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DIRECTOR INDEPENDENCE IN THE INDEPENDENT SECTOR

*Dana Brakman Reiser**

INTRODUCTION

In the for-profit sector, solid corporate governance has come to be marked by the existence of independent directors.[1] Corporate boards are urged, if not mandated, to compose themselves with a majority of independent directors.[2] Further, these independent directors should be used to staff committees with important monitoring and gatekeeping roles. In particular, independent directors should make up the ranks of audit,[3]

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1. *See* Bus. Roundtable, Principles of Corporate Governance 14 (2005), *available at* http://64.203.97.43/pdf/CorporateGovPrinciples.pdf (stating that public corporations should have substantial independent majorities because "[p]roviding objective independent judgment is at the core of the board's oversight function"); Cal. Pub. Employees' Ret. Sys., Core Principles of Accountable Corporate Governance 8 (2007), *available at* http://www.calpers-governance.org/principles/domestic/us/downloads/us-corpgov-principles.pdf (describing independence as "the cornerstone of accountability"); TIAA-CREF, Policy Statement on Corporate Governance 7 (2007), *available at* http://www.tiaacref.org/pubs/pdf/governance_policy.pdf ("Director independence is a principle long advocated by TIAA-CREF that is now widely accepted as the keystone of good corporate governance."); E. Norman Veasey, *An Economic Rationale for Judicial Decisionmaking in Corporate Law*, 53 Bus. Law. 681, 687 (1998) ("Perhaps the most effective stockholder protection device is the independence of directors.").

2. *See, e.g.*, Am. Stock Exch., Company Guide § 802(a), http://wallstreet.cch.com/AMEXtools/PlatformViewer.asp?SelectedNode=chp_1_1_8&manual=/AMEX/CompanyGuide/amex-company-guide/ (last visited Oct. 2, 2007); NASDAQ, Marketplace Rule 4350(c), http://www.complinet.com/nasdaq/display/display.html?rbid=1705&element_id=1014 (last visited Oct. 2, 2007) (similarly requiring an independent board majority); NYSE Euronext, Listed Company Manual § 303A.01, http://www.nyse.com/Frameset.html?nyseref=http%3A//www.nyse.com/regulation/listed/1182508124422.html&displayPage=/lcm/lcm_section.html (last visited Oct. 2, 2007) (requiring "a majority of independent directors").

3. *See* Sarbanes-Oxley Act of 2002, § 301, 15 U.S.C. § 78j–1(m)(3) (Supp. IV 2004) (requiring independence for all members of audit committees of issuers under the Securities Exchange Act); Rules and Regulations Under the Securities Exchange Act of 1934, 17

compensation,[4] and nominating committees.[5] Independent director requirements have been widely adopted by regulators, self-regulating organizations, and individual corporations as a primary method for preventing failures due to malfeasance or negligence of corporate decision-makers.[6] While only the future can determine whether independent director reforms will be successful in reforming the companies they target, the success of these reforms in being adopted cannot be questioned.

With this dynamic established, it is not hard to imagine state or federal regulators applying the independent director concept to cure perceived accountability and other failures in nonprofit organizations. Indeed, a few such calls have already been made. Federal proposals to improve nonprofit governance floated in recent years would require nonprofit boards to contain independent majorities.[7] This concept is not entirely novel, as independence requirements have been on the books in a few states for several years.[8] Further, legislation recently passed to improve nonprofit

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C.F.R. § 240.10A-3(b) (2006) (requiring exchanges to adopt listing standards mandating audit committee independence); Am. Stock Exch., *supra* note 2, § 803(a) (requiring listed companies to have wholly independent audit committees); NASDAQ, *supra* note 2, at 4350(d)(2) (similar); NYSE Euronext, *supra* note 2, § 303A.06–07 (similar).

4. *See* Am. Stock Exch., *supra* note 2, § 805 (requiring an optional compensation committee to be independent; otherwise, compensation is determined by "a majority of the independent directors"); NASDAQ, *supra* note 2, at 4350(c)(3)(A)(i)–(ii) (requiring chief executive officer compensation to be determined by "a majority of the independent directors, or . . . a compensation committee comprised solely of independent directors"); NYSE Euronext, *supra* note 2, § 303A.05 (requiring entire compensation committee to be independent).

5. *See* Am. Stock Exch., *supra* note 2, § 804 (generally requiring director nominations to be made "by either a Nominating Committee comprised solely of independent directors or by a majority of the independent directors"); NASDAQ, *supra* note 2, at 4350(c)(4) (requiring nomination of directors by either a wholly independent committee or "a majority of the independent directors"); NYSE Euronext, *supra* note 2, § 303A.04 (requiring "nominating/corporate governance committee composed entirely of independent directors"); *see also* NASDAQ, IM-4350-4 Board Independence and Independent Committees, http://www.complinet.com/nasdaq/display/display.html?rbid=1705&element_id=1019 (last visited Oct. 2, 2007) (offering additional guidance on independent board composition and committee credentialing requirements).

6. *See* Cal. Pub. Employees' Ret. Sys., *supra* note 1, at 8 (recommending majority independent boards and encouraging "substantial majorit[ies] of independent directors" (footnote omitted)); Council of Inst. Investors, Corporate Governance Policies 2 (2007), *available at* http://www.cii.org/policies/Current%20CII%20Corporate%20Governance%20Policies%2003-20-07.pdf; TIAA-CREF, *supra* note 1, at 7–8, 12–16 (promulgating policy that substantial board majorities should be independent, and audit, compensation, and nominating committees should be composed of independent directors); Gen. Motors Corp., Bylaws arts. 2.11, 3.2, 3.4–.8 (2007), *available at* http://www.gm.com/corporate/investor_information/docs/corp_gov/bylaws.pdf (requiring a majority of independent directors for the board and requiring independent directors to compose investment funds, audit, executive compensation, public policy, and corporate governance committees); *supra* notes 2–5; *see also* GM Board of Dirs., Corporate Governance Guidelines (Index) 4 (2007), *available at* http://www.gm.com/corporate/investor_information/docs/corp_gov/cg_guidelines.pdf (discussing, in a set of governance guidelines, the need for a "substantial majority of independent Directors").

7. *See infra* Part I.A.

8. *See infra* Part I.A.

accountability in California mandates that independent directors staff audit committees, and legislative proposals in other states have included similar requirements.[9] With the persistent focus on nonprofit governance, independence requirements will no doubt continue to be proposed and considered.

The adaptation of independent director reforms to the nonprofit sector, however, raises important questions regarding the useful meaning of "independence" in the context of nonprofit directors. Independent director reforms in the for-profit sector seek to counterbalance many concerns, including financial integrity, failures of objectivity, and domination. Each of these concerns arise in the nonprofit sphere, but they have somewhat different dimensions there than in its for-profit counterpart. Moreover, even if the concerns were precisely the same, it is unclear how to define independence in a nonprofit—an organization with multiple legitimate stakeholders, none having comprehensive primacy.[10]

This essay explores how a notion of independence would deal with these concerns in the particular context of nonprofit corporations.[11] Part I begins by describing in more detail the independence requirements mentioned above. With the objects of the analysis thus set, Part II examines the core purposes of independence requirements and considers the extent to which these concerns are important in nonprofit governance.

Finding they are important, Part III then moves to the crucial definitional question: how can a notion of an independent nonprofit director be given meaningful content? This part reviews six types of relationships that might be addressed in crafting a definition of independence for nonprofit directors. Its analysis demonstrates that each of these relationships presents a dilemma for nonprofit governance reformers. Defining independence to exclude each of these relationships would seem to serve the more specific goals of independence requirements. Yet, often, doing so also could hamper the broader goals of improving nonprofit governance and strengthening the nonprofit sector. With these issues thus delineated, Part IV offers advice on crafting limited independent director requirements as

9. *See infra* Part I.B.

10. *See* James J. Fishman & Stephen Schwarz, Nonprofit Organizations 141 (3d ed. 2006) (stating that nonprofit directors "must be responsive to several constituencies: the one that elected or appointed them, the constituency the organization serves, and the constituency of legal accountability" (citing ABA Section of Bus. Law, Guidebook for Directors of Nonprofit Corporations 8–10 (George W. Overton & Jeannie Carmadelle Frey eds., 2d ed. 2002))); Evelyn Brody, *Accountability and Public Trust*, *in* The State of Nonprofit America 471, 472 (Lester Salamon ed., 2002) (noting the challenge of accountability in nonprofits, which depends on "trust involv[ing] multiple—sometimes conflicting—demands from a variety of stakeholders").

11. Although a nonprofit organization may take the legal form of a charitable trust or an unincorporated association, most U.S. nonprofits are formed as nonprofit corporations. *See* Marilyn E. Phelan, Nonprofit Enterprises: Corporations, Trusts, and Associations § 1:03 (2000). Independence requirements, and this essay, are addressed only to nonprofits legally constructed as corporations.

part of an array of reforms that might advance nonprofit governance, and Part V briefly concludes.

I. PROPOSED INDEPENDENT DIRECTOR REFORMS

A diverse group of nonprofit independent director requirements are currently in force, more are under consideration, and still more might be reasonably contemplated. This part divides this universe of potential reforms into two categories: board composition rules, which demand that a certain percentage of a nonprofit's board members qualify as independent, and committee credentialing requirements, which mandate independent credentials for some or all members of key nonprofit board committees. In explaining these categories, it also introduces the principal jurisdictions, regulators, and self-regulatory bodies that have adopted and advocated such reforms.

A. *Board Composition Rules*

Board composition rules require that a percentage (typically a majority) of nonprofit boards be comprised of independent directors. These rules are not entirely unique to the current post–Sarbanes-Oxley nonprofit reform environment. Independent majority requirements have been in existence in a handful of states for several years[12] and in California since 1980.[13] An optional provision in the 1987 Revised Model Nonprofit Corporation Act required that public benefit nonprofits compose their boards with no more than forty-nine percent of members being "financially interested."[14] Indeed, language from this optional provision appears to have been used to form the board composition requirements in Maine, North Dakota, and

12. *See, e.g.*, Me. Rev. Stat. Ann. tit. 13-B, § 713-A(2) (2005) (adopted 2001, effective 2003) (limiting "financially interested persons" to forty-nine percent of the board of a public benefit corporation); N.H. Rev. Stat. Ann. § 292:6-a (1999) (adopted and effective 1996) (mandating that the boards of each charitable nonprofit must "have at least 5 voting members, who are not of the same immediate family or related by blood or marriage"); N.D. Cent. Code § 10-33-27(2) (2005) (adopted and effective 1997) (limiting "financially interested individuals" to forty-nine percent of the board); Vt. Stat. Ann. tit. 11B, § 8.13(a) (1997) (providing that "no more than 49 percent of the individuals serving on the board of any public benefit corporation may be financially interested persons").

13. *See* Cal. Corp. Code § 5227(a) (West 2006) (adopted 1978, effective 1980) (limiting "interested persons" to forty-nine percent of the board of a public benefit corporation).

14. *See* Revised Model Nonprofit Corp. Act § 8.13 (1987). Interest in such a provision, however, was always lukewarm and may now be completely absent. A comment to the optional section stated the worries of "many members" of the drafting committee, including that "[l]egitimate public benefit corporations might have difficulty in finding active and competent directors who had no financial interest in the corporation." *Id.* § 8.13 official cmt. The current drafting process to revise the Act includes no language on independent board composition—whether mandatory or optional. Revised Model Nonprofit Corp. Act ch. 8 (Exposure Draft 2007) (on file with author) (including no such section).

Vermont.[15] Yet to date there has not been widespread adoption of these requirements at the state level.

In the current thrust for more accountability from nonprofit directors, board composition proposals have resurfaced—particularly on the federal level. The initial proposals by the Senate Finance Committee staff in its June 2004 Discussion Draft addressed independence on several levels.[16] One proposal would have permitted nonprofits to have only a single board member who is compensated by the nonprofit and could not serve as board chair or treasurer.[17] Another would have required public charities to have at least twenty percent of their directors be independent, with a minimum of one member, and contemplated higher independence minima in certain circumstances.[18] "An independent member would be defined as free of any relationship with the corporation or its management that may impair or appear to impair the director's ability to make independent judgments."[19]

Although the board composition requirement advocated by the Discussion Draft has not yet been adopted, the federal Pension Reform Act of 2006 did require tax-exempt credit counseling agencies to establish "non-financially interested" board contingents.[20] Its mandate operates on two tiers:

> [N]ot more than 20 percent of the voting power . . . [may be] vested in persons who are employed by the organization or who will benefit financially, directly or indirectly, from the organization's activities (other

15. *Compare* Revised Model Nonprofit Corp. Act § 8.13 (1987), *with* Me. Rev. Stat. Ann. tit. 13-B, § 713-A(2), N.D. Cent. Code § 10-33-27(2), *and* Vt. Stat. Ann. tit. 11B, § 8.13(a). The California requirement uses similar language, but predates the Revised Model Nonprofit Corporation Act (RMNCA). As the California nonprofit corporation statute was the source of some of the RMNCA's core content, perhaps the RMNCA requirement was derived from California's preexisting language. *See* Michael C. Hone, *Aristotle and Lyndon Baines Johnson: Thirteen Ways of Looking at Blackbirds and Nonprofit Corporations—The American Bar Association's Revised Model Nonprofit Corporation Act*, 39 Case W. Res. L. Rev. 751, 758 (1989) (describing the California nonprofit corporation statute as serving as "a beta site for the American Bar Association's Revised Model Nonprofit Act").

