

**AUXILIARY ORGANIZATION
STANDARDS OF CONDUCT AND COMMITMENT:
A POLICY DEVELOPMENT & PRACTICE GUIDE**

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Auxiliary Organizations Association

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Professional Monograph Series

I. Purpose

For over three decades the *Auxiliary Organizations Association (AOA)*¹ has commissioned and published professional papers for its members on timely governance and management subjects.

AOA continues the series with this policy development guide. Its purpose is to help auxiliary organization governing boards and management formulate sound policy and practices under statutory standards of conduct and conflict of interest requirements.

This guide analyzes statutory standards and transaction restrictions, as well as accepted corporate principles, and includes implementation materials.

This paper does *not* constitute legal, accounting or other compliance advice. Conflict/commitment of interest and self-dealing issues follow patterns, but most are quite fact and circumstance sensitive, and should, therefore, be addressed and resolved in consultation with appropriate advisors. AOA will endeavor to keep this monograph up-to-date. The analysis, conclusions and approaches in this monograph are those of the author, not the AOA or its member organizations.

¹ The AOA, a California public benefit nonprofit corporation, is organized to develop and foster sound relationships between members and with their customers and clients; and to provide governance and management development programs, services and publications. AOA members are auxiliary organizations serving campuses within the California State University. The AOA is *not* an auxiliary organization.

II. Background

To the layman, employee, or even the experienced Board member, the term *conflict of interest* may seem an amorphous of concepts, some rational, some not.

Let's begin by carving out requirements that do not apply to auxiliary organizations (with notable exceptions). The *Political Reform Act*² ("the Act") was enacted by an initiative measure (Proposition 9) in the mid-1974, and is the jumping off point for conflict of interest laws in California.³ The basic prohibition under the *Act* disqualifies *public officials* from participating in *government decisions* in which they have a financial interest. The phrase "public officials" encompasses not only elected and appointed officials in the ordinary sense of the term, but also any "member, officer, employee or consultant of a state or local government agency."⁴ Regulations have given this term very broad meaning over the years.

Similarly, application of the terms "government decisions" and "financial interest" have expansive meanings under the Act. An elaborate reporting system is in place to aid in compliance.

Thus, with a critical caveat, application of the Act does not extend to auxiliary organizations. Some campuses have assigned state employees to auxiliary organization positions. To the extent such an employee is subject to its provisions, they continue to be under the Act while assigned to an auxiliary organization.

The statutory focus in this area of public policy for nonprofit corporations and auxiliary organizations is at the governance level. While that is a convenient place to start, it is important for boards and management to appreciate a larger realm: *instilling corporate values and values across the organization by adopting sound policy and implementing procedures.*

This Guide attempts to reach beyond statutory compliance and into how governance and operations *ought* to behave and the need to commit plainly to corporate and professional standards.

Board members are *individually* held to statutory requirements in the exercise of their duties. Since auxiliary organizations are also nonprofit corporations, auxiliary board members must follow applicable provisions of the *California Nonprofit Corporation Law*. They are also subject to financial interest restrictions in the *California Education Code* for auxiliary organization governing bodies.

² Cal Govt Code §81000 *et seq.*

³ *Ibid* at §§87100-87500, dealing solely with "conflicts of interest."

⁴ *Ibid*, §82048.

III. Statutory Standards

A. California Nonprofit Corporation Law

The “Fiduciary” Standard (Strict and Contemporary). The term “fiduciary” refers to one who holds a position requiring trust, confidence, and scrupulous exercise of good faith and candor. Included are those with a duty, created by a particular undertaking, to act primarily for the benefit of others relating to the undertaking with trust and confidence exercised with fairness and good faith.⁵ There is a strict, traditional interpretation of the term generally confined to trustees.⁶ Then there is the less strict use of the term used to describe a nonprofit director’s “fiduciary” duties of care, the duty of inquiry, the duty of loyalty, and the duty to comply with investment standards.⁷

The strict trustee standard of duty is generally *not* imposed on directors of California nonprofit entities. In the case of auxiliary organizations serving as the trustee of charitable trusts, the traditional interpretation may well be applicable by extension to the governing board of that entity.⁸ Thus, the fiduciary duties of auxiliary organization governing directors are not only to the entity, but also to the institution it serves, to trustors, and the general public.⁹

Duty Standards

Duty of Care: Directors owe a duty of due care in the performance of their governance functions.¹⁰

“The duties of a director, including duties as a member of any committee of the board upon which the director may serve...” shall be performed “in good faith, in a manner such director believes to be in the *best interests of the corporation* and with such care, including reasonable inquiry, as an ordinary prudent person in a like position would use under similar circumstances.” (*Emphasis added.*)

This standard is almost the same as that imposed on business corporations, but, unlike trustees under the strict fiduciary standard, nonprofit directors may delegate corporation management “to any person or persons, management company, or committee.”¹¹

⁵ *Black’s Law Dictionary* (6th Ed 1990).

⁶ See generally *California Probate Code* Sections 16000-16015.

⁷ See *Guidebook for Directors of Nonprofit Corporations* (ABA, Nonprofit Corporations Committee, 1993).

⁸ *Cal Corps Code* Section 5250.

⁹ Auxiliary organizations are classified as “public benefit” nonprofit corporations. Citations to support this posture: *Holt v College of Osteopathic Physicians & Surgeons* (1964) 61 C2d 750, 754, 40 CR 244; *Queen of Angels Hosp. v Younger* (1977) 66 CA3d 359, 136 CR 36.

¹⁰ *Cal Corps Code* Section 5231(a).

¹¹ *Ibid* at Section 5210.

Duty of Inquiry: The director's obligation to make reasonable inquiry is triggered only when circumstances suggest that further inquiry is needed. Directors may rely on information, opinions, reports, or statements, including: financial statements prepared or presented by officers or employees believed to be reliable and competent in the matters presented; by counsel and independent accountants on matters believed to be within their professional competence; and by board committees on matters charged to that committee.

