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Warren Buffett's Mistake: How The Saint Of Capitalism Damaged His Reputation

By Saki Knafo

Yesterday morning, thousands of shareholders of Berkshire Hathaway, one of the world's most well-regarded companies, flocked to a convention hall in Omaha, Nebraska, for a meeting with their venerated leader, Warren Buffett.

Over the course of his long and extremely lucrative career, Buffett has built a reputation for himself as a paragon of integrity and virtue, and the annual meeting of his company's shareholders has come to resemble a sort of beatification ceremony, if you can imagine a religion in which the same person is beatified year after year. Buffett has called the gathering the "Woodstock of Capitalism," nicely evoking both the massiveness of the crowd and the blissed-out vibe that pervades it. The vibe going into this year's convention, however, was different.

The trouble began about five months ago, when David Sokol, a top lieutenant in Berkshire Hathaway, persuaded Buffett to take over a chemical-products manufacturer called Lubrizol. Buffett later said that he had initially been cool on the idea, and it's hard not to wonder if something Sokol told him bothered him on some level, even an unconscious one. At some point in their conversation, Sokol had mentioned that he owned personal stock in Lubrizol (his lawyer says that Buffett was in fact informed of this not once but twice), yet he didn't say how much he owned or how he'd come to own it.

As it turned out, Sokol had come to own the stock only a few weeks before, after learning about Lubrizol through a group of investment bankers who suggested that Berkshire look into buying the company. And as it also turned out, he'd come to own a lot of it — ten million dollars worth, to be exact. In other words, Sokol bought the shares knowing there was a chance he could convince Buffett to take over the company, which would almost certainly make the stocks' value shoot up.

Shoot up, it did. Buffett bought Lubrizol for 9 billion dollars, and Sokol's 10 million dollars became 13 million. Was this insider trading? Perhaps. The legalities are murky. But as any first-year business student could have told you, it reflected poor ethical judgment on Sokol's part. Sokol resigned when the full story came out, and is now under investigation by the Securities and Exchange Commission. Buffet's vaunted reputation, meanwhile, took a blow.

On Tuesday, an audit committee convened by Berkshire Hathaway released a report that sharply rebuked Sokol for violating the company's "highest standards of business ethics," while absolving Buffett and further distancing him from his former presumed successor. According to the report, Sokol first learned of Lubrizol last fall through investment bankers at Citigroup, who'd specifically come to him with the names of companies they thought might interest Buffett.

On December 13, a Monday, Sokol asked Citi to introduce him to Lubrizol's CEO, James Hambrick, and the next day, he made his first purchase of Lubrizol stock, 2,300 shares. That Friday, a Citi representative told Sokol that Hambrick had agreed to convey the news of Berkshire's possible interest to the Lubrizol board, and on Tuesday, Sokol unloaded his stock. But two weeks later, over the course of three days, he bought 96,060 shares for a total of $10 million.

On January 14, Hambrick and Sokol agreed to meet, and either that day or the next Sokol made his pitch to Buffett. The report says Buffett was "initially unimpressed," but asked how Sokol had learned of the company. Sokol "mentioned" that he owned Lubrizol stock but did not say how much he'd bought, or when he'd bought, or anything about his conversations with Citi or Lubrizol that might have caused concern. In fact, the report maintains that Buffett didn't learn of Citi's involvement until after Berkshire and Lubrizol announced the signing of the merger agreement in March, when "a Citi representative with whom Berkshire Hathaway did business congratulated Mr. Buffett" and mentioned that Citi investors had played a part.

In response to the report, a lawyer for Sokol said Sokol had been "studying Lubrizol for personal investment since the summer of 2010," and that when he bought the stock, he "had no reason to anticipate that Mr. Buffett would have any interest whatsoever in Lubrizol."

Despite the audit committee's apparent confidence in Buffett's blamelessness, Buffett still faces criticism over a letter that he wrote to the media last month, in which he announced Sokol's resignation while playing down any suggestion that the younger man had done anything wrong. "Neither Dave nor I feel his Lubrizol purchases were in any way unlawful," he wrote. This seemed surprising coming from a businessman who has constantly exhorted his employees not just to stay within the law but to do what's ethically right, who famously said, "Lose money for the firm and I will be understanding, lose even a shred of reputation and I will be ruthless."

