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# Sibley Memorial Hospital

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The Lucy Webb Hayes National Training School for Deaconesses and Missionaries was established in 1891 by the Methodist Women's Home Missionary Society for the purpose, in part, of providing health services to the poor of the Washington, D.C., area. The school was incorporated under the laws of the District of Columbia as a charitable, benevolent, and educational institution in 1894. The following year, the school built the Sibley Memorial Hospital, on North Capitol Street, to facilitate its charitable work. Over the years, operation of the hospital became the principal concern. As increasing demands were made on Sibley's facilities, it was renovated several times. In the mid-1950s, the hospital was relocated to Loughboro Road, in northwest Washington. This was an upper-class, affluent area of the city at the time and continues to be so today. The new 355-bed Sibley Memorial Hospital was dedicated on June 17, 1962. One half of the $8.8 million construction costs came from federal sources.

## BOARD OF TRUSTEES[1]

In 1960, shortly after ground was broken for the new building, the board revised the corporate bylaws in preparation for an expected increase in the volume and complexity of hospital activities. The new bylaws required the board to meet at least twice a year and to consist of from 25 to 35 members; the number varied from 27 to 33 during the 1960s and early 1970s. The board continued to be self-perpetuating (i.e., existing board members chose replacements to fill vacancies). Between meetings, an executive committee represented the board (see Appendix A). Several powers vested in this committee were financial: to open checking and savings accounts, to approve the hospital's budget, to renew mortgages, and to enter into contracts.



[1]The corporate board was called a board of trustees and its members were known as trustees even though no trust was involved and they actually functioned like corporate directors. This practice is common in health services organizations, especially hospitals.

Most board members were prominent leaders in the community—a number were heavily involved in investment management and banking. The board chairman, Stacy M. Reed, was a Washington, D.C., attorney. Donald R. Ernst, former chairman of Steuart Investment Company, also in Washington, was the board treasurer. John M. Orem, M.D., was a board member and the administrator. All three were members of the executive committee. Others relevant to this case and their affiliations are listed in Table 1. As administrator, Orem was employed by the hospital. Although not an employee, Ernst was physically in the hospital on an almost-daily basis. All other

Table 1. Sibley trustees and their hospital and financial institution responsibilities

| Trustees | Hospital responsibilities | Financial institution responsibilities |
|---|---|---|
| Stacy M. Reed | Trustee (1956– )<br>Executive Committee (1961– )<br>Finance Committee (1961– )<br>Investment Committee (1961– )<br>Board Chairman (1960– )<br>President (1968–1972; 1973– ) | Security National Bank<br>Director (1930– )<br>Executive Committee (1937– )<br>Minor stockholder |
| Lanier P. McLachlen | Trustee (1956– )<br>Investment Committee (1960–1973) | McLachlen National Bank<br>Director (1974– )<br>Board Chairman (1953–1973)<br>President (1922–1954)<br>Principal stockholder (8.1%) |
| George M. Ferris | Trustee (1956– )<br>Finance Committee (1973– )<br>Investment Committee (1962–1970)<br>Acting Treasurer (1972–1973) | Ferris & Co.<br>Senior Partner (1971– )<br>Board Chairman (1971– )<br>Principal stockholder (42%) |
| Edward K. Jones | Trustee (1959– )<br>Executive Committee (1959– )<br>Finance Committee (1960–1973)<br>Investment Committee (1971–1973) | Interstate Building Association<br>Director (1932– )<br>Executive Committee (1932– )<br>Board Chairman (1969– )<br>President (1954–1969)<br>Minor stockholder<br>Riggs National Bank<br>Director (1967– )<br>Executive Committee (1967–1974)<br>Minor stockholder |
| Fred W. Smith | Trustee (1964– )<br>Executive Committee (1964– )<br>Invectment Committee (1967–1973) | Riggs National Bank<br>Advisory Director (1964– )<br>Minor stockholder<br>Jefferson Federal Savings & Loan<br>Director (1954– )<br>Executive Committee (1957– )<br>President (1959– ) |

trustees had principal vocations elsewhere, and service to the hospital was voluntary and incidental to their primary activities.

