

## **The Independent Director**

By Jane Garthson

The field of corporate governance is currently obsessed with counting independent directors and commenting on appropriate roles. Is it most important that they be on the audit committee, the nominating committee, the compensation committee? Yet some companies file securities commission reports showing immediate relatives and current suppliers as independent. Others do not perceive them as independent, but there is no legal definition to enforce a common standard. In addition, academics are questioning whether the number of independent directors has any correlation to company performance or protection from company wrong-doing. One recent report from York University suggests that processes to involve independent directors appropriately are more important than percentages or absolute numbers.

It seems the regulators and the public would be satisfied to see SOME truly independent directors on corporate boards and on certain committees. I believe the nonprofit sector, as usual, is being held to a higher standard. People sometimes question the integrity of nonprofit organizations unless ALL directors are perceived as fully able to make fair decisions in the best interest of the organization. The Duty of Loyalty, confirmed in common law and many guides to good governance, requires that directors must act with honesty and in good faith in what they reasonably believe to be the best interests of the organization.

There is a risk that our standards could in fact be lowered and made less appropriate through application of Sarbanes-Oxley or other corporate governance thinking without sector-appropriate definitions or standards.

### **Principles and Premise**

What principles are at stake? The main one, common to both sectors, is the need for directors to make fair and impartial decisions on behalf of the organization. Society does not perceive the decision-making as fair if the director's vote is influenced by issues such as household income or the need to stay on good terms with the boss. Nor is any potential director encouraged by the sight of “trained seal” directors voting to support the recommendation of a friend or superior.

This article is *not* about the legality of who is on the board or what situations are legally unacceptable. In some jurisdictions, law limit or prevent certain types of board appointments, such as staff members, and prohibit direct financial benefits without prior government approval. I am not aware of any law requiring nonprofit boards to have any directors who ARE dependent!

My premise is that governance is more likely to be effective and ethical if every board member can make all or most board decisions as an independent. That means only short-term decisions, with no lingering involvement, could be ethically resolved by a conflict of interest (COI) declaration (provided the situation itself is legal) and compliance with COI policies. The COI process, no matter how good, is inadequate in my opinion for long-term situations, particularly those involving primary responsibilities of the board.

### **Constraints on Independence**

What could keep a director from being independent? Here are some examples:

#### **Business**

- Receiving direct business income as a supplier to the organization (e.g., an owner, an employee or salesperson for a supplier; a partner in a law firm supplying services)

- Receiving indirect business benefit such as an expectation of reciprocal business, corporate board appointment or some other business-related favour
- Trying to market to the organization's clients or members
- Using inside knowledge gained at the board to start or expand a business by capitalizing on that non-public knowledge

### **Employment**

- Having your superior on the board, so that discussion and voting are constrained by the presence of someone who controls your performance appraisal, pay and promotion
- Being an employee of the organization and thus at risk if strategic directions for the organization are inconsistent with continued need for your position
- Being a senior staff member of another organization where the senior staff officer of this organization is on your board and your compensation committee (common in the corporate world)
- Being interested in an upcoming staff position at the organization

### **Family and Personal**

- Having a family member on staff or as a supplier, affecting household income in some cases and perceived ties of affection in all cases
- Having a family member on the board, where dissenting opinions can cause family arguments, family arguments can interfere with the Board's decision-making and some family members will not be comfortable speaking up at all in the presence of a more dominant member of the family
- Using the board position to get extra benefits not available to other members of the organization, such as a director who is also a client trying to jump to the head of a waiting list

### **Divided loyalties**

- Unthinking, unquestioning devotion to a founder or long-time leader at the organization
- Putting another organization first when making decisions at this board, perhaps the organization which elected or appointed the person to the board
- Continuing to sit on related boards whose mission have started to diverge and perhaps even conflict (made worse if perceived a public spokesperson for one or both)

Sometimes these situations are minor enough to be acceptable to stakeholders, at least until a crisis erupts. Then what was being quietly ignored can look quite unethical.

Let us review each group.

### **Business**

People who have never run an organization may think it obvious that the board members should not be suppliers. However, occasionally, an air conditioner manufacturer finds themselves on the board of a nonprofit that needs an air conditioner. They can provide a good quality air conditioner at wholesale rather than retail cost. Should the nonprofit be denied this deal? Probably not, as long as the "deal" is confirmed by independent quotes and the equipment matches the need. Good record-keeping and communication are critical.

But in one professional membership organization I know of, the President was also the largest supplier, paid every month for their largest expense – association management! That arrangement, quite frankly, stank. And since every board meeting involved items that had to be communicated to members, he would have had to declare a conflict for much of the content of

every board meeting. It is hard to chair from outside the room. Clearly, directors would not have felt fully comfortable raising issues such as moving to a staffed office of their own, returning to volunteer efforts, or switching suppliers. The arrangement was discontinued.

On the other hand, people at public companies think it normal for directors to do business with the company and bring business to the company. They may be required to own stock and make a profit from good company returns. This is a major difference between the sectors, between volunteers serving for the good of the community and paid directors serving to benefit a company's bottom line.

The rising number of sponsorships to nonprofits introduces a grey area, particularly in professional and trade associations. Members often see a first chance to sponsor events or activities at their own association as a member benefit and I have heard no objection to directors participating in the same way as other members. If a board member is giving money or in-kind services and products to their own charity or association in their business name, it seems acceptable. However, naming a new charity building after a director's company might get a different reaction. I would love to hear from anyone who has seen this happen.

