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Strategy and the Decline—or Rise—of the Inpatient Hospital

A series of new media reports and consultant commentary on industry evolution highlight the increasing pressure on health system boards to fully engage in sophisticated strategic planning—and thus may be useful reading for the strategic planning committee.

In a February 25 op-ed piece in *The New York Times*, Dr. Ezekiel Emanuel offers a provocative perspective on the future of hospitals. His view is that the importance of hospitals in the delivery system is declining for a series of reasons: e.g., the increasing risk of hospital-acquired infection; the ability to perform more complex care safely and effectively in other settings; and the possibility of more rapid recovery in "hospital at home" programs. As a result, he predicts, "many of today's hospitals will downsize, merge or close. Others will convert to doctors' offices or outpatient clinics. Those that remain will be devoted to emergency rooms, high-tech services for premature babies, patients requiring brain surgery and organ transplants, and the like."

A somewhat similar perspective was offered by *The Wall Street Journal* in its February 26 "special report" on health. The *Journal*'s view focused on the shift away from traditional inpatient facilities and the increasing investment by providers in outpatient clinics, same day surgery centers, free standing emergency rooms and microhospitals. Those experts interviewed for the article described a future in which there would be a need for fewer "full service" hospitals, and a major change in the scope of treatment provided at other hospitals. Like the *Times* piece, the emphasis of the *Journal* is on the fading of the "full service hospital, the fewer number of inpatient stays and the steady increase in outpatient visits."

Yet a different and interesting perspective is offered by Ryan Gish of Kaufman Hall in his new commentary, *Freight Trains and the Core Business of Healthcare*. Mr. Gish points to America's freight rail transportation system as an example of how one industry successfully improved its core business in a rapidly changing environment. He suggests that those strategies and results carry important lessons for America's hospitals and health systems, and may help them as they rethink the approach to their core business. Among the relevant "railroad" lessons cited by Mr. Gish are the following: rethink basic structures and processes; aggressively manage cost, price, and efficiency; and apply innovative technology.

These three articles, and others like them, relate directly to the fundamental issue of the long term sustainability of the inpatient health care mission of the hospital. This can be very useful fodder for hospital and health system board members who are involved in strategic planning or who are otherwise working to be suitably informed in order to react to management proposals relating to strategic initiatives, and to provide oversight of initiatives that have been implemented.?

Director Accountability

A new corporate governance initiative from the powerful New York City Pension Funds (NYC Funds) demonstrates the willingness of pension funds and similar investment groups to influence the board practices of companies in which they invest.

NYC Funds' "Boardroom Accountability Project 2.0" is intended to encourage companies to improve the quality of their corporate governance practices, with particular emphasis on matters of race and gender diversity and climate competence, for the purpose of improving long-term corporate value. The focus of the initiative is the disclosure by each contacted company of a "meaningful board matrix" that sets forth each director's particular skills, experience and attributes as they relate to the long-term strategy and risks of the company, and the director's gender and race.

The goal is to provide investors with a "big picture" perspective on director attributes, and how they contribute to achieving the highest oversight competence level in the boardroom. The NYC Funds' initiative also reflects a strong preference for "robust" director assessment and refreshment practices.

The efforts of the NYC Funds, as well as other pension funds, and asset managers such as BlackRock, Inc. and State Street Corp., is consistent with a larger trend of third parties to affect the governance of companies with which they have significant financial or other control relationships. This is something that hospital and health system governing boards should anticipate.?

ACC Chief Legal Officers Survey

The 2018 version of this important annual report from the Association of Corporate Counsel (ACC) provides valuable information for the general counsel, particularly in terms of advising senior leadership as to the evolving focus of the legal department.

Perhaps one of the most significant observations of the 2018 report is its conclusion that "[T]he most critical issues facing companies today are legal issues". For this reason, ACC suggests that the "Age of the Chief Legal Officer" has begun—making it essential, in ACC's view, that the general counsel/chief legal officer (CLO) "be at the executive table, in the boardroom and reporting to the CEO." In that manner, much of the report focuses on the general counsel/CLO's role as "a contributor to preventing problems and proactively addressing legal and regulatory risks to the company."

The key issues identified by ACC as "keeping CLOs up at night" include: (i) regulatory or government changes (including but not limited to the potential for new regulations affecting data and information privacy); (ii) data breaches and the threat of cyberattacks; (iii) similarly, matters of information privacy (*e.g.*, data and information how best to handle cybersecurity); (iv) technology developments; and (v) ethics and bribery matters.