There were 11 members of the executive committee, and it was the real source of power on the board. Orem and Ernst were the most important members, as evidenced by the fact that their recommendations were routinely accepted and their actions ratified, usually without question. This relationship with the executive committee existed from the early 1950s until 1968, when Orem died after a brief illness. Ernst continued to be a dominant figure on the executive committee after Orem's death. Ernst died in 1972.

The 1960 changes in bylaws created a finance committee and an investment committee (see Appendix A). The former's primary functions were to review the budget and to report regularly the amount of cash available for investment. In turn, management of investments was to be supervised by the investment committee, which was to work closely with the finance committee.

Yet, from their creation in 1960 when the bylaws were modified until 1971—3 years after Orem's death—neither the finance nor the investment committee had ever met or conducted business. During this period—until 1968 —budgetary and investment decisions, like most other management decisions affecting the hospital's finances, were made by Orem and Ernst. The executive committee and the full board gave these decisions only cursory review.

Orem's death in 1968 obliged other board members to play a more active role in managing the hospital. The executive committee, and particularly Reed, who at that time was president of the hospital as well as chairman of the board, became more deeply involved in day-to-day management while efforts were made to find a new administrator. In 1970, he unsuccessfully pressed Ernst to activate the finance and investment committees.

It was some months after Orem's death until his replacement was selected, and during this time there was a modest reorganization. The position of executive director was created, and Garth L. Jarvis, M.D., was the first incumbent. Charles Blatchley was named administrator. Jarvis had little managerial experience, and Reed worked closely with him. It was generally agreed that Jarvis's performance was not entirely satisfactory. Ernst continued to make most of the financial and investment decisions for Sibley. However, his actions and failure to make prudent investment decisions slowly came under increasing scrutiny by several other trustees, particularly after a series of disagreements between Ernst and the hospital comptroller led to the comptroller's discharge in 1971.

In 1971, Sibley Hospital applied for a $500,000 planning grant from the Department of Health, Education, and Welfare (HEW). It was denied. Major reasons cited by the reviewers were: Jarvis's authority was substantially undercut by board involvement in the administrative operation of the hospital, and his function was undermined by the lack of an "effective" table of organization or "experienced and educated professional staff to support the chief executive officer." HEW also noted that the grant application had been developed without the knowledge of the hospital's medical staff and that the application was not of high quality generally.

## THE TREASURER

Ernst maintained almost exclusive control of the hospital's investments for more than a decade, until his death in 1972. As board treasurer, he shifted money between banks or accounts within banks and purchased or sold securities without consulting any other trustee. Because the investment and the finance committees never met, only Orem and a few other officers apparently were aware of Ernst's investment policies. Ernst did not consult with the hospital comptroller, although the comptroller did have some information about the accounts.

Ernst kept confidential the records of checking and savings accounts, the opening and closing of accounts, and the balance of various hospital accounts. Balances were never reported to other board members. Yearly audit reports were distributed to board members and other similar information was available for inspection, but the reports were treated as mere formalities. The executive committee did have to approve the opening of new accounts, however.

Board members approved Ernst's recommendations as a matter of course and rarely if ever read the relevant details of audits critically; investment decisions were left to the presumed expertise of Ernst. Some found that the treasurer regarded their suggestions as "interference" in these matters, and none forced the issue. A more vocal board member was Edward K. Jones. Over the years of Ernst's tenure, Jones repeatedly asked for information about the investment activities. He was more persistent after the hospital comptroller was forced out by Ernst. However, Jones did not believe a move to oust Ernst would succeed, and no such effort was made. Jones's belief that, over the years, Ernst's investment activities had benefited the hospital also kept him from taking steps that otherwise might have been deemed necessary.

Under Ernst's direction, Sibley kept large amounts of money on deposit with certain banks and savings and loan associations. As shown in Table 2, the hospital maintained most of its liquid assets in savings and checking accounts rather than in U.S. treasuries or investment securities that would have yielded higher interest. Note in Table 2 the change from 1971 to 1972, which resulted from Reed's review of hospital investment policies. In 1971, for example, more than one fourth of the more than $4 million available for investment was deposited in checking accounts, compared to only $135,646 in securities and $310,436 in U.S. treasuries. Although substantial sums were used to purchase certificates of deposit, which produce at least a moderate amount of income, the hospital occasionally purchased from one financial institution a certificate yielding lower interest rates than were available elsewhere.