Duty of Loyalty: A director must act in a manner that the director believes to be in the best interest of the organization and all of its members, including minority member factions, and to administer corporate powers for the common benefit – to advance and achieve the corporation's purposes.

Duty to Investments: In dealing with the organizations invested assets, directors must follow three statutory standards:

- Avoid speculation and look instead to permanent disposition of the funds, considering the probable income and the probable safety of the corporation's capital;¹²
- Comply with any additional standards imposed by the corporation's articles or bylaws or by the express terms of an instrument or agreement under which the assets were contributed;¹³ and
- Meet the general standard of care requirements applicable to directors of public benefit corporations.¹⁴

Self-Dealing Transactions

The law covering nonprofit directors does not use the term "conflict of interest".¹⁵ There are, nevertheless, strict sanctions imposed on auxiliary organization governing directors who engage in a self-dealing transaction involving the corporation the directors are serving.

"Self-dealing transactions" are any transactions to which the corporation is a party and in which one or more of its directors has a material financial interest, unless the transaction (1) is specifically excluded from coverage by statute¹⁶ or (2) although otherwise covered by the prohibition, is approved by the Attorney General or validated.¹⁷

¹² Ibid at Section 5240(b)(1).

¹³ Ibid at Section 5240(b)(2).

¹⁴ Ibid at Section 5240(d).

¹⁵ Ibid at Section 5233.

¹⁶ Ibid Section 5233(b).

¹⁷ Ibid Section 5233(d).

A director with a material financial interest in a transaction involving the corporation served is an “interested director.” The law does not define “financial interest” or “material.”

The statutory exclusions from the “self-dealing transactions” definition include:¹⁸

- Board actions fixing compensation for directors;
- Transactions that are part of the corporation’s public or charitable purpose and that the corporation approves in good faith and without unjustified favoritism, even if one or more directors or their families benefit as part of a class of persons intended to benefit from the program; and
- Transactions of which the interested director has no actual knowledge and which do not exceed the lesser of 1 percent of the gross receipts of the corporation for the preceding fiscal year, or \$100,000.

The organization can engage in a self-dealing transaction if it is approved or validated, either before or after the transaction is consummated, in any one of the following ways:¹⁹

- Upon written and supported request to the Attorney General²⁰;
- Petition to the court;²¹
- Validation by the corporation board under specified pre-conditions;²² and
- Interim approval by other authorized persons under specified pre-conditions.²³

Also see Section IIB for parallel *self-dealing* requirements specifically applicable to auxiliary organization governing boards found in the *California Education Code*. The *Education Code* requirements are in some respects more restrictive than those in the *Corporations Code*. Under principles of statutory interpretation, the *Education Code* provisions are generally perceived to be controlling over board actions, but there are issues to the kind of transaction, financial materiality thresholds, remedies, and validation in the *Corporations Code* that could apply.²⁴ Legal counsel should be sought for advice in circumstances that raise these issues.

¹⁸ Ibid Section 5233(b).

¹⁹ Ibid at Section 5233(d).

²⁰ See Cal Code of Regs §§999.2(c) for notice and approval procedures.

²¹ Ibid at Section 5233(d)(1).

²² Ibid at Section 5233(d)(2)

²³ Ibid at Section 5233(d)(3).

²⁴ The Attorney General has broad statutory oversight over charitable organizations (*Cal Gov Code* §12581).

Director Personal Liability

Given these standards, can a director avoid personal liability simply by disengaging – skip meetings, ignore reports and operations? If a director fails to take reasonable precautions that attend the duties of their corporate office, exposure to personal liability may result from injuries or losses caused by the organization.

On the other hand, so long as the director exercises reasonable diligence and care, he or she will be free from personal liability, even when poor judgment results in loss or injury to the corporation.

The relative freedom from personal liability enjoyed by nonprofit governing directors is reposed by statute:²⁵

“There shall be no personal liability to a third party for monetary damages on the part of a volunteer director or volunteer executive officer of a nonprofit corporation...caused by the director’s or officer’s negligent act or omission in the performance of that person’s duties as a director or officer, if all the following conditions are met:

- The act or omission was within the scope of the officer or director duties;
- The director or officer acted in good faith;
- The act or omission did not involve self-dealing; and
- The act or omission was not reckless, wanton, intentional, or grossly negligent.”

Additional court procedural protections are also afforded nonprofit volunteer directors, but these have many exceptions.²⁶

Under the federal *Volunteer Protection Act of 1997*,²⁷ volunteers, including nonprofit entity directors, cannot be held liable for harm caused by the volunteer’s act or omission on behalf of the nonprofit when specified circumstances are present.²⁸

²⁵ Ibid at Section 5239(a).

²⁶ *Cal Code of Civil Procedure* Section 425.15.

²⁷ 42 USC Sections 14501-05.

²⁸ Ibid at Section 14503(a): acting within duty scope; required license or certificate possessed; no willful or criminal misconduct, gross negligence, etc., and not caused by operated vehicle.

Attorney General Oversight of Specific Transactions

The *California Nonprofit Public Benefit Law*²⁹ gives the Attorney General considerable oversight authority over nonprofit public benefit corporations. All auxiliary organizations fall into this classification. There are certain corporation transactions that require formal advance notice to and in some cases the approval of the Attorney General (Charitable Trusts Section).

1. *Loans and Guarantees to Directors or Officers.* Such transactions are generally prohibited unless the Attorney General approves the transaction.³⁰ The procedure to request approval is generally the same as for requesting approval of a self-dealing transaction.³¹ Transactions exceptions³² to this requirement are:

- Expense advances reasonably expected in performing duties;
- Life insurance premium payments (repayment secured by policy proceeds and cash surrender value);
- Home purchase secured loan to officer (with required Board findings);
- Legal expense advances to defend against charges related to duties or in representing the corporation.

