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Maritime Disasters and Distressed Hospitals: What Every Board Should Know About Assessing Risk

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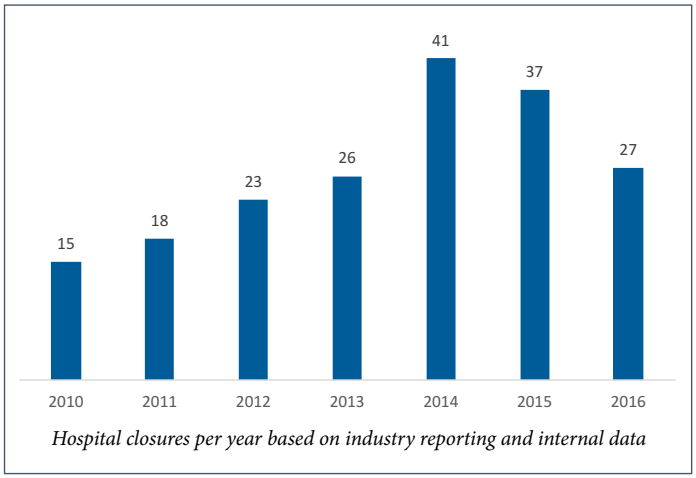
On September 30, 2015, the cargo ship *El Faro* left port in Jacksonville, Florida, bound for Puerto Rico and aware of Tropical Storm Joaquin and its projected path. The ship's captain, an experienced seaman, had charted a course that would allow *El Faro* to reach San Juan while maintaining a safe distance from Joaquin's destruction. With *El Faro's* owner approving that course, the ship and crew left port despite forecasts from the National Hurricane Center that Joaquin would develop into a hurricane the next day.

Twenty-six hours after setting sail, battered by the winds and seas created by Category 3 Hurricane Joaquin, *El Faro* sank off the coast of a Bahamian Island, losing her entire 33-person crew. As the ship's recorded bridge audio and other intelligence would later determine, a confluence of events—some within the captain's control and some beyond it—ultimately contributed to making this voyage one of the worst disasters in the modern history for the U.S. Merchant Marine. With the benefit of advanced weather forecasts, satellite imagery, and modern communications, it's easy to ask: how did a disaster like the *El Faro* happen?

> With the swells increasing in size and frequency, *El Faro's* Captain was asked about altering course. "No, no, no. We're not gonna turn around."
> *–El Faro Bridge Audio Recording*

Across the United States, hospital management teams and governing boards are facing their own gathering storm. Since 2010, approximately 190 hospitals across the country have closed. Similarly, and by these authors' count, approximately 85 hospitals have sought the protection of the U.S. bankruptcy courts since 2011. While the number of hospital closures and bankruptcies may seem small compared to the 4,862 community hospitals in the United States, the hospital industry has experienced fundamental structural changes that make closure or bankruptcy a risk that is now visible on the horizon for many hospitals.

Table 1: Hospital Closures in the U.S.



Hospital closures per year based on industry reporting and internal data

Like the captain and crew of *El Faro*, many hospital management teams and governing boards are increasingly struggling just to keep their ships afloat, let alone make it safely to port. With hindsight, we can ask of a hospital that has closed, "Why didn't it change course, away from the threat, when it had time?" The speed of most cargo vessels and approaching storms provides ample time to gather new data, react, and change course. Yet the Captain and owners of the *El Faro* did not take steps to keep the ship and crew out of harm's way. Likewise, in most instances, hospitals that close or go bankrupt struggle for many years with deteriorating market position, poor operating results, and eroding balance sheets. We scratch our heads and ask, how could *El Faro* sail into harm's way without changing course? In a similar light, it's not difficult to ask of a now-defunct hospital, how did it progress from being a stable institution to a stressed, and

eventually distressed entity without altering its doomed trajectory as years passed? Captains and hospital governing boards, by tradition and law, are responsible for the safety of personnel and assets under their watch. Yet the most common regret we hear from board members after we complete an assessment of strategic options is "I wish we had this conversation two years ago."