Most of these funds were deposited in financial institutions in which board members also served in ownership or managerial capacities. An example was a single checking account, drawing no interest and maintained alternately at Riggs National Bank and Security National Bank. It usually contained more than $250,000; once it grew to nearly $1 million.

Ernst's reasons for pursuing this conservative investment policy were not clear. It was suggested by some that his experience during the Depression (i.e., bank failures)

Table 2. Summary of Sibley financial assets, 1967–1972, as of December 31[a] (in dollars)

| Type of account | 1972 | 1971 | 1970 | 1969 | 1968 | 1967 |
|---|---|---|---|---|---|---|
| Sibley | | | | | | |
| Checking | 501,333 | 1,148,769 | 1,265,288 | 588,735 | 522,174 | 655,084 |
| Savings | 2,015,448 | 826,435 | 588,979 | 866,374 | 774,661 | 646,649 |
| Certificates | 2,043,435 | 2,029,211 | 1,325,000 | 900,000 | 900,000 | 900,000 |
| U.S. treasuries | 310,764 | 310,436 | 383,786 | 220,000 | 220,000 | — |
| Securities (at cost) | 135,749 | 135,646 | 140,446 | 71,621 | 71,621 | 70,052 |
| All Hahnemann net financial assets[b] | 413,152 | 588,464 | 538,755 | 505,046 | 687,909 | 427,638 |
| Total | 5,419,881 | 5,038,961 | 4,242,254 | 3,151,776 | 3,176,365 | 2,699,423 |

[a]Average liquidity equal to 6 weeks' operating expenses.

[b]Hahnemann Hospital, another Methodist charity, was merged with Sibley in 1956 in anticipation of the move to the new facility. Hahnemann had been retained as a separate corporate entity solely to receive certain charitable contributions under the terms of various wills and trusts, agreements that predate the merger. Sibley's board members also constitute the Hahnemann board, and Hahnemann funds have been maintained in most of the same banks as Sibley's.

was an important factor. That same experience probably helps explain his belief that Sibley should maintain close relationships with a few local banks and his apparent decision to favor those banks that held a mortgage on the hospital and that had interlocking directorships with the Sibley Hospital Board. Ernst had been chairman of Steuart Investment Co., whose majority owner was Curtis S. Steuart, a Riggs Bank director, executive committee member, and stockholder.

Ernst's decisions were reached without any apparent encouragement from the banks or board members who held directorships in interlocking fashion. These same persons, however, frequently approved transactions that benefited institutions with which they were affiliated, and occasionally they would even seek out such an arrangement, but there appears to have been no conspiracy or effort to obtain personal gain from such an arrangement. When the board's investigations in early 1971 showed the inadequacy of Ernst's policies, they moved toward a more realistic investment program in a manner that negated existence of a prior agreement.

Ernst's inability to work with the comptroller resulted in the comptroller's forced resignation in September 1971. He had joined the hospital as assistant director for finance and comptroller in 1969. Beginning in early 1971, Ernst refused to cooperate with him in any fashion. It was about this time that accounts shown in Table 2 exceeded the usual norm of 1 month's operating expenses. This factor may have caused the relationship to deteriorate. The animosity must have been significant because the minutes of a February 1972, executive committee meeting show that, when Ernst was criticized by a board member about the extent of moneys being held in non–interest-bearing accounts, Ernst accused the already dismissed comptroller of misinforming the committee.

Prompted by these difficulties, Reed decided to activate the finance and investment committees in the fall of 1971. However, as chairman of the finance committee

and member of the investment committee as well as board treasurer, Ernst continued to exercise dominant control over investment decisions and, on several occasions, discouraged and flatly refused to respond to inquiries into such matters. After Ernst's death in October 1972, other members of the board assumed a more identifiable supervisory role over investment policy and hospital fiscal management in general.

## INTERLOCKING DIRECTORATES

Table 1 shows the extent to which board members who performed a variety of important hospital responsibilities also had significant positions in financial institutions with which Sibley had dealings.

