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How Warren Buffett Protégé David Sokol Lost His Way

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From the panoramic windows of his 20th-floor corporate law office, Harold J. Daub Jr., a Republican former four-term congressman and mayor of Omaha, shows the imprint his longtime friend David L. Sokol has made on their hometown. Daub points out the emerald field of the TD Ameritrade (AMTD) baseball stadium, brand-new home of the College World Series. As a board member of the municipal arena authority, "Dave Sokol did as much as any citizen of Omaha to get that beautiful thing built," Daub says. The same nonprofit board oversees the Qwest Center, where Berkshire Hathaway (BRK.A), Sokol's former employer, holds its annual meeting on Apr. 30. "Over there, that's Creighton University," Daub continues, "and that lovely red brick building is the D.J. Sokol Arena." The tidy 2,500-seat gymnasium for women's basketball and volleyball is named for Sokol's late son, who died of Hodgkin's disease in 1999, a few weeks after graduating from high school. "And Dave isn't even a Creighton alum; he's UNO"–University of Nebraska at Omaha–"and one of their big supporters, too," Daub says. "The man puts his money where his mouth is, that's for darn sure."

Putting his money behind personal convictions of a different sort has now landed Sokol in deep trouble. Until Mar. 30, he was widely seen as heir apparent to 80-year-old Warren E. Buffett, Berkshire's chief executive officer and the prophet of heartland common sense. That day, Buffett made headlines by announcing that Sokol, 54, would resign from Berkshire. On Wednesday, Apr. 27, Berkshire's audit committee again electrified the financial world. In a scathing 18-page report, it accused Sokol of violating company standards by misleading Berkshire about his personal stake in Lubrizol (LZ), a chemical manufacturer he recommended to Buffett as a takeover target. The committee stopped short of concluding that Sokol committed insider trading under federal law when he bought Lubrizol shares worth $10 million in January and then pitched the company to Buffett. But the company signaled that the former corporate star is now on his own, and Berkshire will cooperate "with any government investigations relating to this matter." The Securities and Exchange Commission is investigating, although a spokeswoman declined to comment.

Berkshire's harsh report intensifies the attention the Sokol affair has focused on the succession question at Berkshire, a company whose achievements and $205 billion market capitalization depend heavily on its reputation for "playing in the middle of the court," to use a famous Buffettism, and nowhere near the ethical boundary lines. Sokol's sudden fall has also shaken a city that takes tremendous pride in its association with Berkshire. "We're all sad, indeed," says Daub, a partner with the law firm Husch Blackwell. "It's a shock."

It's certainly not the outcome any who knew Sokol imagined for the assertive executive, who was not born to power or wealth and relied on his energy, competitiveness, and outsider's will to become the ultimate insider, Omaha-style–a protégé of two local business legends, builder Walter Scott Jr. and Buffett. As a member of their charmed circle, Sokol enjoyed access to opportunities unavailable to other executives. Buffett trusted him to scout multibillion-dollar investments and fix failing companies. Sokol repaid his mentor with clever deal ideas and extraordinary balance sheets.

"Dave Sokol is a real important guy around here," says Terry L. Moore, president of the Omaha Federation of Labor. Sitting at his usual breakfast table at the downtown Hilton, the AFL-CIO leader shakes his head in wonderment. He has negotiated with Sokol and done political battle against him. Despite their differences, Sokol had Moore's respect. "About the smartest business guy I know," Moore says. "We're all baffled by this–what happened, and why did it happen?"

The Berkshire committee's report provided a devastating version of the "what," suggesting that Sokol "intended to deceive" Buffett about several key aspects of the Lubrizol episode. The "why" remains more of a mystery: Why was Sokol, already a rich man with a vacation retreat near Jackson Hole, Wyo., and a yacht to go with a third home in Fort Lauderdale, dabbling in the stock of a company he suggested that his boss acquire?

On Wall Street, this kind of trading is often considered front-running. It's usually a firing offense, if not necessarily illegal. "It just doesn't smell right," says Andrew Kilpatrick, a retired stockbroker and author of *Of Permanent Value: The Story of Warren Buffett.* A Berkshire shareholder has sued Buffett and Sokol in Delaware Chancery Court, alleging that they put the company at risk of an SEC enforcement action. The audit panel said Berkshire is considering suing Sokol "to recover any damage the company has sustained, or his trading profits, or both." After Berkshire announced its $9 billion acquisition of Lubrizol on Mar. 14, the chemical maker's stock soared; Sokol may have pocketed as much as $3 million in profit, depending on whether he sold his shares.

The audit committee report constituted a startling reversal from an earlier written statement, issued Mar. 30, in which Buffett praised his protégé as a managerial genius. "Neither Dave nor I feel his Lubrizol purchases were in any way unlawful," Buffett wrote at that time. "He has told me that they were not a factor in his decision to resign." In a Mar. 31 interview with CNBC, Sokol went further, saying he had done nothing even remotely improper and that his resignation was unrelated to the Lubrizol stock incident. His attorney, Barry W.