16. *See* Staff of S. Fin. Comm., 108th Cong., Staff Discussion Draft 13 (2004), *available at* http://finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf. This Discussion Draft consisted of nineteen pages of proposed reforms to improve the governance and functioning of tax-exempt nonprofits and touched off a firestorm of hearings, reform proposals, and the convening of the Panel on the Nonprofit Sector. *See Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities: Hearing Before the Subcomm. on Finance of the S. Comm. on Finance*, 108th Cong. (2004) [hereinafter *Charity Oversight and Reform*]; Letter from Sen. Chuck Grassley, Chairman of the S. Fin. Comm., & Sen. Max Baucus, Chairman and Ranking Member of the S. Fin. Comm., to Diana Aviv, President and CEO of Indep. Sector (Sept. 22, 2004), *available at* http://www.nonprofitpanel.org/about/SFCltr.pdf. For more information on the Nonprofit Panel, see *infra* text accompanying notes 28–33.

17. *See* Staff of S. Fin. Comm., 108th Cong., *supra* note 16, at 13. A recent report recommending governance changes at the American Red Cross advocates adoption of a similar standard. *See* Am. Red Cross Bd. of Governors, American Red Cross: Governance for the 21st Century 55 (2006), *available at* http://www.redcross.org/static/file_cont5765_lang0_2202.pdf.

18. *See* Staff of S. Fin. Comm., 108th Cong., *supra* note 16, at 13.

19. *Id.*

20. *See* Pension Protection Act of 2006, § 1220(a), I.R.C. 501(q)(1)(D) (West 2007).

> than through the receipt of reasonable directors' fees or the repayment of consumer debt to creditors other than the credit counseling organization or its affiliates), and
>
> ... not more than 49 percent of the voting power of which [may be] vested in persons who are employed by the organization or who will benefit financially, directly or indirectly, from the organization's activities (other than through the receipt of reasonable directors' fees).[21]

The credit counseling industry has been under recent scrutiny by the Internal Revenue Service (IRS) due to concerns about self-dealing and other abuse issues,[22] and the new governance rules mandated for them appear to indicate the direction at least some legislators would like to pursue for more general tax-exempt governance reform.[23] Other federal agencies and programs likewise have proposed or adopted board composition rules emphasizing independent majorities, including proposed governance standards for entities participating in the AbilityOne program[24] and the Department of the Treasury's anti-terror financing guidelines.[25] Although

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21. *Id.* § 1220(a), I.R.C. 501(q)(1)(D)(ii)–(iii) (West 2007).

22. *See* IRS, Credit Counseling Compliance Project (2006), *available at* http://www.irs.gov/pub/irs-tege/cc_report.pdf; IRS, Executive Summary, Credit Counseling Compliance Project (2006), *available at* http://www.irs.gov/pub/irs-tege/cc_executive_summary.pdf; *see also* Jennifer Bayot, *Senate Panel Seeks to Hasten Inquiries of Credit Counselors*, N.Y. Times, Mar. 25, 2004, at C2 (reporting the Senate Finance Committee's interest in the area); *IRS Ends Exempt Status for Some Credit Counselors*, N.Y. Times, May 16, 2006, at C6 (describing the results of this scrutiny).

23. *See* J. Comm. on Taxation, Technical Explanation of H.R. 4, The "Pension Protection Act of 2006," as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006, at 318 n.435 (2006), *available at* http://www.dol.gov/ebsa/pdf/x-38-06.pdf (noting that inclusion of provisions addressing governance of credit counseling agencies, including the independent board provision, "affirms the importance of these core issues to the matter of tax exemption, both to credit counseling organizations and to other types of exempt organizations").

24. *See* Comm. for Purchase from People Who Are Blind or Severely Disabled: Nonprofit Agency Governance and Executive Compensation, 70 Fed. Reg. 74,721, 74,722 (Dec. 16, 2005) (codified at 41 C.F.R. pts. 51-2, 51-3, 51-4) (identifying boards with "no fewer than five unrelated directors" as a best practice and suggesting that it may adopt this practice as a requirement for its participating nonprofit agencies). AbilityOne, formerly known as the Javits-Wagner-O'Day program, provides opportunities for the blind and disabled to work in industry, manufacturing products for use by the federal government. *See* Comm. for Purchase from People Who Are Blind or Severely Disabled, About Us, http://www.abilityone.gov/jwod/about_us/about_us.html (last visited Oct. 2, 2007).

25. *See* U.S. Dep't of the Treasury, Anti-terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities 4–5 (2006), *available at* http://www.treasury.gov/offices/enforcement/key-issues/protecting/docs/guidelines_charities.pdf (emphasizing the importance of independent oversight for charities, and noting that board members "ordinarily should not have an active role in the day-to-day management of the charitable organization"). Interestingly, although the Internal Revenue Service (IRS) has recently seen fit to offer its pronouncements on "good governance practices" for organizations that receive tax-exemption under I.R.C. § 501(c)(3), its recommendations for boards do not address independence. *See* IRS, Draft: Good Governance Practices for 501(c)(3) Organizations (n.d.), *available at* http://www.irs.gov/pub/irs-tege/good_governance_practices.pdf.

not imposing a board composition requirement, the newly revised draft of the Form 990, the main informational return filed by tax-exempt nonprofits, twice asks each reporting entity to disclose the number of independent members of its governing body.[26] As such, independent board composition appears to have continuing salience for federal legislators and regulators.

Self-regulation proponents also have seized on board composition requirements as key to improving nonprofit governance. The release of the Senate Finance Committee's Staff Discussion Draft was followed by a series of hearings and other meetings on reforming federal law relating to nonprofits.[27] Shortly after these events, the committee's chairman and ranking member asked Independent Sector "to convene an independent national panel on the non-profit sector to consider and recommend actions that will strengthen good governance, ethical conduct and effective practice of public charities and private foundations."[28] Independent Sector complied by establishing the Panel on the Nonprofit Sector, which over the next eighteen months released a series of reports recommending governance and other reforms for tax-exempt nonprofits.[29] The Nonprofit Panel's final

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26. I.R.S. Draft Form 990, Return of Organization Exempt from Income Tax (OMB No. 1545-0047) pt. I questions 3 & 4, pt. III questions 1a & 1b (2007), *available at* http://www.irs.gov/pub/irs-tege/form990coreform.pdf. The proposed glossary of terms defines "independent member of a governing body" as

> [a] person: [w]ho is not compensated as an employee of the organization; [w]ho does not receive compensation or other payments from the organization as an independent contractor (other than reimbursement of expenses or reasonable compensation for services provided in the capacity of serving as a member of the governing body); [w]ho does not receive, directly or indirectly, material financial benefits from the organization except, if applicable, as a member of the charitable class served by the organization; and [w]ho is not a spouse, sibling, parent, or child of any individual who is employed by, or receives compensation or other material benefits from, the organization.

IRS, Tax-Exempt & Government Entities Div., Office of Exempt Orgs., Draft Form 990 Redesign—Glossary 6 (2007) (emphasis omitted), *available at* http://www.irs.gov/pub/irs-tege/draftform990redesignglossary.pdf (citing Treas. Reg. 53.4958-6(c)(1)(iii) (2006)) (noting that the definition was adapted from the Panel on the Nonprofit Sector Revised Principles—Draft for Public Comment 13 (n.d)). Although the IRS has announced it will further revise the current draft, it has reiterated its commitment to retaining governance questions on the new Form 990. *See* Grant Williams, *Governance Is Key Issue in Regulating Charities, IRS Official Tells State Leaders*, Chron. of Philanthropy, Oct. 16, 2007, http://philanthropy.com/news/updates/3255/governance-is-key-issue-in-regulating-charities-irs-official-tells-state-leaders.

27. *See supra* note 16.

28. Letter from Sen. Chuck Grassley & Sen. Max Baucus, *supra* note 16.

29. *See* Letter from Diana Aviv, President and CEO of Indep. Sector, to Sen. Chuck Grassley, Chairman of the S. Fin. Comm., & Sen. Max Baucus, Chairman and Ranking Member of the S. Fin. Comm. (Oct. 12, 2004), http://www.nonprofitpanel.org/about/acceptance_html.html; *see also* Panel on the Nonprofit Sector, Interim Report Presented to the Senate Finance Committee (2005), *available at* http://www.nonprofitpanel.org/interim/PanelReport.pdf; Panel on the Nonprofit Sector, Strengthening Transparency, Governance, and Accountability of Charitable Organizations: A Final Report to Congress and the Nonprofit Sector (2005) [hereinafter Panel on the Nonprofit Sector, Final Report], *available at* http://www.nonprofitpanel.org/final/Panel_Final_Report.pdf; Panel on the Nonprofit Sector, Strengthening Transparency Governance Accountability of Charitable Organizations: A

report included a recommendation that Congress should direct amendments to treasury regulations to require at least one-third of the members of boards of tax-exempt public charities to be independent.[30] The definition of independence the Nonprofit Panel employed would deem independent

> individuals (1) who have not been compensated by the organization within the past twelve months, including full-time and part-time compensation as an employee or as an independent contractor, except for reasonable compensation for board service; (2) whose own compensation, except for board service, is not determined by individuals who are compensated by the organization; (3) who do not receive, directly or indirectly, material financial benefits (i.e., service contracts, grants, or other payments) from the organization except as a member of the charitable class served by the organization; and (4) who are not related to (as a spouse, sibling, parent, or child) any individual described above.[31]

In addition to its recommendations to Congress, the Nonprofit Panel created an advisory committee to study self-regulation and released a report of the Principles for Good Governance and Ethical Practice in October 2007.[32] These Principles also prominently include a commitment to independent boards, recommending a supermajority in most cases.[33]

Support for independence requirements can also be found in the American Law Institute's draft Principles of the Law of Nonprofit Organizations. Although it eschews a broad-reaching concept of independence for nonprofit directors,[34] the draft encourages board majorities that are separate from management. Directors composing this majority would not be "compensated by or otherwise obtain[] a direct financial benefit from the charity other than as . . . board member[s]."[35] In

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Supplement to the Final Report to Congress and the Nonprofit Sector (2006), *available at* http://www.nonprofitpanel.org/supplement/Panel_Supplement_Final.pdf. In addition to offering downloads of its three major reports, the Nonprofit Panel describes much of its work on its web site, www.nonprofitpanel.org.

30. *See* Panel on the Nonprofit Sector, Final Report, *supra* note 29, at 75.

31. *Id.*

32. *See* Panel on the Nonprofit Sector, Principles for Good Governance and Effective Practice: A Guide for Charities and Foundations (2007), *available at* http://www.nonprofitpanel.org/selfreg/Principles_Guide.pdf. For a critique of earlier drafts of the Principles, including criticism of the lack of definition of "self-regulation" and their one-size-fits-all approach, see Adam Meyerson, The Philanthropy Roundtable, An Open Letter to Independent Sector on Its Draft Principles of Self-Regulation (2007), *available at* http://www.acreform.com/legislative/2007/comments/documents/an-open-letter.pdf.

33. *See* Panel on the Nonprofit Sector, *supra* note 32, at 15 (recommending that a "substantial majority of the board of a public charity . . . should be independent" and defining "substantial" generally to mean at least two-thirds).

34. *See* Principles of the Law of Nonprofit Orgs. § 310(c)(2), at 66 (Tentative Draft No. 1, 2007) (explaining that a concept of "external board-member independence—is not required and indeed might constitute lack of accountability to key constituents of the charity"); *see also* Evelyn Brody, *The Board of Nonprofit Organizations: Puzzling Through the Gaps Between Law and Practice*, 76 Fordham L. Rev. 521, 525–26 (2007). In her essay, Professor Evelyn Brody, reporter for the ALI project, expands on this issue. *Id.*

35. Principles of the Law of Nonprofit Orgs. § 310(c)(3), at 67 (Tentative Draft No. 1, 2007).

sum, board composition requirements have become a mainstay of private recommendations on best practices for nonprofit organizational governance.

B. *Committee Credentialing Requirements*

In addition to proposals demanding or recommending independent board majorities, proposals have been raised to address the independent credentials of nonprofit board committee members. These proposals typically speak to audit committees, and require them to be staffed by independent directors.[36] The California Nonprofit Integrity Act,[37] adopted in 2004, requires nonprofit corporations that receive $2 million or more in annual gross revenues to prepare annual, independently audited, financial statements and to establish audit committees to review and oversee the audit process.[38] Audit committee members are subject to various credentialing requirements; although they need not be board members, they may not be staff members, may not receive any compensation from the organization (other than for board service generally), and may not have "a material financial interest in an entity doing business with" the organization.[39] A recent Hawaii proposal includes similar audit committee independence requirements,[40] as did some versions of nonprofit governance reform proposals put forward in New York[41] and Massachusetts.[42]

36. *See* Ellen P. Aprill, *What Critiques of Sarbanes-Oxley Can Teach About Regulation of Nonprofit Governance*, 76 Fordham L. Rev. 765, 771–73 (2007). Professor Aprill describes and critiques the fact that "[n]onprofit adaptations of [Sarbanes-Oxley's] audit committee requirements . . . largely accept the independence mandate." *Id.* at 771. Advocates and individual organizations have also suggested staffing compensation and nominating committees solely with independent directors. *See* ABA Coordinating Comm. on Nonprofit Governance, Guide to Nonprofit Corporate Governance in the Wake of Sarbanes-Oxley 34–37 (2005) (advocating that nonprofit compensation and nominating committees should be staffed entirely by independent directors); Judith A. Cion, *The Role of the Nominating or Governance Committee of a Nonprofit*, *in* Nonprofit Governance and Management 179, 180 (Victor Futter et al. eds., 2002) ("The nonprofit nominating committee, like a corporate nominating committee, should consist entirely of outside directors."); *see also* Am. Red Cross Bd. of Governors, *supra* note 17, at 61, 86 (recommending all-independent nominating and compensation committees for the American Red Cross and citing these sources in support of the former recommendation).