One example of conflict of interest occurred when George M. Ferris advised and voted on the hospital's decision to contract for investment services. The idea was raised by Jones at a meeting of the reactivated investment committee in early 1971. It was decided that Ferris, a member of that committee, should present a proposal from Ferris & Co., of which Ferris was chairman of the board and principal stockholder, for the provision of continuing investment advisory services to Sibley. Ferris presented such a proposal on April 12, 1971, and the committee voted to recommend approval. Ferris urged acceptance and may have voted in favor of that recommendation at an informal session of the investment committee, but he then resigned from the investment committee to avoid further possible conflicts of interest. For a short time he served as acting treasurer following the death of Ernst, but several members of the board objected.

On formal approval by the hospital's legal counsel and the executive committee, of which Ferris was not a member, Sibley entered into the "investment advisory agreement" with Ferris & Co., and the written contract remained in effect for several years. Fees charged by Ferris & Co. were fair. There is ample evidence that Ferris & Co. did a good job, although shifts in market prices resulted in some loss in the account. This would not have occurred had the hospital kept the money in certificates of deposit.

A less clear example of conflict of interest occurred in the continuation of a mortgage dating from the late 1950s, when the board began negotiations with local banks to obtain a loan to finance construction of the new hospital building. When these negotiations broke off, the board obtained a commitment from a Texas bank. Although local banks had earlier refused to assist the hospital, several board members then organized a syndicate of Washington banks willing to provide the loan on terms equal to the Texas proposal and persuaded the board to accept the local offer. As a result, the syndicate agreed in 1959 to lend Sibley $3 million, secured by a mortgage on the hospital. The sum was increased to $3.5 million in 1961.

The loan was renewed in 1969 and repaid fully in 1972. Although Sibley had sufficient funds in 1969 to pay off the loan without totally impairing its ability to meet obligations as they came due, the executive committee voted instead for renewal. The committee reasoned that reduced cash flow would have put operations on a tight basis, and available funds might be needed to renovate certain property owned by Sibley, or for a new construction.

Terms of the loan were entirely fair to Sibley. There is no indication that the board could have received better terms elsewhere or that it had failed to diligently seek an optimal arrangement at the time of the original loan. The renewal in 1969 also appears to have been a reasonable, good-faith business decision. There is no indication that either decision was motivated by a desire to benefit the banks involved at the hospital's expense. Nonetheless, the hospital held significant amounts of funds in low– or non-interest–bearing accounts in many of the same banks to which it continued to pay interest on the mortgage.

It is unclear to what degree full disclosure preceded the frequent self-dealing that occurred during the 1960s. It is reasonable to assume that board members were generally aware of the various bank affiliations of their peers, but there is no indication that these conflicting interests were stressed in the executive committee or at meetings of the full board when it voted to approve particular transactions. At one time or another, all those on interlocking directorates approved self-dealing transactions, most of which were of relatively minor significance: one interested board member would join a dozen disinterested fellow members of the executive committee in unanimously approving a new bank account; two or three interested board members would support a similarly large group in voting to give or renew the hospital's mortgage.

There was no evidence that the financial institutions ever had any contact among themselves relating to handling Sibley's business, its apportionment, or even its existence. Board members as a group did not solicit business for any particular bank or savings and loan association, and, indeed, it appears that most of the Sibley business done with these interlocking institutions was initiated by hospital officers without advance knowledge or direction of the board. There was no recognizable pattern of dealing, no discussion, no complaint of deviation from a course of agreed conduct—in fact, nothing from which a conspiracy between board members and the banking institutions can be implied beyond the simple fact that the hospital did considerable business with financial institutions that had some interlocking ties to its board.

## UNWELCOME PUBLICITY

In 1969 and 1970, Bradshaw Mintener, vice chairman of the board, began to raise questions about the quality of investment practices. Board minutes show that at various times he estimated losses as high as $50,000–$60,000 per year from failure of the board to have more aggressive investment policies. This amount was the estimated income that would result from placing checking account funds in a savings account or similar investment rather than paying off the 7⅛% mortgage. At one point in this controversy, Reed threatened Mintener with legal action.