Levine, said in a written statement that he was "profoundly disappointed" by the audit panel's report and that Sokol's trading was "specifically allowed by his employment agreement." Berkshire and MidAmerican Energy Holdings, a Berkshire unit that Sokol formerly headed, did not respond to phone messages or e-mail.

Leaving aside whether anything illegal occurred, there's the less technical matter of how someone so smart and successful could stumble over dealings that seem so trivial. Sokol's biography and interviews with people who know him fill in a picture of an executive who may have become too comfortable in his rarefied environment and, temporarily at least, lost his bearings. The outsider who became an insider grew accustomed to the unique access to deals afforded those in the Buffett circle. Sokol also got used to the unusual combination of stock trading and corporate stewardship that characterizes Berkshire. This lucrative mix can raise sticky questions about the insider's advantage. Over the years, Sokol has developed a high regard for his own integrity, much as Buffett has. Like the older man, Sokol has become a font of bromides about capitalism and the good life. His stumble illustrates an occasion when, for all his strengths, he apparently came to believe that if he did something, then, by definition, it was right.

If Sokol never quite escaped the shadow of his boss in the public sphere, those who know him speak of an intense man propelled by a mix of determination and ritual. Sokol rises at 5 a.m., jogs five miles, and lifts weights. He has an athlete's solid physique and flawless posture. He typically spends half the year on the road. On weekends, depending on the season, he hunts, fishes, or skis. He abhors lateness. By his own account, he keeps a notebook, updated monthly, in which he ranks all his aides in the order in which he would fire them if forced to do so. "Early on," he writes in *Pleased But Not Satisfied*, the autobiographical business treatise he self-published in 2007, "I figured if I worked harder, I at least would be the last person let go if such an eventuality occurred." He hands out copies of the slender volume to subordinates.

The grandson of Polish immigrants, Sokol was born in 1956, the youngest of five children. His father managed a food store. Growing up in blue-collar North Omaha, he writes, he often found himself "bruised and mildly in trouble." David attended a Catholic grade school and public high school. He wrestled, played football, and ran track. The grocery chain where he worked nights helped pay his tuition at the local campus of the University of Nebraska. He considered studying medicine but fainted at the sight of a cadaver, so he switched to civil engineering. As a young man, he writes, "I was not always the smartest individual in the groups I worked in, but I had a driving fear of failure that caused me to always give 110 percent no matter what the task was."

That fear served him well, and success came quickly. After stints at an architectural engineering firm and Citibank, Sokol signed on in 1983 to start a waste-to-energy business with $500,000 in seed money from a company called Ogden. In just six years, the subsidiary grew to a billion-dollar corporation with plants in Oklahoma and Oregon and more than 1,000 employees. Ogden took it public in 1989.

"Here I was, 32 years old and CEO of a New York Stock Exchange company," Sokol writes. "Then," he adds, "a real dose of the ugly side of human nature showed up." He clashed with the son of Ogden's CEO, and in 1990 he was shown the door. In his next job, as president of JWP, a New York contractor, Sokol uncovered what he considered accounting improprieties. "Integrity," he writes, "is merely doing what is right, even when no one is looking." He informed the JWP board of directors of the accounting problems and resigned in 1992.

At this point, hometown connections kicked in to rescue the young executive from the hazards of integrity. He received a phone call from Walter Scott, then the CEO of Peter Kiewit Sons', a nationally prominent construction company based in Omaha that had done work for Ogden. "Get back here to Omaha, and let's get something started," Scott said, according to Sokol's memoir.

The Scott-Sokol partnership evolved from a small geothermal business into what's now MidAmerican, a large and profitable utility with headquarters in Des Moines. Scott, a childhood friend of Buffett, sat on Berkshire's board and brought Sokol into the Buffett extended clan. In 2000, Berkshire acquired an 80 percent stake in MidAmerican and added the power company to an eclectic portfolio that now includes the car insurer Geico, Burlington-Northern Santa Fe, and the Nebraska Furniture Mart.

Sokol expanded MidAmerican with savvy acquisitions, and the company has a strong customer service record. For these labors, he has been well compensated. During the decade he ran MidAmerican since helping to arrange its buyout by Berkshire, he earned a total salary of $8.8 million, bonuses totaling $53.9 million, and $26.3 million in profit sharing, according to math done by Jeff Matthews, founder of RAM Partners (PPS), a hedge fund in Greenwich, Conn., and author of *Pilgrimage to Warren Buffett's Omaha*. Since 2000, by Matthews's tally, Sokol has sold MidAmerican stock and stock equivalents worth $145.5 million back to the company. It pays to be on the inside.