37. Nonprofit Integrity Act, 2004 Cal. Stat. ch. 919 (as signed by governor Sept. 29, 2004), *available at* http://www.leginfo.ca.gov/pub/03-04/bill/sen/sb_1251-1300/sb_1262_bill_20040930_chaptered.pdf.

38. *See* Cal. Gov't Code § 12586(e)(2) (West 2005).

39. *Id.* The statute also places limitations on overlap of membership among audit and finance committees. *See id.*

40. S.B. 73, 24th Leg., Reg. Sess. § 2 (Haw. 2007) (requiring an independent audit committee in those nonprofit corporations required to file audits with the state and in those of a certain financial size).

41. *See* N.Y. Legislative Bill Drafting Comm'n, Program Bill No. 68–05 § 3 (2005) (amending N.Y. Not-for-Profit Corp. Law § 712(g)(3)(B)), *available at* http://www.oag.state.ny.us/charities/char_pdf/ag68-05.pdf (mandating that nonprofit corporations who have financial statements audited by a public accountant and those of a certain financial magnitude establish audit committees, each member of which must have independent credentials).

The Nonprofit Panel's Principles for Good Governance and Ethical Practice also recommend that nonprofit boards consider independence requirements for audit committee members.[43] This suggestion appears in the Nonprofit Panel's rationale for its principle on financial record keeping, review and auditing, and notes the value of an independent audit committee in "reducing possible conflicts."[44] As nonbinding "principles" for "good governance and ethical practice," these proposals are not intended to be adopted as government mandates.[45] However, they demonstrate the broad appeal of independence requirements to those seeking to improve nonprofit governance, whether by government regulation or sector-initiated recommendations of best practices.

Credentialing rules requiring independent audit committees obviously have more limited scope than general board composition requirements, but they nonetheless raise important practical and theoretical issues. Staffing the audit committees of nonprofits is often quite challenging, as their role can be difficult.[46] Volunteers without relevant financial experience[47] may

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42. *See* Press Release, Office of Mass. Att'y Gen. Tom Reilly, AG Reilly Introduces Charities Legislation to Promote Financial Discipline, Protect Against Mismanagement and Overcompensation § 3 (May 1, 2005), *available at* http://www.nerche.org/Reilly_Press_Release___Charities_Act_6-06.pdf (proposing a statute, Mass. Gen. Laws ch. 12, § 8O, to require public charities of a certain financial magnitude to establish an audit committee of independent members).

43. *See* Panel on the Nonprofit Sector, *supra* note 32, at 20 (recommending such organizations "should consider establishing an audit committee composed of independent board members with appropriate financial expertise").

44. *See id.* The Senate Finance Committee Staff Discussion Draft did not address audit committee credentials, but indicated that audit review should be performed by the entire board. Staff of S. Fin. Comm., 108th Cong., *supra* note 16, at 11–12. The independent board composition rules discussed earlier, *supra* text accompanying notes 27–33, would thus apply to these individuals.

45. *See* Panel on the Nonprofit Sector, *supra* note 32, at 2–6; *see also* Diana Aviv, *Shared Principles: Drafting Standards for Ethical, Effective Management*, Nonprofit Times, Mar. 15, 2007, at 12 (describing the idea behind the Panel on the Nonprofit Sector's principles of effective practice as a complement to improved government regulation and enforcement).

46. *See* Wendy K. Szymanski, *An Allegory of Good (and Bad) Governance: Applying the Sarbanes-Oxley Act to Nonprofit Organizations*, 2003 Utah L. Rev. 1303, 1316 (addressing "the difficulty many nonprofits encounter when searching for qualified directors and board members").

47. Another related, but distinct, reform idea has been to propose that audit committee or board members should be financially literate. *See, e.g.*, S.B. 73, 24th Leg., Reg. Sess., § 2 (Haw. 2007), *available at* http://capitol.hawaii.gov/sessioncurrent/bills/SB73_.htm (proposing a statute, Haw. Rev. Stat. § 414(D)(d), to require at least one audit committee member to have financial experience sufficient to evaluate the organization's financial statements and the competency of auditors); Panel on the Nonprofit Sector, Final Report, *supra* note 29, at 79 (explaining that charitable organizations should have board members with financial literacy in order to be able to perform audit oversight, or should establish a non-board, non-staff audit committee to assist the board in this role). This issue is, of course, linked to concerns about job performance by these fiduciaries and thus has some policy content in common with the independence requirements addressed by this essay. Still, the proposals are distinct and the balance of the essay will put financial literacy proposals aside.

shy away from mastering the complexities of monitoring an audit, favoring other committee assignments.[48] Some of those with relevant financial expertise may be unwilling to serve because they would like to leave their work *at work*. Others will be unable to serve, at least as independent audit committee members, due to a professional relationship with the nonprofit. Those candidates remaining will be in ever shorter supply.[49] Thus, the practical impact of adding an independence requirement for audit committee members may be to increase the difficulty of filling these important positions.

Committee credentialing requirements demanding independence also expose the theory that stands behind the independent director idea and ideal. Independent audit committee requirements reveal the concern that "independent" eyes, ears, and voices are needed in order to appropriately vet the financial operations of nonprofits, as a key to avoiding misconduct and scandal. For this reason, these requirements have been an integral part of the general advocacy around requiring nonprofit audits and audit committees.[50] These reforms embrace the idea that independent credentials for nonprofit audit committee members are central to a functioning audit process.[51]

Although board composition and committee credentialing requirements are distinct types of reforms, the balance of this essay will consider them together. Both reform categories stem from a belief that independence will allow directors and committee members to perform similar functions. Both rely upon independence as a proxy for other, more difficult to measure, qualities that will benefit nonprofit boards or committees. And, both are in play—separately and together—as important ideas in the current discussion on reforming nonprofit governance. The next part will consider why independence is viewed as likely to enhance fiduciaries' ability to pursue their important roles.

II. THE PURPOSES OF DIRECTOR INDEPENDENCE REQUIREMENTS

To understand how independence reforms might perform in the nonprofit sector, it is best to start by considering the impetus behind independence

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48. *See* Lumen N. Mulligan, *What's Good for the Goose Is Not Good for the Gander: Sarbanes-Oxley-Style Nonprofit Reforms*, 105 Mich. L. Rev. 1981, 2008–09 (2007) (discussing the unique challenges posed to directors asked to comprehend nonprofit accounting); Szymanski, *supra* note 46, at 1316 (noting the increasing difficulty of the tasks of nonprofit directors).

49. *Cf.* Usha Rodrigues, *The Fetishization of Independence* 16 (Univ. of Ga. Sch. of Law Research Paper Series, Paper No. 07-007, 2007), *available at* http://ssrn.com/abstract=968513 (reporting in the for-profit sector "anecdotal evidence suggest[ing] that the heavy demands placed on independent directors and the concomitant threat of increased liability discourage people from agreeing to serve, thus creating a scarcity of well-qualified independent candidates").

50. *See* Dana Brakman Reiser, *There Ought to Be a Law: The Disclosure Focus of Recent Legislative Proposals for Nonprofit Reform*, 80 Chi.-Kent L. Rev. 559, 595 (2005).

51. *See id.*

requirements and whether these goals resonate in the nonprofit context. Independence requirements seek to improve fiduciaries' and boards' abilities to fulfill their roles by three main routes. First, independent directors might be used to address concerns about directorial and managerial integrity, particularly self-dealing issues.[52] Second, independent directors might improve efficiency, by adding a voice to the boardroom from outside the tunnel vision of those within it or otherwise closely related to the organization.[53] Third, independent directors might be seen as less subject to potentially damaging domination by a powerful executive or other influential board member.[54] The independent director concept has been the object of much criticism,[55] but the independent director idea and its purposes remain relevant as policy proscriptions

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52. *See* Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 Harv. L. Rev. 597, 607–09 (1982) (evaluating, in a pathbreaking article on the subject of independent directors, the role of these actors in monitoring the integrity of management); Donald C. Clarke, *Three Concepts of the Independent Director*, 32 Del. J. Corp. L. 73, 80 (2007) ("[O]ne role for NMDs [non-management directors] is as a monitor of related-party transactions, in which there can be a conflict of interest."); Note, *Beyond "Independent" Directors: A Functional Approach to Board Independence*, 119 Harv. L. Rev. 1553, 1561 (2006) ("More narrowly conceived, independence represents a form of insurance against managerial self-dealing.").

53. *See* Brudney, *supra* note 52, at 607–09 (suggesting, and then criticizing, independent directors' ability to improve a corporation's efficiency by providing an outsider's point of view); Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 Geo. L.J. 797, 798 (2001) ("'Independence' is a subjective concept that connotes a willingness to bring a high degree of rigor and skeptical objectivity to the evaluation of company management and its plans and proposals."); Note, *supra* note 52, at 1557–60 (describing views of independent directors as "objective monitors" or "unaffiliated professionals").

54. *See* Barry D. Baysinger & Henry N. Butler, *Revolution Versus Evolution in Corporation Law: The ALI's Project and the Independent Director*, 52 Geo. Wash. L. Rev. 557, 563–64 (1984); Clarke, *supra* note 52, at 81 ("In the United States, the NMD has traditionally been seen as the solution to the problem of managerial domination of the board."); Note, *supra* note 52, at 1556 (noting the role of the independent directors in avoiding managerial domination (citing and referring to the review of managerial domination concerns in Delaware special litigation committee decisions by Joshua L. Vineyard, Comment, *The More Things Change, the More They Stay the Same? Twenty Years of Corporate Board Domination and the Aronson v. Lewis Standard*, 72 U. Cin. L. Rev. 1067 (2004))).

At one time, independent directors were even considered as possible advocates for corporate social responsibility. *See* Brudney, *supra* note 52, at 639–58. In today's account of independent directors, this role is largely absent, perhaps due to the ascendancy of the shareholder-primacy paradigm.

55. The two major studies of independent directors' impact on firm value have reached inconsistent results and spawned some controversy over their accuracy. *See* Sanjai Bhagat & Bernard Black, *The Non-correlation Between Board Independence and Long-Term Firm Performance*, 27 J. Corp. L. 231 (2002); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 Yale L.J. 1521, 1529–33 (2005) (discussing the ineffectiveness of the independent director requirement for audit committees); Kathleen M. Boozang, Does an Independent Board Improve Nonprofit Corporate Governance? 16–17 (July 2007) (unpublished manuscript, Seton Hall Univ. Sch. of Law, Legal Studies Research Paper Series), *available at* http://ssrn.com/abstract=1002421 (canvassing the surveys and the controversy surrounding them); *see also* Clarke, *supra* note 52, at 75–77 (discussing similarly inconclusive results).

favoring nonprofit independent director requirements mount.[56] Thus, this part will elaborate somewhat further the features of these three main areas of concern and relate how independence requirements have thus far been drawn to address them.

A. *Integrity Concerns and Financial Interest*

Limiting breaches of integrity is one goal to which director independence requirements address themselves.[57] Of course, any fiduciary can face moments when her personal interests come into conflict (or possible conflict) with the interests of the organization she serves. The integrity goal of independent director requirements, however, posits that independent directors might well have fewer of these conflicts as a class, owing to the lack of ties to the organization that brands them as independent in the first place.[58] As such, independent directors also frequently can play an important structural role in managing both consistent and onetime conflicts.[59]

The role of independent directors in dealing with consistent conflicts is most obvious in proposals to require nonprofit audit committees to be staffed by independent directors. In an audit, managers (who may or may not be directors) will have the operations and performance of their organization critiqued by an outside viewer. This is a critique of the organization and of its management. When the outside reviewer (the auditor) submits a report on the organization's operations and performance, managers have a personal interest in supporting the report's positive findings and downplaying its negatives. Thus, an audit committee staffed by independent directors is designed to be able to perform the audit oversight role assigned to it, free of personal conflicts.[60]

In addition to their role in dealing with consistent conflicts of interest like these, independent director requirements are linked to the idea that these directors can often play a useful role in onetime conflict situations. In these situations, such as a transaction between a director and her nonprofit, protection for the transaction is likely available if financially disinterested

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56. *See generally* Michael W. Peregrine & Bernadette M. Broccolo, *"Independence" and the Nonprofit Board: A General Counsel's Guide*, 39 J. Health L. 497 (2006) (reporting and commenting on this trend). *But see* Suzanne Perry, *Key Senator Has No Plans for Legislation to Curb Charitable Abuses*, Chron. of Philanthropy, Aug. 10, 2007, http://philanthropy.com/news/updates/2841/key-senator-has-no-plans-for-legislation-to-curb-charitable-abuses (suggesting that the current chair of the Senate Finance Committee may step away from nonprofit governance reform generally).

