

LAWRENCE A. CUNNINGHAM
and STEPHANIE CUBA

MARGIN *of* TRUST



The Berkshire
Business Model

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We dedicate this book to our daughters,
Becca and Sarah, forever and always.

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PROLOGUE

The Carrot of Trust

TRUST IS THE ESSENCE of the business model Warren Buffett developed at Berkshire Hathaway. This simple idea has profound implications for corporate life.

We have been studying and writing about Warren Buffett and Berkshire Hathaway for decades. In 1996, Lawrence Cunningham hosted a symposium on these subjects that resulted in his publishing *The Essays of Warren Buffett: Lessons from Corporate America*, which quickly became an international best-seller and then a cult classic. Since then, volumes have been written about the Buffett-Berkshire example, especially for investing and, to a lesser extent, management.

While legions of investors follow Buffett's lessons, embracing the value approach, a smaller number of managers have adapted Berkshire's managerial practices. Timing may explain the difference: Buffett's outstanding investing track record dates back six decades, whereas the unique features of Berkshire's organizational structure have proved themselves only for a decade or two. Interest is picking up, however.

Researchers interested in organizational structures that best promote innovation are drawn to the Berkshire business model, especially its focus on autonomy and decentralization.¹ Those probing the role of culture in corporate productivity and compliance are turning their attention to the Berkshire approach, which relies more on mutual integrity than on traditional internal controls.²

Entrepreneurs across the spectrum—including tech giant Alphabet (formerly known as Google), financial information company Morningstar, and business promotions manufacturer Cimpres—are embracing elements of the Berkshire business model. Boards of directors are studying Berkshire’s people and practices as they evaluate their own workplaces and policies on matters ranging from the content of a mission statement to the role of leverage and capital allocation. College classes on strategic management and competitive advantage have begun to feature Berkshire.³

“Three Little Words” was the headline *Forbes* gave to Cunningham’s 1998 interview about *The Essays of Warren Buffett*, referring to the most important concept in Buffett’s investing philosophy: margin of safety.⁴ Decades later, the three little words that best explain Berkshire’s management philosophy echo the sentiment: margin of trust.

Margin of safety directs investing only at a price well below value, a rarity that warrants loading up when seen. Similarly, margin of trust directs dealing with only those people you trust deeply, another rarity that warrants heavy reliance when found.

Buffett believes that trust is hard to come by, especially among bankers, brokers, and financial institutions. That’s why he and Berkshire avoid intermediaries as much as possible. They scout acquisitions themselves instead of hiring brokers and generate funding internally, primarily through insurance float, rather than borrow from third parties. When Berkshire and Buffett find people they trust, from acquisition partners to business managers, they rely heavily on them. That’s why they are so comfortable doing

little due diligence when making acquisitions and giving managers enormous leeway in operations.

Many regard Berkshire and Buffett as *sui generis* rather than a model that can be emulated, but such intuition is just partly correct. True, only fools would hope to prove a facsimile of Buffett or mirror the dazzling organization he created. To some degree, it is a unique set of interlocking attributes—including personality traits and luck—that best explain this success.⁵

That said, many of the principles offer an adaptable framework that can work in settings beyond Berkshire. The key is to understand the broad tenets, especially the idea of trust and its implications, and then find ways to apply them.

In Berkshire's case, distinctive management principles are decentralization and autonomy. All operational power is devolved from the parent to subsidiary CEOs, who also tend to delegate and push power down to colleagues closest to the relevant product, market, or customer.

Research indicates that trust is a powerful motivator and that autonomy is more value-enhancing than control. Researchers in the field of business management demonstrate that trust-based cultures can be a competitive advantage.⁶

Management experts stress how a culture of autonomy empowers employees to focus on tasks rather than on reporting compliance. Payoffs include more effective leadership, lower cost of administration and other corporate efficiencies, adding to competitive advantage. Ultimately, superior performance and profitably can result.⁷

Large global corporations today, like Berkshire and most of its subsidiaries, must address threats to their competitive advantages ("moats," Buffett calls them). Such advantages—whatever their form, from traditional brand strength to contemporary platform networks—are due to dominant knowledge of the market, business methods, and distribution techniques. Protecting those moats to maintain leadership requires being quick, imaginative, and adaptive in responding to disruptive competitors and technologies.⁸

Yet the contemporary structure of large corporations—with hallmarks of hierarchy and heavy reliance on internal controls—can inhibit meeting such challenges. Berkshire's answer to defending moats and promoting innovation is a looser organizational structure than the prevailing hierarchical-control model allows.

The Berkshire business model does pose challenges. These arise from placing too much trust in the untrustworthy—managers who abuse their wide discretion—or insufficient trust in others—not hiring acquisition advisers who can identify pitfalls, for example. External costs arise from being different: when other companies extensively rely on hierarchies, internal controls, and outside advisers that Berkshire skips, a skeptical press and public pounce on such side-effects. At Berkshire's scale moreover, critics wonder not only if its size prevents performing much above average, but whether such oversight risks raise costs.

On the other hand, Berkshire and Buffett are far from alone in embracing trust. Trust-based cultures, and implications such as autonomy and decentralization, appear frequently among insurance companies, where trust seems to be an essential feature of the business model. To name a few boasting kindred cultures: Alleghany Corporation, Fairfax Financial Holdings Ltd., and Markel Corporation.

The Berkshire approach also characterizes many businesses Buffett is associated with. These date back decades to Capital Cities/ABC under the leadership of Thomas S. Murphy, today a long-serving Berkshire director. They span to contemporary exemplars, such as the Marmon Group, led by the Pritzkers and their successors for three decades before Berkshire acquired it a decade ago.

But it is the rising external interest in the organizational side of Berkshire that is of greatest significance. Aspects of the model have become increasingly obvious and important to sustain a diverse range of prosperous noninsurance companies, such as Constellation Software, Danaher Corporation, and Illinois Tool Works.

Berkshire's version begins with trustworthy people—managers, directors, and shareholders alike. It includes specific corporate practices that reflect and strengthen that trust, including passionate communications and celebratory gatherings, as well as business methods, quick decisions on acquisitions, autonomous decentralized operations, and permanent time horizons.

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One specific case illustrates virtually all the major principles of the Berkshire business model, including trust in a network of advisers. This was Berkshire's 2015 acquisition of Detlev Louis Motorradvertriebs GmbH, the German motorcycle accessories and apparel purveyor.

Since 1985, Berkshire has stated what it looks for in acquisition candidates: simple businesses, consistent earning power, solid returns on unleveraged equity, and trustworthy management in place.

Many favored prospects are multigenerational family businesses. The scores of companies Berkshire acquired during those several decades are diverse by industry, business, and structure. All, however, met the general criteria, and share common values, such as integrity, autonomy, and patience.

The bigger the better: the minimum size is usually \$75 million in annual earnings. But Berkshire prefers companies vastly larger—called “elephants” in the world of business acquisitions—and made an exception for its first foray into Europe, as Louis is about half the usual minimum size.

But Louis met all the other criteria. Founded in 1938 by Detlev Louis, an entrepreneurial motorcycle racer, the company began as a motorcycle sales and repair shop. By the 1960s, it had grown into Germany's largest motorcycle business. The timing matched the period's popular biking culture, as romanticized in such films as *Easy Rider*, starring Dennis Hopper and Peter Fonda.

Detlev broadened his customer base and merchandising reach through a mail-order catalogue. In addition, he offered accessory

products, such as belts, boots, gloves, helmets, and visors. With new business partner, Günther Albrecht, in the 1970s, the company drove forward on two fronts: enlarging physical store size, while simultaneously growing the mail-order business.

During the 1980s, now joined in the business by Detlev's wife, Ute Louis, and their son, Stephan Louis, the team catapulted the business to the next level: building a network of shops across Germany. Starting in Hanover in 1981, they built stores in Berlin, Dusseldorf, and Regensburg, owning and operating eighteen shops by 1989.

In 1986, the mail-order business grew to a prodigious 357-page catalogue of accessories and clothing, some designed in-house with help from Ute. To coordinate operations for such scale, in 1991, Louis constructed a vast new logistics center in Hamburg, gleaming with automation and conveyors.

To build on its strengths, in 1996, Louis split off the motorcycle sales business and focused all company resources on marketing apparel and accessories. By then, the mail-order catalogue ran six hundred pages. In 1997, Louis went online, drawing a pan-European customer base to its website where an expanding product line now included thirty thousand products. These encompassed necessary repair parts, like brake pads and mirrors, as well as motor oil.

Louis sustained steady sales growth, and sprinted to double its volume in a six-year period in the early 2000s. It added capacity to its logistics facility in tandem with growth. Sales in its growing chain of stores—more than eighty at last count in four countries—continued to rise even as its Internet business counted for more than two-thirds of orders. From 2002, the company has operated the Louis Academy, where it trains employees, now numbering in the thousands.

Simply put, the company generates substantial cash with scant debt to post impressive financial metrics: stable annual revenue in the range of \$250 million, even amid a recessionary Europe

post-2008; solid operating margins steadily ranging close to 20 percent; and strong returns on equity of more than 30 percent.

Louis's sustained sales growth and successful move into e-tailing signal impressive brand strength. Such brand strength suggests the capacity to penetrate further: beyond Germany and Austria by strategic store openings in selected European cities and toward greater online penetration into U.S. and Japanese markets.

The Louis record reflects a degree of insulation from adversity. For one, Louis's products are low-tech, making the business easy to understand and reducing the risk of technological disruption or obsolescence. Louis's market also appears to be less cyclical than typical consumer products companies, particularly since it left motorcycle sales to concentrate on accessories like clothing and necessities like replacement parts.

Louis succeeded in the strategy of forward integration—designing and manufacturing products, especially clothing, and marketing all of its products successively through physical stores, mail order, and the Internet. Scalability meant low incremental capital costs coupled with continued revenue growth and enhanced returns on equity. The company's favorable treatment of customers and employees created valuable loyalty: an employee focus is evident in its training academy, and a customer focus is inferable from its steadily expanding product line.

A final competitive edge is the “security of obscurity”: Louis operates in a small niche market where large strong rivals are unlikely to be lured into competing. The primary candidates would be motorcycle manufacturers, such as Harley Davidson or Yamaha. But their most attractive opportunities are in selling new motorcycles, not in aggressively competing in the specialty accessories and parts businesses. In fact, they benefit from Louis's independent presence, which reinforces the biker culture.

In 2012, Detlev Louis died, leaving the prosperous company to his wife Ute. In considering the sale of a family business such as Louis, there were several options, starting with the motorcycle

manufacturers as strategic buyers. But during the two years after Detlev's death, no such deal was struck, suggesting a lack of mutual interest.⁹ Another alternative was financial buyers, such as a private equity fund. But while Louis would have made a salivating target for their typical approach, it likely would have been repellant to Ute Louis.

What might a private equity firm have done if it acquired Louis? A page from the playbook:

- cut costs, perhaps closing the training academy, trimming the workforce, and cutting inventory of slower-moving products
- monetize real property tied up in the physical stores, maybe arranging sale-leasebacks, distributing cash proceeds as dividends, while committing to a fixed long-term cost structure
- borrow heavily—a radical change from Louis's pristine balance sheet—to pursue rapid expansion, putting new stores throughout Europe
- move headquarters from Germany to a tax haven such as Liechtenstein or Luxembourg.

To execute this playbook, of course, would mean initially installing new top management, despite Louis's team being seasoned veterans, and ultimately selling the company within a few years to cash in.

Berkshire offered the opposite on all counts.¹⁰ After Ute's financial advisor, Zypora Kupferberg, contacted a U.S. counterpart whose father had known Buffett for many years, Buffett offered Berkshire's standard and unbroken pledge to Ute Louis: maintain the company's existing operations, workforce, strategy, and capital structure; keep headquarters where they are; retain the existing management team; and commit to holding the company indefinitely.

Companies selling to Berkshire often accept a lower cash price to compensate for such commitments, and Berkshire requires that the seller make an offer, which Berkshire accepts or rejects. In the case of Louis, the price was about US\$450 million all paid in cash, customary for Berkshire acquisitions given the high quality of its stock. At about one and a half times sales, four times book value, and ten times earnings, the price was below comparable public company valuations. Given Louis's impressive returns on equity and potential sales growth, Berkshire paid a fair price but hardly a premium.¹¹

Berkshire is less concerned about a company's exact lines of business than whether it possesses the criteria of quality that meet the Berkshire philosophy. In Louis's case, it was an insignificant coincidence that Berkshire's venerable GEICO subsidiary sells motorcycle insurance, that Berkshire made a substantial investment in Harley Davidson during the 2008 financial crisis, or that Berkshire had recently acquired a large automobile dealership in the United States.

Potential sellers must be concerned about overlaps with Berkshire's business that would give competition authorities pause, however. For Louis, Berkshire's ownership of apparel companies, such as Brooks Running Shoe Co. and Fruit of the Loom, was pertinent. But European authorities did not find any anticompetitive problems.¹²

Why has the acquisitive conglomerate only just recently crossed the Atlantic in the hunt for wholly owned businesses? The two primary reasons for Berkshire's historical U.S. bias are its circle of competence and passive acquisition strategy. Buffett invests only in what he knows—referring to both types of business and managers—and he simply knows less about those outside the United States. But there are some antecedents, such as General Reinsurance Corporation (Gen Re), an international insurance company with a strong presence in both Germany and the United Kingdom; sizable minority stakes in Germany's Munich Reinsurance Company and the French drug maker Sanofi S.A.; and

ownership for nearly a decade of ISCAR Metalworking of Israel, which has European operations.

More to the point is Berkshire's acquisition practice of awaiting proposals rather than seeking them. Such a strategy requires a network of referrals that must be grown abroad. Fortunately for the Louis deal, Kupferberg knew of Berkshire's reputation, and Buffett trusted the person making the connection. As Buffett said, "You can't force it: the people that own the business have to have a reason they're thinking about selling."¹³

. . . .

For a Berkshire acquisition, the reasoning must be mutual, as must the trust. Above all, trust is Berkshire's unifying organizing principle. This book weaves together a variety of observations recorded over the past several years that bring this point home.¹⁴ The book is arranged in four parts:

- Part I presents the pillars of Berkshire as a trust-based organization: Berkshire's people and roles, partnership practices, and business methods.
- Part II zeros in on three perspectives within the Berkshire model viewed through the lens of the trust-based approach: business contracts, corporate boards, and internal controls.
- Part III illuminates the model using a compare-and-contrast method: first contrasting shareholder activism and private equity, and then comparing organizational structures at select businesses.
- Part IV considers challenges the model poses and ways to address them, including risks of error in both reposing or withholding trust, and problems with public perception.

More specifically, chapter 1 introduces the players—the top executives, directors, shareholders, and managers—and their distinctive

roles at Berkshire. They operate in a governance structure featuring Buffett, a controlling shareholder who effectively founded the firm in 1965, and who has served continuously as chairman and chief executive since 1970.

Berkshire's formal governance is headed by Buffett's hand-picked board of directors—friends and family—who pride themselves more for being trustworthy stewards of fellow shareholders than management monitors. Berkshire shareholders embrace the company's unusual approach. They trust Buffett and Berkshire's team of executives, from the sage, dour vice chairman, Charlie Munger, to the bright and seasoned successors of the next generation, vice chairmen Greg Abel and Ajit Jain.

Chapter 2 discusses the partnership practices that define Berkshire and hold the players together. Buffett views Berkshire as a partnership, declaring: "while our form is corporate, our attitude is partnership." The essence of partnership is trust. Berkshire's partnership attitude is a legacy from Buffett's start: He was running a partnership in 1965, when it acquired Berkshire, and many contemporary Berkshire shareholders date from that era, such as David S. ("Sandy") Gottesman of First Manhattan.

Despite Berkshire's huge scale, Buffett kept the partnership spirit alive through such practices as a high-quality shareholder letter and annual meeting and giving shareholders a voice on matters from charitable donations to dividend policy. The vast majority of Berkshire shareholders reciprocate: they are interested, engaged, and informed; concentrate heavily in Berkshire stock and hold it for long periods; and otherwise behave like owners and partners, with relatively few transient stock traders or diversified indexers.

Chapter 3 reviews business methods. Built over a half century through scores of acquisitions and investments, Berkshire has grown into a half-trillion-dollar conglomerate. Berkshire has rarely borrowed money, retained a business broker to scout for acquisition targets, or engaged an investment banker for advice.

Upon acquisition of a company, Berkshire gives unit chiefs *carte blanche* to run their businesses without interfacing with parent-level officers. This explains why to be acquired by Berkshire, a company must have trustworthy management in place. The decentralized model lacks the hierarchical control protocols common in corporate America, inculcating instead a trust-based culture of stewardship.

These preferences reflect skepticism about the trustworthiness of financial intermediaries. More important, they reflect greater confidence in self-reliance.

Turning to part II, Ronald Reagan famously said of negotiating with the Soviets, “trust but verify.” Buffett is no fool either and appreciates the need to balance trust with assurance. Yet even this practical orientation veers more toward trust than conventional practice elsewhere in three important recurring settings: deal contracts, boards of directors, and internal affairs.

Chapter 4 considers the central role of trust in deal making. While prevailing practice in corporate America favors formalized legal contracts, Buffett prefers handshakes and simple informal agreements. Some of Berkshire’s earliest and more recent acquisition and employment agreements illustrate this preference. The letter of the law contrasts with the spirit of the deal.

Chapter 5 draws on Buffett’s extensive experience on corporate boards to offer a short list of principles every director should abide. The first is as important as all the rest combined: pick an outstanding trustworthy CEO and stay out of his or her way. Among other transcendent tips: directors are best and most trustworthy when they imagine they represent a single absentee owner.

Chapter 6 reflects on how a trust-based corporate culture compares with command-and-control cultures. This approach highlights that trust-based cultures tend to be more effective at a relatively smaller scale, and decentralization and segmentation facilitate that result within larger organizations. Berkshire aspires

to a culture with what Buffett calls an “owner orientation,” which compensation and other incentives can nurture.

Part III puts Berkshire in context by contrasting it with rival models and comparing it to some following a similar approach.

Chapter 7 presents the contrasts. First, shareholder activism tends to be antagonistic, and often erodes trust, whereas Buffett has long cultivated a preference as an investor for cooperative engagement, building trust. From investments in the 1980s as a “white squire” to those of 2008 as a credit lifeline, managers know they can trust Buffett as an investor, and in exchange, they offer far better terms.

Second, private equity as an investment model contrasts sharply with the Berkshire approach on several dimensions: it uses leverage with heavy reliance on financial intermediaries where trust is not part of the calculation; it intervenes intensively with management, extending virtually no trust-based deference; and it seeks the earliest plausible exit, showing no trust in long-term value, but rather flipping acquired businesses.

Chapter 8 compares Berkshire with other kindred companies, especially insurers and conglomerates. Each illustrates a unique company adapting parts of the Berkshire model to suit its needs. While these companies are diverse, they share an unusual faith in trust as an organizing business principle.

Part IV turns to challenges facing a trust-based model. Chapter 9 acknowledges its main risk: trusting some people too much and others too little. Misplaced trust in executives is the greatest peril in a trust-based organization—something Berkshire has experienced on a few occasions.

A second risk is failing to trust outside consultants enough, evident in the few times when Berkshire acquired a company without discovering flaws traditional due diligence would uncover. The upshot is an endless search for balance between trusting others and self-reliance.

Chapters 10 and 11 consider two aspects of corporate size. The first aspect (in chapter 10) concerns how large diverse corporations such as Berkshire can seem to the public and media like Goliaths, even when internally segmented into a larger number of relatively small units. A conglomerate can draw outsize attention to its individual units. How decentralized units handle such public scrutiny is instructive.

The second aspect of size (in chapter 11) is more general. The U.S. public is traditionally skeptical of large corporations, perhaps for good reason. This creates a challenge for conglomerates, even those far smaller than Berkshire. This skepticism can be mitigated, however, by emphasizing the autonomous decentralized approach.

Chapter 12 examines the role of trust in succession. Berkshire has adopted among the most intricate succession plans imaginable, one with multiple elements to match Buffett's multiple roles. Buffett has identified successors to his roles as chief executive, board chairman, chief investment officer, and controlling shareholder. Despite careful planning, effective succession will depend on trust, particularly the continuing trust of shareholders in Berkshire business model.

The epilogue wraps up on a dramatic note, stressing ruthless treatment of anyone disappointing Buffett's trust. If trust is the carrot in Berkshire business model, ruthlessness is the stick. While the trust-based model is largely self-enforcing, Buffett seals it with a stern admonition that even moderately disappointing behavior will not be tolerated. As he famously put it in spine-tingling oratory: "Lose money for the firm, and I will be understanding; lose a shred of reputation for the firm, and I will be ruthless."¹⁵

We conclude by illustrating what ruthlessness means with the prominent 2011 case of a senior Berkshire executive, David Sokol. His infractions, involving technical matters of securities trading, were small in relation to the price he paid, a highly publicized

Prologue: The Carrot of Trust

termination for cause. While law enforcement authorities opted to drop the matter, Berkshire made it an example.

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In some ways, Berkshire Hathaway is complex. We have even playfully compared the richness of its culture to the wonders of the rings of Saturn. But just as the vast field of value investing can be boiled down usefully to three words, “margin of safety,” we believe that this vast management philosophy can be distilled to “margin of trust.” We also think that this simple idea, animated by the discussion that follows, offers useful insights for every manager and shareholder in corporate America.

PART I

Pillars

The Players

IN 1956, A TWENTY-SIX-YEAR-OLD Warren Buffett formed an investment partnership to acquire small businesses and equity stakes in larger companies. In 1965, the partnership took control of Berkshire Hathaway Inc., a struggling publicly held textile manufacturer. The Buffett Partnership soon dissolved, with Berkshire shares distributed among the partners.

Today's Berkshire Hathaway was born. Berkshire proceeded to acquire interests in diverse businesses, including insurance, manufacturing, finance, and newspapers. Despite the change from a partnership to the corporate form, Buffett has preserved the sense of partnership at Berkshire. This legacy has been reflected for decades in the first of fifteen principles stated by Berkshire in its *Owner's Manual*: "Although our form is corporate, our attitude is partnership." Berkshire differs from the typical public company model characterized by separation of share ownership from managerial control and associated agency costs.¹ Rather, Buffett has been Berkshire's controlling shareholder since 1965. He initially

owned 45 percent of Berkshire's voting and economic interest; beginning in the early 2000s, he made regular annual transfers of shares for charitable purposes that steadily reduced his interest.

Berkshire may not have needed many of the devices designed to control agency costs in public companies, such as strong oversight from an independent board. While controlling shareholders can create another set of costs for minority shareholders, Buffett has avoided imposing those costs too.

Since 1970, Buffett has served as Berkshire's only chief executive and board chairman. Such longevity is unique. Most modern CEO tenures are far shorter. This tenure enabled Buffett to put a seemingly indelible imprint on the company. Some companies and advocates endorse age limits for officers and term limits for directors, but Berkshire's shareholders have gained substantially thanks to Buffett's long tenure in both roles.

Buffett's attitude of partnership is one of profound trust. Berkshire's *Owner's Manual*, a statement of the company's fundamental operating principles, elaborates: "We do not view the company itself as the ultimate owner of our business assets but, instead, view the company as a conduit through which our shareholders own the assets." That view, aptly called "radical," disintegrates the corporate veil.²

While Buffett views shareholders as the owners of Berkshire, corporate law defines them as merely owning shares of its equity—the residual interest after assets are offset by liabilities. Buffett takes the partnership conception to mean that managers are stewards of shareholder capital, accepting a higher standard of obligation than the law imposes. It is a lofty standard, like what Benjamin Cardozo said partners owe one another: "a punctilio of an honor the most sensitive."³

In pursuing that standard, Buffett treats Berkshire's other shareholders the way he would want to be treated if positions were reversed. In disclosure, for example, he explains business decisions faithfully, admits mistakes, and catalogues the events that

have defined Berkshire culture—all in the style of an equal partner rather than a corporate chief executive.⁴ Buffett writes to Berkshire shareholders directly, without the filter of communications professionals, and hosts an annual meeting where he fields questions from shareholders for up to six hours straight.

Berkshire's policies and Buffett's explanations of them are designed to attract shareholders and business owners who agree with the Berkshire business model and its emphasis on trust.

Number Two: Munger

Buffett's best friend and business partner, dating to the 1960s, is Charles T. Munger, who became vice chairman of Berkshire in 1978. Buffett says Munger's presence has contributed enormous value—many billions of dollars' worth—over the years. Buffett's intellectual partner and confidant, Munger provides a screen: if he opposes a proposed action, Berkshire usually refrains.

Central to their prosperous relationship is their shared belief in trust as an essential element in business and corporate life. A joint belief in values like integrity and keeping promises is one facet of the Buffett-Munger relationship that makes it work.

The second facet is possessing complementary talents of temperament, attitude, and vision. Despite these distinct aspects to their relationship, such superlative business teams are more common than many think. Classic examples include Thomas S. Murphy and Daniel B. Burke at Capital Cities/ABC or Michael D. Eisner and Franklin B. Wells at Walt Disney Co.

In his book, *Working Together*, Eisner described his experience working with Wells, as teaching that “ $1 + 1 = 3$.”⁵ Berkshire and its subsidiaries have long appreciated the power of a leadership duo. Most recently, the company has promoted two long-time managers to its board, naming them vice chairmen, in planning for the future.

Vice Chairmen: Abel and Jain

As part of Berkshire's succession planning, in 2018, its board appointed Gregory E. Abel and Ajit Jain, two veteran company executives, as vice chairmen of Berkshire and elected them to the board. Buffett hired Jain in 1986 as an insurance executive. Then new to the field, Jain prospered instantly, forging new markets for super-catastrophic insurance and overseeing both innovative offerings and underwriting discipline. As vice chairman, he now oversees all Berkshire insurance operations.

Overseeing all noninsurance operations is Abel, who joined Berkshire upon its 1999 acquisition of MidAmerican Energy (now called Berkshire Hathaway Energy). Abel has demonstrated mastery of capital allocation, savvy in acquisitions, and appreciation of the principles of autonomy and decentralization. While growing the energy business to \$25 billion in annual revenues with twenty-three thousand employees, Abel maintains a lean headquarters staff of two dozen.

The Board

Buffett's controlling position has allowed him to nominate and elect Berkshire's board of directors from the outset. During that time, Berkshire's board came to assume characteristics quite different from today's typical public companies. From the earliest decades, the board included Buffett's late wife Susan and his close friends and, since 1993, has included his son Howard G. Buffett. It was and remains a classic advisory board, common in the United States before the corporate-governance revolution that began in the 1980s and that now is nearly extinct.⁶

Since the 1990s, the regulation and norms of corporate governance have shifted to increasingly define a board's primary role

as monitoring management. That means independent directors, often a powerful nonexecutive chairman, and numerous strong committees (on governance, board nominations, and CEO review) all overseeing elaborate internal control systems.

In theory, monitoring boards improved oversight on behalf of shareholders, fortified by shareholder advocates, such as institutional investor councils and shareholder advisory services. This type of regime, designed to control agency costs, is inspired by a clear lack of trust. While sometimes effective, such a regime produces the potentially inert result of “agents watching agents.” At Berkshire, this is called bureaucracy. Whatever its merits elsewhere, no such layers exist at Berkshire, and its board cannot be classified as a monitoring board.⁷

Berkshire’s board adheres to legal requirements concerning requisite committees, independence, and expertise. Its audit committee, for example, excludes Buffett, who, as chief executive, is not considered “independent.” The committee includes at least one financially literate member and oversees the legally mandated internal audit function. Berkshire has added numerous outside directors—that is, they are not employees and don’t have direct economic ties.

In fact, however, all are handpicked by Buffett and have personal or professional connections to him. They are chosen because of their integrity, savvy, owner orientation, and interest in Berkshire, not for their status. Indeed, half of the board members are older than sixty-five and most have served Berkshire for a decade or more. These facts would compel their departure under typical age-limit and term-limit regimes endorsed by some shareholder advocates.

