



Compensation of Nonprofit Board Members: A New End That Justifies the Means?

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Summary

This article analyses the debatable, and understudied, practice of the compensation of non-profit board members. While the remuneration of such people is legally permitted, most nonprofits do not pay their board members. In this debate, on the one hand, some argue such compensation is not in keeping with the idea that these organisations must serve public purposes, or a diversion of resources or assets to the detriment of beneficiaries. On the other, in a disruptive and competitive market, such compensation could be viewed as a necessary means for the long-term survival of the organisation.

Keywords

Governance
Compensation
Remuneration
Nonprofit board
Non-distribution constraint

Compensation of board members of nonprofit organizations is a subject of intense debate. From a purely legal standpoint, fair remuneration of board members is permitted. Yet, most nonprofits do not pay their board members. It has been argued that such compensation was likely to violate the non-distribution constraint – which prohibits the distribution of profits – and was hardly in keeping with the idea that nonprofits should be serving a public purpose. In that sense, compensation of board members is considered as a diversion of resources or assets to the detriment of beneficiaries, as well as, by extension, taxpayers. In a disruptive and competitive market, however, such compensation could also be viewed as a necessary means for the long-term survival of the organization. In order to foster their growth, nonprofits need more flexibility. This is particularly true in the education sector, where they are competing with other, private or public, nonprofits and even with for-profit structures. The ability to recruit and competitively compensate high-level talent may appear as an appropriate way for them to keep pace with their peers.

Introduction

The third sector¹ is changing around the world: it is becoming more market-oriented, increasingly incorporating business logics and practices. As new models and methods of enacting philanthropic agendas are challenging traditional giving patterns and structures, the vocabulary is evolving as well: the terms "venture philanthropy", "seed money" or "impact investing" are now systematically associated with the world of new philanthropy. Professional circles (i.e., scholars, nonprofit executives, donors, media, etc.) are talking about "strategic philanthropy"², an idiom that reflects both a search to optimize available resources and a desire to maximize impact. This quest is economic by nature. It often requires adopting innovative and disruptive practices whose successful implementation inevitably calls for new skills. However, members of foundation boards or association committees can rarely claim fair remuneration for their services.

The existing model encourages – forces – members of the foundation board or the committee of an association to

volunteer (see below, section 1.). This situation may seem surprising. Especially since the governance of large nonprofit organizations is structurally similar to the governance of for-profit organizations. Their good management requires specific skills, often associated with a high degree of responsibility. It is therefore necessary to ask whether current practices are still justified in the light of the reality of the new philanthropic world (see below, section 2.). The implications for philanthropic organizations involved in education and development will be addressed in the last part (see below, section 3).

The Universal Practice

The question of paying or not paying directors is a perennial nonprofit debate³. It seems nevertheless customary for members of foundation boards or association committees to perform their duties on an exclusively (unpaid) voluntary basis. At most, they are entitled to claim payment for their actual costs arising from the regular fulfilment of their mandate (travel, subsistence, administrative and other organization-related expenses), with an injunction to keep them down to the lowest level. Literature has long defended and continues to defend this approach, on the (questionable) grounds that volunteering is the only way to respect the spirit of the non-distribution constraint (see below, 1.1.) and that the disinterestedness of the members of the top management body would be an essential premise for the pursuit of the public purpose of the nonprofit (see below, 1.2.).

The non-distribution constraint

A nonprofit activity must be carried out exclusively for the public purpose for which the entity concerned is formed and may not be organized for the private gain of any person. This is the expression of the non-distribution constraint developed by Hansmann (1980). According to this theory, “a nonprofit organization is, in essence, an organization that is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees” (Hansmann, 1980, p.838). Funders, donors, as well as members, beneficiaries or users indeed expect their contributions to be invested on programs and services, and board members have a fiduciary duty to manage the organizations’ funds in such way. However, the notion of revenue must be understood here as a “pure profit” (Ibid.), i.e. the result of the activity, after deduction of all the expenses and investments necessary for operating, as well as any allocations to a reserve fund⁴. This means that the organization can reasonably remunerate the services (labor or capital⁵) provided in the course of its activities. This is how the non-distribution constraint should be understood. As such, it is not disputed that nonprofits may hire staff. Yet, a persistent belief is that volunteering – and the strict application of the non-distribution constraint to the board’s remuneration – would somehow guarantee that contributions will not be converted into personal gain by top management of the nonprofit.

