Q&A

LEGAL MATTERS WITH CHARLES T. MUNGER

Charles T. Munger is a man of many interests, much like his hero Benjamin Franklin. Self-taught in a range of disciplines, he's a strong advocate for interdisciplinary education saying, "If I can do it, many people can." A student of physics and mathematics before entering law school, he left his mark on the legal profession early in his career by co-founding Munger, Tolles & Olson in 1962—a firm that is today consistently ranked at the top of its field. Now an icon of the business world, he joined forces with Warren Buffett in the mid-1960s—leaving law to become vice chairman of Berkshire Hathaway and a partner in one of the most successful firms in the world.

Over the years Munger has gained a reputation as something of a no-nonsense voice for sound investment strategies and responsible business practices—as well as simple common sense. But lately it is the mythical Greek character Cassandra who is much on his mind. After living through the Great Depression, serving in WWII, and entering the business world in an era of restraint and sensible regulation, he is irritated by what he calls "the asininities" of today's government and business leaders that led to the current crisis. He saw the financial train wreck coming and voiced his concerns loudly. But almost no one shared them.

"It is painful to see the tragedy coming, to care about all the people who are going to be

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clobbered, and not to be able to do one damn thing about it," said Munger, as we prepared for the interview that follows. As the nation navigates through this crisis, entering waters previously uncharted, perhaps the powers that be will be more willing to address issues previously ignored.

Joseph A. Grundfest '78, the W. A. Franke Professor of Law and Business and co-director of the Arthur and Toni Rembe Rock Center for Corporate Governance, is more than familiar with many of Munger's complaints. A former commissioner at the Securities and Exchange Commission (SEC) and counsel to the President's Council of Economic Advisers, Grundfest is today a prominent voice for sense and responsibility in corporate governance. Grundfest founded Stanford's Directors' College, the premier venue for continuing education of directors of publicly traded firms, and also founded the award-winning Stanford Securities Class Action Clearinghouse, which provides detailed, online information about the prosecution, defense, and settlement of federal class action securities fraud litigation. His scholarship focuses on matters related to securities fraud, complex litigation, corporate governance, and statutory interpretation, and his name regularly appears on lists of the nation's most influential attorneys. -SHARON DRISCOLL

GRUNDFEST: I'll begin with two words: Bernie Madoff. What do you think "l'affaire Madoff" teaches us about the operation of our financial system?

MUNGER: One of the reasons the original Ponzi scheme was thrown into the case repertoire of every law school is that the outcome happens again and again. So we shouldn't be surprised that we have constant repetition of Ponzi schemes.

And of course there are mixed schemes that are partly Ponzi just shot through American business. The conglomerate rage of buying companies at 10 times earnings and issuing stock time after time at 30 times earnings to pay for them was a legitimate business operation mixed with a Ponzi scheme. That made it respectable. Nobody called it illegal. But it wasn't all that different from mixing a significant amount of salmonella into the peanut butter.

Harry Markopolos, a hedge fund expert, sent a detailed memo to the Securities and Exchange Commission (SEC) articulating why Madoff must have been a fraud. The SEC did nothing with it. We don't know the reason why, but I'm willing to suggest that the lawyers who received Markopolos's warning simply didn't understand the finance or math that Markopolos relied on.

Lawyers who only know a mass of legal doctrine and very little about the disciplines that are intertwined with that doctrine are a menace to the wider civilization.

Why didn't the SEC understand the warning that was clearly placed at its door?

The SEC is pretty good at going after some little scumbag whom everybody regards as a scumbag. But once a person becomes respectable and has a high position in life, there's a great reticence to act. And Madoff was such a person.

Why aren't our regulators capable of addressing many of the issues that we confront in the market today?

Most of them plan to go back to living off money made in the system they are supposed to regulate. You can argue that financial regulation is so important that no one in such a position should ever be allowed to do as you partially did—serve and then leave to make money in the regulated field. Such considerations led to lifetime appointments for federal judges. And we got better judges with that system.

So government service should be a little like a monastery from which you can never escape?

What you *can* opt to do is retire, which is pretty much what our judges do.

What about the idea that investors should be able to fend for themselves?

We want the sophisticated investor to protect himself, but we also want a system that identifies crooks and comes down like the wrath of God on them. We need both.