Furthermore, Berkshire directors own Berkshire stock—many in large quantities. They all purchased their shares in open-market transactions paid in cash, rather than awarded by the company in stock-based compensation plans, common in corporate America. Berkshire pays its directors token fees, typically

\$1,000 per meeting, whereas directors at like-size companies average \$250,000 per year—and even companies at the lowest end pay nearly six figures.⁸

Perhaps the clearest demonstration of trust is that Berkshire does not buy director liability insurance. This is unheard of in corporate America and would be impossible without the reasonable expectation that the company, or perhaps Buffett personally, would cover all reasonable losses.

Berkshire's principal parent-level activity is accumulating and allocating capital, often making substantial acquisitions. At most companies, CEOs might formulate a general acquisition program and then present specific proposals to the board, which would then discuss deal terms and approve funding. The board's role in this setting is an example of its service as a check on executive power.

Berkshire does the opposite, enabling Buffett to seize opportunities that would be lost if prior board involvement was required.⁹ Berkshire's board, as well as the general public, knows Buffett's philosophy of acquisitions. The board might discuss large deals in advance in conceptual terms. But it is not involved in valuing, structuring, funding, or even approving any specific acquisition. With few exceptions, the board does not find out about an acquisition until after it is publicly announced.

Berkshire's board has two regularly scheduled meetings annually, unlike the more typical eight to twelve meetings held at other Fortune 500 companies. Formal aspects of Berkshire board meetings follow the familiar business pattern. In recent decades, succession planning has been discussed regularly at virtually every meeting.

Before each meeting, directors receive a report from Berkshire's internal auditing team. The board's spring meeting coincides with Berkshire's annual shareholders' meeting in May. Directors spend several days in Omaha, mingling with Berkshire officers, subsidiary managers, and shareholders. The fall meeting features opportunities

to meet one or more CEOs of Berkshire subsidiaries, either in Omaha or at a subsidiary's corporate headquarters. One or more CEOs make presentations and exchange ideas with the directors and fellow unit chiefs.

According to director Susan Decker, Berkshire's approach to board meetings, as well as to Berkshire events involving directors' participation outside of the boardroom, produces a "strong inculcation of culture." Cynics might say such an environment promotes structural bias that can impair the independent judgment that corporate-governance advocates have hailed in recent decades.¹⁰ But this immersion of directors in Berkshire culture flattens the typical hierarchies of corporate governance, keeping directors in shareholders' shoes.

Contemporary corporate-governance structures are skeptical of trust, insisting instead on staffing boards heavily with outsiders who are independent of chief executives. Although in compliance with the rules, the Berkshire board is quite different. In addition to having included Buffett's late wife, the board now includes their son Howard, since 1993; Buffett's best friend Charlie Munger, since 1978; fellow Omaha businessman Walter Scott Jr., since 1988; and Ronald L. Olson, law partner in Munger, Tolles & Olson, since 1997. Berkshire uses Olson's law firm extensively for acquisitions and other legal work.

Expansions of the board in 2003 and 2004 added several long-time business associates and friends (see table 1.1). These new board members included Donald R. Keough, a veteran Coca-Cola executive, where Berkshire holds a substantial equity position, and Thomas S. Murphy, long-time chief executive of Capital Cities/ABC, another Berkshire investee. Additions also included old friends, David S. ("Sandy") Gottesman, a New York investor and Buffett's friend since 1962, and William ("Bill") H. Gates III, founder of Microsoft Corporation and Buffett's friend since 1991.

Table 1.1
Current Berkshire directors

	Born	Elected	Relation	Role
Warren E. Buffett	1930	1965	Founder	Chair and CEO
Charles T. Munger	1924	1978	Partner	Vice chair
Walter Scott Jr.	1931	1988	Friend	
Howard G. Buffett	1954	1993	Son	
Ronald L. Olson	1941	1997	Lawyer	
David S. Gottesman	1926	2003	Friend	
Thomas S. Murphy	1925	2003	Friend	
Charlotte Guyman	1956	2003		
William H. Gates III	1955	2004	Friend	
Susan L. Decker	1962	2007		
Stephen B. Burke	1958	2009		
Meryl B. Witmer	1962	2013	Shareholder	
Ajit Jain	1951	2018	Executive	Vice chair
Gregory E. Abel	1962	2018	Executive	Vice chair

As for stock ownership among Berkshire directors, leading the group is Gottesman, who has owned up to 3 percent of Berkshire's interest for decades, representing a large portion—around one-fourth—of his and his firm's portfolio. Gates comes next, with substantial personal ownership along with significant ownership through the Bill and Melinda Gates Foundation, thanks to Buffett's recent bequests of his shares to the charity. Others likewise tend to hold personally meaningful stakes, notably, Murphy and Meryl Witmer (part owner of Eagle Capital). In the year after his appointment as vice chairman and election to the board, Jain disclosed acquiring, for cash, some \$20 million of Berkshire stock.

The Owners

Berkshire's shareholders are also unusual. They embrace the idea of Berkshire as a partnership. They believe that they are owners and relish that Berkshire has no corporate veil, no monitoring board, and no corporate bureaucracy or hierarchies. Buffett's fellow owners resemble partners in a private firm more than shareholders of a public company. Mutual trust is the glue.

What makes these shareholders so special? Above all, Berkshire's ownership remains dominated by individuals, not institutions. In 1965, individuals owned 80 percent of U.S. corporate equity and institutions owned 20 percent; today those figures for large public companies are reversed.¹¹ At Berkshire, in contrast, the figures remain close to what they were in 1965.

Buffett's individual percentage ownership is still influential, although no longer strictly controlling, after his ongoing transfers to charitable organizations. In addition to Buffett's block, individuals control some 40 percent of Berkshire's economic interest and voting power, making institutional investors far less important at Berkshire than elsewhere in corporate America.

At most big companies today, a changing cast of faceless financial giants owns large stakes—more than 5 percent—that, in aggregate, swamp the ownership of other owners. At Berkshire, only Buffett owns more than 5 percent of the premium Class A shares and just one giant (Fidelity) comes close.

For Class B shares, only a few giants surpass 5 percent, aggregating to more than 20 percent of that class. Given Class B's low vote, however, this ownership adds to less than 5 percent of the voting power. Their investment rationale is formulaic: BlackRock, State Street, and Vanguard run S&P index funds that necessitate holding Class B shares. (More details and the reasons for Berkshire's dual-class structure are discussed in chapter 2.)

Berkshire's more important institutional owners are boutique firms that have owned Berkshire for decades. They have reputations tied to Berkshire's identity and many cater to families. From the 1970s, these owners have included Davis Funds, First Manhattan, and Ruane Cunniff's Sequoia Fund—all led by Buffett's friends and Berkshire aficionados. Since the 1980s, renowned value investors such as Akre Capital Management, Gardner Russo & Gardner, and Markel Corporation have also owned large stakes.

Most capital in the United States is controlled by institutions whose performance is measured pre-tax or that are tax exempt, such as foundations and pension funds. The typical Berkshire shareholder, however, including all directors and managers, is both taxable and tax conscious.

This difference helps explain Berkshire's unusual dividend history. While most big public companies pay regular dividends that shareholders welcome, Berkshire has not paid one since 1967, and in 2014, the shareholders overwhelmingly voted against another.

Why? For one, Berkshire has been able to reinvest each dollar of earnings to generate corresponding gains in market value. But as important, dividends increase the taxable income of most Berkshire shareholders. By Berkshire reinvesting the pretax dollars, after-tax returns grow—galactically in earlier decades, but still significantly today despite the anchor of Berkshire's enormous size. When continued for years on end, capital compounds at much higher rates, accumulating greater wealth for shareholders than if Berkshire had paid dividends.

To spread out their risk, typical institutional investors avoid concentrating portfolios in the stock of one or a few companies. Among holders who publicly disclose stakes, for instance, few of the largest hundred shareholders of blue-chip companies like Apple, ExxonMobil, or Walmart allocate more than 5 percent of their portfolios to a single company's stock.

In contrast, many Berkshire shareholders concentrate in Berkshire shares. To illustrate, half of the one hundred largest publicly

disclosed Class A owners hold more than 5 percent of their portfolio in Berkshire stock, including Buffett and several other notable individuals and boutique firms. A dozen more of the largest Class B holders are so concentrated.

Indeed, many Berkshire shares are owned by people for whom Berkshire is among their largest holdings. Many hundreds of Berkshire shareholders concentrate more than 3 percent of their portfolios in Berkshire stock, something no other large public company comes close to achieving.¹²

Today's institutional investors often challenge managers to divest subsidiaries and focus on a single business. That contrasts with the Berkshire acquisition model and commitment to hold subsidiaries forever. The Berkshire shareholder embraces the diverse and permanent conglomerate, where divestitures are rare exceptions. For these shareholders, permanence builds trust; transience dissipates it.

Since at least 1993, Buffett has advised ordinary investors to use index funds rather than pick individual stocks as he and Berkshire have always done.¹³ Yet, since at least 1979, he has strongly advocated that Berkshire shareholders be more like him, not indexing across corporate America but rather loading up and sticking around in Berkshire stock.¹⁴ Over half a century, Buffett has consciously sought to attract only those shareholders who have the devotion and intelligence to understand Berkshire.

These are engaged investors. They devour Berkshire's annual report and attend its shareholder meetings in droves, both rare in corporate America. They are analytical and long-term investors. They include hundreds of wealthy individuals and thousands of rich families. Among these are many billionaires, including, in addition to Buffett and Gottesman, Homer and Norton Dodge (early investors), Stewart Horejsi (acquired 4,300 shares in 1980), Bernard Sarnat (cousin-in-law of Benjamin Graham), and Walter Scott Jr. (also a Berkshire director).¹⁵

Many founders or executives of Berkshire subsidiaries became independently wealthy by building those businesses, including several

ranked as *Forbes* 400 multibillionaires. Billionaires or near-billionaires include the following: the late Harold Alfond of Dexter Shoe, Jim Clayton of Clayton Homes, William Child of RC Willey Home Furnishings, Doris Christopher of Pampered Chef, Barnett Helzberg Jr. of Helzberg Diamonds, Lorry I. Lokey of Business Wire, Drayton McLane of McLane Company, the late Jay and Robert Pritzker of Marmon Group, Richard Santulli of NetJets, the late Al Ueltschi of FlightSafety, and Stef Wertheimer of ISCAR/IMC Companies.

Long-time Berkshire shareholder and author Andrew (“Andy”) Kilpatrick makes a practice of tracking fellow shareholders to highlight in his monumental company history, *Of Permanent Value*.¹⁶ By collating a small sampling from his copious research, as well as our own personal knowledge, we created the following short list of Berkshire shareholders. You will find famous investors, athletes, politicians, authors, musicians, business executives, and professors—an impressive list not likely matched by many other companies.

Some Notable Individual Investors of Berkshire

Sid Bass	Sen. Orrin Hatch	Sen. Jay Rockefeller
Billy Beane	LeBron James	Alex Rodriguez
Sen. John Barrasso	Shawn Jefferson	Rep. Paul Ryan
Franklin Otis Booth Jr.	Sen. Bob Kerrey	Paul Samuelson
George W. Brumley III	Billie Jean King	Richard Scylla
Jimmy Buffett	Ted Koppel	Don Shula
Rep. David Camp	Ann Landers	George Soros
Glenn Close	George Lucas	Candy Spelling
Lester Crown	Archie MacAllaster	Roger Staubach
Barry Diller	Forrest Mars Jr.	Ben Stein
Sen. Dick Durbin	Newton Minow	Bill Tilley
Harvey Eisen	Andy Musser	Prem Watsa
Charles D. Ellis	Sen. Bob Nelson	Byron Wein
Marvin Hamlish	Rep. Tom Osborne	Dirk Ziff

Skimming the list of Berkshire's highly concentrated and long-term shareholders reveals some of the most distinguished investors and investment firms in America. These include shareholders who have owned substantial stakes in Berkshire for one to four decades.

The Managers

When Berkshire finds managers it trusts, it leaves them alone. At most companies, corporate tasks tend to be centralized, with divisional and sub-division heads (middle management); reporting hierarchies; systematic policies concerning budgeting, personnel; and intricate systems of procedures and practice. Such structures add overhead in the name of effective oversight.

In contrast, with the exceptions of financial reporting and internal auditing, Berkshire skips such staples of corporate life, viewing most as bureaucratic excess. Berkshire devolves these and all other internal matters to its subsidiaries. Home office overhead is negligible at Berkshire, with a staff of only two dozen. Each subsidiary maintains its own programs and policies concerning budgeting, operations, and personnel—as well as conventional departments such as accounting, compliance, human resources, legal, marketing, and technology.

Consistent with this decentralized approach, each subsidiary is led by its CEO without interference from headquarters. Berkshire defers as much responsibility as possible to subsidiary chief executives with scarcely any central supervision. All quotidian decisions qualify, including advertising budget, product features and environmental quality, and product mix and pricing.

The same applies to decisions about hiring, merchandising, inventory, and receivables management. Berkshire's deference extends to subsidiary decisions on succession to senior positions, including unusual deference on CEO succession. Berkshire does

Pillars

Some Quality Institutional Investors of Berkshire

AKO Capital	E. S. Barr	Lourd Capital
Akre Capital	Everett Harris & Co.	Mackenzie Investments
Allen Holding Inc.	Fairholme Capital	Mar Vista
Aristotle Capital	Fiduciary	Markel Corporation
Arlington Value Capital	Management Findlay Park	Mraz, Amerine & Associates
Atlanta Capital Investment	First Manhattan	Neuberger Berman
Baillie Gifford & Co.	Flossbach von Storch	Punch Card Capital
Baldwin Investment	Fort Washington	Robotti & Company
Barrow Hanley	Investment Advisors	Ruane, Cunniff & Goldfarb
Beck, Mack & Oliver	Gardner Russo & Gardner	Sleep, Zakaria & Co.
Boulder Investment Advisers	Giverny Capital	Smead Capital
Bridges Investment	Greylin Investment	Speece Thorson Capital
Broad Run	Hartford Funds	Sprucegrove Investment
Brown Brothers Harriman	Hartline Investment	Stearns Financial Services
Budros Ruhlin & Roe	Henry H. Armstrong Associates	Timucuan Asset Management
Burgundy Capital	Hikari Tsushin	Tweedy, Browne
Check Capital	Jackson National Asset Management	Wallace Capital
Clarkston Financial	Jolley Asset Management	Water Street Capital
Consulta Ltd.	Klingenstein Fields	Wedgewood Partners
Cortland Advisors	Lafayette Investments	Weitz Investments
Davis Selected Advisors	Lee, Danner & Bass	WhaleRock Point
Douglass Winthrop	London Company of Virginia	Wintergreen Advisers
Eagle Capital		

not transfer businesses between subsidiaries and only rarely moves managers.¹⁷ Berkshire has no retirement policy and many chief executives continue working well into their seventies or eighties.

The only qualifications on managerial autonomy at Berkshire appear in a short letter Buffett sends unit chiefs every two years. The missive states the mandates Berkshire places on subsidiary CEOs: (1) guard Berkshire's reputation, (2) report bad news early, (3) confer about postretirement 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 Berkshire headquarters, and (6) submit written successor recommendations.¹⁸

Buffett's directive that Berkshire CEOs designate a recommended successor explains why most Berkshire subsidiary successions are seamless. In an emergency situation in 2011, for example, David Sokol resigned from what was then MidAmerican Energy. He was succeeded by Abel, a savvy company veteran and part owner, whose team grew and rebranded the formidable firm now called Berkshire Hathaway Energy. That miniconglomerate, in turn, now owns the vast network of real-estate agents spanning the United States, the ubiquitous Berkshire Hathaway Realty.

We consider a few challenges of management succession at Berkshire's subsidiaries in chapter 9, but the overwhelming majority have been effective. Many Berkshire subsidiaries evolved through multiple successions where successors took the company to heights undreamed of by predecessors. Pronounced examples recur in some of Berkshire's businesses with family origins, including Clayton Homes, Jordan's Furniture, Justin Brands, the Marmon Group, McLane, and RC Willey. Recent successions have been effective at a dozen subsidiaries, including Business Wire, Fruit of the Loom, General Reinsurance (Gen Re), Lubrizol, MiTek Systems, and Star Furniture.

Three recent successions bear special mention, given the companies and people involved: See's Candies, GEICO, and FlightSafety International.

See's Candies is among Berkshire's earliest acquisitions, in 1972. It marked the change in Buffett's investment philosophy from one obsessed with cheap purchase prices to one focused on high-quality businesses with enduring franchise value. The incumbent CEO, Chuck Huggins, remained at the helm until 2006.

Then, in an unusual move, Buffett tapped another Berkshire executive, Brad Kintler, for the job. Kintler had served, since 1987, in several other roles at Berkshire, including as CEO of Fechheimer Brothers, the uniform maker. Kintler had an impressive run at See's, maintaining the company's boutique quality while expanding its merchandising reach nationally.

Upon Kintler's retirement in 2019, it was perhaps fitting that his successor, like him, was plucked from another Berkshire business. In this case, Pat Egan was tapped. Notably, Egan was formerly a senior executive in Berkshire Hathaway Energy, the business long overseen by Abel.

GEICO likewise holds a special place in Buffett and Berkshire history. It was among the first businesses Buffett studied carefully, writing an article about it in 1951; Berkshire bought a substantial percentage of GEICO in 1976 and the rest in 1995. Its long-time CEO, who retired in 2018, is a Berkshire legend: Olza M. ("Tony") Nicely joined GEICO in 1961 at age eighteen and became CEO in 1992. Not many executives spend more than 50 years at the same company, but Nicely is one of several Berkshire executives holding that distinction.

Nicely led GEICO's transformation. On his watch, GEICO went from a bit player in car insurance, with 2 percent of the market and paltry growth, into a powerful industry force with nearly 14 percent share. That growth translated into at least a tripling of premium volume, float, and profit.

Despite this success, Nicely never boasted nor sought the spotlight. Befitting that style, Nicely's retirement came without fanfare—no press promotion or journalist coverage. Buffett paid Nicely a great tribute in his 2018 letter, however, also extolling the talents of his successor, long-time colleague Bill Roberts.

The FlightSafety succession is a sadder one, marking the passing of Bruce Whitman in 2018 at the age of eighty-five.¹⁹ Like Nicely, Whitman spent his career at one company, beginning in 1961 as the number two and in 2003 becoming president and CEO.

In 1996, Berkshire acquired FlightSafety, which marked a turning point for both companies and for Buffett. During 1996, Berkshire began its transformation from a minority investor in large public companies into a conglomerate, acquiring scores of businesses in diverse industries.

Specifically, since Berkshire's acquisition of FlightSafety through today, Berkshire has made some forty-five acquisitions, at a combined cost of around \$165 billion, while driving shareholders' equity up more than \$275 billion. Since 1996, Berkshire's book value per share rose from \$20,000 to \$200,000; its Class A share price climbed from \$35,000 to \$300,000; and market capitalization soared from \$60 billion to \$500 billion.

Buffett attributes Berkshire's success to its managers. In his famous annual shareholder letters, Buffett extols his subsidiary heads, aptly dubbing them the "All Stars" of American business. On several occasions, Buffett singled out accomplishments of Whitman, Nicely, and Kintzler, along with dozens of others. Buffett stresses that Berkshire CEOs, while all at the top of their fields, each play the game distinctly. As he wrote in his 2015 letter to shareholders:

Berkshire's CEOs come in many forms. Some have MBAs; others never finished college. Some use budgets and are by-the-book types; others operate by the seat of their pants. Our

team resembles a baseball squad composed of all-stars having vastly different batting styles. Changes in our line-up are seldom required.

Effective leadership transfers at Berkshire's subsidiaries are vital to the decentralized conglomerate model. Berkshire headquarters has scant resources to intervene, so succession planning is the responsibility of the managers.

Whitman was succeeded by two colleagues, taking the titles of co-CEO and sector presidents of the pilot-training company: for commercial aviation, David Davenport, who joined FlightSafety in 1996 and worked closely with Whitman at headquarters from 2012, and for military aviation, Raymond E. Johns Jr., who retired as a U.S. Air Force general in 2013 when he joined FlightSafety and also worked closely with Whitman at headquarters.

Until Whitman's passing, FlightSafety under Berkshire's ownership had only one change in lineup—when founder Ueltschi passed the ball to Whitman in 2003. This succession plan was nearly foolproof, given Whitman's decades of steadfast service leading up to it. In his 1999 memoir, *The History and Future of FlightSafety International*, Ueltschi explained:

The company has a small but tremendously effective corps of executives, most of whom arrived as enthusiastic youngsters and stayed for the long haul. One of the first on the scene proved to be one of the best, Executive Vice President Whitman. He has been my right-hand man since the day he arrived—a very good day for us all.

Buffett, in his 2007 annual letter, officially proclaimed Whitman's succession totally effective.

Several other Berkshire CEOs have written autobiographies. These efforts reflect the character of their authors and are as varied as Buffett suggested. Berkshire CEO authors—including Jim

The Players

Clayton and Doris Christopher—attribute their success to such different forces as imagination, empathy, and passion.

Despite the diversity among managers, all of them have emphasized the importance of trust—being trusted by Buffett and Berkshire and demanding trustworthiness from their teams. As Whitman put it: “Buffett trusts me so much with Berkshire’s money that I am even more careful in handling Berkshire capital than in handling my own.”²⁰

Partnership Practices

BUFFETT'S PARTNERSHIP ATTITUDE is genuine, not platitude. This attitude is most evident in a wide range of corporate policies, in his annual letters, and at Berkshire's annual meetings. Consider first a few of the policies—for example, on charitable giving, dividends, and executive pay—before exploring the annual letters and meetings and how they complement each other.

Policies

At most U.S. corporations, boards and senior executives set corporate charitable contribution policy, deciding how much to give and to what charities. Such an attitude is an anathema at Berkshire, where the board removed itself from the equation to let shareholders name the charities of their choice.

Under its shareholder charitable contribution program, Berkshire's board approved the maximum portion of net earnings to donate, and then allowed each shareholder to name favored

charities for their share of that amount. The vast majority of shareholders participated, allocating \$200 million over twenty years.¹

Consider also Berkshire policy on dividends: aside from a small dividend in 1967, it has never paid one. Buffett has repeatedly explained Berkshire's policy, which is to retain each dollar of earnings so long as it translates into at least one dollar of market value. Many companies, in contrast, pay a regular dividend without considering relative available opportunities for deploying retained earnings and without consulting shareholders or articulating the rationale.

Berkshire has polled its shareholders on this policy on at least two occasions, once in 1984 and again in 2014, in a formal proxy statement ballot. It got the same answer both times: shareholders overwhelmingly endorse the policy, with more than 90 percent affirming. Few chief executives poll their shareholders on anything, although they may hire consultants and experts to do so, again underscoring Berkshire's partnership attitude.

Most large public companies have a policy of regular stock splits. When stock price rises above a certain level, such as \$100 or \$500, the board divides each share in two, doubling the number outstanding and halving price. They do this to promote trading in the stock, and in the process pay fees to intermediaries, including stockbrokers and stock exchanges. Berkshire has shunned such a policy of stock splits, reducing the role and fees of intermediaries.

The aversion to stock splits endured even when Berkshire's stock price surpassed dizzying heights. After reaching \$30,000 in 1996, most shareholders, with no interest in selling, were content. But some, needing cash or wishing to make gifts, signaled interest in lowering the share price. At this time, as Berkshire's stellar performance had become well known, demand rose among non-shareholders for a more affordable piece of the action.

Inspired by the demand, two financial promoters designed an investment vehicle to meet it. They proposed to create unit trusts that would buy the expensive Berkshire shares and then issue

fractional interests at far lower trading prices of around \$500 each. To eliminate the appeal of such trusts, and the associated fees the promoters would charge, Berkshire created a second class of stock (the Class B), with fractional voting and economic rights, set to trade at around \$1,000 per share.

The move has proven advantageous in other ways. For instance, by 2010, these new Class B shares traded above \$3,000 while the original class (Class A) reached \$100,000. That year, Berkshire acquired BNSF Railway, partly paid in stock. To enable the railroad's many employee-shareholders to accept Berkshire stock, its board split the Class B stock fifty-to-one, lowering its price to around \$60 per share. (Lately, the Class B share price has hovered around \$200 and Class A has risen above \$300,000.) The two-class structure also enables Berkshire shareholders to create liquidity, as Class A shares can be converted, tax-free, into Class B shares.²

Buffett is particularly proud of Berkshire's approach to executive compensation, which he contends is based on ultimate rationality and never involves outside consultants. He and each top executive simply agree on a base salary plus bonus based on achieving desirable outcomes within the executive's control. The time horizon often spans years, rather than the customary calendar year, to reflect more faithfully the vicissitudes of given businesses and to promote a longer time horizon. (We look at compensation again in chapter 6.)

Letters

At most public companies, the annual letters to shareholders are ghostwritten, dull and aptly ignored. Buffett pens his missives; they are edited by an unpaid but dedicated writer friend, Carol Loomis; and we have been honored to distribute the classic compendium of them as *The Essays of Warren Buffett: Lessons for*

Corporate America. Berkshire shareholders devour these letters, and parents often give them as gifts to their children.

What most distinguishes Buffett's annual letters to Berkshire shareholders is not their clarity, crispness, or wisdom—although these are hallmarks. It is rather that they are not letters at all. Each missive, as Buffett calls them, is instead a series of essays: short literary compositions on discrete subjects expounding the author's viewpoint.

Every Buffett essay has a specific motivation, foremost to attract shareholders and colleagues who embrace the Berkshire business model and deter others. Buffett seeks, and through a half-century has attracted, constituents who think in terms of value rather than price; economic substance over accounting results; and businesses as human creations to hold, not commodities to trade.

In style, Buffett writes as an uncle might, imagining he's writing to relatives whose trust he has gained and seeks to sustain. A recurring motif, earning Buffett the misleading label "contrarian," is the artful practice of disagreement. Buffett recites conventional wisdom along with multiple reasons why it is inaccurate or incomplete.

Yet Buffett's peculiar positions never sound defensive, even when expressly addressing critics. And the rhetorical style boasts the fine carpentry of written excellence, from syntax to sequencing. Opening lines entice while closing ones leave a lingering thought. In between are excursions in logic, sometimes straight to a single point and elsewhere with complex subtlety yielding compound payoffs.

Buffett's essays are rich with history, putting current debates in broad context, and steeped in statistics, anchoring arguments in data. Buffett contrasts and compares; jokes and quips; and tends to praise by name but to criticize by category.

Above all, the work expresses who Buffett is—a joyous, confident, rational, and astute capitalist. Yale University writing professor William Zinsser says that "Motivation is at the heart of

writing.” Buffett loves Berkshire, his curated life’s work defined by unusual shareholders, adroit managers, and idiosyncratic principles. Munger has commented: “Buffett’s whole ego is poured into Berkshire.” That’s Buffett’s not-so-secret sauce.

Meetings

With some exceptions, corporate annual meetings are time drains and few shareholders attend. Berkshire’s annual meeting is a packed intellectual, cultural, and social extravaganza. Buffett adds enduring value to his annual letters by making them the centerpiece of the ensuing shareholders’ meeting, an equally iconic spectacle that draws tens of thousands.

Typical Berkshire shareholders have read Buffett’s letter before the ensuing meeting and discuss it together in breakout sessions. Most people posing questions from the meeting floor show knowledge based on the letter. Fellow owners cheer astute queries and hiss or boo when ignorance is shown.

Recurring themes appear in both the reports and the meetings, increasing the value of both. Together, the devices amount to a long-term program of defining Berkshire’s distinctive ways and of educating shareholders about their value.

