Berkshire Beyond Buffett: The Enduring Value of Values (Chapter 8)

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Abstract:
Berkshire Hathaway, the $300 billion conglomerate that Warren Buffett built, is among the world’s largest and most famous corporations. Yet, for all its power and celebrity, few people understand Berkshire, and many assume it cannot survive without Buffett. This book proves them wrong.

In a comprehensive portrait of the corporate culture that unites Berkshire’s subsidiaries, Lawrence Cunningham unearths the traits that assure the conglomerate’s perpetual prosperity. Riveting stories of each subsidiary’s origins, triumphs, and journey to Berkshire reveal how managers generate economic value from intangibles like thrift, integrity, entrepreneurship, autonomy, and a sense of permanence.

In chapter 8, excerpted here, Cunningham discusses the value of autonomy in a business organization, highlighting Berkshire’s Pampered Chef subsidiary and noting the model and some of its limits at its Scott Fetzer subsidiary.

The chapter portrays Berkshire’s embrace of autonomy as reflecting a trust-based model of corporate governance, in contrast to the prevailing control-oriented model. It dramatizes with a close look at the case of David Sokol, a top Berkshire executive widely seen as Buffett’s heir apparent, until his purchase of the stock of a potential Berkshire takeover target caused a rare scandal at the conglomerate.

Keywords: Buffett, Berkshire, Doris Christopher, corporate governance, corporate culture, autonomy, delegation, independent contractors, distributors, subsidiaries, conglomerates, decentralization, Sokol, Munger, internal control, trust, insider trading

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8

Hands off

At corporate headquarters in Omaha, Berkshire employs two dozen people; worldwide, Berkshire subsidiaries employ more than 300,000. The practice at the top is hands-off, stressing decentralization and individual autonomy—values that define Berkshire culture. In contrast, most business organizations are hierarchies with a bureaucratic chain of command. They act through committees and meetings, with multiple layers of reporting and review.

Berkshire’s hands-off management approach was made by choice but became necessary by default—with such a large number of subsidiaries in such a broad range of businesses, strict hands-on control would not be feasible. The choice to operate in a decentralized manner from the beginning reflected a belief in the value of autonomy and a conviction that people properly entrusted with authority will generally exercise it faithfully. Business value results from letting responsible people make decisions, whether about manufacturing, distribution, customer service, acquisitions, or any other aspect of running a business.

And just as Berkshire Hathaway takes a decentralized approach, so do many of its subsidiaries; throughout the Berkshire universe are scores of companies in which individuals are supported by a larger corporate structure but empowered to drive their own success.

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The Pampered Chef, founded by Doris Christopher, provides a vivid illustration of some advantages—and pitfalls—of organizations that grant broad autonomy. Although a hands-on manager, Christopher’s business model is based principally on empowering others.
During the late 1960s, Christopher taught home economics in a special program at the University of Illinois. In 1980, at age thirty-five and with her children in school, she faced the challenge of finding a work–family balance that would allow her to enjoy a rewarding career and joyous parenting. In resolving this challenge, Christopher earned both a Horatio Alger Award and an Ernst & Young Entrepreneur of the Year designation.

At her husband’s suggestion, Christopher seized upon a modern version of the old-fashioned Tupperware business model: direct marketing of sophisticated cooking tools sold at gatherings in people’s homes. In 1980, she borrowed $3,000 under a life insurance policy—the only debt the company would ever incur. Christopher bought an inventory of gadgetry wholesale and began her business. She hosted “kitchen shows” (not Tupperware parties) and would dub her sales team “kitchen consultants” (not Avon ladies). At the shows, consultants demonstrate wares by cooking dishes, and all guests then enjoy a feast.

The business, initially operated from Christopher’s basement, grew slowly at first. Year-one (1981) sales totaled $67,000, with twelve kitchen consultants on board. In 1984, sales reached $400,000, outgrowing the basement. By 1989, two hundred kitchen consultants generated revenues of $3.5 million.

As the number of kitchen consultants steadily rose, revenue grew in tandem: 1991, $10 million; 1993, $65.3 million; 1995, $200 million; 1997, $420 million. By this time, the Pampered Chef had grown to twenty-five thousand kitchen consultants—a figure that would double and then triple before long.

Christopher chose products carefully, with an eye toward making the cooking experience enjoyable for professionals and novices alike. She experimented with all tools before marketing them and even developed recipes and menus to demonstrate their use.

