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## **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: *Section 501(c)(3) and Conflict of Interest 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 Joint Relationships between the University and Private Entities: *Section 501(c)(3), Conflict of Interest Restrictions, and Conflict of Commitment***

Whenever the University is contemplating a relationship or commitment with a private entity (such as a venture fund) 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.<sup>1</sup> 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, and/or the ability of University employee to do his or her University job in the future, you should seek legal advice if either issue may be a possibility.

### **Private Inurement and Private Benefit**

#### **I. Private Inurement**

The Private inurement rule prohibits a University “insider” from receiving a benefit that exceeds the fair market value of goods and services provided by the insider to the University. If private inurement occurs, the University’s 501(c)(3) status may be revoked. The term “Insider” is not precisely defined by the tax law or Treasury Regulations but likely includes those who have a “substantial level of influence” over the University. This suggests that University Insiders include members of the Board of Regents, Officers of the University, 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 by them (each, an “Insider”). If 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 Insider be formally approved without the participation or involvement of the Insider; and 2) the terms of such transaction or arrangement (e.g., provision of University space, University 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

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<sup>1</sup> *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. For example, transactions or arrangements involving **UC Health entities and private parties** may raise significant legal issues in other areas, including 1) federal and state anti-kickback laws; 2) the federal physician self-referral statute (commonly known as the “Stark Law”); and 3) antitrust laws, all of which are beyond the scope of this discussion. It is important to seek legal advice so that these arrangements are structured to take all applicable legal and policy issues into account.*

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, Private Benefit can be avoided by ensuring that the transaction or arrangement with any Private Party furthers the University's Section 501(c)(3) purposes and its terms are at arm's length and for fair market value.<sup>2</sup>

## 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 Form 700 Statement of Economic Interests form. Some examples where vigilance is necessary include those where University decision makers 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 employee 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 financial interests:

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. This might be triggered if the University decision affects a company in which he or she is an investor.
3. Any *real property* in which the employee has a direct or indirect interest worth \$2,000 or more.

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<sup>2</sup> 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.

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. This might be triggered if the University decision affects a company from which you have received compensation.
5. Any *business entity* in which the employee is a director, officer, partner, trustee, employee, or *holds any position of management*. This might be triggered if the University decision affects a company in which you are a manager or founder.
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.) This might be triggered if the University decision affects a company that gave you a free trip or other benefit. Gov't Code § 87103.

### 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.

## **Conflict of Commitment**

Finally, no one in the service of the University should devote to private purposes any portion of time due to the University and any outside employment should not interfere with the performance of University duties. University policies provide guidance with respect to different categories of employees.

Outside professional activities that interfere with a faculty member's professional obligations to the University represent a conflict of commitment. See APM 025, <http://www.ucop.edu/academic-personnel-programs/files/apm/apm-025-07-01.pdf>); APM – 664 <http://www.ucop.edu/academic-personnel-programs/files/apm/apm-664.pdf>.

Staff who are not Senior Management Group are bound by general University policies governing employment hours and use of University resources. See UC Personnel Policies for Staff Members Policy 82.III.B; Business and Finance Bulletin, BUS 43.III.Part 5; Business and Finance Bulletin, BUS 29.III.M; UC Electronic Communications Policy, section III.D.8.

Senior Management Group (SMG) members are responsible for ensuring that their outside professional activities do not violate conflict of commitment and/or conflict of interest policies of the University. See Regents Policy 7707, section III. All outside professional activity, compensated or uncompensated, must be approved by the individual to whom the SMG member reports before engagement in the activity.

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