After his letter came out, questions swirled: What had happened to the valiant hero who'd made that famous vow? Had Buffett grown soft? Had he lost the will or the nerve required to be ruthless?

At the meeting yesterday, Buffett was harder on Sokol, and on himself. He called the situation "inexplicable and inexcusable" and said, ""I obviously made a big mistake by not saying, 'Well when did you buy it?"

So why didn't he? The most obvious and plausible explanation is the one that casts Buffett in the kindest light. Buffett built his company on the principle that the managers under him should be allowed to operate with as much freedom as possible. Had Berkshire Hathaway been an ordinary company, Sokol might have had to report his stock purchases to a legal department, but no one has ever accused Berkshire Hathaway of being a ordinary company.

Only 21 people, including Buffett himself, work at the company's headquarters, which occupy a single floor of an office building in Omaha. Berkshire is often described as "decentralized," which is another way of saying that it's centered around Buffett's trust in his managers. "Trust has gotten Berkshire very far," said Jeff Matthews, a Berkshire Hathaway shareholder and the author of "Secrets in Plain Sight: Business & Investing Secrets of Warren Buffett."

"It's worked," he said. "People do what they're good at, they do what they love to do. They don't work for the money, they work for the joy of it. They don't have some home office MBA telling them how to run a business."

Buffett trusted Sokol. In his 11-year tenure at Berkshire Hathaway, Sokol had proven highly adept at earning Buffett money, and Buffett, in turn, had endowed Sokol with a great amount of responsibility. Most recently, he'd put him in charge of NetJets, a Berkshire subsidiary that offered rentals and fractional ownerships of luxury jets and specialized in causing Buffett distress; it lost $711 million before taxes in 2009.

Sokol ordered a gut renovation of NetJets, reducing its debt from 1.9 billion to 1.3 billion, slashing about $100 million in costs, furloughing hundreds of pilots, and sweeping senior management out the door.

This turned out to be the right move. Within a year, NetJets was posting profits again, as Buffett triumphantly reported in a letter to shareholders, lauding the "breadth and importance of Dave Sokol's achievements" just a week before the impropriety of Sokol's Lubrizol purchase came to light.

By giving free reign to Sokol, who many considered to be his top choice for a successor, Buffett opened the way for a breach like this to happen. In other words, the very quality that has arguably made Buffett one of the most admired business leaders in history, never mind the third-richest man in the world, is the same quality that exposed his company to abuse.

Which is not to say that Buffett himself is perfect. Far from it. He's been linked to questionable dealings before, notably in 2004, when General Re, an insurance concern that Buffett had owned since 1998, came under investigation for conducting fraudulent business with American International Group in 2000.

Then, as now, Buffett was criticized for granting an executive too much leeway to operate; in that case, the role of Sokol was played by Ronald Ferguson, then the CEO of General Re. In 2008, a jury convicted Ferguson and three other former General Re executives, along with one former AIG executive, on corporate fraud and conspiracy charges, and Ferguson was sentenced to three years in prison.

So Buffett's management style is a gamble, and it's possible that if he were to adopt a more cautious approach he wouldn't be nearly as successful as he is. Of course, that still doesn't answer the question of why he defended Sokol even after the full story of his purchases was disclosed.

success in life by how many of the people you want to have love you do love you. I know people who have a lot of money, and they get testimonial dinners and they get hospitals wings named after them. But the truth is that nobody in the world loves them."

If it's true that Buffett initially held back from censuring Sokol out of some fear of losing respect or admiration or even love, how ironic that this misstep should cost him so much of those very things. At yesterday's meeting in Omaha, Buffett took steps to restore them. He discussed the possibility of two acquisitions that would be about the size of the Lubrizol deal, and said that he was considering someone new to step into his shoes.

"I would lay a lot of money," he said, "on him being straight as an arrow."

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