Intuitively, we know that the sooner a new course is plotted, the greater the benefit to sailors and hospital stakeholders alike. By acting earlier, the magnitude of the course correction is lessened and developing risks are mitigated before they become acute. The disruption, risk, and cost of a massive change in course are avoided. Why, then, do hospital boards defer action until the hospital's options have narrowed to the equivalent of 1) staying with a sinking ship that has lost propulsion and is being battered by huge waves, strong winds, and shifting cargo or 2) abandoning ship into a Category 3 hurricane with estimated 140 mph winds and 50-foot waves? In hindsight, it is clear that a chance to preserve options and reduce operating risk was missed, but what can we glean from the *El Faro* disaster and recent health care industry trends regarding hospital closures and bankruptcies?

Whether regarding the *El Faro* or distressed hospitals, hindsight makes clear that decision makers have not accurately assessed a changing set of environmental risk factors. As objective advisors to hospital boards and leadership teams, attorneys are often placed in positions where they can see the early warning signs of organizational stress. Correctly identifying these early warning signs, proactively engaging a board in these fraught conversations, and applying the proper solutions at the appropriate level of intensity can steer health care organizations back on course and avoid calamity. Lessons from the *El Faro* provide fitting analogs for those leading or advising hospitals and health systems in various levels of financial and operational stress.

What Are the Warning Signs of Increasing Organizational Risk?

Academic literature addressing hospital bankruptcies consistently, and not surprisingly, has found similarities among hospitals that file for bankruptcy. These hospitals lose money in the years prior to closure, operate in aging facilities, experience declining equity positions, and struggle to meet current obligations. Among most business enterprises, however, a negative trajectory in any of these metrics would typically trigger course correction strategies. Based on our experience, most hospital boards do not evaluate available information from a strategic perspective on a regular basis. Instead, financial results and operating statistics are often compared to budget and prior year results. As a result, key trends in performance and operating risk can be missed.

The failure to compare the organization's performance beyond its budget forecast and prior year performance unnecessarily escalates operating risk and reduces available course correction options. For example, many boards are only provided with an overview of the organization's financial performance in the context of a 30-minute session to review and approve audited financial statements. These sessions often fail to address longer term, fundamental, strategic or operating trends occurring over several years. A variance to budget is explained by a mild flu season or the departure of a key physician, while longer-term financial, operating, and strategic trends are not monitored and go unheeded.

One of the most important ways to provide boards with a sound assessment of organizational strength is to ensure that the board and management examine long term trends for clinical, operating, market, and financial indicators at least annually. A review of key risk indicators should capture a longer-term trend line that provides an assessment of the organization's strategic position and identifies areas of risk. Importantly, an objective review of these key risk indicators provides both board members and management with a distance from the daily management and operations of the organization that may otherwise cloud the ability to see more subtle and steady signs of performance erosion (e.g., an aging ship, a strengthening storm, an aging medical staff or gradual shifts in patient migration patterns for key services). These signs of performance erosion can be missed when the focus is about maintaining shipping schedules or performance to current year budget.

"What's concerning me is that the umm—is that—the information we're getting from other sources is so much different from this." *–El Faro's Third Mate after reviewing new weather advisories and questioning whether to change the current course.*

A sample of key risk indicators that should be monitored and reported annually with a five-year trend analysis is provided below in Table 2.

Table 2: Key Risk Indicators

Category	Risk Indicator
Financial Indicators	• Operating Revenue Trend • Operating Cash Flow & Cash Flow Margin Trends • Days in A/R Trend • Debt Service Coverage Trend • Operating Margin Trend • Days Cash on Hand Trend
Operating Indicators	• FTEs per AOB Trend • Case Mix Index Trend • Payer Mix Trend • Key Volume Trends (O/P and I/P) • Practice Operations, Production and Losses Trend
Value Indicators	• Medicare Cost Position Trend • Attributed Covered Lives Trend • Quality Scores Trend
Market Position	• Market Share Trend • Provider Alignment, Recruitment and Retention versus Documented Need, Turnover, Productivity

How Can We Avoid Disaster?