2. *Sale or Other Disposition of All or Substantially All of Corporate Assets.*³³

B. California Education Code

There are concomitant self-dealing requirements for auxiliary governing boards in the *Education Code*. These appear more restrictive than the nonprofit corporation law standards and, therefore, would control over the *Corporation Code* requirements. The Attorney General's statutory oversight jurisdiction³⁴ may involve notice and/or approval steps even under the following *Education Code* standards. Also, the *Education Code* (at Section 89909) also prohibits the use of non-public auxiliary organization information by board members for personal pecuniary gain, regardless of whether the gain was realized.

Financial Interest Conflicts

Except in certain circumstances, a director must avoid *transactions of the board* in which the director has a financial interest.³⁵ The term includes contracts approved by the governing body. To do so is "misconduct in office" and the

²⁹ *Cal Corp Code* §5110 *et seq.*

³⁰ *Ibid* at §5236(a).

³¹ *Cal Code of Regs* §999.2(c).

³² *Cal Corp Code* §§5236(a)-(c), 5238(f).

³³ *Ibid* at §5911 to 5913. For notice and approval procedures, see *Cal Code of Regs* §999.2(e), 999.3(e), and 999.4.

³⁴ *Cal Govt Code* §12598; *Cal Corps Code* §§5233(d); and *Cal Code of Regs* §§999.1(a), 999.2, 999.4.

³⁵ *Cal Ed Code* Section 89906.

transaction breaching this prohibition is void, unless it meets a qualified two-element validation test:³⁶

- Is the transaction just and reasonable as to the auxiliary *when approved*; and
- Was the financial interest disclosed or known to the board and noted in the meeting minutes, followed by a favorable, good faith board vote sufficient for the action without including the interested director(s)?

Any one of several exceptions revives the prohibition. Here they are:

- The transaction is directly between the interested director(s) and the auxiliary.³⁷
- The transaction is between the auxiliary and a partnership or unincorporated association in which a director(s) holds an ownership, partnership or other proprietary interest.³⁸
- The transaction is between the auxiliary and a corporation in which the interested director(s) owns or directly or indirectly holds more than five percent (5%) of the outstanding common stock.³⁹
- The director(s) fails to disclose to the board the financial interest in the transaction at a public meeting, then influences or attempts to influence one or more board members regarding the transaction.⁴⁰

Thus, the following board transactions are specifically deemed *impermissible*:

- Any transaction, other than an employment contract, directly between the organization and a Board member.
- Any transactions between the organization and a partnership or unincorporated association in which a Board member is a partner, or owner, or holder, directly or indirectly, of a proprietorship interest.
- Any transaction between the organization and a for-profit corporation in which the organization's Board member is the owner or holder, directly or indirectly, or 5 percent or more of the outstanding common stock.

On the other hand, the following board transactions are *permissible* if the Board follows the prescribed procedure (see below):

³⁶ Ibid Section 89907.

³⁷ Ibid Section 89908(a).

³⁸ Ibid Section 89908(b).

³⁹ Ibid Section 89908(c).

⁴⁰ Ibid Section 89908(d).

- Transactions between the organization and a for-profit corporation in which a Board member is the owner or holder, directly or indirectly, of less than 5 percent of the outstanding common stock.
- Transactions between the organization and a for-profit corporation on whose governing body a Board member serves as a director and owner or holder, directly or indirectly, of less than 5 percent of the outstanding common stock.
- Transactions between the organization and a nonprofit corporation on whose governing body a Board member serves as a director.

But what if a transaction involving the organization and an “interested director(s)” never reaches the Board? Indeed, auxiliary governing boards commonly delegate to officers or management the authority to enter into transactions (including contracts) for the organization with others, including potentially, individuals who are “interested directors.” In such cases, the Corporations Code “self-dealing transaction” standards (Section 5233) applicable to nonprofit public benefit corporations may come into play. See Section IIA above.

Appendix A compares the *Education Code* restrictions applicable to “self-dealing” transactions involving an auxiliary organization Board and interested Board members with those requirements for nonprofit public corporation boards and directors set out in the *Corporations Code*. The interplay between these two sets of statutory standards is fact and circumstance intensive. For example, a “permissible transaction” under the *Education Code*, may still require attention to the *Corporations Code* standards and procedural requirements.

Board Deliberations and Actions Under Financial Interest Circumstances

Under the Education Code standards, the following procedure should be observed: any Board member with an apparent or actual financial interest in a proposed or completed transaction shall promptly disclose the nature and scope of that interest to a designated officer(s), and thereupon be recused from participating in any deliberations or actions by the Board on that matter. The Board meeting minutes shall note the disclosure and recusal. The Board shall then make a determination whether or not the proposed transaction is permissible and just and reasonable for the organization at that time and under the circumstances. If so, the Board may then authorize, approve, or validate the transaction in good faith by a vote sufficient for the purpose of the action without counting the vote(s) of such financially interested Board member(s).

Attorney General and Board Validation/Remedies May Apply

As outlined in Section IIA above, auxiliary organizations, as nonprofit public benefit corporations, may be subject to certain Board, Attorney General and court actions in handling self-dealing situations. The advice of legal counsel should be sought to analyze and assist in such situations.

Board Member Use of Non-Public Information for Personal Pecuniary Gain

Having dealt with “self-dealing” transactions by governing board members, the Education Code then moves on to set and apply a standard for the use by a director or directors of an auxiliary organization’s proprietary information for personal pecuniary gain.

