Innovation, Entrepreneurship, and Technology Commercialization: Avoiding Conflict Of Interest And Tax Risks For The University

The goal of the Office of General Counsel is to assist University administrators and faculty in building a vibrant culture of innovation across the University of California system. One way of accomplishing this goal is to identify potential legal vulnerabilities early in the deal formation process to ensure that contemplated deals protect the University’s interests and its status as a Section 501(c)(3) organization. Related personal and business risk can then be avoided, minimized, or otherwise appropriately weighed in the decision-making process.

Toward that end, we have created the attached, “Legal Primer on Relationships between the University and Private Entities: Conflict of Interest and IRS Restrictions.” The Legal Primer explains conflict of interest and tax-exempt organization risks for the University that should be considered whenever the University is contemplating a relationship or a transaction with a private entity, such as a venture fund, or individual in the University’s innovation efforts.

We welcome any requests for legal advice. Please see the contact information at the end of the Legal Primer.

Office of the General Counsel
Legal Primer on Relationships between the University and Private Entities: Section 501(c)(3) and Conflict of Interest Restrictions

Whenever the University is contemplating a relationship or a transaction with a private entity or individual (a “Private Party”) there are at least two primary issues that must be considered to ensure that the University and its interests are protected. These are: 1) private benefit and private inurement under the federal tax law applicable to Section 501(c)(3) organizations; and 2) conflicts of interest. Because these issues have the potential to jeopardize the University’s Section 501(c)(3) status, the viability of the relationship or transaction and/or the ability of University employee to do his or her University job in the future, legal advice should be sought if either issue is or may be a possibility.

Private Inurement and Private Benefit

I. Private Inurement

Private inurement occurs when an “insider” with respect to a Section 501(c)(3) organization receives a benefit in excess of the fair market value of goods and services provided by the insider to the Section 501(c)(3) organization. If private inurement occurs, the University’s tax-exempt status may be revoked. Note that the term “insider” is not precisely defined by the tax law or Treasury Regulations, but it would likely include those who have a “substantial level of influence” over the University, which suggests that it would include Officers of the Regents and certain UCOP senior employees, Chancellors, Provosts, Vice Chancellors and Deans, together with each of their family members and entities owned in whole or in part (generally 35% or more) by them (each, an “Insider”). To the extent that the University is entering into a relationship with a Private Party that is an Insider, then it is essential that: 1) any transaction or arrangement between the University and the Private Party be approved without the participation of the Insider; and 2) the terms of any transaction with between the University and the Private Party (e.g., provision of space, equipment or services by University staff) be at arm’s length and for fair market value.

II. Private Benefit

As a Section 501(c)(3) organization, the University cannot provide more than “incidental” benefits to any Private Party, regardless of whether that Private Party is an Insider. The University’s provision of more than incidental benefits to any Private Party (“Private Benefit”) may put the University’s tax-exempt status in jeopardy. Specifically, Private Benefit jeopardizes a Section 501(c)(3) organization’s tax-exempt status when the benefits provided by the Section 501(c)(3) organization are quantitatively and qualitatively more than incidental. This is a fact specific analysis. Accordingly, as a general matter, and similar to the private inurement

---

1 Note that the facts and circumstances of a specific transaction or arrangement may raise other issues that must be considered. This document is purposefully limited to the discussion of private benefit/inurement and conflict issues, and should not be viewed as a comprehensive discussion of all potential University policy, legal or reputational issues.
above, Private Benefit can be avoided by ensuring that the terms of the transaction or arrangement with any Private Party are at arm’s length and for fair market value.\(^2\)

**Political Reform Act of 1974 and Conflict of Interest**

The California Political Reform Act of 1974 (the “Act”) contains a general prohibition against conflicts of interest in public decision making. The University applies the restrictions of this Act to all University employees, without regard to whether they are required to file an annual conflict of interest form. Some examples where vigilance is necessary include those where University employees are managers or investors in venture funds that invest in University created start ups, or where individuals from the private sector take over elements of University decision making.

I. The General Prohibition — What it Is

The law generally prohibits a University official from making, participating in or influencing University decisions that will materially affect the official’s financial interest. Gov’t Code § 87100. Any person who willfully violates the general prohibition is guilty of a misdemeanor. Gov’t Code § 91000. Alternatively, person could be subject to civil or administrative fines. This prohibition applies to all University employees.

II. Conflicting Financial Interests

Conflicts of interest in University decision making involve more than just an employee’s own finances or investments. A University employee may have a conflict of interest if it is reasonably foreseeable that the University decision in which he or she is involved will have a financial effect any one of six economic interests. Gov’t Code § 87103:

1. The *personal finances* of the University employee or a member of his or her immediate family

2. Any *business entity* in which the employee has a direct or indirect *investment* worth $2,000 or more, including ownership of stock by the employee or the employee’s spouse or dependent child.

3. Any *real property* in which the employee has a direct or indirect interest worth $2,000 or more.

4. Any *source of income* that provides $500 or more in value promised to, or received by, the employee within 12 months prior to the time when the decision is made

---

\(^2\) Although not specifically discussed in this document, transactions or arrangements with Private Parties may also raise gift of public funds issues under California law. Some legal authority interpreting this issue suggests that a gift of public funds can be avoided where benefits provided to a Private Party are not more than incidental, which suggests that a transaction that does not raise an impermissible level of private benefit under the federal tax law, should also not raise a gift of public funds issue under state law.
5. Any business entity in which the employee is a director, officer, partner, trustee, employee, or holds any position of management.

6. Any donor of a gift or gifts totaling $460 or more, received, or promised to the employee within 12 months prior to the decision being made. Meals, travel costs, or anything else of value may be included in the $460. (This amount is tied to a consumer price index and is occasionally adjusted.)

III. When Disqualification is Required

If the employee will be involved in or influence a University decision making that will have a material effect any of these six kinds of economic interests, the employee will likely have a conflict of interest. Where a conflict of interest exists, the employee must disqualify himself or herself from involvement in the University decision making. This includes not participating in University discussions about the decision or contacting University staff about the decision.

Even where the specific criteria is not met and a true conflict of interest does not exist, University employees should be sensitive to the appearance of conflict, and should carefully consider whether to participate in a decision-making process whenever they have any financial interest at stake.

Please contact for questions:

Mark Morodomi, Senior Counsel
Office of the General Counsel
University of California
Office of the President
1111 Franklin Street, 8th Floor
Oakland, CA 94607
Phone: (510) 987-9748
Fax: (510) 987-9757
Mark.Morodomi@ucop.edu
(Conflict of Interest)

Thomas C. Schroeder, Senior Counsel
Office of the General Counsel
University of California
Office of the President
1111 Franklin Street, 8th Floor
Oakland, CA 94607
Phone: 510.987.9740
Fax: 510.987.9757
Thomas.Schroeder@ucop.edu
(Section 501(c)(3) issues (Private Benefit))