Every hospital board should examine its five-year trend line for the above metrics on an annual basis. This conversation should involve management and a robust and pragmatic discussion of underlying trends. Specifically, the board and management should review trends with a focus on the competitive landscape and the hospital's available resources and capabilities to address adverse operating, financial, clinical, and competitive factors. While undertaking expense reductions is a vital tool for many hospital turnarounds, "the process used to determine which services or facilities are eliminated" serves as an "important distinction that separates successful and unsuccessful turnarounds." For boards weighing the effectiveness of a proposed turnaround plan, it is important to differentiate between short-term, one-time gains that can be achieved through "across-the-board" cost reductions and more thoughtful cost reductions that address specific programs, services, or facilities that systemically contribute to the organization's poor financial performance. Based on our experience working with hospitals with varying levels of stress or distress, the spectrum below (Table 3) serves as a signpost that can provide hospital boards, management teams, and their advisors with some perspective of the warning signs indicative of organizational stress or distress.

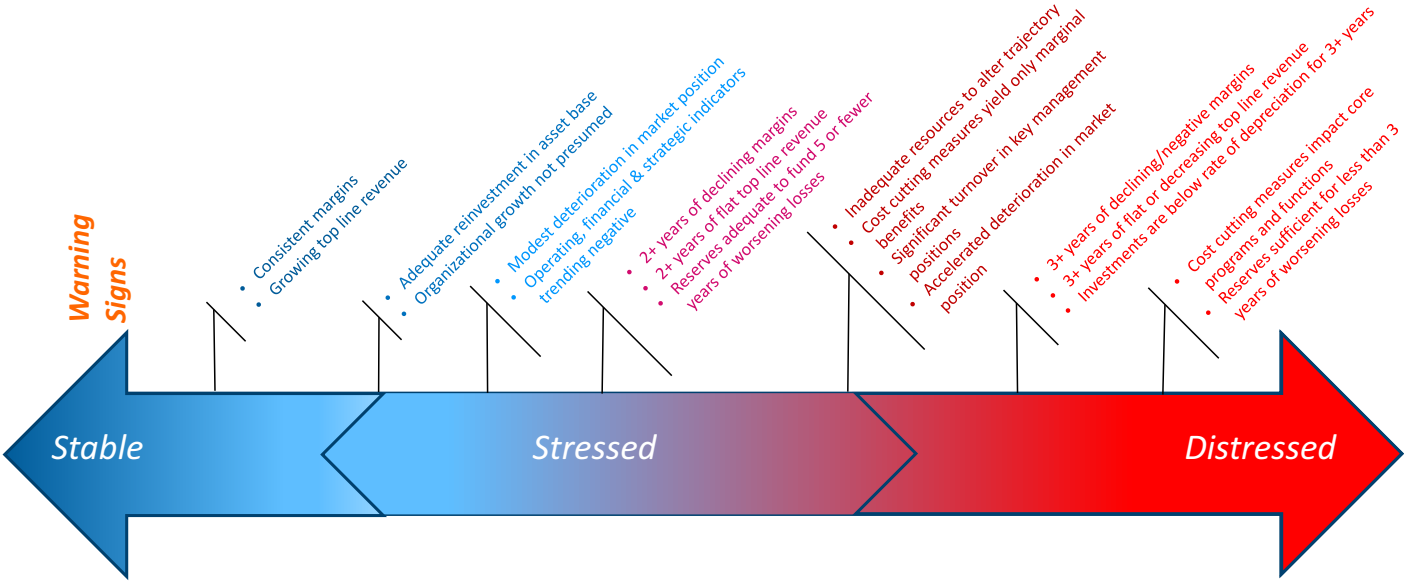
A successful hospital turnaround plan places significant demands upon a hospital's board and its management team. Developing a successful turnaround plan requires that the organization fully assess and harness its available human, facility, and financial resources; address gaps in organizational capabilities; identify the hospital's niche segment within the area's overall health care competitive landscape; and then execute on that plan. Boards and management often benefit by having outside experts involved in formulating and monitoring performance against the turnaround plan. This is true whether existing management remains in place or whether the board elects to bring in new management.