Numerous events occur throughout the weekend of the Berkshire annual meeting, scattered across Omaha. Thousands of shareholders attend conferences at the University of Nebraska, panel discussions at Creighton University, and a dinner hosted by Columbia University.

Berkshire shareholders tend to be avid readers. For the past two decades, Buffett has designated a few dozen books for sale at each annual meeting, adding to 120 different titles. Guidance is especially helpful in categories of special interest to Berkshire shareholders. These include designating the top 30 of the 330-plus book titles containing the word “Buffett.”

Berkshire's shareholders are part of the company's culture. The Berkshire shareholder is interested yet patient, skeptical yet faithful, and serious yet fun. Berkshire's family of subsidiaries is often likened to an art collection, with Buffett as the curator. It's not a stretch to portray Berkshire meeting attendees as the visitors, patrons, and, yes, lovers of the curated content as well as the guides, docents, and tutors for newcomers and veterans alike.

For a collection of essays published in 2018, *The Warren Buffett Shareholder: Stories from Inside the Berkshire Hathaway Annual Meeting*,³ we asked dozens of Berkshire shareholders to explain the importance of the Berkshire meeting. Many immediately connected the meeting to Buffett's letters and wrote inspiring essays about what the meetings mean to them. They feature themes of partnership and trust.

Consider highlights from *The Warren Buffett Shareholder* contributor Robert Denham, longtime Berkshire denizen and Buffett confidant. Denham served, at Buffett's request, as CEO of Salomon from 1992 to 1997, turning it around after its life-threatening bond trading scandal. Since then a corporate lawyer at Munger, Tolles & Olson, Denham explains how the partnership attitude plays out in Buffett's letters and Berkshire's meetings:

Berkshire's annual report provides a great field guide for those attending the Meeting. It is written carefully and clearly to explain Berkshire's businesses and the economic environment in which they operate to co-owners not involved in the business but motivated to understand it. Those having read the Annual Report are well-prepared to ask questions, understand the answers, and put both questions and answers in a broader business context. In other words, they are prepared to be a participant in the Meeting and in the weekend's multiple conversations surrounding it.

Denham expounds on Buffett's tactful style of address, which reflects on *how* to think rather than *what* to think. This is an expression of both respect and trust.

Buffett never fills in the parameters for his listeners or gives his answer. This reticence reflects a belief that every investor has to take responsibility for forming his or her own view of such fundamental items. Although the central focus of discussion is Berkshire's business and more or less related questions about markets and economics, there is also discussion of how to live a morally valuable life. These discussions reflect the deep commitment to teaching others how to live not just an economically successful life, but also a virtuous and meritorious life.

The contribution by Simon Lorne, Denham's former law partner and Salomon colleague, likewise stresses the partnership attitude:

In a way, the Meeting is the natural outgrowth of Buffett's famous shareholder letters. Just as the letters evolved over the years, so has the Meeting. But in fact, just as the Meeting is the natural evolution from the letters, the letters are the natural outgrowth of Buffett's nature. Buffett treats Berkshire's shareholders as the true owners of the enterprise. The letters come from that vantage point, and to many the Meeting may be its most visible expression.

Lorne identifies trust as the Berkshire model's single strategic benefit, of potential value to all: "The rapport that [Berkshire executives] have with their shareholders through devices like the letters and the Meeting, and the trust that is engendered by that process, give them leeway for occasional missteps that other corporations could use."

The idea of trust is ultimately about faith in people. In *The Warren Buffett Shareholder*, Georgetown University professor

Prem Jain captured this point as he reflected on his decades'-long search for Berkshire's secret to success:

At the Annual Meetings, Messrs. Buffett and Munger continued to speak at length about Berkshire's managers and employees. Year after year, they spoke about their managers frequently and passionately and never disagreed in their judgments—where they tended to disagree a lot on many other matters from acquisition prospects to national economic affairs.

After many years, it dawned on me that the deeper answer I was seeking was right before my eyes. The answer was there when Messrs. Buffett and Munger talked about Ajit Jain, Lou Simpson and dozens of other able, trustworthy and passionate managers at Berkshire. There it was, the answer to Buffett's success: his ability to identify outstanding people.

I concluded that when Buffett invests, he invests in exemplary managers, not thinking of companies separately from management. He allocates capital to people, not just to companies. Products, operations, and financial metrics are important, but secondary.

If people are primary, trust is paramount.

Business Methods

BERKSHIRE'S BUSINESSES exude trust. This trust fuels the most consequential recurring activities that define Berkshire's business methods: self-reliant finance, internal capital allocation, decentralization, and acquisitions.

The value of trust explains Berkshire's preference to finance operations and growth internally rather than through third-party lenders. They trust themselves more than they trust bankers.

Trust is a *sine qua non* for Berkshire's decentralized autonomous approach as well as a primary reason for this model's success. Trust is earned, moreover, and must be nurtured, which explains many preferences Berkshire has in the acquisition arena. It also explains Buffett's preference to look to personal networks over brokers when hunting for acquisitions as well as his unusually minimalist due diligence.

Finance

Berkshire finances operations and acquisitions primarily through retained earnings, with leverage contributed by insurance float

and deferred taxes. Berkshire generally does not use banks or other intermediaries. In the few times when Berkshire has borrowed funds, mostly for use of its capital-intensive and regulated public utility and railroad business, loans are long-term and fixed-rate. Use of traditional debt could juice Berkshire's results, but borrowed money is costly and creates risk of default along with collateral damage.

Berkshire's preferred source of leverage is float in its insurance operations. Float refers to funds that insurance companies hold between the time premiums are received and the time claims are paid. So long as insurance underwriting breaks even (total premiums received equal expenses plus total claims paid) the cost of float is zero. With an underwriting profit, an insurer can effectively be paid for holding float, and even with modest underwriting losses, float is usually cheaper than bank debt.

Deferred taxes are also a cheap and riskless source of leverage. They arise when tax laws require accruing obligations on appreciated assets but do not require repayment until the asset is sold. Although a real liability, there are no interest costs, covenants, or due dates. The timing of repayment is optional.

When done well over long periods of time, the amount of float can grow massively. At Berkshire, float rose from a mere \$39 million in 1970 to \$1.6 billion in 1990 and has soared in decades since—to \$28 billion in 2000 and to \$66 billion in 2010—and are estimated to reach \$125 billion by 2020. Berkshire's deferred taxes stand at around \$50 billion, pushing the total of these unconventional leverage sources toward \$175 billion (representing the lion's share of total liabilities).

These obligations are real liabilities, of course, so poor underwriting can be disastrous. For example, underwriters may price risks too low in relation to eventual payouts, whether due to competitive pressures or faulty actuarial modeling. Such poor underwriting has drained many an insurer, rendering them insolvent.¹ Berkshire's insurance subsidiaries hedge against disaster. They use

compensation plans designed to encourage underwriting discipline, with bonuses tied to underwriting profit and to the cost of float rather than to premium volume.

Unlike float (or deferred taxes), bank debt comes with covenants, stated interest, and due dates. Loans are marketed by agents whose interests conflict with those of borrowers, whether concerning a loan's size, duration, cost, or covenants. Berkshire's approach thus provides the leverage benefits of debt without these downsides. Berkshire's model underscores the value of fiscal self-reliance and self-discipline. Ultimately, Berkshire trusts itself rather than lenders.

Internal Capital Allocation

Berkshire's conglomerate structure enables internal cash reallocation to businesses generating the highest returns on incremental capital. Berkshire's success at capital reallocation has vindicated its conglomerate business model, otherwise denigrated across corporate America. It also skillfully avoids third parties.

Cash-transferring subsidiaries distribute cash to Berkshire without triggering any income tax consequences. Cash-receiving subsidiaries obtain corporate funding without frictional costs of borrowing, such as bank interest rates, loan covenants, and other constraints. Some subsidiaries generate tax credits in their businesses that they cannot use but that can be used by Berkshire's other subsidiaries.

Subsidiary managers prize the effortless source of funds. Outside Berkshire, a chief executive needing funds faces layers of approvals that tend to reflect skepticism rather than trust. This process starts with a board to obtain authorization and financial advisors on the best sources and types of funding. These, in turn, involve underwriters for equity securities or banks for debt.

At each step, fees are incurred as well as haggling over terms that limit the company's flexibility, in operations and financial management. Berkshire's subsidiary managers avoid all of that: when they want funds, they tell Buffett, the friendliest banker you can imagine—no interference, contracts, conditions, covenants, due dates, or other constraints of intermediation.

Decentralization

Decentralization—pushing autonomy and responsibility downward throughout the business organization—pervades Berkshire. It starts at the top, with Buffett and Berkshire headquarters, and trickles down.

Buffett keeps Berkshire simple: there is not even an organizational chart. If Berkshire had one, it would resemble that shown in figure 3.1, which we created.

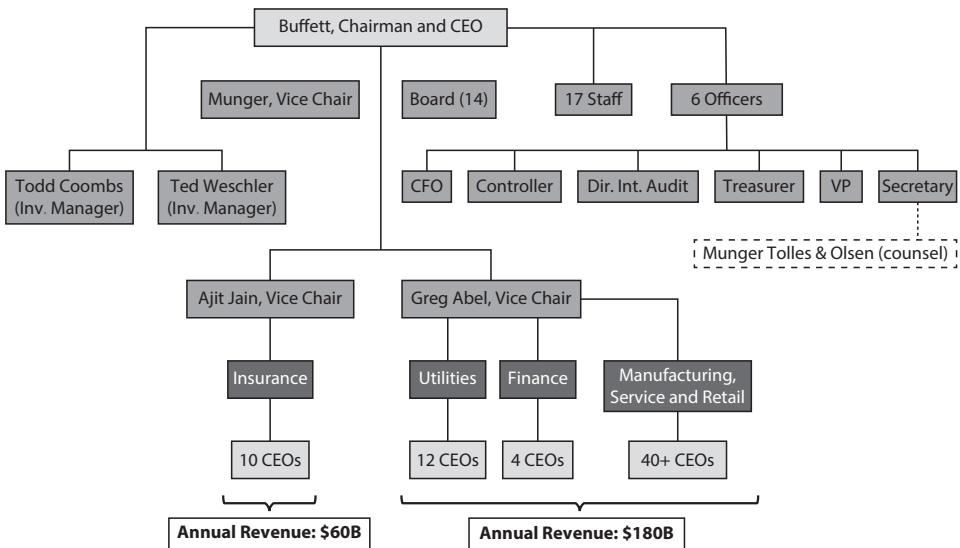


FIGURE 3.1 Hypothetical org chart for Berkshire Hathaway.

Buffett brags of employing only a couple dozen people at Omaha headquarters in a conglomerate brimming with nearly four hundred thousand employees.

Buffett makes almost all Berkshire-level capital allocation decisions, including acquisitions. On major outlays, he has long consulted Munger—and lately Abel and Jain. In the early 2000s, Berkshire hired two investors—Todd Combs and Ted Weschler—to manage sizable portions of its securities portfolio.

Formal oversight of Berkshire's subsidiaries concerns financial matters, led by five officers in Omaha: the chief financial officer, controller, director of internal audit, treasurer, and vice president of finance. The only other officer is the corporate secretary, something like a general counsel, but primarily overseeing the outside lawyers handling Berkshire's acquisitions and securities work.

Each Berkshire subsidiary is self-contained, with all traditional corporate functions, and defines its own departments. The result is overhead at Berkshire headquarters of approximately \$1 million annually and salary expense under \$10 million.² For context, Berkshire's annual revenues run around \$250 *billion*.

For additional support, each subsidiary has a small board—typically five members. Buffett serves on the boards of larger and risk-sensitive subsidiaries. Each CEO sits on his or her own board. Other directors are supplied by Berkshire's board, the Omaha team, or from among other Berkshire subsidiary CEOs. All other corporate functions remain at each subsidiary after acquisition, as before, with their own organizational structures.

As Berkshire has grown in the past two decades into a gargantuan conglomerate, and Buffett's attention has spread thin, the company has decentralized not only by maintaining acquired businesses as autonomous units but also by *sustained decentralization*, meaning further pushing functions down at the subsidiary level; *segmented decentralization*, by splitting acquired businesses further; and *reporting decentralization*, increasingly pushing senior managers up.

Sustained decentralization is illustrated by Berkshire Hathaway Energy (BHE) under Abel. In 1998, Abel began running the group's main business, MidAmerican. Since then, he has led fifteen major acquisitions to build a conglomerate, now generating some \$25 billion in annual revenue, with five utilities, two pipelines, numerous renewables, and hundreds of real estate brokerages, operating under the BHE brand.

As often happens with growth, centralization crept in, with many functions at headquarters and related overhead costs. In recent years, Abel and BHE aggressively decentralized, pushing all functions down. The head office employs a couple dozen people compared with twenty-three thousand company-wide personnel. The logic for this decentralization runs along both geographic and product lines: the businesses are in specific regions and face different pricing environments, regulatory oversight, and labor markets. Each unit gains from autonomous local leadership with specific infrastructure and personnel.

Headquarters has a general counsel and a few lobbyists to coordinate global regulatory issues (these are discussed further in chapter 10). An HR director has consolidated expertise on unionized labor markets and helps negotiations in each unit. Other than internal audit, all other functions are pushed down.

Decentralization by segmentation often occurs at Berkshire upon acquisition. For example, in 2006, Berkshire's Fruit of the Loom subsidiary, the underwear company, acquired Russell Athletic, maker of athletic apparel such as jerseys and uniforms. Russell also owned a few specialty businesses, including Brooks Running Shoe Co.

After the deal closed, Buffett asked Brooks' then-president, Jim Weber, whether Brooks was similar to or different from Russell and Fruit. Weber said that although all three companies primarily manufactured abroad and shipped worldwide, Brooks had little else in common with Russell and Fruit. They then moved Brooks out of the Fruit hierarchy to make it a direct Berkshire subsidiary

with Weber in charge, entrusted with his own profit-and-loss (P&L) statement.

The logic of this move focused on differences in the business models and Buffett's explicit trust in Weber. Fruit and Russell make commodity goods for ordinary consumers that don't change athletic performance. Products are sold through general retailers in a competitive price environment—with little need for research and development (R&D). In contrast, Brooks sells performance-enhancing athletic equipment to avid runners in high-end shops, and charges a premium, as rivals compete on quality more than price—in turn making R&D investment considerable.

In another case, in 2000, Berkshire acquired Justin Industries, a mini-conglomerate composed of a few boot companies and several brick companies (called Acme Brick) operating under centralized management. The founder, John Justin, admitted that the products had little in common, quipping that at least all were made of natural materials. Buffett again noted the availability of two outstanding managers to run these different types of businesses.

Boots can be produced anywhere and generally are manufactured abroad and shipped worldwide; they're sold through retail outlets to individuals; and with Justin's strong ad-driven branding—generally a uniform Western look—Justin Boots commands some pricing power. Boots wear out naturally, so loyal customers buy again. As an organization, these features tended to warrant a relatively centralized approach to design, manufacturing and marketing.

Brick production, on the other hand, is constrained by weight and geography and is produced and distributed more locally. Buyers primarily include commercial parties in competitive markets that put a premium on relationships. Acme offers one-hundred-year warranties. These features make Acme more effective when organized regionally, with production and sales operating as independent businesses, while investing centrally in quality control.

Buffett, therefore, separated the boot businesses from the brick businesses. Each became a direct Berkshire subsidiary, with each chief executive responsible for the entire P&L from operations through administration. This decentralization has enabled both Acme Brick and Justin Boots to prosper far more than they would have under the same corporate roof.

Reporting decentralization occurs by reducing the direct reports of senior managers without adding layers of bureaucracy, chiefly by collecting logical business units into group portfolios. A good example is Berkshire's Marmon Group, a diverse manufacturing powerhouse. In 2005, before Berkshire bought Marmon, CEO Frank Ptak oversaw ten divisional direct reports, which he thought too many. Therefore, he segmented the ten divisions into four companies, with four direct reports (figure 3.2 illustrates).

The rationale is simple: as a company grows ever larger, no manager can master everything. Senior managers must constantly regroup and delegate to levels at which junior managers, in aggregate, can do so. (Our discussion of the Marmon Group continues in chapter 8.)

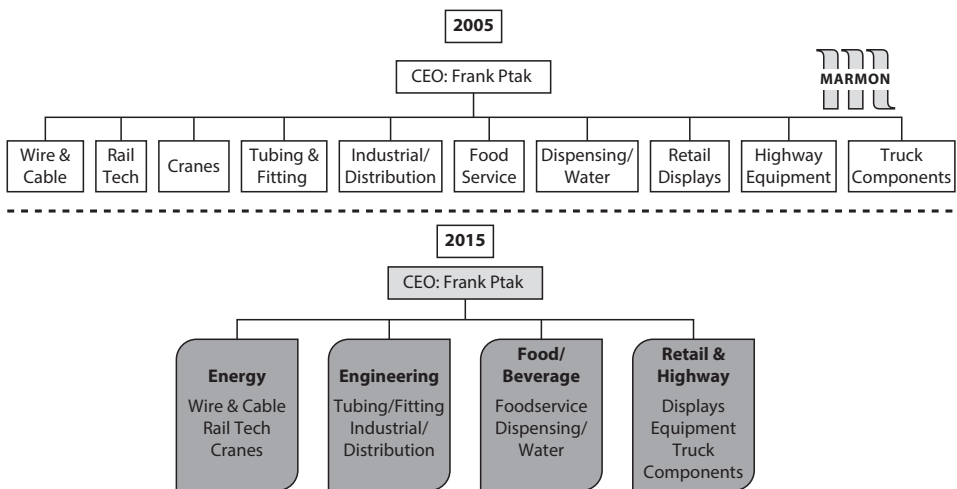


FIGURE 3.2 Decentralization of Marmon Group. The number of direct reports for the CEO went from ten in 2005 (*top*) to four in 2015 (*bottom*).

Reporting decentralization can be an ideal model to handle not only growth but also the challenges of succession. This is illustrated by Berkshire's insurance business, with annual revenues (premiums earned) around \$60 billion. For decades, Buffett had three direct reports from major units since their acquisition—Nicely at GEICO; Jain at NICO; and Franklin ("Tad") Montross at Gen Re.

When Montross retired in 2016, rather than simply find a successor, Buffett pushed Jain up to oversee both NICO and Gen Re. Thereafter, Montross's successor reported not to Buffett but to Jain. This both expanded Jain's purview over Berkshire's insurance operations and cut Buffett's direct reports.

This change excluded GEICO, where Nicely continued to report to Buffett, sensible given Nicely's decades-long tenure. But after Jain became vice chairman of insurance in 2018 and Nicely retired, it was easy to have Nicely's successor, Bill Roberts, report to Jain, not to Buffett. This form of decentralization is a model that can be used to accommodate further successions across Berkshire's segments. To work, all participants must have a high degree of mutual trust.

. . . .

All organizational structures pose trade-offs. Decentralization allows for efficient and effective decision making by managers closest to the issue. It runs the risk, however, of erroneous decision making, too. But Buffett justifies it: "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."

A commonly cited advantage of centralization is avoiding duplication of resources. But at Berkshire it seems to work the other way around: there may be sixty legal departments instead of one, but the alternative would likely be a general counsel's office far larger than the sum of those existing at the subsidiaries.

Efficiency follows because each manager has economic and cultural incentives to minimize the size of his or her staff. And that is a

significant advantage of Berkshire's decentralized model: each CEO can design the structure best suited to his or her specific operations.

Acquisitions

Most corporations, including conglomerates, adopt a formal pipeline plan charting desired sectors in which to expand, sometimes even naming acquisition targets. Many companies have acquisition departments that scout for and seize opportunities. Such internal functions exhibit some features common to intermediaries, including a valuable claim to expertise. But they also have potentially skewed incentives to favor activity when inaction would be more prudent.

Berkshire has never had such a department or plan. Instead, when describing given transactions in his annual letters, Buffett calls Berkshire's acquisition strategy "haphazard" and "serendipitous," neither "carefully crafted" nor "sophisticated." The approach helps to avoid costly value-destroying acquisitions, one important factor in Berkshire's sustained success.

In the acquisitions market, companies commonly hire investment banks and brokers to vet deals. Berkshire generally avoids these hires. Deal brokers charge fees, often high ones. Many deal fees are contingent on closing, giving brokers an incentive to close despite a clients' best interests.

In such cases, acquisition costs are far greater than out-of-pocket fees, however significant these may be. These costs are measured by the difference in value between what was invested and what was obtained. In this scenario, the best corporate strategy might be to hire two brokers—one who is paid if the deal closes and the other who is paid if the deal doesn't.

Rather than rely on brokers, Berkshire has long used an ever-growing network of associates, partners, colleagues, and friends to bring acquisition opportunities. In addition, in 1986, Berkshire

ran an ad in the *Wall Street Journal* stating its interest in acquisitions and criteria, which Buffett has repeated in his annual shareholder letters. Consequently, Berkshire rarely initiates the process, but rather responds to proposals from others.

Lawrence Cunningham's book, *Berkshire Beyond Buffett*, collates the sources of the deals for which information appears in Berkshire's public disclosure.³ *Eleven* involved sellers contacting Berkshire; *nine* arose when existing business relationships contacted Buffett; *seven* involved friends or relatives reaching out to Buffett; *four* involved Berkshire contacting the seller directly; and *three* were teed up by strangers or acquaintances.⁴

Consider Berkshire's 1986 acquisition of Scott Fetzer, where a "major investment banking house" tried unsuccessfully to find a buyer for the midsize diversified conglomerate. After a hostile raider targeted the company, Buffett contacted the latter's CEO to discuss a deal, which they quickly closed.

Reprovingly, Buffett noted, the company still had to pay its banker \$2.5 million, even though it did not find the buyer. As Berkshire's experience suggests, Buffett believes it is better for sellers and buyers to find each other directly than to retain bankers or brokers. A favorite Buffett line admonishes: "Don't ask the barber whether you need a haircut."

In typical acquisitions, as negotiations of the terms of agreement proceed, accountants scrutinize a company's controls and financial figures, while lawyers probe contracts, compliance, and litigation. Such examinations usually are done at corporate headquarters, along with meetings where principals get acquainted and tour facilities. The heavily intermediated process can take months and generate significant fees. Berkshire—proudly—does little of that.

Buffett sizes people up in minutes; deals are sometimes reached in an initial phone call, often in meetings of less than two hours and invariably within a week. Formal contracts are promptly negotiated. Deals—including big ones involving billions of dollars—can close within a month of initial contact.

Benjamin Moore was a family-controlled company whose stock was also listed on the over-the-counter market. Having decided it was time to sell, the company retained financial advisors who, upon study, suggested a price. But the firm could not find a buyer at the sought price. Directors contacted Buffett, presenting Benjamin Moore as a Berkshire kind of company.

Asking only a few questions and for public documents, Buffett made a proposal within a week. He offered to acquire Benjamin Moore for \$1 billion cash and the board accepted—aware that seeking a higher price from Buffett was probably futile. Related investigations consisted of Buffett meeting with the company’s CEO and Berkshire’s outside lawyers conducting basic due diligence. (We continue our discussion of the Benjamin Moore acquisition in the next chapter.)

Buffett’s commitment to staying within his “circle of competence” enables him to make such momentous decisions based on moderate digging. For one, his prodigious business reading provides significant knowledge and familiarity with many companies and their leaders. And his intensive focus on industries he comprehends and business methods he embraces has added discipline. When he lacks competence—whether in the business, about the business method, or to judge the people involved—he passes.

Concerning trust, in particular, if Buffett has any doubt about the trustworthiness of a prospective business colleague—seller, manager, or otherwise—he usually politely declines interest. This is the essence of the *margin of trust*: it’s not enough to be an excellent judge of business, business methods, or character—although Buffett has honed those skills. It is, above all, a disciplined aversion to misplaced trust that must rule.

PART II

Perspectives

Deals

IN HIS WONDERFUL BOOK, *Capitalism, Democracy, and Ralph's Pretty Good Grocery*, Ohio State University professor John Mueller stresses trust as an essential element in deal making. Trust enabled some of the most substantial deals in American industrial history:

People in American business rely on trust and reputation to make deals happen. For example, the agreements between Standard Oil and the railroads in the nineteenth century, of enormous economic consequence to both parties, were mostly sealed simply with a handshake. Indeed, if there is even a small chance that the courts would be required to make a deal work, the deal will probably not be consummated in the first place. [Where] trust has arduously, and profitably, been built up, efforts to further guarantee honesty by mechanical legalistic devices could actually be counterproductive.¹

While most players in corporate America defer to the formality associated with legal contracts, bargains often go forward

without them. Buffett prefers the informal route, though elaborate formal agreements are unavoidable in many circumstances. Buffett's views and experiences with contracts, a subject almost never discussed in the thousands of books or articles on Buffett, offer insights into his profound preference for trust.

Informal Promises

Begin with two of the most famous of the many informal promises Buffett has made repeatedly since taking control of Berkshire in 1965 through today. The first concerns his regular declaration that he regards Berkshire as a partnership, not a corporation, among all shareholders. This conception is the first of a dozen operating principles Berkshire publishes in its annual reports, dating to the mid-1980s, and included in every one from 1995 to 2017.

If there is a partnership, then Buffett and the rest of Berkshire's leadership owe owners far more stringent loyalty oaths than the fiduciary duties law puts on corporate directors. If taken at face value, Buffett's repeated statements suffice to form a partnership as a legal matter.

In context, they are aspirational statements of business philosophy to convey a conviction that shareholders are owners along with Buffett. No shareholder has sued alleging violation of such partnership duties, of course, given that Buffett and Berkshire's other leaders have undoubtedly met even the highest standards of partnership obligation.

Yet with each passing year, as Buffett both repeats and honors the oath, his personal commitment strengthens while Berkshire shareholders broaden the deference they give him to deliver on it. The process illustrates how to build a reservoir of goodwill through a business practice rather than a legal contract. It illustrates one of Muller's points noted in the quotation from *Ralph's Pretty Good Grocery*: "[Where] trust has arduously, and profitably, been built

up, efforts to further guarantee honesty by mechanical legalistic devices could actually be counterproductive.”

Turning to the second of Buffett’s two famous promises, for forty years, he has repeatedly declared, in official Berkshire documents, presentations, and commentary, that when Berkshire acquires a company, it intends to hold it forever. And he has made good on that overture—retaining even companies that struggle financially. This is a claim on which sellers invariably place a great deal of trust in Buffett.²

Berkshire makes the specific point in acquisition discussions and it is often a basic rationale for many sellers to Berkshire, especially families and entrepreneurs, who value the commitment of permanence. But no such promises appear in the formal acquisition agreements Berkshire signs. That makes sense because an intention, backed by practice, is probably all that can realistically be given and provides the seller a sufficient basis to proceed.

Suppose, moreover, a seller requested Buffett or Berkshire to put the commitment in writing in a legally binding contract. Their signal could be construed as mistrust, which might doom the deal. To quote again from *Ralph’s Pretty Good Grocery*: “if there is even a small chance that the courts would be required to make a deal work, the deal will probably not be consummated in the first place.”

Acquisition Agreements

In the past two decades, Berkshire acquired some twenty public companies.³ The deals are memorialized in highly formalized contracts, dictated by the practices of public companies. The common focus in these and all such acquisitions is on the seller’s financial statements, which it represents to be fairly stated and on which any buyer relies.

These financial statement representations are elaborated in great detail. They explicitly reference arcane points: encompassing notes to the financial statements, schedules to securities law filings, the balance sheet, income statement, and cash flow statement—all as of specified dates or time periods; in accordance with a specific set of accounting standards, such as Generally Accepted Accounting Principles (GAAP), International Financial Reporting Standards (IFRS), or some other comprehensive basis of accounting; and subject to a separate schedule enumerating exceptions.

Lawyers and business people invest significant effort in delineating the financial statement representation to reduce any doubt about exactly what each side has agreed to. They try to leave no wiggle room for either side to argue that the commitment was ambiguous or that some issues had not been decided. In effect, both sides aim to preclude the other from arguing, in court, that a judge should set aside the plain terms of the writing in favor of listening to testimony about the surrounding context.