The standard is expressed as a categorical prohibition: “It is unlawful for any person to utilize any information, not a matter of public record, which is received by him by reason of his membership on the governing board of an auxiliary organization, for personal pecuniary gain, regardless of whether he is or is not a member of the governing board at the time such gain is realized.”⁴¹

Public contract statutes and court opinions also contain broad prescriptive self-dealing and financial interest language that, in certain circumstances, could apply to auxiliary organization transactions, employees, officers, contractors, and agents when the organization enters into certain relationships with a State agency, including the CSU or a campus.⁴²

Use of Non-Public Information for Personal Gain by Anyone

There is a broader parallel proscription over the use of non-public information for personal gain. *Education Code* Section 89006 makes it “unlawful for any person to utilize any information, not a matter of public record, that is received by that person by reason of his or her employment by, or contractual relationship with the trustees, the California State University, or an auxiliary organization of the California State University, for personal pecuniary gain, not contemplated by the terms of the employment or contract, regardless of whether the person is or is not so employed or under contract at the time the gain is realized.

⁴¹ Ibid Section 89909. The term “non-public” extends to auxiliary or other information not generally available to the public.

⁴² *Cal Govt Code* §1090 strictly prohibits State employees from having a personal financial interest in any State contract with limited exceptions, and voids the contract, whether the personal financial interest is as an employee, officer, agent, attorney, broker, agent, landlord, or tenant of the contracting party. *Thompson v. Call*, 38 Cal.3d 633 (1985) adds the “appearance” of conflict in addition to actual conflicts of interest.

Cal Pub Cont Code §§10831 and 10832 set out specific restrictions on CSU employees contracting with the CSU.

C. California Government Code

It is quite common for university (State) officers to also be officers, board members, or employees of a campus auxiliary organization, and certainly the university and the auxiliary organization enter into manifold agreements. Existing law generally prohibits elected officials or State employees from being financially interested in any contract made by them in their official capacity, or by any body or board of which they are members. However, under *Government Code* Section 1091(a), a conflict does not exist if there is only a “remote interest” that is adequately disclosed, and other procedural steps are taken. The term “remote interest” includes a situation where the State officer or employee is also an officer or employee of a nonprofit, tax exempt entity⁴³ (as are all auxiliary organizations).

Application of this “remote interest” conflict is dubious at the campus level, since the university officer or employee has no board on the “State-side” to make a disclosure, and there is no campus board considering action on the contract. However, this may not be the case with a system-wide auxiliary organization officer or board member who is also a member of the Board of Trustees.

IV. Federal Interest in Exempt Organization Conflicts of Interest

Congress and the U.S. Internal Revenue Service have kept a close eye on the nonprofit sector over reoccurring “conflict of interest” issues. In 2005, a national panel presented a report to Congress that included a series of specific recommendations dealing with charitable organization governance, transparency and accountability. The objective of the report was to head off additional laws and regulations, and to demonstrate to lawmakers and the IRS that the nonprofit sector was up to more effective self-regulation. One report recommendation pertinent to this monograph found its way into the revised IRS Form 990 (2008).

Part IV, “Governance, Management and Disclosure,” on the new 990 *requests* additional information on policies *not required by the Internal Revenue Code*. Section B in Part IV asks specific questions dealing with conflicts of interest:

Line 12a – Does the organization have a written conflict of interest policy?

Line 12b – Are officers, directors or trustees, and key employees required to disclose annually interests that could give rise to conflicts?

Line 12c – Does the organization regularly and consistently monitor and enforce compliance with the policy?

Then in Part VI, Section C, at *Line 19*: Describe in Schedule O how the organization makes its governing documents, conflict of interest policy, and financial statements available to the public.

⁴³ *Cal Gov't Code* §1091(b)(1).

So-called “transactions with Interested Persons” are the subject of additional inquiry in Part VI, *Lines 25 and 26*, Schedule L, Parts I, II and IV.

This inquiry into the documented policy and practices of the filing organization clearly represents a continuing public policy concern over if and how nonprofit corporations, including auxiliary organizations, commit to follow standards of conduct. These reporting requirements do not pre-empt State law.

V. Standards Beyond What the Law May Require

A. Corporate Ethical Perspective

Over the past decade there have been both tensions and cooperative endeavors between the government, nonprofits, and the for-profit sector to raise and resolve issues of accountability, transparency and conflicts of interest.⁴⁴

Increased commercial and research activities and opportunities have led to perceptions that such situations threaten the for-profit sector, and to compromise the intended public policy purposes of the nonprofit sector.

Like many important concepts, “conflict of interest” can fit many meanings. Affixing it to a debate opponent can appear to prove misconduct. But the term really has meaning only with reference to an explicit body of norms that the actor and others would agree constrain their behavior. Only those subject to some professional code, or some generally accepted standards of practice or performance are expected to avoid “conflicts of interest.” Furthermore, not all conflicts of interest are avoidable or unacceptable. The mere fact of a conflict does not by itself mean wrongful behavior, and more specifically, it does not equate to professional misconduct.

In an abstract sense, these conflicts are ubiquitous. A person may be said to have a conflict of interest whenever self-interest is different from those of others, or when one has two conflicting desires or goals. But such a perspective on the concept would make it so universal as to be meaningless – a notion with no limit and no practical value.

So, in the context of auxiliary organization policy and practices development, the definition begins by excluding conflicts that are trivial and unavoidable. A practical definition also must be more than a projection of *individual* values; more than merely that a conflict “is in the eye of the beholder.” Conflicts of interest in the organizational setting can best be developed and understood only if it is

⁴⁴ See more recently, Panel on the Nonprofit Sector, *Strengthening Transparency, Governance, Accountability of Charitable Organizations*, a final report to Congress and the Nonprofit Sector, June 2005 (with Supplement, April 2006).

widely agreed that a given person (a participant) is *supposed to obey a particular set of norms*.

