person” and defined a key person as someone who is **not** an officer or director and who, whether or not employed by the corporation, has responsibilities or powers similar to those of officers and directors, manages the corporation of a substantial part of its activities, assets or finances, or has a role in controlling a substantial part of its capital expenditures or budget.

A key person might be

A founder who, although he or she has no title or official role, exercises apparent authority over the organization, or

A substantial donor who, although he or she has no official role or title in the organization, participated in setting the agenda and making employment decisions.

² The amendments changed the term “key employee” to key person and amended the definition of that term. An explanation of the change is included later in this guidance.

Conflict of Interest Policy: Minimum Statutory Requirements

The board of each nonprofit must adopt, implement and oversee compliance with a Conflict of Interest Policy “to ensure that its directors, officers, and key persons act in the [nonprofit’s] best interest and comply with applicable legal requirements.”

The policy must cover conflicts and possible conflicts of interest, including related party transactions, which are defined by the N-PCL as transactions, agreements or arrangements in which a related party has a financial interest and in which the nonprofit or an affiliate is a participant. The policy may also cover other types of conflicts that may exist even though there is no financial interest at stake or the circumstances are otherwise outside the definition of a related party transaction.

The Conflict of Interest Policy must include:

1. A definition of the circumstances that constitute a conflict of interest (N-PCL § 715-a(b)(1)).

The statute gives the Board of Directors discretion to define the circumstances that constitute a conflict of interest, including the discretion to define exceptions for de minimis transactions and ordinary course of business transactions not covered by the policy. The board also has discretion to define the procedures that should be followed for different types of conflicts. This discretion includes the power to define additional restrictions on transactions between a board member and the corporation, or between the nonprofit’s employees and third parties (for example, by articulating a no acceptance of gifts policy, a no nepotism policy, or by incorporating Food and Drug Administration or Public Health Service conflict standards into a university’s conflict policy).

In addition, there may be circumstances specific to the organization that involve dual interests but do not present a significant risk of conflicting loyalties. For example, religious corporations in their charter or by-laws frequently will include directors who are members of religious orders, employees of sponsoring or related churches, or bishops who, by canon law, hold title to all property of related religious corporations and may be called upon to approve the disposition of that property. City-related nonprofits may define “circumstances that constitute a

conflict of interest” to exclude the responsibility of an ex-officio director to the electorate or the city appointing official, particularly where such *ex-officio* role is specifically set forth in the nonprofit’s enabling legislation, charter or certificate of incorporation, since the role and definition of the *ex-officio* includes the responsibility of advocating a broader public interest in board discussions, and that role is clear to all non-city directors.

2. Procedures for disclosing a conflict of interest to the board or a committee or the board (N-PCL § 715-a(b)(2)).

These procedures may include expectations for each class of conflict reporters, forms, record-keeping, custodians; disclosure to other persons within the nonprofit or to third parties, timing, and committee review and action.

3. Requirement that the person with the conflict of interest not be present at or participate in board or committee deliberations or vote on the matter giving rise to such conflict. (N-PCL § 715-a(b)(3)).

The language of the statute refers only to board or committee deliberations and votes. It is recommended that the board adopt a more comprehensive policy that articulates standards of conduct for board members, officers and key persons regarding conflicts of interest, disclosure requirements, reporting requirements, and procedures for mitigation.

In the board or committee setting, however, the board may request that the person with the conflict of interest present information as background or answer questions at a committee or boards meeting prior to the commencement of deliberations or voting.

4. Prohibition of any attempt by the person with the conflict to influence improperly the deliberations or voting on the matter giving rise to such conflict. (N-PCL § 715-a(b)(4)).

“Improperly influence” in this context should have a meaning similar to that used by the Securities and Exchange Commission in addressing improperly influencing audits: “coercing, manipulating, misleading, or fraudulently influencing (collectively referred to herein as “improperly influencing”) the “decision-making “ when the officer, director or other person knew or should have known that the

action, if successful, could result “in the outcome which the officer or director could not deliberate or vote on directly. (“Improper Influence on Conduct of Audits,” <http://www.sec.gov/rules/final/34-47890.htm>).

5. Requirement that existence and resolution of a conflict be properly documented, including in the minutes of any meeting at which the conflict was discussed or voted upon. (N-PCL § 715-a(b)(5)).

6. Procedures for disclosing, addressing, and documenting related party transactions pursuant to N-PCL § 715. Related party transactions include any transaction, agreement, or other arrangement in which a related party has a direct or indirect financial interest and in which the nonprofit or an affiliate participates. (N-PCL § 715-a(b)(6)).

A person has an indirect financial interest in an entity if a relative, as defined by the N-PCL, has an ownership interest in that entity or if the person has ownership in an entity that has ownership in a partnership or professional corporation. This is consistent with the definition of “indirect ownership interest” that is found in the instructions to Form 990, Schedule L.

A director, officer, or key person must disclose his or her interest in a transaction, agreement or arrangement *before* the board enters into that related party transaction.