Two of Berkshire's earliest acquisitions had very different financial statement warranties. Buffett recounts these stories in his 2013 and 2014 shareholder letters, recalling deals that came to define Berkshire. At the time, they not only were critical acquisitions but involved personal characteristics that warranted a different touch: one selling group was a family and the other was a friend of Buffett's.

The first example describes one of Berkshire's earliest and still historically most important acquisitions in terms of size—the 1967 purchase of National Indemnity Co. (NICO), today the world's largest property and casualty insurance company. As Buffett recounted in his 2014 letter to shareholders:

[Insurance] has been the engine that has propelled our expansion since 1967, when we acquired National Indemnity and its sister company, National Fire & Marine, for \$8.6 million. Though that purchase had monumental consequences for Berkshire, its execution was simplicity itself.

Jack Ringwalt, a friend of mine who was the controlling shareholder of the two companies, came to my office saying he would like to sell. Fifteen minutes later, we had a deal. Neither of Jack's companies had ever had an audit by a public accounting firm, and I didn't ask for one. My reasoning: (1) Jack was honest and (2) He was also a bit quirky and likely to walk away if the deal became at all complicated.

The purchase agreement we used to finalize the transaction was 1-½-pages long. That contract was homemade: Neither side used a lawyer. Per page, this has to be Berkshire's best deal: National Indemnity today has GAAP (generally accepted accounting principles) net worth of \$111 billion, which exceeds that of any other insurer in the world.

The second example describes one of Berkshire's earliest family-company acquisitions, —the 1983 purchase of Nebraska Furniture Mart (NFM), then owned by the Blumkin family. This was likewise among the most important for establishing Berkshire's trust-based approach to its relationships. As Buffett recounted in his 2013 letter to shareholders:

I went to see Mrs. B (Rose Blumkin), carrying a 1-¼-page purchase proposal for NFM that I had drafted. Mrs. B accepted my offer without changing a word, and we completed the deal without the involvement of investment bankers or lawyers (an experience that can only be described as heavenly). Though the company's financial statements were unaudited, I had no worries. Mrs. B simply told me what was what, and her word was good enough for me.

The circumstances of both NICO and NFM acquisitions show extraordinary trust. Berkshire made these substantial investments on very informal terms. One of the central elements of such a deal, the financial statements, is accepted with a broad general

statement of their veracity by an individual Buffett trusted. Yet what would have happened had the financial statements turned out to be inaccurate or if Buffett's interpretation of the relevant accounting differed from that of either NICO or NFM?

In traditional formal contracts, financial statement representations provide rules to resolve such fights, such as that the statements are "fairly presented" or "comply with GAAP." But under these informal contracts, there are no such rules. Resolving any disagreement would require understanding the context of the business, the negotiations, and what each side understood about both.

Maybe Buffett simply assumed that he and both Ringwalt and Blumkin either would have had a shared understanding or been able to work out any difference. If they needed to turn to an impartial arbiter to decide, such as a court, the arbiter would need to gather a substantial amount of information beyond the limited guidelines included in the informal contracts.

The upshot is the enormous level of trust among these parties. If industrial America's most consequential formative deals were those between big oil and the railroads, Berkshire's were those with NICO and NFM. Those early purchases established Buffett and Berkshire's reputations as believers in trust. Buffett's decision to retell these stories from 1967 and 1983 in his letters of 2013 and 2014 affirms his continuing conviction to the value of trust.

Best Efforts and Good Cause

Many acquisitions require multiple agreements, such as both a formal merger agreement and separate employment contracts for key executives. One example concerned Berkshire's acquisition of the Scott Fetzer Company in 1986. Berkshire was a white knight amid hostile takeover overtures that put Scott Fetzer "in play."

The merger agreement was signed for Berkshire by Munger and largely written by him.⁴ It spanned just four pages when first

executed and only eight pages upon being amended and restated in final form—about 20 percent the average length of merger agreements at the time.

Some provisions are common and straightforward. For example, among a few simple representations, the central one concerns financial statements and securities law filings. Likewise, one clause limited Scott Fetzer's rights to talk to other potential suitors who might be willing to pay more (a "no-talk" clause).

Then there were some novel provisions. For one, while state law required only a majority shareholder vote to approve the deal on the Scott Fetzer side, the contract called for a supermajority of two-thirds. In addition, the no-talk clause omitted any exception that would allow the board to talk to third parties if the board's fiduciary duties required that.⁵

On the contrary, the contract required Scott Fetzer's board to use its "best efforts" to close the Berkshire deal. This is a vague general concept whose meaning depends on context. To provide some context, however, this best efforts clause added a further novel and specific requirement: if the two-thirds vote were not received, Scott Fetzer would call another meeting the next quarter and "proceed with extraordinary diligence" to obtain the required votes. The contract then explains its purpose, another rare feature for typical merger agreements:

The purpose of the two-possible-stockholder-solicitations procedure is (i) to cause the first (and probably only) solicitation to be scheduled early to facilitate early payment of merger proceeds to Scott Fetzer shareholders and (ii) to assure that [Berkshire], an extremely creditworthy and responsible corporation which is committed to the proposed merger with minimal contingencies, for the benefit of Scott Fetzer shareholders, will remain committed to the Merger for an extended period of time and will receive for its benefit in exchange for its commitment, a very thorough consideration of the terms of the proposed transaction by Scott

Fetzer shareholders, the mutual commitments being deemed reasonable because the Agreement is submitted to an inherently demanding test of approval by two-thirds of Scott Fetzer outstanding shares.

The brevity, novelty, and clarity of this clause are bracing. The approach distinguishes it from many others, and reflects a sophistication that would jump out at any judge interpreting the contract. The scope of most “best efforts” clauses would usually require attention to context, but the plain words accompanying this clause leave no mistake about what duty the parties wanted the board to have.

As written, the best efforts clause applied no matter what—even if corporate fiduciary duties might require the board to discuss a potentially better deal with other suitors. Courts have a hard time taking such clauses at face value and sometimes say fiduciaries cannot make a contract that eliminates their fiduciary duties.⁶ There is often a tension between the contract’s plain meaning and the deal’s context.

In this case, the context is a white knight acquisition competing with at least one hostile bid that the Scott Fetzer board was determined to resist. Scott Fetzer and Berkshire both likely preferred the tightest possible clause. They seemed to have trusted each other very much, and mistrusted all other suitors intensely.

The Scott Fetzer acquisition agreement also called for Berkshire to honor the seller’s existing senior executive employment agreements. On this point, Berkshire made a separate employment contract with the CEO, Ralph Schey, about which Buffett wrote in his chairman’s letter to Berkshire shareholders a few years later:

Our compensation arrangement with Ralph Schey was worked out in about five minutes, immediately upon our purchase of Scott Fetzer and without the “help” of lawyers or compensation

consultants. This arrangement embodies a few very simple ideas—not the kind of terms favored by consultants who cannot easily send a large bill unless they have established that you have a large problem (and one, of course, that requires an annual review).

Our agreement with Ralph has never been changed. It made sense to him and to me in 1986, and it makes sense now. Our compensation arrangements with the managers of all our other units are similarly simple, though the terms of each agreement vary to fit the economic characteristics of the business at issue, the existence in some cases of partial ownership of the unit by managers, etc.

In the Scott Fetzer transactions, therefore, we have two very different kinds of agreements: a formal merger agreement (if an unusually short one) and an informal employment agreement (though obviously containing the key compensation terms). For good reasons: the merger agreement serves a specific discrete and temporary one-off function: the Scott Fetzer board getting the Scott Fetzer shareholders to approve the merger so that it can be closed and ownership acquired. While a degree of trust is important, and the fewer provisions the better, it is easy to zero in with maximal detail on exactly what's important without addressing anything else.

In contrast, the employment agreement addresses an ongoing working relationship of indefinite duration—it lasted fourteen years through Schey's retirement at seventy-five. While compensation and incentives are important, it's hard to say what will matter most. That is why when employment contracts specify an employee's duties, they usually contain broad general language such as requiring the employee to exert his or her "best efforts" on the employer's behalf. Such a concept relies heavily on trust and determining the specific obligations it entails requires attention to context.

Berkshire usually carries over incumbent managers' contracts upon acquisition—and some are elaborate. Take that of David Sokol, head of MidAmerican Energy Company when Berkshire acquired it in 2000. The contract is fifteen single-spaced pages, with excruciating detail, including intricate treatment of termination.

Sokol was among Berkshire's most visible subsidiary CEOs and was widely seen as Buffett's successor. Yet, in 2014, he embroiled Berkshire in controversy by allegedly front running—buying stock in a company before pitching it to Buffett as an acquisition target. The contract was pivotal because it restricted the company's termination right under a tight definition of “good cause.”

The definition runs 425 words; subdefines legal concepts like “willful”; sets qualifications like *gross* misconduct and *demonstrable* injury; and requires advance warning of deficiencies and passage of a board resolution meeting stated criteria. For an executive in trouble, this provides strict plain parameters; a court need not even look up “willful” in a law dictionary.

But consider an executive in trouble under a vague approach, akin to how Buffett described the Schey deal. The contract sets a term for a period of years, so a legitimate reason (“good cause”) would be needed to terminate. But exactly what counts as “good cause” depends on both general legal definitions and the specifics of the deal.

Presumably front running would qualify, so Sokol would have been out under such a contract. After all, disappointed trust should be readily remedied. Under Sokol's actual contract, however, negotiated not by Berkshire but by the predecessor MidAmerican Energy, Berkshire's termination was more difficult. Sokol's lawyer even claimed the agreement permitted front running.

In the end, Berkshire followed the procedures and terminated Sokol. The detailed contractual provisions required such corporate exertions, terms emanating not from a reservoir of trust but instead from mechanistic legalese. (We detail this episode further from additional perspectives in the epilogue.)

The Spirit and the Letter

At stake in the degree of formality or informality used in creating and interpreting contracts is what matters more, the letter or the spirit of agreement. On this issue, another pair of Berkshire contracts illustrates how an informal promise was observed solemnly, while a formal one was observed more in the breach.

In each example, Berkshire acquired a public company with a family-held bloc concerned with aspects of history or operations: in 2000, the paint manufacturer Benjamin Moore & Co., which had a longstanding commitment to an independent distributor model rather than big box retailers; and, in 2013, the condiment maker H. J. Heinz Company, which had an abiding loyalty to its hometown community in Pittsburgh.

One major difference marks these deals: Berkshire acquired all of Benjamin Moore, whereas Berkshire acquired Heinz in partnership with the private equity firm, 3G, which called most of the shots.

With Benjamin Moore, several contracts were signed, including a formal merger agreement and a shareholders' agreement committing Moore family members and other insiders to the transaction. All participants appreciated the centrality of the independent distributor system to the company as related public disclosure made plain.

The formal agreements contained no related promises. Shortly after closing, however, hearing concerns from distributors about continuity, Buffett made a video in which he expressly promised to maintain the system and not sell through big box retailers. Over ensuing years, when two successive CEOs at Moore signaled their willingness to break that promise out of business necessity, Buffett intervened to remove them, citing his commitment.

In Heinz, the merger agreement devoted an entire section to the company's cultural connection to Pittsburgh. It declared "that after

the Closing, the Company's current headquarters in Pittsburgh, Pennsylvania will be the Surviving Corporation's headquarters."

A covenant, which survives the closing and is made by the acquisition subsidiary Berkshire jointly owned (called the "Parent"), promises: "after the Closing, Parent shall cause the Surviving Corporation to preserve the Company's heritage and continue to support philanthropic and charitable causes in Pittsburgh."

The contract referenced the company's contractual right to name Pittsburgh's professional athletic stadium, called Heinz Field, and required keeping that name. The contract required the parties to reference these commitments in their press releases about the deal.

But within a year after the Heinz deal, the company, led by managers appointed by Berkshire's coacquirer, 3G, cut three hundred jobs at its Pittsburgh headquarters. A further Pittsburgh dilution occurred soon thereafter, when Heinz merged with Chicago-based Kraft Foods Group to form Kraft Heinz Company.

While the company adopted dual headquarters and asserted it was keeping its Pittsburgh covenants, locals perceived a hollowing out and migration to Chicago. The company actions may not have violated the covenants, but raised reasonable questions. At Moore, a most informal promise was honored with spirited punctiliousness, whereas at Heinz, a highly formalized agreement was managed quite technically.

What of enforcement? In Moore, the circumstances might warrant letting the distributors enforce Buffett's promise. Amid known distributor centrality and concerns, express promises are made directly to distributors who, if induced to remain, would be entitled to enforce the promise.

In Heinz, the language is less precise or ironclad than one might expect of a long-term corporate promise to maintain a corporate identity. For instance, there's no time frame (just repeatedly saying "from and after Closing") or benchmarks (only vague references to "preserving heritage" and "supporting charities").

In addition, the Heinz promises are made by the buyer, which, upon closing, owns the seller and will not sue itself for breach. The agreement disclaims third-party enforcement rights other than stated exceptions, such as option holders and personnel covered by indemnification. There's no mention of, say, Pittsburgh headquarters' personnel, Pittsburgh charities, or the Heinz family. As a formal matter, it seems there is either no promise at all or, at best, a promise without a plaintiff.

But what about the circumstances? To Buffett, who believes in trust, the agreement memorializes a commitment—with imprecision that is understandable given the context. You might even say a conflict exists between the Pittsburgh promises and the no-third-party-rights clause, which would require more information to determine what was really intended by the clause. That conflict might suggest that the Pittsburgh promises were included only as a publicity stunt. If that seems deceptive, you could imagine letting the Pittsburgh interests have their day in court.

The Moore promise seems to be an avuncular assurance of intention rather than a contractual commitment—much like Buffett's vows of permanence, which he also uttered in the video. Likewise, the Heinz agreement may well involve an expression of “intent for the time being,” statements of business conviction rather than legal covenant—much like Buffett's vows of Berkshire as a partnership. Ultimately, however, the Heinz contract and subsequent actions look more like a typical corporate approach to an acquisition than the more trust-animated Berkshire approach. The inclusion of 3G in the Heinz acquisition likely explains this difference. (This transaction, and private equity generally, are discussed further in chapter 7.)

. . . .

A famous line appears in the annals of corporate acquisition agreements: “In Texas, a handshake is a contract.” That argument persuaded a Texas jury in 1985 to find Texaco guilty of wrongfully disrupting a merger between Getty Oil and Pennzoil.

The formal elaborate merger contract was never signed, but the jury's \$10 billion verdict sent Texaco into bankruptcy.⁷ Whether that is good law or wise public policy, people do rely on informal promises to bind. This is a practice worth heeding, even when knowing that many legal details must be left for the formal printed agreement. It's right to honor both the letter of the law and the spirit of the deal.

Boards

THE NUMBER-ONE QUESTION Warren Buffett wants to know about any director candidates is whether they are shareholder oriented. When building trust with shareholders, there are few better ways than appointing many such people to a corporate board.

Trust is essential in the boardroom and, according to Buffett, this trust underlies the board's most important duty: selecting an outstanding CEO. All other tasks are secondary because, if the board secures an outstanding CEO, it will face few other major problems.

Not many boards can live life so simply, however, so Buffett offers additional guidance for public company directors. And he should know. He once joked that his service on a score of public company boards revealed a "very dominant, masochistic gene."¹ In his board service, Buffett has interacted with more than three hundred directors and scores of CEOs.

Among CEOs Buffett considers best are Thomas S. Murphy, who led Capital Cities Communications before and after it acquired ABC in 1985; Robert Iger, a Murphy protégée who has been running

Walt Disney Company since 2005; and Katharine Graham, who skillfully ran Washington Post Company from 1973 to 1991.

Such CEOs all meet Buffett's practical bottom line test: they are people anyone would trust and be happy to have their child marry.

All CEOs must be measured according to a set of performance standards, Buffett notes. A board's outside directors must formulate these standards and regularly evaluate the CEO in light of them—without the CEO being present. Standards should be tailored to the particular business and corporate culture but should stress fundamental baselines, such as returns on shareholder capital and progress in market value per share.

Performance should not be based on quarterly earnings or the achievement of related guidance targets. In fact, Buffett argues that companies are usually better off not providing analysts with earnings guidance. Directors might remind CEOs that such guidance is not required and may not serve shareholder interests.

To promote an environment of trust, Buffett advises, all directors should act as if there is a single absentee owner and do everything reasonably possible to advance that owner's long-term interest. They need to think independently to tighten the wiggle room that "long-term" gives to CEOs: although corporate leaders should think in terms of years, not quarters, they must not rationalize sustained subpar performance by perpetual pleas to shareholder patience. To that end, it is desirable for directors to buy and hold sizable personal stakes in companies they serve, so that they truly walk in the shoes of owners.

Buffett embodies this commandment. He is a shareholder advocate *par excellence*, whose board service has almost always involved companies where Berkshire owns a significant stake. Prominent examples include Capital Cities/ABC (1986–1996); Coca-Cola Company (1989–2006); Gillette (1989–2003); Kraft Heinz (2013–2016); Salomon (1987–1997); US Airways Group (1993–1995); and Washington Post Company (1974–1986 and 1996–2011).

Buffett's board tenure is also a long-term commitment. In all but two of the foregoing instances where his board service ended, it did so only because the company ceased to exist: Capital Cities/ABC merged into Disney; Gillette into Procter & Gamble; Salomon into Travelers Insurance; and US Airways into America West Airlines; Washington Post Company's assets were divided up for sale. One exception was at Kraft Heinz, where Buffett was succeeded by Berkshire vice chairman, Greg Abel.

The other exception was at Coca-Cola. In 2005, despite Berkshire having long owned a substantial stake in the company—worth \$8 billion then and nearly \$20 billion now—the California Public Employees' Retirement System (CalPERS) as well as Institutional Shareholder Services (ISS) challenged Buffett's independence as a director. They cited their checklist rules against specified business relationships, pinpointing how various Berkshire subsidiaries, including Dairy Queen Corporation, were customers of Coca-Cola.

In the ensuing board election, 16 percent of Coca-Cola's shares were cast as withhold votes on Buffett, so he was reelected, but he nevertheless opted to stand down. While we disagreed with those doubting Buffett's independence, he responded to the shareholder ballot and set an example: any director receiving a nontrivial level of withhold votes should withdraw from the board. But the argument was perverse: neither CalPERS nor ISS asked whether Buffett was a trustworthy steward of shareholder capital at Coca-Cola, a question that would have required looking at context rather than referring to a checklist.

If the CEO's performance persistently falls short of the standards set by the outside directors, then the board must replace the CEO. The same goes for all other senior managers they oversee, just as an intelligent owner would if present. In addition, the directors must be the stewards of owner capital to contain any managerial overreach that dips into shareholders' pockets. Such pickpocketing can range from imperious acquisition sprees

to managerial enrichment through interested transactions or even myopia amid internal scandal and related crisis.

All these problems undermine trust. In addressing these problems, the director's actions must be fair, swift, and decisive. In crisis, the Berkshire mantra is "get it right, get it out, and get it over."² The classic case concerned Salomon's 1991 bond-trading imbroglio referred to earlier. Amid knowledge of illegality, CEO John Gutfreund allowed problems to fester, refraining from firing the guilty and failing to inform the board or regulators. On becoming aware of these dire events, the board promptly requested Gutfreund's resignation. They then appointed a reluctant Buffett to lead the investment bank out of its dark days and reshape its culture.

Directors who perceive a managerial or governance problem, including eroding trust, should immediately alert other directors to the issue. If enough are persuaded, concerted action can be readily coordinated to resolve the problem.

In the American boardroom in recent years, trust has been demoted in favor of mechanistic approaches to corporate governance. Examples include the movement to split the roles of chair and CEO, expanding board size, adding independent directors, adopting a new code of ethics, updating firm compliance programs, and appointing multiple committees to administer it all.

Although such steps can improve an organization's health, the informal norms that define a corporate culture are more powerful. Directors do best by promoting, earning, and sustaining a culture of trust—appointing a trustworthy CEO and winning shareholder trust in the judgment.

Companies should make their directors available to their largest long-term investors, Buffett says. These representatives should discuss issues put to shareholder votes that affect enduring value. In fact, companies should seek reciprocal access, getting their directors out to receive the shareholder perspective.

Even high-quality directors can fail because of what Buffett calls "boardroom atmosphere." Populated by well-mannered individuals,

boards see broaching certain topics as akin to belching at dinner—from questioning the wisdom of an acquisition to CEO succession.

Adjust the social atmosphere of the room, Buffett urges. How to do so depends on the corporate culture and personalities involved. Aside from formal meetings, boards can convene for meals, training sessions, and retreats. All these opportunities offer the chance for diplomatic engagement, to build trust, and to promote better deliberations and outcomes.

Here, too, shareholders can play a role. A few large institutions, acting together, can effectively reform a given company's corporate governance simply by withholding their votes for directors who were tolerating odious behavior, Buffett observes. In some cases, he laments, "this kind of concerted action is the only way that corporate stewardship can be meaningfully improved."³

Finally, what qualities should be sought in directors when boards undertake their own succession planning? The answer is people who are capable of honoring these commandments, meaning those who are skilled managerial recruiters and overseers given the company's particular business and culture; people who are owner-oriented, engaged, articulate, communicative, and astute. Basic habits such as diligence, preparation, and attendance are essential. Above all, however, companies do best by having trustworthy directors, and boards do best by appointing outstanding CEOs then leaving them alone.

Internal Affairs

THE MOST GENERAL IMPLICATION of the Berkshire model is to preserve the possibility for variation in governance design and business structure. This spans many topics, including especially the character and duties of the board, the strength of corporate chief executives, and the degree of organizational direction harnessed by trust versus control. Over the past thirty years, U.S. policies on all such topics have moved in directions opposite those Berkshire has taken.

During the latter half of Berkshire's rise to prominence, boards of U.S. companies shifted from the advisory model to the monitoring model. People from multiple vantage points heralded the outside director as a solution to governance challenges. The rise of independence displaced the importance of expertise.

This shift obscured the traits Berkshire boasts in its directors, especially an owner orientation, an understanding of business, and a commitment to Berkshire's prosperity. These policy paths were driven largely by the periodic need to quell political disputes or

respond to crises. The appeal to independence generated consensus at the price of costly flaws.¹

While director independence remains a vaunted characteristic in corporate governance, expertise is making a comeback. The Sarbanes-Oxley Act of 2002 all but requires financial expertise on the board, and the Dodd-Frank Act of 2010 contemplates a similar approach to compensation committees. There is a case for the inside director, even if an uneasy one.

The Berkshire model proves both the value of expertise and the value of having some deliberative body available to handle crises (such as terminating executive employment contracts) and to steer the business during transitions (Buffett is relying heavily on the Berkshire board to promote continuity after he leaves the scene). The Berkshire model suggests both reasons to have a board and reasons to oppose its primacy.² Berkshire shows that a corporation can thrive with an old-fashioned advisory board.

Before the 1990s, CEOs wielded substantial power, selecting directors and preferring deferential or passive shareholders. The rise of the independent board and of shareholder activism changed the dynamic. As boards and owners gained influence, they exercised it to curtail executive power. The long-term effects of such a shift are yet to be felt, but they could be sweeping.³

The Berkshire model is a reminder of the value of executive power and a cautionary note about such broad-scale change. Indeed, in his role as chief executive, Buffett has avoided the trap of icons who may be prone to vanity or licentiousness, proving that such flaws are not inevitable in CEOs.⁴ Berkshire's plan to divide Buffett's historical roles as chairman and chief executive between two individuals shows the appeal of governance design flexibility for different contexts—uniting the roles has been best during Buffett's tenure, but dividing them may be best post-Buffett (chapter 12 explores succession).

Similar implications follow across all aspects of a company's internal affairs. This chapter touches on a few: controls, norms, and Berkshire's interest in promoting an owner orientation.

Controls and Trust

During the past four decades, corporate internal controls became a first-order policy option in response to a wide variety of national problems, from financial fraud to terrorist financing. Despite their proliferation as regulatory tools to address issues spanning consumer price gouging, worker safety and environmental protection, it is difficult to evaluate whether such controls work effectively and are worth their considerable cost.

Corporate controls began in the early twentieth century as internal processes, seeking to help corporations meet their objectives. This conception created modest expectations of results. Since the latter twentieth century, however, the use of controls as a leading policy option assumed a negative character. They become processes designed to prevent undesired events from occurring, a conception doomed to disappoint.

After all, controls are inherently limited in what they can do. They can be used sensibly to address the modest expectations associated with aspirational controls. But they increase the likelihood of the dashed hopes associated with the more ambitious efforts of preventive controls.

Systemic forces make controls an attractive policy option. The rise of the board-monitoring model played an important role, as controls dovetailed with and facilitated such oversight.⁵ Deregulation and increased cooperative compliance made controls appealing alternatives to direct regulation. Resistance to federal preemption of state law makes controls an attractive way to inject federal policy into corporate affairs.

The corporate social responsibility movement calls for greater corporate accountability; controls addressing interests of particular corporate constituencies seem tailor-made for the purpose. An entire compliance industry arose, led by auditors and lawyers who developed expertise in the design, implementation, and testing of controls.

Yet these forces often resulted in controls that appear to work and can be audited, rather than controls that work in fact. As a result, corporate America tends to expect far more from internal controls than such systems can deliver.⁶

The Berkshire experience, using minimalist controls in favor of heavy reliance on trust, demonstrates that controls are not necessary to promote compliance or other desirable outcomes. Policy makers should be willing to tolerate more trust-based corporate cultures than the prevailing climate favoring control permits. Companies ought to experiment.

But even Berkshire maintains a system of internal control over financial reporting. As Buffett joked, “no sense being a damned fool.”⁷ The expression begs the question: what is the right balance between trust and control, between norms and rules?

Norms and Rules

Most mainstream employees are trustworthy. They voluntarily obey company policy and applicable laws. But some cheat.

Why most people are obedient and a minority are miscreant is endlessly debated. Two broad theories vie to explain.

One theory looks to cost-benefit analysis and associated rules, the other to a sense of right versus wrong and norms. Rule-oriented organizations invest heavily in internal controls to promote a culture of compliance; trust-based organizations invest heavily in norms to promote an ethical culture.

The rules-oriented approach sees people as rational wealth maximizers who choose compliance or violation according to the applicable cost-benefit calculation.⁸ Cost-benefit calculations vary across companies. Benefits of cheating might include bonuses from meeting certain targets, while the costs might include punishments if caught discounted by the probability of being caught). Companies increase costs by applying formal internal controls, publishing and enforcing rules, conducting regular reviews, and imposing sanctions.

For particular companies, it is challenging to design corresponding frameworks to reduce the cost-benefit calculus in favor of compliance. The task is complicated by the diverse settings where incentives arise and the wide variety of circumstances different individuals face, from varying years until retirement to varying prospects of alternative employment. The upshot is an incentive for companies to double-down on controls. But that poses costs, especially creating a sense of a stifling bureaucracy that discourages innovation and entrepreneurship.

Norms refer to a sense of right and wrong. They are spontaneously generated standards of conduct, where departures are shameful.⁹ Reaching for targets is encouraged, but not by crossing any lines or cutting any corners. Within corporations, norms are formed through a range of forces that include the trust that arises when managers appreciate that they are acting on behalf of others, guilt that accompanies defying conventional expectations, and respect that responds to hortatory expressions in official policy.

The relative achievements of controls versus trust vary across companies. They work better or worse in different cultures and their relative presence in turn helps to define those cultures.

Norms work best when employees believe that applicable standards are fair and that any specific guidelines have been developed in a legitimate way. This explains why Buffett is emphatic about honesty and integrity. He demands that managers protect Berkshire's reputation and expects that message to get to all employees.