57. *See supra* note 52.

58. *See* Note, *supra* note 52, at 1555–56.

59. *See* Brudney, *supra* note 52, at 608–09; Clarke, *supra* note 52, at 80.

60. A similar role for independent directors can be seen in proposals to establish credentialing requirements mandating independence for compensation and other board committees. *See* Peregrine & Broccolo, *supra* note 56, at 513 (addressing the application of independence standards to nonprofit board committees beyond audit, although noting that "[t]he most common application of independence standards is at the audit committee level").

directors review and reasonably approve it after full disclosure.[61] Again owing to their lack of ties to the organization, independent directors will often be members of the financially disinterested group that serves in the review and approval capacity. Maintaining a group of directors able to play this important role is another benefit of requiring a majority, or at least some critical mass, of independent directors.

The credentials of independent directors may lead to fewer situations where their personal interests conflict with that of their organizations. However, this will not necessarily be the case. The concepts of independence and financial disinterestedness are not identical.[62] Independent directors may also be financially interested directors as to a particular transaction. Directors with no contacts or conflicts with the organization at the time of their nominations could become involved in interested transactions during the course of their terms. Moreover, this may happen by design, as when a director is recruited in the hope of securing some product or service for the organization through his contacts in a particular industry. Or such a director might be found to have a unique skill set useful to the organization only long after she joins the board, and the organization would like to approach her to work as a consultant. Future events cannot be planned for comprehensively, and anything can happen.[63] When they do, other directors not financially interested in the transaction in question—whether or not they are "independent" directors in some broader sense—can and should be called on to play the review and approval role necessary to legitimate and shelter the conflicted transaction.

Therefore, while independence reforms and procedures for disinterested review of conflicted transactions can be related, the ideas of independence and disinterest need not entirely overlap. Some director independence proposals would make this overlap more significant and formal, however, by designating as non-independent those directors who have experienced interested transactions in the past. Early proposals limiting audit committee membership to independent directors in New York would have refused independent director status to those who "have participated in any . . . interested party transactions . . . within the previous year."[64] A

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61. *See* Principles of the Law of Nonprofit Orgs., §§ 330, 375 (Tentative Draft No. 1, 2007). The Principles here essentially follow the familiar safe harbor paradigm of corporate law. The more lenient business judgment rule scrutiny will apply to an interested transaction that has received advance approval by disinterested board members, and the burden of proof will rest with the transaction's challenger. Without proper advance approval, interested transactions will be subject to strict fairness review and the burden of proving fairness will lie with the defendant fiduciary.

62. *See id.* § 310 cmt. c(1), at 66 ("The concept of independence overlaps with, but is analytically distinct from, the concept of (usually financial) disinterest."); Peregrine & Broccolo, *supra* note 56, at 501–02 (contrasting independence as a structural question with conflicts of interest, which can occur episodically).

63. The American Red Cross Governance Report offers one method for managing potential changes in independent status: an annual independence questionnaire to be completed by all board members. *See* Am. Red Cross Bd. of Governors, *supra* note 17, at 17.

64. *See* N.Y. Legislative Bill Drafting Comm'n, *supra* note 41, § 3.

Massachusetts proposal, also on audit committee membership, would have placed a permanent ban on independent status for any director who experienced a conflict.[65]

B. *Objectivity Concerns and the Quest for Efficiency*

In addition to avoiding breaches of integrity, independent director requirements arguably can contribute to more efficient direction and management by nonprofit boards.[66] The credentials that mark directors as independent are intended to afford them some greater level of objectivity as to the organization's internal affairs than their non-independent colleagues.[67] They can use this "outsider" perspective to challenge conventional wisdom, ask more probing questions, "think outside the box," and offer the other benefits of objectivity touted by auditors, management consultants, and other professional outsiders.[68] Obtaining a core group of such objective voices on the board is one of the main goals of independent director requirements.

The benefits of this objectivity can extend to all of the jobs that directors are tasked to perform. For example, objectivity will be valuable in carrying out the board's role in hiring and evaluating the performance of its top executives and setting their compensation.[69] When engaging in oversight on audit committees, independent directors will not be saddled with the baggage of working as part of the executive team. Nor, on some definitions

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65. Press Release, Office of Mass. Att'y Gen. Tom Reilly, *supra* note 42 (proposing a statute, Mass. Gen. Laws ch. 12, § 8O(3), to require, in addition to non-compensation (other than for director or audit committee service), that members of the audit committee not "have participated, at any point in the past, in any related party contracts or transactions").

66. *See* ABA Coordinating Comm. on Nonprofit Governance, *supra* note 36, at 23 (emphasizing the importance of "independent and non-management board members . . . to assure the exercise of independent judgment in key committees and general board decision-making"); Panel on the Nonprofit Sector, Final Report, *supra* note 29, at 78 ("[T]he effort to find independent members is important to the long-term success and accountability of the organization . . . .").

67. *See supra* note 53.

68. *See* Bruce F. Dravis, Independent Director's Guidebook 3–4 (2007) (describing observations by commentators that "independent review of key management decisions also may reduce the effect of potentially negative decision-making biases"); *see also* Martin Kihn, *"Outside the Box": The Inside Story*, Fast Company, June 2005, at 40 (describing the clichéd nature of the phrase "outside the box" and its frequent use by consultants).

69. *See* Principles of the Law of Nonprofit Orgs. § 320, at 112 (Tentative Draft No. 1, 2007) (stating that hiring the chief executive and evaluating his or her performance is one of the normal functions of a nonprofit board); Jack B. Siegel, A Desktop Guide for Nonprofit Directors, Officers, and Advisors: Avoiding Trouble While Doing Good § 4.4(a), at 88–89 (2006) (advising nonprofit fiduciaries on how to approach the "common decision" of how to set compensation for executive directors and senior officers); Francie Ostrower & Melissa M. Stone, *Governance: Research Trends, Gaps, and Future Prospects*, *in* The Nonprofit Sector: A Research Handbook 612, 613 (2d ed. 2006) (describing hiring and oversight of the CEO as one of a nonprofit boards' traditional responsibilities); *see also* Langevoort, *supra* note 53, at 801–02 (explaining that selection and evaluation of the CEO is one of the three main roles of the for-profit corporate board).

at least,[70] will they be limited by other financial, familial, or social relationships with this team or its leader, allowing their review to be untainted and rigorous.[71] Likewise, the board's more general monitoring function may be improved by the existence of a powerful group of independent directors without daily familiarity with (or, even co-option into) management's worldview.[72] Their outsider status may enable them to engage in less bounded strategic thinking.[73] It may allow them to play a more constructive role as the mediator among the varying constituencies of the organization.[74] Objective voices are valuable in accomplishing all of these important tasks.

Of course, objectivity has its disadvantages as well. As its critics in the for-profit arena have recognized, to some degree, objectivity must be traded off against expertise.[75] Those without organizational involvement that would threaten their objectivity will likewise lack expertise regarding the particular entity at issue, and perhaps will lack more general expertise within the relevant industry or area of operation, depending on how far one is willing to push the search for objectivity. This lack of expertise may be compounded by reliance on management and other non-independent directors for information necessary to make the very decisions for which their objectivity is prized.[76] If such reliance becomes substantial, the

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70. For much more on defining "independent director," see *infra* Part III.

71. *See* Melvin Aron Eisenberg, The Structure of the Corporation: A Legal Analysis 166 (1976) (asserting that for a board to effectively play its important role in monitoring the CEO, it must be independent of the CEO).

72. *See* Brudney, *supra* note 52, at 632 ("For improving management's performance as a wealth maximizer, the outside director's value is to be found principally in the traditional function of availability for expert advice and for consultation from a less involved point of view.").

73. *See* Dravis, *supra* note 68, at 4; Langevoort, *supra* note 53, at 798 (describing how independent directors might be seen to help overcome the cognitive biases of management).

74. *Cf.* Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 Wash. U. L.Q. 403, 422 (2001) (describing a view of for-profit corporate boards' role as to mediate among the potentially conflicting interests of the various groups involved in corporations).

75. *See, e.g.*, Kenneth B. Davis, Jr., *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 Iowa L. Rev. 1305, 1340 (2005) (opining that "the challenge is to use the occasional board opening to strike the best balance between independence and other desired traits such as industry experience or financial expertise"); William T. Allen, *An Outside-the-Box Idea: Go Inside for Directors*, Corporate Board Member, Mar./Apr. 2004, at 58, 59 (advocating the retention of inside directors in order to combat this problem).

76. *See* Elizabeth Cosenza, *The Holy Grail of Corporate Governance Reform: Independence or Democracy?*, 2007 BYU L. Rev. 1, 23 ("Unlike inside directors, who have direct access to information by virtue of being employees or having other close ties to the corporation, independent directors rely upon the reports of others for the information necessary to discharge their monitoring duties."); *see also* Eisenberg, *supra* note 71, at 143–44 (discussing the difficulties directors have obtaining information).

promised objectivity of independent directors may be more perceived than real.[77]

C. *Concerns About Domination*

Finally, independent directors also have been urged as a partial counter to the potentially destructive influence of domination.[78] Of course, the concern about director domination is tied to the issues of integrity and efficiency explored above. A dominating director may be able to push through interested transactions without sufficient analysis and questioning. Likewise, such a persona may pose obstacles to broad discussion of strategic or tactical options. There is, however, also some separate content to the domination concern.

Governance through a board of directors is, at bottom, a commitment to governance by a group.[79] Committees likewise embrace the value of group decision making. A dominating single force on a board or committee severely undermines this core concept. Ideally, independent directors, due to their lack of employment, familial, or other personal relationships with such a dominating personality, would be able to curtail some of the effects of domination, or avoid a situation of domination from arising altogether. If so, independent director requirements could help boards avoid this potential obstacle to achieving the group decision-making ideal nonprofit corporate law envisions.

Of course, this assumes a very broad definition of independence, more than the current and proposed requirements would demand. Furthermore, the counter-domination benefit of independent directors can be challenged as naïve, on much the same type of argument as was used to challenge their contributions to objectivity above.[80] If independent directors count on the dominating personality on the board to set the agenda, or at least to provide them with much of the information they will need to make their decisions, their ability to avoid or counteract her dominating influence will be substantially limited.[81]

77. *See* Brudney, *supra* note 52, at 634 (warning that independent directors' "modesty" may make it difficult for them to achieve efficiency gains for their corporations); Cosenza, *supra* note 76, at 23 (addressing this dynamic).

78. *See supra* note 54.

79. *See* Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 Vand. L. Rev. 1, 12 (2002).

80. *See supra* notes 75–77 and accompanying text.

81. Even beyond the problems of agenda setting and informational asymmetry, a dominating director might still, by force of personality or otherwise, be able to exercise dominating influence. *See Symposium Panel Discussion*, 37 U. Miami L. Rev. 319, 320 (1983). Professor Kenneth Andrews argues that such domination of independent directors surely can occur. *Id.*

D. *Director Independence Concerns and the Nonprofit Context*

Much of the critical exploration of independent director requirements has occurred in the for-profit context. Concerns around integrity, objectivity, and domination, however, are also implicated by director independence reforms in nonprofit board settings.[82]

Certainly, instances of consistent and onetime conflicts of interest can and do occur in nonprofits. Although nonprofit directors generally serve voluntarily,[83] nonprofit managers are often compensated and can serve on boards.[84] Thus, consistent conflicts over evaluating their performance and setting their compensation will occur. In addition, there is a case to be made that conflict situations will be even more common in nonprofits, as these resource-strapped entities often recruit board members with the intention of securing their assistance in obtaining needed items or services.[85] Although many times these director recruitment efforts contemplate at- or below-cost arrangements, such arrangements are not always possible given the directors' responsibilities to the other entities they serve. Questions of conflict of interest are presented most starkly

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82. This essay is only part of a larger effort to explore the issues raised by nonprofit independent director requirements. *See* Boozang, *supra* note 55 (discussing the genesis of independent director reforms in the for-profit sector and the problems with applying them in the nonprofit sector); Peregrine & Broccolo, *supra* note 56, at 498–501 (discussing the policy focus and the "evolution" of independence requirements in the for-profit sector in a piece recommending best practices for independence in the nonprofit context); *see also* Marion R. Fremont-Smith, Governing Nonprofit Organizations: Federal and State Law and Regulation 436 (2004) (commenting that in 2004 "[t]he definition of 'independent directors' is . . . in need of clarification, particularly as to whether it includes donors or other persons dealing regularly with the charity such as consultants and professionals").

83. *See* Fremont-Smith, *supra* note 82, at 168; Francie Ostrower, Urban Inst., Nonprofit Governance in the United States: Findings on Performance and Accountability from the First National Representative Study 11 (2007), *available at* http://www.urban.org/UploadedPDF/411479_Nonprofit_Governance.pdf (finding that only two percent of boards compensated directors); BoardSource, Nonprofit Governance Index 2004, at 8 (2005), http://www.boardsource.org/dl.asp?document_id=424 ("Board service remains almost entirely voluntary. Only 2 percent of participating organizations pay board members a fee or honorarium for their service.").