And here I think what's intriguing is we have a failure of both.

Yes.

As we look at the current situation, how much of the responsibility would you lay at the feet of the accounting profession?

I would argue that a majority of the horrors we face would not have happened if the accounting profession developed and enforced better accounting. They are way too liberal in providing the kind of accounting the financial promoters want. They've sold out, and they do not even realize that they've sold out.

Would you give an example of a particular accounting practice you find problematic?

Take derivative trading with mark-to-market accounting, which degenerates into mark-to-model. Two firms make a big derivative trade and the accountants on both sides show a large profit from the same trade.

And they can't both be right. But both of them are following the rules.

Yes, and nobody is even bothered by the folly. It violates the most elemental principles of common sense. And the reasons they do it are: (1) there's a demand for it from the financial promoters, (2) fixing the system is hard work, and (3) they are afraid that a sensible fix might create new responsibilities that cause new litigation risks for accountants.

Can we fix the accounting profession?

Accounting is a big subject and there are huge forces in play. The entire momentum of existing thinking and existing custom is in a direction that allows these terrible follies to happen, and the terrible follies have terrible consequences. The economic crisis that we're in now is, in its triggering circumstances, worse than anything that's ever happened.

Worse than the Great Depression?

The economy hasn't contracted as much as during the Great Depression, but the malfeasance and silliness, the triggering events for today's crisis, were much greater and more widespread. In the '20s, a tiny class of people were financial promoters and a tiny class of people were buying securities. Today, it's deep in the whole culture, and it is way more extreme. If sin and folly get punished appropriately, we're in for a bad time.

And do you see a chance that our current economic woes could reach to a level closer to the Great Depression?

Well, nobody can predict that very well because we've never faced conditions as extreme.

Very few people realize how much we've screwed up. Even in leading law schools and business schools very few people realize that the mess at Enron never could have happened if accounting customs hadn't been changed. What we have now is a bigger, more widespread Enron.

When the regulators put in the option exchanges, there was just one letter in opposition saying "you shouldn't do this," and Warren Buffett wrote it. When they wanted to make the securities market function better as a gambling casino with vast profits for the people who were croupiers—there was a big constituency in favor of dumb change. Buffett was like a man trying to stop an elephant with a pea shooter. We're not controlling financial leverage if we have option exchanges. So these changes repealed longtime control of margin credit by the Federal Reserve System.

You get unlimited leverage.

Unlimited leverage comes automatically with an option exchange. Then, next, derivative trading made the option exchange look like a benign event. So just one after another the very people who should have been preventing these asininities were instead allowing foolish departures from the corrective devices we'd put in the last time we had a big trouble—devices that worked quite well. The investment banks of yore, chastened by the '30s, were private partnerships, or near equivalents. The partners were dependent for their retirement on the prosperity of the firms they left behind and the customs and culture they left behind, and the places were much more responsible and honorable. That ethos, by the time the year 2006 came along, had pretty well disappeared. Our regulators allowed the proprietary trading departments at investment banks to become hedge funds in disguise, using the "repo" system—one of the most extreme credit-granting systems ever devised. The amount of leverage was utterly awesome. The investment banks, to protect themselves, controlled, to some extent, the use of credit by customers that were hedge funds. But the internal hedge funds, owned by the investment banks, were subject to no effective credit control at all.

You and your partner, Warren Buffett, have for years warned about the dangers of the modern derivatives markets, particularly credit derivatives, and about interest rate swaps, currency swaps, and equity swaps.

Interest rate swaps have enormous dangers given their size and the accounting that has been allowed. But credit default derivatives took that danger to new levels of excess—from something that was already gross and wrong. In the '20s we had the "bucket shop." The term bucket shop was a term of derision, because it described a gambling parlor. The bucket shop didn't buy any securities. It just enabled people to make bets against the house and the house furnished little statements of how the bets came out. It was like the off-track betting system.

Until the house lost its money and suddenly disappeared. Or the house made its money and suddenly disappeared.

That is right. Derivatives trading, with no central clearing, brought back the bucket shop, because you could make bets without having any interest in the basic security, and people did make such bets in the billions and billions of dollars. Some of the most admired people in finance—including Alan Greenspan—argued that derivatives trading, substituting for the old bucket shop, was a great contribution to modern economic civilization. There's another word for this: bonkers. It is not a credit to academic economics that Greenspan's view was so common.