Corporate size matters. People are more likely to adhere to norms within smaller communities than in larger ones. But Berkshire is massive, with four hundred thousand employees and generating \$250 billion in annual revenue. Its solution: radical decentralization into scores of smaller subsidiaries that are divided, in turn, into thousands of still smaller business units. Employees become attached to their unit rather than to an abstract conglomerate power.

Consider responsibility. Trust is a powerful motivator. Responsibility is empowering and encourages reciprocity, in which case those who are trusted vindicate that trust. To quote Abraham Lincoln: “The people when rightly and fully trusted will return the trust.”

Berkshire’s practice of autonomy speaks to this, and over the years, scores of Berkshire managers have echoed what Bruce Whitman said: being trusted makes them committed to earn that trust.

The time horizon matters, too. Norms that induce compliance may be more effective in settings offering longer time horizons and broader goals (such as “rolling ten-year returns on invested capital”) than shorter horizons and narrow goals (like “this quarter’s earnings per share”). Again, Berkshire’s time horizon and commitment to permanence tap into this feature.

To sum up, Berkshire’s trust-based culture flourishes thanks to a clear normative tone at the top, decentralization, autonomy, and permanence. The system is reinforced by its aspiration to adopt an owner orientation.

Owner Orientation

As part of the conviction that Berkshire is a partnership, Buffett always stresses the importance of the company having an owner orientation. How to create this orientation varies across and down the business units, with compensation practices often playing a role. That is another reason for Berkshire’s decentralization:

all compensation is set at the level of the direct report. Buffett sets the pay of the staff at headquarters and heads of the subsidiaries, which in turn are responsible for setting the pay of their troops.

As a general rule, stock options have never been part of any compensation package at Berkshire. No one other than Buffett is responsible for the overall performance of the company, so payment to anyone but him in its stock would be inappropriate. (In the future, the board might reasonably decide to pay successors, such as Greg Abel or Ajit Jain, in stock or stock options.)

In contrast to stock options, share ownership is an important part of Berkshire culture. For example, the owners of many companies who sell to Berkshire retain an ownership stake in their companies. Exact reasons vary with the deal: sometimes Berkshire requests the arrangement and sometimes the shareholders request it; very often both desire to do so.

Berkshire may value continuity in the traditional owner-manager attitude at some companies after absorption into Berkshire. This occurred when Berkshire acquired Shaw Industries, requiring the two top executives and their families to maintain substantial ownership for several years. At that point, Berkshire would buy the balance at a price tied to change in book value.

Berkshire made similar arrangements—buying a large controlling position, while temporarily leaving a block with family managers for a period of time—in two other large acquisitions: Marmon Group from the Pritzker family and ISCAR/IMC Group from the Wertheimer family. In each case, both sides valued the gradual ownership transition—the family for a combination of tax and planning reasons, and Berkshire for the signal and substance of continuity.

At Berkshire, many incentive arrangements are made at the time of acquisition. An explicit example concerns the self-starters at MiTek, manufacturer of construction materials acquired in 2001. Senior managers of the firm, which had operated as a subsidiary of a U.K. parent, were eager to participate in the Berkshire deal.

So 10 percent of the company's stock was allocated to a group of fifty-five of the managers. Each person staked \$100,000 in the venture, many borrowing to do so. The managers thus shared in the business as owners.

At Berkshire, many compensation arrangements are tied to subsidiary profits. Some are explicit and directly promote an owner orientation. One outstanding example is H. H. Brown Shoe Company, a Berkshire-style business with roots dating to 1883 when it was founded by Henry H. Brown in Natick, Massachusetts, then a center of the nation's shoemaking industry. In 1927, Brown sold the company for \$10,000 to Ray Heffernan, a twenty-nine-year-old entrepreneur who ran it until he died at the age of ninety-two in 1990.

Heffernan had minted an unusual compensation system, in which top managers were paid nominal annual salaries, but shared in a portion of company profits. Thanks to that incentive structure, the business grew steadily over the years, including through occasional acquisitions and pioneering product innovations, such as using Gore-Tex for shoe linings. Buffett has never given any indication that the compensation system has changed, and it is not something Berkshire would stick its nose into.

Many people assume that Berkshire's compensation structure is uniform, but this is not the case. Especially surprising is the variety of metrics that apply in different businesses and related compensation and bonus schemes. For example, at GEICO, the car insurer, every employee employed more than one year can share in profits. At GEICO, what matters most is the retention rate and underwriting profit on seasoned business. In contrast, at Gen Re, what counts is the growth in float and cost of float.

Distributors at Benjamin Moore and franchisees at Dairy Queen earn their compensation as all business owners do—revenues minus expenses. For those two companies, such owner-managers keep corporate expenses low while driving revenues higher. Executives of such companies therefore have a like incentive to manage the business with an owner orientation.

Entrepreneurs have many motivations, making money among them. Al Ueltschi and Bruce Whitman at Berkshire's FlightSafety were driven by a passion for aviation and personal appreciation of the need for effective pilot training. At bootmaker Justin Brands, John Justin wanted to validate his Texas family's cowboy boot business and reinforce his personal connection to ranch life. But all three also sought business results, ultimately measured in money.

Most entrepreneurs have mixed motives: a desire to achieve for its own sake—for some intangible value—and to profit. That is true even for those who have already achieved financial success, including many Berkshire CEOs who are independently wealthy and do not need additional financial rewards. But few of them were independently wealthy when they began businesses: for example, Greg Abel, Jim Clayton, and Al Ueltschi all won the Horatio Alger Award—and financial rewards motivated them.

Compensation incentives alone do not guarantee any particular behaviors. For that, an understanding of what motivates specific people is necessary. In business, a sense of ownership is probably the best reference point, and it can be provided in different ways. Again, these are reasons to prefer decentralization, where those who know best set policy. The result at Berkshire? An owner orientation with few corporate scandals or labor squabbles (we discuss exceptions in chapter 9).

Berkshire vice chairman Ajit Jain once observed to us that "Berkshire is not a supermarket, but a collection of corner grocery stores." This insight explains much about the company's internal affairs, including how trust is more adhesive in smaller than larger organizational units.

PART III

Alternatives

Contrasts

BERKSHIRE'S DISTINCTIVE features are put into sharper focus by contrasting popular alternative models. Consider on the investor side the practice of shareholder activism and on the organizational ownership side, private equity (PE). Although trust may play some role in the many aspects of activism and PE, it is not the dominant feature of either model.

In fact, the antagonism common to activist campaigns is by definition a loss of trust in current management. It often erodes trust, as directors seeking or earning seats on activist short slates can attest. (One of this book's authors, Lawrence Cunningham, has twice been in such positions.) The intricate arrangements of PE depend far more on legal maneuvering and power dynamics than on trust. Take activism—and Buffett's aversion to it—first.

Activism

In 1965, as a thirty-five-year-old Nebraskan, Buffett took control of Berkshire Hathaway, Inc., a dying New England textile company. The local press portrayed him as an outsider and takeover artist:

a liquidator of the sort that inspired Danny DeVito's fiendish character in *Other People's Money*.

True, Buffett acquired Berkshire on the cheap—for a fraction of its \$22 million book value of \$19.24 per share—and eventually was forced to shutter the mills. But he has always campaigned vigorously against hostile bids, heavy borrowing, asset flipping, and other controversial Wall Street practices.

Buffett became a vocal critic of Wall Street, as he favored cash to debt, held companies for the long term, and defended trustworthy managers against short-term pressures. His oratory sounded more like the high-minded defender of the corporate bastion in *Other People's Money*, played by Gregory Peck, than an apostle of greed.

Speaking as the reluctant interim chairman of Salomon after its 1991 bond trading scandal, for instance, Buffett famously broadcast to Congress a new credo given to his Wall Street bankers. It is quoted in this book's prologue and worth repeating: "Lose money for the firm, and I will be understanding; lose a shred of reputation for the firm, and I will be ruthless."¹

In addition to steady criticism, however, Buffett has also been a vital friend to Wall Street. His stint as Salomon chairman followed from Berkshire's "white squire" stake in the investment bank, designed to deter a hostile takeover bid. The year was 1987, when Salomon's largest shareholder grew frustrated with management and flirted with selling a 12 percent block to Ronald Perelman, the corporate raider who had recently seized control of Revlon. Fearful of being next, Salomon CEO John Gutfreund turned to Buffett, who pledged fidelity, while buying a sizable issue of convertible preferred stock yielding 9 percent.

Buffett's reputation for offering hands-off long-term capital dates back to 1973 when Berkshire accumulated a stake in Washington Post Company. Buffett vowed loyalty to CEO Katharine Graham, who soon asked him to join the board. In 1986, Buffett extended his loyalty further when Berkshire took a large position in Capital Cities/ABC, giving its managers, Daniel B. Burke and

Thomas S. Murphy, proxy power to vote Berkshire's shares as they saw fit.

During that era of hostile takeovers, Berkshire and Buffett likewise backed managers against raiders at companies such as Champion and Gillette. As noted, Berkshire defeated Ivan Boesky's run at Scott Fetzer Company (in chapter 4), paying \$315 million to acquire the conglomerate, which Berkshire still owns.

Buffett's reputation as a high-quality shareholder would continue to pay off over the decades. This occurred in spectacular fashion during the financial crisis of 2008 when few but Berkshire commanded any investment capital. Buffett supplied funds to several financial institutions, all on exceedingly favorable terms to Berkshire.

In the twenty-five days after the 2008 collapse of Lehman Brothers, Berkshire invested \$15.6 billion in numerous companies, when most of corporate America was starved for credit. For one, Berkshire staked \$5 billion for preferred stock in Goldman Sachs, paying a 10 percent dividend and redeemable for a 10 percent premium. Berkshire also got an option to buy a similar amount of Goldman common stock at \$115 per share, below the market price of \$125, making it "in the money."

In 2011, after the crisis passed, Goldman redeemed the preferred stock. Berkshire earned a few years of dividends plus the buyback premium, adding to \$1.8 billion. In early 2013, Berkshire exercised its option to buy Goldman common stock. Rather than pay the \$5 billion cash price (then worth \$6.4 billion), Berkshire took stock valued at the difference of \$1.4 billion. Berkshire's total gain on its \$5 billion investment was \$3.2 billion, 64 percent in just a few years—along with 3 percent of Goldman's common stock.

Meanwhile, Bank of America continued to struggle to the point where, in 2011, it likewise turned to Berkshire for a \$5 billion investment. Berkshire received preferred stock paying a 6 percent dividend and redeemable for a 5 percent premium. In addition, Berkshire obtained the right to purchase seven hundred million

shares of the bank's common stock at a per share exercise price of \$7.14, or just under \$5 billion. For a total investment of less than \$12 billion, today Berkshire owns 9.5 percent of Bank of America's shares with a market value exceeding \$22 billion.

Buffett now wears many different hats in corporate life and is a pragmatist, not a purist—neither Martin Lipton nor Carl Icahn. He is a shareholder first, but also chief executive of one of the largest public companies and has been a director of many others, including several targets of shareholder activism. Such diverse roles and experiences are bound to produce nuanced yet conflicting positions.

Buffett's preferred form of shareholder activism, which tends to suit his personality, is better called corporate diplomacy. For example, in 2014, activist David Winters launched a public campaign challenging Coca-Cola's executive compensation plan. He urged Berkshire—owner of nearly \$18 billion worth of the stock at the time—to support it.

Instead, Buffett privately engaged the chief executive, Muhtar Kent, as well as a board member, Howard Buffett, Buffett's son, and worked outside the spotlight to redress the objections. A replay occurred in 2016 concerning American Express, when Buffett declined an overture from activist Jeffrey Ubben, who sought management and strategic change. Buffett favored direct consultation with long-time chief executive officer Kenneth Chenault.

If Buffett's influence goes unheeded, he is most likely to follow the old-fashioned Wall Street rule and sell. For example, Berkshire owned a large stake in Capital Cities/ABC from 1986 through 1996 when Disney acquired the company for stock. Berkshire soon sold its Disney shares.

In doing so, however, Buffett never publicly criticized the company's strategy or new leadership, under CEO Michael Eisner, although sharp cultural differences were obvious. Most managers respond to threatened divestiture by a large and loyal shareholder, certainly in the case of a Berkshire sale.

Buffett's most public shareholder activism was his reluctant agreement to assume the chairmanship of Salomon, removing and replacing Gutfreund. Even then, Buffett never singled out culpable individuals (remember, in a trust-based model, praise by name, criticize by category).

Private Equity

Berkshire's preferences can be contrasted with that of PE, once known as leveraged buyout (LBO) firms. The PE or LBO business model and philosophy are at the other end of the spectrum from that of Berkshire Hathaway in nearly every way.

Having arranged for the purchase and sale of thousands of U.S. companies, the PE industry has structured mountains of debt, generated enormous fees from merger advisory work, and reaped additional gains from innumerable consulting services.

The PE business model involves creating a series of separate funds that buy, run, and sell a discrete number of individual companies, relying on massive borrowing. A typical fund deal is financed with at least 70 percent debt.²

Moreover, virtually all equity—all but 1 or 2 percent—is staked not by the firm but by outside investors solicited in private placements facilitated by intermediaries, including pension plans, university endowments, rich families, sovereign wealth funds, banks, and insurance companies.³

In form, funds are dubbed partnerships, with the PE firm as the general partner and each such equity investor a limited partner. The attitude, however, is hierarchical, with the general partner calling all shots in a setting rife with conflicts of interest.⁴

The PE firm, as general partner, is far less an investor than a multiline intermediary. In a typical arrangement, the PE firm collects 2 percent of investors' equity called a "management fee" plus

20 percent of the return on investment above a hurdle rate (typically 8 percent) dubbed “carried interest.”

In addition, the PE firm levies extensive fees for a wide variety of activities it might engineer, such as board service on acquired companies, strategic consulting, executive search, merger guidance, and financing advice.

PE’s time horizon for deals is far more short term than long term, and it is never indefinite. Rather, purchases and subsequent steps are all conducted with a focus on exiting by maximizing profits and minimizing duration. Purchases are not made without an exit strategy—ideally, a premium-priced public offering or a sale to a strategic buyer or another financial buyer.

As with most other activities that PE firms conduct on behalf of the funds and companies they buy, the firm charges fees to make such arrangements. When buying and selling, PE firms favor formal valuation models, such as earnings multiples, rather than traditional business analysis of the kind Berkshire and other long-term investors apply.⁵

Operational change is usually part of every takeover plan. Although PE operators may look for incumbent managers to remain in place, weak management is often blamed for a target’s struggles and the takeover includes reshuffling or replacements. In every case, intervention is deep, as the PE firm provides close direction to managers to execute the plan and conducts careful monitoring.

Cost reductions are often part of the plan, meaning the PE firm directs not only management changes but also plant closings, layoffs, research and development cuts, product terminations, pension reductions, and other business surgery with clear-cut short-term gains. The long-term prudence of such steps is not the focus.

Financial engineering is at the heart of many PE deals, all involving substantial and costly intermediation. Often pejoratively dubbed asset stripping, standard examples include sale-leaseback arrangements⁶ and dividend recapitalizations.⁷ These transactions are designed and implemented by numerous intermediaries

operating between the company and investors, including the general partner, leasing agents, lessees, and all their various agents, including accountants, bankers, and lawyers. Each receives compensation for services, with the most substantial going to the general partner. In the process, costs are borne by other constituents of the portfolio companies, including employees, suppliers, customers, communities, and creditors.⁸

Because PE firms are more like intermediaries than investors, they are inclined to take greater risk than an investor would tolerate. High leverage appeals because the rewards from boosting returns on equity can be considerable, whereas excessive debt that leads to bankruptcy inflicts little pain. Whether a company prospers or fails, PE firms earn fees for themselves and generate fees and interest for other intermediaries, including financial institutions.

The PE industry has considerable influence, in both the popular and political realm. One example is U.S. federal income tax law. It has long treated the PE industry's carried interest as capital gain taxed at 20 percent rather than ordinary income taxed as much as twice that rate.⁹ This treatment has persisted through the substantial overhaul of the tax code in 2018.

PE firms also elude oversight applied to many other financial firms. They face little regulation and limited transparency that would facilitate systematic examination of pricing power. While critics clamor for change, the industry is adept at pushing back.¹⁰

Berkshire Compared

Berkshire and PE firms are both buyers of businesses and, therefore, rivals. What the two offer sellers of businesses, however, differs greatly. Berkshire stakes all of the capital to offer a permanent autonomous home in a distinctive corporate culture free of short-term pressure. PE firms stake little funding—borrowing most and bringing in diverse limited partners—and offer an

operational and financial reengineering plan to deliver rapid and sizable fees for themselves along with debt discharge and returns to outside investors.

Outcomes vary. Not all Berkshire companies prosper, though virtually no company is sold. Likewise, PE experiences both triumphs and failures, but virtually all companies are sold.

In addition to commanding their own fees and returns, PE firms stress returns to shareholders above all else in corporate life—including employees, retirees, suppliers, and customers. Although the Berkshire model is also investor first—embracing an owner orientation—the long-term focus aligns shareholder returns with those of other constituents.

Suppose labor costs are high: if the end game is two years, all cuts must be made in two years, necessitating layoffs and wage freezes; if, however, the horizon is indefinite, cuts can be made gradually over a decade, which might be done through attrition and lower raises. The Berkshire approach is not altruistic, but rather is congruent with generating high and sustained long-term returns on capital for shareholders.¹¹ The Berkshire model aspires to be win-win.

The Berkshire model, of course, has downsides. The self-reliance in acquisitions runs the risk of error given the absence of a significant cross-check. The autonomy reposed in subsidiary managers sometimes proves to be misplaced, absent vetting or oversight (such challenges are illustrated further in chapter 9).

The differences between Berkshire and PE firms reflect fundamental cultural contrasts. In the PE model, heavy debt levels and associated covenants not only boost immediate returns but “impose . . . a stringent discipline on management, forcing executives not only to keep costs down, but also to divest any business that might fetch a price higher than the value they had placed on it.”¹²

Berkshire culture requires no such external stringency: trust is an inherent fundamental value. It induces cost minimization without need for covenants to impose discipline. The idea of selling a business is antithetical to the sense of permanence intended

to hold Berkshire together in perpetuity. In contrast to the thick corporate culture that pervades Berkshire's subsidiaries, PE companies have no common corporate culture.¹³

PE firms are not even companies in the same sense that Berkshire is. Berkshire is a corporate entity owned by its shareholders and comprising hundreds of operating businesses and other investments to be held indefinitely. PE firms, in contrast, consist of a series of distinct limited partnerships organized as equity funds with finite lives rarely more than a decade. Unlike conglomerates, which seek to retain the businesses they acquire, PE firms want to divest them as rapidly as it is profitable to do so.

The Odd Case of 3G

Despite contrasts between Berkshire and the PE industry, Buffett has teamed up on a few occasions with a major PE player, 3G. The relationship has raised eyebrows and prompted questions from Berkshire shareholders. 3G is a PE firm that partnered with Berkshire in their 50–50 acquisition of Heinz and its subsequent merger with Kraft. Kraft Heinz later proposed but withdrew an unsolicited bid for Unilever. Each transaction had more in common with PE methods than with Berkshire traditions, worth a closer look.

In 2013, Heinz initially declined the 3G bid. It accepted only after 3G upped its offer from \$70 to \$72.50 and made several promises to preserve Heinz's Pittsburgh roots and heritage, including keeping the headquarters there. Those promises proved somewhat hollow after Heinz merged into Kraft, which is based in Chicago (this point is discussed further in chapter 4). When 3G makes an acquisition, it intervenes and downsizes—the opposite of the Berkshire model. 3G's approach is that of a typical PE firm, not that of a product manager or developer, which is at the core of consumer products companies.

Buffett anticipated criticism in his 2013 shareholder letter, giving a one-line account: “Though the Heinz acquisition has some similarities to a ‘private equity,’ transaction, there is a crucial difference: Berkshire never intends to sell a share of the company.” In 2014, he deflected criticism by conveying that downsizing decisions were not Berkshire’s but 3G’s: “I’m not embarrassed to admit that Heinz is run far better under [3G’s leadership] than would be the case if I were in charge.”

Such explanation was too little for some critics, however, whose persistence inspired Buffett to expand on it in the next year’s letter. Buffett’s opening stated what Berkshire and 3G share: “We share with them a passion to buy, build and *hold* large businesses that satisfy basic needs and desires.” The point is then tempered: “We follow different paths, however, in pursuing this goal.” The essay then contrasts but strongly defends the 3G way: “Their method, at which they have been extraordinarily successful, is to buy companies that offer an opportunity for eliminating many unnecessary costs and then—*very promptly*—to make the moves that will get the job done. Their actions significantly boost productivity, the all-important factor in America’s economic growth over the past 240 years.”

Buffett continues comparing and contrasting:

At Berkshire, we, too, crave efficiency and detest bureaucracy. To achieve our goals, however, we follow an approach emphasizing *avoidance* of bloat, buying businesses that have long been run by cost-conscious and efficient managers. After the purchase, our role is simply to create an environment in which these CEOs—and their eventual successors, who typically are like-minded—can maximize both their managerial effectiveness and the pleasure they derive from their jobs. We will continue to operate with extreme—indeed, almost unheard of—decentralization at Berkshire. But we will also look for opportunities to partner with Jorge Paulo.

Jorge Paulo Lemann, a principal of 3G, is a long-time friend and confidant of Buffett, dating to 1998, when they served together on the Gillette board of directors. Buffett makes it unmistakable how much he trusts Lemann. That said, Buffett reinforced his recurring message of Berkshire's uniqueness:

Berkshire, however, will join only with partners making friendly acquisitions. To be sure, certain hostile offers are justified: Some CEOs forget that it is shareholders for whom they should be working, while other managers are woefully inept. In either case, directors may be blind to the problem or simply reluctant to make the change required. That's when new faces are needed. We, though, will leave these "opportunities" for others. At Berkshire, we go only where we are welcome.

But two years after that, in early 2017, Kraft Heinz made an unsolicited bid for Unilever, the global giant dual-headquartered in Amsterdam and London. When Unilever promptly made clear the overture was unwelcome, Kraft Heinz—on whose board Buffett then sat and in which Berkshire then held a large but minority stake—withdrawed it. Although many suggested that the deal was a flop, Buffett and Berkshire shareholders actually dodged a bullet (chapter 9 will continue this discussion of 3G).

. . . .

Over nearly six decades, Buffett and Berkshire arduously built a distinctive business model, one founded on trust: friendly deals sealed with handshakes, boardroom troubles resolved diplomatically, promises kept come hell or high water, and deference to managers seen as best positioned to address business challenges. Shareholder activism and PE have their place, but their approaches differ radically from the Berkshire model. As the next chapter suggests, aspects of the Berkshire model can be adapted without embracing every dimension, but trust remains the touchstone.

Comparisons

BERKSHIRE MAY BE UNIQUE, but its model is often emulated. Companies that share the model's practices and policies likewise draw on trust. The comparisons in this chapter illustrate, and further the contrast with private equity (PE).

To classify a company as closer to the Berkshire model or to PE, compare it on two dimensions: acquisitions and operations. Regarding acquisitions, chief differences involve leverage, intervention, and time horizon. Berkshire prefers no debt, limited intervention, and a permanent time horizon. In contrast, PE borrows heavily, intervenes intensively, and looks for the earliest possible opportunity to flip.

Concerning operations, PE exerts strong control with heavy oversight and a view toward reselling; Berkshire is highly decentralized with managerial autonomy and a commitment to holding. And Berkshire is fiercely guarded in promoting and protecting a reputation for ethical elevation, an aspiration not generally recognized as a high priority in PE.

Many boards and managers developing strategy debate where their policy mix should reside on this continuum, some consciously thinking of the poles as the Berkshire model versus the PE model. This chapter provides some examples of companies closest to the Berkshire model.

Insurance

The insurance sector is particularly well suited to the Berkshire model—after all, insurance is Berkshire’s backbone. The industry attracts skilled managers of capital who think long-term and for whom the Berkshire model is inherently congenial. To boot, insurance is a trust-based industry, where policyholders pay premiums based on their faith in the insurer to honor promises in the distant future.

Consider Markel Corporation, a holding company for global insurance, reinsurance, and diverse noninsurance businesses. Founded in 1930, as a family firm, the public face of the company since the early 2000s has been Tom Gayner. Dating to at least 1985, Markel has consciously modeled the company on Berkshire.

In addition to substantial insurance and reinsurance operations, the company is an opportunistic buyer of operating companies in various sectors, from manufacturing baking equipment to merchandising ornamental houseplants. It has impressively outperformed peers and the overall market on a regular basis for many decades. Highlights from its website illustrate company principles:

The Markel approach is one of spontaneity and flexibility. This requires a respect for authority but a disdain of bureaucracy. At Markel we hold the individual’s right to self-determination in the highest light, providing an atmosphere in which people can reach their personal potential.

Our companies are leaders in their respective industries. Our management teams are the leaders of those companies. We provide corporate governance and other related services to our companies but refrain from affecting management's day-to-day activities. Therefore, our companies can focus on what they do best. From providing healthcare solutions, affordable housing, or retail price solutions across the US to manufacturing capital equipment around the world, each of our companies strives to achieve long-term success for its customers, employees, and communities.

The company's 2012 letter to shareholders is explicit about the role of trust at Markel:

One key reason why things have worked out so well for Markel over time is the environment of TRUST that exists at your company. We appreciate that you as shareholders have entrusted us with your capital to build the value of your investment over time. You've given us great latitude to pursue this goal without artificial constraints, and we've validated your faith in us by producing excellent results over time.

We work hard every day to maintain and build a level of trust around Markel because we think that makes our business better. It is almost magical to live in this environment and enjoy the mutual commitment that the people of this company feel towards each other and towards the company.

Or consider Alleghany Corporation, another reliably successful insurance company. Alleghany, which was founded in 1929, owns and operates important insurance businesses, including Transatlantic Holdings (TransRe), a venerable company founded in 1977 by Maurice R. ("Hank") Greenberg of AIG (American International Group) and acquired by Alleghany in 2012.

Led since 2004 by Weston Hicks, Alleghany also owns a variety of autonomous decentralized operating companies in a wide range of businesses. These include manufacturing toys (including Peppa Pig), fabricating steel for massive industrial projects (from sports stadiums to office building complexes), and producing funeral parlor products.

In its annual reports, Alleghany attaches a brief set of operating principles. It is akin to Berkshire's *Owner's Manual* and contains some assertions that parallel the Berkshire model. Following are a few selections:

As the owner of insurance and reinsurance companies, Alleghany Corporation itself is, to a significant degree, an asset management company. Like a closed-end fund, the corporation retains most of its profits and reinvests those profits on behalf of its stockholders.

Alleghany Capital Corporation is our investment subsidiary that acquires and oversees primarily non-financial companies with durable businesses. Unlike a private equity firm, we do not acquire companies with the intention to sell them in the future. Rather, we believe that we provide a stable ownership structure when the founders or other control owners need to effect a capital transition. We believe that our ownership allows our owner-manager partners to grow their company and to improve each company's results over time.

Our primary function in overseeing operating businesses is to provide strategic guidance, to set risk parameters, and to ensure that management incentives are appropriate. We don't "run" our subsidiaries—their executive teams do.

A final example is Fairfax Financial Holdings, a diversified insurance company led since 1985 by Prem Watsa. The company, which has outperformed peers and the overall market

by substantial margins, was formed after Watsa acquired the Canadian truck insurance business of Markel.

Over ensuing decades, Watsa steadily grew the business into an insurance giant, today composed of dozens of major separately operated insurance companies along with a variety of noninsurance businesses, including restaurant chains and retail shops as well as significant investments in assorted public companies. The company's guiding principles have been in place from those early years. They include the following, from the company's website:

We expect to compound our mark-to-market book value per share over the long term by [15 percent to 20 percent] annually by running Fairfax and its subsidiaries for the long-term benefit of customers, employees, shareholders and the communities where we operate—at the expense of short term profits if necessary. We always want to be soundly financed. We provide complete disclosure annually to our shareholders.