Among the interesting statistics contained in the report are that 64 percent of the respondent CLOs report directly to the CEO (and of that 64 percent, 61 percent are involved with the CEO, the executive leadership team and the board of directors on strategic initiatives).?

Continued Pressure on Tax-Exempt Status

A series of recent developments, above and beyond the Tax Cuts and Jobs Act, continue to place pressure on the ability of nonprofit hospitals and health systems to justify their federal tax exempt status.

First are the recent efforts by BlackRock and other institutional investors (*e.g.*, ISS) to encourage the corporations in which they invest to more affirmatively pursue a "social purpose" and respond more directly to societal challenges.

The BlackRock effort may have the unintended effect of further undercutting the ability of large, nonprofit health care systems to justify tax-exempt status. Both Congress and the Internal Revenue Service (IRS) have longstanding concerns with how the delivery of health care services through a tax-exempt, nonprofit model is distinguishable from the delivery of such services through a proprietary model. To the extent for-profit hospitals and health systems begin to pursue societal purposes, the ability to draw a distinction between the for-profit and nonprofit health care sectors will become more difficult.

And now, most recently, come Senators Charles Grassley and Orin Hatch, raising new concerns with the IRS on whether nonprofit hospitals provide sufficient charity care and other community benefits to justify their tax-exempt status. The two leading senators have asked the IRS to identify how many tax-exempt hospitals satisfy the various Internal Revenue Code Section 501(r) requirements for charitable hospitals.

The general counsel is well-situated to brief the board on these and similar efforts, and to assist organizational efforts to restate and clarify how charitable purposes are satisfied in the nonprofit hospital/health system model.?

Strategic Use of Board Seats in M&A

As "member substitution"-styled M&A transactions proliferate in health care, greater consideration is warranted on the most effective use of board and committee seats as "currency" for such transactions.

There is no "set" number of board (or committee) seats that must be applied in extending governance input by the "acquiring party" to the "acquired party." The general concept is a number that is sufficient to guarantee a "voice" in board and committee processes. To that extent, 49 percent or similarly high (but less than 50 percent) levels are not usually necessary to provide the necessary vehicle for input. Smaller percentages are often buttressed by the addition of special powers (*e.g.,* supermajority voting rights, with respect to certain agenda items).

A recent article in *The Wall Street Journal* on the control-related approach taken by activist investors serves to extend the "board seat currency" discussion, to control of key committees. As the article points out, in certain situations obtaining control or significant influence on certain key board committees may provide particularly strong levels of organizational influence.

Most prominent among those committees would be (i) the executive compensation committee (with the related impact of direct connection to the chief executive officer); (ii) the finance committee (with its control over capital projects and related commitments); (iii) the strategic planning committee (with its influence on the long-term strategic mission of the organization); and (iv) the executive search and succession committee (with its involvement in CEO recruitment and retention).

In this context, "control" could be manifested by commitments of the "acquiring party" to extend committee chairmanship for a set period of time to a representative of the "acquired party." The broader point is that the consideration of governance commitments as consideration in member substitution or similar transactions may wish to focus less on sheer numbers of board seats, and more on the power associated with such seats.?

The Unique Challenge Confronting the Compliance Committee

The rapid convergence of federal regulation efforts and heightened expectations of governance accountability is creating a signficant challenge for the audit & compliance committee.

Indeed, deregulation efforts like US Department of Justice's recent "Brand Memorandum" (prohibiting the conversion of agency guidance into enforceable rules) and its long-anticipated relaxation of the controversial "Yates Memorandum" on individual accountability, will be welcomed by many health care companies.

But the expectation of relaxed regulations and more limited civil and criminal enforcement activity carries with it a risk of being interpreted by some as a "green light" to pursue potentially problematic arrangements. This attitude could threaten the authority and influence of the committee's compliance agenda.

This relaxing of executive attitudes towards legal boundaries would come at the worst possible time, with emerging expectations of fiduciary obligations heading in exactly the opposite direction. New trends (reflected in court decisions, regulatory actions and academic commentary) would hold directors more directly accountable for corporate compliance failures. "Where was the board when all this was going on?"

The audit and compliance committee may need to take proactive steps in order to counter the consequences of the deregulation/accountability convergence. It may be important to send a clear message throughout the organization that corporate policies on legal compliance, corporate conduct and legal risk evaluation of business initiatives will not change—and may even be strengthened.?

The General Counsel and the Activist CEO

The general counsel can play an important role in providing advice concerning the emerging phenomenon of "CEO activism," in which companies and their CEOs publicly comment on leading social issues.