These allegations are clearly outdated: nonprofit organizations are no longer the “black boxes” they may have been several decades ago⁶. Much progress has since been made in terms of transparency and a number of structural control measures have been introduced (*checks and balances*). Moreover, remuneration is subject to particular scrutiny by stakeholders, the media and, sometimes, by supervisory authorities. The diversion of resources through compensation seems to be therefore more difficult than ever and, moreover, strongly discouraged. In contrast, failure to fairly compensate senior executives is much more likely to lead them, sooner or later, to believe that the organization is, in a way, beholden to them⁷. This sense of accountability could (potentially) lead them to seek other, often more obscure, compensation channels legally questionable, e.g. assets misappropriation, embezzlements, accounting manipulations, transactions with related parties, or even corruption⁸. In that respect, it is argued that proper compensation will actually reduce the temptation to take advantage of board service for personal gain (Lampkin, 2018, p.3).

Due to their tax exemption, nonprofit organizations are also subject to supervision by tax authorities. In many jurisdictions, the (sometimes significant) compensation of executive directors (CEOs) is becoming a common practice and has never been considered to be inconsistent with the non-distribution constraint, as long as it does not exceed what is reasonable under like circumstances. Determining what is reasonable may be difficult, but is usually a matter of fact – which may also involve moral elements. From a legal and economic perspective, however, there is no objective reason to treat the board members’ compensation differently.

The quality of commitment

Many researchers, advocates and even practitioners argue that the main motivation of a person sitting on the board of a nonprofit organization should be the sole achievement of the public (ideal) purpose of the organization and not any incentive policy, whether monetary or otherwise (Pfister, 2017, p. 336). In other words, the intrinsic motivation, i.e. the practice of an activity for pleasure and personal satisfaction would be sufficient in itself to ensure a sufficient commitment of board members. Moreover, serving with no compensation would be the only guarantee of a genuine commitment that goes beyond any extrinsic considerations, in particular remuneration. This may hold true for those that have devoted their entire life to a special cause, but for the majority of individuals who are working in the nonprofit sector, this is neither practical, nor realistic. Worse, this vision tends to portray an image of an outdated form of philanthropy reserved for a group of wealthy people who can contribute to the common good outside their usual paid or self-employment – if any. This conception is undoubtedly detrimental to the development of modern philanthropy. Furthermore, it has been proven that

when rewarded, philanthropists tend to help more and to be more invested in their mission (Tirole, 2019, p. 578). In this regard, it should be noted that the honorific aspect of a high-end function as well as the prestige and the recognition associated to it are all extrinsic components of human motivation. In fact, optimal engagement may only result from a judicious balance between intrinsic and extrinsic incentives, in form of non-pecuniary and monetary benefits⁹.

The Price of Doing Good

It is long held by the general public that because of the charitable mission of nonprofit organizations, compensation would merely be draining resources away from their mission. This belief persists even among researchers. Advocating for the imposition of a salary cap in the nonprofit sector, senior economist Dean BAKER recently wrote in the *Stanford Social Innovation Review*:

To see the implications of a pay cap, let's take the case of Harvard University, where its former president, Drew G. Faust, earned more than \$1.5 million in 2016, her last year in the position. If her pay had been capped at \$400,000, it would have freed up \$1.1 million. In addition to the president, many other people in top-level positions at Harvard earn salaries in the high hundreds of thousands of dollars, including the provost, college deans, vice presidents, and other executives. If we assume 30 people in such positions, with an average pay of \$600,000, the potential savings would be \$6 million. Added to the savings on the president's pay, this would free up more than \$7 million a year. (Baker, 2019, p. 58).

The proposed demonstration, surprisingly, ignores the intrinsic worth of individuals in the marketplace and the value they add to the organization by running it. Nonprofits – and their directors – operate in a complex market in which boundaries between them and new forms of mission-driven for-profit entities have never been so blurred. These new philanthropy organizations (especially LLCs in the US) benefit from tremendous flexibility particularly when it comes to compensation (Brakman Reiser, 2018a, pp.931). This allows them to hire people that would, most likely, command a very high salary¹⁰, draining best talents out of market¹¹.

If traditional nonprofits want to stand out in this competitive environment and continue to attract funding, they must undertake an important shift from good intentions to real impact, adopting innovative, disruptive and efficient practices. This requires a strong and effective board, which is able to assume the strategic overall management of the nonprofit. According to a 2015 study, however, more than a quarter of nonprofit directors do not have a deep understanding of their organization's mission and strategy. Nearly one-third of them are dissatisfied with the board's ability to evaluate organiza-

tional performance, and a majority does not believe that their fellow board members are very experienced or engaged with their work (Larcker et al., 2015, p.3). These are very alarming figures¹². Organizations should take steps to attract and retain the most qualified and able individuals in the first place, but should also work to keep them committed to their mission. That is where attractive extrinsic incentives come into play. It is indeed well known – and documented – that a more competent and committed board can improve the overall performance of the organization. Without even considering the question of impact and its assessment, managerial performance can already be measured, or at least estimated, through cost efficiencies and fundraising (which are therefore the focus of most incentive plans).

