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Board Members Compensated for Services

When a member of the board of directors of an exempt organization receives compensation from the organization as either a: (i) paid staff member; (ii) consultant; or (iii) board member, the director is vulnerable to allegations of conflict of interest. Interest in this topic recently has been heightened by New York City governmental agencies' enforcement of contract provisions barring paid staff members from serving on the boards of the organization that employs them.

Avoiding Conflicts of Interest

Neither the New York Not-for-Profit Corporation Law nor the Internal Revenue Code expressly prohibits compensated directors from serving on an organization's board of directors. Rather, both State and Federal law are concerned with whether or not a board member would use his or her position of authority to obtain a "sweetheart" compensation package from the organization, and, therefore, both contain provisions relating to conflicts of interest.

The Board of Directors is responsible for setting compensation for directors, officers, employees and agents of the non-profit organization.¹ A conflict of interest arises when a board member's duty of loyalty to the nonprofit comes into conflict with a competing personal or financial interest.² Directors that receive any form of compensation (other than reimbursement of expenses) from the organization upon whose board they serve are considered "interested directors" and therefore should not vote on any matter that affects their personal compensation. It is very important for those paid by the organization to avoid the conflicts of interest, both apparent and material, which arise from their positions as directors.

To guard against the risk of a conflict of interest, boards should establish and enforce a Conflict of Interest Policy consistent with both state and federal law. At its core, a conflict of interest policy should require the disclosure of a conflict to the board, a determination that the interested party transaction is in the best interest of the corporation, recusal of the interested director, and approval of the transaction by a disinterested board. All board members should be required to sign the Conflict of Interest Policy and disclose any material conflicts of interest upon joining the board, as well as at the start of each board year.³ The policy should require full disclosure, and should outline a plan of action for dealing with conflicts as they arise.

¹ N.Y. N-PCL § 202(a)(12) (McKinney 2008): "Each corporation, subject to any limitations provided in this chapter or any other statute of this state or its certificate of incorporation, shall have power in furtherance of its corporate purposes: To elect or appoint officers, employees and other agents of the corporation, define their duties, fix their reasonable compensation and the reasonable compensation of directors, and to indemnify corporate personnel. Such compensation shall be commensurate with services performed."

² Independent Sector, Panel on the Nonprofit Sector, Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations (October 2007), <http://www.independentsector.org/issues/accountability/Checklist/index.html>. At p. 9.

³ *Id.*

Best Practices for Board Independence

Most nonprofit best practices published recently recommend that at least a substantial majority of the board (two-thirds or more of its membership) be independent. Better Business Bureau of New York actually recommends that not more than one person or 10 percent (whichever is greater) directly or indirectly compensated person(s) should serve on the board.⁴ These “independent” members should not be compensated as employees of the board; they should not have their compensation determined by individuals who are compensated by the board; receive direct or indirect financial benefits from the organization; or be related to anyone who fits the above descriptions.⁵ The Independent Sector offers some exceptions to this general standard, allowing that some private foundations, medical research institutions and religious organizations may be permitted to have a higher ratio of interested board members.

There are also best practice recommendations with respect to officer positions. When paid staff is serving on the board, the Independent Sector asserts that the positions of chief staff officer, board chair and board treasurer ought to be held by separate individuals to ensure checks and balances.⁶ Better Business Bureau also recommends that compensated members not serve as the board’s chair or treasurer at all.⁷

A Note on Contracts with Government Agencies

Some governmental agencies are requiring that nonprofits with whom they enter into contracts must have no paid staff on their Boards of Directors. These agencies have the right to include contractual provisions that prescribe board service. Nonprofits should be aware of this practice, and should consider whether compensation of directors, either for board service or based on their status as staff, may affect the organization’s ability to enter into contractual agreements with these agencies. Nonprofits should also closely review government contracts to ensure that they comply with provisions relating to organizational governance.

This alert is meant to provide general information only, not legal advice. Please contact Judith Moldover at (212) 219-1800 ext. 250 if you have any questions about this alert.

⁴ Better Business Bureau, New York: Standards for Charity Accountability (2003), www.newyork.bbb.org. At 2.

⁵ *Supra*, see note 10, at 15.

⁶ *Id.*, at 16.

⁷ *Supra*, see note 12, at 2.