

September 19, 2019

**Legal Alert: Conflict of Interest Issues Nonprofits Should Consider
Before Accepting a Loan from an Insider**

Many nonprofits face financial constraints and seek additional and creative sources of funding to help them carry out their missions. In some cases, Board members, Officers, or nonprofit staff may wish to help support the nonprofit organization's activities by loaning money to the organization. While this may seem like a simple solution, nonprofits should proceed with caution. This legal alert lays out the legal obligations of a New York nonprofit organization that accepts a loan from a Board member, Officer, or employee.

1. Can Board members and Officers loan money to the nonprofit organization?

Yes. However, because loaning the money will constitute a transaction between the organization and a person with a fiduciary duty to the organization (i.e. the Board member or Officer), there is the appearance of a conflict of interest. New York nonprofits should treat the loan as a related party transaction. This does not mean that the transaction cannot occur. However, the organization must follow the procedures in its conflict of interest policy for reviewing related party transactions, to ensure that the loan is fair, reasonable, and in the organization's best interests.¹

In addition, the IRS may subject the loan to particular scrutiny because it involves an insider. If the IRS finds that the terms of the transaction are not reasonable, it may treat the loan as an excess benefit transaction and impose financial penalties on both the lender and the nonprofit. In most instances, following the related party transaction procedures will create a rebuttable presumption that the loan is not an excess benefit transaction, and will protect the organization and the insider from being penalized.²

2. Can staff members loan money to the nonprofit organization at which they work?

Yes, staff members may generally loan money to the nonprofit organizations that employ them. However, the organization should review its personnel policies to make sure that accepting the loan is not prohibited by any policies. If the staff member is an Officer, falls within New York's definition of a key person (for example, the Executive Director or Chief Financial Officer), or is related to a Board member, Officer, or key person, then the organization must treat the loan as a related party transaction, and follow the procedures in its conflict of interest policy for reviewing such transactions.³

In addition, some employees who are neither an Officer nor a key person may be considered a disqualified person under the IRS rules regarding excess benefit transactions, which would subject the loan to the extra scrutiny applied to transactions involving insiders. This might include, for instance, someone who is not currently a key person but in the past five years held a position of substantial influence within the organization.⁴ As described above in response to question #1, in most instances,

¹ See NY Not-for-Profit Corporation Law ("N-PCL") §§ 102(a)(24), 715, 715-a.

² See Internal Revenue Code 4958; Treas. Reg. 53.4958-1 to -8.

³ A key person is one who: (i) has responsibilities, or exercises powers or influence over the corporation as a whole similar to the responsibilities, powers, or influence of officers and directors; (ii) manages the corporation, or a segment of the corporation that represents a substantial portion of the activities, assets, income or expenses of the corporation; or (iii) alone or with others controls or determines a substantial portion of the corporation's capital expenditures or operating budget. N-PCL § 102(a)(25).

⁴ Treas. Reg. 53.4958-3.

following the related party transaction procedures will create a rebuttable presumption that the loan is not an excess benefit transaction, and will protect the organization and the insider from being penalized.

3. How can the organization determine that the loan is reasonable and in the best interests of the corporation?

Accepting the loan may be in the best interest of the organization if the loan proceeds are needed to fund programming or meet other financial needs, and the terms of the loan are the same as or better than the organization would receive from an unrelated party. The organization will need to follow the process for addressing conflicts of interest as set forth in its conflicts policy. In general, the process for addressing conflicts is as follows:

