

A Declaration of (Director) Independence

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It never fails. If we want to lose our board audience, all we need to do is to try to describe the difference between director independence and conflicts of interest. The eyelids droop, and the heads begin to sag. The hook comes out for the lawyers. Exit stage left.

THAT'S TOO BAD, BECAUSE THE concepts are distinct, and the distinction is one with a difference. Effective non-profit corporate governance depends in large part on assuring board control in independent directors, and also in the maintenance of a robust conflicts disclosure and management system. *But wait, aren't they pretty much the same thing? I mean, using two separate concepts—conflicts of interest and independence—to describe fundamentally the same thing gets a little too complicated, don't you think?*

Well, no, we don't. While lots of boards understand the basic tenets of conflict of interest, they don't quite get "the independence thing." All too often, the concepts are confused, misstated, misapplied, or misunderstood. Yet, the concept of director independence as a standalone element of effective corporate governance is too important to give up on or to punt. So, let's try it again, building the case for a "declaration of director independence" from the ground up.



Public Policy

It's a pretty simple idea. To assure effective governance, an organization has to maintain a level of separation between those who manage the corporation (the CEO and the executive leadership team) and those who oversee the managers in the performance of their duties (the board). Absent some form of structure, though, the ability of directors to effectively exercise that function can be tripped up by the practical realities of the director/CEO relationship.

The concept of director independence arises from the principle that board members should eschew relationships that would undermine their ability to make objective decisions, and to exercise active oversight, on behalf of the corporation. The thinking is that directors

with some financial "skin in the game" (i.e., personal financial interest in the affairs of the corporation), for example, may be less likely to scrutinize the decisions of management team members who "make the call" on their compensation or fees, or to give unbiased evaluation of proposed changes in management; hence, the need to assure exercise of informed oversight by board members, a majority of whom are independent from management. It's not necessarily that directors can't have properly structured and fundamentally fair financial relationships with the company, but rather that those kinds of folks should not constitute a majority of the board.

At its most fundamental level, "independence" refers to the lack of a direct financial relationship between the director and the corporation—that the director is not financially beholden to the CEO or other key members of senior management.

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Sharper Focus

Director independence came into sharper focus as a governance principle in the aftermath of the Enron scandal and related controversies. Many observers attributed a significant portion of the blame for these corporate disasters to a governing board that failed to properly supervise executive management, whether due to excessive passivity, excessive deference, or lack of independent oversight. In response, the Sarbanes-Oxley legislation required, among other things, that public company audit committees be composed of independent members. In addition, many of the leading corporate policy commentators recommended as a new governance best practice that a substantial majority of the members of the board of directors be independent of the corporation's senior executive officers, in both fact and appearance. Further, the leading stock exchanges amended their listing requirements to involve the adoption of board independence standards by all listed corporations.

The focus on director independence was one of several core Sarbanes-Oxley principles generally considered applicable to non-profit corporations. Principle #12 of the Panel on the Nonprofit Sector's *Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations* recommends that no less than two-thirds of the members of the board of charitable corporations consist of members who are determined "independent" according to a specific definition.

Separately, the IRS has contributed to the emphasis on non-profit director independence. It requires on its redesigned Form 990 that the filing organization disclose the total size of its board and how many members of its board are independent members (with a specific definition of "independent voting member of the governing board"). It is not difficult to do the math—it will be obvious to the Form 990 reader whether a majority of the board is independent under the 990 standard. The IRS also shows support of the contributions of independent board members in its published guidance on tax-exempt organization governance.

So, Is It a Requirement?

Yes, no, and maybe:

- **Yes.** Hospitals that wish to retain federal tax-exempt status must maintain a board, a majority of which constitutes "independent community leaders"—or be controlled by a parent company whose board is so composed. That's part of the "community benefit" standard of exemption. In addition, a few states require as a matter of non-profit corporate law that the board of such an organization be controlled by independent members. For example, the California non-profit corporation law provides that not more than 49 percent of a non-profit corporation may consist of "interested" persons.
- **No.** The majority of state non-profit corporation laws do not contain a requirement similar to California's.
- **Maybe.** It's fair to treat the Panel on the Nonprofit Sector's "independence" principle as a non-profit governance best practice. While "best practices" are aspirational goals and not the equivalent of law, it is fair to expect that their pursuit by the governing board would be perceived as evidence of the board's good faith commitment to corporate governance—a goal worth pursuing. That notwithstanding, satisfying the Panel's

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“two-thirds” requirement might require a lengthy transition period for many non-profit organizations.

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What about Committees?

Here’s where it gets kind of confusing. Most statements of non-profit sector best practices—and some state laws—follow the Sarbanes-Oxley theme calling for the audit committee to be composed entirely of independent members. Many leading best practices compilations call for membership of other key committees such as executive compensation, governance, and compliance to similarly be composed entirely of independent members. Further, the IRS’ requirements for satisfying the “rebuttable presumption of reasonableness” for purposes of financial relationships with corporate “insiders” include approval by an authorized body

composed of “disinterested” individuals—

a term pretty close to director independence under most recognized standards.

But, there’s no single source that describes as a non-profit governance best practice the establishment of all of these committees with membership composed entirely of independent members. It’s a judgment call for the board.

What Definition Do We Use?

There just isn’t one standard, all-encompassing definition of “independence” that works for purposes of state corporate law, federal tax law, self-regulatory entities, public company best practices, and non-profit sector best practices. Increasingly, non-profit organizations have been adopting the IRS definition as contained in the glossary to the Form 990, but



such a decision should be thoughtfully made. Independence themes contain the following basic criteria: whether the director or committee member a) is or has recently been a compensated employee or independent contractor; b) has their compensation determined by persons who are compensated by the organization; c) receives other financial benefits from the organization; or d) is related to or resides with any such person so described.

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A board’s adoption of a definition of “director independence” should take into consideration any applicable state definition and the IRS definition, and refine it further based upon criteria applied in the best practice definitions. It should also recognize the possibility that certain nonfinancial matters (e.g., familiarity, friendship, more attenuated family relationships, respect for past service) may also threaten the desired separateness. The end result should be one which is consistent with the core public policy goals, is understood by the board, and is capable of being consistently applied.

And that Conflict-of-Interest Stuff Again?

In the final analysis, “independence” is a structural concern—a matter of a director’s positional relationship with the board (or committees)—is he or she independent, or not? An

evaluation of a director’s independence should be made annually and in conjunction with the governance and nominating committee, which is charged with the responsibility for helping confirm that the number of independent directors is sufficient to assure board control.

In comparison, “conflicts of interest” is an episodic determination, which requires resolution whenever disclosure suggests the potential for bias to affect a specific instance of board decision making. It is not related to how the board is structured and requires resolution whenever related issues arise—not just once a year. In that regard, consider that it is conceivable for an independent director to have a conflict of interest that did not affect his or her standing as independent because the nature of the conflict was external rather than internal (i.e., unrelated to his/her relationship with management).

Conclusion

Matters of director independence arise from the same general “duty of loyalty” base as do conflicts issues. The former is positional in nature, while the latter is episodic in nature. Independence serves to assure a proper level of separation between the board and management. Public policy, governance principles, and charity law enforcement practices are in agreement that when that separation erodes, effective oversight breaks down and charity assets may be placed at risk. Therefore, it’s the smart play for boards to understand how director independence is distinct from matters of conflict of interest. ●

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