

# Journal of Health Law

Fall 2006 Volume 39, No. 4

## **“Independence” and the Nonprofit Board: A General Counsel’s Guide**

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# “Independence” and the Nonprofit Board: A General Counsel’s Guide

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**ABSTRACT:** In the wake of the Sarbanes-Oxley Act regulations that govern the public company sector, standards are emerging to assure that nonprofit corporate boards are maintaining appropriate levels of independence. This Article provides a summation of the current trends in the development of independence standards for nonprofit corporate governance, from both tax and corporate law perspectives. The authors consider independence standards for nonprofit boards of governance and discuss the evolution of independence standards as they relate to the duty of good faith, and the distinction between independence and conflicts of interest. The authors also seek to examine the evolution of current federal regulations and study state models that have been successfully implemented to insure the independence of nonprofit corporations. Finally, the authors propose a set of core guidelines to be considered when addressing board and committee independence issues.

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Issues associated with the independence of the nonprofit governing board are increasingly requiring the attention of the corporate general counsel. Appropriately, adoption of board independence standards has been a hallmark of post-Sarbanes-Oxley<sup>1</sup> governance practices in the for-profit sector. Now,

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<sup>1</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

as corporate responsibility principles “spill over” into the non-profit mainstream, many such boards are being called upon to address issues relating to their own structural independence.

This development may be due to any number of factors: a desire to adopt best practices, compliance with new state laws, reaction to notorious nonprofit governance controversies, Senate Finance Committee initiatives, Panel on the Nonprofit Sector reports, or circumstances which may have been unexpectedly forced upon the board. Whatever the reason, the legal challenge is to identify the proper standard of independence applicable at board and committee levels. Unfortunately, there exists no overarching, “one size fits all” independence standard that incorporates relevant nonprofit corporate laws and governance best practices. Therefore, the nonprofit governing board must affirmatively address this vacuum if it is to adopt practical and effective governance standards. The corporate general counsel is well-positioned to guide the board in this regard.

## I. Why the Fuss?

### A. Basic Public Policy

In the post-Sarbanes-Oxley environment, the “independence” of the governing board is perceived as both a significant attribute of good governance and a material deterrent to oversight failures. Many of the governance best practices compilations emerging in recent years have promoted processes to augment the independence of outside directors.<sup>2</sup> “Corporate responsibility and sound corporate governance thus depend upon the active and informed participation of *independent directors* and advisers who act vigorously in the best interest of the corporation and are empowered to exercise their responsibilities effectively.”<sup>3</sup>

The underlying policy goal is that the prudent and effective governing board will maintain a substantial degree of independence from management and from other problematic relationships in both fact and appearance. This goal is based on

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<sup>2</sup> See, e.g., TASK FORCE ON CORPORATE RESPONSIBILITY, AM. BAR ASS'N, REPORT OF THE AMERICAN BAR ASSOCIATION TASK FORCE ON CORPORATE RESPONSIBILITY 62–63 (2003) [hereinafter ABA TASK FORCE ON CORPORATE RESPONSIBILITY], available at [www.abanet.org/bus-law/corporateresponsibility/final\\_report.pdf](http://www.abanet.org/bus-law/corporateresponsibility/final_report.pdf) (last visited Sept. 22, 2006).

<sup>3</sup> *Id.* at 12 (emphasis added).

the assumption that governing board members having other business or personal relationships with the corporation or senior management may find it more difficult to render objective decisions, as such board members could be influenced by those other relationships.<sup>4</sup> In other words, the expectation is that the governance oversight role will be enhanced by positioning the majority of directors to be free of relationships with the corporation or its management “whether business, employment, charitable or personal—that may impair, or appear to impair, the director’s ability to exercise independent judgment.”<sup>5</sup>

### ***B. Evolution of Standards***

Sarbanes-Oxley itself does not specifically address independence issues at the board level. Nonetheless, virtually all of the most prominent “post-Enron” governance policies and best practices compilations address standards of independence of both the board and certain key committees. Reflective of these are recommendations adopted by such diverse organizations as American Law Institute,<sup>6</sup> the Business Roundtable,<sup>7</sup> the National Association of Corporate Directors,<sup>8</sup> the American Bar Association,<sup>9</sup> and The Conference Board.<sup>10</sup> Similarly relevant are policies adopted by leading businesses such as General Motors,<sup>11</sup> General Electric,<sup>12</sup> Boeing,<sup>13</sup> American International

<sup>4</sup> ABA COORDINATING COMM. ON NONPROFIT GOVERNANCE, *GUIDE TO NONPROFIT CORPORATE GOVERNANCE IN THE WAKE OF SARBANES-OXLEY 24–25* (2005) [hereinafter *ABA GUIDE TO NONPROFIT GOVERNANCE*].

<sup>5</sup> BUS. ROUNDTABLE, *PRINCIPLES OF CORPORATE GOVERNANCE 2005*, at 14 (2005) [hereinafter *BRT PRINCIPLES*], available at [www.businessroundtable.org/pdf/CorporateGovPrinciples.pdf](http://www.businessroundtable.org/pdf/CorporateGovPrinciples.pdf) (last visited Sept. 22, 2006).

<sup>6</sup> See AM. LAW INST., *PRINCIPLES OF THE LAW OF NONPROFIT ORGANIZATIONS: DISCUSSION DRAFT 110–13* (2006) [hereinafter *ALI DISCUSSION DRAFT*].

<sup>7</sup> See *BRT PRINCIPLES*, *supra* note 5, at 14–17, 21–23.

<sup>8</sup> GOVERNANCE COMM., NAT’L ASS’N OF CORPORATE DIRECTORS, *GOVERNANCE GUIDELINES OF THE NATIONAL ASSOCIATION OF CORPORATE DIRECTORS 3–4, 7–8* (1998) [hereinafter *NACD*], available at <http://tinyurl.com/ye3jgi> (last visited Sept. 22, 2006).

<sup>9</sup> *ABA GUIDE TO NONPROFIT GOVERNANCE*, *supra* note 4, at 24–25.

<sup>10</sup> CONFERENCE BD. COMM’N ON PUB. TRUST AND PRIVATE ENTER., *FINDINGS AND RECOMMENDATIONS: PART 2: CORPORATE GOVERNANCE 6–11, 21–24* (2003) [hereinafter *CONFERENCE BOARD FINDINGS AND RECOMMENDATIONS*], available at [www.ecgi.org/codes/documents/757.pdf](http://www.ecgi.org/codes/documents/757.pdf) (last visited Sept. 22, 2006).

<sup>11</sup> GEN. MOTORS, *CORPORATE GOVERNANCE DOCUMENTS: CORPORATE GOVERNANCE GUIDELINES*, available at [www.gm.com/company/investor\\_information/corp\\_gov/guidelines\\_pg2.html#8](http://www.gm.com/company/investor_information/corp_gov/guidelines_pg2.html#8) (last visited Sept. 25, 2006).

<sup>12</sup> GEN. ELEC., *GOVERNANCE PRINCIPLES*, available at [www.ge.com/en/citizenship/governance/govprinc.htm](http://www.ge.com/en/citizenship/governance/govprinc.htm) (last visited Sept. 25, 2006).

<sup>13</sup> BOEING, *THE BOEING COMPANY DIRECTOR INDEPENDENCE STANDARDS*, available at [www.boeing.com/corp\\_gov/independence\\_standards.html](http://www.boeing.com/corp_gov/independence_standards.html) (last visited Sept. 25, 2006).