The key to the company’s success, however, was its team of kitchen consultants. An exquisite example of decentralization and autonomy, consultants make a modest initial payment for a starter demonstration set to use in their shows. The company adds new items a few times a
year that consultants must buy and market. It supplies consultants with guidance for
demonstrations, including recipes and care instructions.

Adding consultants increases revenue and profits—without increasing expenses.
Consultants earn a starting commission of 20 percent on gross sales plus an additional 2 percent
for gross sales above a target level. Consultants work as little or much as they wish, so long as
sales reach a relatively low monthly minimum. Additional sales incentives include bonuses in the
form of all-expenses-paid family vacations.

Christopher hails the consultants as the company’s “crown jewel,” stating they are “by far
our most valuable asset” and the “heart and soul of our business.” She stresses that they are
independent, not employees of the Pampered Chef, “an army of self-employed
businesspeople.” They have no fixed hours or sales territories. Most direct-sales organizations
conduct weekly sales meetings, but at the Pampered Chef, monthly meetings suffice. The
monthlies are low-key pep rallies rather than the pressure cookers found at many corporate sales
meetings. They are social as well as business, which helps morale and offers the opportunity to
exchange useful ideas.

The Pampered Chef also uses the multi-level marketing model. Consultants can recruit
other consultants and earn commissions on their sales, too (called “overrides”). The opportunity
to generate overrides encourages people to build a sales team. The Pampered Chef assures that
these arrangements ultimately drive sales to consumers, and are not, as some have alleged about
other multi-level marketers, merely used by larger distributors to extract sales from smaller and
smaller ones down a daisy chain, amounting to no more than a pyramid scheme. In multi-level
marketing programs, the trade-off between autonomy and authority is stark. Give distributors
business power, and most will embrace it responsibly and profitably; restrain the sales force by
strong internal control, and many will not perform as well.

Christopher is by nature a hands-on manager and built the Pampered Chef by working
around the clock, immersing herself in operational details. The business model, however,
required giving consultants autonomy, and scale eventually required delegation to colleagues at the corporate level. Christopher believes in the principle of “responsibility with authority.” She explains: “People don’t like being dictated to. . . . Give [employees] the freedom to run with the ball.”

The Pampered Chef’s greater problem had been managing revenue growth. In the late 1980s, for example, recruiting multiplied so quickly that sales volume outpaced capacity for inventory management, order fulfillment, collections, and payment processing. The company faced a dilemma familiar to many successful entrepreneurs: sustain growth at some cost in service quality or cede growth and maintain standards. In direct sales, a recruiting freeze is often a death knell—a bad signal to consumers and a morale downer to the troops. But in 1990, the Pampered Chef opted for quality over quantity and imposed a temporary freeze on new recruits. This controversial and gutsy move meant putting fundamental values ahead of short-term profit, but it ultimately translated into economic gain. As Christopher reflected years later:

Looking back, the recruiting freeze augmented our reputation with our sales force, customers, and vendors. People saw us as an honest company that was trying to do the right thing and not overestimate its capabilities. We are very conservative in our business practices by nature, and our people knew that. When we told them something, they knew it was the truth.

By 2002, annual sales exceeded $700 million, thanks to sixty-seven thousand kitchen consultants. Christopher cemented her plans for the company’s future by contacting Berkshire and arranging a meeting with Buffett in Omaha. Eying her squarely, Buffett explained that selling to Berkshire would not increase her net worth and could decrease it. The transaction involved trading an asset she owned outright for cash that she would invest in diverse assets. In the future, he advised, the company would likely be worth more than the asset portfolio. So, he wondered, why would she sell?
Christopher explained her decision in terms of the value of values: she wanted to sell to Berkshire in order to protect her sales force and employees and to maintain the culture they had built together. Christopher had considered a public offering, which can yield rich paydays for accomplished entrepreneurs. (Remember Jim Clayton noting how the millions he netted going public explains why so many entrepreneurs consider an IPO.) But Christopher valued Berkshire because it did not interfere with operations and promised permanence. Buffett, who has an uncanny ability to measure character in brief meetings, liked Christopher instantly. The two made a deal within three weeks. As in many other Berkshire deals, employees received a thank-you bonus of $1,000 for each year they had worked for the company.

An example of the support and consideration for these consultants was the way Berkshire addressed a political controversy that led to the termination of Berkshire’s shareholder charitable contribution program in 2003. At most corporations, boards choose which charities receive corporate beneficence, but that goes against Berkshire culture. Conceived by Munger in 1981, Berkshire’s program let shareholders name the organizations, with the aggregate amount set by the board. The program was popular with Berkshire shareholders, not only because it allowed for effortless philanthropy, but also because this type of giving was modestly more tax efficient than direct philanthropic contributions. Shareholders designated a wide range of recipients, from Catholic Social Services to Planned Parenthood.