84. *See* Fremont-Smith, *supra* note 82, at 168; Ostrower, *supra* note 83, at 20 (noting that "3 percent [of board members] worked for the nonprofit itself"). In connection with executive's board service, Professor Marion Fremont-Smith notes the importance of setting executive compensation "based on the reasonable worth of services and . . . not [as] a disguise for a distribution of profits." Fremont-Smith, *supra* note 82, at 168 (citing the applicability of excise tax rules under I.R.C. § 4958 (West 2006) on compensation arrangements that constitute excess benefit transactions).

85. *See* Fishman & Schwarz, *supra* note 10, at 178–79 ("In many situations, interested transactions are a healthy necessity. They may provide access to resources unavailable from the marketplace. . . . [The appropriateness of a transaction] depends greatly on its facts and circumstances and the director's motivations for entering the transaction."); Fremont-Smith, *supra* note 82, at 236 ("In many situations, self-dealing transactions are the only means by which a nonprofit corporation can gain access to goods and services that would otherwise be too expensive to afford."); Ostrower, *supra* note 83, at 8 (reporting and expanding on a finding that "financial transactions between organizations and board members are extensive").

when deals are struck at above-market prices, but even market rate transactions between directors and their nonprofits may implicate self-dealing concerns.[86]

Efficiency concerns are also present on nonprofit boards. A lack of objectivity can blind those acting in service of a charitable mission just as it might those charged with serving the interests of shareholders. Those on a nonprofit's board may be so committed to serving the mission they have worked years to articulate that they fail to recognize the impact of change on their programs' efficacy.[87] These concerns may well be even greater in the nonprofit context, without clear lines of accountability to groups like shareholders[88] and the limited availability of enforcement.[89] These differences have, in fact, been suggested as explanations for why nonprofits

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86. *See, e.g.*, Comm. to Save Adelphi v. Diamandopoulos (Bd. of Regents of the Univ. of the State of N.Y. Feb. 5, 1997), http://www.regents.nysed.gov/adelphi.html (finding breach of the duty of loyalty by directors who received a lucrative insurance brokerage contract from the university, although recognizing that due to a lack of proper disclosure "we will never know whether or not Adelphi obtained the lowest cost coverage best suited to its needs, or whether another broker would have been a better choice"); Vacco v. Diamandopoulos, 715 N.Y.S.2d 269 (Sup. Ct. 1998) (finding that the Board of Regents report cited above alleged facts sufficient to state a claim for fiduciary breach).

The self-dealing provisions applicable to private foundations under the federal tax code suggest that even at-cost conflicts can raise serious issues. *See* I.R.C. §§ 4941(a)(1), 4941(d)(1)(A) (West 2006) (subjecting to excise taxes any "sale or exchange, or leasing, of property between a private foundation" and a director); Treas. Reg. §§ 53.4941(d)-2(b)(2), 53.4941(d)-2(c)(2), 53.4941(d)-2(d)(3) (2006) (excluding from the definition of self-dealing only such transactions made "without charge" or "without interest").

87. *See* Dana Brakman Reiser, *Nonprofit Takeovers: Regulating the Market for Mission Control*, 2006 BYU L. Rev. 1181, 1184–86 (noting incumbent fiduciaries resistance to permitting mission evolution in the takeover context); Garry W. Jenkins, *The Powerful Possibilities of Nonprofit Mergers: Supporting Strategic Consolidation Through Law and Public Policy*, 74 S. Cal. L. Rev. 1089, 1122 (2001) (addressing directors' unwillingness to recognize the potential value of the change a merger would bring to "the long-term survival and well-being of the organization's mission and its resources").

88. *See* Thomas L. Greaney & Kathleen M. Boozang, *Mission, Margin and Trust in the Nonprofit Health Care Enterprise*, 5 Yale J. Health Pol'y L. & Ethics 1, 2 (2005) (noting "charitable corporations' lack of shareholders and market for corporate control"); *see also* Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. Sch. L. Rev. 457, 489 (1996) (similar); Henry Hansmann, *The Evolving Law of Nonprofit Organizations: Do Current Trends Make Good Policy?*, 39 Case W. Res. L. Rev. 807, 821 (1989) ("[E]ven in nonprofits with members there is no possibility of disciplining managers through a market for corporate control, since unlike business corporations nonprofits have no stockholders with a right to both net assets and control."); Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 Wis. L. Rev. 227, 227–28 ("[I]n the nonprofit world, owners are not well-defined; their voting rights are questionable or non-existent; charitable goals are ambiguous. . . . There is no market for corporate control . . . ." (footnote omitted)).

89. *See* Fremont-Smith, *supra* note 82, at 352 (noting that although state attorneys general have managed to achieve some nonprofit regulatory and enforcement successes, "[a]ll of them operate with severely limited budgets, which has meant a shortage of legal and accounting support"); Brody, *supra* note 10, at 479 ("Funding for charity enforcement has never been high, at either the state or federal level . . . ."); James J. Fishman, *Improving Charitable Accountability*, 62 Md. L. Rev. 218, 257–65 (2003) (addressing the limitations on nonprofit enforcement presented by both standing rules and governmental resources).

tend to be more dogged than for-profits in pursuing goals and maintaining programs long past their useful life.[90]

Finally, of course, those with a desire to dominate the opinions of others are not to be found solely in the for-profit sector. In pursuit of noble or less-than-noble intentions, boards of all types and sizes can struggle with dominating members.[91] The passion that is required to dedicate oneself to service of a nonprofit's mission might even feed the dominating potential of such individuals.

The integrity, objectivity, and domination concerns underpinning independence requirements are persistent issues for nonprofit boards and the nonprofit sector. Thus, director independence proposals can be usefully analyzed and evaluated with respect to these concerns. Yet some of the implications of these concerns for drafting independent director requirements, and particularly for crafting a definition of independence, will be unique to the nonprofit context. The next part will turn to these important points.

III. DEFINING NONPROFIT DIRECTOR INDEPENDENCE

It would seem at this point necessary, if not drastically overdue, to consider the question of defining nonprofit director independence in more detail. As discussed above, many definitions already exist, in both extant requirements and proposed reforms.[92] These definitions track the integrity, objectivity, and domination issues raised above to some degree. Still, no single definition comprehensively addresses all of them. This part outlines some of the more thorny issues that arise in defining independence in the

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90. *See, e.g.*, Fishman & Schwarz, *supra* note 10, at 101 ("Many nonprofits survive too long, drawing down their resources to finance annual deficits, or they stay alive on the basis of faded but still useful reputations. Boards may be embarrassed to close . . . .").

91. *See* ABA Coordinating Comm. on Nonprofit Governance, *supra* note 36, at 27 (discussing the dominating director phenomenon in the nonprofit context).

92. *See* Cal. Corp. Code § 5227(b) (West 2006) ("Any person currently being compensated by the corporation . . . ."); Me. Rev. Stat. Ann. tit. 13-B, § 713-A(1)(A) (2005) (defining "financially interested person[s]" as one "who has received or is entitled to receive compensation"); N.H. Rev. Stat. Ann. § 292:6-a (1999) (limiting the "position of chairperson or presiding officer of the board" to non-employees); N.D. Cent. Code § 10-33-27(3)(a) (2005) (defining "financially interested individuals" to include "[i]ndividuals who have received or are entitled to receive compensation"); Vt. Stat. Ann. tit. 11B, § 8.13(b)(1) (1997) (defining "financially interested persons" to include "[i]ndividuals who have received or are entitled to receive compensation"); Panel on the Nonprofit Sector, Final Report, *supra* note 29, at 75 (excluding those compensated for full- or part-time work from the definition of independent); Panel on the Nonprofit Sector, *supra* note 32, at 15 (excluding those receiving compensation as employees or independent contractors, those whose compensation is determined by such individuals, those receiving other financial benefits from the organization, as well as those with various familial relationships to individuals falling into any of the former categories); Staff of S. Fin. Comm., 108th Cong., *supra* note 16, at 13 (defining a director who is independent as one "free of any relationship with the corporation or its management that may impair or appear to impair the director's ability to make independent judgments").

nonprofit context, and attempts to resolve them for drafters of nonprofit director independence reforms.

A. *Employment and Employment-Like Relationships*

The most frequent credential named for independent directors is status as a nonemployee of the relevant organization.[93] Along this vein, paid consultants, advisors, or officers are often also excluded, as are any partners of the organization or its affiliates.[94] It is easy to appreciate how screening out employees and others with employment-like relationships with an organization would help independent directors to play the roles ascribed to them above. Such individuals will regularly experience conflicts of interest, in each instance of compensation or negotiation of a profit- and/or loss-sharing agreement. They also have their livelihoods and potential fortunes intimately bound up with current management's vision for the organization. These ties obviously would substantially limit their ability to bring objectivity to the boardroom. Finally, employment by the organization, other business relationships with it, or both, would make such individuals particularly susceptible to domination by directors inclined to exercise their influence.

Following the lead of most existing and proposed nonprofit independence requirements, it seems wise to remove employees from the independent category. Challenging breaches of integrity, offering objective analysis and criticism, and avoiding domination all will be difficult for a nonprofit employee on the board. Others with a direct and consistent financial interest in the organization, like paid advisors and co-venturers of various types, have and should be screened out of the definition of independence on the same logic.

Of course, those with employment and employment-like relationships with a nonprofit have much to offer as directors, in terms of information,

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93. *See* Principles of the Law of Nonprofit Orgs. § 310, at 67 (Tentative Draft No. 1, 2007) (noting that definitions of internal independence commonly focus on compensation and other financial benefits); Boozang, *supra* note 55, at 25 (stating that the few available nonprofit definitions of independence "focus on the absence of a financial relationship"). *See generally* Clarke, *supra* note 52 (discussing the pre– and post–Sarbanes-Oxley requirements for for-profit director independence centering upon employment regardless of the term used to describe independence). Specifically, Donald C. Clarke discusses the differences between "non-interested, independent, outside, non-executive, non-employee, and disinterested" directors. *Id.* at 78 (internal quotation marks and footnotes omitted).

94. *See, e.g.*, Me. Rev. Stat. Ann. tit. 13-B, § 713-A(1)(A) (excluding from the definition of independence any individual compensated by the organization for personal services within a twelve-month period, including independent contractors and consultants); Panel on the Nonprofit Sector, Final Report, *supra* note 29, at 75 (excluding independent contractors and others receiving "material financial benefits (i.e., service contracts, grants, or other payments) from the organization except as a member of the charitable class served by the organization" from the definition of independent board member); *see also* Peregrine & Broccolo, *supra* note 56, at 523–24 (suggesting that professional or advisory relationships with an organization are ones nonprofits "may wish to consider" in drafting a standard for director independence).

insight, commitment, and manpower. Nonprofit employees and paid advisors do regularly serve on boards,[95] and surely do so with great distinction. They are an extremely useful set of potential board members, having relevant information, experience, and expertise, as well as a commitment to the organization.[96] But, due to their potential conflicts, lack of objectivity, and susceptibility to domination, employees and those with employment-like relationships cannot logically serve the role we desire independent directors to play.

This seems unlikely to be a problem for independence requirements. Although many boards include employees as members, they should be able to obtain a majority of directors from outside their ranks. Likewise, staffing compensation and audit committees with these non-employed or otherwise directly financially interested individuals should not pose too high a hurdle. It seems a reasonable assumption that most boards with employee members include only a small number of them, perhaps the executive director or chief executive officer and one or two other quite senior managers.[97] Indeed, the existing independence requirements in four states do screen out paid employees,[98] and have operated in those states for some years without creating an obviously greater shortage of qualified directors in those jurisdictions.

A special complication arises, however, in dealing with the non-employee component of the independent director definition in the nonprofit context. How should independence requirements deal with volunteers?[99] It is helpful to evaluate the question of volunteers in light of the three concerns at which independence requirements are aimed. Volunteers do not have a direct and consistent financial interest in their organization in the form of wages or salary. Thus, the likelihood of their financial interests conflicting with that of the nonprofit seems little different than entirely unrelated potential directors.

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95. *See supra* note 84.

96. *See* Revised Model Nonprofit Corp. Act § 8.13 official cmt. (1987) (noting that employees may be "invaluable" board members).

97. In fact, "[t]he practice of including the executive director as a voting board member is less common on nonprofit boards than on corporate boards, but we did find it among a substantial minority (33 percent) of respondents, including 21 percent of those with a paid CEO/executive director." Ostrower, *supra* note 83, at 20.

98. *See* Cal. Corp. Code § 5227(b)(1) (West 2006); Me. Rev. Stat. Ann. tit. 13-B, § 713-A(1)(A); N.D. Cent. Code § 10-33-27(3)(a) (2005); Vt. Stat. Ann. tit. 11B, § 8.13(b)(1) (1997); *see also* N.H. Rev. Stat. § 292:6-a (1999) (prohibiting employees from serving as board chair or presiding officer).

99. By volunteers, this essay refers to individuals who volunteer their time to the nonprofit in addition to their service on the board. The American Red Cross Governance Report suggests a distinction, for independence purposes, between volunteers and volunteer managers. *See* Am. Red Cross Bd. of Governors, *supra* note 17, at 53. If volunteers were to be added to the categories of individuals excluded from service as independent directors, such distinctions might well be necessary. At present, however, they are beyond the scope of this essay.