Group, Inc. (AIG),<sup>14</sup> CalPERS,<sup>15</sup> the New York Stock Exchange,<sup>16</sup> and TIAA-CREF.<sup>17</sup> In most every instance these recommendations and policies promote an increased role for, and authority of, independent directors and “tighten” the definition of independence.<sup>18</sup> Typically, they recommend that a substantial majority of the members of the board be independent of senior executive management (and the authority they possess), in both fact and appearance.<sup>19</sup> They also speak to the importance of independence on certain key board committees.<sup>20</sup>

As discussed more fully below, the nonprofit sector is not immune to this increased focus on independence standards. The Revised Model Nonprofit Corporation Act (RMNCA), adopted in 1987, included a board independence requirement.<sup>21</sup> Ineffective or dysfunctional governance practices have been cited as principal contributing factors to many of the recent, notorious controversies in the nonprofit sector.<sup>22</sup> The rigorous scrutiny of nonprofits conducted by both the Internal Revenue Service (IRS), and by Senator Charles E. Grassley and the Senate Finance Committee has resulted in substantial criticism of the governance practices of these organizations.<sup>23</sup> Indeed, both Senator

<sup>14</sup> AM. INT’L GROUP, INC., CORPORATE GOVERNANCE GUIDELINES, *available at* [http://media.corporate-ir.net/media\\_files/irol/76/76115/corpgov/Corp\\_Gov\\_Guide3.pdf](http://media.corporate-ir.net/media_files/irol/76/76115/corpgov/Corp_Gov_Guide3.pdf) (last visited Sept. 25, 2006).

<sup>15</sup> CALPERS, U.S. CORPORATE GOVERNANCE CORE PRINCIPLES & GUIDELINES, app. B, *available at* [www.calpers-governance.org/principles/domestic/us/page08.asp](http://www.calpers-governance.org/principles/domestic/us/page08.asp) (last visited Sept. 25, 2006).

<sup>16</sup> N.Y. STOCK EXCH., INDEPENDENCE POLICY OF THE NYSE GROUP BOARD OF DIRECTORS (2006), *available at* [www.nyse.com/pdfs/director\\_independence\\_policy.pdf](http://www.nyse.com/pdfs/director_independence_policy.pdf) (last visited Sept. 25, 2006).

<sup>17</sup> TIAA-CREF, GOVERNANCE GUIDELINES FOR THE TIAA BOARD OF TRUSTEES (2006), *available at* [www.tiaa-cref.org/about/governance/docs/tiaa\\_guidelines.pdf](http://www.tiaa-cref.org/about/governance/docs/tiaa_guidelines.pdf) (last visited Sept. 25, 2006).

<sup>18</sup> *See, e.g., supra* notes 12–17.

<sup>19</sup> *See, e.g., id.*

<sup>20</sup> *See, e.g., id.*

<sup>21</sup> REVISED MODEL NONPROFIT CORPORATION ACT: OFFICIAL TEXT WITH OFFICIAL COMMENTS AND STATUTORY CROSS-REFERENCES 211–20 (Michael C. Hone, Reporter, 1987) [hereinafter RMNCA].

<sup>22</sup> *See, e.g.,* PANEL ON THE NONPROFIT SECTOR, STRENGTHENING TRANSPARENCY, GOVERNANCE, ACCOUNTABILITY OF CHARITABLE ORGANIZATIONS: A FINAL REPORT TO CONGRESS AND THE NONPROFIT SECTOR 13–14 (2005) [hereinafter PANEL REPORT], *available at* [www.nonprofitpanel.org/final/Panel\\_Final\\_Report.pdf](http://www.nonprofitpanel.org/final/Panel_Final_Report.pdf) (last visited Sept. 24, 2006); Memorandum from Senator Charles E. Grassley, Chairman, U.S. Senate Comm. on Fin., to Reporters and Editors (July 28, 2006), *available at* <http://finance.senate.gov/press/Gpress/2005/prg072806a.pdf> (last visited Sept. 24, 2006).

<sup>23</sup> *See, e.g.,* Memorandum from Senator Charles E. Grassley, Chairman, U.S. Senate Comm. on Fin., to Reporters and Editors (July 14, 2006), *available at* <http://finance.senate.gov/press/Gpress/2005/prg071406.pdf> (last visited Sept. 24, 2006); Letter from Mark W. Everson, Internal Revenue Serv. Comm’r, to Senator

Grassley and IRS Commissioner Everson have made repeated public statements to the effect that “an independent, empowered, and active board of directors is a critical component of assuring that a tax-exempt organization serves public purposes,” and protects charitable assets.<sup>24</sup> Furthermore, as discussed below, the Panel on the Nonprofit Sector’s influential 2005 Report to Congress contains a specific recommendation on nonprofit board independence.<sup>25</sup>

### C. *Relationship to Good Faith*

Recent academic discourse, based in particular on Delaware law developments, suggests a direct link between adoption of best practices and satisfaction of the good faith element of the business judgment rule. The perspective is that a board’s adoption of one or more best practices (*e.g.*, independence standards) constitutes specific evidence of good faith. In the view of a leading former Delaware jurist, “the conscientious pursuit by directors of principles of best practices is the best prophylactic against liability.”<sup>26</sup> This perspective suggests a related justification for adopting independence standards.

## II. Independence v. Conflicts of Interest

### A. *The Distinction*

The distinction between the concepts of “independence” and “conflict of interest” in the corporate governance context is often blurred in a manner that is confusing for the board. Both concepts focus on the ability of the board to render decisions in an objective manner without undue influence by individual directors who may possess a bias or other private interest. “Independence” is a structural consideration that focuses on the overall relationship between the director and the nonprofit organization and its affiliates. In other words, the “independence inquiry” examines the potential for financial and other relationships that could reasonably be expected to influence a director’s ability to meet fiduciary duty obligations to the nonprofit on a consistent, “global” basis. Directors possessing such relationships should be limited in number.

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Charles E. Grassley 3 (Mar. 30, 2005) [hereinafter Everson Letter], available at <http://tinyurl.com/y4ad66> (last visited Nov. 17, 2006).

<sup>24</sup> Everson Letter, *supra* note 23, at 3.

<sup>25</sup> PANEL REPORT, *supra* note 22, at 75–78.

<sup>26</sup> E. Norman Veasey, *Counseling Directors in the New Corporate Culture*, 59 BUS. LAW. 1447, 1457 (2004).

Conflict of interest, on the other hand, is an “episodic” consideration that focuses on whether a director (or other individual) in a position of control or influence has a financial or other relationship relative to a particular transaction or arrangement that requires the individual be excluded from the deliberations and/or decisions of the board/committee with regard to that particular transaction or arrangement. Therefore, while there are similarities between the two concepts, they are intended to serve different purposes and should be regarded as separate principles of corporate governance to which an organization may aspire.

Nonprofit corporation law has historically been focused primarily on conflicts of interest—as opposed to matters of overall director independence. While many state nonprofit corporation statutes specifically address resolution of governing board conflicts of interest, few such statutes also address matters of director independence.

### ***B. Impact on Fitness to Serve***

The failure to recognize the basic, yet subtle distinctions between these two governance concepts can often lead to unintended consequences and reputational damage. Typical is the situation when a nonprofit director is also the chief executive officer of a significant vendor to the corporation. Such a director is unlikely to be considered “independent” under most accepted definitions, and is quite likely to be regarded as having a conflict of interest with respect to any and all matters related to the nature of the vendor relationship. Yet, some third parties may blur the distinction and argue that the relationship alone should disqualify the director from board service.

What is often lost in the fog of the corporate responsibility debate is that designation as “interested” or “non-independent” does not vitiate a director’s ability or fitness to serve. In most instances, “interested” or “non-independent” directors are fully capable of rendering meaningful, unbiased contributions to the governing boards on which they serve (except on matters for which they may have a conflict of interest). Indeed, many of the most qualified director candidates are those with financial, professional, and social relationships likely to create periodic conflict and/or independence issues. To remove such individuals from board service consideration without evidence of disabling concerns arising from such relationships may not always be in a board’s best interest. The fundamental purpose of effective independence standards and conflicts policies is to

assure that at all times and with respect to all decisions, directors with a disclosed bias cannot control the decisionmaking process. That purpose can often be achieved while allowing an appropriate percentage of board membership to be held by “interested” directors.