With most professions, it is possible to be more specific in this arena. The essence of a profession is that its members commit themselves to a set of standards and behavioral norms qualitatively and extensively beyond those that prevail or are tolerated in the wider marketplace. Such professional conduct-norms provide tangible reference points for corporate conduct-standards setting. It is also useful to distinguish between conflict of interest and conflict of commitment. The former most often involves *money*; the latter typically involves *time*. Conflict of interest exists whenever an individual's personal ties could unduly influence a professional judgment. Conflict of commitment exists when an individual's primary loyalties are in doubt. Both types of conflict can emerge when an independent entity invites the entrepreneurial spirit into its midst.

Based upon the context of this guide, as analyzed above, a serviceable definition is that:

A potential or actual conflict of interest exists when legal obligations or widely recognized professional or established corporation norms are likely to be compromised by a person's other interests, especially if those interests are not disclosed.

Such conflicts can arise when a board member of organization A also sits on the board of organization B, and a decision is before organization A's board dealing with organization B.

B. Corporate Mission and Values

"Conflicts of interest" policy should be formed with reference to not only legal standards (as outlined above), but also to certain values that, by general agreement, a participant is obliged to serve. It is important then to identify and articulate the mission and values that the corporation seeks to pursue.

Naturally, individuals have different roles in auxiliary functions that oblige them to maximize different values – or, more commonly, to prioritize similar values differently. But in a very broad sense, corporation participants (directors, officers, managers, employees, agents and contractors) should share a commitment to at least these values:

- Primary Allegiance to the Corporation and a Commitment to its Purposes.
- Independence – Serving as Public Trust for Knowledge and Learning.
- Open Communication and Dissemination of Knowledge.
- Competence and Integrity in the Services Provided.
- Accountability and Transparency
- Exemplars of High Standards of Professional Conduct

It is critical to the full understanding of all corporation participants – directors, officers, employees and other representatives – that the corporation expresses its organizational values, along with the formal statement of its corporate mission. With these expressions in place, and assuming that they are designed through a process that involved all participant-types, the organization is then in a position to identify the principal sources of conflicts of interest, and then to develop practices for resolving those conflict situation.

C. Policy Principles

There are common conflict of interest issues encountered by auxiliary organizations. These issues, in turn, frame similar principles. The list of principles below should assist directors, officers and employees to think through the issues and develop reasonable conflict of interest policies and practices that address both legal and ethical needs. A documented path needs to be set for the board, officers, and management to follow to help insure arms length dealings, and prevent, or at least help bring out and resolve actual or perceived conflicts.

Primary Commitment to the Corporation

A person who accepts a governance or employment position, or enters into a relationship with the corporation as a representative of that corporation, has an obligation to devote his or her primary professional effort and allegiance to the corporation. Other activities or commitments, consistent with the nature and extent of the relationship, should be arranged so as not substantially to conflict with or dilute this commitment.

It is inappropriate for participants, without prior approval, to divert to other entities, institutions or parties opportunities for business, knowledge, financial support which otherwise might flow to the corporation.

Prior Disclosure of Potential Conflicts of Interest

Corporation participants should be required upon initial affiliation, and periodically thereafter, to disclose significant financial, personal, or professional relationships that raise a potential conflict of interest between their participant role and outside interests, as defined in corporation policy.

Family Relations

Participants usually must disclose any known relationships involving a member of his or her family that may cause a conflict or appearance of conflict.

Confidentiality

In order to encourage full disclosure of potential conflicts without unduly intruding on the privacy or proprietary rights of corporation participants or their families or

associates, disclosures should be treated with confidentiality, and disclosed only to the extent necessary to consider and resolve any conflicts in a lawful manner.

Subsequent Disclosure

Significant financial, personal, or professional relationships that raise a potential conflict of interest (appearance or actual) should be fully and accurately disclosed in communication relating to the activity or transactions in which the participant is involved.

Withdrawal from Decisions

Corporation participants should not exercise decision-making authority or influence concerning any business relationship affecting any association in which they or members of their immediate family have a substantial personal, financial or professional interest.

Gift/Favors Soliciting, Giving or Receiving

Procurement standards have long constrained practices that create or appear to create conflicts or unfairness in the process of acquiring goods and services.

Participants should not solicit gifts or favors from vendors/service providers, nor make or receive anything of value in apparent exchange for other than equal treatment in the acquisition process.

IV. Policy Implementation

While a single “model” policy statement would likely not “fit” all member-organizations, Appendix B represents a template of a Standards of Conduct policy.

Appendix C is a checklist specifically designed to aid officials responsible for reviewing conflict of interest situations involving governing board members.

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APPENDIX

- A. Self-Dealing Statutes Comparison Chart**
- B. Template Standards of Conduct Policy**
- C. “Interested Director” Transaction Decision Analysis Sequence**

