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## Practice 4A: Dealing with Conflicts of Interest

- The land trust has a written conflict of interest policy to ensure that any conflicts of interest or the appearance thereof are avoided or appropriately managed through disclosure, recusal or other means. The conflict of interest policy applies to insiders (see definitions), including board and staff members, substantial contributors, parties related to the above, those who have an ability to influence decisions of the organization and those with access to information not available to the general public. Federal and state conflict disclosure laws are followed.
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A conflict of interest arises when insiders are in a position, or perceived to be in a position, to benefit financially (or create a benefit to a family member or other organization with which they are associated) by virtue of their position within the nonprofit organization. The best way to address conflicts of interest is to understand how they may arise; make board members and others aware of the need to avoid conflicts; require board members, staff and other insiders to disclose any potential conflicts; and establish a policy for dealing with conflict problems as they arise. The IRS recommends that all nonprofits have a conflict of interest policy, and so do *Land Trust Standards and Practices*. A policy should identify who is covered by the policy, identify the types of conduct that raise conflict of interest concerns (such as a financial interest in a transaction, personal relationships that might unduly influence a land transaction or land management action, or being on the governing body of a contributor to the organization) and specify how conflicts should be disclosed and managed. Each board and staff member should have a copy of the policy.

The IRS, under Internal Revenue Code (IRC) Section 4958, generally considers insiders or “disqualified persons” to be persons who, at any time during the five-year period ending on the date of the transaction in question, were in a position to exercise substantial influence over the affairs of the organization. Insiders generally include: board members, key staff, substantial contributors [see IRC 507(d)(2)], parties related to the above and 35-percent controlled entities. While these are strict definitions within the tax code, land trusts are advised to take an even more proactive approach to reduce or eliminate the potential damage that conflicts of interest may cause an organization and also include in the definition of insiders all staff members and those with access to information not available to the general public (such as certain volunteers). The term “related parties” is defined by the IRS to include spouse, brothers and sisters, spouses of brothers and sisters, ancestors, children, grandchildren, great-grandchildren, and spouses of children, grandchildren and great-grandchildren.

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## Legal Issues in Conflicts of Interest

Land trusts almost certainly run a higher risk of suffering public relations and credibility problems from the appearance of conflicts of interest than they do of being successfully sued over an actual conflict. Thus, a land trust needs to develop procedures for dealing with conflicts that are stricter than those required by law in order to manage both actual and perceived conflicts of interest. In order to do so, of course, it needs to know the relevant law.

There are several legal issues, described here, that are pertinent to the discussion of conflicts of interest. This discussion is intended to provide land trusts and their advisors with some guidance in the legal issues that come into play, not to provide a definitive legal discussion of the topic. Each land trust should have its own counsel research its state's law on conflicts.

### **IRS prohibition on private inurement**

The Internal Revenue Code contains statutory bans against private inurement and private benefit. It specifies that for organizations exempt under [Section 501\(c\)\(3\)](#), “no part of the net income [may] inure...to the benefit of any private shareholder or individual.” With regard to conflicts of interest, it prohibits, for example, the payment of excessive compensation, such as for staff or services, and the disposition or rental of property to board members or staff at less than fair market value.

The private benefit proscription also applies to individuals who do not have a special relationship with the land trust and in theory is not restricted to situations where there is a conflict of interest. In practice, findings of inurement have usually been limited to transactions involving insiders—board members, officers and staff. (See practice 2C for further discussion of private inurement and private benefit.)

The IRS and the courts consider private inurement questions in the context of the additional requirement that the organization be “organized and operated exclusively for charitable purposes.” Land trusts must serve a public rather than a private interest. The amount of private benefit that the courts have allowed has depended on the magnitude of the private benefit in relation to the public benefit derived from the activities in question, and whether the private benefit is necessary in order to advance the organization's exempt purposes. For example, whether the payment of compensation to a board member for services rendered to the organization in another capacity constitutes a prohibited form of private inurement is generally judged by whether the payment is reasonable and necessary to carry out the organization's exempt purposes.

### **State laws prohibiting or restricting loans**

A majority of state nonprofit corporation laws flatly ban exempt organizations from making loans to their officers or board members. Others allow a few specific exceptions. Some allow loans if they attain some benefit for the nonprofit corporation or otherwise further some legitimate corporate objective. Of course, loans to an insider also can result in impermissible private inurement, such as loans made on insufficient security or below

market interest rates.

### **State statutes on conflicts of interest**

Some state nonprofit laws have specific provisions dealing with conflicts of interest. The land trust's counsel should be thoroughly familiar with the relevant state statute. The generalized discussion provided here should be helpful for land trusts operating in states without such laws. The requirements and standards drawn from the statutes that do exist provide useful guidance for practical handling of conflicts.

