

# **Governance: Essential Organizational Policies and Protections**

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**Introduction** – Nonprofit organizations are subject to a framework of legal, financial, organizational, and even practical requirements and obligations which can place a heavy compliance burden on the shoulders of their governing persons. As such, establishing and maintaining a strong set of core organizational and institutional policies for a nonprofit organization is essential, and can help set the course toward better organizational effectiveness, governance, smoother transitions between preceding and succeeding governing persons, and non-deviation (even if unintentional) from the charitable mission. The following introduces several significant policies and related practices. However, depending on the size, activities, mission, personnel, and form of the specific nonprofit at issue, some policies may have less immediate relevance while others (or additional policies not addressed herein) may prove particularly advisable.

**Conflict of Interest Policy** – The Internal Revenue Service (“IRS”) inquires about certain nonprofit organization policies on some of its initial and annual forms, including a conflict of interest policy. In particular, on Form 1023, which is used to apply for recognition of federal tax exemption under Section 501(c)(3) of the Internal Revenue Code of 1986 (as amended, the “Code”), Part V, Question 2<sup>1</sup> asks whether the organization has adopted a conflict of interest policy consistent with the sample policy attached to the Form 1023 instructions (a copy of which is attached on Attachment 2), and Part V, Question 1(a) more specifically asks whether such policy was and will be followed in establishing compensation for officers, directors, employees, and independent contractors. Note also that organizations that qualify as hospitals or medical research organizations are more particularly asked, on Schedule C to Form 1023, whether they have adopted a conflict of interest policy consistent with the health care organization-specific sample policy attached to the Form 1023 instructions. Meanwhile, Form 990 continues a similar line of questioning on a yearly basis, again asking whether the nonprofit organization currently has a written conflict of interest policy in Part VI, Section B, Question 12(a) and, further, how such policy was made public during the relevant tax year in Part VI, Section C, Question 19. In general, if the organization lacks a suitable written conflict of interest policy, whether at the time of its initial application for exemption (e.g., in connection with Form 1023) or in a later tax year (e.g., in connection with the annual Form 990), the IRS may ask further and more specific questions to discern whether or not impermissible conflicts of interest are being allowed to occur and, in turn, leading to prohibited conduct such as self-dealing (i.e., Section 4941 of the Code, subject to limited exceptions, generally prohibits private foundations from transacting with any of its disqualified persons) or excess benefit transactions (i.e., Section 4958 of the Code generally prohibits 501(c)(3) public charities and 501(c)(4) social welfare organizations from providing a benefit to or for the use of any of its disqualified persons in excess of the value received in exchange). Self-dealing and excess benefit transactions can each result in significant

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<sup>1</sup> Relevant Excerpts from Form 1023 and Form 990 are attached on Attachment 1.

excise taxes for both the disqualified persons involved in the action as well as the organization's governing persons who participated or authorized the action.

In addition to instituting a strong conflict of interest policy to satisfy IRS rules and expectations, there are state-level requirements to consider. For example, with respect to Texas nonprofit corporations, Section 22.230(b) of the Texas Business Organizations Code ("TBOC") states the following:

“An otherwise valid and enforceable contract or transaction is valid and enforceable, and is not void or voidable, notwithstanding any relationship or interest described by Subsection (a), if any one of the following conditions is satisfied: (1) the material facts as to the relationship or interest and as to the contract or transaction are disclosed to or known by (A) the corporation's board of directors, a committee of the board of directors, or the members, and the board, the committee, or the members in good faith and with ordinary care authorize the contract or transaction by the affirmative vote of the majority of the disinterested directors, committee members or members, regardless of whether the disinterested directors, committee members or members constitute a quorum or (B) the members entitled to vote on the authorization of the contract or transaction, and the contract or transaction is specifically approved in good faith and with ordinary care by a vote of the members; or (2) the contract or transaction is fair to the corporation when the contract or transaction is authorized, approved, or ratified by the board of directors, a committee of the board of directors, or the members.”

Furthermore, state law also imposes a general set of fiduciary duties (i.e., duties of care, obedience, and loyalty), on the directors of nonprofit corporations (for Texas, see TBOC Section 22.221). With respect to conflict of interest policies, a governing person's duty of loyalty is most relevant. The duty of loyalty requires a governing person to act in the best interests of the organization in all matters. Their loyalty is to the organization and not to the governing person's personal interests or to the interest of any other private (or public) concerns. A conflict of interest arises when a governing person has a personal or business interest in a proposed transaction in which the organization is also involved. The duty of loyalty generally requires the governing person to make full disclosure of the conflict, abstain from voting, and not influence or attempt to influence the vote of the other governing persons. The duty of loyalty may also be violated: (i) by a variety of actions (or inactions) committed by a governing person which amount to misuse of the organization's funds or assets, such as: (a) theft or embezzlement, (b) excessive compensation, and (c) personal use of assets, facilities or services of the organization or (ii) by the governing person using their position of trust within the organization to take advantage of an opportunity presented to the organization.

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