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# Berkshire's Disintermediation: Buffett's New Managerial Model

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# **BERKSHIRE'S DISINTERMEDIATION: BUFFETT'S NEW MANAGERIAL MODEL**

*Lawrence A. Cunningham*

## Abstract

*Berkshire Hathaway, among history's largest and most successful corporations, shuns middlemen; its chairman, the legendary investor Warren Buffett, excoriates financial intermediaries. The acquisitive conglomerate rarely borrows money, retains brokers, or hires consultants. Its governance is lean, using an advisory board and bucking all forms of corporate bureaucracy. Berkshire's shareholders also minimize the roles of intermediaries like stockbrokers and stock exchanges by trading little and holding for lengthy periods.*

*By exploring Berkshire's antipathy to intermediation, this article supports the view that public policy ought to make considerable room for companies to define their own internal business practices and that more companies ought to consider emulating aspects of Berkshire's disintermediation. While Buffett's legacy to date has been to lead two generations of value investors, Berkshire's radically ingenious disintermediation has the potential to shape the next two generations of value managers, as argued in this paper and at greater length in the author's recent book, *Berkshire Beyond Buffett: The Enduring Value of Values*.*

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## INTRODUCTION

Berkshire Hathaway's Warren Buffett is famous for dissing financial intermediaries—he is not only a champion of disintermediation but a lifelong practitioner of non-intermediation.<sup>1</sup> At Berkshire, a publicly-traded holding company, disintermediation is acute at the parent level.<sup>2</sup> It starts with a governance structure featuring Buffett, a controlling shareholder who effectively founded the firm in 1965 and has served continuously as its chairman and chief executive since 1970. Today, from an office with two dozen staff in Omaha, Nebraska, Buffett is the steward of a sprawling conglomerate that employs 340,000 people.

Berkshire's formal governance is headed by Buffett's handpicked board of directors, his friends and family, who pride themselves more for being just like shareholders than on serving as monitors of management for them. Berkshire's shareholder body embraces the company's unusual approach to corporate governance and concurs with Buffett's aversion to intermediaries, trading lightly in the stock to the dismay of stockbrokers and concentrating their portfolios in it despite financial advisory orthodoxy to diversify.

Eighty percent of Berkshire's nearly \$600 billion in assets are operated by its sixty principal subsidiaries, supplemented by a portfolio of securities in other companies representing the remaining twenty percent of total assets. Built over five decades through scores of acquisitions and investments, 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 on anything except financial reporting and internal auditing. The decentralized model, akin to disintermediation, lacks the tight control protocols common in corporate America, inculcating instead a trust-based culture of stewardship with a record of strong profitability. Any subsidiary seeking financing need only request it from Berkshire, without resorting to the intermediated channels of America's system of corporate finance.<sup>3</sup>

Berkshire's success using an unorthodox approach underscores the value of flexibility in governance design, the appeal of a trust-based corporate culture, and the capacity for self-reliance in lieu of intermediaries. The variety of distribution channels in its subsidiaries and investees reflects the utility of alternative degrees of mediation, ruled by factors such as the efficacy of self-reliance. While the exact normative implications of Berkshire's complex story are more contestable than its descriptive accomplishments, the touchstone is pragmatism over ideology, with weighty roles for autonomy, efficiency, and thrift.

### I. GOVERNANCE

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 publicly-held and struggling textile manufacturer. The Buffett Partnership soon dissolved, with Berkshire shares distributed to the partners. Berkshire proceeded to acquire interests in diverse businesses, including insurance, manufacturing, finance, and newspapers. Its results through 2015 have vastly exceeded benchmarks such as the Dow Jones Industrial Average or Standard & Poor's 500. From 1965 to 2015, the Dow increased eighteen-fold while Berkshire increased by 12,000 times, a compound annual rate of 21%, double the S&P.

Despite the change from the partnership to the corporate form, Buffett has always preserved the sense of partnership at Berkshire. The legacy is reflected in the first of fifteen principles stated for decades in Berkshire's "owners' manual": "While our form is corporate, our attitude is partnership."<sup>4</sup> The "Berkshire system," as vice chairman Charlie Munger dubbed it recently,<sup>5</sup> differs significantly from prevailing practices at other large American corporations. And while legions of investors have attempted to mimic Buffett's investment philosophy, few have emulated Berkshire's corporate practices.<sup>6</sup> Yet the Berkshire system has many advantages.<sup>7</sup>

#### **A. Buffett**

Berkshire differs from the typical public company model characterized by separation of share ownership from managerial control and associated agency costs.<sup>8</sup> Rather, Buffett has been Berkshire's controlling shareholder since 1965. He initially owned forty-five percent of Berkshire's voting and economic interest; today, having made annual transfers of shares for charitable purposes for a decade, Buffett owns thirty-four percent of Berkshire's voting power and twenty-one percent of its economic interest.<sup>9</sup>

So Berkshire may not have needed many of the devices designed to control agency costs in public companies, which often entail intermediation. But controlling shareholders create another set of agency costs for minority shareholders.<sup>10</sup> And Berkshire's unparalleled success and thorough renunciation of such devices makes it wise to ask whether they are necessary or desirable at companies without a controlling shareholder too.

