



The Ballad of Clayton Homes

Berkshire Hathaway's \$1.7 billion acquisition of a mobile-home company seemed like a perfect match. Then shareholders got a look, and a folksy tale suddenly turned ugly.

From: [Issue 78](#) | January 2004 | Page 76 **By:** Jennifer Reingold **Illustrations by:** Christian Clayton

Warren Buffett sat in Omaha, Nebraska, bushy eyebrows knitted as he tried to get his voice in tune, via speakerphone, with a guitar in Maryville, Tennessee. On the other end of the line, strumming away, was the affable, homespun Jim Clayton, chairman of the \$1.2 billion manufactured-housing giant Clayton Homes, the latest catch in Buffett's billion-dollar acquisition net. The two were practicing for a musical meeting that would introduce Buffett to Clayton's employees and, hopefully, pave the way for a smooth transaction.

It was a fitting scene. If it were a country song, the saga of how Warren Buffett managed to take control of the company might be the kind of downbeat ditty that would have listeners crying in their beer. It's a story of love gone wrong for many outside shareholders, who believed their company was worth far more than what Buffett offered for it and who fought passionately for their prize only to find betrayal and heartache at the bitter end. The notes of this song ring truer for those connected to the Clayton family. In their eyes, it's a blood-pumping anthem of triumph over adversity. Clayton, 69, a helicopter-piloting musician and son of a sharecropper from the Tennessee sticks, made it big--real big. Then, against all odds, he and his son Kevin sold the publicly traded company to the world's most respected investor, saved the community, and got to live happily ever after.

The truth, as in most ballads, bar fights, and divorces, lies somewhere in the middle. Here, then, is the tale of a prominent Tennessee family, rich in stock but relatively poor in cold hard cash, that bit and bit hard when the oracle of Omaha suddenly decided that there was mobile-home gold in the rolling hills outside Knoxville. The struggle that ensued entangled an angry bunch of Denver-based butchers, the most shark-toothed class-action lawyers in the business, and even former vice president Dan Quayle before the deal finally went through (although investors have filed a lawsuit against Clayton and its board).

What we are left with is a darn good yarn about how what began as a cordial meeting of the minds quickly turned into one of Buffett's toughest acquisitions. The Clayton story shows how Buffett's gimlet eye for a good buy is a great thing--as long as you're on the right end of the deal. For the Clayton family, the buyout was the ultimate validation of an entrepreneurial dream; for the outside shareholders, it reeked of a sweetheart setup that couldn't possibly be fair if the world's sharpest value investor wanted in. No one lost it all--the shareholders were paid in cash and the company continues onward--but did anyone other than the Clayton family and Warren Buffett really win?

The battle for the hearts and minds of a company better known for double-wides than charges of double-dealing began back in February of 2003, when a group of students at the University of Tennessee B-school prepared for the most important professional day of their young lives. Thanks to a relationship cultivated over the years by UT finance professor Al Auxier, 40 members of the school's Financial Management Association had flown to Omaha to visit Warren Buffett himself. Buffett is known for his low profile, but for the past six years, he has invited the group to spend a day at Berkshire Hathaway sipping Cherry Cokes, nibbling on See's Candies, and chatting about investments, the economy, and whatever else strikes their fancy. The 2003 meeting was held on February 3, in the middle of a blizzard that had some students fretting--or perhaps hoping--they'd be stranded in Omaha. "We weren't used to seeing that kind of snow," laughs Angel Norman, an MBA student.

Although Buffett had recently dipped a toe into the manufactured-housing market by investing more than \$200 million in the debt of bankrupt Oakwood Homes, the UT students knew more than he did about Clayton Homes, which is

headquartered just outside Knoxville, in neighboring Maryville. Jim Clayton, a UT alum, has contributed generously to the school and donated funds for the students' group to use in investment contests. Professor Auxier and Jim Clayton are friends. And one of the students visiting Omaha, Richard Wright, was actually working part-time as an intern for Clayton.

So when the group was searching for a gift for Buffett, they seized on *First a Dream* (FSB Press, 2002), Clayton's folksy, chatty 2002 autobiography detailing his rise from the feed-sack-wearing son of a cotton farmer to a mainstay on the *Forbes* 400 list of the wealthiest Americans. Clayton started the company in 1966 with one charred mobile home that he and his parents renovated and resold. By 2002, Clayton Homes reached \$1.2 billion in sales and was the pride of its industry.