Governing boards must be concerned with the appearance of impropriety arising from certain potentially problematic director relationships. That notwithstanding, a director’s designation as “interested” or “non-independent” with respect to his/her relationship to the organization as a whole should not, in and of itself create the appearance of impropriety.<sup>27</sup>

### *C. Relative Roles of the Board and Management*

The fundamental component of director independence calls for a basic separation between oversight and management; the charity is best served “if those who govern are not the same persons as those who manage.”<sup>28</sup> Historically, the independent oversight function contemplated “a collegial relationship that is supportive as well as watchful . . . challenging yet positive, arm’s length but not adversary.”<sup>29</sup>

Post Sarbanes-Oxley, however, the relationship between independent oversight and management has become more precise, if not more adversarial. The governance best practices emerging in this environment recommend changes in structure and process as means to increase the independence and resources of outside directors. More significantly, they call for directors to reject the so-called “culture of passivity” with respect to senior executive officers which is perceived to have been a contributing factor to many corporate controversies.<sup>30</sup> In its place, the independent directors are encouraged to adopt “a new culture stressing constructive skepticism” in pursuit of oversight.<sup>31</sup> This does not mean the introduction of a climate of confrontation, but rather one in which directors are allowed to play a more active, independent role.<sup>32</sup>

<sup>27</sup> See, e.g., James Bandler & Charles Forelle, *Interested Parties: In Internal Probes of Stock Options, Conflicts Abound; Directors’ Ties Can Complicate Job of Assuring the Public Investigation is Thorough; Sorting it Out at UnitedHealth*, WALL ST. J., Aug. 11, 2006, at A1.

<sup>28</sup> ALI DISCUSSION DRAFT, *supra* note 6, at 110.

<sup>29</sup> AM. LAW INST., *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* 89 (1994).

<sup>30</sup> ABA TASK FORCE ON CORPORATE RESPONSIBILITY, *supra* note 2, at 27–29.

<sup>31</sup> *Id.* at 29.

<sup>32</sup> *Id.* at 28.

### III. General Standards

#### A. Core Components

The evolving approach in the business corporation context is that the governing board should approve standards for director independence and those standards should be set forth in the organization's statement of corporate governance principles. Such independence standards typically encompass three core components: (1) a definition of "independent directors"; (2) the value derived from assuring majority board control in independent directors; and (3) extending independence concepts to key committee membership.

In assessing these components of independence standards, the various industry proposals and policies focus on familial, employment, and business relationships (although the proposals are not entirely consistent with each other). They are fundamentally consistent to the extent they adopt the following basic themes and practices:

- Independent directors must constitute a *majority* of a company's board.
- The determination of independence should not be limited to the board's articulated standards, but should also consider the presence of other relationships (direct or indirect) "with the corporation, senior management or other board members that could affect the director's actual or perceived independence."<sup>33</sup>
- Boards must convene regular executive sessions of the independent directors.
- For a director to be regarded as independent, the board must *affirmatively confirm* that the director has no *material* relationship with the company.
- An independent director is prohibited from receiving any payments from the company in excess of a certain specified amount (other than for board service; differing by policy); this prohibition extends to the receipt of payments by a non-employee family member of the director.
- A director is not independent if *any* family member of the director is employed as an executive officer of the company (or a parent or subsidiary thereof) or has been so employed within a past specified period of years.

<sup>33</sup> BRT PRINCIPLES, *supra* note 5, at 14.

- An expansion to cover not-for-profit corporations under the current rules prohibiting a director from being considered independent if the company makes payments to an entity of which the director is an executive officer and such payments exceed the greater of a specified dollar amount or a specified percentage or the recipient's gross revenues.
- Former partners or employees of outside auditors who worked on a company's audit engagement are presumptively deemed non-independent for a specified (*e.g.*, three) number of years.
- A "cooling off period" (*i.e.*, a period of years after a person has had the listed relationship before he/she can serve on the board) of a specified number of years (*e.g.*, three for NASDAQ<sup>34</sup> and NYSE<sup>35</sup>) is applied to directors who are not independent due to such factors as: (a) employment by the company or a subsidiary thereof; (b) receipt by the director, or by a family member of the director who is not an employee of the company, of any payments in excess of a specified amount, other than for board service; (c) employment as a professional by present or former internal or external auditors of the company; (d) service on interlocking compensation committees; and (e) employment of the director by another company that accounts for a material portion of the revenues of the company for which the director serves.<sup>36</sup>

Although many of these rules and prohibitions implicate familial relationships, they contain subtle distinctions in the manner in which they address the definition of "Family Members." For example, the NYSE focuses on "immediate" relationships; a term that includes the director's "spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, and anyone (other than domestic employees)

<sup>34</sup> THE NASDAQ STOCK MARKET, INC., CORPORATE GOVERNANCE: RULES 4200, 4200A, 4350, 4351, AND 4360 AND ASSOCIATED INTERPRETIVE MATERIAL 4 (2004), available at [www.nasdaq.com/about/corporategovernance.PDF](http://www.nasdaq.com/about/corporategovernance.PDF) (last visited Sept. 24, 2006).

<sup>35</sup> NYSE GROUP, INC., LISTED COMPANY MANUAL § 303A.02(b)(i) (2004), available at [www.nyse.com/Frameset.html?nyseref=&displayPage=/lcm/1078416930885.html?archive=no](http://www.nyse.com/Frameset.html?nyseref=&displayPage=/lcm/1078416930885.html?archive=no) (last visited Sept. 24, 2006).

<sup>36</sup> See HOLLY J. GREGORY, WEIL, GOTSHAL & MANGES, LLP, COMPARISON OF CORPORATE GOVERNANCE GUIDELINES AND CODES OF BEST PRACTICE 23–24 (2006), available at [www.weil.com/wgm/cwgmhomep.nsf/Files/CorpGovGuide\\_US/\\$file/CorpGovGuide\\_US.pdf](http://www.weil.com/wgm/cwgmhomep.nsf/Files/CorpGovGuide_US/$file/CorpGovGuide_US.pdf) (last visited Sept. 24, 2006) (summarizing independence standards of such organizations as General Motors, American Law Institute, The Business Roundtable, National Association of Corporate Directors, Conference Board, CalPers, TIAA-CREF, and AFL-CIO).

who shares [the director's] home."<sup>37</sup> NASDAQ takes a broader approach, addressing any person who is related by blood, marriage, or who has the same residence as the donor.<sup>38</sup>

### ***B. Impact of Social/Non-Economic Factors***

Two recent decisions from Delaware suggest that non-economic factors may play an increasingly significant role in determining director independence. In a pair of shareholder derivative actions, *In re Oracle Corporation*<sup>39</sup> and *Beam ex rel Martha Stewart's Living Omnimedia v. Stewart*,<sup>40</sup> the courts ruled that nonfinancial relationships can create the basis for bias or lack of independence in director decisionmaking. In the *Oracle* case, the Chancery Court decision appears on its face to have taken this concept beyond the level of any other court in concluding that two Stanford University professors, appointed as special litigation committee members to evaluate the validity of insider trading and other charges against certain corporate officers and directors, were not "independent" due to multiple social and other personal, nonfinancial relationships with the parties at issue.<sup>41</sup>

The *Oracle* court's concept of "independence" was clarified (but not expressly overruled) by a subsequent decision of the Delaware Supreme Court in the *Martha Stewart* case. In that case, the court ruled that mere allegations of friendship alone do not serve as a basis for challenging director independence.<sup>42</sup> However, "reasonable doubt" regarding independence or bias could nevertheless arise from evidence of familial affinity, a particularly close or intimate personal or business affinity, or that in the past such a relationship caused a director to act non-independently with respect to another director.<sup>43</sup>

There has always been an intuitive policy recognition that certain non-economic relationships may create independence concerns (e.g., service as a noncompensated board member of a competitor). Nevertheless, caution should be exercised when attempting to apply the logic of these Delaware decisions beyond their unique facts. In both situations, the "independence" issue

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<sup>37</sup> NYSE GROUP, INC., *supra* note 35, § 303A.02(b) General Commentary.

<sup>38</sup> See THE NASDAQ STOCK MARKET, INC., *supra* note 34, at 1; GREGORY, *supra* note 36, at APP-21 n.9.

<sup>39</sup> *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 938–39 (Del. Ch. 2003).

<sup>40</sup> *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1050–51 (Del. 2004).

<sup>41</sup> *In re Oracle Corp.*, 824 A.2d at 947–48.