"Mariners must be cautioned never to leave themselves with only a single navigation option when attempting to avoid a hurricane … early decisions to leave restricted maneuver areas are [often] the most sensible choice." –*Marine Safety: Assessing Options, National Oceanic and Atmospheric Administration*

In our experience, most hospitals experiencing the early warning signs of stress miss these indicators of increasing distress. For those who do see the signs, it is almost always management that will act. Given the board's delegation of management of the hospital to the management team, this is not surprising. These organizations frequently have sufficient internal resources and capabilities to develop and effectuate a performance improvement plan.

The board's delegation of responsibility to management to develop and implement a performance improvement plan should include board oversight and review of the adequacy of management's plan and tracking of the organization's progress toward targeted results. As the chart on pages 26-27 (Table 4) provides,

Table 3: Warning Signs of Hospital Stability or Distress



external assistance may be retained to provide the board with objective advice and aid in the development of a performance improvement plan that fully inventories the hospital's internal resources and capabilities and positions the organization to maximize its return on these internal assets. If available resources or management's plan prove inadequate to mitigate growing risks, then more drastic intervention is required.

"Sometimes circumstances overwhelm you. You can do all the planning you want."
–Steven Werse, Ship Captain & Secretary-Treasurer of the Master Mates and Pilots Union.

If management's performance improvement plan does not achieve the desired results or events overwhelm the plan, then the Board should be prepared to act before bond covenants are violated or other thresholds are crossed. Timely intervention can greatly reduce the operating, clinical, financial, and market risks associated with executing the hospital's strategic plan.

For some boards, a variety of factors may require the use of external advisors to develop and execute a turnaround plan (e.g., the present management team's is unable to effectively execute an established plan, competitive or market forces overwhelm organizational resources, and/or the attention or participation by secured creditors or bondholders in the development of the hospital's turnaround plan). In such circumstances, it is critical that external advisors secure "early wins" for the organization that result in quick improvements to the hospital's bottom line performance and signal to other stakeholders that lasting organizational improvement is underway.

Among hospitals that are highly stressed and distressed, a lack of internal resources often means that core business office functions or standard managerial activities have either gone dormant or have atrophied severely. Specific opportunities for organizational performance improvement can usually be found in a number of areas, including but not limited to: (1) efficient staffing practices, (2) improved employed-provider practice operations, (3) revenue cycle operations improvement, (4) review of non-core assets and operations, and (5) rigorous supply chain management.

In hospital organizations experiencing higher levels of stress or distress, a successful turnaround plan typically requires some change in key management positions. Depending on the severity of the organization's stress or distress, external advisors may report to the board either through the existing chief executive officer of the organization or directly to the board itself. Developing these clear reporting and accountability channels early in the turnaround process serves as best practice and avoids ambiguity and shirked responsibilities among those involved.

Regardless of whether a hospital's existing management team, interim executive leadership, or external advisors are tasked with implementing a turnaround plan, the responsibility lies with the board to take timely action to correct course. Initiating the necessary board discussions that focus on improving operating results and assess strategic options before all favorable options are eliminated is both prudent and necessary. Taking timely action to correct course is essential to avoid circumstances where the only options are to go down with the ship or to abandon ship into 140 mph winds and 50-foot seas. The responsibility for avoiding such tragic outcomes is one of the most critical responsibilities of any ship's captain or hospital's board.