Organizational efficiency

Strong financial and accounting skills may lead to a general reduction in operational and organizational costs. If marginal efficiency savings are essential, in an industry facing disruption and competition, they are no longer enough to guarantee the survival of the organization. Long-term success often implies organizational changes, better allocation of resources or significant shifts in the main strategic plan. This requires more entrepreneurial skills and managerial expertise, as well as strong leadership and capacity for innovation, which come at a certain price. But, in this context, more is less.

Fundraising

In a sector where resources are generally scarce, the capacity to attract funding becomes vital. Hence, successful fundraising campaigns are a sine qua non condition for the long-term success of the organization. Board members bring some critical forms of leverage to the process: reputation, legitimacy and prestige. The more extensive and sophisticated their networks, the more valuable and irreplaceable the members. Power and influence come with a certain price. And, when it comes to fundraising, more is more.

The Implications for the Education World

Most of voluntary educational associations are neither governments, nor for-profit entities, but independent, non-profit, organizations. They usually adopt a board governance structure and largely rely on fundraising activities or public subsidy to provide financial resources for the execution of their programs or services. This is generally true for education nonprofits working with schools, but also for schools themselves. The reputation of the institution, which derives from the quality of its management and faculty, is crucial for attracting every dollar of tuition and fees, as well as public monies. Strong and sound financial skills are then necessary to make good use of these funds and create value – or impact. The considerations set out above are therefore generally applicable to all nonprofits involved in education, maybe even more rigorously. Besides, many institutions (especially

in higher education) partially base their activities on a commercial model. Consequently, successful business experience or education should be a prerequisite for a majority of members. The education system (especially in the US) has almost always had a very blurred demarcation between public and private sectors, exacerbating therefore the competitiveness of markets; the market of services first, but also the market of funding, as well as the market of talents – whether executives or faculty. This explains why the charitable organizations most likely to pay board members, behind hospitals, are universities (Lampkin, 2018, p.9).

Conclusion

In the light of these simple examples, it can probably be said that higher compensations do not necessarily represent less money for the beneficiaries of the charity in question. On the contrary, talents being an essential premise of effective leadership, well-designed compensation arrangements would likely benefit traditional nonprofit organizations, their networks and, ultimately, the public good. An analysis of the effects that compensation of board members generates in terms of social value and impact would probably reinforce this opinion. The rise of philanthropy LLCs in the US may intuitively support this claim. Further analysis should consider the potential effects of compensation on the overall expected (social) return of the organization. However, one thing is for sure: willingness to do well and desire to serve the mission are not enough anymore, especially in a highly competitive market and an "expensive" member who works professionally can actually be "cheap" for the nonprofit and a "cheap" member may turn out to be, in the long run, pretty expensive (Riemer, 2012). To put it simply, paying Drew G. Faust \$400,000 instead of \$1.5 million would not have "*freed up \$1.1 million*"...

Endnotes

1. The “third sector” is a term usually used to describe various organizations with different forms and purposes, belonging neither to the public sector nor to the private sector.
2. For a comprehensive overview of the concept, see Brest and Harvey (2018).
3. For a brief history in the US, see: Lampkin (2018), p. 2.
4. Nonprofits also face an extremely severe assessment by tax authorities in this area, even though the need to build up such reserves is now widely recognized in practice. Some jurisdictions interpret such reserves as an unjustified accumulation of wealth (hoarding), which can sometimes lead to the denial of exemption.
5. Nonprofit organizations may have creditors.
6. The vast majority of “developed” legal orders have adopted, if not proper (hard) law, at least best practice guidelines in order to strengthen transparency and accountability in the nonprofit sector.
7. Swiss Foundation Code (2015), p. 54, pointing out that honorary roles may bring the foundation to be confronted with “an entitlement mentality from board members”.
8. See Douglas and Mills (2000), endorsed by Greenlee et al. (2007, p. 679), arguing that the lack of business and financial expertise and reliance on volunteer boards are both contributory factors to fraud in the nonprofit sector.
9. For a complete analysis, see Bénabou and Tirole (2003, p. 489)
10. For a brief, but compelling presentation of the arguments for the philanthropic LLC model, see Brakman Reiser (2018b), p. 28. For a more in-depth analysis, Brakman Reiser (2018a), pp. 931.
11. They are therefore not only poised to become the preferred vehicle for the US tech elite philanthropists, but are also likely to spread beyond the rarefied circles of Silicon Valley’s technology magnates (see Brakman Reiser (2018b), p. 26; Brakman Reiser (2018a), pp. 957).
12. These figures must be put in perspective: on average, nonprofit boards consist of 30 members, which is significantly larger than necessary. Although one size does not fit all, the board of directors should be small enough in numbers for efficient decision-making, but large enough for its members to contribute experience and knowhow from different fields and to allocate management and control functions among themselves. In any case, however, it should not exceed ten members (see: Jacquemet, 2019, p. 153).

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