

# GREAT BOARDS

Published by Bader & Associates Governance Consultants, Potomac, MD

## Defining who is an 'independent director'

By Sharon O'Malley

At St. Francis Hospital and Medical Center in Hartford, Conn., a recently updated conflict-of-interest policy requires that two-thirds of trustees have no significant relationships with the hospital other than their board service.

They are not employed by any of the organization's facilities, and neither are any of their immediate family members. They do not work for companies that do or are seeking to transact substantial business with the organization.

They are, in the parlance of a hot governance trend, "independent directors."

St. Francis revised its policy, says general counsel Barry Feldman, to make sure all board decisions not only are—but also appear to be—in the organization's, and not any individual's or vendor's, best interest. "We want to make sure that neither the board nor management has such a relationship with the other that it has the potential to cause inappropriate decisions," he says.

Still, the Internal Revenue Service doesn't say St. Francis or any other not-for-profit healthcare organization has to place such strict limitations on the number of "interested" directors—those who could profit in some way from a relationship with the hospital—who may serve on the board.

That leaves it up to healthcare organizations to craft and enforce their

own conflict-of-interest policies. St. Francis is among the strictest in the country when it comes to peopling its 31-member board with independent directors. But Feldman says others will follow suit as they revisit their conflict-of-interest policies. "They would change their policies if they would consider them now," he says.

### Increasing scrutiny

Those changes would reflect the increasing scrutiny not-for-profit

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organizations—including healthcare systems and hospitals—are under by Congress, the IRS and state attorneys general since the passage of the Sarbanes-Oxley Act.

Sarbanes-Oxley ushered in a new era of corporate governance accountability and independence. It requires directors responsible for oversight of audit and executive compensation to be independent. The law only covers public companies, but its principles—corporate accountability and transparency—can be applied to charitable organizations that receive tax exemptions and are funded, in part, by donors.

Many not-for-profit boards are voluntarily adopting practices to comply with relevant Sarbanes-Oxley

provisions. Among them is stricter vetting of trustees for conflicts of interest—not just on a case-by-case basis as conflicts arise, but proactively.

A recent Governance Institute survey found 64 percent of healthcare boards say they are more aware of conflicts than they were three years ago. Almost 25 percent have established a definition for an independent director, and 14 percent are considering it. And 26 percent have developed "disabling guidelines" that draw clear boundary lines defining when a conflict is great enough to disqualify someone from serving as a director.

### Murky area

So exactly who is an "independent director?"

Except in California, the term is not defined under not-for-profit law, explains Michael Peregrine, a partner in the Chicago law firm McDermott, Will & Emery. "You've got to keep your head on a swivel and determine what the law is that pertains to your type of organization," he notes.

T.J. Sullivan, a partner in the healthcare law firm Gardner Carton & Douglas in Washington, agrees. "Ultimately, the board can decide—within reason—what it wants its definition of an 'independent director' to be."

To develop a workable definition, Sullivan recommends asking two questions:

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1. Is the director, a family member or a business entity owned or controlled by the director being paid by the hospital as an employee or consultant?

2. Does the director, a family member or a business entity owned or controlled by the director have a financial arrangement—such as ownership, investments or compensation—with the hospital or its subsidiaries, vendors or competitors?

If the answer to either of these questions is yes, the director probably is not independent—but isn't necessarily banned from serving on the board.

At St. Francis, an independent director is “one whose conflict of interest (if any) is of such insignificance, as determined by the Governance and Nominations Committee, that the conflict of interest would not be reasonably perceived to exert an influence on the director's judgment.”

To make that determination objectively, a “material” conflict of interest is further defined as one in which “the contract, transaction or arrangement in question is valued at more than 1 percent of the income or revenues of the director, entity or individual who is the recipient of the benefit, and

(a) the director's direct or indirect actual or potential ownership, investment or other interest is more than 5 percent of the total ownership interest, or

(b) the director's direct or indirect compensation arrangement involves more than \$10,000, or

(c) the director's direct or indirect relationship or arrangement would reasonably be expected to exert an

influence on the director's judgment if he or she were called upon to vote on the matter.”

Directors also have a material conflict of interest if they or a family member is on the medical staff or is an employee, director or officer of a competitor organization, or a family member is employed by St. Francis.

That doesn't mean that otherwise-qualified trustees who have material conflicts of interest can't serve on the board, notes Feldman. But not more than a third of board members may have such conflicts, and those who do may not participate on committees that deal with audit, governance, compensation and finance.

### **Conflict-free**

Peregrine endorses the gravitation by not-for-profits toward conflict-free trustees. “The reason for all this focus on independence is very simple,” he says. “It's to make sure board decisions are made by people who don't have a stake in the game.”

Should a board require a minimum number of directors to be independent? The Panel on the Nonprofit Sector has recommended that at least a third of board members be independent. The New York Stock Exchange revised its definition of “independent director” in 2003 to call for a majority of directors to be free from material conflicts.

Peregrine suggests that healthcare boards use those suggestions as a starting point. “There's no need to reinvent the wheel,” he says, but each health system should adopt a policy that makes sense for that organization.

To that end, he suggests that boards begin their deliberations by asking: Why are we trying to do this?

“It should be a thoughtful process for an organization to arrive at a final number,” he says.

Indeed, part of that thought process should include considering the kinds of potential trustees who might be eliminated if the board is entirely independent.

### **Eliminate carefully**

Boards should weigh the benefit of independent directors against the potential loss of knowledgeable, committed trustees, Peregrine explains. He typically does not recommend that boards require more than 51 percent of members to be independent.

And although the St. Francis board requires that two-thirds of its trustees be independent, Feldman says a wholly independent board would be a bad idea.

“Not-for-profit organizations have a lot of ties to the community,” he explains. “Because of the nature of the constituencies that are important to have on an organization's board—and the competencies that need to be on an organization's board—it's virtually impossible to have a board that is totally without conflict.” **GB**

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