"We had run out of ideas" for gifts, says Auxier, whose previous presents to Buffett included an autographed football from the coach of the 1998 UT national champions, Phil Fulmer. This time, Wright, a senior, was the official emissary. "After [the Q&A], we went to go and take pictures, and I handed him Mr. Clayton's book," said Wright. "I said, 'I've been working with Mr. Clayton. These are your types of people.' "

As the legend goes, Buffett was so inspired by Jim Clayton's book that he decided to buy his company. But as with so much else in this story, there's a harder-edged reality beneath the folksy myth.

Buffett's response: "Well, tell [Clayton] he deserves a raise." By the time Wright brought Jim Clayton an autographed picture of Buffett holding the book, Buffett had already read it. As the legend goes, and as local papers and *The Wall Street Journal* have reported, Buffett was so inspired that he called Kevin Clayton, Clayton Homes' CEO, to begin serious discussions about buying the company, which by all accounts had never been for sale. (Buffett's code name in the talks: Mr. Sunshine.)

But as with so much else in this story, it turns out that there's a harder-edged reality beneath the folksy mythmaking. Buffett did not come across Clayton Homes completely by charming happenstance. Kevin Clayton initiated the contact, Auxier says, asking him to tell Buffett that the company was interested in exploring "a business relationship." That relationship quickly blossomed into Buffett's all-cash offer on April 1 to buy Clayton Homes for \$12.50 a share, a 12.3% premium over the March 31 price. The Claytons leaped at the chance to become part of the Berkshire Hathaway empire. And Wright woke up one morning to see a picture of himself handing Buffett the book splashed across the front page of the business section of the *Knoxville News-Sentinel*, with the headline "Gift of Book Sparks Transaction."

Clayton's management and board has portrayed the offer as being as serendipitous as the sudden appearance of a rainbow on a gloomy day. Certainly, it made sense for Jim Clayton himself, who had turned over the day-to-day reins of the company to Kevin in 1999 but remained chairman; it allowed him a way to monetize the 28% of the stock he and his family foundation controlled for \$470 million in cash without dumping his holdings on the open market. "They were rich, but rich on paper," says Greg Taxin, CEO of proxy adviser Glass, Lewis & Co. "The minute they sell a single share, the thing would tank. Along comes Warren Buffett." For Clayton's other executives, Berkshire's reputation for buying well-run family businesses and leaving them be seemed like ideal job security in a time of relative trouble. Also appealing was Berkshire Hathaway's AAA debt rating, a huge edge for a company as dependent on financing as Clayton.

Certainly, things in manufactured housing were not going smoothly. The industry had fallen into one of its worst down cycles in decades, as its overly aggressive lending practices sparked a boom that low interest rates for "real" houses helped turn into an enormous bust. The stock had fallen from a high of \$19 in 2002 to its current \$11, and earnings in 2003's third fiscal quarter were down 10%. The company's dependence on its financial-services unit, which had provided most of its profits in recent months, was seen as a risk. And the Iraq war, which began March 18, had driven down the overall stock market as well. It looked like a good time for value hunting.

At least that's what Buffett, the master of the no-hassle bargain-basement deal, thought. But country songs are filled with twists and turns, and this one was no different. Investors considered Clayton Homes to be the premier player, boasting an efficient vertical model with 20 manufacturing plants, almost 300 company-owned stores, hundreds of independent retailers, 86 manufactured-housing communities, and mortgages for some 168,000 people. Even the homes themselves have a superior look and feel. No tornado traps, they often sit on basements, boast slanted roofs, and, if you weren't there on drop-off day, could fool anyone. A five-bedroom Norris Home, one of Clayton's high-end brands and

priced at about \$60,000, features a working fireplace, a whirlpool bath, stainless steel sinks, a surround-sound stereo system, and GE appliances.

Certainly, the Claytons hadn't signaled a major problem: At the second (fiscal) quarter conference call for 2003 in January, Kevin Clayton, while bemoaning the state of the industry as being in a "full-fledged meltdown," also took pains to differentiate his own company's prospects. "We have a better model," he said. "You're not comparing apples to apples." Indeed, investors had held on to Clayton precisely because it had for years pursued a careful strategy while rivals such as Oakwood Homes lent their way into bankruptcy. At Clayton, dealers were required to bear much of the financing risk of their sales--giving them an incentive to find good customers, not just customers. Investors also believed in management and in the company's relatively pristine balance sheet.