Buffett is, in effect, Berkshire's founder, as he transformed the company from a struggling textile manufacturer into an investment vehicle and then a conglomerate. Throughout most of that time, since 1970, he has also served as Berkshire's only chief executive and board chairman. Such longevity is unique—most modern CEO tenures are far shorter and even legendary long-serving CEOs had tenures half that, including Alfred Sloan, John D. Rockefeller and John F. Welch. The tenure enabled Buffett to put a seemingly indelible imprint on the company, highlighted by non-intermediation. While some companies and advocates endorse age limits for officers and term limits for directors, Berkshire's shareholders have gained substantially thanks to Buffett's long tenure in both roles.

Buffett's attitude of partnership is one of profound disintermediation. The owners' manual 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.<sup>11</sup> 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, starting with himself, are stewards of shareholder capital, accepting a higher standard of obligation than law imposes—perhaps as lofty as that which Benjamin Cardozo said partners owe one another: "a punctilio of an honor the most sensitive."

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 candidly, 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.<sup>12</sup> Buffett writes to Berkshire shareholders directly, without the intermediation 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 philosophy, which champions radical disintermediation in favor self-reliance and savings (you cannot outsource stewardship).

## **B. The Advisory 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 that of typical public companies today. From the earliest decades, the board included Buffett's wife and close friends and, since 1993, his son. It was and remains a classic advisory board, common in the U.S. before the corporate governance revolution that began in the 1980s, and now nearly extinct.<sup>13</sup>

Since the 1990s, the regulation and norms of corporate governance shifted to increasingly define a board's role to monitor management, as intermediaries on behalf of shareholders. That means independent directors, often a powerful non-executive chairman, along with numerous strong committees (on governance, board nominations, and CEO review) all overseeing elaborate systems of internal control. In theory, the monitoring board improved oversight on behalf of shareholders, fortified by shareholder advocates, such as institutional investor councils and shareholder advisory services. While sometimes effective, such a regime produces the potentially inert result of "agents watching agents." At Berkshire, they call it bureaucracy. Whatever its merit elsewhere, no such intermediaries play any role at Berkshire and its board cannot be classified as a monitoring board.<sup>14</sup>

True, Berkshire's board adheres to legal requirements concerning requisite committees, independence, and expertise. Its audit committee, for example, excludes

Buffett, who would not be “independent,” includes at least one financially literate member, and oversees the legally-mandated internal audit function.<sup>15</sup> In form, Berkshire has added numerous outside directors, in the sense that 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.<sup>16</sup> Indeed, half the board members are older than sixty-five and most have served Berkshire for a decade or more—facts that would compel their departure under typical age-limit and term-limit regimes endorsed by some shareholder advocates.

Further, Berkshire directors own Berkshire stock—many in large quantities—all purchased by them with cash rather than awarded by the company in stock-based compensation plans, commonly used in corporate America on the advice of executive compensation consultants. Berkshire pays its directors token fees, typically \$1,000 per meeting, while directors at like-sized companies average \$250,000 per year.<sup>17</sup> Berkshire’s directors serve because of their direct interest, not for the money. Berkshire does not buy directors’ insurance that other boards take for granted, omitting another mini-bureaucracy from its corporate governance.

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 with little board involvement and then present specific proposals to the board, which discusses deal terms and approves funding. The board’s role in this setting is an example of its service as an intermediary. Berkshire does the opposite, enabling Buffett to seize opportunities that would be lost if prior board involvement occurred.<sup>18</sup>

Buffett shares with the board the general philosophy of acquisitions and might discuss large deals with it in advance in conceptual terms. But the board is uninvolved in valuation, structuring, or funding any specific acquisition. With few exceptions, the board does not find out about an acquisition until after it is publicly announced. Rather, overtures, discussions, and negotiations are kept confidential, limited at most to a few Berkshire insiders, typically including Munger.<sup>19</sup>

Berkshire’s board has two regularly scheduled board meetings annually, not the more typical eight to twelve 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. Berkshire’s spring board meeting coincides with Berkshire’s annual shareholders’ meeting in May.

Directors spend several days in Omaha, corporate headquarters, mingling in social gatherings 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 sub'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, especially involving the directors in Berkshire events 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 corporate governance advocates have hailed in recent decades.<sup>20</sup> But this immersion of directors in Berkshire culture flattens the typical hierarchies of corporate governance, keeping directors in shareholders' shoes, the culmination of disintermediation in Berkshire's governance that has proven effective.

