Corporate Governance According to Charles T. Munger

By David F. Larcker and Brian Tayan
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INTRODUCTION

Berkshire Hathaway Vice Chairman Charlie Munger is well known as the partner of CEO Warren Buffett and also for his advocacy of "multi-disciplinary thinking"—the application of fundamental concepts from across various academic disciplines to solve complex real-world problems. One problem that Munger has addressed over the years is the optimal system of corporate governance. How should an organization be structured to encourage ethical behavior among organizational participants and motivate decision-making in the best interest of shareholders? His solution is unconventional by the standards of governance today and somewhat at odds with regulatory guidelines. However, the insights that Munger provides represent a contrast to current "best practices" and suggest the potential for alternative solutions to improve corporate performance and executive behavior.

TRUST-BASED GOVERNANCE

The need for a governance system is based on the premise that individuals working in a firm are self-interested and therefore willing to take actions to further their own interest at the expense of the organization's interests. To discourage this tendency, companies implement a series of carrots (incentives) and sticks (controls). The incentives might be monetary, such as performance-based compensation that aligns the financial interest of executives with shareholders. Or they might be or cultural, such as organizational norms that encourage certain behaviors. The controls include policies and procedures to limit malfeasance and oversight mechanisms to review executive decisions.

Most large corporations today have adopted governance systems that include extensive incentives and controls, including an independent board of directors to monitor management, an internal audit department, compliance and risk management, and elaborate executive compensation contracts. Charlie Munger, however, contends that it is unreasonable to expect such a system to work equally well in all settings:

> *"One solution fits all" is not the way to go. All these cultures are different. The right culture for the Mayo Clinic is different from the right culture at a Hollywood movie studio. You can't run all these places with a cookie-cutter solution.*[1]

He points out that many successful organizations, including Berkshire Hathaway, operate under a model that relies on fewer rather than more controls:

> *A lot of people think if you just had more process and more compliance—checks and double-checks and so forth—you could create a better result in the world. Well, Berkshire has had practically no process. We had hardly any internal auditing until they forced it on us. We just try to operate in a seamless web of deserved trust and be careful whom we trust.*[2]

To Munger, "The right culture, the highest and best culture, is a seamless web of deserved trust."[3] A trust-based system allows individuals to operate without extensive control procedures and therefore avoid the time and cost of having their own actions monitored and having to monitor the actions of others. As such, a trust-based system can be more efficient than a compliance-based system, but *only if* self-interested behavior among employees and executives is low. Munger explains: "Good character is very efficient. If you can trust people, your system can be way simpler. There's enormous efficiency in good character and dis-efficiency in bad character."[4]

POWERFUL CEO

The lynchpin of a trust-based system is the choice of chief executive officer. A CEO of high capability and sound integrity does not require extensive monitoring and can be relied on to make correct (rational) decisions in the long-term interest of the organization. To Munger, "We want very good leaders who have a lot of power, and we want to delegate a lot of power to those leaders."[5] … "I always like the systems where really good people get a lot of power and exercise it well."[6]

From a theoretical perspective, this approach makes sense: one way for a company to reduce agency costs is to hire someone who, because of his or her character, is unlikely to engage in actions that are detrimental to shareholders. The risk is that the board makes an incorrect assessment of an executive's ability and integrity and selects the wrong CEO.

To Munger, once the right CEO is selected, he or she should be empowered to make decisions without extensive review by the board of directors. He uses the example of Warren Buffett:

> *When you have a really complicated place and a good CEO, you want him to have power to speak for the place in dealing with outsiders…. Berkshire Hathaway of course is raised that way. Can you imagine Warren Buffett saying to somebody, "Well I'm sorry I have to go back and check with my directors?" I mean, of course he has to go back to check with his directors, but he knows what they're going to say, and everybody knows that what he says is going to govern.*[7]

RESPONSIBLE CULTURE

The second main element of a trust-based system is the development and maintenance of a culture that encourages responsible behavior. As Munger states, "People are going to adopt to whatever the ethos is that suffuses the place."[8] This is true for all employees, from the CEO to front-line administrators.

