A Free Pass for Warren Buffett? Berkshire Audit Committee's Mistake

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They blasted David Sokol days before Berkshire's annual meeting, but what of the company's chairman? Ethical questions remain.

In an attempt to damp down the controversy over l'affaire Sokol prior to Berkshire Hathaway's annual meeting Saturday, the company yesterday released a report of its Audit Committee, which found that David Sokol misled Warren Buffett, violated the company's insider trading policy, and failed to discharge the duty of candor owed the company (among other things).

In concluding that Sokol acted unethically -- in failing to be candid about his large purchases of Lubrizol stock when recommending a Berkshire acquisition to Buffett in mid-January -- the Audit Committee echoed the conclusions of many commentators, including this one. (It did not opine on whether Sokol violated insider trading or other laws.)
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As for Sokol, the Audit Committee said that in his discussion with Mr. Buffett in mid-January when he pitched the Lubrizol deal, he did not disclose:

- the amounts and timing of his Lubrizol purchases;
- the fact that he bought the shares after discussing Lubrizol with Citi and asked for its help in arranging a meeting with Lubrizol;
- the fact that Mr. Sokol bought shares after learning that Citi had discussed his request for a meeting with Lubrizol's CEO, who told Citi that he would discuss Berkshire Hathaway's possible interest in a transaction with his board.

The committee also said that Sokol misled the Berkshire CFO in March by dramatically down-playing the role of Citi in response to a direct question.

Okay. It's fine for the company to kick that dog, which is down to deal with some of the questions raised by this strange episode.

But the committee, after heavy breathing about how dedicated Berkshire is to highest ethical standards, didn't address two other obvious issues.

First, it gave Mr. Buffett a complete pass.

On the exchange between Buffett and Sokol in January, the Audit Committee says: "It did not cross Mr. Buffett's mind at that time that Mr. Sokol might have bought Lubrizol shares after seeking through investment bankers to initiate discussions with Lubrizol concerning a possible Berkshire Hathaway acquisition of Lubrizol." But shouldn't it have crossed his mind?

Admittedly, at that point Buffett was not interested in the acquisition, but it seems a fairly obvious set of questions (when did you buy, why, how much) to ask then or a few days later when Sokol brought the deal back, rather than just assuming Sokol had held the stock for a long time.
Moreover, the committee is largely silent on Buffett's bizarre public statement on March 30th (especially in retrospect) when announcing Sokol's resignation. That statement praised Sokol highly and said neither "Dave nor I feel the Lubrizol purchases were in any way unlawful." It ignored completely Sokol's ethical failures of which Buffett was then aware (Sokol asked for deletion of a sentence in Buffett's statement saying he had left because Lubrizol issues would prevent him from becoming Berkshire CEO -- which Buffett granted).

Second, it punted on the question of whether Berkshire's loose culture requires much more systematic procedures for approving trades by company insiders (as exist at most other companies constantly active in consideration of acquisitions or dispositions). The Audit Committee offers only the anodyne comment that it should "work with Company management and legal counsel to identify and implement lessons learned from these events, including possible enhancements to its procedures." This issue is not that hard -- there are numerous models out there -- and the committee could have indicated much more clearly that more effective procedures should be adopted.

The Berkshire Audit Committee, by properly criticizing Sokol, tried to draw the nettle from the controversy. But by failing to deal with Buffet's credulity in January and his lack of candor in March -- as well as the need for enhanced (industry standard) procedures to ensure compliance with company insider trading rules -- it just highlighted those issues for tough questioning at Saturday's annual meeting and beyond.

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