### **C. Fellow Owners**

Berkshire's shareholders are unusual and have traits that take out intermediaries as well. 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 more nearly resemble partners in a private firm than shareholders of a public company.

Most Berkshire shares are owned by individuals and families, not firms and funds. Typically, large public companies see seventy to eighty percent of their shares controlled by institutional investors. Decisions are often intermediated by committee and based on financial models that can lead to trading the stock for reasons unrelated to the company. In contrast, at Berkshire a large portion of the voting power and economic interest are controlled by individuals and families, who focus on their specific situation and Berkshire's specific characteristics.

Berkshire shareholders have long holding periods. In the past decade, share turnover has been less than one percent compared to three, four, or five percent for other conglomerates, large insurance companies, or Berkshire's formerly-public subsidiaries.<sup>21</sup> As of 1996, at a time when Berkshire's shares traded above \$35,000 per share, ninety percent of the shares had a basis of less than \$100—meaning that they had held for two or three decades.<sup>22</sup> While more active shareholders may need and value extensive intermediation of stockbrokers, mutual fund managers, and stock exchanges, the typical Berkshire shareholders need little of that.

At most public companies, individual shareholders are rationally apathetic, relying on intermediaries to make decisions. They skip reading company reports, including chairman letters, which are often ghostwritten by the corporate communications department, and rarely attend meetings, which verge on formal ritual, thanks to staging by intermediaries such as public relations experts. In contrast, Berkshire shareholders study Berkshire's annual report, and especially Buffett's shareholder letters, which he writes himself—there is no corporate communications department.<sup>23</sup> Berkshire shareholders flock to its annual meetings. Attendance has risen from 7,500 in 1997 to 21,000 in 2004; 35,000 in 2008; and

40,000 in 2013.<sup>24</sup> At these meetings, un-rehearsed and un-choreographed substantive business discussion takes, where Buffett and Munger spend the entire day on stage answering scores of questions from shareholders.<sup>25</sup>

Sophisticated investors generally follow conventional wisdom—and the typical advice of financial advisors—to avoid concentrating portfolios in the stock of any one company. Among holders who publicly disclose stakes, for instance, few of the largest hundred shareholders of blue chip companies like Apple, ExxonMobil, and General Electric allocate more than five percent of their portfolios to that company's stock. In contrast, Berkshire shareholders tend to concentrate in its stock. For example, forty-three of the hundred largest publicly-disclosed Class A owners hold more than five percent of their portfolio in the stock, starting with Buffett.<sup>26</sup> Many Berkshire shares are owned by people for whom Berkshire is among their largest holdings.

At most U.S. corporations, boards and senior executives set corporate charitable contribution policy, deciding how much to give and to what charities, out of some sense of prerogative. Such an attitude is an anathema at Berkshire, where Buffett and Munger took the board out of the equation to let shareholders name the charities of their choice. Under its shareholder charitable contribution program, Berkshire's board approved the amount of money to donate, and then enabled each shareholder to name favored charities for their share of that. The vast majority of shareholders participated, allocating \$200 million over twenty years.<sup>27</sup>

Or consider Berkshire policy on dividends: aside from a small dividend in 1969, it has never paid one. Buffett repeatedly explains Berkshire's policy, which is to retain each dollar of earnings so long as it translated into at least one dollar of market value. Most companies, in contrast, pay a regular dividend without regard to 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 and got the same answer both times: they overwhelmingly endorse the policy, more than ninety percent affirming.<sup>28</sup> Few chief executives poll their shareholders on anything, though they may hire consultants and experts, again underscoring both Berkshire's partnership attitude and disintermediation.

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, with the effect of feeding middlemen fees, including stockbrokers and stock exchanges. Berkshire has shunned such a policy of stock splits, reducing the role and fees of middlemen. The aversion to stock splits endured even when Berkshire's stock price surpassed dizzying heights. After reaching \$30,000 in 1996, while most shareholders, with no interest in selling, were content some, needing cash or wishing to make gifts, signaled interest in lower price shares. At this time, as Berkshire's stellar performance became well known, demand rose among non-shareholders for a more affordable piece of the action.

Inspired by the demand, two financial intermediaries 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 associated fees the promoters planned to charge, Berkshire created two classes of stock, one with fractional voting and economic rights, set to trade at around \$1,000 per share.<sup>29</sup> The anti-intermediary move, aptly called “ingenious,”<sup>30</sup> also enables existing Berkshire shareholders to create liquidity, as the pricey Class A shares can be converted, tax-free, into the cheaper Class B shares.