Pursuant to N-PCL § 102(a)(24), the record-keeping requirements of N-PCL § 715 do not apply to the following three types of transactions: a) transactions in which the related party’s financial interest is de minimis, b) transactions that are not customarily reviewed by the board or boards of similar organizations in the ordinary course of business and are available to others on similar terms, and c) provision of benefits provided to a related party solely as a member of a class that the corporation intends to benefit as part of the accomplishment of its mission.

While these transactions may not require the statutory process mandated by section 715 of the N-PCL, both the related party and the decision-maker have other obligations defined by governing law. The Board member or other related party in each of these cases may not intervene or seek to influence the decision-maker or reviewer in these transactions. The decision-maker, and those responsible for

reviewing or influencing these transactions, should not consider or be affected by a related party's involvement in decisions on matters that may affect the decision-maker or those who review or influence the decision.

- What constitutes a “de minimis” transaction will depend on the size of the corporation's budget and assets and the size of the transaction. A transaction that merits review by the Board of a smaller corporation might not merit review by the Board of a larger organization.
- 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.

Examples of ordinary course of business transactions:

- A. The library of a nonprofit university buys a book written by a member of the board, pursuant to a written library acquisitions policy.
- B. A nonprofit hospital uses the local electric utility for its electrical service and supply, and a 35% shareholder of the local electric utility is a member of the board.
- C. General counsel of a health system has a written, established, and enforced policy for the selection, retention, evaluation, and payment of outside counsel. A board member is a partner of and has a greater than 5% share in one of the firms retained by general counsel.
- D. The curatorial department of a museum has a paid summer intern selection process involving resume review and evaluation and group interviews. The daughter of a board member is selected pursuant to the process as a summer intern.
- E. The grandson of a board member of a hospital has just graduated from a university nursing school. He applies for and is selected by the Nursing Department of the hospital for a tuition repayment benefit and will receive a salary and overtime, consistent with the hospital's written policy regarding recruitment of new nursing graduates.
- F. A board member is the sole owner of a fuel delivery company. In the ordinary course of business, the facilities department of a nonprofit housing

project puts out a written request for proposals for fuel supply for its properties, evaluates, and documents the selection of the board member's company based upon cost and service.

- G. A university board member owns a 35% share of a restaurant conveniently located near the campus of the university. Some faculty members responsible for arranging staff holiday lunches buy food from this restaurant, using university credit cards. Each department has a modest authorized budget for these lunches, and faculty members have discretion about where to buy food for the lunches.

To qualify for the exception for benefits provided to a related party solely as a member of a class that the corporation intends to benefit as part of the accomplishment of its mission, the benefits must be provided in good faith and without unjustified favoritism towards the related party.

Example of a transaction in this category: A legal services program agrees to handle the eviction case of one of its board members who is eligible to be a client, and who is serving as one of the minimum number of client-eligible board members that is required by federal regulations. The decision to accept the case is made pursuant to the organization's established case acceptance policy, without regard to the client's status as a board member.

Transactions related to compensation of employees, officers or directors or reimbursement of reasonable expenses incurred by a related party on behalf of the corporation are not considered related party transactions, unless that individual is otherwise a related party based on some other status, such as being a relative of another related party . However, such transactions must be reasonable and commensurate with services performed, and the person who may benefit may not participate in any board or committee deliberation or vote concerning the compensation (although he or she may be present before deliberations at the request of the board in order to provide information).

7. The Policy must require that each officer, director and key employee submit to the Secretary prior to initial election to the board, and annually thereafter, a written statement identifying possible conflicts of interest. That statement should include, to the best of the individual's knowledge, any entity of

which the director is an officer, director, trustee, member, owner, or employee and with which the corporation has a relationship, and any transaction in which the corporation is a participant and in which the director has or might have a conflicting interest.

Disclosure of conflicts is required; the requirement of disclosure to the Secretary can be satisfied by disclosure to the Secretary's designee as custodian (e.g., the compliance officer), if set forth in the conflict of interest policy.

When initial election to the board is not reasonably foreseeable, for example when board candidates are nominated from the floor at an annual meeting of members held to elect directors, the written statement may be provided to the Secretary promptly after the initial election.

A conflict of interest disclosure statement is required from directors, officers, and key persons of nonprofits. All types of nonprofits are covered, including religious corporations.

The Secretary must provide a copy of the completed statements to the chair of the audit committee or the chair of the board. There is no statutory requirement that conflict of interest disclosure statements be shared with other members of the board, or members of the corporation, or with the public. Conflict of interest disclosures often contain sensitive personal financial information that could be harmful if disclosed.

The Secretary may direct his/her designee/custodian to provide a copy of the completed statements to the chair of the audit committee or the chair of the board. The Secretary should maintain a record of conflict of interest disclosures.

The N-PCL does not prescribe the method or content of assertions that a board member, officer, or key person's participation in deliberations or voting is barred by a conflict as defined by the policy. The N-PCL does require that the "existence and resolution of the conflict be documented in the corporation's records, including the minutes of any meeting in which the conflict was discussed or voted upon." The records or minutes do not need to reflect the specifics of a conflict of interest not "discussed or voted upon" so long as the records reflect that an

individual board member, officer, or key person did not participate in discussions or voting on the topic.