APPENDIX A

AUXILIARY ORGANIZATION SELF-DEALING STATUTESⁱ COMPARISON CHART

Transactions ⁱⁱ	Corporations Code	Education Code
Permissible:		
1. -- Fixing compensation of board member or board member as an officer	Section 5233(b)(1) – Self-dealing transaction exclusion	No provision dealing with such transactions (Corp Code applies)
2. – For employment contract directly between corporation and board Member	Business Judgment Rule applies. ⁱⁱⁱ	Sections 89006 and 89906^{iv} provisions should be interpreted together (Corp Code applies)
3. – As part of corporation’s public or charitable programs	Section 5233(b)(2) – <u>if</u> approved by board in good faith <u>and</u> without unjustified favoritism, even if one or more board members or their families benefit as part of class of persons intended to benefit from the program	No provision dealing with such transactions (Corp Code applies)
4. – In which “Interested” board member has financial interest –	Section 5233(b)(3) – of which “interested board member” has no actual knowledge, <u>and</u> which does not exceed the lesser of 1% of corporation gross receipts for preceding fiscal year, or \$100,000.	<p>Sections 89907 and 89908(c) -- Where between corporation and for-profit corporation in which “interested” board member owns or holds (directly or indirectly) <u>less</u> than 5% of outstanding common stock --</p> <p><u>If</u> financial interest disclosed or known to corporation board <u>and</u> noted in meeting Minutes, <u>and</u> board thereafter approves in good faith by vote sufficient w/o “interested director(s).”</p>
5. -- Although otherwise prohibited (see <i>Impermissible</i> below)	Section 5233(d) – <u>if</u> approved <i>prior to</i> or <i>after</i> transaction by Attorney General or court action, or by board or board authorized validation <i>prior to</i> transaction. ^v	No parallel provision
Impermissible:		
1. -- Directly between corporation and board member(s) having a material financial interest.	Section 5233(a) – <u>unless</u> transaction specifically excluded from coverage by statute (see <i>Permissible</i> above).	Sections 89906 and 89908(a) – (except employment contracts under Sections 89006), transaction is void and board member is disqualified and guilty of misconduct in office. Education Code control
2. Between corporation and a partnership or unincorporated association of which a board member is the owner or holder (directly or indirectly) of a proprietary interest.	<i>Note:</i> Section 5233 prohibitions may extend to board member relatives (especially, a spouse); but not transactions with another entity in which the board member is merely an officer. ^{vi} See Note iii	Sections 89906 and 89908(b)

3. -- Between corporation and a for-profit corporation in which a board member is the owner or holder (directly or indirectly) of <u>5% or more</u> of outstanding common stock.	See above note. Education Code applies	Sections 89906 and 89908(c)
4.-- In which “interested” board member, without first disclosing such interest to the board at a public meeting, influences or attempts to influence one or more board members to enter into the contract or transaction.	See above note. Education Code applies	Sections 89906 and 89908(d)

ⁱ The *Education Code* provisions, applicable to auxiliary organizations (operating within the California State University) appear more restrictive as to actions by the governing board (with exceptions) than the *Corporations Code* standards. Therefore, under principles of statutory interpretation, *Education Code* standards would likely control. There are, however, certain transactions involving financial materiality thresholds, remedies, and actions under the *Corporations Code* that may apply to auxiliary organization “self-dealing” transactions between the auxiliary and “interested directors,” particularly other than those involving board transactions. Legal counsel should advise in such circumstances.

ⁱⁱ The statutes do not define terms “transactions,” “contracts,” “material,” or “financial interest.” With respect to the *Education Code* standards (other than the exclusions and exceptions to the exclusions), the term “transaction” refers to an action ...“entered into by the board...”

ⁱⁱⁱ The Section 5233 standard (while it may not extend specifically to transactions involving relatives) prescribes for directors a fiduciary duty to always act in the best interest of the organization and to evaluate each transaction entered into by board action with that standard in mind. The *business judgment rule*¹ is the standard adopted by the courts in deciding whether a director, acting without a financial interest in the decision, has met his or her fiduciary duty. That duty is fulfilled if the director has enough information to make an informed decision and rationally believes that the transaction is in the best interest of the corporation. *If that transaction happens to be between the corporation and a board member relative, it is important for the board to document the steps taken to explore alternatives, together with the discussion on the pros and cons of the proposed action.*

^{iv} *Education Code* Section 89906 uses the phrase “any contract or other transaction,” while Section 89006 (enacted with Section 89906) uses the phrase “employment by, or contractual relationship with...” If there had been legislative intent to include employment relationships with board members in Section 89906, the phrasing could easily have read (for example) “...any employment relationship, contract, or other transaction.” Use of the term “employment” in Section 89006 *and* its absence in Section 89906 is most reasonably interpreted as the end result of the intent to *include* “employment relationships” in Section 89006, and to *exclude* them in Section 89906.

Furthermore, the Section 89006 prohibition constitutes a self-dealing and conflict of interest standard of employees of auxiliary organizations that stands on its own, making unnecessarily redundant an interpretation that the Section 89906 phrase “contracts and other transactions” extends to employment relationships.

^v Board validation criteria set out in *Corps Code* Section 5233(d)(2); See 11 *Cal Code Regs* §§999.1(a), 999.2-.3 for information required by Attorney General to consider transaction approval.

^{vi} See Ballantine & Sterling, *California Corporation Law* §406.02. But, see Note iii above.

APPENDIX B

[Name of Auxiliary Organization]

SECTION NO.

[**TEMPLATE**] POLICY MANUAL

DOCUMENT NO.

SECTION: **POLICY STATEMENT – GOVERNANCE**

SUBJECT: **STANDARDS OF CONDUCT POLICY**

PURPOSE: To restate statutory standards of conduct applicable to the Board members, and to establish a policy framework of parallel standards for volunteers, employees and other representatives of the organization.

REFERENCE: Education Code Sections 89906-09; and Corporations Code Sections 5233.

NEW/REVISED: New

EFFECTIVE
DATE:

I. Background

The [name of auxiliary organization] is a nonprofit public benefit corporation and its Board members, officers, employees and others representing the organization have a fiduciary duty to exercise care, skill and sound judgment in all organization affairs.

There are “self-dealing transaction” standards that generally apply to the “interested” board members of such corporations. See *Cal Corps Code § 5233*.

However, as an auxiliary organization operating within the California State University system, the [name of auxiliary organization] is subject to standards generally considered more stringent covering governing board transactions involving financially interested directors, as expressed in *California Education Code §§89906-09*. This policy statement restates these standards for Board members, and establishes parallel standards for organization employees, volunteers and others having a business relationship with the organization.

Some Board members, officers and employees may also be state employees or officers subject to statutory and Board of Trustees requirements distinct from the requirements set forth in this statement. This policy applies to all Board members.

