



CONFLICT-OF-INTEREST POLICIES: DISCLOSURE, MONITORING, AND ENFORCEMENT

Conflict-of-Interest Policies: Legal Background

Under the Internal Revenue Code, a tax-exempt organization cannot use its assets for the private benefit of corporate insiders, such as the founder, officers and directors, other key employees and their family members (commonly known as the “private inurement rule”).

The Internal Revenue Service has long held that one of the best ways for an organization to ensure it is complying with the private inurement rule is to:

- Adopt a conflict-of-interest policy;
- Regularly monitor compliance with the policy; and
- Ask each individual covered by the policy to disclose, on an annual basis, any relationships with people doing business with the organization that could give rise to a conflict of interest.

Although nonprofit organizations are not required to have a conflict-of-interest policy in order to qualify for federal tax-exemption, the IRS considers having such a policy a good governance and accountability practice.

In fact, IRS Form 990, the annual information return form filed by public charities, asks organizations to provide information about their adoption and

enforcement of conflict-of-interest policies.

What is a Conflict-of-Interest Policy?

According to the IRS, a conflict of interest is present when a person in a position of authority over an organization, such as an officer, director, or manager, may benefit from a decision he or she could make in his or her organizational capacity. This may include indirect benefits, such as to family members or businesses with which the person is closely associated.

An effective conflict-of-interest policy, therefore, should accomplish the following:

- Define what constitutes a conflict of interest;
- Identify the individuals within the organization covered by the conflict-of-interest policy;
- Provide a means for the individuals to disclose information that help identify conflicts of interest; and
- Outline the procedures to be followed in managing conflicts of interest.

Disclosure of Conflicts

At least once a year, the tax-exempt organization should distribute a certification and disclosure form to its officers, directors and key employees, in

which each respondent should certify that he or she:

- Has received a copy of the conflict-of-interest policy;
- Has read and understands the policy;
- Has agreed to comply with the policy; and
- Understands that the organization is charitable and that in order to maintain its federal tax exemption, it must engage primarily in activities that accomplish one or more of its exempt purposes and not engage in activities and transactions that provide impermissible benefits to individuals or entities.

In addition, the certification and disclosure form should also require each person to either:

- Certify that he or she has no actual or possible conflict of interest to report; or
- Describe any relationships, transactions, or other circumstances, including those of family members, that could result in a conflict between the organization's interests and his or her personal financial or other interests.

As part of the annual process, the organization should provide each person covered by the conflict-of-interest policy with a copy of the policy and offer individuals the opportunity to ask questions about the policy. The covered persons should then be required to complete and sign the certification and disclosure form, which should be retained in the organization's files.

Monitoring and Enforcing Conflict-of-Interest Policies

To properly monitor and enforce a conflict-of-interest policy, an organization should be diligent in reviewing the annual disclosure forms submitted by covered persons, and in compiling and maintaining a list of potentially conflicted entities and individuals. Proposed transactions can then be matched against the list as a means of identifying possible conflicts. The organization should identify a person ultimately responsible for maintaining the list and screening for possible conflicts of interest.

When dealing with major vendors and service providers, the organization should consider asking the vendor or service provider to disclose any relationship - personal, financial, or otherwise - that the vendor or service provider has with any of the organization's directors, officers, employees or volunteers.

In addition, the organization should undertake a periodic review of transactions involving any significant expenditure of organizational funds to ensure any compensation paid continues to be reasonable.

If a possible conflict is identified with respect to a proposed transaction, the organization must be committed to following the procedures set out in its conflict-of-interest policy for determining whether an actual conflict of interest exists, and the procedures for addressing the conflict of interest.

Among the steps the organization should take are the following:

1. The person with the potential conflict with respect to a transaction should disclose such potential conflict.
2. The person should not participate or be present at any meeting during which the discussion of the possible conflict of interest takes place.
3. The chair of the board should, if appropriate, appoint a committee of the board made up of disinterested directors to investigate alternatives to the proposed transaction.
4. If a more advantageous transaction is not reasonably available, the governing board or committee should determine, by a majority vote of the disinterested directors, whether the transaction is in the organization's best interest and is fair and reasonable.

The organization should also document, through well-kept minutes, any decisions related to transactions involving an actual or possible conflict of interest. Finally, the organization must be diligent in taking appropriate disciplinary and corrective action if a person who is covered by the conflict-of-interest policy fails to disclose an actual or possible conflict of interest.

When responding to Part VI of the Form 990 - "Does the organization regularly and consistently monitor and enforce compliance with the policy?" - the organization should describe its practices for monitoring proposed or ongoing transactions for conflicts of interest and dealing with potential or actual conflicts, whether discovered before or after the transaction has occurred.