In early 1973, information about the controversy over investment policy was leaked to the *Washington Post,* and a series of articles followed. The *Post* articles raised questions among various members of the public. The articles reported that as much as $1 million was being held in interest-free accounts, costing the hospital and its patients more than $100,000 a year in interest income. The articles estimated that the failure to

pay off the mortgages added $1.11 to each patient day at Sibley. It was also reported, however, that the average per diem at Sibley of $111 was lower than that of most Washington, D.C., hospitals. More than a quarter of its $11.3 million annual revenue was received from the federal government, primarily through Medicare and Medicaid.

Reed was quoted in the article as saying that the hospital's attorneys did not believe board members were violating the law because, in Reed's view, they did not gain any personal benefit from transactions with the hospital. If there was any benefit, it was overshadowed by the benefit to the hospital of having the bankers' expert advice on financial matters. "Such advice," he said, "cannot be reckoned in terms of money." Reed went on to explain that large cash reserves were held in checking and savings accounts in order to pay for future remodeling or hospital expansion. This was done instead of retiring the mortgage.

The articles quoted a board member as saying that Reed and Ernst had periodically fought for control of Sibley since Reed had joined the board in 1956. As Reed got the better of these struggles, the balances in the account at his bank, Security, would rise. Likewise, as Ernst achieved more control, hospital balances at Riggs would go up. Reed became president of Sibley as well as chairman of the board in 1968. One year later, the hospital's primary checking account was switched from Riggs to Reed's bank, Security. When Ernst objected to the high balance at Security in September 1971, the primary account was transferred to Riggs and balances quickly rose to between $400,000 and $750,000.

On February 13, 1973, just over 1 week following disclosure of the alleged improprieties at Sibley Hospital, legal action was filed by David M. Stern and others as consumers of health services in a class action suit against the hospital and several board members and financial institutions. The plaintiffs contended that the five board members and five financial institutions were engaged in a conspiracy to enrich themselves at the expense of the hospital (and, ultimately, those who paid for services there). The interlocking relationships cited in the complaint are shown in Table 1. It was alleged that the defendants accomplished the conspiracy by arranging to have Sibley maintain unnecessarily large amounts of money on deposit with the defendant banks and savings and loan associations, drawing inadequate or no interest. Table 2 shows that the hospital did maintain its liquid assets in savings and checking accounts rather than in treasuries or securities, at least until the investment review instituted by Reed in late 1971. The plaintiffs also attempted to bolster the conspiracy theory by pointing to two other hospital transactions: continuation of a mortgage with the defendant financial institutions and the investment advisory agreement with Ferris & Co.

The plaintiffs also contended that the facts revealed serious dereliction of duty on the part of the defendants, who were alleged to have engaged in mismanagement, nonmanagement, and self-dealing; in other words, a breach of the fiduciary relationship that existed by reason of their service as board members.[2] Mismanagement was

[2]To be a fiduciary means that one may not take selfish advantage of one's position or act in such a way as to benefit oneself. Fiduciaries must exercise good faith and serve the purposes of the organization. They must not utilize inside information or the power of office for personal benefit.

allegedly shown by the failure to use due diligence in investing and using hospital funds. Nonmanagement was alleged in the failure to supervise management of hospital investments or even to attend meetings of the committees charged with such supervision. The plaintiffs also alleged that self-dealing resulted from investing funds in financial institutions in which board members had director or officer status.

Prior to trial, but after suit was brought, the board adopted a new bylaw based on guidelines issued by the American Hospital Association (AHA). The AHA guideline is shown in Appendix B. It uses the modified corporate rule, which relies on disclosure and abstaining from voting or any attempts to influence other members as means of eliminating or reducing potential conflicts of interest.

The fact that a lawsuit was filed against Sibley Hospital and against individual board members and their affiliated financial institutions shocked and angered virtually the entire board. They wondered what they had done to incur such an embarrassing reaction by members of the public, which they had labored to serve. It was a fine way to be thanked for their many hours of donated time and hard work on behalf of the community. However, they were determined to fight the allegations and make every attempt to vindicate themselves.

## APPENDIX A: ADMINISTRATION OF THE HOSPITAL'S FINANCES

The bylaws of the hospital provided that business of the corporation should be transacted by a board of trustees (Article II), which should have regular meetings in October and May of each year (Art. III, Section 1):

> There shall be two regular meetings to be held in Washington, D.C., on dates to be fixed by the Executive Committee. One of said regular meetings shall be held in May of each year. The other regular meeting, to be known as the Semi-Annual Meeting, shall be held in October of each year.