The program’s size and reach drew attention from social activists on hot topics like abortion, who in the early 2000s, orchestrated boycotts of Berkshire subsidiaries or their products. Among the targets was the Pampered Chef. Consultants reported to Christopher that they were receiving threats from activists to boycott their business if Berkshire continued to fund charitable organizations with positions they opposed. The boycotts impaired the potential earnings of the Pampered Chef consultants, an unintended side effect. The campaign became so intrusive that Christopher took the matter to Buffett.

Consequently, Berkshire discontinued its shareholder charitable contribution program.
This decision reflected something unexpected about hands-off management coupled with individual autonomy: it does not leave people on their own but provides support. To make autonomy work in an intensely decentralized organization, this commitment must extend to all who exercise the autonomy on the organization’s behalf. For the Pampered Chef, this includes its kitchen consultants. The cost to Berkshire of cancelling its shareholder charitable contribution plan was worth paying in the name of the more fundamental Berkshire values of autonomy and integrity.

Buffett put it this way:

[The boycotts] meant that people who trusted us—but who were neither employees of ours nor had a voice in Berkshire decision making—suffered serious losses of income. For our shareholders, there was some modest tax efficiency in Berkshire doing the giving rather than their making their gifts directly. But these advantages paled when they were measured against damage done to loyal associates [of the Pampered Chef] who had with great personal effort built businesses of their own. Indeed, Charlie and I see nothing charitable in harming decent, hard-working people just so we and other shareholders can gain some minor tax efficiencies.

The true value at the Pampered Chef is in the fleet of kitchen consultants, as Marla Gottschalk, who became the company’s chief executive in 2006, quickly realized. Gottschalk came to the Pampered Chef after a fourteen-year career as a senior executive at Kraft Food Groups Inc. and immediately noticed glaring cultural differences. Where Kraft favors a controlling managerial philosophy, Berkshire is hands-off; where Kraft has thick levels of managerial oversight, the Pampered Chef has a thin management layer.17 Gottschalk’s primary focus was on how to maintain the appeal of being a kitchen consultant and how to help consultants succeed. Every morning, Gottschalk studied two daily figures, sales volume and consultant numbers.18 Of the two, she stressed, the number of consultants is by far the more
important, as the consultants remain the company’s most valuable asset.

In December 2013, having enjoyed a successful tenure, yet facing lackluster growth, Gottschalk stepped down as chief executive of the Pampered Chef. Christopher, returning to the helm from retirement, found the company’s culture of autonomy and entrepreneurship intact. But the business model confronted challenges from Internet based merchandising and other demographic changes. In an interview for this book, Christopher said she is happy serving her encore role as chief executive while looking for the right visionary to shape the next generation of the Pampered Chef.

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The Pampered Chef’s direct-sales method has counterparts in the divisions of Scott Fetzer, which is best known for pioneering door-to-door sales of Kirby vacuum cleaners and World Book encyclopedias and the direct-response television marketing of Ginsu knives. The Kirby vacuum, for instance, has always been marketed with the Kirby Marketing System.19

Distributors pay Kirby a wholesale price and then resell through dealers who make door-to-door sales to consumers. Kirby requires all its salespeople to use the same printed materials, including owner’s manuals and warranties. Beyond that, distributors and dealers run their businesses as they see fit. Self-starters thrive with such incentives. By empowering the sales force, the company increases sales without adding expenses, thus boosting profits and margins.20

A chief concern of any decentralized business model is policing personnel, such as when distributors mistreat dealers21 or when dealers use illegal high-pressured sales tactics. At Scott Fetzer, distributors of Kirby vacuums are autonomous businesses. But they also represent the brand and company. Occasionally, they violate company policy on proper marketing and employment practices or even break consumer protection and fair labor laws.22 Private lawsuits and state enforcement actions result.23
To avoid the costs of legal entanglements and liability would require withdrawing distributor autonomy and revising the business model to subject all employees to comprehensive training, supervision, and remediation. Such an approach imposes direct administrative costs, as well as unobservable costs to entrepreneurship and the spirit of ownership that autonomy showers on self-starters. Managers at Scott Fetzer have concluded, based on decades of experience, that the distributorship system’s autonomy value outweighs such costs.