The thrift undergirding Berkshire’s disintermediation was also reflected in the underwriting fee in the Class B offering: 1.5% of the proceeds, far less than the then-prevailing average of 5.7%.<sup>31</sup> At Berkshire, the policy goes, if you cannot remove the middleman, at least pay him less. In 1988, to give another example, Berkshire relisted its stock from the Nasdaq to the New York Stock Exchange because trading costs there were lower.<sup>32</sup>

#### **D. Trusted Managers**

Another novel form of disintermediation at Berkshire concerns the internal corporate management structure. At most companies, especially conglomerates, 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 entail incremental overhead in the name of effective oversight. In contrast, with the exception of a basic internal auditing function, Berkshire eschews such staples of corporate life 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, focused primarily on financial reporting and auditing. 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, technology, and so on.

Consistent with this decentralized approach, each subsidiary is led by respective CEOs without direction or interference from headquarters. Berkshire defers as much as possible to subsidiary chief executives with scarcely any central supervision. All quotidian decisions qualify: advertising budget; product features and environmental quality; the 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 chief executive officer. Berkshire does not transfer businesses between subsidiaries nor move managers around.<sup>33</sup> Berkshire has no retirement policy and many chief executives work into their seventies or eighties.

The only qualifications on managerial autonomy at Berkshire appear in a short letter Buffett sends its 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 post-retirement benefit changes and large capital expenditures (including acquisitions, which are encouraged); (4) adopt a fifty-year time horizon; (5) refer any opportunities for a Berkshire acquisition to Omaha; and (6) submit written successor recommendations.<sup>34</sup>

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.

Even as Berkshire minimizes its use of intermediaries, law imposes some unavoidable requirements. As a public company, federal law requires an internal audit function, imposes specific requirements on board audit committees and requires annual financial statements audited by outside auditors. Auditing is a quintessential illustration of intermediation and reveals both its appeal and limits. Shareholders may value external attestation of managerial financial statement assertions, but since the company pays the auditors' fees, the auditor is not as independent as shareholders might wish.<sup>35</sup> That remains true despite legal reforms that put auditor oversight in board audit committees rather than corporate managers.<sup>36</sup>

## **II. STEWARDSHIP**

In 1996, Buffett was a director of Gillette Co. and Berkshire owned eleven percent of its stock. Gillette agreed to acquire Duracell International, Inc., then thirty-four percent owned by the leveraged buyout firm, Kohlberg Kravis Roberts (KKR), for \$7 billion worth of Gillette stock. After terms were agreed, KKR submitted a bill for its services, as well as those of its co-advisor, Morgan Stanley & Co., of \$30 million. The bill was high compared to the \$16 million Gillette's advisors sought, but in line with prevailing advisory fees and, on its face at 0.39% of the deal size, fractional.<sup>37</sup> Although the rest of the Gillette board approved the fee, Buffett considered it excessive and protested by abstaining. Buffett figured that, under the stock deal structure, existing Gillette shareholders would bear eighty percent of Duracell's fees which, given Berkshire's eleven percent stake, translated into it shouldering \$2.64 million of the total.

### **A. Debt-Free 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 cases where 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.<sup>38</sup> Use of traditional debt could juice Berkshire's results, but borrowed money is also costly and creates risk of default along with collateral damage.

Berkshire's preferred sources of leverage are float in its insurance operations and long holding periods that generate considerable levels of deferred taxes. Float refers to funds insurance companies hold between the time premiums are received and claims 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.

When done well over long periods of time, the amount of float can grow to large proportions. 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 to \$66 billion in 2010 (and \$84 billion today).<sup>39</sup> Berkshire's deferred taxes have accumulated to nearly \$58 billion today, making the total of these unconventional leverage sources \$148 billion (for context, assets total \$526 billion, liabilities \$283 billion, and shareholders' equity of \$243 billion).

Such obligations are real liabilities, however, and poor underwriting can prove 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.<sup>40</sup> But control is in their own hands, rather than outsourced to lenders. Berkshire's insurance subsidiaries use compensation plans designed to encourage underwriting discipline, with bonuses tied to underwriting profit and the cost of float rather than to premium volume.

Unlike float (or deferred taxes), bank debt comes with covenants, stated interest, and due dates. And loans are marketed by an agent 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 (more assets deployed) without the costs, constraints, and conflicts. Ultimately, Berkshire's model underscores the value of fiscal self-reliance and self-discipline versus reposing either in financial intermediaries.

## **B. Frictionless Conglomerate Capital**

Berkshire's conglomerate structure enables internal cash reallocation to businesses generating the highest returns on incremental capital. Berkshire's success at such internal capital reallocation has vindicated its conglomerate business model that has otherwise been denigrated across corporate America. The strategy skillfully avoids intermediaries. 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 can be used by sister subsidiaries.

Subsidiary managers prize the effortless source of funds. Outside Berkshire, a chief executive needing funds faces layers of intermediation, starting with a board to obtain authorization and financial advisors on the best sources and types of funding. These will in turn involve underwriters for equity securities or banks for debt. In each case, there will be fees, along with haggling over terms that put limits on 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.

