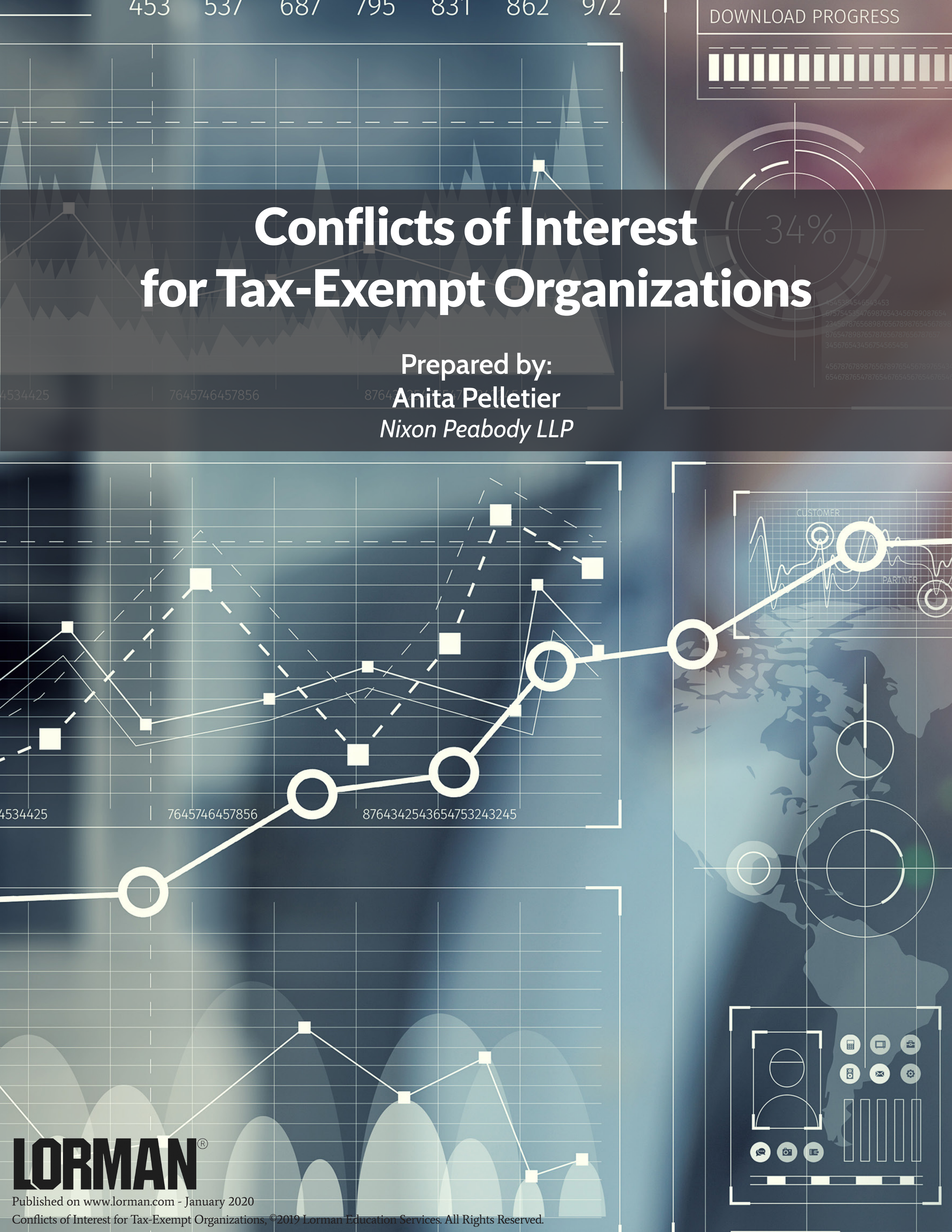

Conflicts of Interest for Tax-Exempt Organizations

Prepared by:
Anita Pelletier
Nixon Peabody LLP

LORMAN®

Published on www.lorman.com - January 2020

CONFLICTS OF INTEREST

The concern with transactions with directors/officers relates to the requirement that an individual should avoid using his or her position to obtain improperly a benefit for himself or herself, or an advantage which properly belongs to the corporation. *See*, *e.g*., *Fitzgerald v. Nat. Rifle Ass'n of Am.*, 383 F. Supp. 162 (D.N.J. 1974) (directors breached fiduciary duty by denying a directoral candidate an opportunity to advertise in *The American Rifleman* magazine and thereby using corporate instrumentality to perpetrate themselves in office). The fact that the transaction is one in which the director has a personal interest is usually less significant than whether it was fair to the corporation at the time the decision was made and whether the decision was reached in an impartial board environment. The clear exception is for self-dealing by private foundations under Internal Revenue Code Section 4941.

➢ *A Director Must Place the Interests of the Corporation Ahead of Personal Gain.*

A director is expected to make decisions objectively, to refrain from participation, and to obtain approval from the corporation where there is a relationship that impairs the director's objectivity. American Law Institute, Principles of Corporate Governance: Analysis and Recommendations § 5.02 (1993). In a conflict of interest situation, the director might receive returns more favorable than he or she would otherwise gain in an open market.

A conflict of interest is present whenever a director has a material interest in a transaction to which the corporation may be a party. *See A.B.A., Guidebook for Directors of Nonprofit Corporations* 28 (1994). Conflicts can occur either directly or indirectly, whether through personal involvement, a family relationship, or an employment or investment relationship.

The conflict may involve: use of the corporation's property or funds, transactions with the corporation that unfairly favor the director, usurping corporate opportunities, or competing with the corporation.

➢ *The Prevalence of Conflicts.*

Conflicts of interest, divided loyalties, and transactions among directors, officers, and their corporations abound in the charitable sector. Breaches of loyalty are not only much easier to identify than breaches of care, they are more prevalent. In many situations, interested transactions are a healthy necessity.

- They may provide access to resources unavailable from the marketplace.
- The financial status of the organization may be so poor that market sources of credit, supplies, or services are unattainable.
- A loan of money, goods, or services may be obtainable only from a director, an individual concerned with the organization's welfare.

In other situations, the interested transaction may be unethical or illegal and, therefore, violate the director's duty of loyalty to the corporation and to the public. *See, e.g., Scheuer Family Found. v. 61*

Assocs., 582 N.Y.S.2d 662 (App. Div. 1992) (defendant-directors of foundation had an interest in the foundation's investment advisor and asset manager, which allegedly mismanaged the foundation's assets, including by investing in publicly traded securities issued by a corporation in which the defendants were officers).

In analyzing conflicts of interest, it is necessary to focus upon both the procedural aspects of the transaction and upon its substantive nature. The procedural aspects of the transaction relate to the process by which the transaction is approved for the corporation by a board of directors. The procedural inquiries include:

- whether corporate procedures for interested transactions have been established and whether they were followed in the particular transaction;
- whether a board environment was impartial and objective at the time the decision was made;
- whether the information relating to the transaction was fully disclosed by the interested director to the relevant decision makers; and
- whether the interest of the director was disclosed to the relevant decision makers.

Substantive factors in conflict of interest transactions involve:

- the fairness of the transaction to the corporation in terms of what the corporation received,
- the frequency of interested transactions between directors and the organization (along with corresponding inurement concerns under the tax laws), and
- the overall financial status of the organization in relation to the transaction.

Whether an interested transaction should be permitted or not depends greatly on its facts and circumstances and the director's motivations for entering the transaction. A type of transaction which may be perfectly proper in one context may be inappropriate under slightly different circumstances. Within the context for charities, conflicts of interest must also be addressed within the context of Code Section 4958, which is a topic for another presentation.