This flinty conservatism came straight from Jim Clayton's hardscrabble upbringing. Born into a destitute farming family near tiny Finger, Tennessee, that relied on a "thunder bucket" under the bed on winter nights rather than an outhouse, Clayton was working the fields by age 5, yet still managed to make it through high school and pursue his dream of being a country singer. While performing on a local show, Clayton crossed paths with the likes of Wink Martindale, Carl Perkins, and later Elvis Presley and Dolly Parton. He sold everything from vacuum cleaners to flower seeds, became a radio repairman and an accomplished pilot, and received an engineering degree and a law degree from the University of Tennessee while fixing up and reselling used cars.

Clayton was anything but a sucker. He never overpaid for an asset, prided himself on giving his customers good value, and even outsmarted his way out of bankruptcy when a local bank that had overextended itself suddenly foreclosed on his car lot. (Clayton was savvy enough to buy back the repossessed cars in an auction, using cash committed by customers who trusted him.) With Clayton Motors, and later Clayton Homes, he became famous throughout the South as a master of the deal who prided himself on rooting out the diamond chips in other people's trash piles. From cars, Clayton moved to homes, where he grew with a strategy of careful expansion, decent pricing, and high quality. "He's value-driven in everything he buys," says Tom Gunnels, a friend and tennis partner of Clayton. "Whether it's a pair of tennis shoes or a helicopter, he shopped around until he found the best deal."

Never had he accepted the first bid on anything--until now. So how was it, wondered many shareholders, that such shrewd businessmen as Jim and Kevin Clayton would leap at what seemed to be such a low offer when the industry had already hit bottom? Why not try to beat the bushes for a better bid? Could it be that the family's interests had diverged from those of its other shareholders? "I was in shock that night," says Carl Tash, CEO of Cliffwood Partners, a real-estate investment firm that held 1.2 million Clayton shares. "For a year we had been telling our investors that it would be a \$20 stock. I thought it was an April Fools' joke." Tash was particularly upset because the previous October, he had offered Kevin Clayton help financing some newly purchased loan portfolios. "His point to us," says Tash, "was that it's a lucrative business, and we will do it ourselves." Both Claytons refused to comment on this point or any others, citing the ongoing litigation.

Quickly, opposition to the deal began to form. One criticism centered on the quality of the fairness opinion of Morgan Keegan, a local investment bank. Orbis Investment Management, the fourth largest holder of the stock with some 5%, complained that the bank didn't appropriately value the company. Proxy adviser Glass, Lewis & Co. figured the company was worth between \$15.80 and \$17.20 a share, well above Buffett's offer. Shareholders also noted that the stock prices of both Clayton and its peers had risen significantly since the offer was made, as the stock market surged. Clayton itself traded above Buffett's offer for the entire month of June, indicating that people expected either a better price or that the deal wouldn't close.

Dan Quayle showed up--representing a hedge fund named for the three-headed dog guarding the gates of hell.

Suddenly, the Claytons found themselves in the rather unusual position of having to convince investors of how bad their business was. Complicating matters was the general sense that if Buffett bids for something, it must, by definition, be undervalued. Michael Winer, portfolio manager of the Third Avenue Real Estate Value Fund, called Buffett as a courtesy before he issued a press release blasting the deal. "He tried to convince me that I was wrong," Winer says. "We agreed to disagree, but it was interesting to hear Warren Buffett say how bad a business it was, and he's paying \$1.7 billion." Buffett wouldn't comment.

Shareholders were also worried about Clayton's record of corporate governance. In 2002, the Council of Institutional Investors put Clayton on its "focus list" of underperforming companies and criticized the company's independence standards. Of the then-seven directors, three were

Claytons, there was no nominating committee and a compensation committee board member, Thomas McAdams, was a partner at the company's primary law firm. Another outside member, C. Warren Neel, who currently heads up the UT's new Center for Corporate Governance, is a scuba-diving and skiing buddy of Jim Clayton and his wife Kay, and advised Clayton on the purchase of some local banks. Clayton calls McAdams "my special friend" in his autobiography and includes several photographs of Neel and his wife in social situations. "There was reason to doubt that this company had in its DNA the right level of care and responsibility to shareholders," says Glass Lewis's Taxin.