Several organizational features contribute to a responsible culture:

Accountability. Munger cites former Columbia University philosophy professor Charles Frankel who believed that "truly responsible, reliable systems must be designed so that people who make the decisions bear the consequences."[9] … Frankel "said that systems are responsible in proportion to the degree in which the people making the decisions are living with the results of those decisions…. So a system like the Romans had where, if you build a bridge, you stood under the arch when the scaffolding was removed—or if you're in the parachute corps, you pack your own parachute—those systems tend to work very well."[10] Conversely, "a CEO who's there for five years while the company looks good, after which he's gone on a pension, is not operating in a responsibility system like that of the Roman engineers."[11]

Basic Controls. The organization should remove easy opportunities to engage in self-interested behavior: "A very significant fraction of the people in the world will steal if (A) it's very easy to do and (B) there's practically no chance of being caught. And once they start stealing, the consistency principle—which is a big part of human psychology—will combine with operant conditioning to make stealing habitual. So if you run a business where it's easy to steal because of your methods, you're working a great moral injury on the people who work for you…. It's very, very important to create human systems that are hard to cheat."[12] Munger calls systems that are easy to cheat "perverse." "A system is perverse when good people go bad because of the way the system is structured. If you run a big chain of stores and you make it easy to steal by your own sloppiness, you will cause a lot of good people to go bad. You will have created an irresponsible system."[13]

Conservative Accounting. Conservative accounting creates a margin of safety in financial reporting, providing assurance to investors and management that corporate performance is at least as good as reported. According to Munger, "The liabilities are always 100 percent good. It's the assets you have to worry about."[14] Aggressive accounting also encourages aggressive practices such as overstating revenue and underestimating loan-loss provisions, allowances for uncollectible accounts, reserve estimates, and other accounts to inflate net income. "Ninety-nine percent of the troubles that threaten our civilization come from too optimistic accounting. And yet these damn accountants with their desire for mathematical purity want to devote exactly as much attention to accounting that is too pessimistic as they do to accounting that is too optimistic—which is crazy. Ninety-nine percent of the problems come from being too optimistic. Therefore, we should have a system where the accounting is way more conservative."[15]

Modest Executive Compensation. Munger also proposes that CEOs receive modest compensation after they have achieved a reasonable level of wealth: "People should take way less than they're worth when they are favored by life."[16] … "I would argue that when you rise high enough in American business, you've got a moral duty to be underpaid—not to get all that you can, but to actually be underpaid."[17] He cites Costco as an example, where Munger serves on the compensation committee. Former CEO James Sinegal routinely requested compensation below his peer group (see Exhibit 1). "There's a lot to be said for the people who have the power getting into a position where they make their money with the shareholders and not off them."[18] … "Carnegie was always very proud that the bulk of his fortune had been earned while he took no salary from Carnegie Steel. John D. Rockefeller the First took practically nothing in salary. Over the years, Cornelius Vanderbilt prided himself on living on his dividends and taking no salary. It was a common culture in a different era. All those people had the psychology of being the founder—and maybe that's what influenced Warren."[19]

Modest Director Compensation. Similarly, Munger contends that modest director compensation is consistent with the independent judgment that directors are expected to demonstrate. He quotes a former U.S. cabinet member who said, "'No man is fit to hold office who isn't perfectly willing to leave it at any time,' … I think that ought to be more the test in corporate directorships. Is a man really fit to make tough calls who isn't willing to leave the office at any time? My answer is no."[20] Consistent with this, Berkshire Hathaway directors receive annual compensation of only $1,800 to $5,600, compared to $229,000 at the average large capitalization company (see Exhibit 2).[21] Modest director compensation might also help to dampen executive compensation levels: "The more you pay the directors, the more they'll pay the CEO. The ordinary rules of social psychology require that result."[22]

Finally, Munger advises that corporate systems maintain simplicity: "One of the greatest ways to avoid trouble is to keep it simple. When you make it vastly complicated—and only a few high priests in each department can pretend to understand it—what you're going to find all too often is that those high priests don't really understand it at all…. The system often goes out of control."[23] …