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Berkshire corporate policy strikes a balance between autonomy and authority. Buffett issues written instructions every two years that reflect this balance. The missive states the mandates Berkshire places on subsidiary CEOs: (1) guard Berkshire’s reputation; (2) report bad news early; (3) confer about post-retirement benefit changes and large capital expenditures (including acquisitions, which are encouraged); (4) adopt a fifty-year time horizon; (5) refer any opportunities for a Berkshire acquisition to Omaha; and (6) submit written successor recommendations. Otherwise, Berkshire stresses that managers are chosen because of their excellence and are urged to act on that excellence.

Berkshire defers as much as possible to subsidiary chief executives on operational matters with scarcely any central supervision. All quotidian decisions would qualify: GEICO’s advertising budget and underwriting standards; loan terms at Clayton Homes and environmental quality of Benjamin Moore paints; the product mix and pricing at Johns Manville, the furniture stores, and the jewelry shops. The same applies to decisions about hiring, merchandising, inventory, and receivables management, whether Acme Brick, Garan, or the Pampered Chef. Berkshire’s deference extends to subsidiary decisions on succession to senior positions, including CEO, as seen in such cases as Dairy Queen and Justin Brands.

Munger has said Berkshire’s oversight is just short of abdication. In a wild example, Lou
Vincenti, the chief executive at Berkshire’s Wesco Financial subsidiary since its acquisition in 1973, ran the company for several years while suffering from Alzheimer’s disease—without Buffett or Munger being aware of his condition. “We loved him so much,” Munger said, “that even after we found out, we kept him in his job until the week that he went off to the Alzheimer’s home. He liked coming in, and he wasn’t doing us any harm.” The two lightened a grim situation, quipping that they wished to have more subsidiaries so earnest and reputable that they could be managed by people with such debilitating medical conditions.

There are obvious exceptions to Berkshire’s tenet of autonomy. Large capital expenditures—or the chance of such—lead reinsurance executives to run outsized policies and risks by headquarters. Berkshire intervenes in extraordinary circumstances, for example, the costly deterioration in underwriting standards at Gen Re and the threatened repudiation of a Berkshire commitment to distributors at Benjamin Moore. Mandatory or not, Berkshire was involved in RC Willey’s expansion outside of Utah and rightly asserts itself in costly capital allocation decisions, like those concerning purchasing aviation simulators at FlightSafety or increasing the size of the core fleet at NetJets.

Ironically, gains from Berkshire’s hands-off management are highlighted by an occasion when Buffett made an exception. Buffett persuaded GEICO managers to launch a credit card business for its policyholders. Buffett hatched the idea after puzzling for years over an additional product to offer its millions of loyal car insurance customers. GEICO’s management warned Buffett against the move, expressing concern that the likely result would be to get a high volume of business from its least creditworthy customers and little from its most reliable ones. By 2009, GEICO had lost more than $6 million in the credit card business and took another $44 million hit when it sold the portfolio of receivables at a discount to face value. The costly venture would not have been pursued had Berkshire stuck to its principle of autonomy.

The more important—and more difficult—question is the price of autonomy. Buffett has explained Berkshire’s preference for autonomy and assessment of the related costs:
We tend to let our many subsidiaries operate on their own, without our supervising and monitoring them to any degree. That means we are sometimes late in spotting management problems and that disagreeable operating and capital decisions are occasionally made. . . . Most of our managers, however, use the independence we grant them magnificently, rewarding our confidence by maintaining an owner-oriented attitude that is invaluable and too seldom found in huge organizations. We would rather suffer the visible costs of a few bad decisions than incur the many invisible costs that come from decisions made too slowly—or not at all—because of a stifling bureaucracy.

Berkshire’s approach is so unusual that the occasional crises that result provoke public debate about which is better in corporate culture: Berkshire’s model of autonomy and trust or the more common approach of command and control. Few episodes have been more wrenching and instructive for Berkshire culture than when David L. Sokol, an esteemed senior executive with his hand in many Berkshire subsidiaries, was suspected of insider trading in an acquisition candidate’s stock.

In 2010, Buffett asked Sokol, then running both MidAmerican Energy and NetJets after Richard T. Santulli left, to scout acquisition opportunities. All Berkshire subsidiary chiefs are encouraged to seek acquisitions, but this assignment might have been a proving ground for Sokol, by then widely seen as the leading candidate to succeed Buffett.