Sokol enthusiastically concurs with the adulation Buffett receives from nearly all quarters. "He is as soundly based in the fundamentals of business as any human in history," Sokol writes. "Warren creates a climate for business managers akin to playing in the Pro Bowl." Unlike the postseason exhibition football game, at Berkshire the bottom line counts. Sportsmanship, on occasion, gets overshadowed by brutal blocking and tackling.

Last year a state court judge in Omaha went out of his way to mention Sokol by name in a ruling that concluded that MidAmerican had acted "inequitably, unfairly, and dishonestly" in its dealings with shareholders of an irrigation project in the Philippines. The dispute stemmed from a complicated deal in which Sokol's company invested in the water project on the condition that if the project's "internal rate of return" fell below a certain level, the minority shareholders would lose their entire stake. Judge Gary B. Randall of Douglas County, Neb., ruled last April that MidAmerican's decision to change the method of calculating the internal rate of return, which Sokol directly oversaw, was intended to harm the other shareholders. Randall awarded the victims $32 million in damages and also gave them stock in the project that could yield substantial profits in the future.

"The judge accurately portrayed Sokol's conduct in this particular case as deliberately wrongful and betraying a partner," says James W. Kennedy, the New York lawyer who represented the minority shareholders. After MidAmerican appealed, the case settled out of court on confidential terms, Kennedy says. MidAmerican did not respond to requests for comment.

Whatever the settlement cost, it amounted to peanuts for MidAmerican, which had net earnings of $1.2 billion in 2010, up 7 percent. In his Mar. 30 statement, Buffett congratulated Sokol and his right-hand man, Gregory E. Abel, who now assumes sole leadership of the company, for "the best performance of any managers in the public utility field."

Moore, the Omaha labor leader, knows Sokol well in part because he has persuaded the executive to use union contractors for power plant construction at MidAmerican. Moore has also clashed with Sokol in their roles as Omaha political power brokers–most recently in a Republican campaign earlier this year to recall the city's Democratic mayor, Jim Suttle. Sokol wrote a check for $50,000 to help finance the recall; Moore helped organize the successful countereffort that kept Suttle in office.

"Someone once told me that Dave makes a beautiful omelet–just delicious–but he breaks a lot of eggs and leaves a mess," Moore says. "I don't think he worries too much about what other people think about the mess."

Omelet making describes Sokol's role at NetJets, a Berkshire property he has revived financially since parachuting in two years ago. A provider of fractional ownership of sleek executive airplanes, NetJets, based in Columbus, Ohio, had an aggregate pretax loss of $157 million in 11 years through 2009, according to Buffett's Feb. 26 annual letter to shareholders. That loss would have been hundreds of millions of dollars larger if NetJets hadn't enjoyed the benefit of Berkshire's rock-solid credit. Sokol turned the company upside down. In 2010, after layoffs, asset sales, and a management shakeup, NetJets earned a $207 million pretax profit.

Some NetJets employees, and especially ex-employees Sokol laid off, came to despise him. The personal website of Bloomberg News columnist Alice Schroeder, author of *The Snowball: Warren Buffett and the Business of Life*, became a venue for vituperation from current and former workers alleging that NetJets had been taxiing toward a recovery before Sokol arrived and that he harmed the company by shrinking it. Enraged, Sokol fired back in an unusual e-mail to NetJets workers last August (which Schroeder obtained and published). He decried "a campaign designed to decrease the number of owners in the NetJets program, poison our relationships with our business partners, and incite our team members into providing a reduced level of service." His detractors said the e-mail illustrated part of the problem. "David Sokol can tolerate no disagreement of any kind regarding his decisions," one anonymous commenter posted. "The mere fact of suggesting a different course of action is in and of itself an act of 'sabotage' to him."

In the end, of course, the opinion of one NetJets passenger matters the most: that of the owner. "I can't overstate the breadth and importance of Dave Sokol's achievements at this company," Buffett wrote in February to Berkshire shareholders. Buffett noted that he and his family have flown more than 5,000 hours on NetJets planes, with only superlative service.

Sokol made a lot of money for Buffett, and that in turn generated a lot of confidence in his ability. In addition to running companies for Berkshire, Sokol scouted investment opportunities. For much of 2008, as the Wall Street crisis worsened, Sokol served as Buffett's agent, assessing potential bargains created by the financial chaos. Urgent pleas came over a period of months from the top management of struggling Lehman Brothers, a victim of reckless dealing in subprime securities. In September 2008, Lehman's chief of investment banking, Hugh E. McGee III, reached out once again to Sokol. "McGee asked, 'Do you have any ideas to save us?' " according to a 2010 U.S. Bankruptcy Court examiner's report on Lehman. "Sokol, who was bear hunting in Alaska at the time, told McGee that he did not." Days later, Lehman filed court papers to begin liquidating.