In addition, the organization should include an explanation of which class of people - such as officers, directors, and

the CEO - are covered under the policy, the level at which determinations of whether a conflict exists are made, and the level at which actual conflicts are reviewed.

The organization should also discuss its commitment to following the procedures set out in the conflict-of-interest policy, and include and explain any restrictions imposed on persons with a conflict, such as prohibiting them from participating in the governing body's deliberations and decision in the transaction.

Reporting of Transactions with Interested Persons

Members of an organization's governing board who are not involved with the potential conflict have the legal authority to determine that, notwithstanding the conflict of interest, it is in the organization's best interests to enter into a transaction involving a current or former officer, director, or key employee. If an organization enters into such a transaction, it will be required to disclose the transaction on its Form 990. The organization may also be required to report details regarding the transaction on Schedule L of the Form 990. If the board carefully monitors compliance with the organization's conflict-of-interest policy, and interested persons annually certify whether or not they have an actual or potential conflict, this will assist the organization in determining whether it needs to make disclosures concerning any transactions with interested persons on the Form 990.

Sample Policies

The IRS has a sample conflict-of-interest policy that it recommends that a tax-

exempt organization adopt. The IRS's sample policy (modified to remove certain language applicable to tax-exempt hospitals) is included at the end of this Alert as Attachment A.

The sample is generally worded so as to cover a wide range of organizations, but should only be used as a basis for drafting an individually designed policy.

Any organization considering adopting a policy should meet with an appropriate advisor to tailor the policy to the organization's particular structure and activities.

A sample Conflict-of-Interest Policy Certification and Disclosure Form is also included at the end of this alert as Attachment B.

Additional Resources

You may also find the following information helpful in establishing your organization's conflict-of-interest policy and procedures:

- Form 990, Schedules and Instructions.
<http://www.irs.gov/charities>
- Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations
<https://independentsector.org/programs/principles-for-good-governance-and-ethical-practice/>

The following is a sample document for a nonprofit organization seeking to qualify or maintain its status as a tax-exempt organization under Section 501(c)(3) of the Internal Revenue Code. This sample is provided only for informational purposes and does not provide specific legal advice for any individual situation. Some or all of this document may not be appropriate for your organization. The sample reflects the provisions of the Internal Revenue Code as of the date it is written. However, laws change. Only an attorney with knowledge of your particular situation can provide the legal assistance you need.

Attachment A

Sample Conflict-of-Interest Policy for Tax-Exempt Organizations

Article I Purpose

The purpose of the conflict-of-interest policy is to protect this tax-exempt organization's (Organization) interest when it is contemplating entering into a transaction or arrangement that might benefit the private interest of an officer or director of the Organization or might result in a possible excess benefit transaction. This policy is intended to supplement but not replace any applicable state and federal laws governing conflict of interest applicable to nonprofit and charitable organizations.

Article II Definitions

1. Interested Person

Any director, principal officer, key employee or member of a committee with board-delegated powers, who has a direct or indirect financial interest, as defined below, is an interested person.

2. Financial Interest

A person has a financial interest if the person has, directly or indirectly, through business, investment, or family:

- a. An ownership or investment interest in any entity with which the Organization has a transaction or arrangement;
- b. A compensation arrangement with the Organization or with any entity or individual with which the Organization has a transaction or arrangement; or

- c. A potential ownership or investment interest in, or compensation arrangement with, any entity or individual with which the Organization is negotiating a transaction or arrangement.

Compensation includes direct and indirect remuneration as well as gifts or favors that are not insubstantial.

A financial interest is not necessarily a conflict of interest. Under Article III, Section 2, a person who has a financial interest may have a conflict of interest only if the appropriate governing board or committee decides that a conflict of interest exists.

Article III Procedures

1. Duty to Disclose

In connection with any actual or possible conflict of interest, an interested person must disclose the existence of the financial interest and be given the opportunity to disclose all material facts to the directors and members of committees with board-delegated powers considering the proposed transaction or arrangement.

2. Determining Whether a Conflict of Interest Exists

After disclosure of the financial interest and all material facts, and after any discussion with the interested person, the interested person shall leave the governing board or committee meeting while the determination of whether a conflict of interest exists is discussed and voted upon. The remaining board or committee members shall decide if a conflict of interest exists.

3. Procedures for Addressing the Conflict of Interest

- a. If a conflict of interest exists, an interested person may make a presentation at the governing board or committee meeting, but after the presentation, the interested person shall leave the meeting during the discussion of, and the vote on, the transaction or arrangement involving the conflict of interest.
- b. The chairperson of the governing board or committee shall, if appropriate, appoint a disinterested person or committee to investigate alternatives to the proposed transaction or arrangement.
- c. After exercising due diligence, the governing board or committee shall determine whether the Organization can obtain with reasonable efforts a more advantageous transaction or arrangement from a person or entity that would not give rise to a conflict of interest.