Sokol began in a most un-Berkshire-like way, however, by hiring bankers to help with the search. Sokol instructed the team, from Citi, to focus on the chemicals industry. They identified eighteen potential targets, and Sokol was attracted to one, The Lubrizol Corporation, maker of specialty chemicals, including additives for the automotive and petroleum industries. On December 13, 2010, Sokol told the bankers to ask Lubrizol’s chief executive, James L. Hambrick, if the company might be interested in speaking with Buffett about a Berkshire acquisition. Hambrick said he would raise the proposition with Lubrizol’s board, and on December 17, Citi reported this to Sokol.
Sokol regarded Lubrizol as an outstanding company and an excellent investment. As a result, during the first week of January 2011, Sokol, with an annual income of $24 million, bought $10 million worth of Lubrizol stock. (He had also bought, then quickly sold, a smaller amount of the stock in mid-December.) The next week, on January 14, Hambrick called Sokol to express interest and set a meeting with Buffett. Sokol then reported the acquisition opportunity to Buffett.

Buffett responded, “I don’t know anything about Lubrizol.”

Sokol said, “Well, take a look at it. It might fit Berkshire.”

Buffett asked, “How come?”

Sokol replied, “I’ve owned it and it’s a good company. It’s a Berkshire-type company.”

Buffett studied Lubrizol’s annual reports. He did not comprehend all of the chemical science, except to appreciate that petroleum additives are indispensable to running engines. However, understanding a business’s arcane details is far less important than grasping the economic characteristics of its industry and the company’s position, Buffett says. After speaking with Sokol and lunching with Hambrick on February 8, Buffett had a sense of Lubrizol’s culture and found the company’s prospects favorable.

By March 14, Berkshire agreed to acquire Lubrizol for a 30-percent premium over Lubrizol’s stock market price. After the announcement, John Freund, a Citi banker and Buffett’s stockbroker, called Buffett to congratulate him, expressing pride in Citi’s role in facilitating the deal. Surprised to hear of this role, Buffett had Berkshire’s CFO, Marc Hamburg, call Sokol for information about Citi’s participation in the deal and Sokol’s ownership of Lubrizol stock. During the next week, Sokol would provide greater detail, as Berkshire’s
attorneys from Munger, Tolles & Olson grilled him while assisting Lubrizol’s lawyers in drafting disclosure documents about the transaction. Buffett was in Asia that week, and when he returned, Sokol tendered his resignation. Sokol tried to retire from Berkshire on two previous occasions, but Buffett and the other Berkshire directors persuaded him to stay. This time he would go.

On March 29, Buffett drafted a press release reporting Sokol’s resignation. He sent the draft to Sokol for review. The draft attributed Sokol’s resignation to how recent events had dashed Sokol’s hopes of succeeding Buffett at Berkshire. Sokol objected to this explanation. Not only did Sokol disclaim pretensions of succeeding Buffett, he said he was resigning for personal reasons and did not believe he had done anything wrong.

So before issuing the press release the next day, Buffett replaced the original wording with an excerpt from Sokol’s resignation letter. The release attributed Sokol’s resignation to his desire to manage his family’s resources. Buffett then lauded Sokol’s “extraordinary contributions” to Berkshire, referencing MidAmerican Energy, NetJets, and Johns Manville. The release then summarized Sokol’s Lubrizol stock purchases, concluding that they were lawful and reiterating Sokol’s claim that they had nothing to do with his resignation.

The March 30 press release sparked criticism. People could not reconcile Berkshire’s and Buffett’s usual rectitude with mild commentary on what appeared to outsiders a case of insider trading. It “suggested a degree of [Buffett’s] closeness to Sokol and perhaps a degree of reciprocity and a willingness to let him slide because he had done good things for Berkshire in the past.” Shareholders demanded to know why Buffett was not furious.

Buffett accepted the criticism, noting that had Berkshire’s lawyers written the release, it would have been worded more carefully. Munger acknowledged that the press release was flawed, though cautioned against letting anger figure in such exercises. Corporate lawyers have honed the sober craft of drafting press releases, and CEOs usually entrust the task to them. Much as with Buffett’s idea to move GEICO into the credit card business, his mistake of writing his own press release underscored the value of delegation. In the Sokol case, this was rather
ironic, considering how critics soon attacked Berkshire culture as being too hands-off.

Berkshire’s audit committee had lawyers from Munger, Tolles & Olson evaluate the case. On April 26, the committee concluded that Sokol’s purchase of Lubrizol stock violated Berkshire policies. These policies restrict managers from buying stock in companies Berkshire is considering acquiring and bar putting confidential corporate information to personal use. Above all, Sokol violated rule one of Buffett’s biannual letter to Berkshire CEOs mandating that they safeguard Berkshire’s reputation. The audit committee’s stinging rebuke overruled the slap on the wrist conveyed by Buffett’s March 30 press release.