Yet, in terms of their objectivity, the situation of volunteers seems much closer to that of employees. They are enmeshed in the current programs and operations of the nonprofit. The extent of this enmeshment will likely vary with the extent of their volunteer service. At least those who volunteer significant time to the organization, though, are at serious risk that their objectivity will be clouded by the current vision of that organization and its programs.

Volunteers' potential for domination is a bit of a mixed bag. If the power to dominate resides in a directors' ability to harm a fellow director's financial interest in the organization, volunteers' lack of compensation should insulate them from this influence. But, the capacity for domination can also flow from a role in setting the agenda for the organization, controlling its culture, and the charisma of leadership. If a director intent on dominating has a major role in setting the organization's vision and leading the team that pursues it, volunteers are certainly subject to potential domination by this individual.

With these partial and conflicting results on how volunteers will play the role of independent directors, I would hesitate to remove them categorically from the definition of independence for nonprofit directors. This hesitation stems in part from concern about potentially limiting the pool of independent director candidates so severely that there are insufficient candidates to fill the needed positions. In addition, it is motivated by the reality that volunteers are particularly valuable as potential board members. They have proven by their volunteer service that they are willing to devote their time and energy to the organization, and devotion of both is required to serve effectively as a director. Moreover, their volunteer service suggests a commitment to the mission and activities of the organization that directors also will need.

Of course, defining independent director to exclude volunteers would not bar them from board service. However, screening volunteers from the definition of independence might be perceived as denigrating the service of this vital group. I am anxious about sending the message that independent directors, the ones we trust to guard the integrity and the objectivity of the boardroom, cannot be volunteers. It seems unnecessarily harsh to state categorically that volunteers' commitment to the organization, their willingness to dedicate their precious time and energy for free, makes them less able stewards of the organization. Doing so might not only limit the ranks of potential candidates for independent directorships, but also shrink the ranks of needed volunteers in other capacities. For these reasons, the exclusion from the independent director category should be limited to compensated employees.

B. *Family Relationships*

Family members again seem an easy target for independence reforms. The conflicts of fiduciaries and other employees will become the conflicts of their family members.[100] And ties of blood or affinity with other directors or management may dampen directors' enthusiasm for challenging conflicted transactions. They may trust the opinions of their family members too much, sacrificing objectivity or submitting to domination. When the dominating presence is a relative, the family member may willingly submit to her domination, out of either trust or familial fealty. When a dominating executive or other director has power over one's relatives, domination may not be voluntary, but is also quite likely. Thus, the exclusion of family members of directors, officers, and employees from the category of independent director follows clearly from the policy goals of these proposals.

Such exclusions have been included in both existing and proposed independence requirements.[101] Existing independent board composition rules in several states exclude from the independent category relatives of those with financial relationships to the nonprofit.[102] The Nonprofit Panel's final report made a similar recommendation.[103] New Hampshire goes further, and addresses the relationships of directors to each other. It requires charitable nonprofits to have boards of at least five members, and none of these members can be "of the same immediate family or related by blood or marriage."[104]

It is worth noting, however, the practical problems that can arise with this definitional choice, if independence reforms are to be applied to nonprofit private foundations.[105] Foundations, especially ones associated with the generosity of a particular family, may have employees from that family and

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100. *Cf.* I.R.C. §§ 4946(a)(1)(D), 4958(f)(1)(B) (West 2006) (including family members in the definition of "disqualified persons," for whom transactions with relevant tax-exempt entities are prohibited or targeted for greater scrutiny).

101. *See, e.g.*, N.H. Rev. Stat. § 292:6-a; Vt. Stat. Ann. tit. 11B, § 8.13(b)(2); Panel on the Nonprofit Sector, Final Report, *supra* note 29, at 75.

102. *See* Cal. Corp. Code § 5227(b)(2) (including as an "interested person," "[a]ny 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 [interested person]"); Me. Rev. Stat. Ann. tit. 13-B, § 713-A(1)(B) (defining "financially interested person[s]" to include "spouse, brother, sister, parent or child" of a compensated individual); N.D. Cent. Code § 10-33-27(3)(b)–(c) (defining "financially interested individuals" to include "[a]ny parent, child, child of a spouse, brother, or sister" of a compensated individual, the spouse of the specified relations, and the spouse of a compensated individual); Vt. Stat. Ann. tit. 11B, § 8.13(b)(2) (defining "financially interested persons" to include "[a]ny spouse, brother, sister, parent or child of any [compensated individual]").

103. *See* Panel on the Nonprofit Sector, Final Report, *supra* note 29, at 75. Notably, while certain state statutes apply broadly across nonprofits, see *supra* note 102, the Nonprofit Panel final report would apply its independence requirement to public charities only. *See id.*

104. *See* N.H. Rev. Stat. § 292:6-a.

105. *Id.*

boards composed largely of family members.[106] If the drafters of independence reforms intend to apply their proposals to family foundations, and particularly if they take New Hampshire's lead, they should expect some resistance and questions of whether the independence reform game is worth this particular candle. Indeed, New Hampshire, the state that has addressed familial ties most aggressively in its independent director requirement, appears to have decided that applying its rule to family foundations is not advisable. It specifically excepts private foundations from its independent director requirement entirely.[107] The Nonprofit Panel's recommendations for both government mandate and self-regulatory effective practice do the same.[108]

Such a categorical exception for foundations is, of course, one way to make a restriction on familial ties among directors workable. But such an exception seems to undermine the idea that independent director requirements are linked to improving the ability of directors or boards to serve their assigned functions. There is no reason to believe that private foundations as a group are less susceptible to the problems of financial conflict, lack of objectivity, and domination than are nonprofits generally. In fact, criticisms of governance and accountability are often leveled with particular concern for the conduct of foundations and their fiduciaries.[109]

The exception suggests instead a link between independence requirements and a concern about increasing the diversity of nonprofit boards. It suggests that public charities[110] should have a broader range of

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106. *See* Council on Founds., Family Foundation Board Makeup tbl.6 (2004) (on file with author) (finding, in a survey of over 1000 board members at nearly 150 family foundations, that 77% of directors were family members and that 45% of the foundations surveyed have boards consisting only of family members); Panel on the Nonprofit Sector, Final Report, *supra* note 29, at 78.

Indeed, this problem may well extend beyond foundations. *See* Ostrower, *supra* note 83, at 20–21 (finding "[f]ully 26 percent of boards of nonprofits with under $100,000 in expenses have members who are related to one another" and significant, though lower, percentages in larger nonprofits as well).

107. *See* N.H. Rev. Stat. § 292:6-a.

108. *See* Panel on the Nonprofit Sector, Final Report, *supra* note 29, at 75, 78 (recognizing this difficulty, and thus applying its independent board composition reform recommendation to public charities only); Panel on the Nonprofit Sector, *supra* note 32, at 15 (noting as well that its board independence principle would not apply to foundations and a few other types of nonprofits for whom its requirements would pose special difficulties).

109. *See, e.g.*, *Charity Oversight and Reform*, *supra* note 16 (including statements of former IRS Commissioner Mark Everson and former head of the New York Attorney General Charities Bureau William Josephson, among others, commenting specifically on perceived abuses in foundations); Nina J. Crimm, *A Case Study of a Private Foundation's Governance and Self-Interested Fiduciaries Calls for Further Regulation*, 50 Emory L.J. 1093 (2001) (criticizing governance and operations at many private foundations); William Josephson, Assistant Att'y Gen.-in-Charge, Charities Bureau, Remarks to the Funders Alliance of Upstate New York 7 (Sept. 30, 2003) (on file with author) ("With respect to the private foundation boards, often they seem *not* to be able to distinguish between the money they gave to their foundations and their own.").

110. The universe of charitable nonprofits exempt from federal tax laws is split roughly into two categories: the public charity and the private foundation. *See* I.R.C. § 509 (West

persons as board members, perhaps because they benefit from widespread public support, or engage in programs and activities relied upon by the general public, or both. The New Hampshire statute's own text supports this view, stating that its provisions are put forward "[i]n the interest of encouraging diversity of discussion, connection with the public, and public confidence."[111] Private foundations,[112] presumably with more confined purposes and sources of support, may staff their boards from a narrower group. This alternative view of the purpose of independent director requirements is certainly defensible, and might coexist with the view of independence requirements as aimed toward improving governance. Indeed, a case can clearly be made that broad diversity of directors will add to the board's ability to avoid and manage conflicts of interest, maintain sufficient objectivity, and avoid domination. However, the current focus among legislators and regulators pursuing nonprofit law reform seems intent on improving governance and preventing abuse directly, rather than broadening the general representativeness of nonprofit boards in order to do so.[113]

To address the serious concerns regarding integrity, efficiency, and domination, defining independent nonprofit director to exclude family members of compensated employees and others with direct financial interest is quite sensible. Whether to screen out related directors raises more troublesome theoretical and practical questions.

2006) (defining private foundation). Public charities are those organizations that are either traditional charitable institutions (hospitals, schools, etc.) or meet one of several tests of broad public support. *See id.* § 509(a)(1)–(4). As such, "[p]ublic charities . . . derive most of their support from government or the general public, or the nature of their activities makes them accountable to a broader constituency." Fishman & Schwarz, *supra* note 10, at 751.

111. N.H. Rev. Stat. § 292:6-a.

112. Private foundations are defined by default; the term includes any organization exempt under I.R.C. § 501(c)(3) that does not qualify as a public charity. *See* I.R.C. § 509(a); *see also supra* note 110 (discussing the definition of "public charity"). Private foundations are typified by a single or small group of funders, ongoing financial support derived from investment income, and operations consisting of grant making, rather than running direct charitable programs or activities. *See* Bruce R. Hopkins, The Law of Tax-Exempt Organizations § 12.1(a), at 352 (9th ed. 2007).

113. Although it has not been the dominant theme in these reform efforts, there have been instances in which improving board representativeness, in various respects, has been raised. *See, e.g.*, Pension Protection Act of 2006, § 1220(a), I.R.C. 501(q)(1)(D)(i) (West 2007) (demonstrating congressional interest in board representativeness in at least one context, by requiring credit counseling agencies to have a governing body "controlled by persons who represent the broad interests of the public"); Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 Ind. L.J. 937, 985–99 (2004) (discussing the Hershey case in which representation for members of the Hershey community seemed important to regulators); Mark Sidel, *The Struggle for Hershey: Community Accountability and the Law in Modern American Philanthropy*, 65 U. Pitt. L. Rev. 1 (2003). Moreover, board diversity, another possible indicator of representativeness, certainly needs improvement. For example, a recent Urban Institute study found whites represented eighty-six percent of board members. *See* Ostrower, *supra* note 83, at 18 (reporting this finding and questioning "the ability of many boards to truly represent and respond to the diversity of the public they serve").

C. *Donor Relationships*

The difficulty in crafting a definition of independence for nonprofit directors only increases as one considers other possible categories for exclusion from this status. Donors pose perhaps the trickiest problems for defining independent nonprofit directors. The donor category addressed here is intended to denote those donors whose contributions are substantial, either in objective terms or within the budget of the relevant nonprofit. Nominal donations signifying one's belief in or support of an organization are certainly valuable and, when aggregated across many donors, they may be financially quite significant. However, small donations by a donor-director are unlikely to implicate the issues of integrity, objectivity, and domination, as would a director's history (and potential future prospects) of making large donations.

Substantial contributions certainly create financial relationships between donors and donee nonprofits. A donor's financial involvement with and commitment to her nonprofit also may undermine her ability to offer objectivity or make her a potential subject or source of domination. Donors, however, are an important constituency for nonprofits,[114] and many substantial donors desire, if not expect, that their donations will be accompanied by board membership.[115] Moreover, many nonprofits in turn desire, if not expect, that once an individual joins their board, he will make sizeable donations.[116] Thus, answering the question whether donor status should exclude potential directors from the independent category raises both theoretical and practical difficulties that require further consideration.

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114. *See* Murray S. Weitzman et al., The New Nonprofit Almanac & Desk Reference 91 tbl.4.1 (2002) (showing private contributions representing nearly twenty percent of total independent sector revenue, thirty-five percent if health-care services are excluded); Brody, *supra* note 10, at 473 (describing donors as one of the constituencies of charities, to whom they must consider their accountability obligations).

115. *See* Boozang, *supra* note 55, at 24 (pointing to the "desire to attract potential donors" as the primary reason that "[n]onprofit boards tend to be larger than for-profit boards"); *see also Why Do People Join Boards?*, Stan. Soc. Innovation Rev., Spring 2005, at 48, 48 (noting that it is common for board seats to be offered to and expected by major donors).

116. *See* ABA Coordinating Comm. on Nonprofit Governance, *supra* note 36, at 21 (noting that "contributing or raising money for the organization is often an explicit or implicit expectation of nonprofit board members"); Brody, *supra* note 34, at 539 ("Membership on the boards of some cultural and other high status, donation reliant organizations depends on generous monetary contributions—notoriously, some even have a known 'price list.'"); Pamela Ryckman, *Getting into Charity Through Its Board*, Fin. Times, July 20, 2007, http://www.ft.com/cms/s/cc12f36a-36d6-11dc-9f6d-0000779fd2ac.html (reporting that "[m]ost non-profit organisations ask that board members make a donation that is 'personally significant'" and give or get up to a set goal amount); *see also* Fisher Howe, *Fund Raising: The Roles of the Board and the Staff*, *in* Nonprofit Governance: The Executive's Guide 249, 250–51, 253–54 (Victor Futter & George W. Overton eds., 1997) (advocating that every board member should annually contribute to the organization, yet offering some criticism of the practice of setting a minimum required contribution); Boozang, *supra* note 55, at 27 (strongly critiquing the practice of requiring board member contributions).