- a) Any insider who stands to gain financially from a transaction with a nonprofit organization must disclose the conflict ahead of time, and the transaction must be reviewed by non-interested Board members. If there are doubts about whether there is a conflict, the best course of action is for the insider to disclose the financial transaction.
- b) The Board (or an authorized committee of the Board) should make sure that the interested party – the person who stands to gain financially from the transaction – recuses himself or herself **before** deliberation about the transaction takes place. The interested party cannot be present at, or participate in, Board or committee deliberations or vote on the matter giving rise to the conflict. The interested party cannot attempt to improperly influence the deliberation or voting on the matter.
- c) Next, the Board or authorized committee of the Board should make a determination about whether the transaction is fair, reasonable, and in the best interests of the nonprofit organization. The organization's conflicts of interest policy may include a process for researching the fair market value of a transaction. In any case, the Board should ask questions like:
 - Were multiple loan quotes obtained?
 - What terms do private lenders impose for similar transactions in the market?
 - Is there another option that would be better for the nonprofit organization?
- d) After the transaction is reviewed, the Board or committee will vote to approve (or disapprove) the transaction.
- e) Don't forget to document the organization's compliance with its conflict of interest policy! The documentation should be contemporaneous (meaning very soon after the transaction), and should record:
 - the fact that the interested person was recused,
 - what factors the Board considered in determining whether the transaction was fair, reasonable, and in the corporation's best interest, and
 - what the Board's determination was.

Depending on the facts, a Board member or Officer who fails to make proper disclosures may be subject to a charge of breach of the duty of loyalty. In New York, if a transaction with a related party is not fair, reasonable, and in the corporation's best interest, the Attorney General can bring an action to void the transaction, seek restitution from the organization or insiders who benefitted, or remove directors from a nonprofit organization's Board. The person who received an unfair benefit can be required to repay any profits received from the transaction.

For more information on conflict of interest policies under New York law, please see Lawyers Alliance’s June 2019 Legal Alert, “Conflict of Interest Policies,” https://lawyersalliance.org/userFiles/uploads/legal_alerts/Conflict_of_Interest_Policies_Legal_Alert_June_2019_FINAL.pdf.

4. Once approved by the Board, how should my organization document the loan?

It is important that the parties sign a promissory note or loan agreement that establishes the following terms of the loan: (i) the amount of the loan; (ii) the interest rate; and (iii) when and how the loan will be repaid. This helps to ensure that all parties agree on the key terms, and creates a record of the loan. It is advisable to work with an attorney to draft the relevant documents.

5. After the loan transaction is approved, what are my organization’s obligations?

Once the Board has approved the transaction and the organization has received the money, the organization must continue to follow its conflict of interest rules throughout the life of the loan. The person who loaned the money will continue to have a conflict of interest regarding the loan. The organization will need to follow its conflict of interest policy to ensure that the conflicted individual is not present for any deliberations regarding the loan and does not vote on any issue relating to the loan.

The lender may also have conflicts with regard to other organizational decisions. For example, consider an organization that has taken a loan from a Board member for general operating expenses. A year later, the Board learns of a great new opportunity to expand its services under a government contract and wants to apply for it. However, the contract creates additional financial risk for the organization, and part of that risk is that the organization may not be able to pay some of its debts – including the loan from the Board member. In this case, the Board should consider whether the Board member who loaned the money should be recused from conversations about whether to apply for the government contract.

6. What if my organization cannot repay the loan in a timely manner?

An organization should take out a loan only if it intends to repay it. However, if an organization finds itself in a situation where it is questioning whether it can repay the loan on time, the Board will likely meet or otherwise discuss how to proceed. The person who provided the money should not be present at any deliberations or be involved in any discussions. That individual must recuse him or herself, because he or she has a conflict of interest with respect to the loan.

7. If the lender decides to forgive the loan, can it take a tax deduction?

If an organization takes a loan from a Board member, Officer, or employee, and later cannot repay the loan, the lender may decide to forgive the loan. That person may be able to take a charitable deduction for the amount forgiven – if there is valid evidence of an enforceable loan, such as a promissory note or loan agreement.

8. Can my organization loan money to one of our Board members or corporate officers?

In most cases, no. New York nonprofit corporations are generally prohibited from lending money to their Board members and Officers. The only exceptions to this rule are for loans (1) purchased through bonds (or other similar instruments that are usually sold in public offerings) or through ordinary deposit

of funds in a bank, or (2) between two charitable organizations.⁵ Organizations will still need to follow their conflicts of interest rules, even for these types of transactions.

This alert is meant to provide general information only, not legal advice. If you have any questions about this alert please contact Senior Policy Counsel Laura Abel at (212) 219-1800 ext. 283 or visit our website at www.lawyersalliance.org for further information.

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⁵ N-PCL § 716.