Coming on the heels of the press release, however, critics objected to the absence of an impartial investigation. The audit committee is an arm of the board, and the Lubrizol episode raised a question of board oversight. Moreover, the committee might have retained any number of firms to conduct a review, yet used Munger, Tolles & Olson, which has deep Berkshire ties.

Nevertheless, the audit committee’s repudiation of Buffett’s initial judgment caused Buffett to change his mind. On April 30, at Berkshire’s annual meeting, Buffett dedicated the opening segment to the topic. He showed a clip from his press interview at Salomon Brothers twenty years earlier in which he told employees to avoid behavior they would not wish reported on the front page of a newspaper. Then Buffett went on to denounce Sokol’s conduct as “inexcusable and inexplicable”—a phrase Buffett had also used when addressing the perpetrators of the Salomon scandal. Discussion turned to broader criticism then circulating about Berkshire’s culture of hands-off management.

Critics contended that the very fact that Sokol (or any executive) would violate company policy raised doubts about the effectiveness of a company’s internal control systems. Modern corporate control systems rely heavily on formal commands, consisting of mandatory procedures, reporting, approvals, and redundant oversight. Berkshire, in contrast, puts its trust in people rather than in processes. Critics suspected Berkshire’s culture of autonomy and trust was a culprit in the Sokol affair.
It would be overstatement to suggest that any given violation is an indictment of a corporation’s controls or culture. No system prevents all violations, not even the most effective command and control. Rather, the Sokol episode represented the kind of thing every company hopes that culture and controls will deter. The episode did expose limits of the autonomy-and-trust model.

Munger expanded on this theme at Berkshire’s 2011 annual meeting on April 30:

The greatest institutions . . . select very trustworthy people, and they trust them a lot . . . There’s so much self-respect you get from [being] trusted and [being] worthy of the trust that [the] best compliance cultures are the ones which have this attitude of trust. [Some corporate cultures] with the biggest compliance departments, like Wall Street, have the most scandals. So it’s not so simple that you can make your behavior better automatically just by making the compliance department bigger. This general culture of trust is what works. Berkshire hasn’t had that many scandals of consequence, and I don’t think we’re going to get huge numbers either.

In any corporate culture, it is important how officials respond to transgressions. In congressional testimony concerning the Salomon Brothers bond trading scandal, Buffett formalized his admonition to company personnel in words that reverberated through the arena of the 2011 Berkshire shareholders’ meeting: “Lose money for the firm, and I will be understanding; lose a shred of reputation for the firm, and I will be ruthless.”

Amid the Sokol affair, other Berkshire subsidiaries found an opportunity to offer a lesson. Todd Raba, chief executive of Johns Manville, where Sokol had intervened as chairman, gave Buffett a copy of a note issued to his company’s employees the day the audit committee report was published. It said:

The audit committee clearly found that Mr. Sokol compromised the integrity-related values both Berkshire and JM have worked so hard to ingrain in the fabric
of both companies. This should serve as a tragic lesson learned for every employee in JM. There are no gray areas when it comes to integrity.

In Sokol’s case, Berkshire turned over all information to the Securities and Exchange Commission. The SEC looked into the matter, but ultimately dropped the case in January 2013. The SEC did not offer any explanation, but a victory was uncertain. For one, Sokol had no authority over whether Berkshire would acquire Lubrizol. That meant the “information” he had when he bought Lubrizol stock was neither ripe nor reliable. So the SEC might have had difficulty proving the legal requirement of “materiality.” Plus, since Sokol was not a Lubrizol employee, he did not commit classic insider trading when buying its stock, so the SEC would need to show that he “misappropriated” Berkshire property, which was not obvious.

The SEC’s decision not to pursue a case against Sokol contrasts with the audit committee’s judgment condemning him for violating Berkshire policy. Differences between business judgments and legal conclusions are common in corporate practice because ethics codes are often stricter than legal mandates. Law sets minimum requirements, leaving companies free to refine standards upward. In fact, many command-and-control structures are efforts to comply with the letter of the law; Berkshire’s trust-and-autonomy culture aspires to a higher bar.

Consistent with the SEC’s conclusion, Sokol’s mistake was less in buying Lubrizol stock than in failing to disclose his recent purchase to Buffett. The audit committee’s reaction underscored Berkshire’s sensitivity to public perceptions, whereas Sokol heralded the SEC’s decision as his vindication. His attorney even argued that what he had done was expressly permitted by his employment agreement with Berkshire. Sokol’s infraction was small in relation to the price he paid, illustrating what ruthlessness means.