We can begin with the concern over conflicts of interest and potential breaches of integrity. A donor has no continuing or residual claim on the funds he contributes to a nonprofit charity,[117] but his contributions do create a financial relationship with the organization. Such relationships fit uncomfortably, if at all, into our established idea of conflicted transactions. Directors' conflicts of interest typically regulated by nonprofit law occur when a director stands on both sides of a contract, such as a loan or property sale by a director to his nonprofit, and will personally benefit from the transaction's completion.[118]

In some cases, of course, donations can create conflicts of interest between a donor (or potential donor) and her donee nonprofit. If a donor-director desires to make a substantial contribution with restrictions on the terms of its use by a recipient nonprofit, she may find herself on both sides of a transaction—the contribution transaction—with her nonprofit. The nonprofit may need to negotiate these terms, or the amount of the gift, as not all gifts on all terms should be accepted.[119] The donor's personal interest in the terms of the donation may differ from that of the nonprofit, and her financial interests are certainly implicated, due to the potentially significant tax advantages of some contributions.[120] So one certainly could imagine contribution transactions where the two sides are, in some real sense, adversaries.

Although potentially serious, this turn of events seems rather unusual. Thus, alone, it would not suffice to argue for removing donors from the definition of independence. Instead, the interested transaction approval process[121] could be used to regulate these predictable, though infrequent, conflicts. It would be sensible to prepare internal conflict rules and best

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117. *See* Siegel, *supra* note 69, § 10.4(b), at 445 ("Under the common law, once a donor makes a gift, he has no continuing interest in the property but may sue for its return if the donor retained a right of *reverter*."); Laura B. Chisolm, *Accountability of Nonprofit Organizations and Those Who Control Them: The Legal Framework*, 6 Nonprofit Mgmt. & Leadership 141, 147 (1995) (pointing out that only the attorney general, as "society's representative" has the right to enforce gift restrictions under common law). *But see* Evelyn Brody, *From the Dead Hand to the Living Dead: The Conundrum of Charitable-Donor Standing*, 41 Ga. L. Rev. 1186 (2007) (discussing the complex and at times conflicting ways courts view a donor's right to enforce gift restrictions and offering a compromise solution).

118. *See* Principles of the Law of Nonprofit Orgs. § 310(b) (Tentative Draft No. 1, 2007) (offering a nonexclusive list of typical conflict transactions, including compensation and other financial transactions, use of charity's property or information, obtaining a material benefit out of one's position with a charity, "action by or on behalf of an adverse party," competition with the charity, and taking a business opportunity).

119. *See* Siegel, *supra* note 69, § 10.4(a), at 441–43 (providing examples of the difficulties that unscrutinized gift restrictions can create, and counseling negotiation in advance); John K. Eason, *The Restricted Gift Life Cycle, or What Comes Around Goes Around*, 76 Fordham L. Rev. 693, 697–708 (2007) (describing the negotiation process that has come to mark the creation of restricted gifts, and noting that not all such gifts should be accepted).

120. Deductions from federal income, estate and gift taxes are available for contributions to qualifying donee nonprofits. *See* I.R.C. §§ 170(c), 2055(a), 2522(a) (West 2006).

121. *See supra* note 61 and accompanying text.

practices that take account of such situations and offer guidance on using the interested transaction approval process or some other procedure to manage them.[122]

Donors' ability to offer objectivity to boards, and thereby provide this advantage of independence, can also be questioned. Donors might feel a special commitment to particular parts of a nonprofit's program to which they have donated funds. Even those donors who have contributed to the nonprofit's general funds may be unable or unwilling to act as true "outsiders." Substantial donors, whether they have made a single significant donation or amassed a history of substantial support through a course of donating over many years, likely feel committed to maximizing the impact of these donations. And this cuts both ways. On the one hand, this may make them especially committed to considering every option to improve their organization. On the other hand, it may wed them to the conventional wisdom and practice of how the nonprofit is run. Having thrown their support behind a particular vision of how to achieve the organization's mission, or behind the individuals that have pursued that vision during the time of their support, substantial donors may not sufficiently consider the utility of changing course. These potential biases threaten donors' ability to offer the benefits of objectivity that independent directors are intended to provide.

The involvement, personal and financial, of donors and their nonprofits also may challenge donors to offer the anti-domination benefits ascribed to independent directors. If a donor, as described above, has become committed to the vision of her nonprofit articulated by a particular powerful individual within the organization (be it an executive director, chief executive officer, or a fellow director), this influential individual may be able to dominate the donor in their board interaction. Perhaps even more

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122. Many authorities encourage nonprofits to establish such conflict of interest policies. *See, e.g.*, Principles of the Law of Nonprofit Orgs. § 330 gen. cmt. (a)(3), at 234 (Tentative Draft No. 1, 2007); Panel on the Nonprofit Sector, Final Report, *supra* note 29, at 81; *see also* ABA Coordinating Comm. on Nonprofit Governance, *supra* note 36, at 41.

The IRS has also shown an interest in such policies. As part of the application for tax-exempt status, the IRS provides a sample conflict of interest policy and inquires as to whether the applicant enacted such a policy, though adoption is not required. *See* I.R.S. Instructions for Form 1023 (Cat. No. 17132z) app. A (Sample Conflict of Interest Policy) (2006), *available at* http://www.irs.gov/pub/irs-pdf/i1023.pdf. Its recently issued draft revised Form 990 similarly asks each filing organization to report whether it has "a written conflict of interest policy." I.R.S. Draft Form 990, Return of Organization Exempt from Income Tax (OMB No. 1545-0047) pt. III question 3a (2007), *available at* http://www.irs.gov/pub/irs-tege/form990coreform.pdf. This interest may well be paying dividends, at least in terms of establishment of conflict of interest policies. A 2006 study of nearly 1000 nonprofits found 78% of nonprofits now had such a policy, up from 67% just last year. Grant Thornton, The 2006 Grant Thornton LLP National Board Governance Survey for Not-for-Profit Organizations 3 (2006), *available at* http://www.grantthornton.com/staticfiles/GTCom/files/Industries/NotForProfit/nfp_board1.pdf; *see also* Ostrower, *supra* note 83, at 9 (reporting a lower percentage (half) of nonprofits that had adopted such a policy); BoardSource, *supra* note 83, at 8 (reporting a similar rise over the past decade).

serious is the possibility that donors will engage in domination. The financial reliance of nonprofits on their major donors' largesse may empower these donors to dominate their colleagues on the board.[123] Even if a donor does not actively try to dominate his colleagues, the influence of a major donor's position on an issue will be difficult for other directors to ignore. If a director who is also a nonprofit's major donor refuses to vote to initiate a new program, it might well pressure her colleagues on the board to vote against it as well. Thus, domination remains a concern with donor-directors, and casting them as independent in order to serve an anti-domination function is somewhat dubious.

Still, donors often are excellent[124] and extremely desirable board members. What is more, donors are valuable resources and assets to their nonprofits in ways that go far beyond their financial contributions.[125] They can have a real dedication to the pursuit of the nonprofit's mission and programs, at least those to which they feel connected via their donations. They may have information and expertise in the organization's affairs or industry, which brought them and their funds to the organization or which they acquired in order to research their contributions. Thus, like with volunteers, anyone considering legislating donors out of the category of independent directors should proceed with caution.

Of course, it bears repeating that designating a class of individuals ineligible for independent director status does not bar them from nonprofit governance entirely. A definition of independence that excludes substantial donors would still allow them to serve, but it could seriously limit their participation. If combined with an independent majority requirement for board composition, donor-directors would be eligible to fill fewer than half of the available board seats. In many boards, some non-independent board seats will be needed for employees, thereby curtailing further the number of available directorships for donors. Using a definition of independence that excluded donors in combination with an audit committee credentialing requirement also would limit donors' participation in nonprofit governance, leaving them to staff only those committees other than audit.

Excluding donors from the definition of independent may also raise some donors' hackles, and not without good reason. If the theory of independence is that these directors will be less likely to experience conflicts of interest, more objective, and less of a domination concern, it is understandable that the non-independent label may be perceived as less

123. *See* ABA Coordinating Comm. on Nonprofit Governance, *supra* note 36, at 27 (contemplating just this possibility).

124. *See generally* Jeffrey L. Callen, April Klein & Daniel Tinkelman, *Board Composition, Committees, and Organizational Efficiency: The Case of Nonprofits*, 32 Nonprofit & Voluntary Sector Q. 493 (2003) (reporting evidence consistent with the proposition that donors on boards engage in monitoring of nonprofit performance and accountability).

125. *See* Boozang, *supra* note 55, at 27 ("Empirical data support the presumption that donors and corporate leaders benefit nonprofit boards in ways beyond financial.").

desirable. These important nonprofit actors may understandably chafe at being excluded from playing some of the most significant roles in an organization. These fears may ascribe to donors an unrealistic level of desire to do the difficult work of nonprofit governance,[126] but when one is considering action that may frustrate donors, a light touch is probably prudent.

Thoughtful legislatures would likely decline to risk upsetting donor bases and therefore would not exclude donors from the definition of independence, following the course of those states that adopted the nonprofit independent director requirements currently in force.[127] After all, major donors' commitment and passion are a large part of what makes them desirable directors. And, make no mistake, these donors are desirable directors. Furthermore, boards must be staffed and, in order to function, they must be kept within some manageable size.[128] Thus, simply increasing the total number of directorships to deal with donor demand for non-independent board seats would have adverse side effects. For all of these reasons, donors should not be categorically removed from the definition of independence. Still, for the reasons discussed above, permitting substantial donors to serve as independent directors may limit the ability of independence requirements to serve the goals that stand behind them.

D. *Other Financial Relationships*

Numerous financial relationships can exist between directors and nonprofits, beyond those created by employment, employment-type roles, and donations. Students enrolled in a nonprofit university, parents of children attending a nonprofit private school,[129] subscribers to a theater company, and owners of local businesses within the orbit of a community development organization all might frequently have personal interests in the decisions that are made by their organizations' boards. Of equal or greater import, there is a class of directors or director candidates whose potential

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126. *See* Michael Klausner & Jonathan Small, *Failing to Govern?: The Disconnect Between Theory and Reality in Nonprofit Boards, and How to Fix It*, Stan. Soc. Innovation Rev., Spring 2005, at 42, 47–48 (suggesting a bifurcated board model in order to deal with the problem that donors (and some other valuable directors) may not want to engage in governance, but still want to serve on nonprofit boards); *see also* Callen et al., *supra* note 124, at 516 (finding "major donors appear to be underrepresented on monitoring committees" in their study, but not offering a reason for this state of affairs).

127. *See* Revised Model Nonprofit Corp. Act § 8.13 official cmt. (1987) (clarifying that the RMNCA's optional independent board composition requirement does not apply to donors, even ones who "contributed all or substantially all of the assets of a public benefit corporation and simply serve on its board").

128. *See* Siegel, *supra* note 69, § 3.3(a)(iii), at 30 (offering views of the advantages and disadvantages of large boards); IRS, *supra* note 25, at 1 (2006) (commenting on the problems of boards that are too large, particularly that they may be inattentive); Panel on the Nonprofit Sector, Final Report, *supra* note 29, at 77 (reviewing perspectives on appropriate board size); Boozang, *supra* note 55, at 24 (reporting the common wisdom that cautions against large boards and reviewing the evidence addressing this issue).

129. I thank David Reiss for this example.

financial relationship with the nonprofit is a major reason for their desirability on the board,[130] such as the head of a local bank or owner of a local property the nonprofit seeks to rent. If the idea is to screen from the independent category all of those individuals who might possibly experience financial conflicts, clouds on their objectivity, or susceptibility to dominate or be dominated, the sweep of the non-independent category would be so broad that board seats would almost certainly go unfilled. A definition that casts such a wide net is surely unworkable. Rather, the dangers of influence by these kinds of relationships would likely be dealt with more profitably by the individualized development and scrupulous application of a conflict of interest policy specific to each nonprofit or class of nonprofits.

E. *Social Relationships*

No currently adopted definition of independence has targeted social relationships beyond families. While such conflicts may create a lack of independence in particular circumstances, "[a]llegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence."[131] Still, commentators on the impact of independence requirements have argued that they would be more effective if they could somehow address directors with social relationships with other directors and management.[132]

The potential for social relationships to impact integrity, objectivity, and domination is clear. These relationships, though perhaps not as much as blood ties, can taint directors with conflicts by association. They may be unwilling or unable to give thorough scrutiny to the conflicts of their close

130. *See supra* note 85 and accompanying text; *see also* Peregrine & Broccolo, *supra* note 56, at 522–25 (noting that vendor and other financial relationships beyond compensated employments are ones nonprofits should consider when defining director independence).

131. Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1050 (Del. 2004); *see also In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 937–48 (Del. Ch. 2003) (finding that directors' employment by Stanford University rendered their independence subject to challenge in the context of serving on a special litigation committee considering a suit against others with relationships to Stanford as donors and a former professor).