Our companies are decentralized and run by the presidents except for performance evaluation, succession planning, acquisitions, financing and investments, which are done by or with Fairfax. Investing will always be conducted based on a long-term value-oriented philosophy. Cooperation among companies is encouraged to the benefit of Fairfax in total.

Complete and open communication between Fairfax and subsidiaries is an essential requirement at Fairfax. Honesty and integrity are essential in all our relationships and will never be compromised. We value loyalty—to Fairfax and our colleagues.

In his 2012 letter to Fairfax shareholders, Watsa also stressed the central role of trust at his company:

Fairfax benefits greatly from our “fair and friendly” culture that we have developed over the past 27 years. Our small holding company team, with great integrity, team spirit and no egos,

keeps the whole company going forward, protecting us from unexpected downside risks and taking advantage of opportunities when they arise. The glue that keeps our company together is trust and a long-term focus. From our Board of Directors through our officers and all our employees, you can count on them to do the right thing, always taking a long-term view.

So at Fairfax you will not see a huge holding company that checks every move our companies make, companies being sold to maximize short term profits, excessive compensation among our management, mass layoffs, management turnover or promotion of our stock. Our officers almost never sell our stock, and are a pleasure to work with. We have never lost a President or officer whom we wanted to keep. Our Presidents, officers and investment principals, who have been with Fairfax for an average of 13-1/2 years, are ultimately the strength of our company and the reason I am so excited about our future.

The Berkshire model—or call it the Alleghany, Fairfax, or Markel model—is followed in other industries as well. Exemplars operate with a high degree of trust, although all with variations in exact practices and their execution, as illustrated next.

General Businesses

Illinois Tool Works (ITW) is a global Chicago-based manufacturer formed by Byron L. Smith in 1912. Built by diverse industrial acquisitions funded mainly with internally generated capital, the company always strived to maintain managerial autonomy, although as it grew, it also tended to centralize.

From the late 1970s, the leadership eventually organized into eight separate divisions composed of eight hundred different businesses. The founder's son, Howard Smith, president from 1972–1981, explained: “The key to it is the realization that if you're

going to have an organization like we had, if you're going to have that spread of very capable people involved in all these businesses, you had better show them that the avenue of really running their own business is open.”¹

The ITW approach assumed the status of the ITW business model during the tenure of CEO John Nichols (1982–1995). He explained:

We set up separate entities and gave autonomy to the people by getting decision-making out to these operating entities. I learned everything about what *not* to do when I worked at Ford and ITT.

You learn that you can't run everything and you have to get good people to do it and let them do it. All of a sudden people had a chance to do their own product development and build their own organization.

During the Nichols' era, ITW grew at an average of nearly thirty acquisitions annually, to a total of 365. One reason for ITW's commitment to autonomy was practical: any given manager can only handle so much oversight.

The chief change after ITW acquired a company was to segment the business into manageable units. A parallel practice was for group executive vice presidents to invest in training programs to prepare personnel for management roles.

ITW executives say the greatest difficulties they face are around integration of new businesses; ITW business unit managers, having been integrated, say the same thing. As one ITW group president put it: “Once you acquire the company, the hard part is integrating the business and getting them to be ITW-ized. Even though it is common sense and practical, not everybody gets it. Some get it more quickly than others.”²

Nichols's successors embraced most of the model, but they also tried to simplify by combining units rather than continuing to

segment them. Jim Farrell, CEO from 1995–2005, also pursued larger, pricier acquisitions. Despite shifts, Farrell maintained the core philosophy:

We believe it is necessary to split a company. The larger a company is, the more bureaucratic and slow it gets, and the more expensive it gets. Our units have their own operations, sales, marketing, and finance. There are no traditional functional heads in the corporate office. Individual operating units are much faster to market, to get problems resolved, and have opportunities realized—and we do it with less cost than a centralized operation.

Although ITW continued to prosper in the post-Nichols era, it never quite achieved the same results. The cautionary note is clear—sustained segmentation can be more effective than combination. Indeed, each business unit is unique and evolves in its own way, based on its particular history and practices, and segmentation is more likely to enable creating the most value out of that uniqueness.

Despite these points, ITW drew criticism from shareholder activists amid the contemporary wave of anticonglomerate sentiment. In response to activist pressure from Relational Investors LLC, the company, under the leadership of CEO Scott Santi, appointed one of its nominees to the board, and from 2012 to 2016 ran a divestiture and consolidation program.

Yet throughout this period, Santi stated and restated the long-standing core elements of the ITW business model, including decentralization and a unit-level focus on efficiency and customer-based innovation. Santi's 2014 letter explained this approach in a succinct statement, repeated in subsequent annual reports. It includes these points:

Our decentralized, entrepreneurial culture allows us to be fast, focused, and responsive. Our people are clear about what is

expected of them with regard to our business model, our strategy, and our values. Within the confines of this framework, we empower our business teams to make decisions and customize their approach in order to maximize the relevance and impact of the ITW Business Model for their specific customers and end markets.

In every market in which we operate, our businesses work hard to position themselves as the “go-to” problem solver for their key customers. Inventing solutions for our customers to help them address difficult technical challenges or improve their business performance has been the central focus of ITW’s approach to innovation all the way back to the founding of our company over 100 years ago.

Another cousin of the Berkshire model, and the ITW model, is Marmon Group (introduced in chapter 3).³ Begun in the 1960s by Jay and Robert Pritzker through acquisitions and organic growth, the Pritzker brothers invariably retained existing management and followed a hands-off policy that gave managers autonomy to make operating decisions. They built an industrial conglomerate in diverse manufacturing businesses: agricultural equipment, apparel accessories, automotive products, cable and wire, piping and tubing, musical instruments, and retailing equipment as well as services involving mining and metals trading.

Through the 1980s and 1990s, the acquisition rate was high, although many deals were of modest size: thirty acquisitions in 1998; thirty-five in 1999; and twenty in 2000. Assimilation was not a problem, as the company operated in a decentralized manner. After Jay died and Bob retired, the Pritzker family drew ITW’s John Nichols out of retirement.

Nichols promptly divided Marmon into ten business sectors, each with a president reporting to him. That enabled him to oversee the sprawling organization while facilitating growth and acquisitions at divisional and product levels. As the company

grew, Nichols added divisions to accommodate that. Nichols then handed the reins to a former senior ITW colleague, Frank Ptak, whose explanation echoed the ITW approach. Ptak included the following sentence in a callout box in the letter he included in Marmon's annual reports from 2015 to 2017:

The Marmon business model employs the time-tested lessons of 80/20 statistical analysis as part of a comprehensive, continuous thinking process. Key elements include decentralized management of small, homogenous, segmented businesses, continuous improvement in operating efficiency and productivity, [and] selective bolt-on acquisitions to enhance strategic direction.

Marmon's decentralization was created rigorously, using the 80/20 principle. This thought process is based on a common statistical distribution: 80 percent of given outcomes are contributed by 20 percent of the inputs. Marmon executives found, for example, that 80 percent of sales came from 20 percent of the product mix, and 80 percent of profits were due to 20 percent of customers.

Armed with such insights, Marmon generates highly segmented profit and loss statements to zero in on what specific parts of every business contribute most and least to overall performance. With laser focus, managers allocate time and resources to the divisions, products, and customers that drive the greatest profits. This approach enables pinpointing parts of the business that warrant reinvestment to foster innovation and growth.

The process entails endless pursuit of greater segmentation and decentralization that yields product breakthroughs. Recent examples include cables used in subway systems and high-rise buildings that can withstand two-thousand-degree flames for two hours; copper fittings for refrigeration equipment that can be connected by pressing, without need for an open flame; greaseless "fifth wheels," the plate that couples trucks to trailers; and kink-free

extension cords. Marmon's 80/20 model of decentralization is an innovative way to take advantage of size.

Ptak made a further refinement: creating three autonomous divisions. Each divisional president oversaw three or four units whose presidents reported to them, and each divisional president reported to Ptak. Ptak continued the relentless segmentation, ultimately forming four autonomous groups, fifteen separate divisions, and two hundred business units (an organizational chart reflecting these changes appears in chapter 3).

In 2008, Berkshire acquired Marmon. Since then, it has continued to operate as it always had, now like a Russian nesting doll as a subsidiary within a like-minded parent. Within Berkshire, several other successful industrial conglomerates follow similar organizational principles, including Berkshire Hathaway Energy, MiTek, and Scott Fetzer. These examples illustrate Berkshire's practice of bucking the trend.

In recent years, the industrial conglomerate has been dying off—with long-gone names such as Gulf & Western Industries; ITT Corporation; and Textron. The call for business focus is so strong that it even catches companies that are diversified but far from the conglomerates of old. Examples include DuPont, which was pressured into first merging with Dow Chemical and then splitting the combination in three, and United Technologies, first merging with Collins and then spinning off its Carrier air conditioning and Otis elevator units before merging with Raytheon.

Despite intense pressure, the principles—especially autonomy and decentralization—often endure, at a wide range of diverse businesses today, such as Danaher, Dover, Roper Technologies, and TransDigm Group. All use slightly different approaches to managing scale and justifying it, some aligned more with the Berkshire approach than others.

Consider Danaher, a conglomerate operating in several industries and across multiple platforms. Danaher was founded in 1983

by the brothers Mitchell and Steven Rales, who still own a large stake, although they withdrew from management roles long ago. At Danaher, the Rales brothers began a system that is both similar to and different from the Berkshire business model.

Called the Danaher Business System, it has been relentlessly refined under the stewardship of three successive world-class CEOs. They have built a mighty industrial conglomerate, while along the way spinning off several divisions into freestanding businesses that have achieved great scale in their own right.

Danaher is similar to Berkshire in at least three key ways: an acquisitive, autonomous, decentralized organization. It differs in at least two primary ways: Danaher uses a rigorous company-wide system of management recruitment and training around a set of shared fundamental operating principles stressing leanness in every step.

Differences aside, trust remains an important element of the Danaher Business System, a feature that helps make any such training and best practices program work. For a glimpse at the culture and the record, start with this from George Sherman, Danaher CEO from 1990 to 2001:

When I joined Danaher eleven years ago, sales totaled less than \$750 million, and the company sold a fragmented assortment of products. Over the next decade, we evolved Danaher into a global corporation with leading positions in higher growth multi-billion dollar markets. Over the last ten years, our sales and earnings per share have grown, respectively, at a 15 percent and 21 percent compounded annual growth rate. Danaher stock has appreciated over the past ten years at a 33 percent compounded annual growth rate. While we were developing a stronger business mix and a clearly articulated operating philosophy and culture around our powerful [Danaher Business System], we also grew our organizational capability.

Sherman's successor was among the first executives he had hired at Danaher: H. Lawrence Culp, Jr.. After an impressive decade-plus tenure at Danaher, Culp in 2018 was tapped to head the beleaguered General Electric. The first Danaher annual report he issued, in 2002, elaborated on the history:

In the mid-1980s, a Danaher division faced with intensifying competition launched an improvement effort based on the then-new principles of lean manufacturing. The initiative succeeded beyond anyone's expectations—reinforcing the division's industry leadership as well as spawning the Danaher Business System (DBS). Since this modest beginning, DBS has evolved from a collection of manufacturing improvement tools into a philosophy, set of values, and series of management processes that collectively define who we are and how we do what we do.

As a final contemporary example, take Constellation Software Inc. (CSI, where Lawrence Cunningham is a director). CSI buys, improves, and operates vertical market software companies worldwide. Now numbering more than three hundred separate business units, each is operated autonomously in a highly decentralized structure. What holds the culture together is trust. In his 2011 letter to CSI shareholders, CEO Mark Leonard explained:

A long-term orientation requires a high degree of mutual trust between the company and all of its constituents. We trust our managers and employees and hence try to encumber them with as little bureaucracy as possible. We encourage our managers to launch initiatives, which in our industry, often require 5 to 10 years to generate payback. We are comfortable providing them with capital to purchase businesses that won't be immediately accretive, but that have the potential to be long-term franchises for CSI.

We nearly always promote from within because mutual trust and loyalty take years to build, and conversely, newly hired smart and/or manipulative mercenaries can take years to identify and root out. We incent managers and employees with shares (escrowed for 3–5 years) so that they are economically aligned with shareholders. In return we need and want loyal employees: if they aren't planning to be around for 5 years, then they aren't going to care much about the outcome of multi-year initiatives, and they certainly aren't going to forego short-term bonuses for long-term profits.

At CSI, as with Berkshire, structure is a salient organizational motif. In both cases, however, structure was not the cause of success but a consequence of the real cause: a culture of trust. When managers encourage employees to produce, innovate, and excel, they tend to rise to the occasion. When trust is central in a business organization, decentralization and autonomy result. Success follows.

So it was interesting when in 2015 the founders of Google created a new holding company structure, called Alphabet, to house not only the legacy Internet search business but some twenty-six other separate autonomous business units operating in a decentralized structure. The move prompted speculation that Alphabet wanted to become the twenty-first-century version of Berkshire. We share their enthusiasm.⁴ But we'd stress that this will not occur by virtue of the structure alone. It can succeed only if the structure is embedded in a culture of trust.

. . . .

In recent years, business people increasingly dream of creating businesses in Berkshire's image, much as proverbial literary types aspire to write the great American novel. It is achievable, if on a smaller scale, but not formulaically.

A key lesson from the Berkshire business model is the margin of trust. Being suitably skeptical of most, especially financial

intermediaries, proponents seek out special managers and partners who are trustworthy. They win the trust of shareholders and employees alike by honoring promises.

Neither decentralization nor autonomy are the primary reasons for Berkshire's success or durability. Trust is. Autonomy is a manifestation of trust; decentralization is a consequence of it. The model is based on values, not formulas.

PART IV

Challenges

Judgment

A TRUST-BASED ORGANIZATION faces two major problems. The first occurs when senior managers abuse trust. The second involves pitfalls of self-reliance in such areas as improvident acquisitions. Although the challenges are real, Berkshire has generally overcome them. With scores of acquisitions and executive appointments over six decades, the conglomerate offers only a few examples of error in judgment.

Acquisitions

For decades, Buffett has called all the parent-level shots at Berkshire, with limited investigation and no oversight, especially those concerning acquisitions and investments. Unlike most sizable public companies, Berkshire does not rely on its board of directors or senior executives to approve acquisitions; and it does not use outside advisors to vet deals.

Buffett explains his general philosophy to the board but rarely seeks its approval; he often consults with Munger, and lately with Greg Abel and Ajit Jain, but he does not do so inevitably and does not always heed their counsel. Berkshire rarely uses business brokers or investment bankers to identify acquisition targets, but rather relies on an informal network of friends and business associates. Most of the suggestions he is given work out well, but not all, entailing some costs of error.

One of Berkshire's most unusual acquisitions occurred in 2001. Buffett's friend, Julian Robertson, founder of the preeminent Tiger Management (the Tiger Fund), signaled to Buffett his willingness to sell a large stake in XTRA Lease, the truck leasing company.

Buffett upped the ante, proposing to XTRA's board the making of an all-shares tender offer to its shareholders, which it endorsed, and Berkshire soon closed. Contrary to Berkshire's usual practice of maintaining both management and operations after an acquisition, within three years, XTRA's CEO was replaced, its headquarters was relocated, and the company divested a large part of its asset base.

Although such significant changes are commonly part of many corporate acquisitions, they are normally avoided at Berkshire. Berkshire likes to acquire well-running businesses, not those that need fixing. It is anomalous for a Berkshire acquisition to entail such efforts. But Berkshire sometimes accidentally buys troubled companies needing such changes. It is a by-product of the informality of Berkshire's acquisition process, especially when spontaneously acting on tips from friends and conducting limited due diligence.

XTRA turned out to be a profitable acquisition, but another unusual deal posed disastrous financial results: Berkshire's 1993 acquisition of Dexter Shoe. Berkshire paid \$443 million—all in Berkshire stock—for the dying New England cobbler. The company had been a dynamo, producing millions of shoes in local factories annually. Dexter maintained production in the United

States, paying higher wages than rivals and outdid imports from low-wage countries in terms of quality and style.

Despite these positive traits, Dexter had a big latent negative: manufacturing costs in the United States were ten times those in China. Eventually, rivals produced shoes as good as Dexter but at one-tenth the cost. By 2007, Buffett confessed that acquiring Dexter was the worst deal he ever made, as Berkshire shuttered it. The cost was the value of the Berkshire stock surrendered, which by 2020 exceeds \$8 billion. This revealed another lesson about the perils of using a high-quality stock like Berkshire to acquire businesses.

Buffett alone made the mistake—without input of the Berkshire board or any inner circle. Even the greatest investors and decision makers commit costly mistakes. Buffett is aware of this, of course, which is why he often vets proposals with Munger. Although Buffett values Munger's counsel to veto a deal—earning Munger the nickname the “Abominable No Man”—Buffett has not always listened, as the even more costly 1999 acquisition fumble of General Reinsurance Corporation (Gen Re) attests.

Berkshire paid \$22 billion for Gen Re—all in Berkshire stock (the lesson from Dexter to avoid paying in stock was not evident until 2007). Buffett and Munger knew that Gen Re, a large reinsurer, maintained a significant derivatives business that posed considerable risk.

Munger suggested avoiding the deal, but Buffett figured managers would unwind that business unit promptly after closing. Once Berkshire acquired Gen Re, however, the managers did not do so and, consistent with Buffett's hands-off approach, he did not push them (such reluctance underscores how unusual the postacquisition shuffles at XTRA were).

In addition to the patent problems of the derivatives business, more latent challenges also beset Gen Re's operations. Buffett had known Ronald Ferguson, Gen Re's chief executive, for many years, and he relied heavily on that relationship and Ferguson's

experience. What neither Buffett nor Ferguson knew, however, was that Gen Re's underwriting discipline and reserves had slipped.

Gen Re had under-reserved for risks it covered, which it translated into low prices on subsequent policies. Underwriters also pursued business they should have rejected and concentrated their risks excessively. From 1999 to 2001, Gen Re incurred underwriting losses adding to \$6.1 billion. Unwinding the derivatives business was both costly and protracted, causing Buffett angst for many years.

Munger is not only influential, sometimes vetoing deals, but also deferential when Buffett wishes to proceed anyway. In 2007, Buffett invested \$2 billion in the debt of a leveraged buyout of Texas electric utilities. It soon busted amid the financial crisis, costing Berkshire almost \$1 billion. Ironically, the deal was arranged by the private equity firm KKR (formerly Kohlberg Kravis Roberts), in one of its biggest (\$44 billion) and worst deals to that point.¹

Reporting this in 2013, Buffett wrote, "Next time I'll call Charlie." Although investment committees, common at most businesses even fractions of Berkshire's size, limit opportunistic capital allocation, deals like this underscore the cost of having a one-man investment committee.

A final example concerns 3G, and Buffett's trust in its principal, Jorge Paulo Lemann. As noted in chapters 4 and 7, Berkshire's partnership with the private equity firm—in 2013 to acquire Heinz and in 2015 to merge it with Kraft—gave Berkshire a 27 percent stake in Kraft Heinz Company. Alas, 3G's business strategy, focused on cost cutting, has stumbled. In late 2018, the company drew a subpoena from the Securities and Exchange Commission over certain business practices.²

Buffett understands the appeal and limits of the model and seems to believe that others can execute it as he has. Conversely, the Berkshire succession plan envisions splitting the roles of chief executive and chief investment officer and the roles of management

from board chair. Accordingly, the Berkshire succession plan envisions a somewhat tighter leash on Buffett's successor (chapter 12 considers succession further).

For other firms, insisting on a capable decision maker based on core competencies and a proven track record seems imperative before opting to follow the Berkshire model. At a minimum, firms should embrace the fundamental Buffett-Berkshire tenet of the circle of competence defined cross-functionally: industries and business, business methods, and people playing multiple roles, such as managers as well as partners.

Berkshire's preference to pay cash not stock is helpful but, as with most solutions, it poses minor problems of its own. The cost to Berkshire is most acute in the context of targets that are publicly traded family business. Family businesses appeal to Berkshire as they often bring a sense of legacy and permanence, which are prominent fixtures in the Berkshire business model.

Many families prize Berkshire's commitments to autonomy and permanence, moreover, often selling to Berkshire for less than rival bids or intrinsic value. For family businesses owned solely by close-knit groups who all wish to sell to Berkshire, the cash preference at a discount creates no problem.

Problems arise, however, for publicly traded family businesses. When directors of such companies sell control, they are duty-bound to get the best value for shareholders.³ In a stock deal where all holders share gains in future business value, those directors could consider Berkshire's special culture in valuing the transaction.⁴

But with cash, all such future value goes to Berkshire's shareholders, not to the target's public stockholders, who gain nothing from the autonomy or permanence that family members prize in a sale to Berkshire. So target directors will resist an all-cash sale at a discount. They will seek rival suitors at higher prices, even stimulating an auction to drive up the price—repelling Berkshire, which avoids auctions.

Challenges

An example can be drawn from Berkshire's 2003 acquisition of Clayton Homes, a publicly traded family business bought for a modest (7 percent) premium to market. Certain Clayton shareholders objected: one, Cerberus Capital Management, told Clayton it wanted the chance to make a competing bid; another sued.⁵ The result was a six-month delay in getting to a shareholder vote, which narrowly approved the Berkshire deal.

Some Clayton shareholders were disappointed, but Cerberus opted not to outbid Berkshire, and the court dismissed the lawsuit. The scenario remains unattractive to Berkshire, however, given the risk of litigation, delay, and rival bids—wary that courts might require target directors to take affirmative steps. The risk of an auction would be enough to deter Berkshire from bidding at all. The upshot: the publicly traded family business is outside Berkshire's acquisition model, amounting to an opportunity cost for what would otherwise be a sweet spot.

Executives

The challenges of Berkshire's trust-based structure are most dramatic when senior executives depart after being ensnared in widely publicized imbroglios. Buffett pays close attention to manager identity when acquiring a company but then relies on such managers to appoint successors. At the same time, there is no middle management, so in modern management parlance, a single person may have eighty direct reports. The chief costs result from mistakenly releasing or retaining senior executives in circumstances that suggest crisis.

Crisis was the hallmark of a series of executive shuffles at Berkshire's NetJets subsidiary, which involved two managers on the short list of Buffett successors, Richard Santulli and David Sokol. NetJets, which Santulli founded and led through 2009, is a competitive and capital-intensive business with a unionized employee

base. Selling fractional interests in private aircraft to the elite, Santulli conceived of the business as a luxury brand and operated it accordingly.

But the company struggled and, amid financial adversity following the 2008 financial crisis, Buffett made a change. Why he did so remains a mystery and certainly an anomaly, however, as Buffett rarely second-guesses managers, especially company founders like Santulli.

As NetJets's new CEO, Buffett appointed Sokol, who perceived NetJets to be bloated and forthwith cut costs aggressively. Unionized employees were furious and a sense of crisis soon engulfed the company. Why Buffett chose Sokol to run NetJets is also a curiosity. Sokol was running Berkshire Hathaway's energy business (then called MidAmerican Energy) and troubleshooting as board chairman at Johns Manville.

Buffett has almost never moved a CEO from one Berkshire company to another. Having the same CEO run two Berkshire companies was unprecedented. But Buffett had grown to trust Sokol immensely, having been introduced to him by one of his most intimate confidants, Walter Scott Jr., fellow Omaha denizen and Berkshire board member. Buffett's faith, however, was misplaced, as Sokol resigned from all of his Berkshire jobs in 2011 after allegedly trading stock in a public company ahead of pitching it to Buffett as a Berkshire acquisition.

At NetJets, Sokol's successor was Jordan Hansell. Sokol had recruited Hansell from Berkshire's energy business, where Hansell had served as general counsel. NetJets's pilots loved Santulli and lamented his departure. They opposed both Sokol and Hansell, and especially their cost-cutting strategy.

After Santulli left, management-labor relations deteriorated, and during 2013–2014 the pilots' union hurled invective at Hansell in aggressive campaigns from the Internet to the *Wall Street Journal* and *Omaha World-Herald*. Pilots picketed outside Berkshire's annual meeting in 2014 and 2015. Amid mounting turmoil,

in early 2015, Hansell resigned and two Santulli-era senior executives who had left NetJets earlier that year were recruited back to lead the company.

From these circumstances, it is tempting to infer that Berkshire's acquisition of NetJets was a mistake. Perhaps it belongs in the prior section's list of troubled acquisitions due to having a single decision maker. But it also speaks to the lack of any formal programs at Berkshire concerning executive recruiting, review, promotion, or grooming. Sokol had no experience with fractional aviation or much else relevant to leading NetJets, such as consumer or union relations. Sokol selected Hansell, a young lawyer at the energy company, who likewise lacked obviously relevant credentials or experience.

The executive shuffles at NetJets resembled successive shuffles at Berkshire's Benjamin Moore paint manufacturing subsidiary. When Berkshire acquired it in 2000, as noted in chapter 4, Buffett personally promised to continue its longstanding practice of selling only through independent distributors, not through powerful big box retailers such as Home Depot and Lowe's. By 2012, after five years at the helm, Denis Abrams was ousted for planning to sell paint through such retailers. To find a replacement, Buffett turned to his newly hired management assistant, twenty-eight-year-old Tracy Britt Cool.

The recently minted Harvard MBA suggested Robert Merritt, who was installed. But not two years later, Merritt succumbed to the same fate due to relentless pressure from big retailers. He resigned amid concurrent criticisms about a new culture of chauvinism at the venerable paint company. Surrounding both episodes was an atmosphere of crisis. Distributors and other constituents complained about the company's decline. How such a great company could take such a plunge befuddled them.

The Benjamin Moore departures reveal two variations on the challenges of the Berkshire model as it relates to executive oversight. The first concerns the wisdom of Buffett's commitment to

maintain Benjamin Moore's old-fashioned distributorship in the first place. Two successive CEOs intuited the difficulty associated with exclusively selling paint that way given contemporary distribution channels. Yet they were handcuffed by a commitment made solely by Buffett.

The second variation of the Benjamin Moore challenge concerns how executives are chosen at Berkshire. Although Buffett delegated the executive search function when finding Merritt, the power was exercised by just one person who was young and new to Berkshire. And Cool identified Merritt from among her own professional circle, not through a national search.

The private network approach is consistent with the Berkshire model—seen in Santulli's recruitment of Hansell and Buffett's recruitment of several other CEOs. But it does present risk and therefore a challenge compared with formal programs for recruiting, vetting, and promoting executives.

The risk of this type of managerial succession crisis could be mitigated by modest expansion of corporate bureaucracy (like asking a board committee's opinion on executive personnel decisions) or slight adjustments to the trust-based culture (such as conducting background checks or adding periodic reviews and evaluations).

In the early 2010s, Berkshire began to move in this direction: holding regular annual meetings of the subsidiary CEOs, sometimes joining the board without Buffett's presence. More formal and frequent meetings have been occurring and are likely to become regularized. Such gradual changes would maintain the trust-based model Berkshire prospered on while guarding against errors the approach poses.

For all of that, again, the record remains strongly in favor of the Berkshire business model. Each of the challenges chronicled here is important and may offer lessons. But aggregating the scorecard over six decades and hundreds of such decisions, these are dwarfed by the achievements.

Public Perception

WHEN BERKSHIRE STUMBLES—or is perceived to stumble—it attracts outsize attention. This occurs for two reasons that pose a challenge for any large trust-based corporation.

First, the general public is skeptical of corporations, especially large ones. Skepticism persists even for decentralized companies like Berkshire, better seen as a collection of smaller businesses, rather than a single mammoth one.

Second, policy experts extol control and hierarchy over trust so that when a trust-based organization such as Berkshire falters, critics pounce.

These forces pose challenges to large companies with lean structures. They may invest little in traditional public relations campaigns common in corporate America. Modest staffing may be enough for the occasional challenges that arise.