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Bill Child, the entrepreneur who built family-operated RC Willey into a regional furniture and
appliance powerhouse, relates the story of a rival who taught him lessons about autonomy. The competitor had begun business, just as Willey had, from a building next to his house, with no overhead, low prices, and one-on-one-service. The business grew, and he built a store in a commercial zone. He hired employees, and the business grew even more.

But the owner never empowered any of his employees. Instead, he tried to perform every aspect of the business himself, as he had always done. The result: customer service and employee morale both suffered. Finally, the man could not sustain enough sales to cover the rising cost of overhead, and he lost his business. Child draws two lessons from the story:

First, delegation is vital to growing a small business. Second, true delegation only exists when the leader trusts his people enough to allow them to perform their responsibilities without constant interference.

Berkshire CEOs, in correspondence and interviews for this book, stress the value they assign to Berkshire’s autonomy, which is useful for large corporations as well as small. At Clayton Homes, the large vertically integrated manufactured housing company, for example, Kevin Clayton explained that the company treats its business groups autonomously. Each group—manufacturing, retail, finance, insurance, trailer park—stands on its own. This, he explains, creates long-term economic value. The company also embraces the 90/10 rule: junior managers should make 90 percent of the decisions, while senior managers collaborate on the other 10 percent, which involve unusual risk, require special skills, or go beyond the junior manager’s expertise.

In another interview for this book, Jim Weber, CEO of Brooks, Berkshire’s running shoe subsidiary, said that he has never had so much autonomy in his business career and never felt so accountable and responsible. The lesson: reposing trust and confidence in business managers can be the most effective way to promote desired results.

Lubrizol’s James Hambrick concurs about the value of autonomy at Berkshire and offers
insight into making it work. He writes a quarterly report to Buffett. Unless there is something notable in it, Hambrick does not hear back. The report covers both the operations of Lubrizol and the activities of Hambrick, who is constantly on the road connecting with the global company’s 7,500 employees and innumerable stakeholders. Supplying the quarterly report means that when Hambrick sees an opportunity needing approval, he can summarize it and get Buffett’s approval within minutes without needing to review the background. This approach is especially valuable to those Berkshire subsidiaries which, like Lubrizol, seek acquisition opportunities, as the next chapter will illuminate.
Notes 8. Hands-off


61. Ibid., 148.

62. Ibid., 124, 126.

63. Ibid., 173.

64. Ibid., 173.

65. Ibid., 162–67.

66. Ibid., 166–67. Other Berkshire subsidiaries have resolved the dilemma in the same way. Bill Child of RC Willey said:

> If you grow too fast, the infrastructure and systems of a company aren’t
able to handle it. Those must grow at the same level that sales grow. Otherwise a company becomes inefficient in the delivery of its product. The result is higher costs and decreased customer satisfaction.


69. Ibid., 196, 242.
72. Chan, *Behind the Berkshire Hathaway Curtain*, 118.
76. See Cahill, “Here’s the Pitch”; Dawson, “Kirby Always Cleaning Up After Others.”
77. See Jordan v. Scott Fetzer Co., No. 4:07-CV-80, 2009 WL 1885063 (M.D. Ga. June 30,
2009); Howard, “Ex-Kirby Employees Can Join Suit.”


81. Ibid.

82. In late 2010, Sokol was serving as chairman, CEO, and president of NetJets as well as chairman of both MidAmerican Energy and Johns Manville.

83. Berkshire annual meeting, transcript of Sokol section, Buffett’s opening comments.

84. Ibid.

85. Ibid., Buffett responding to shareholder questions.


90. Berkshire Hathaway 2011 annual meeting, transcript (copy on file with the author), Buffett responding to shareholder questions.
Ibid., Munger responding to shareholder questions.

The Salomon incident is noted in chap. 1.

Ben Berkowitz, “Sokol Affair Tarnishes Buffett Style,” *Globe & Mail*, March 31, 2011, quoting Charles Elson of the University of Delaware: “The fact that this could happen does raise questions as to the effectiveness of the company’s controls to prevent something like this from happening.”


Berkowitz, “Sokol Affair Tarnishes Buffett Style,” quoting John C. Coffee of Columbia University Law School: “It’s the kind of behaviour that, as a matter of corporate governance, sophisticated companies try to avoid.”