Isn't it ironic in a sense that what we now have is a world in which every major financial institution is a federally chartered bank.

We had a rule that a business couldn't also be a deposit-insured bank, because we didn't want every business to be able to use the government's credit to do anything it wanted. It was a profoundly good idea to prevent the banks from being in other businesses.

Well now, when the captive finance companies like General Motors Acceptance Corporation are too big to fail and get in

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trouble, we give them a bank charter so that a company whose main interest is to preserve employment in Michigan gets to use the government's credit in huge amounts to sell more cars. This is crazy. Our whole regulatory system was long designed to prevent what we're stumbling back into as a reaction to a crisis. We do not need a bunch of non-banks with unlimited access to the government's credit.

So some of the steps that we're putting in place now to try to correct the problems are creating new problems.

Yes. We're also recreating old problems because we're reacting hurriedly to a crisis.

I think it's a given that you have to change General Motors in order to save it.

Well, of course. But count on some changes being silly.

The Federal Reserve is today buying assets that it wouldn't have even considered looking at a year ago.

I think the problem is so extreme that nothing non-extreme has any chance of working. I like the fact that it is so willing to do things that have never been done before, because we have problems that we have never seen before. I am a right-wing Republican, and I like the fact that Obama has put into the White House Larry Summers, who is a ferociously smart human being and will try to do the right thing even if it offends some people. I think that's a quality that we need right now.

What do you think of the job that President Obama is doing so far?

Given the circumstances, I think he's doing very well indeed. I don't want to trade him in at the moment for any other Democrat.

Do you have any views on the fiscal side of things—the mix of fiscal stimulus, tax cuts, and the like?

We have to save the financial system, in spite of our revulsion about the way many of its denizens behave. We also need a huge spending stimulus from the federal government. We have a whole lot of things that are worth doing. By and large, the president does not plan to have people standing around holding shovels in the middle of some forest. He is talking about fixing infrastructure and so on. In the city of Los Angeles, where I live, the streets are a disgrace compared with the streets in Japan. Japan had so much fiscal stimulus that you can't find a pothole on a side of a mountain.

As part of the response, the U.S. government and governments worldwide are printing money at a rate that is absolutely unprecedented. Should people be worried about deflation?

Sure. But the dangers from what we have to do are less than the dangers that would come if we responded much as we did in the '30s.

I think it is dangerous to have big disasters in a modern economy. I regard pre-World War I Germany as an advanced, decent civilization. After all, little Albert Einstein got a very good, subsidized primary education in German Catholic schools. But in its economic misery, Germany became dominated by Adolf Hitler. We've seen some god-awful people come to power in various miseries in various countries. Enough misery has huge dangers in a world where we have new pathogens, atomic bombs, and so forth. So we can't afford to have huge economic collapses. I think we have to do what we're doing. We're hooked. And so are the other advanced nations.

What I'm hearing from you, Charlie, is "so far so good"?

It is very reasonable to react with the extreme vigor that's been shown. In retrospect the vigor wasn't quite enough. I would argue that it was pluperfectly obvious the government had to save all these banks and major investment banks.

So on a scale of 1 to 10, how big a mistake was it that they let Lehman Brothers go?

I don't think that was a mistake. You can't save everybody. That would have created unlimited revulsion in the body politic. I probably would have let Lehman go, too.

Even though the market seized up very dramatically afterwards and we had some of the most difficult short-term financial consequences of that failure?

We needed a total correction to a system that was evil and stupid. You can't have a rule that no matter how awful you are, you're always going to be saved. You have to allow some failure. We don't need all our bright engineers going into derivative trading and hedge funds and so on. We need some revulsion.

How and why do you think economists have gotten this so wrong?

I would argue that the economists have not been all that good at working concepts of good and evil into their profession. Nor do they understand, at all well, the economic consequences of bad accounting.

In fact, they've made a profession of driving value judgments out of the subject.

Yes. They say it's not economics if you think about the consequences of good and evil, and good and bad business accounting. I think what we're learning is that when you don't understand these consequences, you don't have an adequately skilled profession. You have big gaps in what you need. You have a profession that's like the man that Nietzsche ridiculed because he had a lame leg and was very proud of it. The economics profession has been proud of its lame leg.