Article V, Section 14, described the duties and responsibilities of the treasurer as follows:

> The Treasurer shall receive all funds and shall be the custodian of all securities belonging to the Corporation and shall perform the usual duties attendant upon this office, and the Treasurer may delegate such duties as are approved by the Board or Executive Committee of the Board.

Article VIII provided that the board shall elect from its members an executive committee. Section 2 of this article was as follows:

> The Executive Committee shall exercise general supervision and administration of the affairs of the corporation and during the interim of the meetings of the Board of Trustees shall be authorized to fully exercise the powers and duties of the Board, except that said committee shall have no power to amend the Bylaws or to fill vacancies which may occur in the Board of Trustees.

Article IX, Section 1, provided for establishment of a finance committee consisting of the treasurer, the chairman of the investment committee, and three additional members. Section 2 was as follows:

> (A) It shall be the duty of the Finance Committee to administer all funds for the maintenance, operation, and development of the Hospital, including appropriations made by the Department of Work in Home Fields of the Woman's Division of the Board of Missions of the Methodist Church, and gifts, grants, bequests, and annuities from interested friends, patrons, and other sources.
>
> (B) The Finance Committee, with the President, shall prepare the annual budget and submit it to the annual meeting of the Board for its approval.
>
> (C) The Treasurer, under the direction of the Finance Committee, shall establish and maintain a separate fund, keeping the necessary books and records thereof, to be known as the *building fund,* in which shall be kept all securities or cash which are intended to be set aside for use in the building expansion program of the Hospital.

Article X provided for an investment committee consisting of the treasurer and two members of the board. Its duties were set forth in Section 2 as follows:

> (A) It shall be the duty of the Investment Committee to invest all moneys belonging to the Corporation which are available for investment purposes, under the direction of the Board of Trustees or the Executive Committee, and to see that all conditions, provisions, and specifications attached to any gifts, grants, and bequests to the corporation are complied with and carried out.

(B) The Treasurer, under the direction of the Investment Committee, shall establish and maintain a separate fund, keeping the necessary books and records thereof, to be known as the ***endowment fund,*** in which shall be kept all securities and cash which are to be retained as a permanent endowment. Only the income from said Endowment Fund shall be expended and such income shall be used solely for maintenance or current operating expenses of the Hospital, except that all or any of said fund may at any time be used for capital improvements or other expenditures as the Board may direct.

The following facts were established from hospital's bylaws, minutes of board meetings and various committees, and papers filed with the court during the legal proceedings:

1. The finance committee was charged with the responsibility of and did review the budget of the hospital, approved it, and submitted it to the executive committee for approval. The finance committee determined what funds of the hospital were available for investment.
2. The investment committee was charged with the responsibility of and did review the hospital's investments and submitted its recommendations to the executive committee.
3. The treasurer, under the direction at times of the executive committee or the president and at other times on his own initiative, handled the funds of the hospital, opened checking and savings accounts, and purchased certificates of deposit from the various financial institutions as well as reviewed the balances in various accounts.

## APPENDIX B: AMERICAN HOSPITAL ASSOCIATION— ARTICLE XXVIII, CONFLICTS OF INTEREST[3]

### *Section 1*

Any duality of interest or possible conflict of interest on the part of any governing board member shall be disclosed to the other members of the board and made a matter of record through an annual procedure and also when the interest becomes a matter of board action.

### *Section 2*

Any governing board member having a duality of interest or possible conflict of interest on a matter shall not vote or use his or her personal influence on the matter, and he or she shall not be counted in determining the quorum for the meeting, even where permitted by law. The minutes of the meeting shall reflect that disclosure was made, the abstention from voting, and the quorum situation.

### *Section 3*

The foregoing requirements shall not be construed as preventing the governing board member from briefly stating his or her position in the matter, nor from answering pertinent questions of other board members since his or her knowledge may be of great assistance.

### *Section 4*

Any new member of the board will be advised of this policy upon entering on the duties of office.

[3]Adopted by the board of trustees of Sibley Hospital in 1974.