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Strengthening Communities Through Legal Services

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Legal Alert: Director Conflicts of Interest

Is your organization equipped to handle conflicts of interest as they arise?

The duty of loyalty requires that directors of not-for-profits always act in the best interests of the organization and not for the benefit of themselves or other parties. The best way to prevent problems with the duty of loyalty is for an organization's board of directors to **adopt a formal policy for dealing with conflicts of interest.**

Duty of loyalty and Conflicts of interest

One of the duties that a director of a not-for-profit owes to the organization is the **duty of loyalty**. The duty of loyalty requires that **directors always act in the best interest of the organization and not for the benefit of themselves or other parties**. Breaches of the duty of loyalty usually involve usurping corporate opportunities or self-dealing (each of which is described below). Often a breach of the duty of loyalty results from a board director financially benefiting from his or her relationship with the organization, and the board acting without addressing this potential conflict of interest. Conflicts of interest also arise when a director's friends or family members have interests that conflict with or appear to conflict with the interests of the organization, and the friends or family members receive a financial benefit because of their relationship to the director.

Conflicts of Interest Policy

The **best way to prevent problems with the duty of loyalty is for an organization's board of directors to adopt a formal policy for dealing with conflicts of interest.** This way, directors will know exactly how to handle potential conflicts of interest before they arise. Implementing a formal policy also raises awareness of the duty of loyalty obligations with the directors.

A **conflicts of interest policy** works best to overcome any self-dealing conflict if it can identify the conflict as soon as possible and *definitely* before the transaction is entered into and finalized. A good conflicts policy should require each of the directors to complete an annual questionnaire that discloses each director's financial interest. This provides additional assurance that a conflict will not be overlooked. But the availability of the questionnaire does not change the obligation to disclose a conflict when it arises.

Once a conflict is identified, the interested director and the organization should take the following steps:

1. **Disclosure** – The interested director must disclose the conflict of interest to the entire board of directors of the organization.

2. **Independent confirmation** – The board should obtain independent information to determine what a comparable arms-length transaction would look like. Using this information, the board can confirm if the interested director's proposal is fair to the organization.

    1. This step may require the board to request bids or quotes from other suppliers, appraisals from independent parties, or any other independent information that provides a basis of comparison between the interested director's proposal and a proposal from a disinterested person.

3. **No participation by interested director** – The organization should prohibit participation by the interested director in the discussions about and voting on the transaction. This is best ensured by not allowing the interested director to be present during the discussion and voting process. This is referred to as having the interested director "recuse" himself/herself from the transaction.

4. **Decision by independent directors** – If the directors who do not have a conflict of interest (referred to as "independent directors") decide—without the vote or influence of the interested director—that the transaction is in the best interest of the organization, the transaction may be entered into without violating the duty of loyalty.

1. If the board of directors does not follow these steps, and the transaction is later challenged, the organization and the interested director will have the heavy burden of proving that the transaction was fair and not a violation of the duty of loyalty.

Organizations should be aware that the annual tax-exempt informational return—Internal Revenue Service ("IRS") Form 990—asks whether an organization has adopted a conflict of interest policy, and Form 990 also solicits information from directors and officers relating to potential conflicts on a regular basis.

Can The Law Project help my organization?

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