Table 4: Indicators, Warning Signs, and Navigation Options

Stable / Stressed / Distressed	Indicators & Warning Signs	Navigation Options
Stable Level 1	• Consistent margins • Growing top line revenue	➢ Shape organization culture to match organization's objectives ➢ Engage in intermediate and long-term strategic planning ➢ Develop capital planning and use strategy
Stable Level 2	• Adequate reinvestment in asset base • Organizational growth no longer presumed	➢ Accelerate organization cultural alignment initiatives ➢ Analyze strategic options available to organization ➢ Develop a performance improvement plan and develop organization's personnel to execute on plan
Stressed Level 1	• Modest deterioration in market position • Operating, financial and strategic indicators trending negative	➢ Undertake a strategic options analysis ➢ Development of a performance improvement plan; recruit key personnel to execute on plan ➢ Task management with effectively executing on performance improvement plan with objective milestones and key performance indicators of success

Stable / Stressed / Distressed	Indicators & Warning Signs	Navigation Options
Stressed Level 2	• 2+ years of declining margins • 2+ years of flat top line revenue • Reserves adequate to fund 5 or fewer years of worsening losses	➢ Commission a strategic options analysis developed by an outside party ➢ Seek out and realize improvements in revenue cycle management ➢ Consider placement of a Chief Implementation Officer
Distressed Level 1	• Inadequate resources to alter trajectory • Cost cutting measures yield only marginal benefit • Significant turnover in key management positions • Accelerated deterioration in market position	➢ Commission a strategic options analysis, including analysis of liquidity position and creditor analysis ➢ Seek out and realize improvements in revenue cycle management to improve cash position ➢ Consider placement of a Chief Restructuring Officer tasked with realizing performance improvement opportunities ➢ Consider undertaking an affiliation process for a new owner/operator
Distressed Level 2	• 3+ years of declining/negative margins • 3+ years of flat or decreasing top line revenue • Investments are below rate of depreciation for 3+ years • Cost cutting measures impact core programs and functions • Reserves sufficient for less than 3 years of worsening losses	➢ Execute on strategic options that preserve value of the organization and best ensure long-term viability ➢ Retain a Chief Restructuring Officer ➢ Evaluate effectiveness of negotiating with creditors via out-of-court channels or the bankruptcy court ➢ Undertake an expedited affiliation process

Correcting Course in Advance of a Coming Storm

While not all hospital bankruptcies and closures can be avoided, hospital boards can take timely action before risk factors escalate and remaining options fade away. For a hospital board, charting a low-risk course as an early action is essential to prevent damaging delays and avoid organizational tragedy. Our experience tells us that many boards wait two years or more in the face of mounting danger before they take action. An annual report assessing financial, operational, value, and market risk factors and trends—as well as a robust yearly conversation about organizational resources and capabilities and the competitive landscape—are essential activities of every hospital board.

"Look at the red sky over there. Red in the morning, sailors take warning." –El Faro's Captain on the morning of El Faro's last voyage.

Unfortunately, the industry risk factors buffeting hospitals and health systems have only grown more acute and more dynamic in recent years. Hospital and health system boards need to appreciate both the organization-specific and industry-wide sources of risk confronting their organizations. Failing to recognize risk factor trends can greatly diminish strategic options, placing the organization in grave danger. ◆

ENDNOTES

1 See Landy PhD, Amy Yarbrough and Robert J. Landry III, JD "Factors Associated with Hospital Bankruptcies: A Political and Economic Framework," 54 *Journal of Healthcare Management* 4 (July/August 2009) 252-72 (citing, among other studies, an qualitative analysis of hospitals that filed for bankruptcy).

2 See Langabeer II EdD, James "Hospital Turnaround Strategies," 86 *Hospital Topics: Research and Perspectives on Healthcare* 2 (Spring 2008) 3-10 at 4 (finding that a "severely depressed hospital has endured on average 2-6 years of continuous operating, and sometimes net, losses").

3 Landy at 254 (stating "a proactive approach that identifies organizations with the potential for future problems in advance of poor financial statements requires the examination of nonfinancial factors in addition to financial ratios and balance sheets").

4 See Langabeer at 7-8 (offering a conceptual framework for assessing contraction and expansion strategies in successful hospital turnarounds).

5 Id. at 7.