<sup>42</sup> *Beam*, 845 A.2d at 1052.

<sup>43</sup> *See id.*

related to the ability to cut off shareholder derivative action under Delaware law and not to specific governance matters. Indeed, there is no parallel statutory concept under nonprofit corporate law. Thus, it would be “a stretch” to argue on the basis of *Oracle* and *Martha Stewart* that independence standards (particularly in the nonprofit sector) *must* incorporate material non-economic relationships.

### C. Execute Session Practice

Independence concepts are also present in the emerging governance best practices relating to executive session. These include recommendations both that (1) the independent members of the board should periodically meet regularly outside of the presence of any senior executive officers, and (2) the general counsel of the corporation should meet regularly and in executive session with a committee of independent directors to communicate concerns regarding legal compliance matters. The former practice reflects a view that “frequent, regular meetings of the non-management directors is a [crucial] component for oversight of the CEO function.”<sup>44</sup> The latter practice is intended to “enhance the general counsel’s ability to assure that critical issues, including all issues of material law and fiduciary duty violations, are reviewed by appropriate corporate authorities” (*i.e.*, the independent members of the board).<sup>45</sup>

### D. Presiding Director

A significant, related independence concept that has arisen from the post-Sarbanes “best practices” compilations is that of the “presiding,” or “lead independent,” director. The concept is designed to preserve independence in board leadership and is applicable to those situations when the chief executive officer (or perhaps another interested/non-independent director) is elected to serve as Board Chair.<sup>46</sup>

To preserve independence in these situations, the “presiding” or “lead independent” director is called upon to perform some or all of the traditional duties of the board chair, such as advising on meeting schedules and agendas; presiding at meetings in the absence of the chair; overseeing the transmittance of

<sup>44</sup> CONFERENCE BOARD FINDINGS AND RECOMMENDATIONS, *supra* note 10, at 6.

<sup>45</sup> ABA TASK FORCE ON CORPORATE RESPONSIBILITY, *supra* note 2, at 38–39.

<sup>46</sup> See BRT PRINCIPLES, *supra* note 5, at 15; CONFERENCE BOARD FINDINGS AND RECOMMENDATIONS, *supra* note 10, at 8; NACD, *supra* note 8, at 3 (noting that the CEO may not serve as Board Chairman); see also GREGORY, *supra* note 36, at 17.

information to the board; providing oversight of chief executive officer performance evaluations; presiding over meetings of independent directors in executive session; and providing crisis management leadership and other duties.<sup>47</sup>

## IV. Nonprofit Application

There is a general recognition that many governance best practices transcend the distinction between for-profit and nonprofit corporate organization status; *i.e.*, that in many cases they apply as readily to nonprofit corporations as they do to for-profit, publicly traded, corporations.<sup>48</sup> Attention by the nonprofit sector to director independence issues can be traced to the 1987 adoption of the Model Nonprofit Corporation Act.<sup>49</sup> Yet, the fact remains that the broad application of director independence principles to the nonprofit sector has been far less widespread than the sector's general embrace of corporate responsibility principles. This is due in large part to the presence of two fundamental challenges.

First are the political considerations inherent in making independence-related adjustments to membership of boards and committees comprised of volunteer community leaders. Voluntary boards with a long history of collegial relationships are likely to be reluctant to deny renomination to otherwise effective members simply in order to accommodate new, "independent" directors. This reluctance is compounded by a natural inclination to equate the factors creating the lack of independence with lack of fitness to serve. This is notwithstanding the fact that independence standards are structural in nature and by their application are not intended to comment upon, or otherwise taint, a director's ability to meaningfully exercise his/her oversight duties.

Second is the absence of any over-arching standard of independence for the nonprofit organization. Nonprofits are required to reconcile standards emerging from business corporations, state business corporation law, and governance best practices with pre-existing federal exempt organization tax law principles.

The nonprofit sector's movement towards greater focus on governance independence has gained significant momentum

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<sup>47</sup> BRT PRINCIPLES, *supra* note 5, at 15.

<sup>48</sup> ABA TASK FORCE ON CORPORATE RESPONSIBILITY, *supra* note 2, at 31 & n.62. *See generally* ABA GUIDE TO NONPROFIT GOVERNANCE, *supra* note 4.

<sup>49</sup> RMNCA, *supra* note 21, at xix-xx.

in recent months, however, from several high-profile developments. These include (1) the rating agencies' emphasis on the role of effective governance in the credit analysis of nonprofit healthcare organizations; (2) the focus on independent committee review in the IRS' scrutiny of executive compensation practices of tax-exempt organizations; and (3) specific recommendations on board and committee independence made by the Panel on the Nonprofit Sector in its "Final Report" submitted to Congress in June of 2005.<sup>50</sup>

In the summer of 2005, Fitch Ratings, Moody's Investors Service, and Standard and Poors each released reports addressing the role that corporate governance plays in the credit evaluation of nonprofit hospitals.<sup>51</sup> The Fitch Ratings "Special Report" emphasized compliance with relevant provisions of Sarbanes-Oxley, including the establishment of an audit committee of the board comprised entirely of independent directors.<sup>52</sup> The Moody's "Special Comment" spoke to the specific elements of corporate governance (apart from Sarbanes-Oxley compliance) it considers in connection with an evaluation of the institutional credit profile.<sup>53</sup> Without referring specifically to independence, Moody's underscores the importance of board composition and structure to the credit analysis. In this way, the rating agencies' actions placed for the first time an identifiable economic value on the adoption of governance best practices.

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The IRS's long-running focus on executive compensation practices of tax-exempt organizations focused in large part on the governance decision making process and the independence of the participants in such process. Both the "Soft Contact Audit" initiative of 2004-2005,<sup>54</sup> and the "Community Benefit Compliance Check Questionnaire," released in 2006,<sup>55</sup> addressed questions relating to the role of corporate governance in deter-

<sup>50</sup> PANEL REPORT, *supra* note 22, at 75-78.

<sup>51</sup> FITCH RATINGS, *SARBANES-OXLEY AND NOT-FOR-PROFIT HOSPITALS: INCREASED TRANSPARENCY AND IMPROVED ACCOUNTABILITY* (2005); MOODY'S INVESTORS SERVICE, *SPECIAL COMMENT: GOVERNANCE OF NOT-FOR-PROFIT HEALTHCARE ORGANIZATIONS* (2005); STANDARD & POOR'S, *PUBLIC FINANCE CRITERIA: NOT-FOR-PROFIT HEALTH CARE* (2005).

<sup>52</sup> FITCH RATINGS, *supra* note 51, at 3.

<sup>53</sup> MOODY'S INVESTORS SERVICE, *supra* note 51, at 2.

<sup>54</sup> See *IRS Initiative Will Scrutinize EO Compensation Practices*, IRS NEWSWIRE, Aug. 10, 2004, [hereinafter *IRS Initiative*], available at [www.irs.gov/newsroom/article/0,,id=128328,00.html](http://www.irs.gov/newsroom/article/0,,id=128328,00.html) (last visited Sept. 24, 2006); WILLIAM S. MANNE, MILLER NASH, LLP, *CHARITABLE ORGANIZATIONS SHOULD PREPARE FOR IRS "SOFT AUDIT"* (2005), available at [www.millernash.com/showarticle.aspx?Show=367](http://www.millernash.com/showarticle.aspx?Show=367) (last visited Oct. 23, 2006).