An episode recounted in *First a Dream* adds to those doubts. About a decade ago, an independent board member enraged Clayton by demanding an investigation into a dispute with an outside auditor. Dismissing the investigation as a pretext for steering business to a local law firm,

Clayton persuaded the board to vote, six to two, to suspend it. The two dissenters resigned. From then on, the board was peopled with friendlier types, all of whom supported the Buffett offer. After the failure of separate attempts by Orbis and others to block the sale or require that it go through only if a majority of independent shareholders voted for it, the Clayton shareholders meeting was set for July 16, 2003 at 11 a.m. The sense was that the vote would be very close. Strangely, proxy adviser Institutional Shareholder Services supported the deal while its own subsidiary, Proxy Voting Services, opposed it. No one knew what to expect when they walked past the two black stone lions proudly guarding the Clayton Homes headquarters that morning.

What followed was a shareholder meeting like no other. The appointed hour came and went with no executives to be found. The crowd began to grow restless, until finally, at about 11:25, Jim Clayton entered the room. Gone was the fun-loving man who enjoyed getting people in the mood with a tune or two. This time, says Steve Parham, a shareholder and attendee, he looked "somber." "These things can get complicated," Clayton said, explaining that Kevin wasn't there because he was on the phone with some shareholders.

Although the first item on the agenda was the vote, Clayton suddenly decided to take investor questions. "He was clearly nervous and clearly stalling," says William B. Gray, president of Orbis. According to attendees, virtually all of the questions that followed were negative in tone. Finally, Tash, the head of the firm that held a chunk of Clayton stock, stood up. "The purpose of this meeting was to have a vote," he announced, "and I'm asking you to call for a vote." Clayton's reaction, according to the affidavits of several people there, was bizarre. He looked at a colleague standing by the door and asked, "Is there any change?" The man shook his head no. Clayton, rather than responding to Tash's request, immediately announced an adjournment for lunch. In a deposition, Clayton later testified that he had no recollection of the request for a vote. (The August 13 deposition was remarkable for Clayton's lack of memory: He failed to recall certain events 103 times in the two-and-a-half-hour interview.)

The company picked up the tab for the meal, then reconvened the meeting a little after 1 p.m. Kevin Clayton announced that three large institutional shareholders had asked for a two-week adjournment so the company could have a chance to attract other bidders. Gray later said he talked to two of the investors and they both denied making the request. He also charges that Clayton set voting rules on the motion to adjourn that guaranteed it would pass. Gray, furious, asked for a vote on the merger itself, but Clayton said that the motion to adjourn superseded that vote. The meeting ended in confusion.

Behind the scenes, it turned out, Kevin Clayton had learned that Fidelity--which as of March 31 had been the second largest shareholder with 8.5% of the vote--had accidentally voted in favor of the deal, despite its policy in contested mergers of withholding votes until the last second, and wanted to pull back its support. Suddenly, the Claytons were looking at possible defeat rather than a narrow victory. That day, according to the deposition of Berkshire CFO Marc Hamburg, Clayton executives spoke with Buffett's people, who agreed to put off the deal a little bit longer in return for a \$5 million fee. Buffett reiterated that he wasn't going higher. The company hadn't pressed him before. Why should he change now?

Allen Goolsby, an attorney representing Clayton Homes at Hunton & Williams based in Richmond, Virginia, says the adjournment was simply a way to be responsive to shareholders and give other bidders a chance. But angry

shareholders believe that Clayton adjourned the meeting rather than hold a vote the company knew it was about to lose. "We came prepared on the 16th and we won," says Tash. "We played by their rules, and they moved the goal line."

"It was interesting to hear Warren Buffett say how bad a business it was, and he's paying \$1.7 billion."