Every Board member has an affirmative duty to know and understand the conflict of interest standards, and to disclose to the Board any known real or perceived transaction conflict, and to step aside from Board deliberations and actions on such matters.

II. Policy

A. *Financially Interested Director Transactions under Education Code Standards*

Except in certain circumstances, a Board member must avoid *transactions of the board* in which the Board member has a financial interest.¹ The term, *transactions of the board*, includes contracts approved by the Board of Directors. To do so is “misconduct in office” and the transaction breaching this prohibition is void, unless it meets a two-element circumstance exclusion test:²

- Is the transaction just and reasonable as to the organization *when approved*; and
- Was the financial interest disclosed or known to the Board and noted in the meeting minutes, followed by a favorable, good faith board vote sufficient for the action without including the interested director(s)?

But there are several *circumstance exceptions* to the application of the above two-element exclusion test, any one of which revives the prohibition:

- The transaction is directly between the interested Board member(s) and the organization.³
- The transaction is between the organization and a partnership or unincorporated association in which a Board member(s) holds an ownership, partnership or other proprietary interest.⁴
- The transaction is between the organization and a corporation in which the interested Board member(s) owns or directly or indirectly holds more than a five percent (5%) of the outstanding common stock.⁵
- The Board member(s) fails to disclose to the Board the financial interest in the transaction at a public meeting, then influences or attempts to influence one or more Board members in entering into the transaction.⁶

¹ *Cal Ed Code* Section 89906.

² *Ibid* Section 89907.

³ *Ibid* Section 89908(a).

⁴ *Ibid* Section 89908(b).

⁵ *Ibid* Section 89908(c).

⁶ *Ibid* Section 89908(d).

Thus, in summary, the following transactions are specifically deemed *impermissible*:

- Any transaction, other than an employment contract, directly between the organization and a Board member.
- Any transactions between the organization and a partnership or unincorporated association in which a Board member is a partner, or owner, or holder, directly or indirectly, of a proprietorship interest.
- Any transaction between the organization and a for-profit corporation, in which the organization's Board member is the owner or holder, directly or indirectly, of 5 percent or more of the outstanding common stock.

On the other hand, the following transactions are *permissible* if the Board follows the procedure described in Section III(A) below:

- Transactions between the organization and a for-profit corporation in which a Board member is the owner or holder, directly or indirectly, of less than 5 percent of the outstanding common stock.
- Transactions between the organization and a for-profit corporation on whose governing body a Board member serves as a director and owner or holder, directly or indirectly, of less than 5 percent of the outstanding common stock.
- Transactions between the organization and a nonprofit corporation on whose governing body a Board member serves as a director.

B. *Self-Dealing Director Transactions under Corporations Code*

Transactions of the organization that involve a board member with a material financial interest may be subject to Corporations Code self-dealing standards not covered by the Education Code (described in Section A above). The following are typical examples of permissible transactions under Corporations Code standards (either not covered by, or represent a potentially higher standard than the Education Code):

- Setting compensation for board members or board members as officers;
- Employment contract between organization and board member;
- Actions that are part of the organization's public or charitable purposes, when approved in good faith and without unjustified favoritism (even if one or more board members or their families benefit as part of the class of persons intended to benefit from the program);
- Other organization transactions involving an "interested" board member(s) who have no actual knowledge of the transaction, and the financial interest in the

other party to the transaction does not exceed the lesser of 1% of gross receipts for the preceding fiscal year, or \$100,000; or

- The approval prior to or after the transaction is obtained from the Attorney General, or through the validation process prescribed by statute by the governing board, or by a committee or officer authorized by the board.

C. Other Actions or Transactions

Organization directors, officers, employees, volunteers or designated agents or other representatives shall not engage in self-dealing actions or transactions in which they have a personal pecuniary interest. Examples include, acceptance of compensation, advances, discounts, loans, gifts, entertainment or other favors in actual or perceived exchange for, or to influence organization actions, judgments or transactions.

The organization encourages the prompt disclosure of any such conflict, real or perceived, to the [title of chief operating officer] for review and determination. In the case of the [title of chief operating officer], disclosure shall be made to the Board Chair for review and determination consistent with this policy statement.

C. Use of Information for Pecuniary Gain

It is unlawful⁷ and against organization policy for any person, including Board members, employees, volunteers, or organization agents or other representatives to utilize any information, not a matter of public record, which is received by the person by reason of his or her membership on the Board of Directors, organization employment, or relationship with the organization, for personal pecuniary gain, regardless of whether he or she is or is not a Board member, employee, or otherwise engaged with the organization at the time such gain is realized.

III. Procedures

A. Board Deliberations and Actions under Financial Interest Circumstances

Any Board member with an actual or apparent financial interest in a pending or completed transaction shall promptly disclose to the nature and scope of that interest to the designated officer(s), and thereupon be recused from participating in any deliberations or actions by the Board on that matter. The Board meeting minutes shall note the disclosure and recusal. The Board shall then make a determination whether or not the transaction permissible and just and reasonable for the organization at that time and under the circumstances. If so, the Board may then authorize, approve, or validate the transaction in good faith by a vote sufficient for the purpose of the action without counting the vote(s) of such financially interested Board member(s).

⁷ *Ibid*, Section 89909.

B. Board Member Initial and Annual Certification

Each Board member shall initially and annually thereafter receive, review, complete, sign and return a *Related Party Questionnaire and Conflict of Interest Certification* in accordance with written procedures established by the [title of chief operating officer] charged with implementing this policy statement.

