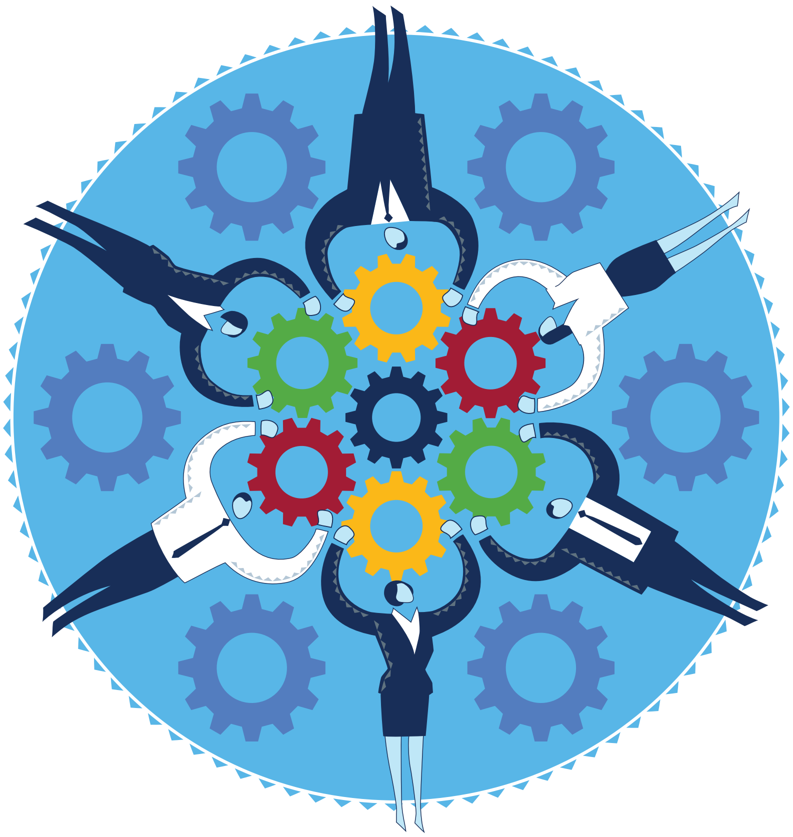
Trustee Insights

INNOVATION



Health Care Governance on the Eve of Disruption

Effective responses to disruptors rely on board/management partnership

BY MICHAEL W. PEREGRINE AND KENNETH KAUFMAN

Corporate boards, across industry sectors, are increasingly being called upon to support management as the company responds to how innovative competitors "disrupt" their existing business model. Blockbuster, Borders and ESPN are prime examples of established companies that have been pulled into the financial undertow created by nimble disruptors.

In the context of the internet economy, business disruption refers generally to the activity of innovative companies that use technology, scale, and consumer insights to create a lower-priced, more convenient experience, drawing customers away from traditional companies and setting those companies on a path of compulsory cost cutting and lost relevance.[1] The corporate victims of innovative business disruption are typically those that overlooked the trajectory of the incipient disruptors, who choose to focus initially on perfecting their business model rather than the product or service itself.[2]

In recent months, the health care sector has been a focal point of business disruption, through a combination of various new and nontraditional entrants into the sector, unique hori-

TRUSTEE TALKING POINTS

- Disruptors use technological innovations to draw customers away from traditional companies.
- Some disruptors want to develop a more contemporary patient experience at lower total costs.
- A board can be a highly effective partner to management's efforts to confront disruptive threats.
- A "response plan" requires trustees to more readily acknowledge the threat posed by disruption.

zontal and vertical mergers in health care, and the increasing impact of data and technology. For example, combinations of insurers and various types of providers appear focused on using scale and technology to develop a more convenient and contemporary patient experience, lower total costs and draw patient loyalty from traditional health care providers. Such disruptive competitors have the potential to put great pressure on the traditional inpatient hospital model.