Conglomerate structures were fashionable in the 1960s and 1970s when companies such as Gulf & Western, Litton, and LTV attracted wide followings among shareholders and the press alike. Managers assembled diverse business assets under one roof on the theory of diversification, buying companies whose varied financial characteristics would contribute appealing net results in different economic environments. But those models lost their luster in the 1980s.

Investor advocates began to stress that investors could obtain the diversification advantages of conglomerates more cheaply and completely through owning a diverse portfolio or index fund. Management theorists explained that managers would perform better by focusing on specific industries rather than sprawling across many. Further, shareholder returns for conglomerates often lagged the market or, when they surpassed it, proved to be the product of accounting overstatements or exploitation of stock market volatility (especially using high priced stock in acquisitions).

Many conglomerates still exist, including Danaher, General Electric, and United Technologies, but their chief executives are often on the defensive. For example, shareholder activist Nelson Peltz seeks to compel the break-up of DuPont, deriding it as a conglomerate. While it is diversified across many chemical industries, DuPont is not sprawling in the manner of the conglomerates of earlier decades—or Berkshire.

Berkshire has made the conglomerate structure work. Beyond a diverse portfolio of overall good businesses supported by internal funding such as float and deferred taxes, the reduced costs of financing are a factor. Independent rivals requiring capital rely on financial intermediaries with associated costs in interest, fees, covenants, and the like that Berkshire subsidiaries avoid.<sup>41</sup> The value of the cost savings amplifies as Berkshire accumulates substantial amounts of excess cash that can be deployed opportunistically when acquisition opportunities arise, another Berkshire piston that is likewise unusual for its lack of intermediation.

### **C. Banker-Free Acquisitions**

Most corporations, including conglomerates, adopt a formal plan charting desired sectors in which to expand, sometimes even naming acquisition targets. Many companies

have acquisition departments whose job is to scout for and seize opportunities. Such internal functions exhibit some features common to intermediaries, including a valuable claim to expertise but also potentially skewed incentives to favor activity when inaction would be more prudent.<sup>42</sup> 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."<sup>43</sup> The disintermediation 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 other intermediaries to broker deals. Berkshire generally avoids these.<sup>44</sup> Deal brokers charge fees, often high ones. Many deal fees are contingent, 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 are, measured by the difference in value between what was invested and what was obtained. Munger quips about the optimal corporate strategy: hire two bankers, one who is paid if the deal closes and the other who is paid if the deal does not close.

Rather than rely on brokers, Berkshire from the outset 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 responds to proposals from others. Here are the sources of the thirty-five deals for which information appears in Berkshire's public disclosure.<sup>45</sup> *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.<sup>46</sup>

Professor DeMott, a leading authority on agency law and student of intermediation, gives the example of Berkshire's acquisition of Scott Fetzer, where a "major investment banking house" tried unsuccessfully to find a buyer for the mid-sized diversified conglomerate. But after a hostile raider targeted the conglomerate, 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 though it did not find the buyer.<sup>47</sup> As Berkshire's experience suggests, Buffett believes it is better for sellers and buyers to find each other directly than 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 test a company's controls and financial figures while lawyers probe contracts, compliance, and litigation. Such examinations are usually 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 completed within a week, ten days, or a month. Deals—including big ones involving billions of dollars—can close within a month of the initial contact. The process does not reflect lack of information but rather Buffett's and Munger's prodigious business reading, which has yielded broad knowledge and familiarity with many companies. Moreover, they have disciplined themselves to stick with areas of expertise, so if they lack understanding they know it and pass.

Two examples observed by Robert Mundheim, former Dean of Penn Law School, illuminate.<sup>48</sup> The first arose when Mundheim was a director of Benjamin Moore, a family controlled company whose stock was also listed on the over-the-counter market. Having decided it was time to go public or sell, the company retained financial advisors who, upon study, suggested a sale and stated a price. But the firm could not find a buyer at the price they suggested. So Mundheim suggested contacting Buffett, as Benjamin Moore was a Berkshire kind of company. With the CEO's blessing, Mundheim called Buffett, who expressed interest.

Asking only a few questions and for public documents, which Mundheim provided, Buffett made a proposal within a week. He offered to acquire Benjamin Moore for \$1 billion cash and the board accepted—after Mundheim advised that seeking a higher price from Buffett was probably futile.<sup>49</sup> Related investigations consisted of Buffett and Munger meeting with the company's CEO, Berkshire's lawyers conducting basic due diligence, and Benjamin Moore hiring a banker to give a fairness opinion. Mundheim is confident that involving more advisors, particularly another investment bank, would not have added value to the transaction but only added costs.