The most challenging type of independence question in the Business category is perceived future benefit. Who is monitoring whether Renee got a board appointment to Ian's printing company three months after recommending him as a supplier? Was it arranged in advance, or a coincidence of timing? Directors have to be prepared to deal with perceptions and sometimes step down if the perception is harming the image of the organization.

Business expansion and new directions are also challenging. A financial planner may join a board serving elderly people because of a genuine interest and then see a marketing edge. Will they put the best interest of the organization first when voting on client privacy policy? Or push for a strategic direction of serving more wealthy members of the community? And clearly, a director should not use insider knowledge of new research for business gain.

### **Employment**

Although it is common in the business sector, there is general agreement that directors with subordinate relationships to the senior staff person lack independence. Managers who sit on corporate boards have great difficulty being perceived as impartial about their CEO's compensation! Imagine telling your boss that his or her performance does not deserve a raise, or that the raise is 2% when you are hoping for an 8% raise yourself.

This situation is less common in the nonprofit sector. Where it does exist, staff on the board are dependent directors. Their livelihood is at stake, as is their quality of life. I have seen organizations which badly needed to expand hours of service because of the nature of their clients – but staff members blocked the change since some would have had to work evenings and weekends. In other cases, staff keep programs alive when they should be dropped in favour of serving emerging needs that require a different skill set or education. I have yet to hear a single good argument for having staff members on the Board and I hear many negatives. Advice from staff and communication with staff can be achieved in much less problematic ways.

Fair and impartial decisions are also jeopardized when chief staff officers sit on each other's boards and compensation committees. They become beholden to each other and are likely to argue for high increases for each other.

### **Family and Personal**

A nonprofit is not a family business, risking only the family's money. Once an organization is formed for public benefit, it should not be an employment haven for relatives or an excuse for family visits at organization expense. Investors are in fact pushing for an end to nepotism at

publicly-traded companies such as British Sky Broadcasting Group PLC. They are suggesting that a young and inexperienced college dropout might not be the best candidate for a top job in the company, even if he is the son of the chair (Rupert Murdoch). This is refreshing!

Founders find it particularly hard to give up family members on the board and staff, because they started with the support of family and friends who agreed with their idea. They do not always realize how potential board members perceive such relationships. They may not see how decision-making is constrained because of the body language used when a director objects to an idea raised by a member of the founder's family.

No one can be perceived as independent in hiring, managing and compensating an immediate family member, yet the system of married couples doing this, one as chair and one as Executive Director, continues. I keep wondering why anyone supports or joins such organizations. I have not heard of any ED terminated by their spouse for poor performance or lack of new and needed skills.

We do not regard children, no matter what their age, as independent of their parents since we perceive them as highly influenced by their parent's views – even when voting exactly opposite every time!

Caveat: Family foundations, with a mission of using family monies to serve the public good, *are* using their own monies and can operate more like a family business. Independent directors may be needed for skills on the board but that is an organizational choice. It is an example of why any standards or legislated solution needs to be extremely sensitive to the diversity of the sector.

### **Divided loyalties**

I see this area as the most problematic to cover in sector-wide standards or laws. I suggest avoiding any mandatory requirements about divided loyalties even if other areas ever get put into law.

Inevitably, some board members will be friends with the chief staff officer and other staff members, sometimes to the point of voting however those staff members wish. Inevitably, some people in multi-tier organizations will wear hats at various levels and be torn at times when the best decision at one level is not best for another. Occasionally, people sitting one more than one board will find the interests of two of their organizations have changed and become in conflict.

I would argue strongly against any requirements that such divided loyalties be prohibited. I have no idea how multi-tier organizations could even function without the dedicated multi-hat people.

I would argue even more vehemently that the issue of divided loyalty should be a key concern of Governance/Board Development Committees.

In many multi-tier organizations, directors are appointed by the next lower level of the tier to serve on the higher body. But if a director of a regional organization says she *must* vote the way her local organization wishes, this is a honking big red flag showing a lack of good orientation and director training. The duty of loyalty has not been taught. It is the organization's responsibility to educate not only its directors but to some extent any organization which elects or appoints people to its board. The duty of loyalty means that while someone is at a board table making a decision on behalf of one organization, they must put that organization first. They are not there to represent the interests of any other organization, even the one that appointed them.

Having other bodies responsible for choosing your directors causes myriad other problems, including overly large boards in some cases and a lack of ability to match skill needs with appointments. Many organizations have changed their bylaws to address these concerns as well

as the divided loyalty. The results is usually a higher percentage of directly elected board members, sometimes 100%, and often a smaller board.

Even without bylaw changes, the Board Development Committee can watch for and avoid divided loyalties. If Vince has voted in favour of every ED recommendation, including those most of the board were against, and his term is expiring, he is likely not a good candidate to put forward for re-election. If the ED recommends her next-door neighbour and workout buddy for the board, think carefully.

## **Summary**

The decisions of the board of our community organizations need to be fair and in the best interest of the organization and its community. To maintain trust and attract the support of donors, volunteers and others, the decisions must also appear to be fair and without personal benefit.

The best ways to do this are:

- to attract, retain and train directors with a passion for the cause, not because their friends are there or they have hope of personal benefit. Good recruitment practices can and should avoid situations where a director might not be fair and independent
- to provide good training to help directors understand what independence means, so they can act appropriately when a problem arises – including resigning when they wish to apply for a staff position or when they sit on boards with conflicting interests
- to have good board structures and processes, such as occasional executive sessions, in order to get the best results from its board of independent directors.

With such commitments, the voluntary sector can continue to be a model to the corporate world and be in a position to justify the necessary differences.