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## **Transactions Between a Non-Profit and a Director**

Many directors get involved with non-profit organizations because they have an interest in the organization's purpose and want to see the organization succeed. In turn, non-profit organizations can greatly benefit from their directors' personal or business resources. Striking a balance between a director's duties and a director's inclination to utilize personal or business resources for the benefit of the organization is important because failure to properly do so could have consequences for the director and an effect on the organization's tax-exempt status. When a non-profit organization evaluates whether to enter into a transaction with a director, it is important to understand the legal limitations.

If a non-profit organization enters into a transaction with a director who receives a financial benefit, even if the benefit is indirect, the Attorney General may find it to be a self-dealing transaction or the IRS may deem it to be private inurement. These determinations mean that the non-profit failed to make decisions in the best interest of the organization and instead made decisions that benefited the individual director involved in the transaction. Self-dealing transactions can lead to a loss of tax exempt status or costly court actions. Therefore, a non-profit should have policies and procedures for entering into transactions with directors who could benefit financially from the transactions.

### **A Non-Profit Board Must Engage In A Multi-Step Process To Avoid A Self-Dealing Transaction**

The directors of a non-profit organization must act in good faith, in the best interests of the organization and with the care of an ordinarily prudent person.

An interested director is a director that has a material financial interest in a transaction with the non-profit organization. If a non-profit organization and interested director enter into a transaction, the Attorney General, another organization director, or organization officer can take action against the non-profit organization if the non-profit organization fails to take certain actions under the Corporations Code to authorize the transaction.

The first option that non-profit public benefit and non-profit religious organizations have to avoid a self-dealing transaction is to internally validate the transaction, or any part of it, prior to finalizing the transaction. In order to do this, the Board must take the following action prior to authorizing or approving the transaction:

- (1) establish that it entered into the transaction for its own benefit;
- (2) find the transaction to be fair and reasonable to the organization at the time the organization enters into it;
- (3) consider the material facts concerning the transaction;
- (4) consider the director's interest in the transaction;
- (5) determine in good faith after a reasonable investigation under the circumstances that the organization could not have obtained a more advantageous arrangement with reasonable effort under the circumstances; or the corporation in fact could not have obtained a more advantageous arrangement with reasonable effort under the circumstances; and
- (6) authorize or approve the transaction in good faith by a vote of a majority of the directors then in office without counting the vote of the interested director or directors.

The Board can only ratify a transaction after the parties have entered into it if the Board can establish that a committee or person authorized by the Board approved the transaction in a manner consistent with the standards set forth above and it was not reasonably practicable to obtain approval of the board prior to entering into the transaction. To ratify a transaction after the fact, the Board must approve the transaction at the meeting immediately following the transaction by a vote of the majority of the directors then in office without counting the vote of the interested director or directors.

It is important for the Board to document in the meeting minutes all of the facts and circumstances that it considered, along with all of the above required points and its basis for the decision to protect itself in the event the transaction is ever challenged by the Attorney General, IRS or another third-party.

The other option non-profit public benefit or religious non-profit organizations have is to seek approval of the transaction, either before or after it takes place, from the California Attorney General, or through a court action in which the Attorney General is joined as an indispensable party.

### **Directors Should Recuse Themselves from Voting When They have a Financial Interest that Prevents Them from Voting Impartially**

Directors of a non-profit organization should recuse themselves from voting on a transaction when the director has any financial interest. A financial interest is any interest that may prevent the director from making impartial decisions or decisions that are not in the best interest of the non-profit organization. The director's financial interest may be obvious but could also be indirect.

A financial interest that may cause the director to act impartially may be direct and obvious if the director has ownership, control or an investment in another organization involved in the

transaction. However, a director's financial interest may also be indirect, such as when the director's family has an ownership, control or an investment in the other organization involved in the transaction.

Since a director's financial interests can prevent the director from acting impartially in both obvious and indirect manners, directors should disclose to their board any time there is an actual or potential financial interest that may prevent the director from acting and voting impartially.

Directors should also recuse themselves from any discussions, investigations and votes related to transactions where they have a financial interest.

Directors who fail to recuse themselves from transactions where they are financially interested may suffer penalties and sanctions. For example, a court could order the interested director to (i) pay damages to the organization, including any profits the director earned from the transaction or the value of the organization's property the director used in transaction, or (ii) return any property the organization lost in the transaction, along with any interest or appreciation. If the court determines the interest director acted fraudulently or maliciously, the court can order the director to pay exemplary damages.

The IRS may also consider a transaction between the organization and the director to be a private inurement if the director received a substantial benefit from the transaction. In this situation, IRS may revoke the organization's tax-exempt status.

It is important for the non-profit organization to have clear policies and procedures relating to transactions with directors who have a financial interest. The non-profit should document its due diligence, board discussions related to the transaction, its justification for entering into the transaction, and if needed, speak to legal counsel prior to entering into transaction. Non-profits can also have their directors sign an acknowledgement of the organization's conflict of interest policy and disclose familial relationships and business affiliations that could present potential conflict issues each year.

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