<sup>55</sup> Internal Revenue Serv. (IRS), FORM 13790: COMPLIANCE CHECK QUESTIONNAIRE

mining executive compensation. Particular attention is applied to both the role of the executive compensation committee and the independence of its members in the process resulting in final compensation awards. A primary concern of the IRS is the presence of any bias in the process that might inappropriately affect decisionmaking.<sup>56</sup>

Perhaps the most significant of these developments were the recommendations concerning independence of the Panel on the Nonprofit Sector.<sup>57</sup> In its Final Report, the Panel takes the position that “the effort to find independent members [of the board] is important to the long-term success and accountability of the [nonprofit] organization and should be a legal requirement for public charities that are eligible to receive tax-deductible contributions on the most favorable terms.”<sup>58</sup> The Panel proposes that “public charities” be required to disclose which of their board members are independent, and maintain at least one-third of their board members as independent.<sup>59</sup> This is in part to compensate for the fact that public charities are not subject to the same prohibitions on self-dealing transactions as private foundations.<sup>60</sup> According to the Final Report, board members considered to lack independence due to an inherent bias would be those who receive compensation for services or who receive material financial benefits from the charity, and the spouses or family members of those who receive material financial benefits.<sup>61</sup> “Individuals who receive services from the organization as part of the charitable class served by the organization should be considered independent unless they were otherwise compensated by the organization or related to an individual who receives compensation from the organization.”<sup>62</sup> The recommendations of the Final Report may evolve into *de facto* best practices if the federal nonprofit oversight legislation long promoted by Senator Grassley fails to materialize.

These three developments add new emphasis to the efforts of the RMNCA,<sup>63</sup> the American Law Institute,<sup>64</sup> and of at least

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TAX-EXEMPT HOSPITALS (2006) [IRS FORM 13790], available at [www.irs.gov/pub/irs-tege/eo\\_hospital\\_questionnaire\\_sample.pdf](http://www.irs.gov/pub/irs-tege/eo_hospital_questionnaire_sample.pdf) (last visited Sept. 26, 2006).

<sup>56</sup> See *IRS Initiative*, *supra* note 54.

<sup>57</sup> PANEL REPORT, *supra* note 22, at 75–78.

<sup>58</sup> *Id.* at 78.

<sup>59</sup> *Id.*

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

<sup>63</sup> RMNCA, *supra* note 21.

<sup>64</sup> ALI DISCUSSION DRAFT, *supra* note 6, at 58-59.

three states—California,<sup>65</sup> Maine,<sup>66</sup> and New Hampshire<sup>67</sup>—to establish independence standards for directors of nonprofit organizations.

The current version of the RMNCA provides that no more than forty-nine percent of the board may consist of financially interested directors, with “financially interested” defined to include:

- (1) Individuals who have received or are entitled to receive compensation, directly or indirectly, from the corporation for services rendered to it within the previous 12 months, whether as full- or part-time employees, independent contractors, consultants or otherwise, excluding any reasonable payments made to directors for serving as directors; or
- (2) Any spouse, brother, sister, parent or child of any such individual.<sup>68</sup>

It is interesting to note, however, that this section is described as “optional.”<sup>69</sup> Commentary to the RMNCA explains that:

[M]any members of the Subcommittee on the . . . Act felt that its [Section 8.13] provisions would be ineffective in preventing intentional abuses, while presenting a burdensome or inconvenient requirement. Intentional wrongdoers would simply ignore its provisions. Legitimate public benefit corporations might have difficulty in finding active and competent directors who had no financial interest in the corporation.<sup>70</sup>

The American Law Institute, in its forthcoming “Principles of the Law of Nonprofit Organizations,” is expected to call for a

<sup>65</sup> CAL. CORP. CODE § 5227 (West 1996).

<sup>66</sup> ME. REV. STAT. ANN. tit. 13-B, § 713-A (2003).

<sup>67</sup> N.H. REV. STAT. ANN. § 7:19 (1998).

<sup>68</sup> RMNCA, *supra* note 21, at 195.

<sup>69</sup> *Id.*

<sup>70</sup> *Id.* at 197, comment to § 8.13. Indeed, the revised version of the RMNCA, currently in development, is not expected to include any provision regarding the independence of directors.

majority of board members to be independent (*i.e.*, “internal independence,” which requires separation of oversight from management):

The board-monitoring model adopted in these Principles generally requires processes conducive to the exercise of independent, informed oversight by a group of individuals *a majority of whom* are separate from management. Commonly, this definition of independence looks to whether the decision-maker is compensated by or otherwise obtains a direct financial benefit from the charity (emphasis added).<sup>71</sup>

The California Corporations Code, Section 5227 provides:

(b) For the purpose of this section, “interested persons” means either:

- (1) Any person currently being compensated by the corporation for services rendered to it within the previous 12 months, whether as a full- or part-time employee, independent contractor, or otherwise, excluding any reasonable compensation paid to a director as director; or
- (2) Any brother, sister, ancestor, descendant, spouse, brother-in-law, sister-in-law, son-in-law, daughter-in-law, mother-in-law, or father-in-law of any such person.

....

(d) The provisions of this section shall not affect the validity or enforceability of any transaction entered into by a corporation.<sup>72</sup>

It is also noteworthy that the core provisions of this statute were amended in 1996 to expressly allow courts to *add* or *remove* directors to bring the nonprofit corporation into compliance:

(c) A person with standing under Section 5142 may bring an action to correct any violation of this section. The court may enter any order which shall provide an equitable and fair remedy to the

<sup>71</sup> ALI DISCUSSION DRAFT, *supra* note 6, at 58–59.

<sup>72</sup> CAL. CORP. CODE § 5227 (West 1996).

corporation, including, but not limited to, an order for the election of additional directors, an order to enlarge the size of the board, or an order for the removal of directors.<sup>73</sup>

The Maine statute takes a similar position in requiring a majority of financially disinterested directors,<sup>74</sup> while New Hampshire requires at least five board members unrelated by blood or marriage.<sup>75</sup>

A significant new endorsement of nonprofit board independence standards comes from the American Red Cross (ARC). As part of its newly announced governance reorganization, the ARC will require ALL board members (except the CEO) to be independent. The independence standards will include provisions relating to board member affiliations with organizations that have relationships with the ARC.<sup>76</sup>

## V. Application to Board Committees

Whether by statute or best practice, independence standards are regularly applied at the level of key committees, such as governance, audit, executive compensation, and corporate compliance.

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### A. Audit Committee

The most common application of independence standards is at the audit committee level. For example, Sarbanes-Oxley and the stock exchange rules both require that the composition of the audit committee be independent, and each offers specific and unique criteria for establishing independence.<sup>77</sup> Sarbanes-Oxley provides that an audit committee member may not, “other

<sup>73</sup> *Id.*

<sup>74</sup> ME. REV. STAT. ANN. tit. 13-B, § 713-A (2003); Donald E. Quigley, *The Rules for Managing Nonprofit Corporations are Changing Fast*, 17 ME. BUS. J. 156, 158 (2002) (discussing the requirement that financially interested persons can constitute no more than 49% of the board members of nonprofit corporations).

<sup>75</sup> N.H. REV. STAT. ANN. § 292:6-a (1998); OFFICE OF THE NH ATTORNEY GENERAL, GUIDEBOOK FOR NEW HAMPSHIRE CHARITABLE NONPROFIT ORGANIZATIONS 8 (2005), available at <http://tinyurl.com/y8muet> (last visited Nov. 17, 2006) (discussing how boards of directors of charitable nonprofit corporations must be composed under New Hampshire law).

<sup>76</sup> AMERICAN RED CROSS: GOVERNANCE FOR THE 21ST CENTURY, A Report of the Board of Governors (Oct. 2006), available at [www.redcross.org/static/file-cont5765-lang0-2202.pdf](http://www.redcross.org/static/file-cont5765-lang0-2202.pdf).

<sup>77</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301(m)(3)(A), 116 Stat. 745, 775–76 (amending 15 U.S.C. 78f (1934)).

than in his or her capacity as a member of the audit committee, the board of directors, or any other committee . . . (i) accept any consulting, advisory, or other compensatory fee from the issuer . . . or (ii) be an affiliated person”<sup>78</sup> with respect to the corporation or an affiliate. What this means, in essence, is that corporate employees, agents, consultants, and professional advisors, as well as employees of controlled corporations, are ineligible to serve as audit committee members (although they perhaps could serve as staff thereto). The ultimate determination of independence is based upon a “facts and circumstances” analysis. Nevertheless, it may prove difficult to support for audit committee membership an individual who receives compensation from the corporation or a controlled company, or who is in a position (other than as “director”) to exercise influence over the business or affairs of the corporation.