Governance can be complicit by failing to position itself (and its management team) to identify and respond to warning signs. And in health care, those signs are increasingly bright.[3] However, a prudently composed and positioned board of directors can be a highly effective partner to management's efforts to confront disruptive threats.

Core Fiduciary Concepts

Leadership responsibility for business disruption is a logical extension of the shared leadership approach historically applied to strategic planning and risk management duties. These traditional duties involve the board encouraging the development of a plan and overseeing management's implementation, with management developing the specific plan and implementing it.

An effective response to business disruption relies on a similar approach. The board encourages management to identify business disruption threats and to develop responsive strategies, and then monitors the evolution of the strategies. Management informs the board about the nature and source of disruption threats, implements a responsive plan and supports the board's ability to monitor the success of that plan.

Business disruption can be a substantial threat to sustainability when it undermines the financial model on which corporate operations are based. For that reason, the impact of business disruption on the board's fiduciary duties is broad based, affecting elements such as information flow to the board, director engagement, director refreshment, board composition, the decision-making process, and ultimately, the nature of the board/management dynamic.

How Governance Is Affected

There are at least three key aspects of a business disruption "response plan": first, an attitudinal change in the boardroom in which directors more readily acknowledge the threat posed by disruption; second, an information system that provides the board and key committees with relevant business disruption-related information; and third, governance structure and process changes intended to support ongoing engagement with business disruption issues. The overarching goal is to position the board as an informed and attentive partner to executive management, as they collaboratively identify and respond to business disruption threats.

Attitudinal shift: This is the "we get it" concept — an increased board awareness of technological and other means of disruption and the potential threat it poses to the company and its specific industry sector. Such awareness incorporates a willingness to pay continuous, focused attention to the shifting sources and paths of disruption.[4] The attitude includes willingness to more closely monitor management with respect to its familiarity with customer needs and preferences, awareness of technological and competitive changes that could affect the company's business model, and ability to identify and implement responsive strategies.[5]

This attitudinal shift will also prompt directors to reconsider how they evaluate the competitive environment, establish organizational goals, and structure themselves and their activities as a board to be more nimble and decisive. This shift in attitude also encourages directors to monitor a broader set of external factors and how they may ultimately affect competition, including socio-economic, technology, investment, transactional, and competitive trends in health care and in business as a whole.[6]

Information reporting system: The executive leadership team can work with board leadership to identify the types of business disruption-related information that should be brought to the board's attention. For example, this could include news and other media articles, judicial decisions, government legislation/regulation, expert advice, educational presentations, corporate filings, management reports, and whistleblower and "hotline" reporting. The combined leadership team should also determine the context in which the information is provided (for example, full original text, or text that is abbreviated/edited by management), as well as the frequency and format.

Structural and procedural changes: A number of specific changes to board process and structure could help facilitate the ability to identify and respond to potential disruptions. Those changes could include the following:

- *Allocating duties.* Formally determine whether fiduciary oversight of business disruption matters should be the responsibility of the board as a whole or delegated to a specific board committee with calendar-specific reporting obligations to the full board. The critical "active monitoring" role of governance would be set forth by resolution of the full board, or by charter of the particular committee.
- *Expectations of engagement.* Direct the general counsel to periodically advise the board and individual committee members on the scope of their fiduciary obligations relating to business disruption oversight, and related legal developments — for example, through director preparation, participation in meetings, communications with management and advisers, and exercise of constructive skepticism with respect to management proposals.
- *Board composition.* Direct the board nominating committee to consider the competencies and backgrounds best suited to address business disruption-related matters — for example, experience with disruptor companies or companies that have been affected by disruption, or simply a broad spectrum of business background and experience.
- *Director refreshment.* Revise director refreshment policies and procedures (e.g., term limits, age limits, removal rights, individual and full-board evaluation policies, officer rotations) to make it easier to add board/committee leaders with necessary expertise and commitment to address business disruption threats.
- *Search/succession.* The board committee responsible for CEO search and succession, and other executive talent-development activities, should consider the extent to which senior executive-level searches and retention initiatives focus on individuals who are innovative thinkers with expertise in new technology.
- *Leadership coordination.* Assure the coordination of strategic planning and enterprise risk-management efforts with the evolution of board oversight of business disruption. Identify the extent to which the responsibilities of the respective oversight tasks are similar, separate, and/or overlap, and refine both charter scope and reporting relationships accordingly. Avoid the "right-hand/left-hand" confusion that often arises with committees that possess broad, all-encompassing portfolios.
- *Decision-making process.* Review the current board decision-making process to "flag" options for streamlining. How can the timing of major decisions be compressed to provide greater organizational agility, without limiting participation by key leaders, reducing access to important advisers, and otherwise handicapping the ability of the board to make informed decisions?
- *Identifying hurdles.* Identify potential legal and regulatory hurdles at federal and state levels to planned responses to particular business disruption threats (for example, laws relating to antitrust and competition).
- *Conflicts policies.* Revise the board conflicts-of-interest disclosure requirements to incorporate relationships of officers and directors with potentially disruptive companies. Prompt greater coordination between committees responsible for director independence/conflicts identification and resolution and those responsible for monitoring the potential for business disruption.
- *Board/management dynamic.* Counsel members of the executive leadership team on the fiduciary expectation of direct board involvement in business disruption planning and strategy. Clarify for all involved parties the relevant lines of authority, and articulate those areas in which the board has specific responsibility, as with shared responsibilities for strategic planning.

Director Liability Implications

Director liability exposure is a legitimate concern, given how rapidly disruptive companies can "upend" an industry and damage a financial model. Yet, Delaware law has historically extended substantial deference to the board's method of monitoring business risks. As long as the board has in good faith adopted and applied a business risk monitoring system, any losses attributed to errors in applying the system (no matter the size of the losses) should be offset by the board's exercise of business judgment. The only exception would be if the board was deficient in its exercise of such business judgment that rose to the level of bad faith, i.e., consciously ignoring the proverbial "red flags."

The less settled question arises in the context of a complete failure by the board to address (or even give thought to) business-disruption risk. This would especially be the case if it had been briefed (or warned) by management of the possible threat. The concern is that failure to even consider the potential for business-disruption risk would be interpreted as "bad faith." There are very few examples under Delaware law that establish liability in such circumstances. However, in the current environment, there is increasing risk that allegations that incorporate extreme or egregious fact patterns could prompt a different result, especially in jurisdictions other than Delaware.[7]

A Challenge to Tradition

Business disruption is one of the most compelling corporate governance challenges emerging in recent years. It is a concept that encourages a response that is developed through the board/management partnership, and which may require significant changes to traditional board practices. Given the strength of tradition in health care, these changes will require significant focus and a sense of urgency.

TRUSTEE TAKEAWAYS

- Encourage management to identify disruption threats and develop responsive strategies.
- Consider making changes to board process and structure to facilitate a "response plan."
- Monitor the implementation of that plan with support from the management team.
- Identify relevant business disruption-related information for the board's ongoing attention.

Editors' note: *Click on this link [http://survivinghcdisruption.com] to listen to podcasts that further discuss disruption in health care and its impact on hospital and health system governance.*

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Endnotes:

1. See, e.g., Natasha Singer, "How Big Tech is Going After Your Health Care," The New York Times, December 26, 2017.
2. *Id.*
3. "The Future of Hospitals" (Journal Reports: Health Care), The Wall Street Journal, February 20, 2018.
4. *Id.* See also "Board Lens: Disruption Tops List of Director Concerns According to Latest NACD Survey," NACD Weekend Reader, December 2, 2017 (subscription required).
5. *Id.*
6. *Id.*
7. See, e.g., In re *Wells Fargo & Co. Shareholder Derivative Litig.,* No. 16-5541, slip op. at 49 (N.D. Cal. Oct. 4, 2017).