There was little reason to believe that a more elaborate control system would have made Sokol do anything differently. Suppose Berkshire had a large compliance department with detailed commands and controls, including a specific procedure for clearing personal investments through a compliance committee. If long-standing general policies Berkshire censured Sokol for violating did not dissuade Sokol’s trade, it is not obvious that an additional layer of bureaucracy would. To the contrary, it is possible that command and control would displace the value of the autonomy-and-trust culture and stimulate more behavior that veered close to the edge.

To illustrate, many companies, including Berkshire, have a specific rule barring employee trades in a list of restricted securities. Berkshire’s restricted list consists of securities of companies in which it owns positions. But Berkshire’s policies are broader, also including a general standard barring trades in securities that Berkshire may acquire. It is easy to compile a complete list of securities a company owns; it is impossible to
assure the completeness of a list of securities it may acquire. A rule-bound command-and-control culture can restrict the former but not the latter; some degree of autonomy and trust is required for that.

98. Berkshire Hathaway 2012 annual meeting, transcript (on file with the author) Munger responding to shareholder questions.


Buffett’s admonition began with the following:

The spirit about compliance is as important or more so than words about compliance. I want the right words and I want the full range of internal controls. But I also have asked every Salomon employee to be his or her own compliance officer. After they first obey all rules, I then want employees to ask themselves whether they are willing to have any contemplated act appear the next day on the front page of their local paper, to be read by their spouses, children, and friends, with the reporting done by an informed and critical reporter. If they follow this test, they need not fear my other message to them: Lose money for the firm, and I will be understanding; lose a shred of reputation for the firm, and I will be ruthless.

100. Berkshire Hathaway 2013 annual meeting transcript (copy on file with the author) (Buffett responding to shareholder questions). By blasting Sokol, the audit committee sent an express warning to all Berkshire personnel. In authorizing Buffett to release the report publicly, it stressed:

Such a public statement will demonstrate to all who work for Berkshire, as well as the other constituencies Berkshire serves, that the Company takes
its policies very seriously, and that its instruction to all its representatives to play in the middle of the court is Company policy, not public relations. We expect this report to send a loud message that those policies are designed to be read broadly, and to deter anyone who may be contemplating a violation of the spirit or letter of those policies in the future.

101. The Sokol affair prompted some Berkshire shareholders to sue the board in Delaware, Berkshire’s state of incorporation. They argued that the board had failed to maintain an adequate system of internal control. The complaint echoed the public criticism of Berkshire’s autonomy-and-trust culture and urged that the board botched its oversight role by abjuring a command-and-control structure. The court dismissed the assertion as “profoundly weak.” Ruling of the Court on Defendants’ Motion to Dismiss, In re Berkshire Hathaway Inc. Deriv. Litig., No. 6392-VCL, 2012 WL 978867 (Del. Ch. Mar. 19, 2012).

These shareholders also tried to sue Sokol to recover $3 million in profits for Berkshire, which the board had declined to do. Boards have the say over whether a corporation should sue someone unless shareholders can show that a board is unable to act impartially. The shareholders could not show that the Berkshire board’s independence was compromised concerning whether to sue Sokol. The Delaware court acknowledged that Buffett’s press release colored the matter, suggesting coziness between Sokol and Buffett that could have biased the board. But that was mere “smoke,” the court said, not enough to infect the board’s judgment. Ibid.

102. The Sokol affair also reflects Berkshire’s sensitivity to public perceptions, which undergirds Buffett’s admonition to test employee behavior according to how it would look if reported on the front page of a newspaper. Suppose Sokol, when he first called Buffett, had said, “Warren, I think Lubrizol is an attractive company—so attractive that I
just bought $10 million for myself, and I think you ought to look at it for Berkshire.” That disclosure would have negated the story. Moreover, Sokol might have gone an extra step to eliminate any doubt about propriety and said, “If Berkshire would like to buy my shares at cost, I’m happy to sell.” Buffett’s probable response would have been something like, “No, that’s fine. If we end up buying it, you’re entitled.”


105. Ibid., 56. In some businesses, autonomy can offer integrity to the brand. For example, among Berkshire’s scores of newspapers—headlined by the Buffalo News—Berkshire management avoids involvement in decisions concerning content or opinion. Managerial oversight is supplied by senior managers at one of the larger papers, the Omaha World-Herald. Employees value the autonomy and appreciate the confidence as they respond by respecting journalistic ethics and newspaper editorial policy.


107. Jim Clayton and Bill Retherford, First a Dream (Knoxville, Tenn.: FSB, 2002), 99.