In such decentralized structures, moreover, units facing more frequent exposure may opt to provide more full-time public relations staff. Within Berkshire, a few examples will illustrate this structure, featuring major businesses involved in insurance, finance, and energy.

Insurance

In 2013, an unfounded exposé attacked Berkshire's practice of generating substantial investable funds from insurance float. This refers to funds derived from policy premiums, which are paid upfront, unlike claims, which need to be paid only much later, if at all. Buffett frequently brags about Berkshire's use of this leverage.

A reporter turned the strategy around on Berkshire. He portrayed Berkshire's approach as giving insurance personnel perverse incentives to do everything possible to avoid or delay paying legitimate claims so they could hold float longer. The reporter even asserted that staff had acted in bad faith as a result.

The focus of the exposé, by Mark Greenblatt of Scripps, was National Indemnity Company's (NICO) specialty business in retroactively reinsuring long-tail asbestos and environmental risks, giving a dozen illustrations from the thousands of policies it wrote. The illustrations involved legal disputes among policyholders, corporate defendants, the original insurer, and Berkshire's companies.

The piece spotlighted lawsuits charging bad faith in payment delays or denials, including lawsuits by policyholders against the ceding insurers under the original insurance policies or against NICO alleging wrongful interference with those policies ("tortious interference with contract").¹ The story quoted malicious charges from claimants and their lawyers and insurance industry executives, blaming Berkshire's float philosophy for the problems.

Greenblatt had reached out to Berkshire and NICO personnel for comment, but the recipients did not grant interviews and time constraints made them unable to respond to every written question he posed. Within days of publication, Berkshire emailed Greenblatt to explain various inaccuracies in the story but, shortly thereafter, Scripps emailed Berkshire to say it stood by it.² Two weeks later, Berkshire publicized a rebuttal, asserting "bias and lack of professionalism" in the report.

For example, the piece wrongly suggested Berkshire controlled the defense of an asbestos case when the corporate defendant did; incorrectly insinuated that Berkshire unreasonably resisted settling cases by focusing on 100 percent of the amount a plaintiff sought rather than Berkshire's fractional share among multiple defendants; and credited critical comments of an insurance claims executive without appreciating potential bias from his involvement in disputes with Berkshire.³

Despite Berkshire's refutation, such allegations reach the public and can resonate. Corporate reputations are shaped. And the Scripps story continued to have legs. In January 2014, a lawyer from K&L Gates collated the cases in a presentation to the American Bar Foundation.⁴ It is not obvious that Berkshire would have done better if it had a more traditional public relations department to respond to the allegations. After all, other insurers such as AIG have also been accused of slow-pay and no-pay practices and, despite such traditional functions, fared no better.⁵

More to the point, Berkshire acts as if it is small, its decentralized structure makes it feel that way, and that structure maintains its trust-based culture. But to outsiders, whether political opponents or the public at large, it is a Goliath. Managers must evaluate how to address the trade-off between meeting infrequent but outsize attacks and overstaffing to fend them off.

Finance

Berkshire and several of its subsidiaries make good political targets. Take a 2015 campaign against Clayton Homes, maker and financier of manufactured homes.⁶ Writing a piece sponsored by a political activist, the Center for Public Integrity in the *Seattle Times*, Daniel Wagner and Mike Baker alleged that Clayton's home sales team channeled buyers into dubious home mortgages. They claimed customers were offered few or no alternative

financing options, terms were seductive (including low down-payment requirements), defaults and foreclosures were high, and collection practices were aggressive.⁷

Clayton promptly issued a response disagreeing with every negative assertion in the piece.⁸ It stressed its policies of customer protection while acknowledging that, in a minority of cases such as those the writers portrayed, customers facing periodic life challenges have difficulty repaying loans and have faced foreclosure. The authors responded with a point-by-point rebuttal.⁹ At the Berkshire annual meeting five weeks later, Buffett also repudiated the piece and, again, one of the writers responded with continued skepticism.¹⁰

The real reasons behind the piece later emerged to be more political than first appeared. At the time of the report, Congress had begun debating regulations applicable to manufactured housing loans. After the financial crisis of 2008, the Dodd-Frank Act added disclosure and timing requirements to such loans bearing high interest rates, which Congress had been considering repealing as onerous and costly.

Clayton and other industry leaders supported repeal, while some homeowner and consumer groups were opposed. On one side, the manufactured housing trade association stressed the importance of unregulated access for lower income people to this kind of housing, while consumer advocates urged regulation to protect the impecunious from costly housing loans.¹¹

Although the original report did not mention these points, the writers added the theme in a story in mid-May—linking their original assertions to Clayton's incentives in the political debate and making it clear that they were on the other side of that debate. Thus, it finally appeared that the authors wrote a piece of political advocacy, not investigative journalism, and targeted Clayton from ulterior motives, not as neutral reporters of facts. Notably, it also came out that one of the writers, Wagner, had an undisclosed conflict of interest: his sister was a lawyer representing plaintiffs in lawsuits against Clayton Homes.¹²

Challenges

As with the exposé concerning NICO, this story suggests the challenges smaller segments of massive institutions face: the risks of overstaffing a public relations department to meet every challenge versus commanding those resources as needed. At Berkshire, the balance is struck with a combination of parental backstops to address periodic media or political crises and subsidiary media resources that can be deployed as needed. At other subsidiaries, facing recurring political battles, a larger public relations staff is warranted, such as with Berkshire Hathaway Energy, discussed next.

Energy

Berkshire Hathaway Energy maintains a coterie of public relations and lobbying professionals. This is worthwhile as the company's business often places it at the center of important national policy debates. These debates span from consumer energy prices to climate change and fossil fuels versus renewables.

One such debate, concerning solar power, occurred in Nevada and affected Berkshire's local public utility, NV Energy. At issue was how much credit residential solar users get for electricity they generate for transmission back to the power grid. State law provided for aggregate credits up to 3 percent of the utility's historical peak load for such "net metering" credit.¹³

As long as statewide solar generation was less than that, all solar users earned full credit; if the limit were exceeded, new solar users would not get the credit. Solar advocates sought to boost the cap, arguing it would soon be reached and stressing the need for economic incentives to sustain solarization. NV Energy resisted, forecasting reaching the cap much later and noting the need to avoid having those without solar panels paying more for energy than those with solar panels.

Both sides lobbied vigorously and engaged in a public relations campaign. And both sides were accused of overdoing it.

At a public hearing on the issue, for example, lawmakers accused the solar industry of sending “aggressive” emails criticizing specific people, prompting a leading solar advocate to apologize publicly for his staff’s work.¹⁴

The accusations against NV Energy went beyond that company to target Berkshire itself and especially Buffett, turning the local story into a David and Goliath match shaded by assertions of overzealous capitalism. One headline read that “Warren Buffett is sending mixed messages on green energy,” contrasting Buffett’s boasts of Berkshire investments in renewables with NV’s position in the Nevada debate—and quoting one source as declaring “It always comes down to money, even if it looks kind of hypocritical.”¹⁵

Editors may have liked the storyline pitting consumer-loving, tree-hugging do-gooders against the monopolistic profiteers at Berkshire. In fact, however, the duller reality was the complex and contestable public policy of transitioning from fossil fuels to renewables. Berkshire has a dog in that fight, and NV Energy is one of the many Berkshire Hathaway Energy subsidiaries actively engaged in the process.

It would be absurd to believe, however, that energy scientists and business executives alone complete the dialogue and process everything that the energy company requires be said. For that, the company needs public relations specialists and lobbying professionals on staff. Berkshire Hathaway Energy does, and this story shows that it can pay for itself.

. . . .

Not all subsidiaries need full-time public relations staff, but a few do. A decentralized structure enables each subsidiary to meet its own needs. Within a larger organization that might attract outside attention, providing as-needed parental support and subsidiary deployment may suffice and avoid overstaffing or bureaucracy. For those more regularly exposed to media scrutiny or political debate, a full-time permanent public relations team may be warranted, in which case, the parent company can remain uninvolved.

Scale

FEW COMPANIES will ever reach Berkshire's vast scale, but many face the rising challenges that accompany corporate growth. These challenges range from finding new ways to "move the needle," to providing oversight of a sprawling organization, to maintaining focus in the conglomerate form of business organization. Ultimately, they all face a general mistrust of bigness in business that is a part of the U.S. political landscape.

Huge corporations have appalled Americans from Woodrow Wilson and Louis Brandeis to Bernie Sanders and Elizabeth Warren. Financial institutions seen as "too big to fail" are the latest repugnant targets, now governmentally regulated when classified as systemically important. Demonization of the conglomerate form, dating to the 1980s, is a private sector pastime, continuing today to challenge some Goliaths as "too big to succeed."

President Wilson stressed that employees' individuality is lost in large corporations to organizational mission, especially for companies that grow by acquisition rather than organically. Employee morale may suffer when workers see themselves as pawns of an

empire, not as human members of a team. Justice Brandeis warned against corporate agglomerations as a threat to social welfare, to the spirit of the nation. Concern went all the way to the top: when one company acquires another, the latter's CEO almost always surrenders the role of ship captain for a mere seat in a crew of corporate bureaucracy.

Today's critics of corporate giants claim they facilitate the transfer of wealth from the workforce to the executive staff. The flow appears in mushrooming executive compensation, often paid using stock that rises in value with more regard to size than performance. As Senators Warren and Sanders view it, all these features drive pernicious wedges along the socioeconomic ladder. Worse, large corporations wield political power proportional to scale, contradicting democratic values.

On the surface, Berkshire might seem to be an easy target for such rebuke. It is among America's largest corporations by any measure, whether assets, capital, or employees. If Berkshire were a country, and its revenue its gross domestic product, it would rank among the top-fifty world economies, rivaling Ireland, Kuwait, and New Zealand. Much of its recent growth is due to an energetic acquisition program. It has acquired nine wholly-owned subsidiaries that, if standing alone, would be Fortune 500 companies.

But Berkshire has avoided the sins that populist antagonists deplore, mainly a result of its distinct corporate culture, starting with its practice of autonomy. In a Berkshire acquisition, incumbent CEOs remain captain of their ship; there is no bureaucratic crew to join. There's even a book devoted to the phenomenon—*The Warren Buffett CEO: Secrets from the Berkshire Hathaway Managers* by Robert Miles.¹ The CEOs report that this autonomy and trust stimulate them to immaculate stewardship.

Although Berkshire executives are highly paid, compensation is not as lavish as with peers at public companies. Pay is explicitly tied to performance metrics under their control, in cash not

stock. In addition, Buffett's pay is trivial compared with other U.S. chief executives.

If critics perceive Berkshire to exercise outsize political influence, there is scant evidence that the corporation, as opposed to specific individuals or units, does so. Through 2004, Berkshire spent little on lobbying, perhaps \$300,000 in a typical year, whereas other large companies from Boeing to Verizon doled out closer to \$10 million.

Since then, as Berkshire's energy business quadrupled and it acquired BNSF Railway in 2009, lobbying by those two regulated units raised yearly costs to some \$6 million. That figure is still a fraction of what like-size companies spend. Berkshire is no political patsy, yet its comparatively modest disbursements defy any accusation of undemocratic crony capitalism.

Too Big to Fail

Sheer size has become vexing for banks, thanks to the 2008 financial crisis. Several financial institutions had grown so large and important that their failure compelled extraordinary government exertion. During 2008, authorities seized control of companies, such as Berkshire insurance rival AIG and one-time investee Freddie Mac; arranged for the sale of others, such as Countrywide and Wachovia; and intervened across the sector, allowing the collapse of Lehman Brothers.

All such institutions became stringently regulated under the Dodd-Frank Act of 2010 to maintain minimum asset levels and caps on debt. In addition to large banks, authorities named large insurance companies to be systematically significant financial institutions (SIFIs), subject to considerable regulation and oversight.

Skeptics of bigness suggested tagging Berkshire with the SIFI label, even resulting in a formal inquiry by the Bank of England to U.S. authorities about why it was omitted. Several reasons explain

this decision. For one, in the 2008 crisis, while all such financial institutions, and many other corporations, hemorrhaged capital, Berkshire commanded an abundant supply.

In contrast to many rivals whose operations remain primarily financial, Berkshire's insurance and finance businesses, once central pistons, have become less so as Berkshire has diversified. Berkshire's evolution from an insurance-driven investment vehicle to a vast industrial conglomerate manifested around 1990—just when the conglomerate form of business organization withered under scathing criticism.

Conglomerates

Berkshire has avoided the major pitfalls of its form of business organization—the conglomerate. While fashionable when Buffett began running Berkshire in 1965, it gradually went out of style.

In the 1960s and 1970s, the conglomerate form flourished in corporate America, in part due to enactment in 1950 of the Celler-Kefauver Act, which discouraged mergers among rivals, stimulating acquisitions of unrelated businesses.² Massive companies were built through numerous diverse acquisitions by powerful chief executives.

Prominent examples include ITT Corporation, which, under the leadership of Harold Geneen and later Rand Araskog, boasted three hundred fifty different companies, including car rentals, baking, hotels, and insurance; and Teledyne Technologies, assembled by Henry Singleton as nearly one hundred different businesses ranging from acoustic speakers, aeronautics, banking, computers, engines, and insurance. By 1980, the majority of Fortune 500 companies were conglomerates.³ Rationales included exploiting scale, seizing synergies, spreading managerial acumen, and diversifying investments.

Critics accused imperious executives of indulgent empire building, however. They stressed that many of these businesses

struggled, incurred significant losses for sustained periods, misallocated capital internally, or otherwise proved difficult to manage. Under pressure from hostile corporate takeover artists seeking to maximize shareholder value, as well as academics urging greater focus, the conglomerate model began to unravel.

Corporate raiders, such as Carl Ichan and Ronald Perelman, and buyout firms, such as Kohlberg Kravis Roberts, targeted or acquired conglomerates and proceeded to break them up. Others, like ITT and Teledyne, simply succumbed to the changing times and divided their conglomerates into multiple discrete corporations.⁴

By 1990, the era of the conglomerates was over and widely viewed as a systemic mistake. Top executives prone to conglomerate-wide systems and micromanagement ultimately undermined operational success. Subsidiary managers could execute more effectively when permitted to apply systems tailored to the needs of their business and focused on areas within their unique expertise.

Boards of directors, increasingly called on as active monitors of managers rather than loyal advisors, could not oversee sprawling empires. Shareholders could diversify more efficiently themselves than conglomerate executives who proved inept at allocating capital. And U.S. antitrust policy had swung back in the direction of solicitude toward mergers among rivals.⁵

During this same period, however, Berkshire transformed itself from a small investment partnership in the 1960s, into a diversified conglomerate with vast stock holdings by 1995. Today, it is a conglomerate more sprawling than ITT or Teledyne or any of the other colossuses of the 1980s, such as Beatrice Companies, Gulf & Western Industries, Litton Industries, or Textron. And its performance is impressive.

One broad reason for this success is that Berkshire recognized and avoided all the pitfalls: Buffett, as chief executive, is the opposite of a micromanager; Berkshire's decentralization and principle of managerial autonomy enable managerial focus; Buffett's investment acumen made Berkshire's practice of diversification valuable

to investors; and Berkshire's internal capital allocation saved stockholders sizable transaction costs and taxes.

Berkshire may be in a class by itself. Yet plenty of others share many practices and much of the prosperity. As noted in chapter 8, these include numerous insurance companies (such as Alleghany Corporation, Fairfax Financial, and Markel Corporation) and numerous noninsurance firms with refined business models (such as Constellation Software, Danaher Corporation, and Illinois Tool Works).

Too Big to Succeed

Today's strain of anticonglomerate fervor inverts regulatory concern about "too big to *fail*" to probe "too big to *succeed*." Evidence suggests that large corporations often underperform smaller rivals over long periods of time. Critics say that size, frequently achieved by acquisition, indicates hidden problems impairing organic growth. They say accumulations, especially through acquisition, spell conflicting and therefore self-defeating internal strategies. As the early populists warned, contemporary critics contend that size can lead executives to stress short-term profits at the expense of the human element.

Others acknowledge uncertainty in the relationship between size and success or failure. These contrarians say size can enable scaling up while controlling its downside using small teams, instilling a trust-based culture, and ensuring that everyone has a sense of purpose. They could point to Berkshire as a model of leadership that fostered a galactic organization formed of units that are often quite small.

Buffett has repeatedly stressed that Berkshire's size is incidental. As early as 1982, Buffett stressed in an annual shareholders' letter, "We will not equate corporate size with owner-wealth." Munger has expressed his socioeconomic aversion to vast concentrations of corporate power when addressing issues from merger activity

to income taxation.⁶ For these two Berkshire builders, it is as if Berkshire's size is accidental, more consequence than conquest.

One's greatest strengths are often one's greatest weaknesses. The same can be said of the Berkshire model. Its valuable business methods—self-reliance, autonomy, decentralization, and opportunistic acquisitions—all promote entrepreneurial executives. At the same time, however, they risk error from independence, wayward souls, and periodic reputational damage.

But size is not a problem. The only real cost of size at Berkshire might be as an anchor against sustained outsize returns on capital. Buffett has been ruing that for decades, as far back as 1994 warning in his annual shareholder letter: “A fat wallet is the enemy of superior investment results. And Berkshire now has a net worth of \$11.9 billion compared to about \$22 million when Charlie and I began to manage the company.”

Times have changed. In seven of the past ten years, Berkshire's *annual* gain in net worth exceeded in seven of the past ten years. As net worth approaches \$300 billion, that is some twenty-five times the 1994 level. Berkshire's corporate culture has enormous value that is invariant to its scale. It is a company that even Brandeis and Wilson might have loved.

Succession

AROUND BUFFETT'S EIGHTIETH BIRTHDAY, the *Economist* wrote that Berkshire was "down to playing its last hand."¹ Steven Davidoff Salomon in the *New York Times* lamented that Buffett graced Berkshire with "an irreplaceable magic touch."² At Berkshire's 2013 annual meeting, the investor Douglas Kass asserted his belief that Berkshire is no more likely to survive without Buffett than Teledyne Technologies was without Henry Singleton.

These criticisms assume that only Buffett holds Berkshire together, failing to consider the role that trust plays. Although Buffett's departure will certainly be consequential, too many other people and cultural elements are implicated to predict such finality so casually. These serious questions require considering the complete succession plan, and the role of trust in Berkshire culture.

It was long a parlor game to predict who will succeed Buffett at the conglomerate's helm. Most boards invest considerable time in succession planning, although Berkshire's was criticized for spending too little. Many boards, however, focus too narrowly on the

notion of CEO succession, whereas Berkshire's board developed a multipronged plan for Berkshire's future leadership.

Berkshire's succession plan has always called for dividing Buffett's role in two. In earlier decades, investments were to be managed by Lou Simpson, long-time savvy portfolio manager at GEICO, the car insurance subsidiary. The executive function was to be handled by Munger. Both men share Buffett's values and understand Berkshire culture. But that succession plan stopped making sense as all three men aged: Simpson retired and Munger entered his eighties.

Today, Berkshire's succession plan envisions investments run by several portfolio managers, likely including Todd Combs and Ted Weschler. On the executive side, Buffett's replacement is to come from among top managers of Berkshire's many subsidiaries. In 2018, Berkshire appointed Greg Abel and Ajit Jain to its board and designated them vice chairmen for noninsurance operations and insurance operations, respectively.

The final part of Berkshire's succession plan calls for splitting the roles of CEO and board chairman, with Buffett suggesting his son Howard Buffett as chairman. While it is tempting to see the split as dividing Buffett's role yet a third way, besides CEO and CIO, it may be more appropriate to see it as dividing Munger's role a second way, besides being the CEO's number two. After all, one of Munger's most important roles has been to say no and that will be one of Howard's most important roles, too. But the kinds of things to say no to will shift.

Munger's veto power tended to add a filter to Berkshire's acquisitions to quash improvident deals. In building Berkshire, that was vital to establish its culture. Howard's role, in contrast, will stress maintaining culture, not building it. His need to say no will be less in vetoing acquisition ideas than on reminding the forgetful of the values that made Berkshire special, such as promise keeping, permanence, and autonomy. In extreme circumstances, Howard's role will mean firing a wayward Berkshire chief executive.

Howard's primary task is thus one his father never had to perform, and his job will entail none of the tasks for which his father became famous. The approach deftly escapes a trap that so often ensnares sons of legends. Those who assume the same roles as parents are measured by their parent's standards and often are found wanting.

Some observers may misunderstand Howard's role and measure him against the impossible standard of his father, unfair as that may be. In time, however, the relevant role will be clear and, given Howard's firsthand knowledge of Berkshire culture and passion for Buffett's creation, he'll most likely measure up. But he cannot do it alone. He will need the continuing trust of Berkshire shareholders. Consider what Howard will be up against.

Powerful forces intensively criticize the conglomerate form; they will clamor to break them up. Such has been the fate at many venerable conglomerates in recent years, including such blue-chip stalwarts as DuPont and United Technologies.

Long before the era of the conglomerate, corporations were thought of as perpetual—enduring institutions, such as Berkshire. As the conglomerate era was eclipsed by the takeover era, corporations became more transient, in perception and fact.³

Transience remains a prevailing mind-set, sustained by those committed to pressuring corporations to deliver immediate shareholder results, whether activists or private equity.

Out of fashion, conglomerates attract hostility, requiring strong defenses. Although the best defense is solid sustained economic performance, another advantage is large loyal shareholdings.⁴ With Buffett firmly in control at Berkshire, no shareholder activist would dare challenge its business model.

But the calculus may differ after Buffett leaves the scene. After all, despite a market capitalization of nearly one-half trillion dollars, many analysts agree with Buffett that Berkshire is worth more. Berkshire's value exceeds the sum of its parts because the structure creates considerable benefits, including optimal capital

allocation, minimal enterprise risk, no insularity, low-cost funding, tax efficiencies, and minuscule overhead.

Citing criticisms of the business model, activists will urge Buffett's successors to sell Berkshire's struggling units, spin off the mediocre ones, and install new managers at some. In the process, activists will call for distributing cash to shareholders. They will explain how the net effect of such sales and distributions would increase immediate value for shareholders.

The counterargument will stress the long-term value for Berkshire shareholders, ironclad pledges to business sellers, a permanent home offering managerial autonomy, and an environment where vast amounts of capital is moved from one subsidiary to another without taxes or transaction fees.

The economic value of such commitments and flexibility is not necessarily reflected in Berkshire's prevailing stock price or the valuations of individual subsidiaries. The premium may manifest only when Berkshire makes an acquisition and may be preserved only by sustaining the conglomerate.

It will be up to Berkshire's shareholders to resolve the merits of such a debate. Assuming Buffett's successors deliver superior economic performance over multiple years, Berkshire's owners will have to decide whether or not to maintain trust in their leadership and the Berkshire model. Their choice will be a referendum on this trust-based culture. Our money is on trust.

EPILOGUE

The Stick of Ruthlessness

BUFFETT HAS SUMMARIZED the Berkshire business model's benefits and costs in clear terms:

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.¹

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 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, 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 Citigroup (Citi), to focus on the chemicals industry. They identified eighteen potential targets and Sokol was attracted to one, 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 it with Lubrizol's board and, on December 17, Citi reported that 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,² 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."³

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. Understanding a business's arcane details, however, is far less important than grasping the economic characteristics of its industry and the company's position, Buffett says.⁴ After speaking with Sokol and lunching with Hambrick on February 8, Buffett had a sense of Lubrizol's culture and found its 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,⁵ called Buffett to congratulate him and take pride in Citi's role facilitating the deal. Surprised to hear of that role, Buffett had Berkshire's chief financial officer Marc Hamburg call Sokol for information about Citi's participation. Sokol shared highlights about Citi as well as his recent purchase of Lubrizol stock, which he had not previously mentioned to Buffett.

During the next week, Sokol would provide greater detail, as Berkshire's attorneys from Munger, Tolles & Olson grilled him while helping Lubrizol's lawyers draft disclosure documents about the transaction. Buffett had been in Asia that week, and when he returned, Sokol tendered his resignation. Sokol had tried to retire from Berkshire on two previous occasions, but Buffett and other Berkshire board members had 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 these events dashed Sokol's hopes of succeeding Buffett at Berkshire. Sokol objected to that explanation. Not only did Sokol disclaim pretensions of succeeding Buffett, he was resigning for personal reasons, he said, and did not believe he had done anything wrong.⁶

So before issuing the press release the next day, Buffett replaced that language 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, including at MidAmerican Energy and NetJets. The release then summarized Sokol's Lubrizol stock purchases, concluding that they were lawful and stating 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 to be 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."⁷ Shareholders demanded to know why Buffett was not furious.

Buffett accepted the criticism, noting that had Berkshire's lawyers written the release they would have been more careful. Munger acknowledged that the press release was flawed, but cautioned against letting anger figure in such exercises.⁸ Corporate lawyers have honed the sober craft of drafting press releases and CEOs usually entrust the task to them. Buffett's mistake of writing his own press release underscored the value of delegation. In the Sokol case, this was ironic, considering how critics soon attacked Berkshire culture as 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 considers 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. It prompted Buffett to change his mind.

At Berkshire's annual meeting on April 30, 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. 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 trust-based business model.

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. As discussed in chapter 6, 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 trust-based culture was a culprit in the Sokol affair.⁹

It would be an 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 approach. 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 trust-based model.¹⁰

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 . . . [T]here'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.¹¹

In any corporate culture, how officials respond to transgressions is important. At the 2011 meeting, the audience heard reverberating through the arena, once again, Buffett's Salomon-era admonition that appears in the beginning and middle of this book and here again at its end: "Lose money for the firm, and I will be understanding; lose a shred of reputation for the firm, and I will be ruthless."¹²

In Sokol's case, Berkshire turned over all information to the Securities and Exchange Commission (SEC). The SEC looked into the matter, but ultimately dropped it 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." In addition, because 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.¹³

The SEC's decision not to pursue a case against Sokol contrasts with Berkshire's audit committee's judgment condemning him for violating company 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 aims for a higher bar.¹⁴

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 or others. The audit committee's reaction underscored Berkshire's sensitivity to public perceptions, even as Sokol heralded the SEC's decision as his vindication. As noted in chapter 4, Sokol's attorney even argued that what he had done was permitted by his employment agreement with Berkshire.¹⁵ Sokol's infraction was small in relation to the price he paid, illustrating what ruthlessness means. Fortunately, in the Berkshire model, ruthlessness is rare. It is the carrot of trust that dominates, and almost all decisions are made with a thick margin of trust.

Notes

Prologue: The Carrot of Trust

1. See Erik P. M. Vermeulen, “Corporate Governance in a Networked Age,” *Wake Forest Law Review* 50, no. 3 (2015): 711–42; Erik P. M. Vermeulen and Mark Fenwick, “The Future of Capitalism: ‘Un-Corporating’ Corporate Governance” (working paper, Lex Research Topics in Corporate Law & Economics, 2016); Mark Fenwick, Wulf A. Kaal, and Erik P. M. Vermeulen, “Regulation Tomorrow: What Happens When Technology Is Faster Than the Law?” https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2834531 (2017); Toshiyuki Kono, Mark Fenwick, and Erik P. M. Vermeulen, “Organizing-for-Innovation: New Perspectives on Corporate Governance” (2017).

2. See David F. Larcker and Brian Tayan, “Berkshire Hathaway: The Role of Trust in Governance” (Stanford Governance Research Program, May 28, 2010).

3. See Jay B. Barney and William S. Hesterly, *Strategic Management and Competitive Advantage: Concepts and Cases*, 6th ed. (New York: Pearson, 2018), 261–62.

4. See Subrata N. Chakravarty, “Three Little Words,” *Forbes*, April 6, 1998.

5. See Jerker Denrell, “Vicarious Learning, Undersampling of Failure, and the Myths of Management,” *Organization Science* 14, no. 3 (May–June 2003): 227–351.