So in order to cure the lame leg, you would lean more toward an approach to economics that takes human nature into account?

If you totally divorce economics from psychology, you've gone a long way toward divorcing it from reality.

The same could be said of psychology. If you divorce economics from psychology …

That's what's wrong with psychology professors. There are

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so few of them that know anything about anything else. They have this terribly important discipline that all the other disciplines need and they can’t communicate that need to their fellow professors because they know so little about what these other professors know. This is not an unfair description of much of academia.

You’ve often said that one of the keys to your success has simply been to avoid making the garden-variety mistakes that you see other people make.

Warren and I have skills that could easily be taught to other people. One skill is knowing the edge of your own competency. It’s not a competency if you don’t know the edge of it. And Warren and I are better at tuning out the standard stupidities. We’ve left a lot of more talented and diligent people in the dust, just by working hard at eliminating standard error.

If you had to characterize a few mistakes that you see executives making, which ones jump out at you?

An extreme optimism based on an inflated self-appraisal is one. I think that many CEOs get carried away into folly. They haven’t studied the past models of disaster enough and they’re not risk-averse enough. One of the very interesting things about Berkshire Hathaway is how chicken it is, how cautious, how low is its leverage. But Warren and I would not have been comfortable with more risk, entrusted with other people’s net worths. There was no reason for our financial institutions to stretch as much as they did, with the leverage, the shady people and the compromises.

Let me play devil’s advocate. People might say, “Wait a minute. I’m at bank A and I’m competing with banks B, C, and D, and they’re running at higher leverage and the system is willing to give them that additional leverage and they’re making more profits. Unless I operate at their leverage ratios, I can’t pay my traders competitively and I will fail.”

You’ve accurately described the way the culture generally works and you have seen in the present crisis how well it works for the wider civilization when everyone insists on not being left behind in lowering standards. I think the culture is simply going to have to learn to work more the way Berkshire Hathaway does, instead of the way Citigroup did.

Do we go back to the old partnership model?

It would be vastly better. The culture of Goldman Sachs as a partnership was morally superior and better for the surrounding civilization than the culture that came after it went public.

Do you think we’re going to be able to go back to some of the more traditional models that you value?

A lot of it is going to be forced, so we’ll go some in that direction. However, there are powerful forces intrinsic to the system that resist reform. But I have lived in my own life with responsible investment banking. When I was young, First Boston Company was an honorable and constructive firm and very much served the surrounding civilization. Investment banking at the height of this last folly was a disgrace to the surrounding civilization.

Looking forward, I think we’ll be fortunate if we’re able to muddle along with 0 to 1 percent growth, 2 or 3 years out.

If you’re used to growing 3 to 4 percent per year and you go to no growth at all for 10 years, which is roughly what happened in Japan, then, as human tragedies go, that’s not major. That’s not the rise of Hitler. It’s painful, but it’s quite endurable.

Are you worried about China and the possibility of unrest there, given this global economic slowdown?

The people rising fastest in the Communist Party are engineers, and that’s hugely desirable. The Chinese people have vast virtues intrinsic to their culture and their nature that make me optimistic that China will keep advancing. If China has to adapt to 4 percent growth instead of 10 percent growth, China will manage.

In many ways I see China and the United States as being natural allies. Both economies are tremendous importers of oil. It’s in both of our interests to come up with effective, low-cost, clean energy solutions. Yet we have these perpetual frictions that tend to dominate the debate. Any views on that and what we could do to address those questions?

China is a nuclear power with more than a billion people, talented, driven, and achievement-motivated. I think we have no practical alternative but to get along with China. I think, properly handled, our relationship can be a big plus.

Getting back to prospects for growth, I would bet on technology.

We think alike. And we may even take our present misery and use it to boost our chance of ending up where you and I want us to go. We probably have a man in the White House who is quite friendly to this concept.