By now, all that sweet music Buffett and Clayton had made together was a distant memory. On July 25, an institutional shareholder, the Denver Area Meat Cutters and Employers Pension Plan, which held some 45,000 shares, suddenly filed suit in Blount County Circuit Court, charging "self-dealing, abusive control, and lack of candor" on the part of Clayton Homes. Who was representing this heretofore-unknown group of red-blooded activists? Milberg, Weiss, Bershad, Hynes & Lerach LLP, the New York law firm whose name strikes fear in the heart of any public company executive. "They sold the company in a way that hurt our members," says Ernest L. Duran Jr., president of the United Food and Commercial Workers Local 7 in Wheat Ridge, Colorado, the umbrella union that includes the Meat Cutters (which still has a separate pension fund). "Our larger concern is to keep corporations more accountable." Darren Robbins, the tough-talking Milberg attorney, puts it more bluntly. "Their shutting down the meeting," he says, "was akin to [former California governor] Gray Davis ordering the National Guard to shut down the polls. It's a well-known fact that they committed a fraud." Other suits continued in Delaware, creating still more confusion because there were similar cases in different jurisdictions.

Then, another potential suitor emerged--a secretive hedge fund called Cerberus Capital Management, named for the three-headed dog guarding the gates to Hades. Cerberus, which in partnership with others had recently outbid Buffett by spending more than \$650 million for Consec's mobile-home lending unit, had written to Clayton expressing possible interest a few days before the meeting. On July 21, Cerberus and its chairman of global operations, former vice president Dan Quayle, showed up to kick the vinyl siding. Some 50 due diligence specialists spent more than a week holed up in high-end double-wides adjoining the main offices and pored over the books. Quayle played the good-cop role, shaking hands and assuring the community that Cerberus's intentions were true. "This is an important company to Knoxville, and we understand that," he told the *Knoxville News-Sentinel*. "You've got good management--the issue is capital."

But if Clayton was in earnest about attracting bids to rival Buffett's, it also must have known that there was one big roadblock to any other transaction. According to the proxy, competing bids could be considered for just a little over a month. If another bid came in after that, the 28% stake owned by Jim Clayton and his foundation would still remain committed to Buffett's deal for another 12 months. With only about 80% of shareholders likely to vote, virtually every single remaining vote would have to support an alternative bid for it to have any hope of going through. In the end, Cerberus decided not to bid.

On July 30, the adjourned meeting finally came to order, starting on time and following the set agenda. The deal barely passed, with just 52.3% of shareholders voting in favor, including the 29% owned by the family/management block. That meant outside shareholders voted against the deal by more than two-to-one, points out Jerry V. Bruni, president of J.V. Bruni & Co., a Colorado-based money-management firm that held about 308,000 shares. "Opposing anything management supports is unusual," Bruni says. Buffett would take control of Clayton Homes, at the original offer of \$12.50 per share, even as the S&P 500 rose 15% and the manufactured-housing industry had bottomed out, although it hasn't yet gone into recovery.

Just to be sure, after an August 6 ruling in Blount County allowed the deal to go forward, Clayton filed merger documents at the crack of dawn allowing it to delist the stock. "The filing was done carefully and consciously," says Goolsby, the Clayton attorney. The company knew that it would be incredibly difficult to re-verse a merger once the stock had stopped trading. A flurry of appeals and counterappeals by the Meat

Cutters and Clayton followed, leaving the merger in a legal no-man's land where the stock no longer traded, but Buffett hadn't paid the shareholders, either. Finally, on September 3, the appeals court ruled that there was "not a scintilla" of evidence of fraud that should keep the merger from being consummated. Said a jubilant Kevin Clayton in a statement: "I hope this puts a stop to the character assassination that has been all too common in this lawsuit." A final appeal failed, but the court did allow the plaintiffs to pursue a class-action suit to try to recover damages from the Claytons and the board. It's in process today.

Months after he had expected to, Buffett returned to Knoxville on October 14 to thank the 40 UT students who had

visited him in Omaha the previous winter. In the University Center Ballroom, he gave a speech, then donned a mortarboard and pulled out a stack of leather binders. As he called the name of the students, he handed each a certificate that bestowed an honorary PhD "to this phenomenally hardworking deal maker in appreciation for your insights and advice in the Clayton Homes acquisition," signed by "Dean/Chairman Warren E. Buffett." Along with each diploma was one share of Class B Berkshire Hathaway stock, valued at about \$2,700. For Professor Auxier, there was an even better prize: a Class A share, worth about \$81,000. The students were thrilled, although Wright jokes that a proper finder's fee for the deal would have been more like 1%, or \$17 million. And so ends the ballad of Clayton Homes--once again with a pleasing, homespun passage that seems to conceal a sour note. Was Clayton Homes sold for a fair price, or for a song?

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