On other occasions, Sokol pushed Buffett to act. Immediately after Lehman's collapse, Sokol pointed out that the stock of Constellation Energy Group (CEG), a Baltimore utility, was dropping fast. As the head of MidAmerican, the Des Moines power company, Sokol perceived a chance to buy assets at a sharp discount. With Buffett's approval, he rushed to Baltimore and struck a deal to acquire Constellation for $4.7 billion, staving off its bankruptcy. Before the acquisition could take place, a French competitor stepped in with a much higher bid. But Sokol's insight did not go unrewarded. Berkshire received more than $1 billion from Constellation, including breakup fees it had negotiated in the event its deal didn't go through–not at all shabby for a couple months' work.

This kind of lucrative opportunism is a big and underappreciated part of the Berkshire formula. Buffett has a reputation for being a benevolent owner, one who values and retains skilled management. As a result, many companies are eager to sell themselves to Berkshire. At the same time, Buffett's aura and track record open doors to non-ownership investments that others can only dream about. Examples of the latter include preferred investments Berkshire made in 2008 to prop up Goldman Sachs (GS) ($5 billion) and General Electric (GE) ($3 billion), when Wall Street panic threatened the stability of both companies. In exchange for these crucially timed gestures, Berkshire ultimately could receive more than $4 billion, including interest, redemption fees, and proceeds from warrants. That's on top of the repayment of Berkshire's $8 billion principal–profits simply not available to regular investors.

The Lubrizol incident and Sokol's abrupt demise occurred in this context: An ambitious executive appears to have taken advantage of his fortunate position within the Buffett universe to bring his boss a promising acquisition and–hey, why not?–make some cash for himself. As illustrated by his autobiography, Sokol regards himself as tough but highly principled, someone who instinctively does the right thing. Integrity, he writes, "is not as complicated or gray as many would have you believe. ... It is playing by the rules and not attempting to get around them."

His former employer said on Apr. 27 that Sokol forgot his own advice and violated both Berkshire's Code of Business Conduct and Ethics and its Insider Trading Policies and Procedures. The story began last fall, when bankers from Citigroup (C) sent Sokol a list of potential Berkshire acquisitions in the chemicals industry. Sokol met with the Citi bankers on Dec. 13, 2010. Sokol, who told CNBC that he had already independently identified Lubrizol as a winner, asked the Citi team to set up a meeting with the chemical maker's management. The next day, he put in an order to purchase 50,000 shares of Lubrizol on the open market. He acquired 2,300 shares, and sold them a week later.

On Jan. 5, the day before Lubrizol's management gathered to discuss a sale to Berkshire, Sokol again began to buy the company's stock. Within three days he had purchased 96,060 shares, worth about $10 million. In mid-January, he told Buffett he owned Lubrizol stock, but according to the audit committee, Sokol did not disclose to his boss that he had bought the shares after discussing Lubrizol with Citi and after learning that Lubrizol's CEO would report Berkshire's interest to his board.

On CNBC, Sokol framed this chronology as beginning with his own investment interests and extending only as an afterthought to Berkshire's. "I'm trying to invest my family's capital," he said, "and if I see a company that I think is interesting and potentially undervalued, to not mention it to Warren, to me, seems inappropriate." As for his own conduct, Sokol said it was blameless.

Berkshire's audit committee disagreed. The panel's report said that Sokol had acted throughout as a Berkshire representative. "If its representatives were to trade ahead of potential mergers in which they represented Berkshire Hathaway, they could undermine the trust that Berkshire Hathaway strives to earn from its potential merger partners," the committee said.

The Citi bankers were not trying to facilitate Sokol's personal stock trades; that's a task for his individual broker. Citi seeks fees from consummated takeovers—by Berkshire, not Sokol. Likewise, Lubrizol's management did not hustle to their boardroom in early January because Sokol was buying millions of dollars of the company's stock on the open market. They gathered in hopes of selling the whole operation to Warren Buffett for billions. Sokol had the opportunity to benefit personally because of his role as a high-level messenger from the home office in Omaha, the committee said.

Now the question inevitably arises: Has Sokol engaged in a similar pattern of trading before other acquisition pitches to Berkshire? The SEC can pull records to check. Whether or not there are ever government accusations of insider trading—an area of law suffused with ambiguity about who constitutes an "insider" and whether information is "material"—a lot of observers, including many Berkshire admirers, have already concluded that things went ethically awry.

"Look, everyone would think it's unfair if Warren Buffett personally bought stock ahead of Berkshire acquisitions," says Kilpatrick, the Buffett biographer, who is also a Berkshire shareholder. "It seems unfair for one of his top managers to do the same thing, whether or not it constitutes a prosecutable offense."

By emphatically distancing themselves from a talented executive, Buffett and his company are attempting to align themselves with the widely held opinion that in business the perception of fairness still counts.