> *The last idea that I want to give to you as you go out in a profession that frequently puts a lot of procedures and a lot of precautions and a lot of mumbo jumbo into what it does: this is not the highest form which civilization can reach. The highest form that civilization can reach is a seamless web of deserved trust—not much procedure, just totally reliable people correctly trusting one another. That's the way an operating room works at the Mayo Clinic. If a bunch of lawyers were to introduce a lot of process, the patients would all die. So never forget when you are a lawyer that you may be rewarded for selling this stuff but you don't have to buy it. In your own life what you want is a seamless web of deserved trust. And if your proposed marriage contract has forty-seven pages, I suggest you not enter.*[24]

WHY THIS MATTERS

1. In recent years, corporate governance systems have become more elaborate, requiring a long list of regulatory procedures and "best practices." Charlie Munger, however, advocates a simplification and reduction in procedures and instead an emphasis on responsible leadership and organizational culture. Would the system that Munger outlines work in the average corporation? How

might corporate leaders go about implementing it?

2. The trust-based system that Munger advocates would eliminate "excessive" and bureaucratic controls but maintain "necessary" controls to reduce the incentive for employees to engage in self-interested behavior. Which governance practices in large corporations today are necessary and which are excessive?
3. The trust-based systems that Munger refers to tend to be founder-led organizations. How much of their success is attributed to the managerial and leadership ability of the founder, and how much to the culture that he or she has created? Can these be separated? How can such a company ensure that the culture will continue after the founder's eventual succession? ■

[1] Stanford University Director's College (June 26, 2006).

[2] Wesco Financial, 2007 Annual Shareholders Meeting, cited in: *Outstanding Investor Digest* (Febuary 29, 2008).

[3] Munger derives the concept of a "web of trust" in part from economist Roland Coase whose theory of the firm posits that corporations exist to capitalize on the production efficiencies that come from coordinated activity. If individuals instead contract directly with one another to produce the same goods and services, transactions costs would be considerably higher and raise the cost of production compared to what it is under an organizational setting. Source: Stanford University Director's College, loc. cit.

[4] Berkshire Hathaway, 1993 Annual Meeting, cited in: *Outstanding Investor Digest* (June 30, 1993).

[5] Stanford University Director's College, loc. cit.

[6] University of Michigan, "A Conversation with Charlie Munger" (2010).

[7] Stanford University Director's College, loc. cit.

[8] Harvard-Westlake School (January 19, 2010).

[9] Berkshire Hathaway, 1993 Annual Meeting, loc. cit.

[10] Wesco Financial, 2008 Annual Meeting, cited in: *Outstanding Investor Digest* (August 31, 2008).

[11] Berkshire Hathaway, 1993 Annual Meeting, loc. cit.

[12] Stanford Law School, "A Lesson on Elementary Worldly Wisdom Revisited," cited in: *Outstanding Investor Digest* (December 29, 1997; March 13, 1998).

[13] University of Michigan, loc. cit.

[14] Wesco Financial, 2008 Annual Meeting, loc. cit.

[15] University of Michigan, loc. cit.

[16] Stanford University Director's College, loc. cit.

[17] Wesco Financial, 2008 Annual Meeting, loc. cit.

[18] Wesco Financial, 2008 Annual Meeting, loc. cit.

[19] Berkshire Hathaway, 2003 Annual Meeting, cited in: *Outstanding Investor Digest* (Year End 2003).

[20] Berkshire Hathaway, 1995 Annual Meeting, cited in: "Warren Buffett: The Businessman," The Charlie Rose Show (July 11, 2006).

[21] Frederic W. Cook & Co., Inc. Director Compensation Report (October 2012).

[22] For research on reciprocity between the board and CEO, see: Charles A. O'Reilly III and Brian G.M. Main, "Setting the CEO's Pay: It's More than Simple Economics," *Organizational Dynamics* (2007). Source of quote: University of Michigan, loc. cit.

[23] Wesco Financial, 2008 Annual Meeting, loc. cit.

