

# Who Is an Independent Director?

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**INDEPENDENCE IS A DUTY OF THE HIGHEST ORDER FOR THE** director of a not-for-profit organization. All directors are expected to make objective decisions based on the best interests of the organization, and not for any personal or professional gain.

Broadly speaking, independence requires a director to have no *material* economic or other relationships with the corporation that a reasonable person might construe as interfering with the director's ability to carry out his or her fiduciary duties. Recent developments are leading to new and different definitions of "independence" for different purposes, however, and this may have an effect on who should or should not serve on boards and their committees.

## New IRS definition on Form 990

The question, "Who is an independent director?" has received renewed interest because of recent revisions to the IRS Form 990. The IRS requires filing organizations to determine and state on the new Form 990 how many of their board members are "independent." It applies the following general definition:

A trustee is not an "independent trustee" if, at any time during the fiscal year, the trustee: (a) received compensation as an officer or employee from the corporation or a related organization; (b) received compensation or other payments as an independent contractor of \$10,000 or more not including expense reimbursement or payment for services as a director; or (c) became involved or had a family member who became involved in a "reportable transaction" with the corporation, whether directly or indirectly through affiliation with another organization.

Generally speaking, reportable transactions include: (1) loans or grants to the director (or the director's family members or entities in which the director or family members have an ownership interest, collectively "related persons"); (2) compensation to a family member of \$10,000 or more; or (3) a business transaction with the director or related persons that exceeds the greater of \$10,000 or 1 percent of the organization's annual revenues, or multiple transactions that exceed in the aggregate \$100,000 during the fiscal year.

For example, a director who received more than \$10,000 for consulting services or whose solely owned company sold more than \$100,000 of goods and services to the hospital would not be counted as independent on the Form 990. **However, even if a director has transactions with the filing organization that are disclosed on the organization's 990, and as a result is not counted as one of the "independent" directors on the Form 990, there is no prohibition on that individual serving on the board, so long as these transactions are disclosed and any potential conflicts of interest are appropriately addressed under the organization's conflict-of-interest policy.**

## Do Physician Directors Meet the Definition of "Independence" on the New Form 990?

The basic rule is this: as long as the physician is *not* being compensated by the organization as an employee (in any amount) or as an independent contractor (more than \$10,000), and there is no reportable direct or indirect business transaction between the physician and the organization, then the physician director can be counted as independent on the Form 990.

Thus, a physician employed by the hospital, or a solely owned medical group, whom the hospital pays more than \$10,000 a year would not meet the test of independence. Neither would a physician who is paid more than \$10,000 to serve as the medical director of a clinical department.

Determining whether a physician is *indirectly* engaged in a reportable business transaction with the organization through a family member or their medical practice can be more complex, says Ralph DeJong of McDermott Will & Emery. For example, what if a physician on the board earns no compensation from the hospital, but has a partner in a two-person practice who serves as the hospital's chief of medicine for a stipend of more than \$10,000 a year? What if a physician's spouse is paid more than \$10,000 a year to provide on-call coverage in the emergency department? Arguably, these are reportable transactions. Even though they do not involve the physician directors directly, these doctors would not be defined as "independent" on the Form 990.

The IRS definition does not explicitly address private practitioners who receive no direct compensation from the hospital, but who generate significant fees from treating patients in hospital facilities. Using a strict reading of the new Form 990 definition, these physicians would be defined as independent, says DeJong, if the only relationships with the hospital are serving as a director and being on the voluntary medical staff.

However, another IRS definition clouds the picture, says DeJong. To satisfy the "community benefit standard for tax exemption," a hospital must show that it or its parent organization is controlled by a majority of independent persons representative of the community. **Historically, says DeJong, the IRS has not treated physicians (on the voluntary medical staff) as independent community representatives for purposes of the community benefit standard.** He adds, "This is a confusing area of the law, and the IRS has yet to definitively state whether its new definition of independent director for Form 990 purposes may also be used for purposes of applying the community benefit test."

Douglas K. Anning, who co-chairs the non-profit organizations practice at Polsinelli Shughart PC in Kansas City, MO, notes, "The advice I'm giving to clients is to strictly comply with the Form 990 definition but not go overboard. A private practice physician who earns no compensation from the hospital would be independent for purposes of the 990." **What about hospitals that want to be stricter and define any active member of the medical staff as "not independent" (but still eligible to serve on the board)?**

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“That’s okay,” says Anning, particularly for determining who can sit on board committees overseeing executive compensation, external audit, and corporate compliance. In its 1997 training materials, Anning notes, the “IRS has said medical staff members may not serve on the compensation committee.” However, even hospitals that adopt a tougher committee standard may still count the private practitioner who draws no compensation as independent on the Form 990.

### Our Advice

As governance advisors, we do not offer legal advice; boards should consult their general counsel to develop policies and practices on independence. That said, we recommend five guidelines:

1. Update the board on the new Form 990 requirements, which address independence, executive compensation, community benefit, and various governance policies and practices.
2. Comply with the IRS definition of independence when filing the Form 990, but remember that independence means more—it takes into account financial and non-financial relationships that could lead a reasonable person to question an individual’s objectivity and loyalty to the organization. The gold standard for independence should be that the board is beyond reproach, in fact and appearance.
3. Adopt a more stringent definition of independence for the board’s committees overseeing executive compensation, physician compensation, audit, and corporate compliance. Physicians on the active medical staff should not serve on these committees even if they are considered independent on the Form 990. Consider requiring that the board chair be an independent trustee.
4. Continue to include physicians as board members, so long as they satisfy the same qualifications as any other board member. However, to meet the intent of the IRS community benefit standard, ensure that the board is composed of a majority of outside, community members, and a minority of “inside” trustees, which would include the CEO, other employees, and physicians on the active staff.
5. Take this opportunity to rethink the appropriate degree of physician participation on the board, the method of selecting physician members, and the criteria for choosing physician board members. For example, some hospitals that have barred employed physicians from serving on the board now employ a growing portion of their medical staffs. They find themselves in the anomalous situation that while private practitioners may serve on the board, employed physicians—arguably the most aligned physicians in the organization—may not. Physician involvement in governance is a larger topic than independence, and we’ll explore this issue in an upcoming Advisors’ Corner.