State conflict statutes tend to deal only with a narrow band on the theoretical conflict spectrum, where the personal financial interest of a board member (including that of his spouse, dependents, and perhaps other family members and close associates) is involved. They also cover indirect financial interests through corporations and partnerships.

Depending on the statute, the board member is required to *disclose* material facts about conflicting interests (such as the extent of a board member's interest in a supplier of goods to the nonprofit organization) and the terms of the proposed contract or transaction. The full board or committee reviewing the transaction *must approve it by a disinterested majority*. In approving, disinterested board members must exercise their normal "business judgment" or "duty of care"; they must believe rationally that the transaction is a proper one for the organization, despite its manifest benefits to their fellow board member. The transaction must be demonstrated to be *fair*, a standard more likely to be met if the organization has been independently represented in negotiating the terms of the transaction by an individual without any conflicting interest, and if the transaction was initiated by someone other than the interested board member. California law requires a finding by the board that a more advantageous arrangement could not have been obtained with reasonable effort under the circumstances.

### **Duty of loyalty**

The basic fiduciary duty of loyalty requires a board member to have an undivided allegiance to the organization's mission. It bars a board member from using his position or information concerning the organization or its property to secure a pecuniary benefit for himself. Pursuing the financial interest of a third person—even if that third "person" is another charitable organization—also may violate the board member's fiduciary duty. Most of the court cases that have arisen on account of alleged violations of the duty of loyalty deal with property transactions, investment or use of corporate assets to promote personal businesses of board members or those of related third parties, and appropriation for personal gain of opportunities suitable for the organization. The prototypical violation arises when an opportunity presents itself—such as the purchase of real estate that would further the organization's goals—and a board member or officer takes advantage of his position to appropriate that opportunity for himself, usually by virtue of superior access to information.

Although the proper disclosure of the existence and nature of such a conflict and the authorization by a disinterested decision maker acting for the organization can mitigate these constraints, the board member must, at all times, put the organization's interests

ahead of his or her own. If an opportunity related to the organization's mission comes to a board member—*whether in his or her capacity as a board member or otherwise*—the board member must make it available to the organization before he/she pursues it himself/herself or suggests its pursuit to a third party.

(Much of the discussion of conflict statutes and the duty of loyalty is drawn from *Board Liability*, by Daniel L. Kurtz, 1988. Published by Moyer Bell Limited.)

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## **Avoiding Conflicts: Screening Board Candidates**

The surest safeguard against conflicts of interest would be to keep off the board anyone who has potential conflict problems. This is rarely a practical option. Those who serve on land trust boards tend to be active, influential people who are involved in the community in a variety of ways, and thus have many crosscutting loyalties. Nevertheless, the land trust probably should exclude people with extreme conflicts—the mother of the chief staff officer, planning commission members if the land trust is actively involved in land use planning, maybe the major real estate agent in the area dealing with undeveloped land. Cyril Houle, in *Governing Boards* (1997, Jossey-Bass, Inc., Publishers), notes, "Appointments involving extreme cases of potential conflict have sometimes worked out well, but it is usually prudent to assume that they will not." Aside from causing potential legal problems and internal tensions, there are serious practical difficulties with board members with extreme conflicts. They may have to refrain from participating in discussions and voting to such an extent that they cannot function effectively.

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## **Developing a Conflict of Interest Policy**

*Land Trust Standards and Practices* recommends that every land trust develop a written policy for dealing with conflicts of interest. Handling conflicts on an ad hoc basis can be extremely difficult. It tends to personalize decisions and either inhibit a frank exchange of views among board members or alienate them. It leaves open the possibility that the land trust will not adequately deal with a potential conflict, which could result in illegal actions and leave the land trust open to public criticism. The board can decide on a case-by-case basis what constitutes a conflict of interest. But it needs a sufficiently clear way to handle potential conflicts, one that is understood by all board members.

A conflict of interest policy can be relatively simple and straightforward and need not be a burden on the trust's operations. A policy should at a minimum reflect the standards of state law, and should be reviewed by legal counsel to be sure the policy meets all applicable legal requirements. A conflict of interest policy should include the following standard elements:

- **Disclosure.** The policy should require disclosure by board members, officers, staff, and other insiders of any real or apparent conflicts.
- **Recusal from vote, and generally from discussion.** Recusal may be beyond the requirements of law, but is so common and advisable as virtually to be required for sound operations. As Daniel Kurtz notes in *Board Liability*:

While the law usually...does not preclude [an interested director's] participating in discussion and debate, there seems to be little good reason for allowing this participation. Either his participation is unnecessary for review and approval, in which case it is, at best, superfluous, or it is essential for approval or at least persuasion, in which case that is exactly the consequence that the law seeks to proscribe.