CEOs—including those in health care—are under increasing pressure from multiple constituencies to take positions on social or political matters that may implicate their own corporate values (*e.g.,* gun control). This has been described as "part of a broad recasting of the voice of business in the nation's political and social dialogue, a transformation that has gained momentum in recent years as the country has engaged in fraught debates over everything from climate change to health care."

Yet such public positioning is not without significant reputational, performance and perhaps legal risk to the CEO and to the company. Such comments can disturb relationships with the board, confuse other members of the management team, undermine corporate relationships with legislators and affect consumer preferences.

To advise them on how best to balance the risks and rewards of public commentary, CEOs are turning to their general counsel as a wise counselor and guardian of the corporate reputation. The general counsel will supplement her technical legal analysis with consideration of applicable moral, ethical, political, economic and environmental factors. She will advise not only whether the proposed commentary is legal, but also whether it is the right thing to do, from the perspective of the corporation, its stakeholders, the public and sound policy.?

Board Deadlock

A new academic article offers interesting commentary on the elements of board structure and processes that can contribute to board deadlock and other similar forms of debilitating disagreements between directors.

Deadlock is traditionally associated with boards in which control is shared equally by different constituencies, pursuant to bylaws, contract or other agreement. However, as the authors point out, there is potential for “deadlock” to occur in more traditionally structured boards. The authors reference surveys in which 67 percent of directors report an inability to decide about certain issues in the context of board discussion, while 37 percent report that they have encountered circumstances of deadlock or division that have threatened the viability of the corporation.

A particularly threatening byproduct of deadlock identified in the article is the entrenchment of an unpopular or unsuccessful CEO, and the inability to remove the CEO and change his/her policies. There are, of course, other governance risks associated with deadlock (*e.g.,* inability to authorize financial/budget or strategic plans and reports).

The authors identify several scenarios, beyond shared governance, that can trigger deadlock or similarly stifling division among directors. These include (i) long director tenure, which may prompt directors to act strategically (and thus perhaps reticent to accept strong CEO candidates); (ii) director diversity, which can also affect the risk of deadlock to the extent the diverse directors’ skills and experience are not associated with strategic change and long term value; and (iii) board composition, especially where new directors are “negatively associated with strategic change.”

The potential for board/committee deadlock is a significant governance concern. This new academic article is a useful prompt for governance committee dialogue on the potential for deadlock or material director division to arise at the board or committee level, and on ways in which such a risk can be reduced. ?

BlackRock Governance Guidelines

Newly updated proxy voting guidelines from the prominent asset management firm BlackRock can provide the health system governance committee with a useful and informed perspective on trends in boardroom practices.

The voting guidelines are intended to set forth how BlackRock makes proxy voting decisions, and to share its views about corporate governance. The 2018 guidelines contain a series of elements that may be noteworthy to hospitals and health systems.

These include (i) a more stringent view on director independence; (ii) failure to exercise oversight with regards to accounting practices or audit oversight; (iii) the role of the compensation committee in periods when executive compensation appears excessive when compared to peers; and (iv) the performance of the governance committee chair where the board is not composed of a majority of independent directors.

Other important positions include: (v) periodic board refreshment (while not opposed to long-tenured director service); (vi) the importance of diversity in director selection, and a preference for “at least two women on every board”; (vii) expanded clawback provisions applicable to senior executives; (viii) limiting outside directors to service on no more than four boards; (ix) limiting the CEO to service on one other board; and (x) a “robust” CEO and senior management succession planning process.

BlackRock’s status as an asset manager notwithstanding, it maintains a highly sophisticated perspective on corporate governance. For that reason, and because its perspectives are often predictors of what may become more established principles, the BlackRock guidelines should be of interest to the health system governance committee. ?

Individual "Weinstein" Liability Exposure

The New York attorney general’s (NYAG) recent civil rights complaint against the Weinstein Company highlights the personal liability risks of leadership inaction to credible harassment evidence.

The complaint named only the company and the Weinstein brothers as defendants. Yet the complaint is notable for its extensive criticism of the company’s management and its board of directors. This includes detailed allegations of board and executive inaction despite being “repeatedly presented with credible evidence” of Mr. Weinstein’s harmful activity.”

Specific criticism included allegations regarding the failure to investigate any complaint over a 12-year period; the inaction of the Human Resources Department; the failure of individual directors to follow up after being notified by management of complaints; and the unwillingness of a majority of the board to support those directors who sought Mr. Weinstein’s personnel file in advance of contract negotiations.

The attorney general also sought termination of complicit executives as part of any sale of the company.

While “Weinstein” is an egregious example of alleged misconduct, the NYAG action provides a clear example of the personal fiduciary risk from unresponsiveness to “red flags” of harassment.

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