132. Concern over this so-called "structural bias" problem has persisted for decades. *See, e.g.*, James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 Law & Contemp. Probs. 83, 85 (1985) (arguing, in a seminal piece, that social psychological mechanisms, including "prior associations" and "common cultural and social heritages," can create bias among putatively "independent" directors serving on special litigation committees (SLCs)); Lisa M. Fairfax, *Sarbanes-Oxley, Corporate Federalism, and the Declining Significance of Federal Reforms on State Director Independence Standards*, 31 Ohio N.U. L. Rev. 381, 408–15 (2005) (raising, in the post–Sarbanes-Oxley environment, concerns that social ties and group dynamics among boards can undermine the ability of directors to perform their roles); Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 Wash. U. L.Q. 821 (2004) (investigating structural bias deeply, and recommending that standards of review be changed in order to deal with its effects). *But see* Davis, *supra* note 75 (offering a recent critique of the structural bias theory as it relates to SLCs).

friends, or even of social or business acquaintances that move in the same circles.[133] Similarly, these directors may be all too willing to defer to the judgment of their social friends or business acquaintances, thereby failing to exercise the objective analysis for which independent directors are prized, allowing themselves to be dominated, or both.[134] This may be due to a sense of trust or obligation to a friend, or perhaps simply motivated by a greater concern for maintaining the social relationship outside the boardroom than protecting the nonprofit's interests within it. Friends, business associates, or even casual acquaintances who become codirectors of a nonprofit simply may trust, rely upon, or defer to one another more than would strangers.

The problems arising from social relationships among directors are easy to anticipate, but hard to fix. At least two difficulties arise when one tries to regulate the influence of social relationships on boards through independence requirements. First, it is extremely difficult to define the social relationships that should preclude a director's inclusion in the independent camp. Crafting legislation or regulations, or even best practices, that turn on words like "friends" or "social relationships" is asking for terribly difficult line-drawing problems. Draftsmen will be hard-pressed to distinguish between those social relationships that compromise independence and those that can be ignored for purposes of establishing independent status. Screening out those with social relationships with existing directors or management may also unreasonably shrink the pool of available director candidates. Although it is uncertain whether nonprofit boards are as homogenous as their for-profit counterparts,[135] they certainly draw new members significantly from the social groups of existing directors.

Even if these difficult line-drawing and staffing problems could be solved, and this is a significant assumption, one would still have to deal with the social relationships among directors that form during their terms.[136] Relationships may be forged or deepened through the shared experience of board service. Moreover, even if their members do not become close social friends, boards still can become subject to "groupthink" that can blind individual directors to lapses in financial integrity, shutter them from new ideas, and make them susceptible to

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133. *See* Brudney, *supra* note 52, at 612 (noting the potential impact of social relationships on independence); Fairfax, *supra* note 132, at 408–09 (describing evidence indicating social ties can undermine board performance); Velasco, *supra* note 132, at 858–60 (offering an account of structural bias based on social relationships).

134. *See* Brudney, *supra* note 52, at 612; Fairfax, *supra* note 132, at 408–09; Velasco, *supra* note 132, at 858–60.

135. *See* James Fanto, *Whistleblowing and the Public Director: Countering Corporate Inner Circles*, 83 Or. L. Rev. 435, 500 n.209 (2004) (noting the relatively "narrow elite" comprising for-profit corporate boards of the largest U.S. companies).

136. *See, e.g.*, Fairfax, *supra* note 132, at 409 ("Studies of boardroom behavior and reports of recent corporate governance scandals also indicate that directors who serve for long periods of time develop strong social ties that might inhibit their independence.").

dominating personas.[137] The social dynamic of serving on a board and pursuing a nonprofit's mission together can lead even formerly complete strangers to over-trust, over-rely upon, and over-defer to one another. Therefore, both social relationships that predate board service and those that develop from it can create obstacles to optimal functioning of "independent" directors.

Thus, social relationships on nonprofit boards raise serious issues. Due to the complexity of demarcating social relationships that threaten independence and the dynamic nature of board service experiences, however, independence requirements are not suited to remedying them.[138]

F. *Commitment to Mission*

Of course, in an extreme attempt to achieve objectivity, a definition of nonprofit director independence could exclude anyone with a commitment to the mission of the relevant organization. This interpretation is at best unworkable and at worst absurd.[139] Measuring commitment to mission would again necessitate extremely arbitrary line drawing. More importantly, such an interpretation would leave the ranks of potential independent directors woefully inadequate. Who would agree to serve in these voluntary positions without any interest in the organization's mission? And why would nonprofits want these directors? The objectivity goal of independent director reforms always trades expertise for objectivity. But looking to staff the majority of nonprofit boards or their important committees with directors having no interest in their organizations' goals would simply be foolhardy.

G. *Who Will Remain?*

The questions of social relationships and how wide a net an independence requirement might cast in defining its key terms dovetail with a final issue worth emphasizing one last time. This is the ever-present concern of screening out too many qualified director candidates.[140] If

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137. *See* Brudney, *supra* note 52, at 611–12, 633–34 (pointing out how the pressures of group dynamics contribute to independent directors' difficulties in policing integrity and efficiency); Fairfax, *supra* note 132, at 410–11 (addressing the potentially detrimental impact of "boardroom norms"); Fanto, *supra* note 135, at 460–72 (describing the damaging effect of "groupthink" and other social psychological pressures on the effectiveness of corporate boards as monitors); Velasco, *supra* note 132, at 860–65 (reviewing the literature on structural bias as a result of social psychological phenomena).

138. *See* Peregrine & Broccolo, *supra* note 56, at 506–07, 525 (finding that current for-profit law on how social relationships impact independence is not a sufficient basis for excluding those with social relationships from a definition of nonprofit director independence, but still advocating consideration of these relationships as a factor).

139. *See* Boozang, *supra* note 55, at 20 ("[A] board wholly comprised of objective monitors in a nonprofit context seems counter-intuitive.").

140. *See* Revised Model Nonprofit Corp. Act § 8.13 official cmt. (1987) (noting this concern led some drafting committee members to disfavor an independent board composition requirement); Ostrower, *supra* note 83, at 23 (reporting a finding that "[s]eventy

independence requirements are to be enforced, a large class of independent director candidates needs to exist from which organizations may recruit. However, independence could be defined so restrictively that the pool of candidates would be too small to fill all of the necessary positions. A shortage of director candidates may be especially difficult for nonprofits that are small, rural, new, less prominent, or more controversial, for whom the struggle to staff boards can already be challenging.[141]

Of equal concern is the possibility that defining independence too restrictively will screen out many potential directors who have other valuable board qualifications, leaving too few director candidates who are both independent and otherwise qualified to serve.[142] Depending on how it is done, screening out those with potential financial interests in the organization, for example, might exclude those with knowledge of the relevant industry or with helpful business or other contacts. Attempts to remove those with social relationships from the independent category may have a similar effect. In the sense that independence trades off with expertise and dedication, there is a point at which the cost of pursuing independence may just be too great.

Thus, defining independence is immensely challenging. Attempts so far have been limited to issues of direct and consistent financial interest or familial ties. The foregoing analysis suggests the advantages of thus limiting the definitional project. Defining independence more broadly might well require theoretically indefensible line drawing, dilute the requirements that will be imposed, or both. Furthermore, drafting these definitions requires care to avoid damaging potential consequences for board recruitment and the health of the nonprofit sector writ large.

IV. MAKING NONPROFIT INDEPENDENCE REFORMS OPERATIONAL

Nonprofit independence reforms must be carefully considered and drafted. This undertaking must grapple with challenging definitional issues posed by translation of the independence idea for application in the

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percent of nonprofits are having difficulty recruiting board members, and 20 percent are finding it very difficult"); Szymanski, *supra* note 46, at 1316–17 (noting the problems nonprofits are encountering in recruiting directors); *see also* Rodrigues, *supra* note 49, at 17 (noting the similar problem faced in for-profits, dealing with their own shortage of director candidates).

141. *See, e.g.*, Panel on the Nonprofit Sector, Final Report, *supra* note 29, at 78 (noting the "particular problem" faced by nonprofits seeking board members in "smaller communities and rural areas"); Szymanski, *supra* note 46, at 1316–17 (noting the especially difficult director recruitment efforts for small nonprofits).

142. *See* Mulligan, *supra* note 48, at 2009 (commenting on the potential difficulty of finding nonprofit directors with needed expertise); Szymanski, *supra* note 46, at 1316 (noting reports that nonprofits have difficulty finding "qualified" candidates for board seats); *see also* Aprill, *supra* note 36, at 773 (noting that some research suggests reform "efforts should concentrate not on independence of the full [audit] committee but on ensuring expertise").

nonprofit sector. It also must be considered within the broader context of improving nonprofit governance and strengthening the nonprofit sector.

If reformers are intent on creating boards composed of majorities or supermajorities of independent directors and requiring independent credentials of most or all audit committee members, such requirements must rely on a narrow definition of independence. Such a practical definition would exclude only compensated employees and others with consistent financial conflicts. At least outside of private foundations, family members of management, directors, and employees would also be excluded. This course minimizes the risk of undermining other important goals for the nonprofit sector, potentially alienating important nonprofit constituencies such as donors and volunteers, and impoverishing the ranks of qualified candidates. Thus, it is no surprise that employment and family relationships surface in nearly every existing and proposed definition of nonprofit director independence. Of course, with this restricted definition, one can expect only limited results on the issues independence reforms are designed to target. With a definition removing only those with the most obvious ties, such a reform can make only partial gains in avoiding integrity breaches, encouraging objectivity, and combating domination.

The extent to which independence requirements based on such a narrow definition will change current boards' composition and audit committee credentials is also unclear. It seems a sensible operational principle that nonprofit boards and audit committees should not be composed primarily or entirely of employees and family members. But empirical study would be required to determine whether this state of affairs truly exists to any substantial degree in the nonprofit sector. This problem is admittedly quite serious where it exists, but it is simply unknown whether majority employee or family boards are common. Without some sense of the scope of these practices, it is hard to recommend a legislative or regulatory mandate prohibiting them. It might seem of little harm to enact legislation mandating the status quo for most nonprofits and outlawing a major governance problem in the few with such clearly interested board or audit committee majorities. Yet, in the context of limited legislative and regulatory resources and energy, such legislation may not be wise if majority employee or family boards or audit committees are not widespread. Even expending the likewise limited capital of self-regulatory recommendation processes on a problem that rarely occurs is difficult to defend.

It is possible, of course, to cast a wider definitional net, focusing on relationships beyond financial and family ones. Due to concerns about avoiding insult to important nonprofit constituencies and maintaining a pool of willing and qualified director candidates, however, broadening the definition will necessitate reducing the extent of independence required among directors and audit committee members. The Senate Finance Committee Staff Discussion Draft made just this compromise. Its vaguer and potentially broader definition would exclude anyone with "any

relationship with the corporation or its management that may impair or appear to impair the director's ability to make independent judgments."[143] Perhaps because of this, however, the draft's independence reforms would require a much lower percentage of the board to qualify as "independent"—only twenty percent or a minimum of one director.[144] This solution removes a bit of the flash of independence requirements, but perhaps this is appropriate. It signals what may simply be the disappointing truth; once operationalized, one should not expect too much change from nonprofit independence reforms.

One way to shore up the gains to be made from independence requirements, whether these mandates are based on narrow or broad definitions of independence, is to supplement them with other approaches to nonprofit governance reform.[145] Board and committee members may respond well to education and guidelines that address how to deal with the relationships of influence that will always exist (to some degree) among their ranks. Crafting and actively using conflict of interest policies can assist them in tracking and managing financial relationships. Training on their fiduciary duties and on group decision making can help them to consider when their own objectivity or that of their colleagues may be clouded, and can alert them to the dangers of domination. The same issues independence requirements would address by fiat can be thereby addressed by encouraging board practices that attune directors of all backgrounds to the need for balance and a reliance on process. These reform avenues can make great strides in solving the real problems of integrity, efficiency, and domination that exist in the nonprofit sphere. They will likely do more than will formal independence requirements—certainly, they will do more as a complement to these requirements than these mandates would do on their own.

CONCLUSION

Director independence is an idea with many threads and not all of them are easily translated from their for-profit origins to the nonprofit context. Therefore, in considering adaptation of director independence reforms to the nonprofit sector, it is important to take into consideration the differing needs of nonprofits and their boards. When such a careful analysis is undertaken, it reveals the relatively limited contribution director independence reforms can make in addressing the real accountability

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143. Staff of S. Fin. Comm., 108th Cong., *supra* note 16, at 13.

144. *See id.* Additionally, the draft's reforms focus only on board composition, not audit committee credentials. *See id.* at 12–13 (envisioning that the entire board would undertake audit oversight rather than a smaller committee).

145. Other commentators have also offered excellent proposals for governance reforms as a complement or substitute for independence requirements. *See* Aprill, *supra* note 36, at 792–94 (offering proposals for federal incentives for nonprofit board education and establishing minimum standards for nonprofit governance); Boozang, *supra* note 55, at 42–48 (advocating changes in board structure and transparency).

challenges faced by nonprofits. Therefore, pursuit of independence reforms should not distract legislators, regulators, and self-regulatory bodies from the importance of focusing energy and resources on education and training for all nonprofit fiduciaries.