
THE LENDER'S EYE: LEARNING FROM THE SOKOL RESIGNATION ABOUT CONFLICTS OF INTEREST

Further reflections on the Sokol case at Berkshire-Hathaway

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In my blog of April 5, "Common Sense Principles For Good Ethics And Good Lending," I observed that potential conflicts of interest occurred frequently in business and in banking. Then by the end of the week, there was the eyebrow-raising news that Mr. David Sokol, considered by many to be the logical successor to Warren Buffett at Berkshire Hathaway, had resigned.

Looking at the case

At the core of the resignation seems to be an apparent conflict of interest. Mr. Sokol had personally invested in a company, Lubrizoil, only a few weeks before proposing to Mr. Buffett and other corporate advisors, that the company would be a good investment for Berkshire Hathaway. Both Mr. Sokol and Mr. Buffett reported that Mr. Sokol had disclosed his investment in the company at the time of Mr. Sokol's favorable recommendation.

A close examination of insider trading rules does not suggest that Mr. Sokol broke any laws relating to his purchase and ownership of Lubrizoil stock. Mr. Buffett said as much in his comments praising Mr. Sokol's activities at the company and in wishing him well in his future endeavors.

Why then all the interest in Mr. Sokol's transaction?

There are several plausible explanations.

First, there are the "optics."

The transaction looks preferentially favorable to Mr. Sokol on its face. Berkshire's subsequent purchase of Lubrizoil certainly enhanced the value of its stock. In a matter of a few short weeks, this translated into a significant profit for Mr. Sokol.

Second, there is the league we are dealing in.

Mr. Sokol is an influential advisor to Mr. Buffett and has the respect and confidence of other advisors to Berkshire

Hathaway. Even if Berkshire had not proceeded with the transaction, the very fact of a disposition to consider it would have raised interest and awareness of the financial consequences among those familiar with Berkshire's activities. Maybe another acquirer would have surfaced or maybe the stock would have found greater favor among retail brokerage clients who are always looking for attractive ideas to follow.

Third, there is the rule everyone apparently forgot about.

What seems most embarrassing to Mr. Buffett is the disclosure during this affair of a longstanding Berkshire policy cautioning senior insiders such as Mr. Sokol to avoid the fact or the appearance of a conflict in their personal investing activities in light of any anticipated corporate activity of Berkshire. The policy, restated and circulated in writing within the last year to Berkshire insiders, said that if a person covered by the policy is actively considering taking a position in a public company's securities and if Berkshire is in any way involved or contemplating involvement, then trading in that company's securities is "expressly prohibited."

That's a pretty good summary of the law surrounding insider trading. The optics that are so inconvenient is the relatively proximate time between Mr. Sokol's personal trade and his recommendation to Berkshire and its advisors of considering the possible acquisition by Berkshire. If he had owned the shares for years, it would likely not have become an issue

You can't ignore the optics

It seems all but impossible that Mr. Sokol drove up the price of Lubrizol stock to Berkshire. If he had, then there would be probable grounds for an insider trading violation. The real damage though is what the public perceives the ethical reality to be. Just because the law was likely not violated doesn't necessarily mean that no ethical breach occurred or was intended.

Consider Mr. Buffett's own words in his testimony to Congress in 1991: Mr. Buffett said he expected all his 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'."

What this means to a working lender

For lenders who bank companies with publicly traded securities, dealing with insider type information is a routine part of the job. Yet many employees of banks with publicly traded securities themselves can also be subject to insider trading rules and restrictions on using insider information.

Even if there are no insider restrictions per se, there is still the specter of reputation risk. Any employee can overstep a line of propriety whether carelessly, deliberately or accidentally. That's why this general subject on appearances of conflicts of interest is so important.

Mr. Buffett's 1991 attitude is cautious and correct. Note that it also ultimately deals with personal behaviors of a judgment nature-not anything typically applying to activities represented on a simple list of dos or don'ts.

What can we learn from this example of potential corporate misbehavior?

To me, two lessons are paramount.

First, appearances are as important as the factual substance.

The real casualty is ultimately to one's reputation or that of the firm. Trust and confidence of customers, vendors, creditors, employees, and the general public are all potentially vulnerable and at potential risk.

Second, the existence of a policy or a rule is no guaranty that it will be observed appropriately-or at all.

Ultimately, the success of any policy or set of internal controls is the rigor with which it is applied and enforced. Many high-sounding policies including mission, vision, and values statements are merely words, without the single-minded attention to their observance and the application of consequences for egregious outcomes.

The flip side of the internal control issue is personal responsibility and accountability.

Without these, no workplace culture is worth much or can ever produce anything approaching a high level of ethical consistency. Unfortunately, personal responsibility needs to be reinforced by the occasional "example" that must be made of offending activities.

That's the "every sacrifice requires a goat" approach to corporate discipline. It has its place and has to be an option however rarely it may be applied.

Alternatives to human sacrifice

There's a better way, though, and it's to encourage responsible activity of employees. They should be reminded and rewarded too. Positive reinforcement is more constructive as well as productive and it's not hard to do.

As managers, all of us should have a wide-angle view of the company and the personal activities of our employees. We need to formulate and promote principles of behavior rather than rely on lists and then be prepared to personally walk the walk and not just talk the talk.

Our credibility with the public hangs in the balance and with some of our constituencies it's in a state of disarray. A good place to start the rehabilitation process is with the scrupulous avoidance of conflicts of interest and their appearance.

But if you're serious about this, don't neglect the "enforcement" component. No culture can stronger than the will to enforce the rules.

About Ed O'Leary:

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O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

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