6. See Aneil K. Mishra, “Organizational Responses to Crisis: The Centrality of Trust,” in *Trust in Organizations: Frontiers of Theory and Research*, ed. Roderick M. Kramer and Tom R. Tyler (Thousand Oaks, CA: Sage, 1996), 261, 282.

Recent discussions by both scholars and the business press suggest that trust is a central factor in organizational behavior and organizational survival for both public and private organization. Several scholars have recently proposed that trust is a central factor enhancing organizations’ long-term success and survival, especially because environments have become more uncertain and competitive.

See Jordan D. Lewis, *Trusted Partners: How Companies Build Mutual Trust and Win Together* (New York: Free Press, 1999); Christel Lane and Reinhard Bachmann, eds., *Trust Within and Between Organizations* (Oxford: Oxford University Press, 1998); and “Special Topic Forum on Trust in and Between Organizations,” *Academy of Management Review* 23, no. 3 (1998): 384–640.

7. See Dennis Reina and Michelle Reina, *Trust and Betrayal in the Workplace: Building Effective Relationships in Your Organization* (Oakland, CA: Berrett-Koehler, 2015); Ken Blanchard and Jesse Lyn Stoner, *Full Steam Ahead: Unleash the Power of Vision in Your Work and Your Life* (San Francisco, CA: Berrett-Koehler, 2011) (“People follow leaders by choice. Without trust, at best you get compliance.”); and Christel Lane, “Introduction: Theories and Issues in the Study of Trust,” in *Trust Within and Between Organizations*, 1 (“Trust is increasingly being viewed as a precondition for superior performance and competitive success in the new business environment.”); Sue Shellenbarger, “Workplace Upheavals Seem to Be Eroding Employees’ Trust,” *Wall Street Journal*, June 21, 2000.

8. Buffett is quoted as follows in a June 30, 1993, interview published in *Outstanding Investor Digest*:

What we refer to as a “moat” is what other people might call competitive advantage. It’s something that differentiates the company from its nearest competitors—either in service or low cost or taste or some other perceived virtue that the product possesses in the mind of the consumer versus the next best alternative. There are various kinds of moats. All economic moats are either widening or narrowing—even though you can’t see it.

See Michael E. Porter, *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press, 1980); Clayton Christensen, *The Innovator’s Dilemma: When New Technologies Cause Great Companies to Fall* (Boston: Harvard Business Review, 1997).

9. Mani, “Warren Buffett to Acquire Detlev Louis Motorradvertriebs In Europe Push,” *Value Walk*, February 20, 2015, <https://www.valuewalk.com/2015/02/warren-buffett-detlev-louis/>.

10. Beiten Burkhard, “Advises Ute Louis on the Sale of Detlev Louis Motorradvertriebs GmbH,” company statement, February 20, 2015.

11. “What Do You Get When You Cross Warren Buffett With a Motorcycle?” *Motley Fool*, February 21, 2015.

12. European Union, “Commission Clears Acquisition of Detlev Louis Motorradvertriebs by Berkshire Hathaway,” press release, April 27, 2015.

13. Alexander Möthe and Astrid Dörner, “Warren Buffet’s German To-Do-List,” *Handelsblatt*, February 25, 2015; see also Steve Jordon, “Warren Watch-Buffett’s ‘German Scout’ on the Hunt,” *Omaha World-Herald*, March 22, 2015.

14. This book adapts and significantly reworks material from more than twenty pieces written from 2013 to 2018 by Lawrence Cunningham and edited principally by Stephanie Cuba:

2018:

- “Warren Buffett on Mentoring,” *NACD Directorship*, July-August 2018;
- “How Shareholders Have Built, Preserved Berkshire,” *Omaha World-Herald*, May 5, 2018.

2017:

- “Warren Buffett’s Ten Commandments for Directors,” *NACD Directorship*, July-August 2017;
- “Berkshire Managers Flourish in Decentralized Structure,” *Omaha World-Herald*, May 7, 2017;
- “Unilever Deal Is Dead, but Buffett’s ‘Big Game’ Danger Lives On,” *CNBC*, February 22, 2017;
- “Contract Interpretation 2.0: Not Winner Take All but Best Tool for the Job,” *George Washington Law Review* 85, no. 6 (2017): 1625–59.

2016:

- “The Writings of a Joyous Investor,” *NACD Directorship*, July-August 2016;
- “Berkshire Hathaway: From Value Investing to Trust Managing,” *Manual of Ideas*, May 2016;
- “Culture of Autonomy Makes Berkshire’s Size More Strength Than Weakness,” *Omaha World-Herald*, April 30, 2016;
- “Berkshire’s Blemishes: Lessons for Buffett’s Successors, Peers and Policy,” *Columbia Business Law Review* 1, no. 1 (2016): 1–59.

2015:

- “Warren Buffett Arrives in Europe: Seeking Quality Companies to Preserve and Protect,” *European Financial Review*, December 28, 2015;
- “Warren Buffett and Wall Street: The Best of Frenemies,” *Financial History* (Fall 2015);
- “Minus the Middleman: Berkshire Model Offers Profitable Lessons,” *Omaha World-Herald*, May 1, 2015;
- “The Philosophy of Warren E. Buffett,” *New York Times*, April 30, 2015;
- “Why Warren Buffett’s Son Isn’t the Heir Apparent,” *CNBC*, March 11, 2015;
- “Understanding Succession at Berkshire After Buffett,” *New York Times*, March 2, 2015;
- “The Secret Sauce of Corporate Leadership,” *Wall Street Journal*, January 25, 2015;
- “Intermediary Influence and Competition: Berkshire versus KKR,” *University of Chicago Law Review Dialogue* 82, no. 1 (2015): 177–99;
- “Berkshire’s Disintermediation: A Managerial Model for the Next Generation,” *Wake Forest Law Review* 50 (2015): 509–31.

2014:

- “Ocwen Would Do Well to Follow the Lessons of Berkshire’s Clayton Homes,” *New York Times*, December 24, 2014;
- “Big-Hearted Warren Buffett’s Guide to Giving,” *CNBC*, December 5, 2014;
- *Berkshire Beyond Buffett: The Enduring Value of Values* (New York: Columbia University Press 2014), chap. 8.

15. See Warren E. Buffett, “Before the Subcommittee on Telecommunications and Finance of the Energy and Commerce Committee of the U.S. House of Representatives” (1991), reprinted in *Wall Street Journal*, May 1, 2010.

1. The Players

1. See Deborah A. DeMott, “Agency Principles and Large Block Shareholders,” *Cardozo Law Review* 19, no. 2 (1997): 321–40.
2. See Lawrence E. Mitchell “The Human Corporation: Some Thoughts on Hume, Smith, and Buffett,” *Cardozo Law Review* 19, no. 2 (1997): 341.
3. *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928).

4. See Amy Deen Westbrook, “Warren Buffett’s Corporation: Reconnecting Owners and Managers,” *Oklahoma City University Law Review* 34, no. 3 (2009): 515–48.

5. See Michael Eisner and Aaron R. Cohen, *Working Together: Why Great Partnerships Succeed* (New York: Harper Collins, 2014).

6. See Melvin A. Eisenberg, “The Board of Directors and Internal Control,” *Cardozo Law Review* 19, no. 2 (1997): 237–64.

7. See Jill E. Fisch, “Taking Boards Seriously,” *Cardozo Law Review* 19, no. 2 (1997): 265–90.

8. Gary Strauss, “Directors See Pay Skyrocket,” *USA Today*, October 26, 2011. Among other lower-paying boards, consider Credit Acceptance Corporation and Constellation Software Inc. (on which author Lawrence Cunningham serves).

9. See Mark Calvey, “Berkshire Hathaway Director Susan Decker Offers Rare Peek Into Warren Buffett’s Boardroom,” *San Francisco Business Times*, December 9, 2014.

10. See James D. Cox and Harry L. Munsinger, “Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion,” *Law and Contemporary Problems* 48, no. 3 (1985): 83–135.

11. See Charles McGrath, “80 Percent of Equity Market Cap Held by Institutions,” *Pensions & Investments*, April 25, 2017. Exact figures vary depending on timing, data, and definition of market scope. Similar figures emerge from examining Federal Reserve data from 1965 through 2015 as calculated by Gary Previts of Case Western Reserve University and on file with Lawrence Cunningham.

12. Lawrence Cunningham’s current research investigates the significance of such shareholder demographics across corporate America. It highlights what he calls quality shareholders, those who concentrate and hold long term, in contrast to indexers who do not concentrate and transients who do not hold long. They add substantial value to corporate affairs that such indexers and transients do not.

13. Warren E. Buffett and Lawrence A. Cunningham, *The Essays of Warren Buffett: Lessons for Corporate America*, 4th ed. (New York: The Cunningham Group; distributed by Carolina Academic Press, 2015), 101 (from the 1993 letter).

14. Buffett and Cunningham, *The Essays of Warren Buffett*, 27–28 (from the 1979 letter, later republished in *An Owner’s Manual* and ensuing annual reports from 1996).

15. See Richard Teitelbaum, “Berkshire Billionaire Found with More Shares Than Gates,” *Bloomberg News*, September 17, 2013.

16. Andrew Kilpatrick, *Of Permanent Value: The Story of Warren Buffett* (Birmingham, AL: AKPE, 2018).

17. Among the rare exceptions are the transfer of residual assets of Dexter Shoe into H. H. Brown Shoe after the former's business deteriorated and the reassignment of Brad Kinstler from Cornhusker Casualty, to Fechheimer Brothers, to See's Candies.

18. See Robert P. Miles, *The Warren Buffett CEO: Secrets from the Berkshire Hathaway Managers* (New York: Wiley, 2003), 357–58.

19. Just a year before Whitman passed, he gave Lawrence Cunningham the honor of writing the foreword to a family memoir Whitman had written, from which this is adapted.

20. Other examples include Jim Weber and Tom Manenti. Weber said he's never been trusted so much in his career, which makes him feel even more accountable. Manenti said being so trusted by Buffett enabled him to trust his team members with enormous delegated responsibility.

2. Partnership Practices

1. Reluctantly, Berkshire terminated the program when social advocates opposed to some donor choices boycotted the products of a Berkshire subsidiary.

2. Today, Class A shares have one vote per share and an equivalent claim to the economic interest, such as dividends, whereas the Class B shares have 1/10,000 of that voting power and 1/1,500 of that economic interest.

3. William Zissner, *On Writing Well* (New York: Harper Collins 1990), 58.

3. Business Methods

1. Insolvency resulting from poor underwriting was nearly the fate of Berkshire's GEICO subsidiary in the 1970s before Berkshire acquired it, and of Gen Re in the 2000s just after Berkshire acquired it.

2. These figures are inferential. Buffett's 2010 letter to shareholders noted that Berkshire's annual rent for headquarters was \$270,212 and total investments in the facility amounted to \$301,363. Warren E. Buffett and Lawrence A. Cunningham, *The Essays of Warren Buffett: Lessons for Corporate America*, 4th ed. (New York: The Cunningham Group; distributed by Carolina Academic Press, 2015), 80 (from the 2010 letter). Berkshire's 2018 proxy

statement, listing the highest-paid Berkshire employees, names the CFO with base salaries in 2015, 2016, and 2017 of, respectively, \$1.35 million, \$1.55 million, and \$1.775 million.

3. Lawrence A. Cunningham, *Berkshire Beyond Buffett* (New York: Columbia University Press, 2014), 213.

4. Only one came from a broker Berkshire retained—an anomalous case in which Buffett asked a Berkshire unit CEO, David Sokol, to initiate the search. The epilogue elaborates.

4. Deals

1. John Mueller, *Capitalism, Democracy and Ralph's Pretty Good Grocery* (Princeton, NJ: Princeton University Press, 1999), 96.

2. See Lawrence A. Cunningham, *Berkshire Beyond Buffett: The Enduring Value of Values* (New York: Columbia University Press, 2014), 11: “During the mid-1980s, Berkshire would divest a few other failing businesses the Buffett Partnership had initially acquired—such as the department store chains Diversified Retailing, Associated Retail Stores, and Hochschild Kohn—but thereafter forswore doing so.” It was then that Buffett discerned the economic value to sellers of Berkshire’s promise of permanence. It was not until 2019 that Berkshire divested another subsidiary, in this case Applied Underwriters, a small specialty insurer whose sale was reportedly triggered by Berkshire’s concurrent ownership of several rival companies operating in the same line. See Nicole Friedman, “Warren Buffett Is Doing Something Rare: Selling a Business,” *Wall Street Journal*, February 27, 2019.

3. Benjamin Moore; BNSF; Clayton Homes; CTB; Dairy Queen; Fruit of the Loom; Garan; Gen Re; Johns Manville; Justin; Lubrizol; MidAmerican Energy; Precision Castparts; Shaw Industries; and XTRA. It also joined in the acquisition of Heinz, followed by its merger with Kraft.

4. We confirmed our hunch about Munger’s drafting role by conferring with Robert Denham and Ronald Olson, two lawyers who were involved in the transaction and are still partners of the firm.

5. Such fiduciary “outs” did not become standard until shortly after this time. But even at this time, they were emerging with some frequency and taken seriously by courts, including in that year’s landmark case, *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

6. See Restatement (Second) of Contracts 193 (1981).

7. See Thomas Petzinger Jr., *Oil & Honor: The Texaco-Pennzoil Wars* (Washington, DC: Beard, 1987).

5. Boards

1. Lawrence A. Cunningham, “Conversations from the Warren Buffett Symposium” (transcript), *Cardozo Law Review* 19, no. 2 (1997): 719, 737; reprinted in Lawrence A. Cunningham, *The Buffett Essays Symposium: A 20th Anniversary Annotated Transcript* (Petersfield, UK: Harriman House, 2016), 13.

2. We owe this point to Ronald Olson, a Berkshire director and partner of Munger, Tolles & Olson.

3. Warren E. Buffett and Lawrence A. Cunningham, *The Essays of Warren Buffett: Lessons for Corporate America*, 4th ed. (New York: The Cunningham Group; distributed by Carolina Academic Press, 2015), 47 (from the 2002 letter).

6. Internal Affairs

1. See Stephen M. Bainbridge, “A Critique of the NYSE’s Director Independence Listing Standards,” *Securities Regulation Law Journal* 30, no. 4 (2002): 370, 381.

2. Compare Kelli A. Alces, “Beyond the Board of Directors,” *Wake Forest Law Review* 46 (2011): 783–836, with Stephen M. Bainbridge, “Director Primacy: The Means and Ends of Corporate Governance,” *Northwestern University Law Review* 97, no. 2 (2003): 547–607.

3. See Marcel Kahan and Edward Rock, “Embattled CEOs,” *Texas Law Review* 88, no. 987 (2010): 201–10.

4. See Tom C. W. Lin, “The Corporate Governance of Iconic Executives,” *Notre Dame Law Review* 87, no. 1 (2011): 351–82 (suggesting that iconic CEOs win too much organizational and legal deference, citing Steve Jobs; are prone to overconfidence, citing Buffett; and can even be licentious, citing Michael Eisner).

5. See Melvin A. Eisenberg, “The Board of Directors and Internal Control,” *Cardozo Law Review* 19, no. 2 (1997): 237–64.

6. See Michael Power, *The Audit Society: Rituals of Verification* (Oxford: Oxford University Press, 1997).

7. Warren E. Buffett and Lawrence A. Cunningham, *The Essays of Warren Buffett: Lessons for Corporate America*, 4th ed. (New York: The Cunningham Group; distributed by Carolina Academic Press, 2015), 298 (from the 2014 letter).

8. Gary S. Becker, “Crime and Punishment: An Economic Approach,” *Journal of Political Economy* 76, no. 2 (1968): 169–217.

9. David A. Skeel, Jr., “Shaming in Corporate Law,” *University of Pennsylvania Law Review* 149, no. 6 (2001): 1811–68; Margaret M. Blair and Lynn A. Stout, “Trust, Trustworthiness and the Behavioral Foundations of Corporate Law,” *University of Pennsylvania Law Review* 149, no. 6 (2001): 1735–810.

7. Contrasts

1. See Warren E. Buffett, Before the Subcommittee on Telecommunications and Finance of the Energy and Commerce Committee of the U.S. House of Representatives (1991), reprinted in *Wall Street Journal*, May 1, 2010. 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.

2. Eileen Appelbaum and Rosemary Batt, *Private Equity at Work* (New York: Russell Sage, 2014), 2.

3. Matthew D. Kain, Stephen B. McKeon, and Steven Davidoff Solomon, “Intermediation in Private Equity: The Role of Placement Agents,” July 14, 2017, <https://ssrn.com/abstract=2586273>.

4. Ryan Kantor and Ryan Sullivan, “A Lawyer’s Guide: Valuation Issues in Private Equity Funds,” December 6, 2012, <https://ssrn.com/abstract=2408295>.

5. Guy Fraser-Sampson, *Private Equity as an Asset Class* (Hoboken, NJ: Wiley, 2007) 9.

6. Appelbaum and Batt, *Private Equity*, 71–72.

7. Id. 68–71, 286–87.

8. Id. 282.

9. See Victor Fleischer, “Two and Twenty: Taxing Partnership Profits in Private Equity Funds,” *NYU Law Review* 83, no. 1-59 (2008).

10. See Gretchen Morgenson, “Private Equity’s Free Pass,” *New York Times*, July 26, 2014; John C. Coffee Jr., “Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated,” *Cornell Law Review* 97, no. 5 (2012): 1019–82.

11. The Berkshire model is not exactly the stakeholder model, which may elevate other constituents above shareholders or make many or all of them *pari passu*.

12. George P. Baker and George David Smith, *The New Financial Capitalists: Kohlberg Kravis Roberts and the Creation of Corporate Value* (New York: Cambridge University Press, 1998).

13. Barker and Smith, *The New Financial Capitalists*, 100.

8. Comparisons

1. Kris Frieswick, *ITW: Forging the Tools for Excellence* (Bainbridge Island, WA: Fenwick, 2012), 67–70.

2. *Id.* 63–64.

3. This discussion about Marmon is adapted from Lawrence A. Cunningham, *Berkshire Beyond Buffett* (New York: Columbia University Press, 2014) and is informed by both interviews and a 2015 book tour event Cunningham hosted with Marmon’s Frank Ptak at Northwestern University (Chicago, February 11, 2015).

4. See Tim Mullaney, “Opinion: The True Mastermind of Google’s Alphabet? Warren Buffett,” *Marketwatch*, August 17, 2015, <https://www.marketwatch.com/story/the-true-mastermind-of-googles-alphabet-warren-buffett-2015-08-17> (extensively quoting Cunningham comparing aspects of the models).

9. Judgment

1. See Peter Lattman, “A Record Buyout Turns Sour for Investors,” *New York Times*, February 28, 2012.

2. See Deena Shanker and Craig Giammona, “Kraft Heinz Slumps on SEC Subpoena, \$15.4 Billion in Writedowns,” *Crain’s Chicago Business*, February 21, 2019.

3. See *Revlon v. MacAndrews & Forbes*, 506 A.2d 173 (Del. 1986).

4. See *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989).

5. See *Denver Area Meat Cutters v. Clayton*, 209 S.W.2d 584 (Tenn. Ct. App. 2006); *Denver Area Meat Cutters v. Clayton*, 120 S.W.3d 841 (Tenn. Ct. App. 2003).

10. Public Perception

1. Mark Greenblatt, “Berkshire Insurance Payments Criticized,” *Scripps*, October 6, 2013.

2. Berkshire Hathaway, News Release October 31, 2013.

3. Berkshire stressed that its payments in this business for claims and claims-expenses exceeded \$2.4 billion annually and \$20 billion cumulatively. It references honoring its multipronged duties to policyholders, insurers, and reinsurers for which it manages claims, regulators, and shareholders “who expect us to operate well above any minimum standards of practice for our business.” Berkshire also noted winning respect from all such constituencies, and awards from peers and industry trade groups. Acknowledging that the runoff and legacy areas involve complex contested claims, it said these cannot be reduced to sound bites, although the piece had tried to do just that. Berkshire stressed that it disfavors public comments on pending cases, but that it felt constrained to defend against a report that seemed calculated to influence those cases.

4. John Sylvester, “Policyholder Litigation Involving Claims Handling by Resolute Management Inc.” (presentation to the American Bar Foundation, January 2014).

5. For example, Dean Starkman, “AIG’s Other Reputation; Some Customers Say the Insurance Giant Is Too Reluctant to Pay Up,” *Washington Post*, August 21, 2005.

6. Daniel Wagner and Mike Baker, “Warren Buffett’s Mobile Home Empire Preys on the Poor,” April 3, 2015, <http://www.publicintegrity.org/2015/04/03/17024/warren-buffetts-mobile-home-empire-preys-poor>.

7. The piece called out its own key findings: using multiple corporate names to make buyers believe they are shopping around; lending at rates exceeding 15 percent and adding significant fees; customers complained of deception and predation via changes, pressure, and fees; and two former dealers said headquarters pressured them into channeling customers to borrow from Clayton despite these problems.

8. “Clayton Homes Statement on Mobile-Home Buyer Investigation,” *Omaha World Herald*, April 3, 2015.

9. Daniel Wagner and Mike Baker, “A Look at Berkshire Hathaway’s Response to ‘Mobile Home Trap’ Investigation,” April 6, 2015, <http://www.publicintegrity.org/2015/04/06/17081/look-berkshire-hathawaysresponse-mobile-home-trap-investigation>.

10. Mike Baker, “Buffett Sticks Up for Mobile-Home Business at Shareholder Meeting,” *Seattle Times*, May 2, 2015. All the claims contradict everything Clayton Homes stands for, as explained in both *Berkshire Beyond Buffett*, and in a *New York Times* column by Lawrence Cunningham several months before Baker’s May 2, 2015 piece. Clayton Homes cited Cunningham’s column in its response, which Wagner and Baker dismissed in rebuttal as written by “a longtime Buffett acolyte.”

11. Compare Clayton Homes, “Manufactured Home Living News,” press release, May 18, 2015, <http://www.reuters.com/article/2015/05/18/idUSnGNX5smRmG+1c5+GNW20150518> (speaking of the importance of opposing regulation to facilitate access to manufactured housing) with Zach Carter, “House Republicans Hand Warren Buffett Big Win on Expensive Loans to the Poor,” *Huffington Post*, April 14, 2015, http://www.huffingtonpost.com/2015/04/14/manufactured-housing-republicans_n_7065810.html (as the title suggests, supporting regulation to protect the impecunious from high-cost loans).

12. Mike Baker, “Buffett’s Mobile Home Business Plan Has Most to Gain from Deregulation Plan,” *Seattle Times*, May 17, 2015, <http://www.seattletimes.com/business/real-estate/buffetts-mobile-home-business-has-most-to-gain-from-deregulation-plan/>; Baker, “Buffett Sticks Up for Mobile-Home Business.”

13. Ariz. Admin. Code, R14-2-1802 et seq; see ASU Energy Policy Innovation Council, Net Metering Rules Brief Sheet (Dec. 2013), https://energypolicy.asu.edu/wp-content/uploads/2014/01/Policies-to-Know-Arizona-Net-Metering-Rules-Brief-Sheet_Updated.pdf.

14. Reem Nasr, “Ground Zero in the Solar Wars: Nevada,” *CNBC*, May 26, 2015, <https://www.cnbc.com/2015/05/26/ground-zero-in-the-solar-wars-nevada.html>.

15. Mark Chediak, Noah Buhayar, and Margaret Newkirk, “Warren Buffett Is Sending Mixed Messages on Green Energy,” *Bloomberg Business*, May 18, 2015.

11. Scale

1. Robert Miles, *The Warren Buffett CEO: Secrets from the Berkshire Hathaway Managers* (New York: Wiley, 2003).

2. See Sanjai Bhagat, Andrei Shleifer, and Robert W. Vishny, “Hostile Takeovers in the 1980s: The Return to Corporate Specialization,” *Brookings Papers on Economic Activity: Microeconomics*, ed. M. N. Baily and C. Winston (Washington, DC: Brookings Institution, 1990), 1–84.

3. Robert Sobel, *ITT: The Management of Opportunity* (Washington, DC: Beard Books, 2000); George A. Roberts, with Robert J. McVicker, *Distant Force: A Memoir of the Teledyne Corporation and the Man Who Created It* (Thousand Oaks, CA: Teledyne Corporation, 2007); and Gerald F. Davis, Kristina Diekman, and Catherine H. Tinsley, “The Decline and Fall of the Conglomerate Firm in the 1980s: The Deinstitutionalization of an Organizational Form,” *American Sociological Review* 59, no. 4 (1994): 547–70.

4. George P. Baker and George David Smith, *The New Financial Capitalists: Kohlberg Kravis Roberts and the Creation of Corporate Value* (New York: Cambridge University Press, 1998), 168.

5. Davis et al., “The Decline and Fall of the Conglomerate Firm,” 554.

6. See Lawrence A. Cunningham, “Conversations from the Warren Buffett Symposium (Transcript),” *Cardozo Law Review* 19, no. 2 (1997), 719, 736–37, 813; reprinted in Lawrence A. Cunningham, *The Buffett Essays Symposium: A 20th Anniversary Annotated Transcript* (Petersfield, UK: Harriman House, 2016), 13, 73.

12. Succession

1. See “Berkshire Hathaway: Playing Out the Last Hand,” *Economist*, April 26, 2014; “Berkshire Hathaway: The Post-Buffett World,” *Economist*, January 10, 2015.

2. Steven Davidoff Salomon, “With His Magic Touch, Buffett May Be Irreplaceable for Berkshire,” *New York Times*, May 21, 2013.

3. See Gerald F. Davis, “The Twilight of the Berle and Means Corporation,” *Seattle University Law Review* 34 (2011): 1121–38; see also Jeffrey N. Gordon, “Corporations, Markets, and Courts,” *Columbia Law Review* 91, no. 8 (1991): 1931–88.

4. See Deborah A. DeMott, “Agency Principles and Large Block Shareholders,” *Cardozo Law Review* 19, no. 2 (1997): 321–40.

Epilogue: The Stick of Ruthlessness

1. Berkshire Hathaway, *Annual Report: Chairman’s Letter*, 2009.

2. Warren Buffett, “Opening Comments” (Berkshire Hathaway Annual Meeting, Omaha, NE, April 30, 2011).

3. Buffett, “Opening Comments.”

4. Buffett, “Opening Comments” (responding to shareholder questions).

5. See Steve Schaefer, “Buffett Breaks Out Elephant Gun for \$9B Lubrizol Buy,” *Forbes*, March 14, 2011; and Katya Wachtell, “Meet John Freund: Warren Buffett’s Broker of 30 Years and the Citi Banker Who Alerted Him to Sokol’s Deception,” *Business Insider*, May 2, 2011.

6. See also “David Sokol Defends His Controversial Lubrizol Stock Purchases” (transcript), CNBC, April 1, 2011, <http://www.cnbc.com/id/42365586>.

7. 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).

8. Buffett, “Opening Comments” (responding to shareholder questions); Charlie Munger (Berkshire Hathaway Annual Meeting, Omaha, NE, April 30, 2011) (responding to shareholder questions).

9. 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”; Jenny Strasburg, “Buffett Is Seen as Too Trusting,” *MarketWatch*, March 31, 2011.

10. Berkowitz, “Sokol Affair,” quoting John Coffee of Columbia University: “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 act any 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 longstanding 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 the command-and-control approach would displace the value of the autonomy-and-trust culture and stimulate more behavior that veered close to the edge.

11. Munger (responding to shareholder questions).

12. See Warren E. Buffett, “Before the Subcommittee on Telecommunications and Finance of the Energy and Commerce Committee of the U.S. House of Representatives” (1991), reprinted in *Wall Street Journal*, May 1, 2010. Buffett’s admonition began as follows:

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.

13. 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 trust-based culture and urged that the board had 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 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. *In re Berkshire Hathaway*.

14. 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."

15. Attorney for David Sokol, "Statement of Dickstein Shapiro Partner Barry Wm. Levine," press release, April 27, 2011.

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