C. Purchasing/Expenditure Authorization Certification

Organization employees or others with purchasing and expenditure authority shall receive, review, sign and return the *Signature Authorization Certification*, in a form prescribed by written procedures, acknowledging the following prohibitions and certifying that they will avoid them:

- Engaging in or having any personal pecuniary interest in any business, transaction, or incurring any obligation which conflicts with or gives the appearance of conflicting with or impairing independent judgment in the discharge of duties owed the organization;
- Accepting money, tips, or other considerations for work required or expected in the regular course of organization duties;
- Self-referring organization clients, donors, or customers, or recommending others with which there is a personal pecuniary interest;
- Accepting gifts, gratuities or other favors from those having a business relationship, or prospect of a relationship, with the organization; or
- Disclosing organization information, not a matter of public record, without authority, or using such information for pecuniary gain.

APPENDIX C

“Interested Director” Transaction Decision Analysis Sequence

This Guide is intended primarily as a tool for officials charged with compliance reviews.

Step 1: Collect, analyze and understand all pertinent transaction facts. Retain transaction documents.

Step 2: If transaction is to be acted upon by the Board of Directors, skip Step 3 and go to Step 4 -- otherwise, go to Step 3.

Step 3:

- A. Analyze transaction facts against Corporations Code Section 5233(b) *interest* thresholds and other self-dealing exemptions¹ that may apply.
- B. If transaction facts are below Section 5233(b) *interest* thresholds, or other exemptions apply, end analysis. Proceed to consider and act on transaction (not self-dealing). [Record facts and retain documents that support analysis as basis for transaction approval.] See *Case Example I* below.
- C. If transaction facts are at or above Section 5233(b) *interest* thresholds (and other exemptions do not apply), use Corporations Code Section 5233(d) validation process to consider and act on transaction. See *Case Example II* below.

Step 4:

- A. For transactions to be considered by the Board, analyze facts against Education Code Section 89908 *validation* thresholds and limitations.
- B. If transaction facts are below Section 89908 *validation* thresholds and other limitations² do not apply, AND such facts are also below Corporations Code Section 5233(b) interest thresholds or other exemptions apply, use Education Code Section 89907 validation process for Board to consider and act to approve transaction. See *Case Example III* below.
- C. If transaction facts are below Section 89908 *validation* thresholds and other limitations do not apply, AND such facts are at or above Corporations Code 5233(b) interest thresholds and other exemptions do not apply, use Corporations Code Section 5233(d) validation process for the Board to consider and act to approve transaction. See *Case Example IV* below.
- D. If transaction facts are at or above Section 89908 *validation* thresholds or other limitations apply, Board should NOT approve the transaction since such action is prohibited by Education Code 89906 and the transaction would be void. See *Case Example V* below.

Case Example I: Director Smith holds shares in a local bank valued at an estimated \$50,000. Management has delegated authority to invest organization funds in Certificates of Deposit in federally-insured local banks. Would placement of organization-invested funds in a CD at the local bank in which director Smith is a shareholder be a self-dealing transaction? No. Such a transaction is below the Section 5233(b) interest thresholds (and therefore exempt), and the transaction is not one requiring Board action.

Case Example II: Director Jones holds stock in a major computer company valued at \$1.5 million. Management has delegated authority to purchase several office personal computers on a competitive bid basis. The computer company in which Director Jones holds stock is the lowest qualified bidder at \$140,000. Director Jones is unaware of the bid results. Would awarding the bid to this company be a self-dealing transaction requiring Management to undertake a Section 5233(d) validation process? Yes, if management was aware of Director Jones' holdings in the computer company. Director Jones has a material financial interest in the transaction.

Case Example III: Director Baker holds a 3% shareholder interest in a local stationary store (a corporation). The Board is to consider approving a major contract valued at \$75,000 with the store for office products required by the organization. What review and approval process should the Board use? The transaction is below the interest thresholds of the Corporations Code and the validation thresholds and limitations of the Education Code. The Education Code Section 89907 process should be used by the Board to validate the transaction.

Case Example IV: The Board is developing a campus child care program as part of its corporate purpose. Directors Delta and Echo are each holders of shares in a construction company that successfully bid on a child care facility to be built by the organization. The total value of both shareholders interest in the company is less than 5%, but transaction value exceeds 1% of the organization's gross receipts for the preceding fiscal year. The transaction appears to involve a material financial interest by both directors (and no exemptions apply) under Section 5233, and is below the Education Code Section 89908 interest thresholds and other limitations. Which statutory validation process should the Board use to consider and approve the transaction? Since the transaction would constitute self-dealing under Section 5233 unless validated using 5233 standards, the Board should utilize the Section 5233(d) validation process. In so doing, the Board would also remain in compliance with the less stringent validation process under Education Code Section 89907.

Case Example V: Director Charles is also a prominent financial services broker and seeks to become the organization's broker through action by the Board. Is such a transaction permitted under statutory standards? No. Such an action by the Board between a director and the organization is prohibited by Education Code 89906 and the transaction would be void. The Section 89907 validation process is unavailable since the transaction relationship is directly between Director Charles and the organization. See limitation under Section 89908(a).

¹ Corporations Code Section 5233(b) provides the following interest thresholds and other self-dealing exemptions:

- a) Board action fixing director compensation as director or officer;
- b) transaction part of public or charitable program, approved in good faith and without unjustified favoritism, and resulting benefit to director or family results from class benefiting from program; or
- c) transaction, absent director's actual knowledge, does not exceed lesser of 1% of organization's previous year gross revenue, or \$100,000.

² Education Code Section 89908 provides the following financial interest validation thresholds and other limitations on Board action when a Section 89907 transaction validation process cannot be used:

- a) transaction directly between director and organization;
- b) transaction between organization and a partnership or unincorporated association in which director is the owner, a partner, or holder (directly or indirectly) of a proprietary interest;
- c) transaction between organization and a corporation in which director is the owner or holder (directly or indirectly) of 5% or more of corporation's outstanding common stock; or
- d) the director, absent first disclosing such interest to the Board at a public meeting of the Board, influences or attempts to influence other Board members to enter into transaction.