Mundheim's second example concerned Salomon Inc., once a venerable investment bank that faced oblivion due a criminal bond trading scandal in 1991. Berkshire owned nearly [twenty] percent of Salomon's stock and Buffett became chief executive to guide the firm's rebuilding. When that task was completed, Salomon was sold to Travelers. Though Delaware case law such as *Smith v. Van Gorkom* prompted boards and advisors to get fairness opinions for a sale, Salomon's board opted not to, and Mundheim suggests this was an example of Buffett's aversion to such costly and redundant exercises. He points to the proxy statement's explanation: "a fairness opinion would have provided little, if any, incremental value to the deliberations of the Salomon Board given the insurance and securities industry expertise of the officers and directors of Salomon and its subsidiaries."

Professor DeMott, in a review of the third edition of *The Essays of Warren Buffett: Lessons for Corporate America*, discerned "a bracing tone of skepticism directed toward transactional intermediaries," which "intrigued her as scholar of agency law and intermediation."<sup>50</sup> Berkshire's skepticism and self-reliance is unusual, she explained, and suggested that it ties into its unique attributes at the parent level (highlighted in Part I above). DeMott explains that the "skepticism running through *The Essays* encompasses concerns about skill, competence, and overall effectiveness, as well as transaction costs associated with intermediation and advisers."<sup>51</sup> Consistent with Professor DeMott's view, this article suggests that autonomy and thrift undergird Berkshire's allergies to intermediaries, a belief in the superiority of conflict-free self-reliance and self-discipline.

## CONCLUSION

Berkshire and its shareholders prosper from unorthodox disintermediation that puts more faith in self-reliance than is conventional in corporate America. The achievement occurs during a period when law and norms have made it increasingly difficult to maintain such autonomy and minimize costs. Law imposes costly and intermediated governance requirements such as internal control systems, monitoring boards and regulated committee oversight. In practice, corporate America grew an expensive bureaucratic culture internally while a growing corps of financial advisors bids to sell shareholders a wide range of costly services. If some such regulation and norms are desirable in some settings, Berkshire offers a dramatic counter-example. If not providing a model every company should follow, it is a compelling case for letting corporations and their shareholders define their own practices, rather than having law or peer pressure do so.<sup>52</sup> And some corporations and shareholders would do well to follow at least some of the examples.

While financial disintermediation often appears to be a novel, technology-driven, youthful element of today's sharing economy, removing the middleman is a venerable and prosaic business feat whose devotees can be stodgy. Warren Buffett is equally at home with disintermediation as digital natives funding businesses with Kickstarter. Entrepreneurial methods span from today's internet apps and 3D printers back to old-fashioned direct marketing by catalogues, 1-800 numbers, and door-to-door salesmen. With Berkshire's sprawling holdings as a microcosm of corporate America, its subsidiaries display a full range of distribution strategies, with the degree of intermediation ruled by relative efficiency.

At Berkshire, where self-reliance and thrift are deeply ingrained, the company omits the middleman at every turn, along the board of directors, among shareholders, in the operating companies, and throughout its financing and acquisition activity. It is a unique model of disintermediation worthy of far more emulation than it has received and an example lawmakers and other companies alike should heed when considering new regulations or nurturing new norms that add bureaucracies of intermediation to corporate America. True, it begins from a "radical" conception of the corporation. Instead seeing shareholders as mere "residual claimants" managers as "agents," at Berkshire there are owners and stewards. Maybe that's why the Berkshire model is seldom copied in corporate America.

## Notes

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<sup>1</sup> Yes, Buffett's dissing of intermediaries gives a new meaning to disintermediation.

<sup>2</sup> Intermediation is the practice of middlemen operating between an originator/producer and end user/consumer. Intermediaries include agents, brokers, distributors, publishers, wholesalers, and retailers; in the financial realm, the term encompasses banks and insurance agents or brokers, credit card companies, fund managers, stock exchanges, and underwriters; in corporate governance, intermediaries include independent directors as well as service providers also called gatekeepers, such as accountants, lawyers, and rating agencies, along with assorted investor advocates and shareholder proxy advisors.

<sup>3</sup> The concept of intermediation are ill-defined and variable. For example, through the late eighteenth century, it was customary for clothing to be sewn by hand at home by family members for kin. The predecessor to Berkshire's Fruit of the Loom subsidiary disrupted the practice by manufacturing garments for sale off the rack to consumers. So the manufacturer emerged as an intermediary, while today we consider it disintermediation when consumers buy direct from manufacturers (as at "outlet stores"). Through the late twentieth century, it may have been uncommon to think of newspapers as intermediaries but the subsequent proliferation of social media capable of conveying original information to users both brings disintermediation to the news business and reveals the industry to be an intermediary. While web sites like Yahoo re-intermediated, corporate web sites now provide considerably more direct information to shareholders and other constituents than ever.

<sup>4</sup> See WARREN E. BUFFETT & LAWRENCE A. CUNNINGHAM, *THE ESSAYS OF WARREN BUFFETT: LESSONS FOR CORPORATE AMERICA* (3<sup>rd</sup> ed. 2013).

