

June 21, 2019

**Legal Alert: Conflict of Interest Policies**

*Conflict of Interest Procedures Checklist for New York Nonprofit Corporations*

- Organization has a conflict of interest policy adopted by the Board
- An attorney has reviewed the conflict of interest policy at least once since 2017 for compliance with NY law and the Internal Revenue Code
- Organization has an up-to-date list of people covered by the conflict of interest policy, which includes at least “related parties” (under NY law) and “disqualified persons” (under the Internal Revenue Code)
- Directors fill out conflict of interest disclosure questionnaire when they join the Board and annually thereafter
- Directors understand the conflict of interest policy and disclosure questionnaire
- Directors, officers, and managers understand which transactions are covered by the conflict of interest policy, and what procedures to follow before the organizations enters into such a transaction
- The Board actively oversees administration of, and compliance with, the conflict of interest policy

**Why should my organization have a conflict of interest policy?**

Compliance with a conflict of interest policy protects both a nonprofit organization and its leadership. The purpose is to avoid improper financial transactions that are not in the organization’s best interest. As of 2014, New York law requires all nonprofits incorporated in New York to have a conflict of interest policy.<sup>1</sup> The Internal Revenue Service requires transactions with insiders to be reported on the Form 990, and scrutinizes those transactions closely to make sure they are fair to the corporation. A conflict of interest policy is one of an organization’s fundamental governance documents, along with the certificate of incorporation and bylaws.

**Which transactions are covered by a conflict of interest policy?**

A conflict of interest policy covers transactions and other situations in which a director, officer, or other corporate insider has an outside interest or relationship that conflicts (or may conflict) with his or her ability to act strictly in the organization’s best interests.

The Internal Revenue Code and NY nonprofit corporation law have similar, but not identical, definitions of who is considered an insider for these purposes.<sup>2</sup> Under one or both of these laws, all of the

<sup>1</sup> NY Not-for-Profit Corporation Law (N-PCL) § 715-a.

<sup>2</sup> The Internal Revenue Code (IRC) covers transactions with “disqualified persons.” For a complete definition of “disqualified person” see IRC § 4958; Treas. Reg. 53.4958-3. NY law covers transactions with “related parties.” For a complete definition of “related party” see N-PCL § 102(a)(23).

following people may be considered insiders such that their transactions with the organization (or an affiliate of the organization) should be scrutinized closely:

- A person who is (or was during the past 5 years) a voting member of the Board of Directors;
- A person who is (or was during the past 5 years) an officer of the corporation, including but not limited to the president, CEO, COO, treasurer, or CFO;
- A person who is a “key person” under NY law because she or he (i) has responsibilities, or exercises powers or influence over the corporation as a whole similar to the responsibilities, powers or influence of directors and officers; (ii) manages the corporation, or a segment of the corporation that represents a substantial portion of the activities, assets, income, or expenses of the corporation; or (iii) alone or with others controls or determines a substantial portion of the corporation’s capital expenditures or operating budget.
- Family members of any of the above (including spouses and domestic partners, siblings (full or half), ancestors, children, grandchildren, or great-grandchildren, and a spouse or domestic partner of any of these people);
- Someone who exerts “substantial influence” over the organization, which may include, for instance, the organization’s founder, people who have made substantial contributions to the organization,<sup>3</sup> and a person whose income primarily derives from a function of the organization under that person’s control.
- An entity in which one of the above owns or controls 35% of the combined voting power (or 5% of the profits interest if the entity is a partnership or professional corporation, or 35% of the beneficial interest if the entity is a trust or estate).

### **How should my organization implement its conflict of interest policy?**

The Board of New York nonprofit organizations must adopt, implement, and oversee compliance with the conflict of interest policy. A conflict of interest policy should define what is classified as a “conflict” for the organization and who is covered by the policy because they are a “related party” under NY law or a “disqualified person” under the Internal Revenue Code, and describe the process for addressing possible financial conflicts. The policy may also cover other types of insiders, as well as conflicts that may exist even if there is no financial interest at stake.