A crisis is …

We may be forced into much desirable change. If there aren’t a lot of new jobs in derivative trading, maybe the engineers will have to do more engineering. If you look at the history of Berkshire Hathaway, you will find that time after time

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The Prolific Professor: Lawrence M. Friedman

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"We were talking about a shopping center in Santa Clara County. The Pruneyard. Do you know why it's called the Pruneyard? Before this was Silicon Valley, it was an agricultural center and the area was full of fruit trees. The Supreme Court decided the Pruneyard case … ." He goes on, explaining the landmark case that pitted the shopping center against several local high school students assembling for the purpose of collecting signatures, and then launches into a lecture on the history of free speech in American law, the undergrads hanging on his every word. Friedman started teaching the undergraduate class, *Introduction to American Law*, in 1985.

"Law in all its forms—Congress, the courts, police—is ubiquitous in this country and extraordinarily important. Yet because legal training is a graduate program, the typical undergraduate student, even at an elite university, will not study the law," says Friedman, who, in addition to this class, still carries a full teaching load at the law school. "I thought our undergraduate students should have this class, so I introduced it with support from the political science and American studies departments."

Friedman's office is a work in progress, or many works in progress, with most available space covered with stacks of files and books.

"I've written or edited around 27 books and something like 200 articles. But who's counting?" he says.

He waves at the piles of folders and stacked books in his office. "My most recent work, called *Dead Hand*, will be published soon. It's a social history of wills and trusts, a fairly short book that I enjoyed working on. So I've never abandoned wills and trusts but came full circle back to them," he says. Within the circle of Friedman's expertise are many vortexes, each demonstrating a broad range of interests. And curiosity. For Friedman is, above all else, a great thinker. What can coroners' reports tell us about our society and the law that governs us? How do wills and estates change over time? Can we explain spikes in crime? How have our views on issues such as equality, privacy, and marriage changed and why? He smiles just asking the questions. And he's lived long enough to have witnessed many changes firsthand.

"I joke to my students that I'm now old enough to be considered a primary source," he says. "Growing up in Chicago, there were no black policemen, no black bus drivers, no black shoppers at Marshall Fields," he says. "Yet in my lifetime so much has changed. We now have an African-American president. It's amazing."

His enthusiasm for the law, history, and society is contagious. After embracing a new area of legal scholarship some 50 years ago, Friedman is now one of the icons of the discipline. Today, young scholars seek him out; they aid him with his research and cheerfully help him sift through those boxes of old files heaped on tables in the law library basement and in his office. And some are lucky enough to gain a credit in one of the many, many papers and books he has written. But, indeed, who's counting? Very likely, the thousands of scholars throughout the world who regularly cite Friedman. SL

IN FOCUS

Just the Facts: Empirical Legal Studies on the Rise

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the serious issues we face today without the benefit of this kind of research? I don't think you can."

That wasn't the case just 30 years ago, says Deborah R. Hensler, Judge John W. Ford Professor of Dispute Resolution and associate dean for graduate studies, who before coming to Stanford led the RAND Corporation's Institute for Civil Justice, a center dedicated to empirical research. When she began her law career in the 1970s, she says, "The idea that you would bring empirical data to bear on questions having to do with legal doctrine was mind-boggling." Hensler's recent work represents the qualitative strand of empirical legal studies; rather than running experiments or statistically analyzing large data sets, she uses interviews to understand why class actions have become increasingly popular outside the United States during a period when they've come into disrepute here. To share information about class-action developments in different countries, Hensler directs the Global Class Actions Exchange (http://globalclassactions.stanford.edu/).

For the most part, empirical legal scholars see themselves as neutral providers of fact. "Too many times we see arguments based on supposition," says Lemley. And although he's referring to the IPLC, he echoes sentiments shared by most empiricists when he says, "Our goal is not to push an agenda, but to give people the data to make up their own minds." SL

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we did something that I describe as turning lemons into lemonade. Part of my Berkshire Hathaway holdings came from a dumb investment.

I didn't realize you made dumb investments.

I certainly did. I think it's part of a life lived right that you learn how to make some lemonade out of your lemons.

So turn the clock back. Imagine that you're a young law school graduate from a top law school, one of the top grads the same way you were several years ago, what advice would you give to a graduate looking at the world today?

Well, that's easy. I would avoid fields where prosperity depended to a considerable extent on misbehavior. I would not go into a plaintiffs' law firm. I would be afraid of what that would do to me. And I would want to work for people at a business that I admired, and I would take less money to do that.

Charlie, we're at the end of our time and I'd like to thank you. You've really been terrific. SL