<sup>5</sup> Charles T. Munger, *Letter to Berkshire Hathaway Shareholders*, BERKSHIRE HATHAWAY ANNUAL REPORT (March 1, 2015).

<sup>6</sup> See Roger Lowenstein, *Forget Buffett the Investor, Try Buffett the Manager*, FORTUNE (May 2, 2015).

<sup>7</sup> See Erik P.M. Vermeulen, *Corporate Governance in a Networked Age*, 50 WAKE FOREST L. REV. \_\_\_\_ (2015).

<sup>8</sup> See Deborah A. DeMott, *Agency Principles and Large Block Shareholders*, 19 CARDOZO L. REV. 321 (1997).

<sup>9</sup> In the spirit of disintermediation, Berkshire adopted a dual class capital structure in 1996. See *infra* text accompanying notes 29-32.

<sup>10</sup> E.g., *Perlman v. Feldman*, 219 F.2d 173 (2d Cir. 1955) (applying New York law); *Weinberg v. UOP*, 457 A.2d 701 (Del. 1983); *Kahn v. Tremont Corp.*, 694 A.2d 422 (Del. 1997); *Paramount v. QVC*, 637 A.2d 34 (Del. 1993); *In re Tyson Foods, Inc.*, 919 A.2d 563 (Del Ch. 2007).

<sup>11</sup> See Lawrence E. Mitchell, *The Human Corporation: Some Thoughts on Hume, Smith, and Buffett*, 19 CARDOZO L. REV. 341, 352 (1997).

<sup>12</sup> See Amy Deen Westbrook, *Warren Buffett's Corporation: Reconnecting Owners and Managers*, 34 OKLA. CITY U. L. REV. 515, 529-31 (2009).

<sup>13</sup> See Melvin A. Eisenberg, *The Board of Directors and Internal Control*, 19 CARDOZO L. REV. 237, 239 (1997).

<sup>14</sup> See Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265, 287 (1997).

<sup>15</sup> Federal securities laws require all public companies to maintain an internal auditing function. See Foreign Corrupt Practices Act of 1977, 15 U.S.C. §78m(2). Berkshire would have this function whether required or not. See Warren Buffett, *Chairman's Letter*, BERKSHIRE HATHAWAY INC. ANNUAL REPORT (March 1, 2015)

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(after referring to Berkshire's leanness, joking of having an internal audit function because there is "no sense being a damned fool").

<sup>16</sup> See BUFFETT & CUNNINGHAM, ESSAYS, *supra* note 4, at \_\_\_; Berkshire Hathaway Proxy Statement, p. 2 (March 13, 2015).

<sup>17</sup> Gary Strauss, *Directors See Pay Skyrocket*, USA TODAY (Oct. 26 2011).

<sup>18</sup> See Mark Calvey, *Berkshire Hathaway Director Susan Decker Offers Rare Peek into Warren Buffett's Boardroom*, S. F. BUS. TIMES (Dec. 9, 2014).

<sup>19</sup> Munger, Letter to Berkshire Shareholders, *supra* note 5.

<sup>20</sup> See James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 L. & CONTEMP. PROBS. 83 (1985).

<sup>21</sup> For example, from 2001 through 2012, share turnover in Berkshire stock was never greater than 0.34% for the Class A or 0.615% for the Class B, except that the Class B in the latter years increased after Berkshire split that class of stock and used it to pay for its acquisition of BNSF Railway. For detail, see LAWRENCE A. CUNNINGHAM, *BERKSHIRE BEYOND BUFFETT: THE ENDURING VALUE OF VALUES* (2014), 284 (Table 14.5).

<sup>22</sup> Warren Buffett, Berkshire Hathaway Annual Meeting (2014); Lawrence A. Cunningham, Editor, *Conversations from the Warren Buffett Symposium*, 19 CARDOZO L. REV. 719, 772 (1997).

<sup>23</sup> Since 1973, Buffett has asked his friend Carol Loomis, long-time editor at *Fortune*, to edit the letters—in exchange for the gift of an addition to her charm bracelet.

<sup>24</sup> See BUFFETT & CUNNINGHAM, ESSAYS, *supra* note 4, at 37.

<sup>25</sup> In the past decade, Buffett has had several journalists and professional investors pose questions too, a seeming trade-off that adds such intermediaries as the price of also increasing independence in an arena brimming with shareholder adulation.

<sup>26</sup> See CUNNINGHAM, *BERKSHIRE BEYOND BUFFETT*, *supra* note 21, at 204-05.

<sup>27</sup> Reluctantly, Berkshire terminated the program when social advocates opposed to some donor choices boycotted the products of a Berkshire subsidiary.

<sup>28</sup> See *Conversations*, *supra* note 22, at \_\_\_.