An audit committee composed entirely of independent directors is recommended as a best practice for nonprofit organizations.<sup>79</sup> Furthermore, the new California Nonprofit Integrity Act includes a requirement that boards of nonprofit corporations with a certain revenue level appoint a discrete audit committee.<sup>80</sup> Membership of the audit committee may include persons who are not board members, but may not include any members of the corporate staff, including the president/chief executive officer, treasurer and/or chief financial officer, or any persons with a material financial interest in any company doing business with the corporation.<sup>81</sup> This provision essentially bars from membership on the audit committee anyone with a material financial interest in any entity doing business with the corporation. This is not a “transaction” based test, but rather a broad institutional conflict test. There is neither case law nor regulations to interpret this provision. In particular, the lack of any definition of “materiality” has created significant uncertainty as to the provision’s implementation.

### **B. Other Committees**

Exclusive “independence” membership is also broadly recommended for such other important committees as Governance/Nominations, Executive Compensation, and Legal Compliance.<sup>82</sup> Indeed, Business Roundtable considers the functions per-

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<sup>78</sup> *Id.* § 301(m)(3)(B).

<sup>79</sup> ABA GUIDE TO NONPROFIT GOVERNANCE, *supra* note 4, at 28–29.

<sup>80</sup> CAL. GOV’T CODE § 12586(e) (West 2005).

<sup>81</sup> *Id.* § 12586(e)(2).

<sup>82</sup> ABA GUIDE TO NONPROFIT GOVERNANCE, *supra* note 4, at 34–35.

formed by the audit, compensation, and corporate governance committees—all of which are to be comprised of independent members—to be “central to effective corporate governance.”<sup>83</sup> The ABA encourages the formation of a separate committee, comprised of independent members, to “review and approve any material transaction between the corporation and any director or senior executive officer of the corporation.”<sup>84</sup> The perspective expressed in these recommendations is that the work of these committees is so essential that they should be comprised solely of directors who are free of any relationships that would compromise their independence.

The Inspector General’s Compliance Program Guidance for Hospitals does not specifically address issues associated with the independence of the compliance committee. Rather, the guidelines stress the “active” nature of the committee and a committee membership “comprised of trained representatives of each of the relevant functional departments, as well as senior management.”<sup>85</sup> Nevertheless, hospitals and their governing boards may be well advised to consider the benefits of applying some independence requirement to the constitution of the compliance committee. This serves to remove any third-party concern with respect to potential bias or self-interest distracting the deliberations of the committee.

Independence is also a critical criterion in the organization of a special committee formed by the board of directors to review or investigate particular matters of sensitivity, significance, and/or legal compliance for the nonprofit corporation. It is an unfortunate fact of organizational life that the need for such committees has materially increased in the current corporate responsibility environment, in both the for-profit and nonprofit sectors. Nonetheless, the work of thoughtfully structured special committees can often result in substantial compliance benefits to the corporation, and potentially forestall negative media coverage and/or invasive regulatory review. To help assure the credibility of the results of the review/investigation, it will be important to structure the committee membership to consist of not less than a substantial majority of directors (100% is ideal, if feasible) who (a) satisfy the general board definition of “independence”; and (b) have no conflict of interest with respect to

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<sup>83</sup> BRT PRINCIPLES, *supra* note 5, at 16.

<sup>84</sup> ABA TASK FORCE ON CORPORATE RESPONSIBILITY, *supra* note 2, at 70.

<sup>85</sup> OIG Supplemental Compliance Program Guidance for Hospitals, 70 Fed. Reg. 4,858, 4,874–75 (Off. of the Inspector Gen. Jan. 31, 2005) (notice).

the subject of the review or investigation. Typically, decisions as to the membership of the special committee are similarly made by either the independent members of the board, or a board committee comprised of independent directors.<sup>86</sup>

These policy recommendations and administrative guidelines are generally perceived as applicable to nonprofit organizations as well as to publicly traded organizations. In addition, the ABA recommends that the audit and compensation committees, among others, be authorized to engage their own legal counsel and other advisors (*e.g.*, accounting and compensation consultants).<sup>87</sup>

### C. Presiding Director

The “presiding” or “lead independent” director concept used in the for-profit sector has logical relevance to the nonprofit sector, even if the number of instances in which it may need to be applied is limited. It is true that in the nonprofit sector, the CEO rarely also holds the position of Chairman of the Board. Nevertheless, it is theoretically possible for the board to elect an “interested” director as Board Chair. Examples could include a director who is (directly or indirectly) a prominent corporate vendor, a leading member of the medical staff or a relative or close personal acquaintance of the CEO or other senior executive. In such a situation, there may be a significant benefit to appointing a “lead independent” director in order to preserve independence in the performance of the traditional, yet crucial, oversight duties of the Board Chair. While the position of the Vice Chair may be well suited to assume this role, it should not be “automatic,” for the Vice Chair may suffer from a similar disability. A nonprofit board is well advised to articulate (at least by resolution, if not by amendment to its organizational documents) the process by which the “lead independent” director would be appointed.

## VI. Reconciliation with Tax Law

The independence standards of nonprofit, tax-exempt organizations must also be drafted to satisfy the related requirements of the IRS under Section 501(c)(3) of the Internal Revenue Code.<sup>88</sup> For hospital governing boards, the IRS has adopted specific

<sup>86</sup> William Schuman & James Sanders, *The Role of Special Committees in Overseeing Internal Investigations*, NACD DIRECTORS MONTHLY, June 2006, at 15.

<sup>87</sup> ABA TASK FORCE ON CORPORATE RESPONSIBILITY, *supra* note 2, at 65–67.

<sup>88</sup> I.R.C. § 501(c)(3) (2006).

independence standards.<sup>89</sup> For all other exempt organization boards, the IRS does not articulate a definitive statement on director independence. Rather, the IRS simply solicits information it can use to assess board composition on the Form 1023<sup>90</sup> (“Application for Recognition of Exemption”) and the Form 990<sup>91</sup> (“Return of Organization Exempt from Income Tax”). Part V, Question 2 of the Form 1023 solicits information regarding the composition of the organization’s officers, directors, and trustees, and the existence of (a) any family or business relationships between them; and (b) any business relationships between the organization and the officers, directors, or trustees (apart from their position as such).<sup>92</sup> Similarly, Part V-A, Question 75b of the new Form 990 asks whether any directors, officers, key employees, or contractors have business or family relationships with each other, and if so, to describe those relationships.<sup>93</sup> This question would identify, for example, the situation in which board members are members of the same family. The instructions do not specifically address this question.

## VII. Special Rules: Nonprofit Hospitals

Revenue Ruling 69-545 established the “community benefit standard” as an essential prerequisite for hospitals to satisfy the standards for tax exemption under I.R.C. Sec. 501(c)(3).<sup>94</sup> That standard focuses on a number of factors to determine whether a hospital operates to benefit the community as a whole rather than for merely private interests. One of those factors is whether board control is vested in “independent civic leaders”<sup>95</sup> (the “Community Board Component”). The IRS has subsequently defined a “community board” as one with a majority of board members who are independent persons representative of the community.<sup>96</sup> The IRS does not, however, define “independent community members,” other than to state that “[p]racticing physicians affiliated with the hospital, officers, department heads, and other employees of the hospital are not independent

<sup>89</sup> See discussion *infra* Part VII, notes 94-110 and accompanying text.

<sup>90</sup> IRS, FORM 1023: APPLICATION FOR RECOGNITION OF EXEMPTION (2006) [hereinafter IRS FORM 1023], available at [www.irs.gov/pub/irs-pdf/f1023.pdf](http://www.irs.gov/pub/irs-pdf/f1023.pdf) (last visited September 16, 2006).

<sup>91</sup> IRS, FORM 990: RETURN OF ORGANIZATION EXEMPT FROM INCOME TAX (2005) [hereinafter IRS FORM 990], available at [www.irs.gov/pub/irs-pdf/f990.pdf](http://www.irs.gov/pub/irs-pdf/f990.pdf) (last visited September 16, 2006).

<sup>92</sup> IRS FORM 1023, *supra* note 89, at Part V, Question 2.

<sup>93</sup> IRS FORM 990, *supra* note 90, at Part V-A, Question 75b.