The process for addressing conflicts is generally as follows:

1. Any insider who stands to gain financially from a transaction with a nonprofit organization must disclose the conflict ahead of time, and the transaction must be reviewed by non-interested Board members. If there are doubts about whether there is a conflict, the best course of action is for the insider to disclose the financial transaction.
2. The Board (or an authorized committee of the Board) should make sure that the interested party – the person who stands to gain financially from the transaction – recuses himself or herself **before** deliberation about the transaction takes place. The interested party cannot be present at, or participate in, Board or committee deliberations or vote on the matter giving rise to the conflict. The interested party cannot attempt to improperly influence the deliberation or voting on the matter.

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<sup>3</sup> A “substantial contributor” is a person who contributed an aggregate of more than \$5,000 to the organization, if that amount is more than 2% of the total contributions received during the tax year. Treas. Reg. 507(d)(2).

3. Next, the Board or authorized committee of the Board should make a determination about whether the transaction is fair, reasonable, and in the best interest of the nonprofit organization. That is, they should ask questions like:
  - Were multiple bids for the work obtained?
  - What do comparable vendors charge for similar goods or services?
  - Is there another option that would be better for the nonprofit organization?
4. After the transaction is reviewed, the Board or committee will vote to approve (or disapprove) the transaction.
5. Don't forget to document the organization's compliance with its conflict of interest policy! The documentation should be contemporaneous (meaning very soon after the transaction), and should record:
  - the fact that the interested person was recused,
  - what factors the Board considered in determining whether the transaction was fair, reasonable, and in the corporation's best interest, and
  - what the Board's determination was.

### **What types of transactions can be handled outside of the conflict of interest policy?**

New York law allows the Board to handle certain types of transactions outside of the formal conflict of interest policy, including:

1. **De minimis transactions:** These are transactions that are small enough that they do not require review under the conflict of interest policy. The law does not establish a bright line rule for what constitutes a de minimis transaction. Each organization should set its own de minimis threshold, taking into consideration the size of its budget and the size of the proposed transaction.
2. **Ordinary course transactions:** If the proposed transaction is consistent either with the nonprofit organization's past practices in similar transactions or with common practices in the corporation's sector, it may be an ordinary course transaction.
3. **Transactions with charitable beneficiaries:** A transaction may fall into 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.

To comply with New York law and the Internal Revenue Code, the corporation must still ensure that these types of transactions are fair, reasonable, in the corporation's best interest.

### **What is the annual disclosure questionnaire?**

The NPCL requires that nonprofit directors complete a conflict of interest disclosure form upon joining the Board and annually thereafter. The questionnaire can often be quite technical, because it asks about situations that are the subject of detailed laws and regulations. Organizations should make sure that the directors understand each question, and that each director returns a completed questionnaire annually. When the questionnaire is distributed, the corporation can also take the opportunity to ensure the Board understands the purpose and procedures of its conflict of interest policy, and to emphasize that the nonprofit organization takes these obligations seriously.

### **What are the possible penalties for noncompliance with the conflict of interest policy?**

In New York, if the transaction is not fair, reasonable, and in the corporation's best interest, the Attorney General can bring an action to void the transaction, seek restitution from the organization or insiders who benefitted, or remove directors of a nonprofit organization's Board. The person who received an unfair benefit can be required to repay any profits received from a transaction, pay the corporation the value of the property, or return lost property or assets to the corporation.

The Internal Revenue Service has the right to revoke tax-exempt status in circumstances where a disqualified person has received a private benefit. The disqualified person may also be required to return the amount of the excess benefit plus interest, or pay an excise tax. An organization's managers may also be held responsible.

### **Where can I find more information?**

Lawyers Alliance, "Good Governance: Developing a Conflicts of Interest Policy" (pre-recorded webinar). To register, visit <https://lawyersalliance.org/recorded-webinars>. There is a \$20 fee.

Chapter 3 of Lawyers Alliance's publication, Getting Organized, covers Directors' Duties, Executive Compensation and Insiders' Transactions. To order a hard or digital copy, visit <https://lawyersalliance.org/publications/list>

NY Charities Bureau, Conflicts of Interest Policies Under the Not-for-Profit Corporation Law (Sep. 2018), [https://www.charitiesnys.com/pdfs/Charities\\_Conflict\\_of\\_Interest.pdf](https://www.charitiesnys.com/pdfs/Charities_Conflict_of_Interest.pdf)

IRS, Intermediate Sanctions, <https://www.irs.gov/charities-non-profits/charitable-organizations/intermediate-sanctions>

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