<sup>29</sup> Today, Class A shares have one vote per share and the equivalent claim to the economic interest such as dividends while the Class B shares have 1/10,000 of that voting power and 1/1,500 of that economic interest. Recent stock market prices: Class A \$220,000 and Class B \$145.

<sup>30</sup> Robert W. Hamilton, *Reflections on the Pricing of Shares*, 19 CARDOZO L. REV. 493, 500, 503 (1997).

<sup>31</sup> Anita Raghavan, *Salomon's 'Baby Share' Underwriting for Berkshire Causes Industry Tremors*, WALL ST. J. (May 9, 1996).

<sup>32</sup> BUFFETT & CUNNINGHAM, ESSAYS, *supra* note 4, at 176-77.

<sup>33</sup> Among rare exceptions: (a) the transfer of residual assets of Dexter Shoe into H. H. Brown Shoe after the former's business deteriorated and (b) the reassignment of Brad Kinstler from Cornhusker Casualty, to

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Fechheimer Brothers, to See's Candies. CUNNINGHAM, BERKSHIRE BEYOND BUFFETT, *supra* note 21, at 29-30 & 38.

<sup>34</sup> See ROBERT P. MILES, THE WARREN BUFFETT CEO: SECRETS FROM THE BERKSHIRE HATHAWAY MANAGERS (2003) 357-58.

<sup>35</sup> See Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, 52 UCLA L. REV. 413 (2004).

<sup>36</sup> See Lawrence A. Cunningham *Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry before it Unravels*, 106 COLUM. L. REV. 1698 (2006).

<sup>37</sup> See DeMott, *supra* note 8, at 338 n. 55.

<sup>38</sup> As of year-end 2014, total consolidated Berkshire debt outstanding was \$74 billion, with \$20 by BNSF and \$35 billion by BHE, and \$13 billion by various finance subsidiaries. Related terms are market-like, with covenants concerning leverage ratios, interest coverage, and debt service. Berkshire Hathaway 2014 Financial Statements, n. 15/p. 70.

<sup>39</sup> BERKSHIRE HATHAWAY INC., ANNUAL REPORT (2014).

<sup>40</sup> Insolvency due to poor underwriting was nearly the fate of Berkshire's GEICO subsidiary in the 1970s before Berkshire acquired and of Gen Re in the 2000s just after Berkshire acquired it. GEICO's case is discussed *infra* Part III.A.

<sup>41</sup> Academic proponents of the "incomplete contracts" approach to optimal capital structure believe that corporate borrowing, while costly, has the virtue of deterring managers from engaging in empire building. See William W. Bratton, *Dividends, Noncontractability, and Corporate Law*, 19 CARDOZO L. REV. 409 (1997) (adapting the same point to the topic of dividends). Insurance underwriting engenders a similar discipline. See *supra* text accompanying note 40.

<sup>42</sup> For debate on this topic between Buffett and governance guru Ira Millstein, see *Conversations*, *supra* note 22, at 739-41.

<sup>43</sup> CUNNINGHAM, BERKSHIRE BEYOND BUFFETT, *supra* note 21, at 213.

<sup>44</sup> See DeMott, *supra* note **Error! Bookmark not defined.**

<sup>45</sup> CUNNINGHAM, BERKSHIRE BEYOND BUFFETT, *supra* note 21, at 213.

<sup>46</sup> Only *one* came from a broker Berkshire retained, an anomalous case when Buffett asked a Berkshire unit CEO, David Sokol, to initiate the search. He hired Citi in the hunt that led to Lubrizol, in which Sokol also violated Berkshire corporate policy by acquiring a personal stake in the stock before pitching it internally as an acquisition candidate. See CUNNINGHAM, BERKSHIRE BEYOND BUFFETT, *supra* note 21, at 113-17.

<sup>47</sup> See DeMott, *supra* note **Error! Bookmark not defined.** (citing BUFFETT & CUNNINGHAM, ESSAYS, *supra* note 4, at 217).

<sup>48</sup> See Robert Mundheim, *Deals without Bankers*, CONCURRING OPINIONS (May 23, 2013) (blog).

<sup>49</sup> Mundheim's advice was sound, including the prediction that Buffett would not increase his bid, as he seldom does. See CUNNINGHAM, BERKSHIRE BEYOND BUFFETT, *supra* note 21, at 214. The approach is a variation on the theme of disintermediation in that it leaves out the frictional costs of haggling.

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<sup>50</sup> DeMott, *supra* note **Error! Bookmark not defined.**

<sup>51</sup> *Id.*

<sup>52</sup> *See* Fisch, *supra* note 14, at 287 (Berkshire’s experience supports “allow[ing] corporations to tailor board structure to the functions most important to individual corporations”, true though one factor in Berkshire’s success has been the presence of Buffett as a controlling shareholder).