- d. If a more advantageous transaction or arrangement is not reasonably possible under circumstances not producing a conflict of interest, the governing board or committee shall determine by a majority vote of the disinterested directors whether the transaction or arrangement is in the Organization's best interest, for its own benefit, and whether it is fair and reasonable. In conformity with the above determination, it shall make its decision as to whether to enter into the transaction or arrangement.

4. Violations of the Conflict-of-Interest Policy

- a. If the governing board or committee has reasonable cause to believe a member has failed to disclose a financial interest, it shall inform the member of the basis for such belief and afford the member an opportunity to explain the alleged failure to disclose.
- b. If, after hearing the member's response and after making further investigation as warranted by the circumstances, the governing board or committee determines the member has failed to disclose a financial interest, it shall take appropriate disciplinary and corrective action.

Article IV

Records of Proceedings

The minutes of the governing board and all committees with board-delegated powers shall contain:

- a. The names of the persons who disclosed or otherwise were found to have a financial interest in connection with an actual or possible conflict of interest, the nature of the financial interest, any action taken to determine whether a conflict of interest was present, and the governing board or committee's decision as to whether a conflict of interest in fact existed.
- b. The names of the persons who were present for discussions and votes relating to the transaction or arrangement, the content of the discussion, including any alternatives to the proposed transaction or arrangement, and a record of any votes taken in connection with the proceedings.

Article V

Compensation

A voting member of the governing board who receives compensation, directly or indirectly, from the Organization for services is precluded from voting on matters pertaining to that member's compensation.

A voting member of any committee whose jurisdiction includes compensation matters and who receives compensation, directly or indirectly, from the Organization for services is precluded from voting on matters pertaining to that member's compensation.

No voting member of the governing board or any committee whose jurisdiction includes compensation matters and who receives compensation, directly or indirectly, from the Organization, either individually or collectively, is prohibited from providing information to any committee regarding compensation.

Article VI
Annual Statements

Each director, principal officer and member of a committee with board-delegated powers shall annually sign a statement which affirms such person:

- a. Has received a copy of the conflicts of interest policy,
- b. Has read and understands the policy;
- c. Has agreed to comply with the policy; and
- d. Understands the Organization is charitable and in order to maintain its federal tax exemption it must engage primarily in activities which accomplish one or more of its tax-exempt purposes.

Article VII
Periodic Reviews

To ensure the Organization operates in a manner consistent with its charitable purposes and does not engage in activities that could jeopardize its tax-exempt status, periodic reviews shall be conducted. The periodic reviews shall, at a minimum, include the following subjects:

- a. Whether compensation arrangements and benefits are reasonable, based on competent survey information, and the result of arm's length bargaining.
- b. Whether partnerships, joint ventures, and arrangements with management organizations conform to the Organization's written policies, are properly recorded, reflect reasonable investment or payments for goods and services, further charitable purposes, and do not result in inurement, impermissible private benefit, or in an excess benefit transaction.

Article VIII
Use of Outside Experts

When conducting the periodic reviews as provided for in Article VII, the Organization may, but need not, use outside advisors. If outside experts are used, their use shall not relieve the governing board of its responsibility for ensuring periodic reviews are conducted.

Attachment B

Sample Conflict-of-Interest Certification and Disclosure Form

Name:

Position (e.g., employee/volunteer/trustee):

Date:

Certification

By signing this form below, I certify that:

1. I have received a copy of the organization's conflict-of-interest policy;
2. I have read and understand the policy;
3. I agree to comply with the policy; and
4. I understand that the organization is charitable and in order to maintain its federal tax exemption it must engage primarily in activities that accomplish one or more of its exempt purposes and not engage in activities and transactions that provide impermissible benefits to individuals or entities.

Conflict-of-Interest Disclosure

Please certify below that you either have no actual or possible conflict of interest to report, or describe below any relationships, transactions, positions you hold (volunteer or otherwise), or circumstances that you believe could contribute to an actual or possible conflict of interest between the organization and your personal interests, financial or otherwise:

____ I have no conflict of interest to report.

____ I have the following actual or possible conflict(s) of interest to report.

1. Please specify below any actual transactions you are aware of between the organization and any entity or person with which you have a business, investment, or family relationship.

(Please attach a supplemental statement if you have additional actual or possible conflicts of interest to disclose.)

2. For the purposes of determining possible future conflicts of interest, please also specify other nonprofit and for-profit boards on which you and/or your spouse sit, any for-profit businesses for which you or an immediate family member are an officer or director, or a majority shareholder, and the name of your employer and any businesses you or a family member own).

1. _____

2. _____

3. _____

(Please attach a supplemental statement if you have additional actual or possible conflicts of interest to disclose.)

I hereby certify that the information set forth above is true and complete to the best of my knowledge.

Signature: _____ Date: _____