- **Fairness to the land trust.** For any transaction involving financial arrangements, the policy should require that the arrangement be fair to the land trust. Procedures range from formal, competitive bidding on major contracts to comparison-shopping by obtaining informal price quotations for common goods and services. If placement of investments is an issue, the land trust should consider having the investments handled by an unrelated outside manager. The land trust should have a disinterested party represent it in negotiating the terms of and implementing any transaction where a conflict is present. The land trust should certainly consider adopting the standard in California law, which requires a finding by the board that a more advantageous arrangement could not have been obtained with reasonable effort under the circumstances.
- **Explanation and enforcement of the policy.** In the induction of new board members, the policies dealing with possible conflicts of interest should be explained, as should the expectation of full disclosure, withdrawal from discussion or decision making on sensitive subjects, etc. It is a good practice to have every board and staff member sign the policy. Some organizations also have a standard process of annual notification and opportunity for disclosure, which helps remind board members, staff members and other insiders of the policy and their responsibilities under it.
- **Written documentation.** In addition to the written disclosures provided above, the land trust should document the actions it takes to manage a conflict of interest. The board minutes should reflect if there was a potential conflict and how it was addressed. A few land trusts use a practice of asking if there is a conflict of interest before every board vote and document the absence of conflict in the minutes.

The best policy still does not assure that conflicts will not occur. Cyril Houle, in *Governing Boards*, notes:

It may sometimes happen, despite these safeguards, that a trustee appears to be putting a private interest ahead of that of the institution. If the offense is not very serious, it may be handled by a casual comment (“Jack, be sure you don’t tell your brother what we’ve decided”) that lets the possibly errant trustee know that

he is being watched. If the problem has greater magnitude, serious measures will need to be taken, all the way to a request for a formal inquiry into what is going on. Such drastic measures are never pleasant, ending, as they can, in lifelong enmity; but those who let matters ride may well find themselves in a courtroom facing the charge that they have been negligent in carrying out the duties entrusted to them.

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## Using Common Sense

Land trust board members are not paid, unlike trustees of investment trusts or board members of business corporations. While that does not excuse them from the duty of undivided loyalty, they should be encouraged to deal with conflicts on a common sense basis. Land trust board members share an interest in common—land conservation—and are frequently friends in the same community. Serious, actual transgressions are not likely, and when they occur, they are in most instances unintentional violations. Board members frequently are simply unaware of their duty of undivided loyalty to the land trust, or, having the best interests of the land trust at heart, do not realize how a potential conflict may be perceived in the community. Ensuring that board members are aware of their responsibility, and establishing a tradition of dealing openly, should go far in avoiding real or perceived conflicts of interest.

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## Links to Other LTA Resources

- [Land Trust Alliance – Conflict of Interest Policy](#)

## Links to More Helpful Resources

- [Internal Revenue Code Section 501\(c\)\(3\)](#)
- [Internal Revenue Code Section 507\(d\)\(2\)](#)
- [Internal Revenue Code Section 4958](#)

## Helpful Publications

- *Board Liability: Guide for Nonprofit Directors*, by Daniel L. Kurtz, 1988. Published by Moyer Bell Limited.
- *Governing Boards: Their Nature and Nurture*, Cyril O. Houle, 1997. Published by Jossey-Bass, Inc., Publishers.

## Sample Land Trust Policies

- [Barrington Hills Conservation Trust \(IL\) – Policy Regarding Board of Trustee Conflict of Interest](#)

- [Chelan-Douglas Land Trust \(WA\) – Conflicts of Interest Policy](#)
- [Connemara Conservancy Foundation \(TX\) – Board of Trustees Conflict of Interest Policy](#)
- [Estes Valley Land Trust \(CO\) – Policy Re: Unsolicited Gifts](#)
- [Forever Wild Land Trust \(fictitious land trust\) – Conflict of Interest Policy](#)
- [Jo Daviess Conservation Foundation \(IL\) – Code of Ethics](#)
- [Marin Agricultural Land Trust \(CA\) – Policy Re: Board of Directors Conflict of Interest](#)
- [New Jersey Conservation Foundation – Statement of Board Members’ Individual and Collective Responsibilities](#)
- [River Fields, Inc. \(KY\) – Policies Governing Conflict of Interest and Confidentiality](#)
- [Sudbury Valley Trustees \(MA\) – Code of Ethics and Standards of Service for Board Members](#)
- [The Nature Conservancy – Conflict of Interest](#)
- [Vermont Land Trust – Personnel Policy Addendum: Conflict of Interest Policy](#)

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***To Fully Implement this Practice, LTA Recommends...***

- A land trust has a written conflict of interest policy that is followed.
- All board members and staff members have a copy of the policy.
- The policy requires disclosure of potential conflicts, includes a prohibition on conflicted parties discussing or voting on the issue and requires written documentation of each conflict.

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