<sup>94</sup> Rev. Rul. 69-545, 1969-2 C.B. 117.

<sup>95</sup> *Id.*

<sup>96</sup> Lawrence M. Brauer & Charles F. Kaiser, *Tax-Exempt Health Care Organizations Community Board and Conflicts of Interest Policy*, in IRS EXEMPT ORGANIZATIONS

due to their close and continuing connection with the hospital."<sup>97</sup> Such individuals may serve on the board (but may not comprise a majority of its members).<sup>98</sup>

The difficult question of the independence of directors who are also vendors to the hospital is addressed by the IRS in a less definitive manner: "Other persons who may have some business dealings with the hospital are usually included in the majority."<sup>99</sup> It is important to note that, by implication, independence is determined on the basis of the overall financial relationship between the person and the exempt organization (or its affiliates), rather than with respect to the person's financial interest in a particular transaction or arrangement.<sup>100</sup> As such, the Community Board component, like the new best practices developments discussed above, focuses on whether an individual has financial interests and other relationships that may affect his or her ability to meet overall fiduciary duty obligations to the nonprofit, exempt organization.<sup>101</sup> The Community Board component is somewhat less stringent than those best practices standards which require that the independent members of a board or board committee have no financial relationship with the organization.<sup>102</sup>

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The IRS has articulated two notable exceptions to this approach for determining director independence under the Community Board Benefit Standard. *First*, for an existing healthcare organization, the IRS will consider the organization's historical development and record of significant charitable operations.<sup>103</sup> The presence of certain facts and circumstances, "such as a long history of substantial community service and the absence of inurement or private benefit," may provide a basis for a waiver.<sup>104</sup> *Second*, the IRS is willing to attribute "community board" status to a hospital when it is "controlled by an exempt organization

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CONTINUING PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM FOR FY 1997, at 18 (1996), available at [www.irs.gov/pub/irs-tege/eotopic97.pdf](http://www.irs.gov/pub/irs-tege/eotopic97.pdf) (last visited Sep. 25, 2006).

<sup>97</sup> *Id.*

<sup>98</sup> *Id.*

<sup>99</sup> *Id.*

<sup>100</sup> *Id.* at 21.

<sup>101</sup> Brauer & Kaiser, *supra* note 95, at 24.

<sup>102</sup> *See id.* at 19, 21 (explaining that the IRS will consider past charitable operations when deciding if it will require an independent community board and listing "disclosure by interested persons of financial interests" as a provision that conflict of interest policies should include).

<sup>103</sup> *Id.* at 19.

<sup>104</sup> *Id.*

whose board is comprised of a majority of voting members who are independent community members”<sup>105</sup> (the “Derived Community Board” Alternative). IRS policy does not expressly define the extent of control the parent must have to take advantage of this alternative. One should reasonably expect that the IRS will require control that is sufficient to prevent the board of the subsidiary from pursuing policies and activities that are inconsistent with the subsidiary corporation’s charitable purposes or using the corporation’s assets in a way that violates the proscriptions against inurement and excessive private benefit.<sup>106</sup> It should be noted, however, that these two exceptions exist only in informal guidance documents, which do not have the precedential value of a Revenue Ruling.

As noted above, both the executive compensation “soft contact audit” initiative of 2004-2005,<sup>107</sup> and the community benefit “Compliance Check Questionnaire” of 2006<sup>108</sup> focused attention on the independence of the executive compensation committee.

Anecdotal evidence suggests that the IRS expects that the nonprofit board will, in its exercise of business judgment, develop an independence standard (for both the board and committees thereof) that is suitable for its organization. Where this is done in good faith, the IRS is unlikely to substitute its judgment for that of the board. In turn, the board is required to prepare a standard that reflects such important considerations as (a) applicable state law; (b) the charitable mission; (c) unique features of the board and the organization; and (d) the organizational history of community service and absence of private inurement and excessive private benefit.<sup>109</sup> These standards should be assiduously applied in the director recruitment and reten-

<sup>105</sup> *Id.* at 21.

<sup>106</sup> See, e.g., Janet E. Gitterman & Marvin Friedlander, *Health Care Provider Reference Guide*, in IRS EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 2004, at 11 (2004), available at [www.irs.gov/pub/irs-tege/eotopic04.pdf](http://www.irs.gov/pub/irs-tege/eotopic04.pdf) (last visited Sept. 16, 2006) (“Control” in this context refers to authority over structural and financial matters. “Structural control” would include the ability to appoint, elect or remove directors of the subsidiary and likely also the ability to enforce policies designed to assure subsidiary compliance with its charitable purposes and the prohibitions against private inurement and excessive private benefit. “Financial control” would include the right to approve annual operating and capital budgets, strategic planning initiatives, and significant transfers or encumbrances of real property.)

<sup>107</sup> *IRS Initiative*, *supra* note 54.

<sup>108</sup> IRS FORM 13790, *supra* note 55.

<sup>109</sup> See, e.g., Gitterman & Friedlander, *supra* note 106, at 30–34 (providing a sample conflict of interest policy).

tion process. Furthermore, the board or applicable committee should be required to periodically review the effectiveness of the standards in preserving board control in directors with no discernable, material, ongoing bias, or private interest.

It is useful to compare the IRS's approach to the overall board independence issue under the Section 501(c)(3) Community Benefit Standard and its approach to determining whether a member of a board or an authorized board committee is "disinterested" for purposes of the "rebuttable presumption of reasonableness" safe harbor available under the Section 4958 intermediate sanctions rules. While they are similar in some respects, they are sufficiently different to conclude that the "disinterested" standard under the rebuttable presumption should not be used *per se* as a proxy for determining whether a board member is an "independent" member of the board for general fiduciary duty and community benefit purposes. The rules for determining "disinterest" for purpose of the rebuttable presumption are based on conflict of interest.<sup>110</sup> They focus on personal interest and lack of independence with respect to a specific compensation arrangement or other financial arrangement with a private individual (*e.g.*, transfer of assets), not on ability to fulfill overall fiduciary duties. Hence, a board or committee member could technically be disinterested with regard to a particular financial relationship or transaction for rebuttable presumption purposes, but have broader relationships with the organization that are unrelated

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<sup>110</sup> The rules require that the transaction or arrangement be approved in advance by an authorized body of the organization composed entirely of individuals who do not have a conflict of interest with respect to the transaction. A board or committee member does not have a conflict of interest (*i.e.*, is a "disinterested" director or member) with respect to a compensation arrangement or other transaction only if he or she: (a) is not the subject of and is not related to any disqualified person participating in the subject transaction; (b) is not employed by or under the employment direction of the subject disqualified person; (c) has no material financial interest affected by the subject transaction; and (d) is not approving a transaction providing economic benefits to a disqualified person when the subject disqualified person will be called on to approve (or has already approved) a transaction providing benefits to the director/member. It should be noted that a board or committee will not qualify as independent for purposes of the rebuttable presumption if any of its members has a substantial financial interest affected by the transaction, regardless of whether the board of the applicable tax exempt organization determines that the financial interest results in a "conflict of interest" under the organization's conflicts of interest policy. In this regard, therefore, this rebuttable presumption criterion requires greater independence than the IRS model conflict policy. See D. Benson Tesdahl & Jodi Finder, *Don't Wait for Intermediate Sanctions Guidance*, 16 NONPROFIT WORLD 22, 24 (1998).

to that relationship or transaction but sufficient to consider the board/committee member to be non-independent under the Community Benefit Standard. Conversely, a board member need not in all cases be considered as non-independent for purposes of the Community Benefit Standard simply because he or she is not considered disinterested for purposes of the rebuttable presumption safe harbor for one financial relationship (*e.g.*, the compensation of a family member). In practice, however, a lack of overall independence should be taken into account as one relevant factor when evaluating whether a board committee member is disinterested under the rebuttable presumption, and the determination that a board/committee member cannot qualify as “disinterested” under the rebuttable presumption for certain financial decisions should in turn be taken into account as one relevant factor in evaluating overall independence under the Community Benefit Standard.