[24] University of Southern California, Law School Commencement Speech (2007).

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EXHIBIT 1 — CEO COMPENSATION AT COSTCO

CEO COMPENSATION: COSTCO VERSUS PEERS (2011)

	Salary	Bonus	Stock Awards	Stock Options	Long-Term Cash Plan	Change in Pension	Other	Total
James Sinegal CEO Costco	350,000	198,400	1,560,015	0	0	1,538	81,206	2,191,159
Michael Duke CEO Wal-Mart	1,232,670	0	12,652363	0	3,852,059	499,062	476,567	18,712,721
Francis Blake CEO Home Depot	1,066,000	0	4,477,108	2,624,997	2,385,516	0	241,332	10,794,953
Gregg Steinhafel CEO Target	1,500,000	1,250,000	4,857,502	3,696,982	2,205,000	673,635	5,523,988	19,707,107

The Committee has authority under its charter to engage compensation consultants but has not used consultants of any kind.[…]

For fiscal 2011, the Committee considered executive compensation data obtained from proxy statements for the following peer companies: Wal-Mart Stores, Inc., The Home Depot, Inc., Target Corporation, BJ's Wholesale Club, Inc., and Lowe's Companies (BJ's Wholesale Club was taken private in September 2011 so public data concerning it were more limited). These companies were selected because they all are recognized as successful retailers and two of them represent the two other major membership warehouse operators. In utilizing the comparative data, the Committee took into account that one of the companies is substantially larger than the Company. The Committee does not use the comparable company data to set mid-points or other specific quantitative comparisons of executive compensation — it has used them only for general reference.[…]

There are no fixed criteria applied by the Committee in considering the amount of these bonuses. Generally, Mr. Sinegal [CEO James Sinegal] recommends to the Committee the bonus he believes is appropriate. Historically, he has recommended modest amounts, seeking to link his bonus (as a percentage of that eligible amount stated in his employment contract) to bonuses earned by employees generally eligible for the bonuses.

The Committee observed that cash bonuses paid to chief executive officers at some peer companies are substantially higher. The Committee, however, wishes to respect Mr. Sinegal's desire to receive modest compensation, in part because it believes that higher amounts would not change Mr. Sinegal's motivation and performance. The Committee has indicated in the past and continues to believe that Messrs. Brotman [Chairman Jeffrey Brotman]and Sinegal are underpaid. The Committee has also noted that Messrs. Brotman and Sinegal have for many years had direct and indirect economic interests in shareholdings of the Company, which further align their interests with the Company's shareholders.

Note: Munger serves on the compensation committee of Costco.

Sources: Costco, DEF-14A filed with the SEC (Dec. 13, 2011); Wal-Mart, Home Depot, Target, Lowe's forms DEF-14A filed with the SEC.

EXHIBIT 2 — DIRECTOR COMPENSATION AT BERKSHIRE HATHAWAY

Directors of the Corporation or its subsidiaries who are employees or spouses of employees do not receive fees for attendance at directors' meetings. A director who is not an employee or a spouse of an employee receives a fee of $900 for each meeting attended in person and $300 for participating in any meeting conducted by telephone. A director who serves as a member of the Audit Committee receives a fee of $1,000 quarterly. Directors are reimbursed for their out-of-pocket expenses incurred in attending meetings of directors or shareholders. The Company does not provide directors and officers liability insurance to its directors.

The following table provides compensation information for the year ended December 31, 2012 for each non-management member of the Corporation's Board of Directors.

Director	Fees Earned or Paid in Cash	Total
Howard G. Buffett	$1,800	$1,800
Stephen B. Burke	1,800	1,800
Susan L. Decker	5,800	5,800
William H. Gates III	1,800	1,800
David S. Gottesman	1,800	1,800
Charlotte Guyman	5,800	5,800
Donald R. Keough	5,800	5,800
Thomas S. Murphy	5,800	5,800
Ronald L. Olson	1,800	1,800
Walter Scott, Jr.	1,800	1,800

Source: Berkshire Hathaway, DEF 14-A filed with the SEC (Mar. 15, 2013).