## VIII. Recommended Independence Standards

The challenge facing the nonprofit, tax-exempt board is to fashion workable board and committee independence standards from a polyglot of disparate and potentially conflicting guidelines. We propose the following core guidelines to be considered in addressing board and committee independence issues *where there is no controlling state law*.

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### A. Required Number of Independent Directors

For tax-exempt hospitals (or a controlling parent organization in a hospital system), a minimum of 51% of the governing board should be comprised of “independent directors.” For other nonprofit organizations, the number may be less.<sup>111</sup> For other organizations that are affiliates of a hospital under a common parent organization, it may be necessary to reserve special powers to the parent (*e.g.*, power to appoint the board, amend articles and approve compensation of physicians and executives). Reference should also be made to state statutes that may set forth a specific board composition requirement.

### B. General Independence Standards

The Board should adopt specific written independence standards with respect to relationships or interests of the Director or the candidate for Director as they may relate to the organization

<sup>111</sup> PANEL REPORT, *supra* note 22, at 75.

and its affiliates. As discussed above, there is no “black letter” standard for independence of nonprofit board members. Rather, each governing board should, in good faith, adopt reasonable standards that make the most sense for the organization given its size, location, industry, history, and charitable mission. Emerging standards suggest a guiding principle that an individual should not possess a relationship that would render him/her “beholden to management.” Specific suggestions with respect to standards/criteria a board may wish to consider are set forth at “C,” below.

### 1. Determination of Independence

Applying its specific written independence standards, the Board of Directors should make a determination of independence with respect to each Director prior to his/her election or appointment to the Board and thereafter at such times as the board considers advisable in light of the Director’s circumstances (but in any event, no less than annually). The Board of Directors may delegate the evaluation of independence matters to a standing committee of the Board, but any determination of independence must be ratified by the Board of Directors.

### 2. General Independence Factors

In making independence determinations, the Board of Directors should consider:

- The issue not only from the perspective of the individual Director but also from the standpoint of persons or organizations with which the Director is affiliated or associated;
- The special responsibilities of the Director in light of the status of the organization as a nonprofit corporation, exempt from federal income taxation under Section 501(c)(3) of the Internal Revenue Code;<sup>112</sup> and
- The “appearance” factor; what is the likely public/media reaction (and the related risks to organization reputation) if the implicated relationship(s) were made public.

### 3. Specific Independence Factors

In making an individual independence determination, the Board of Directors may wish to consider the following *specific* factors:

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<sup>112</sup> I.R.C. § 501(c)(3) (2000).

- (a) **Basic Principles** An independent director should not have any “close and continuing” relationships with the organization and/or its management (whether business, employment, charitable or personal) that may impair, or appear to impair, the director’s ability to exercise independent judgment or objectivity.<sup>113</sup>
- (b) **“Suspect” Relationships** In evaluating independence issues, the Board should pay specific attention to certain relationships which, on their face, present the potential for impairing the director’s ability to exercise independent judgment or objectivity:
- (i) *Employment/Managerial* This would include current or previous employment by the corporation or affiliate in an executive capacity or other management relationships which place an individual in a position to exercise substantial influence over the affairs of the organization.

When the director is an employee of the corporation, it may be appropriate for the independence analysis to consider whether the director, regardless of title:

- a) is a rank-and-file employee;
- b) has no managerial authority with respect to employee compensation, or the purchase of goods or services by the corporation; or
- c) otherwise does not participate in any management decision affecting the organization as a whole or a discrete segment or activity of the corporation that represents a substantial portion of the activities, assets, income, or expenses of the corporation, as compared to the corporation as a whole.<sup>114</sup>

- (ii) *Professional/Vendor* This would include employment or similar professional relationships with: (i) the present or former auditor of the corporation; (ii) an entity which is a paid advisor or consultant (e.g., law, investment banking, or compensation) to the corporation; (iii) a customer or supplier to the corporation; or (iv) an entity with a similar type of busi-

<sup>113</sup> BRT PRINCIPLES, *supra* note 5, at 14.

<sup>114</sup> Note these would not be applicable qualifying factors for a nonprofit, tax exempt hospital, as the IRS considers all employees of the hospital as non-independent.

ness relationship with the corporation. It would also include individuals with personal service contracts with the corporation and, for hospitals, practicing physicians affiliated with the hospital as members of its medical staff.

When the director or the director's affiliated organization is a vendor or service provider to the corporation, it may be appropriate for the independence analysis to consider factors such as:

- a) the dollar value of the services (in absolute terms);
- b) the dollar value of the goods or services relative to the overall volume of goods or services: (i) purchased by the organization in general; (ii) purchased by the organization for this particular good or service (*e.g.*, legal services budget); or (iii) provided by the director or the director's affiliated organization in general.
- c) the director's position within the vendor organization (*e.g.*, owner, partner, or employee);
- d) the impact the business relationship with the corporation has on the director's compensation from or career advancement within this organization;
- e) whether the director provides the services directly, supervises the delivery of services, or has no connection to the delivery of services; and
- f) where in the corporation's organizational hierarchy lies the decision to authorize the goods or services to be purchased from the director/vendor (*e.g.*, board, executive, or departmental level) and whether the director's position in the corporation is likely to involve the director in or give the director influence over, the decision to engage the director or the director's affiliated organization.

(iii) *Financial* A lack of independence can also arise when the board member has a financial interest in the corporation or significant influence over the corporation's financial matters. This would include, for example, relationships where: (i) a person's compensation is primarily based upon revenues derived from the activities of the corporation, or of a particular department or function of the organization, that

the person controls; (ii) a person has the authority to control or determine a substantial portion of the corporation's capital expenditures, operating budget, or employee compensation; (iii) a person is a substantial contributor to the organization; or (iv) a person is employed by a foundation or charitable organization that received grants, endorsements, or other financial support from the corporation.

When a director's financial relationship(s) are implicated, it may be appropriate to consider the substance of such relationships. A de minimis level of financial relationships between the director and the organization/the organization's business should not, in most cases, preclude a determination of independence.

Any evaluation of whether such relationships are indeed de minimis should be made from the following perspectives: (i) the organization; (ii) the relationship; and (iii) the individual director. Particular focus should be placed on whether the financial relationship(s) create the potential for the implicated director to be considered as " beholden to management " or to some other relationship that could bias his or her decisionmaking.

- (iv) *Familial* This would include persons who are members of the immediate family of anyone in any of the foregoing suspect relationships. It may be appropriate in certain situations, however, for an organization to (a) narrow the definition of family member to include members of the immediate family only if the family member lives in the board member's household, the board member manages the family member's financial affairs, or the board member is aware without special inquiry that the family member holds a particular interest or relationship with the organization; or (b) expand the definition to include members of the director's extended family for whom one or more of those same factors exist.
- (v) *Non-economic Factors* This would include social, other personal and nonfinancial professional relationships (e.g., board service or competitor) of such substance as to create a potential to cause the implicated direc-

tor to act with bias or a lack of independence. Mere allegations of friendship or social acquaintance would be insufficient to demonstrate intent.

#### 4. Notification

The Board must rely on the active participation of the Director in monitoring independence matters. Each Director should be obligated to inform the Chairman of the Board of Directors and the Chairman of the Governance and Nominating Committee promptly and otherwise as requested of the existence of such relationships and interests that might reasonably be considered to bear on the Director's independence. This notification obligation would be similar to the obligation of board members under board conflict of interest policies to disclose potential conflicts on a current basis during the period between completion of annual conflict of interest statements.

#### 5. Board Chair

An independent determination should be applied to the individual elected to serve as Chairman of the Board. If that person is determined to be "interested" or "non-independent," consideration should be given to appointing a "lead independent" director (see discussion above).

### IX. Conclusion

Issues of director independence will be an important governance issue for nonprofit corporations in the coming years. Boards should expect increased pressure to adopt independence standards for their members, in addition to enhanced conflict of interest policies. Unfortunately, though, in most states no "bright line" standard exists under both corporate and tax law with respect to the required number of independent members that must serve on the nonprofit board, and the related definition of independence. The criteria suggested in this Article are intended to serve as a guide to the nonprofit general counsel in addressing this important issue.

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